

Time to sell gold

Matein Khalid argues why bond yields will rise, gold prices will fall and the Chinese march to glory will be unstoppable.

Philosopher George Santayana said: “Those who refuse to learn the lessons of history are doomed to repeat them.” He was right. It is impossible to grasp the future potential of financial assets without an understanding of past business cycles, the ebb and flow of credit and the fickleness of investor greed, fear, panic and herd instincts. I am convinced that gold will fall to US\$900, Chinese shares will double and 10-year US Treasury bond yields will rise to five per cent in the next two years. The lessons of history can help me navigate the markets and make money if I am right.

Bond yield

Treasury bonds have been a winner asset class in the past 30 years. The 10-year bellwether US bond peaked at 15 per cent in 1981, when the Volcker Fed choked the money supply in order to fight double-digit inflation rates. Volcker’s tight money regime triggered a global recession, the Latin American sovereign bond debt crisis and epic bear market, crude oil and gold, but it succeeded in bringing down the inflation rate. When Alan Greenspan succeeded Paul Volcker as Fed chairman, he succeeded in convincing the financial markets that monetary policy could be proactive and successful in the fight against inflation. By 1990, the yield on the US Treasury bond was down to 7.5 per cent. The 1990s witnessed Clinton’s budget deficit, a technology revolution in Silicon Valley and a worldwide scramble by Asian central banks to export their surpluses in the US Treasury bond market, the largest, most liquid capital market in the world.

Even as the CPI continued to fall from five to two per cent in the 1990s, the 10-year US Treasury bond yield had fallen to five per cent on the eve of millennium. The collapse of the Silicon Valley tech bubble, the terrorist attacks of September 11,

2001 and another global recession forced Greenspan to slash overnight borrowing rates (the Fed Funds rate) to as low as one per cent by 2004. Even though the US fought wars in Afghanistan and Iraq, the Clinton budget surplus turned into the Bush surplus, oil prices soared almost ten-fold and Wall Street equities had a lost decade, the yield on the US Treasury bond continued to fall to four per cent on the eve of the credit crunch. While Treasury yields plunged as low as two per cent in the investor panic after the failure of Lehman Brothers, 10-year Treasury bond yields have traded in the 3.20-3.80 range since summer 2009.

I believe that Treasury bond yields will rise in the next two years, possibly as high as five per cent from the current 3.60 per cent rate now. Why? Treasury bond yields are abnormally low because the Federal Reserve bought US\$300 billion in Uncle Sam debt and US\$1.2 trillion in mortgage-backed securities to revive the financial markets and economy after the shock of Lehman’s failure. The monetary base of the US has doubled. However, the Fed has signaled that it will be forced to withdraw excess liquidity once economic growth rises. Moreover, as bank loan growth rises, Fed interest rate hikes will force them to sell their Treasury securities. Meanwhile, the Obama White House has led to a US\$1.6 trillion budget deficit and raised the risk premium on long-term Uncle Sam debt. The 10-year US Treasury bond yield can rise even if the Bernanke Fed does not hike interest rates. This means that investors can profit from the coming rise in long dollar rates by buying the shares of an index fund TBT that rises double the amount of any given rise in the yield on the 10-year US Treasury bond. TBT trades at 47-48. If long-term yields rise to five per cent, TBT could trade as high as 60-65 in the next two years.



The price of gold

The price of gold price has quadrupled since that fateful May 1999 when Gordon Brown, then Chancellor of the Exchequer, sold Britain’s entire gold reserves at a price of US\$290. Gold’s spectacular rise in the past decade was the inverse of the bear market in the US dollar, undermined by America’s wars, budget deficits, tech/housing bubble collapses and the Greenspan/Bernanke Fed’s zero interest rate response to successive financial crises. When Lehman Brothers, the proverbial “too big to fail” Wall Street investment banks, failed and the Federal Reserve balance sheet ballooned to US\$2 trillion, I was convinced that investors would buy gold as the only currency that could not be manipulated by the printing presses of the central banks. This is the reason I published a column here in November 2008 that laid out the case for US\$1200 gold when the gold price was US\$850. This was a spectacularly profitable trade for any of my valued readers who agreed with my strategic conviction that the gold price would rise to US\$1200. Gold peaked at US\$1226 in December 2009. I now believe gold is overvalued, over-owned and the monetary bubble currency that deserves to be shorted in 2010. Why?

First of all, the US economic supertanker has begun to turn. January ISM industrial production was 58 and fourth quarter GDP grew at 5.7 per cent. Though the jobless



rate is 9.7 per cent, a quarter million temps have been hired since September. This means a stronger dollar relative to the euro and yen, whose values will be gutted by Greece's fiscal woes, anaemic economic growth, deflation risk and even social unrest. A stronger dollar is the kiss of death for gold. Also, Ben Bernanke has made no secret that a stronger economy will force the American central bank to take back its monetary largesse and tighten liquidity in the money market. I can easily envisage the three-month dollar LIBOR at two per cent and the 10-year US Treasury bond yield at five per cent by the end of 2011. This means that US interest rates could rise, the kiss of death for goldbugs.

In addition, the fear premium in international banking has been unwound, as central banks have bailed out the world's too-big-to-fail money centre banks. This is the reason that the Treasury-Eurodollar yield spread, a proxy for bank risk, has plunged to 12 basis points from 470 basis points just after Lehman's collapse. This fear premium is worth at least US\$300 in the current gold price. In the 1980s, the gold price collapsed when the US Treasury finally helped resolve the sovereign debt crises of Brazil, Mexico, Argentina, Poland, etc. History could well repeat itself in 2010. I would not be surprised to see gold fall to US\$900, as momentum index fund speculators flee a falling market, just as they earlier goosed

a rising market. The bear market in gold began in January 2010 with a US\$180 fall from the December high. I am no Pavlovian goldbug. There is a time to buy the yellow metal and there is a time to sell it. This is the time to sell.

The Chinese potential

China's economic transformation under Deng Xiaoping and his successors is the grandest economist experiment in human history since the Industrial Revolution. In a mere generation, a peasant economy wrecked by Mao's Cultural Revolution and socialist excesses has raised 600 million human beings out of poverty, delivered 10 per cent GDP growth for decades and accumulated US\$2.4 trillion in hard currency reserves. China is the world's banker, factory and, increasingly, its consumer of the last resort, the ultimate emerging markets with a 1.3 billion population and a domestic economy that could well rise ten-fold in the next decade. The Chinese stock market has lost 20 per cent of its value since August as the People's Bank of China hiked bank reserves to restrain a trillion-dollar bank lending spree to avert an embryonic property bubble. Yet, the Politburo is pro-growth and China will be the world's fastest growing economy in 2010 as exports revive.

Economic trends, once established, continue for decades and even centuries, as the rise of the US, the decline of

Britain, the technology revolution and the fall of Soviet Communism have all proved since World War II. China is the world's long-term call option on growth, yet it barely trades at a growth multiple. The Chinese yuan is the most undervalued major currency in the world. The ideal vehicle to buy exposure to China is via the Financial Times Xinhua Fund (symbol FXI), an index fund listed in dollars that incorporates China's top 25 mega-cap crown jewels like Industrial and Commercial Bank of China (ICBC), the China National Offshore Oil Corporation, China Mobile, Bank of China and China Life. The shares have fallen from 45 to 37 since the Beijing central bank hiked interest rates. FXI could well fall to 32-34 in the short run. Yet, I believe FXI will trade above 120 in the next four years.

Successful investing, as Warren Buffett proves, is all about time in the market, not market timing. It is insane to bet against two millennia of human history and the entrepreneurial energy of 1.3 billion Chinese. China's meteoric economic ascent will continue and its stock market titans will become the world's largest companies, as ICBC is already the world's largest bank. Hence, I will swoon over FXI when the correction in Chinese equities ends.

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