

TYCHE SPECIAL MARKET UPDATE

TYCHE INVESTMENT STRATEGY REVIEW – 26 September 2011

A METALS BLOODBATH

On Friday Sept. 23rd, amid relative calm in the stock and oil markets following Thursday's sharp losses, we witnessed one of the biggest routs on record in metals prices, including copper, silver and gold, with gold crashing more than \$100 on the day.

The sudden sharp drawdown is said to have been caused by big hedge funds and margin traders covering losses in other markets or being flushed out of leveraged positions due to margin calls that could not be met, in a self-reinforcing downward spiral. And the response of the CME Group, which oversees trading in U.S. gold and silver futures, to immediately further increase margins/deposits required on trades of these three metals, clearly made matters still worse by adding to the squeeze of futures investors trying to hold onto long positions, i.e. bets on higher prices.

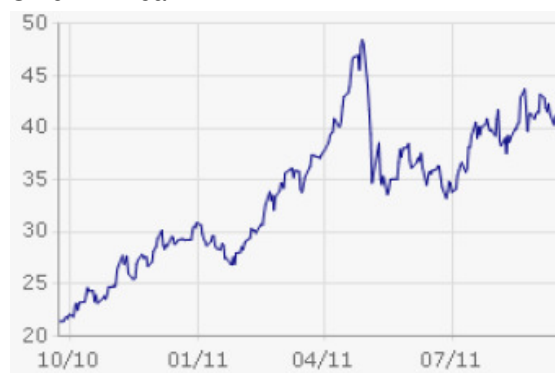
Gold – 1 Year



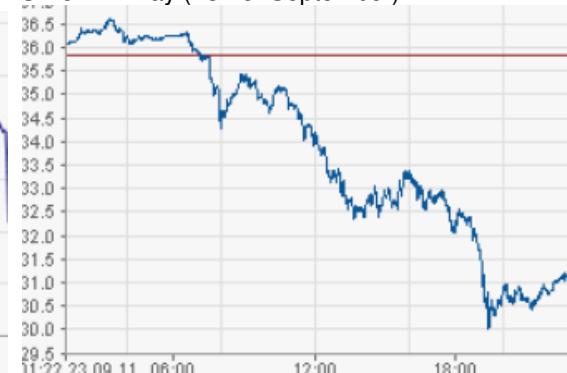
Gold – 1 Day (23rd September)



Silver – 1 Year



Silver – 1 Day (23rd of September)



This type of scenario is clearly not comforting to witness for the precious metals investor (be it in physical precious metals, mining companies or futures), and it does drive home again in particular the point that investing in a speculative way such as by the use of options or any

form of leveraged/margin trading, something that Tyche has been strictly advising against, is always especially risky.

(The same also applies to margin trading on stocks as well, and even on property, where we would like to re-iterate our recommendation to avoid being overly leveraged through mortgages as well, given the unpredictability of the outcome of the Western sovereign debt crisis in particular, and the extremely high volatility that may result from this crisis across any asset classes.)

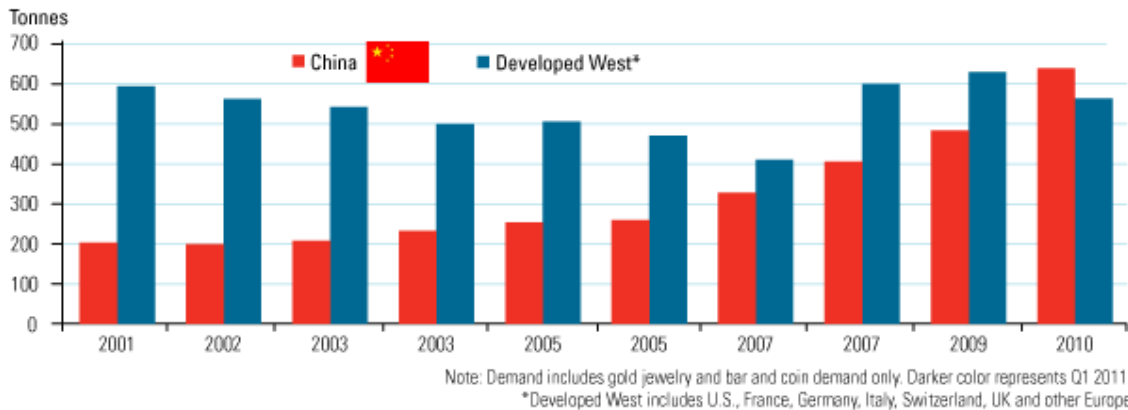
Interestingly, though, while the metals rout seems to have flushed out a lot of margin speculators (which can in a way be a good thing in terms of reducing future vulnerability to a repeat of such 'draw downs' since short-term traders are always the most vulnerable), the stronger handed physical metal buyers and longer term investors appear to be using this occurrence as a buying opportunity to accumulate holdings at good prices. These investors are much harder to drive out of those positions again. One major Canadian physical metals dealer (Sprott Money) reported on Friday: "It's been pretty wild, especially the last three or four days because of the price drop. People are trading in their paper money for gold and silver... Our clients are very savvy, sophisticated and when a price drop of this magnitude occurs, they step in and buy very aggressively. Right now there is a dramatically increased volume and what we are seeing is buying across all spectrums in terms of the size of orders."

Being on the buy-side in precious metals still makes perfect sense, when we take a calm look at the fundamental picture, which remains all but positive on all fronts.

First of all, inflation continues to be on the rise, including locally in Hong Kong where it hit a three-year high of 6.3 percent in August from a year ago, as reported last week, similarly to China's 6.2 percent inflation rate. So, whether one holds 0 percent yielding HK\$, or even 1-1.5 percent yielding RMB, one does go backwards significantly in inflation-adjusted terms that way. And inflation may yet accelerate sharply going forwards, as a result of further QE measures in the West, which appears to be the only way for many countries now to escape the debt-trap and sovereign default.

Furthermore, according to Aaron Regent, president of the world's top gold producer Barrick Gold, "there is a strong case to be made that we are already at 'peak gold'", as global gold production is facing a terminal decline despite record prices and Herculean efforts by mining companies to discover fresh sources of ore in remote spots. This comes amid soaring gold/precious metals demand from China, which was not even on the radar as a gold consumer back in the 1980s when gold hit its previous inflation-adjusted peak of US\$ 2,300.

China's Gold Demand Overtakes Developed World



From the year 2007 to 2010, Chinese gold investment demand actually grew at a compounded annual growth rate of 68 percent, according to CPM Group, with the demand for gold in China now for the first time outpacing the combined total of the developed West. So, if we lump together the gold demand of the U.S., France, Germany, Italy, Switzerland, the U.K. and all other European countries, the sum of these countries is still outpaced by China, and this despite triple-digit increases in demand from France, Germany and Switzerland.

And, talking about China, we should also note that, while the ongoing European and US financial crisis certainly poses major challenges and risks for the entire world, the same crisis can also bring along opportunities for emerging markets and emerging market investors generally. For example, most emerging market economies are much healthier and have got a much lower debt as a percentage of GDP than the developed world, while they are poised to overtake the developed countries' share of world GDP in the near future (if they have not already done so when considering PPP adjusted GDP rather than nominal GDP).

In particular when we look at the banking sector, we can clearly see that the 2008 financial crisis actually appears to have made way for rising giants from emerging markets (especially the major Chinese banks which are now claiming as much as a 26.4% global market share), and this trend may further accelerate over the coming years given the second wave of Western banks problems happening right now.



Top 30 banks worldwide

	# of banks		% market cap.	
	2006	2010	2006	2010
USA	10	6	39.8	25.0
United Kingdom	4	4	12.5	13.1
France	3	1	7.8	2.7
Japan	3	1	11.9	2.6
Netherlands and Belgium	3	0	6.9	0
Spain	2	1	6.5	3.1
Switzerland	2	1	7.5	2.1
Canada	1	3	1.8	6.6
Italy	1	0	2.9	0
Germany	1	0	2.4	0
Australia	0	4	0	8.8
Brazil	0	3	0	7.1
China	0	5	0	26.4
Russia	0	1	0	2.6

Sources: IMF, BanksDaily.com, DB Research

At the same time of course, the same emerging markets' stock indices including China have come down sharply recently, hence it may be an opportune time to gain some exposure to good companies in relatively healthy economies and attractively valued currencies.

However, overall, caution should still remain the priority when investing nowadays in our view, given the unpredictability of the nature and short-term market effects of the unfolding Western countries debt crisis, and hence positions of relatively high volatility should only be entered into for the medium-longer term, and only as part of a diversified and un-leveraged portfolio.

Should you wish to discuss this or have any other query regarding financial matters please do not hesitate to contact your Tyche Adviser.

Tyche Investment Committee
26 September 2011