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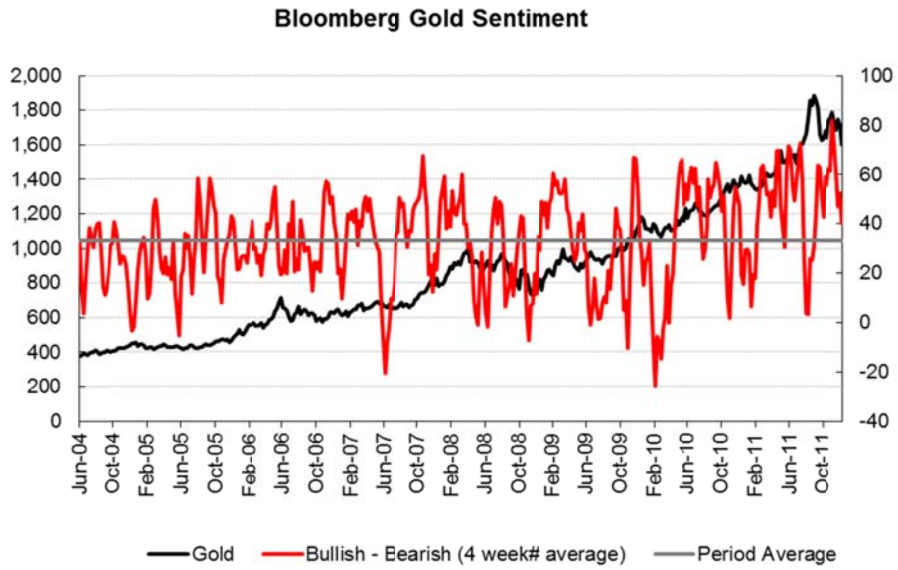
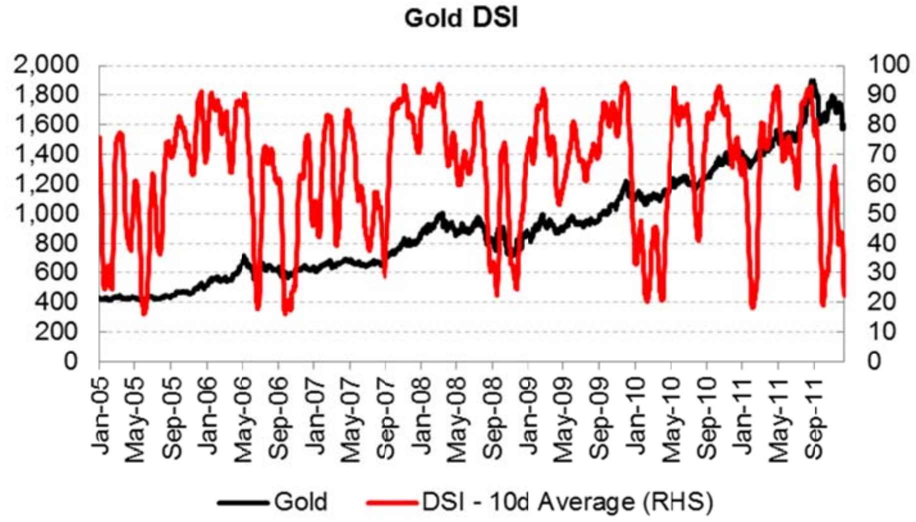
Gold's recent 8% pullback since December 1st has prompted the usual wave of portentous headlines. We'd like to outline our, perhaps slightly more festive (if you're a gold investor!), views here.

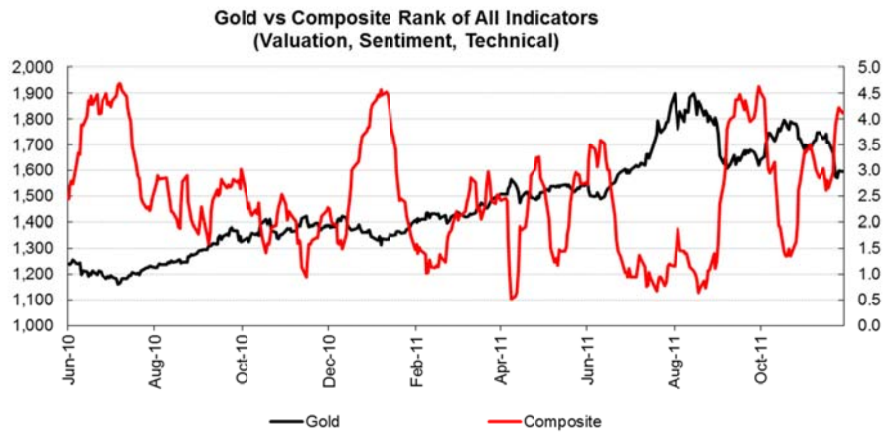
Bloomberg's Gold Sentiment (a weekly survey of traders, investors and analysts on the outlook for gold conducted by Bloomberg) has been hit, but has merely returned to more normal, less stretched levels.



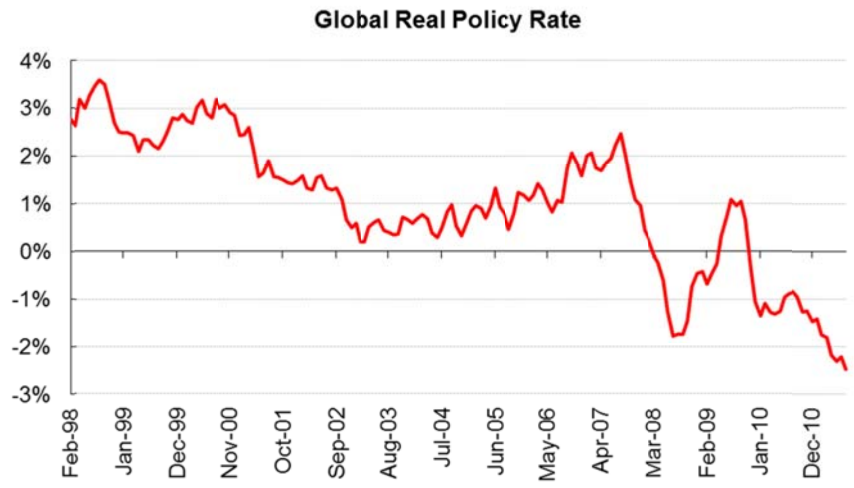
The DSI, another well-established sentiment indicator, is composed mainly from the opinions of retail traders, and therefore is often a good contrarian indicator. Currently it is at very depressed levels.



Moreover, the Hinde Gold Sentiment Indicator, which is a composite of technical, valuation and sentiment indicators is at a level consistent with bottoms in the gold price.

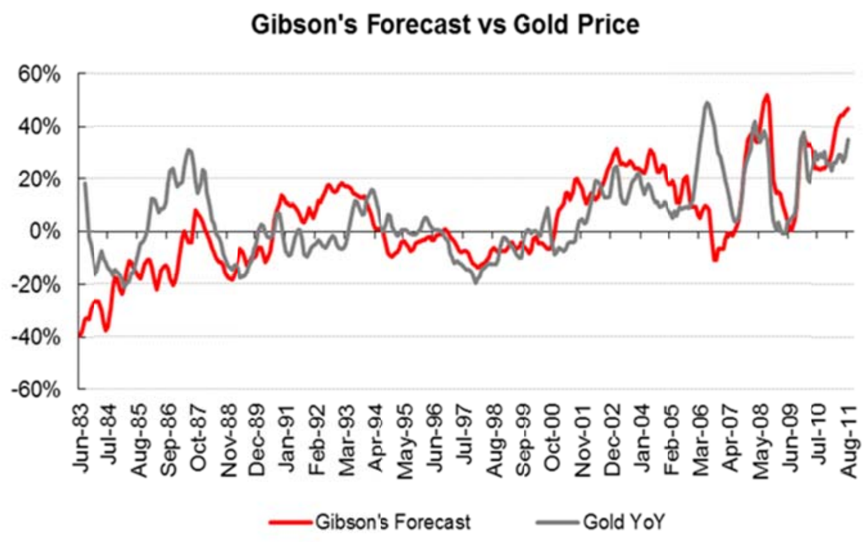


While gold's correction has been quite sharp, the underlying fundamentals have not changed. Global real rates – a powerful long-term driver of gold prices – remain deeply negative, as the following chart shows:



Gibson's Paradox, which we referred to in a recent blog post for King World News, was the product of research by AH Gibson, an English economics writer. Previously it was assumed that interest rates and inflation (ie rate of change of prices) were correlated. In fact, as Gibson showed, interest rates are correlated with prices themselves. This was under a gold standard.

A corollary of this, in an era of non-fixed gold prices, is that as real rates go from being a little positive (~+2%), to negative, this becomes increasingly positive for gold. The last few weeks have not changed this 'axiom', and the forecast for gold using Gibson's Paradox remains intact; to reiterate, that's for gold to reach $2,100 in early 2012.

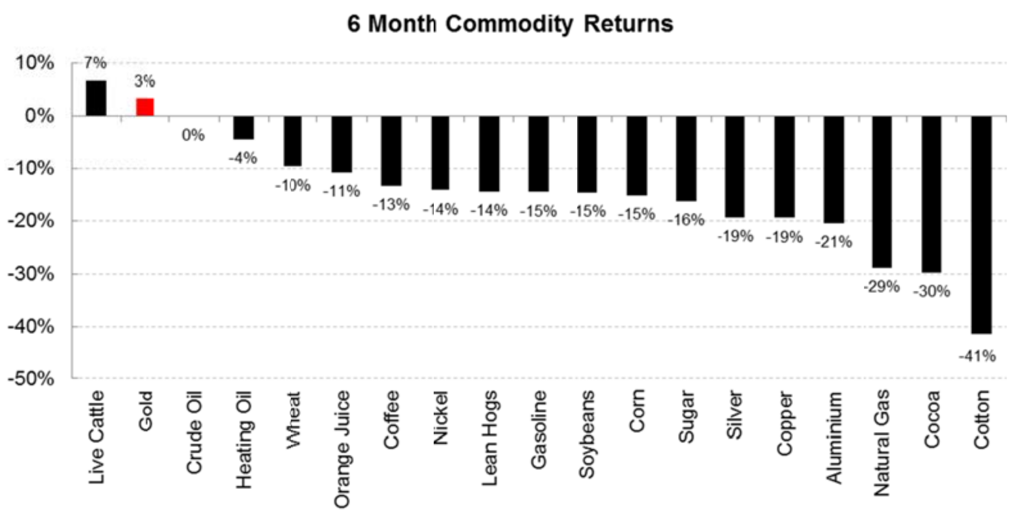


Instead, we believe the reasons for gold's recent decline are less fundamental, but no less important. One significant factor has been the collapse of MF Global. MF Global was the world's largest futures broker, with a specialization in commodities. As a recent Barron's article highlighted, clients of MF Global who held gold futures were suddenly hit with big margin calls when their contracts were transferred to other brokerages. If the client failed to pay the extra margin, the brokerage automatically liquidated the contracts.

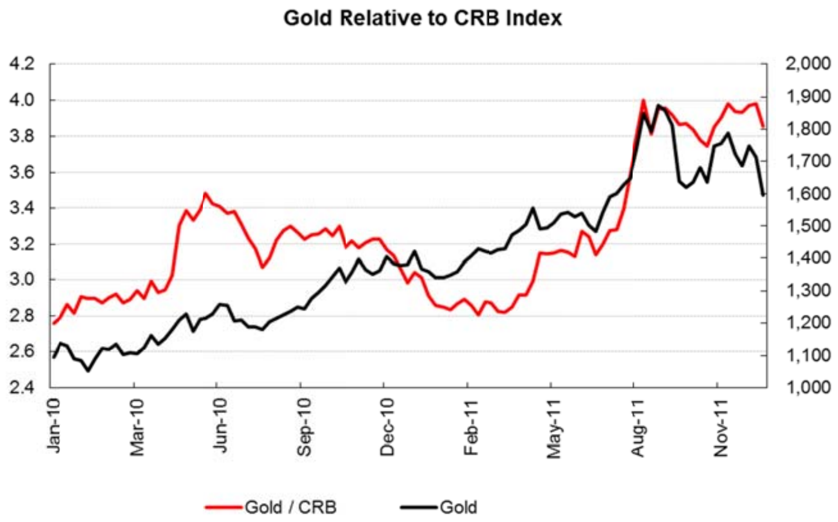
(Hinde Gold Fund was designed to be as divorced from the financial system as is realistically possible. The Fund's exposure to future's margin is small. We wrote about this, and other factors, that make Hinde Gold Fund, we believe, the safest vehicle for investing in gold, in a recent email to clients. We strongly encourage you to read it.)

Thus a lot of the downward pressure in prices has been in the paper, not the physical, market. Underlying demand in the physical market remains robust. Central banks remain buyers. South Korea, for example, increased its gold reserves by 39% in November alone. And lest we forget, the cost of extracting gold out of the ground is around $1,200 per oz. This ultimately places a floor on physical prices.

Another point we should make concerns the commentariat's repeated oversight in looking at gold in isolation. The assumption seems to be that gold can drop 10 to 15% *ceteris paribus*. Unless fundamentals significantly change, a serious drop in the gold price would be accompanied by a drop in the prices of other assets. Gold, however, should fall less, and thus fulfil its role of protector of purchasing power, a role it has fulfilled for many years. Indeed, in the recent gold correction, most commodities have been hit, and many of them are down more than gold over the last 6 months:



And relative to the CRB commodity index, gold is significantly higher (red line in chart below) than where it was last time the gold price itself was under $1,600, in late July:



All indications, from our perspective, are that gold is in the process of bottoming around the current price level (~$1,600). Sentiment has weakened, but from overstretched levels. Contrarian indicators, such as the sentiment of retail traders, suggest a modest near-term bounce in prices, or at least a stabilization. Other factors in the pipeline are positive. Chinese New Year begins early in 2012, and prompts demand for gold as a popular gift.

Also, the prospect of QE3 in the US early new year, remains more likely than not. Even if the US manages to skirt a recession, which would prompt calls for further money printing, the recent relative strength of the dollar will also be in the Fed's thinking. More QE will help weaken the dollar. The ECB has just embarked upon a huge de facto program of QE. In theory, the ECB, through its extension of 3 year loans to banks and a reduction in collateral standards, could liquefy almost the entire European banking sector. The situation in China, too, continues to deteriorate, and policymakers there have shown their willingness to turn on the liquidity spout when the going gets tough. Excess liquidity is ultimately the friend of higher gold prices.

Investors should concentrate on the fundamentals for gold which remain intact. No market moves in a straight line. The long-term picture for gold remains very positive.

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