



# Weekly Market Commentary



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### Highlights

The crowd favorite at the Kentucky Derby this past weekend did not win, surprising many, much like last week's performance Derby where the crowd favorite, commodities, suffered a stunning loss.

While precious metals may have lost during Derby week, they are not ready to be retired from portfolios. It is likely that commodities asset classes—including precious metals—will come back to post gains again.

## The Performance Derby

The Kentucky Derby, the first race of the Triple Crown of Thoroughbred Racing, took place this past weekend. The crowd favorite did not win, surprising many. That was much like last week's performance Derby where the crowd favorite, commodities, suffered a stunning loss. It was a surprising show last week both on Wall Street and on the race track.

### Big Brown

The record crowd at Churchill Downs, and many more on television, watched Animal Kingdom take the lead with 1/8 mile remaining and win by a sizeable 2 3/4 lengths. There was talk of Animal Kingdom being likely to run the next two races and try for the Triple Crown which has gone unclaimed for 33 years. The last horse that came close to taking the Triple Crown was Big Brown.

Big Brown was the winner of the 2008 Kentucky Derby. He was the favorite to win and lived up to those expectations with a stunning win by nearly five lengths. He was the first horse since 1929 to win the race from the worst starting position—the 20th gate on the far outside. Remaining undefeated, he became an overnight pop culture phenomenon with *New York Times* profiles and his trainer made talk show appearances.

Just 10 days after the Kentucky Derby, in his fifth race, the 2008 Preakness Stakes, Big Brown was again the favorite. Big Brown won the second leg of the Triple Crown by more than 5 lengths, becoming only the fourth horse in 133 years to win both the Kentucky Derby and the Preakness while still undefeated. Big Brown, who was from New York, was being hailed as the biggest New York sports star of 2008 by sports writers.

Three weeks later, it was no surprise that Big Brown was again the favorite in the Belmont Stakes, the third and last race of the Triple Crown. Big Brown had become such a fad the betting odds were 1/4 to win the Belmont Stakes—that means you would only win \$1 when you bet \$4! Most of the horses had odds of 38/1 to 50/1—meaning you would make \$38 to \$50 for every \$1 bet. Betting became so popular bookmakers saw record-breaking interest as people who did not usually pay any attention to horse racing were caught up in Big Brown fever. Total wagering at Belmont that year was up nearly 50% over the year before. Bettors saw an amazing record of performance and saw what they thought was easy money. After all, there was no doubt the undefeated Big Brown would be the winner of the Belmont Stakes, by a wide margin and sweep the Triple Crown for the first time in 40 years.



So what happened? Big Brown did not just lose the Belmont—he came in last by a wide margin. In the last turn Big Brown simply—and inexplicably—gave up. Big Brown became the first Triple Crown hopeful ever to finish last in the Belmont. A lot of people lost money that day and tore up their tickets in disgust.

## Big Commodities

Many investors in commodities felt like they made a bad bet this past week. Commodity prices plunged nearly 10%—coming in a shocking last in the performance derby by a wide margin after a long series of wins. Many investors sold their stakes in disgust.

Investors had been big fans of commodities. Trading volumes were way up, especially for precious metals like gold. Commodities, measured by the Thomson Reuters Commodity Research Bureau Index, had put up an amazing record of performance leading into last week. Overall, commodities are up about 150% since the end of 2001, averaging about 10% a year, but precious metal commodity gains were far stronger with gold up about 500% over the same period. Prior to last week's pullback, the past year saw the broad universe of commodities gain 33%, gold posted a similar gain, and silver was up 157%. This compares very favorably over the same period to stocks, measured by the S&P 500, which were up 17% and bonds, measured by the Barclays Capital Aggregate Bond Index, which were up 5%.

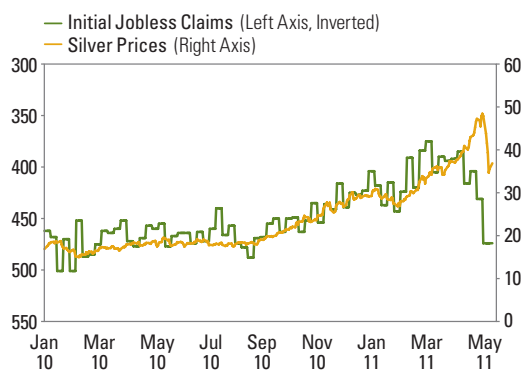
Why the sudden disappointment for commodities last week after so many wins? There are several factors that drove last week's reaction:

- Commodities had run up sharply setting the stage for volatility to the downside.
- Margin requirements were hiked sparking a catalyst for the pullback. The minimum amount of cash that must be deposited when borrowing from brokers to trade silver futures was increased to \$21,600 a contract up from \$11,745 two weeks ago. The sharp increase required investors to deposit 84% more cash to support their positions or sharply reduce their holdings of contracts. The new margin rules take effect today, Monday, May 9.
- Weak economic data added fuel to the selling. Economic data disappointed until Friday's job report which led to a halt in commodities declines. Notably, the non-manufacturing ISM Index, the ADP payroll report, and most importantly initial jobless claims were all worse than expected.

**Chart 1** illustrates the very close relationship between the inverse of initial jobless claims and silver prices. As the economy, measured by weekly initial filings for unemployment benefits (one of the most timely barometers of economic activity), was strengthening, silver moved higher in lock step. When claims faltered, so did silver.

We expect initial jobless claims to rebound as recent exceptional factors abate. With the death toll up over 350, the Alabama tornados were the deadliest national disaster since Katrina. In the wake of Katrina, unemployment claims soared 75,000. So, some of the recent increase in

### 1 Silver Tracking Initial Jobless Claims



Source: LPL Financial, Bloomberg data 05/09/11



unemployment claims may be due to the storms. Claims may move back to around 400,000 soon supporting silver prices.

There was no clear single reason why commodities fell so sharply. The leaders to the downside among commodities were precious metals as many investors simply gave up.

## Is a Bubble Just Starting to Burst?

Gold has been in a bubble before—the bubble inflated through the 1970s, peaked in 1980, and fell by over 60% during the following two and a half years. Are commodities, perhaps best represented by gold, a bursting bubble now? If so, there are likely to be gains ahead than losses using history as a guide.

As you can see in [Chart 2](#), gold prices have tracked the classic bubble pattern but have yet to enter the parabolic stage where the bursting of the bubble and the ensuing sharp losses begin to become a risk—which is after 10 years and a 1,000% gain. The investment bubbles of the past experienced far more inflating than what gold prices have experienced so far. The technology bubble of the 1990s (measured by the NASDAQ), the oil bubble of the late 1990s/early 2000s (measured by oil futures prices), and the housing bubble (measured by the S&P 500 Homebuilding Index) took 10 years and posted gains of about 1,000% before they burst and quickly surrendered most of those gains.

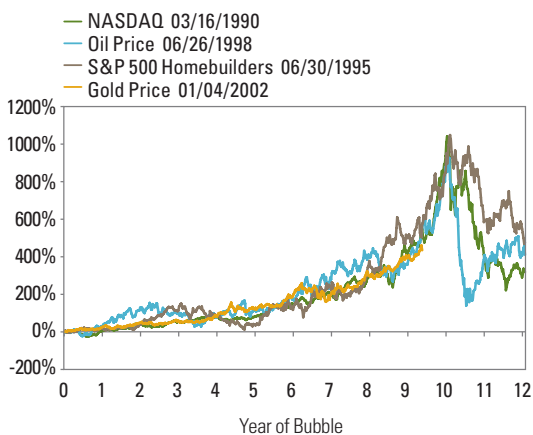
Gold's rally is now just entering its tenth year, historically the best year for gains. If gold tracks the classic bubble pattern—and it has so far—instead of plunge, it would double in value this year. It is worth noting that gold's March 1980 peak at \$850 is about \$2,400 in today's dollars when adjusted for U.S. inflation—well above the current price and near where gold would be headed if it tracked this classic pattern, though past performance is no guarantee of future results.

However, we do not believe gold—or commodities in general—is in a bubble and most likely will not continue to track the classic pattern. But we do see potential for further modest gains for precious metals and other commodities in 2011, to be accompanied by volatility.

The qualitative factors that are combining to allow gold's shine to endure include the following:

1. **The declining dollar and outlook for rising U.S. inflation** – The actions by the Fed to stimulate the economy have led to weakness in the dollar. As the dollar goes down, the price of gold in dollars goes up. While gold surged to an all-time high in dollar terms over the summer and fall of 2010, gold has been flat over the same period in euros and in yen. In Australian dollars, the peak in Gold was back in February of 2009 and is down about 10% since then. So part of our perception of the big surge in gold over the past year is in large part because we are measuring it in weakening US dollars.

## 2 Classic Bubble Comparison



Source: LPL Financial, Bloomberg data 05/06/11

All indices are unmanaged and cannot be invested into directly. Past performance is not indicative of future results.



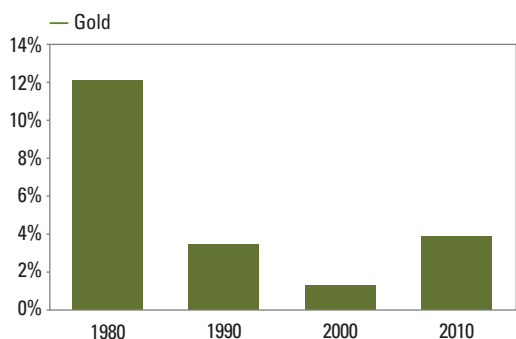
2. **Strong emerging market demand** – In China and India gold is both a savings vehicle and a luxury for an emerging middle class. India and China lead the world in terms of gold demand growth.
3. **Central banks from sellers to buyers** – The world's largest central banks have been selling their gold reserves for decades after moving away from linking their currencies to gold. Most recently, Mexico, Russia and Thailand added to their gold reserves in February and March 2011. Given the current economic environment, we believe central banks may continue to add to their gold reserve base as further currency debasement and long-term inflation concerns persist. As the reserve currency status of the dollar comes into question, emerging economies are increasing their exposure to gold. With China and India holding relatively low levels of gold, a modest increase in their holdings as a percent of foreign reserves—as they diversify away from holdings of U.S. Treasuries - could easily account for 100% of current annual production.
4. **Not just a defensive asset** – Normally a beneficiary of a pullback in riskier investments, investors have often embraced gold as a perceived insurance policy against a return to recession. However, rather than act purely as a defensive investment, gold rose last year along side stocks and bonds.
5. **Supply has been constrained** – The supply-demand equation continues to provide a favorable tailwind for gold prices. After averaging growth of 4% annually since 1980, world production growth of gold has slowed considerably since 2001, averaging -1% annually over the past 10 years. To meet the gradual rise in demand, a steady increase in scrap supply has been needed. But scrap is falling short. It is getting more expensive to mine gold as the most accessible areas have been mined out and new mines are in increasingly remote or hard-to-mine locations. To meet the demand the major producers are pursuing digs formerly thought to not be economically viable at costs over \$1000 per ounce.

Finally, with gold supported by multiple fundamental forces, one of our pre-conditions for a bubble is the asset has to be “over-owned.” All the gold produced around the world over the past 110 years (which accounts for more than 80% of all gold ever mined) at today's prices is equivalent to only about 3.9% of the combined total value of stocks, bonds and cash around the world. While up from the 1.3% in 2000 when gold prices were depressed, it is similar to the 3.5% in 1990 and well below the whopping 12.1% in 1980 when gold traded near its last peak. While gold's popularity is returning, it does not seem “over-owned.”

## Come Back

After the stunning rout at the Belmont, Big Brown returned to racing in August of 2008 with a win in the \$1 million Haskell Invitational Handicap at Monmouth Park, New Jersey. Big Brown's last race was a month later with another win at the Monmouth Stakes. Big Brown then retired after winning 7 of his 8 career races having earned \$3.6 million.

### 3 Gold as a Percent of Traditional Assets



Source: LPL Financial, World Federation of Exchanges, Barclays  
02/07/11



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The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

This Barclays Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The ISM index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The Thomson Reuters/Jefferies CRB Index is an objective and impartial and transparent benchmarks for the performance of the global commodities industry. The indices embrace most of the industry's global market capitalization and have been structured to facilitate transactional efficiency. The index is comprised of 19 commodities: Aluminum, Cocoa, Coffee, Copper, Corn, Cotton, Crude Oil, Gold, Heating Oil, Lean Hogs, Live Cattle, Natural Gas, Nickel, Orange Juice, Silver, Soybeans, Sugar, Unleaded Gas and Wheat.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Precious metal investing is subject to substantial fluctuation and potential for loss.

Stock investing may involve risk including loss of principal.

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