

Jude Wanniski Stephen Anderson President
Chief Market Strategist

jwanniski@polyconomics.com sanderson@polyconomics.com

May 17, 2004

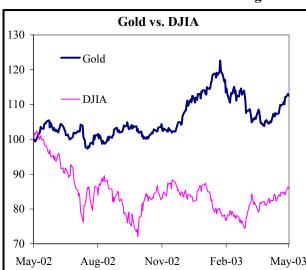
## Isolating the Gold and Equity Variables

The Decline in the Dollar-Gold Price Suggests a Near-Term Pullback in Major Indices, With a Resumption of Advance Depending on Macro and Geopolitical Positives

For the purpose of showing the negative drag on the DJIA from the declining gold price, this report isolates the gold and equity variables. Our findings suggest that the nominal price of equity indices would mean a decline to 9,235 on the DJIA at \$375 gold.

Certainly, the real prices of equities include macroeconomic and geopolitical forces that could be positive or negative in determining the real price of equities. A positive scenario with rising equity indices would have to rely on these forces pulling against the nominal drag, especially a shift in monetary policy that prevents gold from falling further. Our December 2003 forecast of a 12,000 DJIA by year-end 2004 assumes these positives, but as mid-year approaches with no such shift, the target probably will have to be moved forward.

One year ago at this time, equity prices were significantly undervalued. Even as gold began to break through its 10-year and 15-year moving averages— clear signs that deflation had ended—during the spring of 2003, equities remained mired in a post-deflationary funk, made worse by geopolitical concerns. The nominal values of both the DJIA and the S&P 500 were 20% below fair value, based on six-month and one-year equilibriums vis-à-vis gold.



2003: A Significant Buying Opportunity



NOTE: 05/14/02 = 100.

It took the powerful Bush tax cuts and resulting profit growth to take equities out of the basement. While the tax cuts would seem to increase dollar demand (and thus create downward pressure on the gold price), indications that the Fed would stand pat for a prolonged period more than offset this pressure on gold.

However, we think that the major equity indices now have gotten ahead of themselves, at least in nominal terms. Gold has plummeted \$50 (or 11.8%) since hitting a double peak of \$425 in early 2004. Despite a strong Q104 earnings season, major equity indices have declined by 3.5% since April 1, coinciding with the gold decline. If the U.S. dollar stays at this level vis-à-vis gold, we can expect further downward pressure on equities during the next several weeks. The charts indicate equity movements trailing the gold price by one-to-two months.

We also are keeping an eye on a recurrence of deflation. Our concern is that additional tax cuts (as evidenced by last week's Senate passage of the FSC replacement bill) and Fed tightening may accelerate the downward spiral in the dollar/gold price, and eventually to other prices, including equities. We would be especially concerned if gold fell below \$355/oz., which is the 20-year moving average for the dollar/gold price.

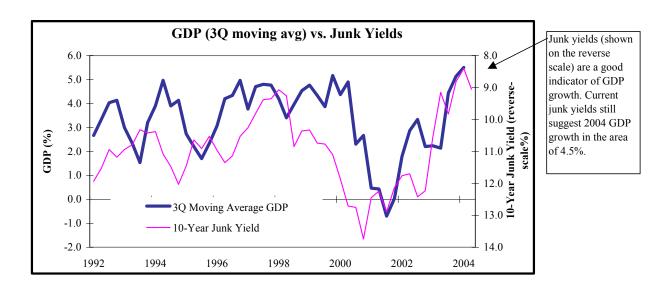
Gold vs. DJIA Gold vs. S&P 500 125 Gold Gold 120 S&P 500 115 110 105 May-03 Nov-03 Feb-04 Aug-03 May-04 May-03 Aug-03 Nov-03 Feb-04

2004: Deflation Threatening Once Again?

NOTE: 05/14/03 = 100.

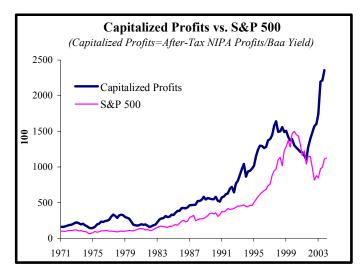
Meanwhile, the underlying macro story remains encouraging. The three-quarter moving average GDP growth of 5.1% is at the high reached during the 1992-2000 recovery. What is more, the chart on top of the next page shows that current 10-year junk bond yields (now averaging 9.1%) hint at GDP growth in the area of 4.5% for the rest of 2004. While still robust, we should note that our GDP forecast (based on this analysis) has been reduced slightly (from 5% to 4.5%) due to recent run-up in the 10-year Treasury yield. However, this has not been accompanied by a general widening of risk spreads. We do not expect significant deterioration in either the 10-year Treasury or junk spreads.

May-04



The profit story also remains quite positive. We should note that corporate profits peaked just at the onset of the 1997-2001 deflation, and a solid two and one-half years before the S&P 500 peaked. Profits reached their nadir in Q401, nearly one year before the S&P bottomed.

While we think that deflation is a growing (though currently small) concern, corporate profits do not show any signs of peaking at the present time. Indeed, they still are registering solid sequential (QoQ) increases of 6.5%, boding well for longer-term gains in equities. Given the recent pullback in the dollar/gold price, though, we will be keeping a close eye on profit growth.



SOURCES: Bureau of Economic Analysis; Bloomberg.

## **BOTTOM LINE:**

- Based on our 6-month and 1-year analysis of gold and equity indices, we estimate the current nominal fair value of the DJIA to be 9,230; and of the S&P 500 to be 1,000. These values assume a dollar/gold price of \$375, and represent an 8% decline from current levels.
- If gold were to fall back to the 20-year moving average of \$355, the nominal fair value of the DJIA would be 8,710. The S&P nominal fair value would be 945.
- In the medium-to-long term, we believe that solid GDP and profit growth bodes well for equities, but this growth still requires policy shifts at the Fed and more positive developments on geopolitical risk than we have today.

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