The Outlook for 2010

Free Gold Money Report
by James Turk

January 2, 2010 – It is time to record my outlook for 2010, but before looking forward to the year ahead, I always like to first look back at what I was expecting for this past year. My forecasts for 2009 were driven by my overall outlook for the economy, which is captured by the following statement: "It's shaping up to be an ugly year for financial institutions and the economy, but a good one I expect for the precious metals." To drive home my expectation as to what would be the important driving force in 2009, I went on to say that "the bust will not end in 2009."

That outlook was right on the money, and my specific forecasts for the precious metals were pretty good. Here are some highlights from what I said back in December 2008 when gold was $836.40, silver was $10.819 and the XAU Index was 112.75:

1) "Gold will climb into 4-digits in the first quarter and this time will remain in 4-digits for the rest of the year. The potential high is $1800 per ounce ($57.87 per goldgram). I expect the low to be $850, which will be reached early in the first quarter."

These targets were off the mark, but my timing and identifying the general trend were good. The low occurred on January 15, 2009, but was lower than I expected at $806.70. While gold did climb to $1001.80 on February 20th, it did not stay above $1000. That event didn't happen until September.

"In short, 2009 is shaping up to be the key 'break-out year' for gold. It will become a 'break-out year' because the average investor will start becoming aware of gold and begin buying."

I was expecting a "break-out" year because gold would move into the second stage of its bull market when $1000 was finally hurdled.

2) "I expect silver will again break above $20 this year...Silver is dirt cheap. It's only a matter of time before it climbs above $30, but if you choose to buy silver, be prepared for the volatility."

The low for silver was $10.42, which was reached the same day gold made its low for the year, January 15th. But silver never made it to $20. The closest it came was $19.30, while silver did remain volatile as expected.

"Silver will outperform gold in 2009." Silver did indeed do much better than gold in 2009. While gold climbed a dazzling 23.9% against the US dollar, silver did more than twice as well, climbing a spectacular 49.3%. I've posted on GoldMoney a detailed comparison of the performance of gold and silver in 2009.

3) "I think the [gold/silver] ratio will not break above over-head resistance in the low 80s. The downside potential for the ratio is 45 or so, which is the bottom of its multi-year trading range."

Resistance in the low 80s not only held, it was never re-tested. The ratio reached its peak at 77.4 on January 15th, the same day gold and silver made their low for the year. But the ratio did not get anywhere close to 45. The lowest point reached was 58.5.

4) "The XAU Index will bounce back strongly in 2009, beginning in the year's first quarter."

This forecast was pretty much on the mark, with the XAU Index gaining 35.6% for the year. From its low of

104.25 in January, the XAU Index remained in an uptrend through the year, though it really didn't begin to gain significant upside momentum until after gold made a correction low in April. Shortly, thereafter, the XAU hurdled and still remains above its 200-day moving average.

"The mining stocks are unbelievably cheap. It is reasonable to expect them to return to more normal levels of valuation, which would imply that the price of the XAU Index in terms of gold would be 6 goldgrams and perhaps as much as 8 goldgrams."

This statement is not really a forecast, but more a comment on relative valuation of the XAU Index, the price of which ranged from 3.6 goldgrams to 5.2 goldgrams during the year. In other words, the mining stocks remain "unbelievably cheap" because they are still below the 6gg threshold, which historically has indicated relative undervaluation of the XAU Index.

So overall, I think my forecasts for 2009 were pretty good. They captured the general direction of the precious metals and mining stocks, and did so with reasonably good timing.

Let's hope I can do as well in 2010. Here is how I expect the year ahead will unfold.

1) The US dollar is on the edge of hyperinflation. Reckless spending by the US government is causing it to borrow increasing amounts of money, which in the aggregate is more than the market is willing to lend to it.

Given its trillion dollar deficits, the US is borrowing more than it can attract from global savings. If it cannot attract enough savings to meet its borrowing needs, rather than reduce its borrowing by cutting spending, it has to 'print' the dollars it spends. Thus, I am not making the old argument about the US government "crowding out" other borrowers (too much supply). Rather, I expect it will become harder for the US government to find buyers for its paper (too little demand). This is of course what "quantitative easing" is all about. The Federal Reserve in the year ahead will therefore continue to purchase government debt and turn it into currency, which will eventually – and probably in 2010 – cause the US dollar to begin hyperinflating.

2) Gold will reach $2000 per ounce ($64.30 per goldgram) some time during 2010. Gold will not fall back below $1000. In fact, it is likely that a floor has been put under the market around $1050, the price at which India made its recent gold purchase from the IMF, though I don't expect gold to fall below $1080. Like 2009, the low point for gold will probably occur early in this year's first quarter.

There will be two forces driving gold higher. The first will be the continuing purchases of government paper by the Federal Reserve as the dollar moves ever closer hyperinflation. The second will be the growing demand for physical metal in preference to paper-gold.

In this regard, an important tipping point occurred in July when Greenlight (a major US-based hedge fund whose decisions are widely followed) announced that it was converting its large position in GLD (the big NYSE-listed gold ETF) into physical metal. Greenlight's decision was a wake-up call for investors and asset managers who began to study Greenlight's decision.

These investors and asset managers are now realizing that there is a fundamental difference between owning 'physical gold' and 'paper gold' in its different forms (ETFs are one of those paper forms). With paper gold you do not own gold. You only own a derivative that gives you exposure to the gold price, and this exposure comes with counterparty risk. Paper gold is a financial asset. Physical gold of course is a tangible asset and therefore does not have counterparty risk.

Also, these investors and asset managers are realizing that the annual carrying cost of ETFs is considerably

higher than owning physical metal. For example, the annual management fee, administrative costs, shareholder reporting, etc. of GLD is in the aggregate about 3-times more expensive than owning physical gold in GoldMoney. But here is the key point that the market is only now starting to understand.

There exists a huge amount of paper gold outstanding relative to the available stock of physical gold at these prices. Therefore, to keep supply and demand in the gold market in balance as the demand for physical metal rises, gold's price has to rise in order to entice present holders of physical metal to sell and hold some national currency instead. After all, physical gold cannot be 'printed' by central banks to satisfy the demand for physical metal.

So how high does the gold price have to rise? My sense of it is that this scramble for physical metal could lead to a vicious short squeeze. Regardless whether or not one occurs, the demand for physical metal won't abate until gold hits at least $2000, which I expect will happen some time in 2010. A huge short squeeze could send gold to that price in a matter of weeks. Otherwise, a continuous demand for physical metal will put gold in a steady climb throughout the year that sends it to $2000 by year-end.

2) The gold/silver ratio will drop to 45, and perhaps make a new multi-year low around 40. If gold hits $2000 and the ratio reaches 45, then silver will be $44.44 per ounce. A ratio at 40 would put silver at $50 with gold at $2000. I mention this $50 target on purpose.

Silver will eventually exceed its $50 per ounce all-time record achieved in January 1980. Will it happen in 2010? It is I think only a 20% probability, but that is high enough for me to mention it. We need to start thinking about silver hurdling above $50. If it doesn't happen in 2010, this important event – which is unimaginable to many – will I expect happen in 2011.

The major driving force behind silver will be – like gold – the demand for physical metal. The probability of a short squeeze in silver sometime in 2010 is higher than it is for gold. My guess is that a silver short squeeze is at least a 33% probability.

3) The XAU Index in 2010 will break above its record high of 206.37. Also, the mining stocks will outperform gold, so that the XAU Index returns to more reasonable levels of valuation above 6 goldgrams. My upside target for the XAU Index for 2010 is 300, which would be about an 80% increase from its 168.25 price for year-end 2009.

If it takes 6 goldgrams to purchase the XAU Index if it reaches 300, gold would be $1555. At 7gg and 300 on the XAU, gold would be only $1333. At 7gg and 400 on the XAU, gold would be $1777. I indentify these relative levels of valuation to highlight how cheap the mining stocks are compared to gold, the product they mine. While political risk always remains the unknown wild-card when it comes to mining stocks, their low relative valuation at present makes it likely that the XAU Index will outperform gold in 2010.

To conclude this annual outlook, I would like to provide my usual caveat that no one can predict the future. So instead of relying upon predictions, one should instead focus on undervalued opportunities and avoid overvalued assets.

Therefore, avoid the dollar and other national currencies as well as the paper issued by governments. Given the huge deficits they are incurring and their refusal to make the hard decision to cut spending, a sovereign debt default in 2010 has to be considered a realistic possibility. It will come either through hyperinflation of the currency or a flat out refusal to repay its debts.

So the best strategy for 2010 is to continue accumulating the precious metals, and if you are so inclined to take

the investment risk, the mining stocks as well. But please keep in mind one last comment from last year that I would like to repeat because it is still relevant. "In an environment in which people are increasingly fearful about the downturn in the economy, the safety of banks, and the outlook for the dollar, anything is possible for gold. And if 2009 turns out to be the year when the biggest bubble of them all pops (i.e., the dollar becomes suspect), the sky is the limit for gold." The dollar bubble didn't 'pop' in 2009, but absent an abrupt 180-degree about-face by policymakers to put the US economy and the dollar on the right path, the dollar bubble will eventually 'pop'. Perhaps 2010 will be the year.