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Watch what the Fed does, and not what they say --- Effect on Gold

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Report on Watch what the Fed does, and not what they say --- Effect on Gold

Details:

Commodity: Gold

Symbol:

MCX - GOLD

COMEX - GC

Gold MCX Chart

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It's pretty clear now that US economy is facing problems on credit front and investors can expect that the Fed would not fight inflation at the expense of growth. But is Fed doing enough to restore the falling investors confidence??? Fed came to rescue of bankers by flushing billions of dollars into the system. Credit crunch that has roiled global financial markets, forced Fed to act on the deteriorating credit situation by cutting the Discount rate by 0.5%.

"Discount Rate is nothing but the interest rate that an eligible depository institution is charged to borrow short-term funds directly from a Federal Reserve Bank"

The discount rate cut will not help the markets to ease the liquidity fear, as it is still one-half point higher than the funds rate, which is at 5.25 percent. That means that banks must pay the Fed more for direct loans from the discount window than they have to pay other banks to borrow for them on an overnight basis. The Federal Reserve reported that the daily borrowing averaged $1.315 billion for the week ending Wednesday. That was the highest average borrowing since the attacks of Sept. 11, 2001.

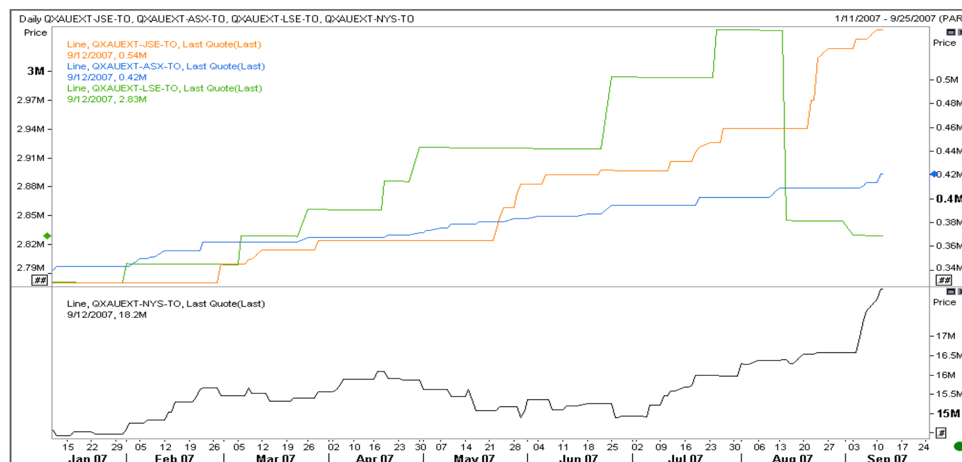
The data released by the Fed helps us to know how banks are responding to the Fed's encouragement for banks to borrow directly from the central bank through a loan facility know as the **Discount Window**. Four of the nation's biggest banks -- Citigroup Inc., JPMorgan Chase & Co., Bank of America Corp. and Wachovia Corp. -- announced they had borrowed a total of $2 billion. ECB has followed Fed and has poured billions of Euros into the system, who is also facing liquidity problems due to sub prime mortgage default.

With so much of ongoing crises Fed fund rate cut expectations are hardening. Fed fund rate the interest banks charge each other -- has been at 5.25 percent for more than a year. A reduction in this rate translates immediately into a cut in commercial banks' prime lending rate, the benchmark for millions of consumer and business loans. The prime rate currently stands at 8.25 percent. Will the market bounce back even if Fed cuts the rate by 0.25 or 0.5 bps? It will definitely ease some pressure from banks but will banks pass on the benefit of rate cut to end consumers by slashing their PLR? Will Fed be able to restore the investors' confidence? Confidence game is such a difficult one… Once the market is convinced it can trade without fear, players will come out, one by one, to deal again. But confidence isn't there yet. Credit crisis is deeper and more dangerous to the economy than anybody realizes it.

"The only thing that is certain is that more uncertainties in the direction of asset prices and volatility are on their way"

Effect on Gold

Gold ends its suffocating trend last week when it broke the psychological resistance of $700 rallying upside till $723 (on 11th Sep'07). Technical break out led to heavy buying among gold investors. ***The upshot is that if the markets decide that the gold price deserves to be higher then the gold price will go higher regardless of direct intervention by the Fed or any other central bank.*** The main driver of this rally is ETF; heavy buying is seen from gold Exchange Traded Funds. New York's StreetTRACKS reported heavy buying, as on date (12thSep'07) it holds 566.95 tonnes. From the chart its pretty clear that investors are parking money in gold ETF. Gold seems to have regained its safe haven role during financial market turmoil. We expect robust buying from gold ETF to continue in near future.



*NYSE StreetTRACKS is shown separately

Current Fundamental reasons leading gold to rally are: -

Weak Dollar: - The current gold rally is being driven primarily by fears that the debt crisis will lead to a breakdown in the Dollar Index and secondarily by the contraction of liquidity. Dollar is further likely to face the pressure against the euro as investors bet the U.S. interest-rate advantage over Europe will narrow amid the housing market slump. U.S. existing home sales will fall 8.6 percent in 2007, exceeding the 6.8 percent drop estimated a month ago, according to the National Association of Realtors. Problem is further likely to occur if Fed cuts the fund rate, which market is desperately waiting for on 18th Sept 2007. Over all weak dollar outlook is likely to keep gold upside intact.

Unemployment: - The dollar slid to a 15-year low against a basket of currencies after data showed U.S. employers cut jobs for the first time in four years stoked expectations for a hefty Federal Reserve rate cut this month. Companies cut 4,000 jobs last month, the first such decline since August 2003. The unemployment rate remained at 4.6%, large number of people dropped out of the labor market. The report, raised fears that the plunging housing sector and worldwide turbulence in financial markets could push the economy toward recession. The August decline in employment centered in the goods-producing sector of the economy. The construction industry lost 22,000 jobs during the month, while factory payrolls plunged by 46,000. Manufacturing employment has fallen by 215,000 in the past year. Factory job declines in August went beyond housing, including auto plants and semiconductors, as well as wood products and furniture.

Rise in Physical Buying: - Global gold demand increased 11 per cent in the first half of the year, compared with the same period a year ago, despite high prices, according to the World Gold Council. Demand for gold jewelry showed the strongest surge reaching record levels in the second quarter of 2007 rising 37% y.o.y. on the back of strong demand in India, China the Middle East and Turkey. Heavy buying is expected from India with upcoming festival season. Physical buying has not catched up the pace it should due to concerns in international markets. Traders are waiting for a dip in prices to stock gold for festive season. India's total gold holdings under exchange-traded funds rose in August compared to the previous month. Total gold holdings under the ETFs were at 3.33 metric tonnes at the end of August, up from 3 tonnes in July.

Dehedging on rise: - Gold miners typically hedge more -- contracting to sell nuggets not yet mined at fixed prices -- when they think bullion prices are in long-term decline. Rise in Dehedging from mining companies has further supported bullish trend in gold prices. Australia's Newcrest Mining Ltd. said its

gold buying spree that scooped more than 2 million ounces of gold in the last few weeks had helped fuel a sharp rise in world bullion prices. Newcrest planned to buy a further 1.7 million ounces of gold over the next 12 months as part of its plan to exit its gold hedges. Dehedging is anticipated to range between 2.5 to 3.5 million ounces (78 to 109 tonnes). The pace is expected to slow in the second half of the year. Dehedging is currently in the range of approximately 8 to 10 million ounces (250 to 310 tonnes). [Source GFMS]

Crude Oil breaches $80 mark: - Gold was further supported by high oil prices recently due to ongoing problems on refinery and supply fronts. Though OPEC ministers agreed to boost output by 500,000 bpd effective Nov. 1 at their regular meeting in Vienna in a bid to keep oil prices under control, series of attacks on Mexico's fuel pipelines this summer has raised fears the key energy supplier could struggle to keep its oil and gas flowing. Analysts expect rising instability in Mexico, a normally reliable supplier, could add as much as $10 a barrel to world oil prices. Violence in big oil producer nations in the Middle East, Africa and Latin America has helped drive red-hot oil markets. Such many more attacks on oil fields would likely have a more significant impact on the global oil markets.

Investors often turn to gold as a hedge against inflationary signs, including high oil prices. Indeed, while countries like India, China and Brazil still use much less oil than the developed nations, especially on a per capita basis, they are responsible for much of the growth in global demand for crude. This has led to projected strong demand for crude over the next few years, and concerns that supplies will not be able to keep up the pace, we expect crude to remain strong for coming days thereby supporting bullish trend in gold.

Areas of concern: -

Hedge Fund Losses: - Hedge funds, deploy leverage to enhance their exposure to markets, When things are moving in the right direction this results in phenomenal profits. However, the 'bets' get bigger and bigger and its only a matter of time before the 'gamblers' find themselves on the wrong side of the market. It was the case with Two of Bear Stearns Hedge funds, which placed highly leveraged bets on packages of subprime mortgage derivative products. When the value and credit worthiness of these bond packages called collateralized debt obligation (CDO') was cut due to the subprime defaults, Bear Stearns virtually wiped out the total value of the funds that had previously been rated as low risk. The CDO packaging enabled institutions to mix good risk and bad risk debt all in one box and label it as good risk. Therefore the financial institutions earned a higher rate of return on what seemed like a relatively low

risk CDO package. Bear Stearns weren't the only people betting on the subprime mortgage market using highly leveraged derivatives.

"As per Moody's Investor Report there's a roughly 50% chance of a big fund collapse"

As per the Report there are many hedge funds that are likely to collapse further due to there over leveraged positions and could further disrupt the market. It is unknown how much damage will be done, but the downtrend in financial market will be the clue that one should keep an eye upon. As financial institutions are forced to 'cover their bets' by making provisions for bad debts, they are in effect withdrawing liquidity from the market place and making it more difficult for borrowers across the board to borrow money for whatever economic activity. This means that it will have greater impact on the economy and thus depress the US housing market further.

Unwinding of Carry Trade: - The low borrowing costs of the yen is responsible for financing massive bets in a variety of high-risk markets such as commodities and emerging markets. The carry trade is expected to be reversed as the Japanese economy strengthens and prices begin to rise. Over the past few years, the financial markets have become very speculative and highly leveraged. Risk appetite is plunging as investors bail out of nearly all assets. Investors' risk appetite fell sharply in recent sessions on fears of the potential knock-on impact from subprime lending market woes. Risk aversion is rocketing today.

There are no official statistics on the size of the carry trade. Some economists estimate the total size could range from $200 billion to as high as $1 trillion. The whole system is reliant on Japanese interest rates remaining low and the Yen weak. If the yen strengthens then the value of the debts increases and thus a rush for the exit as people look to liquidate positions further strengthening the yen

and carry trade losses. A sharp reversal of these positions would have significant negative impact on financial markets. We expect Yen unwinding to further continue thereby taking yen to Y108.9/ dollar (till this year end).

- *CBGA Sales: -* Gold can face some pressure from European Central Banks sales under CBGA. Though ECB will be falling short of there quota (500 tones/year) this year, we expect Italy, Spain, & Swiss Bank to be the major sellers in 4th year of the CBGA agreement. Switzerland announced relatively recently that it planned to sell 250 tonnes of gold by the end of the 2009 sales period. The Italian parliament approved a reserve plan allowing the government to look into using the Bank of Italy's substantial gold reserves to cut the country's huge debt. Italy has some 62% of its foreign exchange reserves value in gold at about 2,452 tonnes. Italy's debt is the world's third highest in absolute terms.

Part of the gold and currency reserves of the Bank of Italy will be used to attack Italy's enormous national debt, currently the equivalent of 107 per cent of GNP. But in recent times despite of heavy gold sales from ECB under CBGA we could see that market could very well absorb the selling pressure which is a good sign for gold investors. But one cannot rule out the impact the central bank selling can have on the gold market. We expect robust selling from ECB in 4th year of the CBGA Agreement.

- *Strengthening of Rupee: -* Strengthening of Rupee is another gauge for gold prices to rise domestically. Government is likely to intervene to keep rupee above 40 levels in order to protect the interest of exporters. We expect rupee to consolidate around INR 40/ dollar with upside potential till INR 38.5/ dollar.

Conclusion: -

From investors point of view one should keep an eye on ***"What Fed does and not on what they say"***. Fed has hardly done anything to restore confidence not only among consumers but also among banks as banks are refusing to deal with one another hits at the heart of the entire system.

We expect two events in next week: -

1. Fed might cut the Fund rate by 0.25% (which every one is expecting) OR
2. Fed might cut discount rate by 0.5% (from 5.75% to 5.25%)

We think Fed might not cut the interest rate and could opt for 2nd option of cutting the discount rate by 0.5%. One needs to wait and watch what action Fed takes on 18th Sept 2007. If Fed does not cut the Fund rate we expect gold premium that has been built on the expectations of rate cut, to come down drastically. And if it does cut then gold can breach previous 26 years high of $732.

Technical Comments: -

Gold has been trading consistently above $700/ounce for past two weeks. MACD is above the zero line indicating further bullishness in gold. We expect upside rally to continue with some correction as gold is trading in overbought zone. All eyes will be on FOMC announcement on 18th Sept 2007. Gold can face some resistance around $733. Two consecutive close above $733 opens ground for $773 level. We eye support at around $698 and good trendline support at $683, which is also 100 days moving average. On short term basis two consecutive close below $712.5 can take gold to $698 level. Overall trend remains bullish, we recommend following trading strategies: -

Trading Strategy: -

1. If Fed Cuts Funds Rate: - Buy MCX Gold Oct contract above 9410 for target of Rs.9590/9850 with stop loss at Rs.9275 (Call is on closing basis)

2. If Fed doesn't cut Fund Rate: - Sell MCX Gold Oct contract below 9245 for target of Rs.9125/9045 with stop loss at Rs. 9340/-(Call is on closing basis)

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