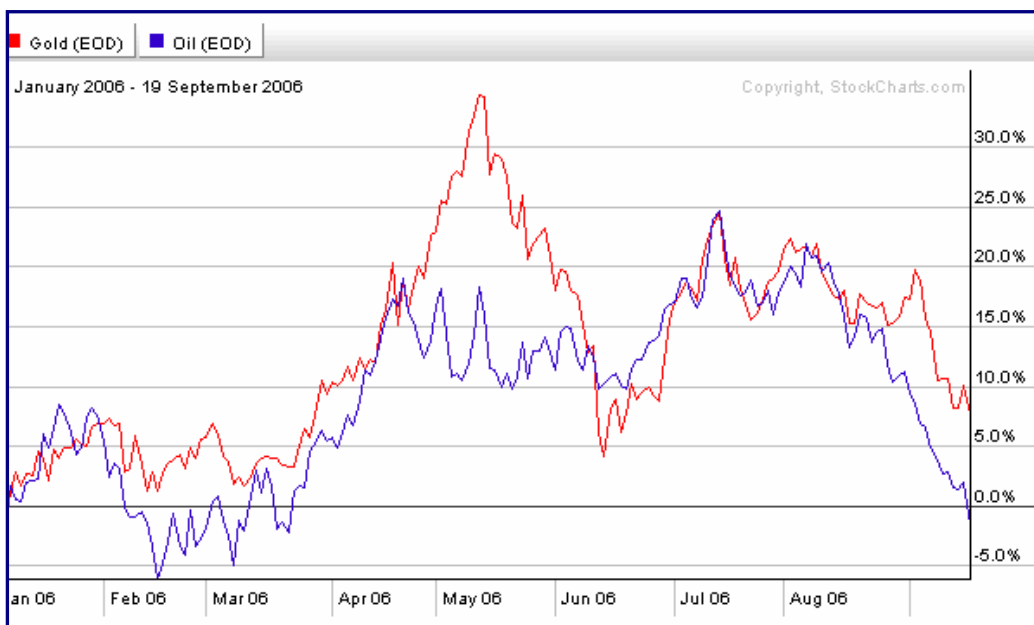


PETRO-BULLION?

There's a great deal of fear and confusion in commodities markets right now. Notwithstanding Wall St.'s ability to levitate, there are a lot of disquieting numbers coming out of the US economy. We've been less bearish than most though we have been telling our readers for months the coming slowdown was inevitable. While we retain the right to change our minds without notice based on incoming data we still think it will not be deep. We don't currently expect a "recession" in the technical (two quarters of negative growth) sense in 2007 but the slowing will definitely be felt.

A lot of traders have come around to this view in the past month and they have been selling. Some of the hardest hit sectors have been in commodities. There is a certain logic to assuming a slower economy will lead to lower commodity prices. They are cyclical after all and will move with the economy even in the midst of a secular bull market. That has been used to explain most of the drop in commodity prices in the past month or so. While it may have been a motivator, it is by no means the full explanation. Most of the selling has been profit taking, mainly by funds. The biggest moves have been reserved for markets with the biggest fund participation, namely oil and gas. Gas does have some well known supply issues (and big margin calls) but the supply demand equation for oil – and most other commodities – has not changed markedly in the past quarter. Selling has hit other markets too, though to a lesser extent.

Oil has been a problem for the gold and silver markets for two reasons. One is that many traders play these markets together, viewing gold as an inflation hedge and assuming that higher energy prices will bring higher inflation and higher gold prices and vice versa. Again, true to a point but an oversimplification, though certainly a reasonable explanation for some of gold's more erratic trading days lately.



Anyone who wonders if there are truly is a tie between the oil and gold markets need look no further than the relative performance chart above for gold and West Texas Intermediate. The chart parallels in the past couple of months especially are uncanny. This convergence has been pointed out by many analysts and while we agree we think it's important to remember that the relationship between gold and oil is not static. There are, in fact, many periods where oil and gold decoupled and went their separate ways. We think we are nearing another one of those points.

Spec money is getting washed out of the oil market and to some extent the gold market as well. As trading returns to more fundamental issues the two commodities should diverge again. Oil will be hampered by fears of an economic slowdown but this should not be doing the same damage to the gold market. A slowing US economy will put paid on the notion that more rate increases by the Fed are immanent. We don't think they are coming soon and if the housing market keeps swooning there could be cuts in early 2007. As expected, trade and current account numbers continue to be awful with no turn around in sight. This is NOT the recipe for a stronger currency. Only in the past couple of trading sessions has this realization dawned on traders, leaving the Dollar to weaken yet again. Gold trades for many reasons but one of the strongest market relationships it has is the inverse correlation with the US Dollar. This will assert itself as the Dollar weakens and, contrary to some reports, buying in most of the major physical gold markets in the Middle East and Asia has swelled as gold dipped below \$600. Yes the paper market has taken a beating in the past month. But the whole point to gold is that it ISN'T paper. That fact remains and should lead to strengthening prices as the Dollar's latest bear market rally ends and gold consequently gets cheaper for everyone else.

David Coffin and Eric Coffin are the editors of the HRA Journal, HRA Dispatch and HRA Special Delivery; publications focused on metals and energy exploration, development and production stocks. They were among the first to draw attention to the current commodities super cycle and have generated one of the best track records in the business thanks to decades of experience and contacts throughout the industry that help them get the story to their readers first. Please visit their website at www.hardrockanalyst.com for more information.