



# MARKET COMMENTARY

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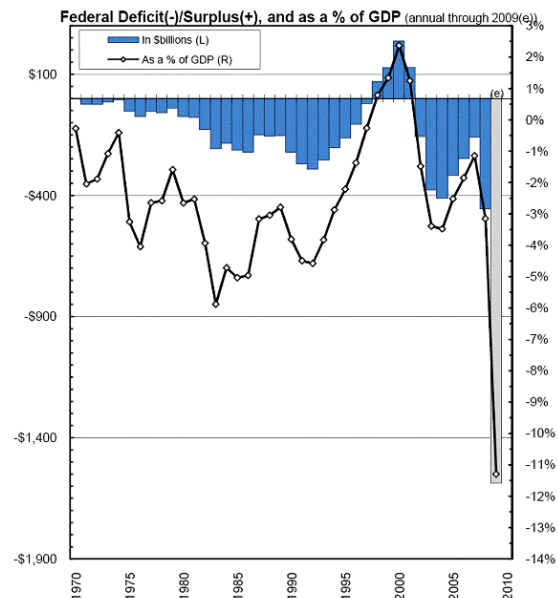
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## Long-term U.S. Dollar Devaluation is Good for Gold

It is becoming clearer that higher gold prices are tracking prospects for further devaluation of the U.S. Dollar. This is a result of the falling relevance and global stature of the U.S. economy, military and political cohesiveness. The stability of gold as a currency provides one of the best and most immediate polls on the direction of a nation's future.

Gold has broken away from the seasonal pattern of flat to declining prices over the summer in each of the last seven years. This may have been a good indication that monetary easing in 2008 was beginning to circulate through the economy, increasing liquidity and the money supply. This presumed increase in liquidity could have been a reason for increases in the price of gold and the Dow. Not surprisingly, the rate of money circulation is anemic, as evidenced by low demand and supply of credit. It appears that liquidity may not be finding its way into either reported inflation indices or growth in gross domestic product (GDP). Without signs of reported inflation or credible signs of a return to a robust economy, the Federal Reserve has little impetus to increase interest rates, making the U.S. dollar less attractive to investors. The gold price and the level for the Dow have achieved higher valuations even as the U.S. dollar depreciates relative to those assets.

The perspective that higher gold prices are not due to either inflation or lack of economic growth in the U.S. does not mean that inflation is not in our future. Simply from a U.S. perspective, gold did not become more valuable, but rather, the U.S. dollar lost value. Considering the United States lack of manufacturing and dependence on imports, higher inflation in the U.S. appears certain. Internationally, very real concerns exist over the U.S. deficit and its level of debt to GDP. While interesting today for traders and speculators, these trends may have very real implications for the economy and future of the U.S. On the present course, even at historic highs, hedging against inflation or further devaluations of the U.S. dollar with gold and gold equities appears to be a reasonable strategy.



Source: Laffer Associates

## **Low Interest Rates are Driving Down the U.S. Dollar**

On October 6, 2009, the Australian central bank became the first to increase interest rates following the global downturn. The increase of only 25 basis points had a profound impact on the U.S. Dollar, the Dow, and the price of gold. Countries such as Australia, Israel, Norway and Brazil were somewhat isolated from the downturn and are the most likely to halt quantitative easing by increasing interest rates. Specifically, those countries whose economies are largely resource based such as Australia, Norway and Canada also have additional flexibility to reign in excess liquidity to prevent inflation and strengthen their currencies, thus making themselves more attractive for foreign investment.

The increase in interest rates in Australia makes investing in their currency more appealing relative to the U.S. dollar. Low interest rates in the U.S. make it attractive to borrow and sell dollars and buy the more speculative higher yielding currencies of Australia or Canada. This lowers the exchange rate of U.S. dollars relative to other currencies. In addition to arbitrage, the initiative shown by Australia in increasing interest rates demonstrates that the global recession is being regionalized, and national economic policies are undergoing increased scrutiny by international investors. Oddly, an increase in interest rates in Australia demonstrates economic stability and increases its desirability for investment by foreign capital. The relative difference in the magnitude of the rate increase of only 25 basis points in Australia, relative to its impact on global currencies, speaks volumes as to both the heightened sensitivity and the fragility of currency levels.

The decline in the U.S. dollar appeared to be a boon to U.S. multinationals, those with significant international presence, lifting their stock prices. Large and mid-size companies are becoming increasingly more dependent upon international business activity. This not only provides a one-time boost for corporate earnings but also suggests increasing competitiveness of U.S. products abroad with potential for increasing market share. While the short-term benefits to corporate profits may be positive, lifting the Dow over 10,000, this may be exceeded by the long-term consequences of the loss of foreign capital as the U.S. is perceived as a less stable location for foreign investment.

It would appear that foreign banks have not yet lost their appetite for U.S. Treasury securities. Over the five weeks leading up to the week ending October 7, 2009, foreign central banks purchased \$48.55 billion in Treasury securities, an average of \$9.71 billion per week. Interestingly, during the same period, the dollar fell more than 3% on a trade-weighted basis against its six primary rivals. Currently, the total amount of U.S. Treasury securities held by the Fed on behalf of foreign central banks has increased to a record of \$2.098 trillion, up from \$1.528 trillion a year ago. While foreign central banks buying U.S. Treasury securities is positive, compensating for lack of domestic demand, any decline in demand or the trend for increasing U.S. deficits may drive the U.S. dollar even lower, or force an interest rate increase. The Fed's low interest rate policy in the U.S. may lead to additional declines in the U.S. dollar, signaling inflation and potentially higher gold prices.

## **Fed Appears Unlikely to Raise Interest Rates Anytime Soon**

It would seem reasonable with the increase in reserves that the Fed would be more cautious in its statements to "sterilize" speculation on both a weaker dollar and inflation. Comments by Fed presidents in the financial media suggest that they have no plan to raise interest rates to reduce quantitative easing anytime soon. Federal Reserve Vice Chairman Donald Kohn said interest rates could stay low for a long time, and that a recovery with sluggish growth should keep inflation under control. From the Fed's perspective, only easy money will stimulate the economy, and this being their primary tool to achieve their mission of full employment, shows little compulsion to reverse direction and increase interest rates.

Kohn does not "think a V-shaped recovery is the most likely outcome this time around... and that the recovery in the U.S. economic activity will proceed at a moderate pace in the second half of this year before strengthening in 2010." He concludes optimistically that "the persistence of economic slack, accompanied by stable longer-term inflation expectations, will keep inflation subdued for some time." This refers to "the substantial rise in unemployment rate and the plunge in capacity utilization" which he views as "considerable." From his perspective, long-term inflation expectations remain stable, and inflation itself could move "appreciative lower" with low interest rates for an "extended period." In addition, Richard Fisher, president of the Dallas Fed believes that no one at the Fed thinks this is the time to raise interest rates.

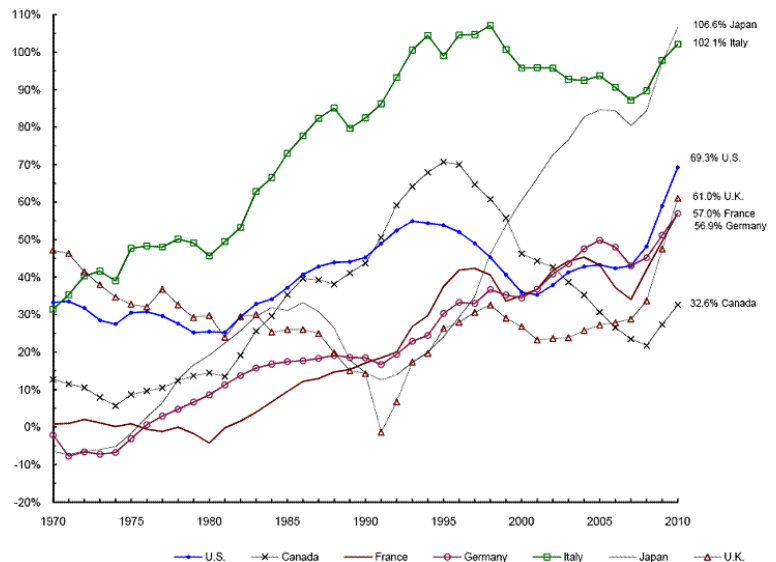
The Fed appears to be fixated on reported U.S. inflation and unemployment as opposed to global indicators such as the price of gold and the falling exchange rate for the U.S. dollar. This caused a minor eruption when it was rumored that some countries were interested in moving away from pricing oil in dollars. This may significantly reduce demand for the U.S. dollar relative to other currencies. The rumor of moving away from the U.S. dollar was rapidly dispatched by the related central banks and declared “absolutely not true.” Kuwait Finance Minister Mustapha al-Shamali said the dollar would remain the currency of oil trading because there is “no problem using it.

The European Central Bank (ECB) President Jean-Claude Trichet said excessive volatility in currency markets is the “enemy” of stable economic activity. While the ECB has confidence that the U.S. is pursuing a policy to strengthen the dollar, other than foreign bank purchases, little other evidence for this initiative is readily apparent. Should the U.S. dollar continue to show systematic signs of weakness, it would be prudent for other central banks to seek to attach to a more stable global currency for international transactions. Interestingly, the ECB president hoped to see a more-flexible yuan exchange rate, providing insight to where he perceives stability.

**Not Worth a Continental or Not Worth a Bernanke (or a Geithner; take your pick)**

The current U.S. Administration may have more in common with its Founding Fathers than they would like to admit. In order to finance the current U.S. Administration’s revolutionary new “Era of Responsibility,” the phrase “not worth a Continental” may be coming back into fashion. Despite politicization of economic reports, TARP and the Federal Stimulus Program may have succeeded in averting a meltdown of the economy, but arguably may have come up short for either increasing supply and demand for credit, stimulating real economic growth, or reducing unemployment as advertised.

The U.S. Administration’s ability to forecast the economy is arguably suspect. They estimated that the \$780 billion stimulus bill would keep unemployment under 8%. This rate is currently 9.8% and is expected to exceed 10% in 2010. Now, their projected budget numbers estimate a trend of deficit spending increasing the federal debt. They forecast a drop in the current deficit to GDP of 9.9% to average 4.8% from 2010 to 2114 and 4% for the years 2015 to 2018. This would increase the federal debt to \$23.3 trillion by 2019, from about \$11.9 trillion today. These forecasts were prior to any additional stimulus programs or exogenous setbacks. The record of their forecasting models to date suggests that these forecasts should undergo additional scrutiny.



Source: Laffer Associates

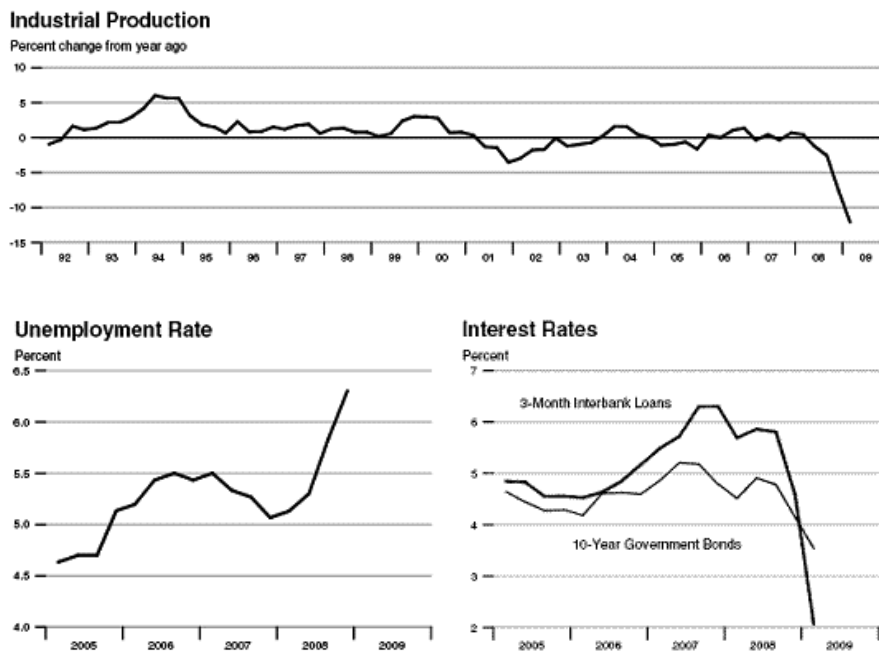
The federal debt was 61.4% of GDP in 2008. It is anticipated to climb to 90.4% in 2009 before reaching 100% in 2011 and remaining over this level through the ten-year forecast period. In 2008, the U.S. ranked 23<sup>rd</sup> for debt-to-GDP, and when it exceeds 100% it will advance to seventh place (behind the likes of Zimbabwe, Japan, Lebanon, Singapore and Italy). Interestingly, at the current level, the U.S. would not be admitted to join the European Union, which requires that participating governments limit debt to 60% of GDP.

The Japanese experience of quantitative easing following their bubble in the 1980s presents a cautionary tale. Debt-to-GDP in Japan increased to 170%, followed by decades of economic stagnation before descending to the current level. During this period, the yen declined from 10.2% of foreign exchange reserves to 3.3% today. By comparison, the U.S. Dollar presently is the most common currency for international transactions, constituting over 60% of other country’s official foreign exchange reserves.

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## The United Kingdom May Provide a Peek at the Future U.S. Economy

The challenges faced by the UK are similar to those faced by the U.S. The UK economy is weak with declining industrial production, a condition that is expected to last for years. The Bank of England (BOE) has responded with its own stimulus program and low interest rates. Inflation is expected to exceed the BOE forecast for inflation of 2% and 3.4% for 2009 and 2010, respectively.



Source: Federal Reserve Bank of St. Louis

Issuance of government bonds in 2008-2010 is expected to be greater than the prior ten years combined. The UK budget deficit is expected to reach 12% to 13% of GDP, with debt-to-GDP growing to 80% to 90% of GDP by 2015, nearly twice of what it was before the economic downturn, and putting its credit rating at risk. As about 30% of bonds issued are expected to be taken by foreign investors, should investors not materialize for future bond sales, the UK could be significantly challenged.

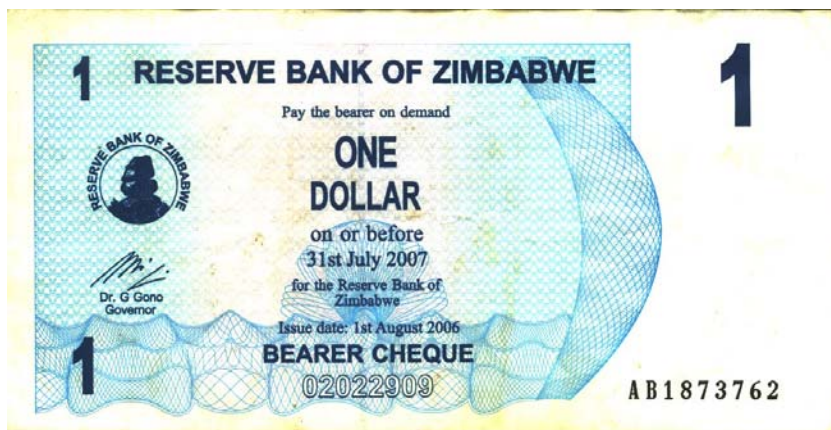
Concern over fiscal policy in the UK that is leading to sustained high deficits and challenging the independence of the BOE have led investors to swap out of the sterling for potentially higher-yielding commodity-backed currencies with better fundamentals. This has led to a similar situation with the U.S. dollar, where the pound is being borrowed and sold to acquire currencies with higher interest rates and better prospects. In the third quarter of 2009, the pound sterling and the U.S. dollar lost 2.3% and 6.9%, respectively, against the euro.

The pound sterling appears to be more vulnerable to devaluation than the U.S. dollar. It is important for other nation's central banks to support the U.S., at least temporarily. Should central banks follow Australia's lead, both the pound sterling and the U.S. dollar will come under pressure. South Korea may be the next to raise interest rates, perhaps before the end of the year. Other likely candidates for increasing interest rates include Israel, Indonesia, Taiwan, India and China. Any of these countries raising rates will absorb global liquidity, thereby reducing the attractiveness of other currencies. That will make it progressively more difficult for the UK to attract foreign investors without increasing interest rates or significant devaluing. From the perspective of an investor in the UK, gold and gold equities will become more attractive. This may provide U.S. investors a peephole into their future, and provide a template for investment in gold and gold equities from the U.S. perspective.

**Prescription for a Sick Economy: Take Your Medicine**

The case for gold from a U.S. perspective may have never been better only because the U.S. dollar has never looked worse. Clearly the dire circumstances suggested by the Japanese experience since the 1980s can be avoided, but this requires leadership, political will and optimism for a brighter tomorrow that is sadly absent from public discourse in the U.S.

The easy path for politicians, academics, and bankers forms the consensus which favors careerism and personal advancement rather than the hard choices which foster an environment for economic growth. This hard path of sacrifice requires a change in mindset, favoring free markets, rule of law, and stable money. This new path would also pursue constructive resource and energy development. While this is contrary to the preservation of political power and other non-market and obstructive agendas, gold remains the best means to preserve wealth from a U.S. perspective given the prospect of further devaluation of the U.S. dollar and stagnant economic growth.



Zimbabwe Dollar: Literally One in a Trillion  
Z\$37,000,000:US\$1  
(4/24/09 Exchange Rate)  
Source: Beacon Rock Research

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<b>Strong Buy</b>	Immediate purchase is recommended. The security is expected to outperform the market over the next six to 12 months.
<b>Buy</b>	Immediate purchase is recommended. The security is expected to outperform the market over the next 12 to 18 months.
<b>Hold</b>	Holding the stock is recommended because the share price's appreciation potential is less than or equal to the market.
<b>Sell</b>	The stock has reached the target price objective and/or conditions have changed sufficiently to alter the outlook for the stock.

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<b>Moderate</b>	The security has about the same volatility as the market and/or the company carries a level of leverage in line with its peer group.
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