TIME FOR EQUITIES, OR NOT

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The recent sell-off in commodities, particularly gold and silver, has caused some investors to consider investing in the broader stock markets. The stock markets have lagged gold and silver the last few years, but earnings are improving and many believe equities are ready to take off. Is this the case? Will the equity markets outperform precious metals over the next six months?

To answer this question, we first must understand the factors that drive the equities and commodities markets. We then can make rational judgments on allocating investment assets.

The largest US equity markets include the NYSE and the NASDAQ, on which over 5,000 issues representing $17.4 Trillion are traded each day. The most frequently used stock market indices are the Dow Jones Industrial Average (DJIA), the Standard & Poor 500, and the NASDAQ Composite.

Earnings are the single most important metric for a company. Equity prices move as a function of future earnings expectations. The key measure is Price/Earnings, or PE ratio. The DJIA is currently trading at 14.4 times earnings; S&P 500 at 16.84; and the NASDAQ at 12.62. These are all lower than PE's seen a year ago.

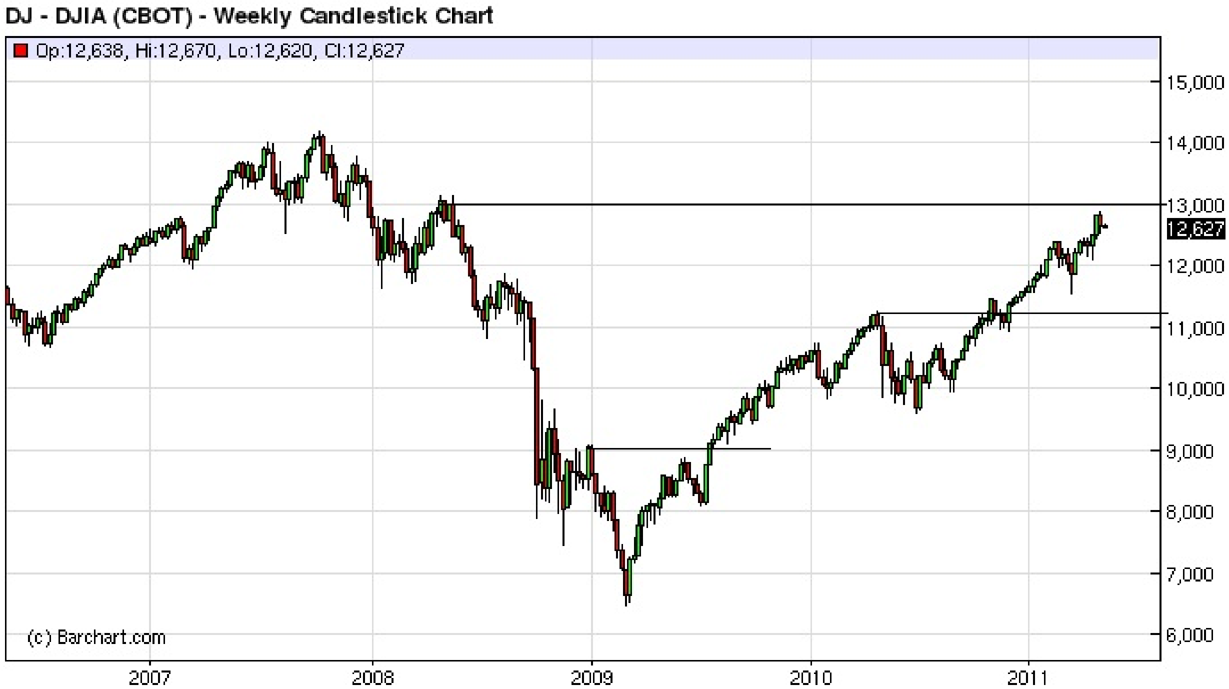
Gold and silver do not have PE ratios. The price reflects the value the buyer is prepared to pay for the metal. That value is typically a premium over the value of paper currency. Therefore, precious metals are considered to be stores of value.

Future earnings for equities are driven by many factors including top-line revenue, operating costs and overhead. As large part of operating cost and overhead is personnel cost. In recessions, most companies cut back on personnel and slow production in an effort to save costs. Today, US unemployment remains high, 16% by one government measure (U-6).

Part of operating costs is the cost of money, or interest cost. Low interest rates usually encourage capital expenditure, but since the financial meltdown in 2009, banks have slowed lending, reducing CAPEX for many companies despite very low interest rates. Today, the banks are holding $1.4 Trillion in excess reserves.

Wall Street stock analysts predict earnings for a traded issue using sophisticated financial and market analysis. An important input is company guidance, the company's own projections for the next quarter or year. But the cat-and-mouse game between Wall Street analysts and company officials can create self fulfilling prophesies that lead to market "surprises". The company may understate guidance in an effort to lower Wall Street consensus estimates. Printing numbers that "beat" the street usually propels the stock price up.

So what is the outlook for stocks compared to gold and silver?



We see from the chart for the DJIA, there have been two significant technical breakouts since the financial meltdown of 2009. The first was a breakout of the head-and-shoulder pattern on July 20, 2009. This was a run from 9,000 to 11,258 on April 26. 2010, a 25% gain. The second breakout occurred November 29, 2010 at 11,092. That move continued up to 12,876 the high last week, a 16 % hike. The next resistance levels are 13,000, then 13,790 and 14,119.

What could slow gains in the DJIA? Many think inflation is already eating into earnings, and seen more earnings erosion coming. Higher global commodity prices are affecting source prices. Now, higher labor costs are pushing up manufacturing costs in China. High fuel prices continue to hinder the global recovery. Slowing demand is also a factor. US GDP growth slowed to 1.8% for 1Q11, down from 3.2% for the previous quarter. World GDP for 2011 is forecast to slow to 4.4% average down from 4.9% average in 2010.

Stock prices have been pushed up by the Fed's easy money policy. Near zero interest rates have kept margin rates low. When the Fed tightens, the stock market slips. We have seen rate hikes kill stock rallies before. But tightening (or even just ending Quantitative Easing 2) is likely to impede the fragile recovery. So it is not clear that the Fed will indeed forsake its easy money policy in June as scheduled.

On the other hand, gold and silver have outperformed stocks for the last few years and are likely to outperform stocks for the next year or more. Despite last week's pullback, today's market action shows the precious metals are resilient and poised to reach new highs.

This is because the forces that favor the precious metals remain intact. Political unrest in northern Africa the Middle East threaten the major oil supplies. The EU has failed to fix its sovereign debt crisis; more bailouts are required for Greece, Ireland and Portugal. Global inflation is on the rise. Oil is trading above $100/bbl. The US debt crisis will hit states and municipalities, and upset Federal budget negotiations. The US Dollar is likely to remain weak. Uncertainty will continue to be the norm.

Uncertainty will continue to propel the precious metals up. Gold is trading above $1500/oz and silver, hurt by massive increases in margin requirements and selling by large hedge funds last week is leading the precious metals rebound, up 6% today, reaching $37/oz or better as new buyers come in. Technical analysis is pointing to $47/oz for silver in the next few months, a retest of the $50 resistance level. Gold is trending to $1600 over the same period.

To reach the 14,000, the 2008 high, PE's would need to expand to 16.19 for the DJIA, representing a 12.4% gain today's price for the index. At $47/oz, silver would have gained 27% from today's price.

For my money, gold and silver are the better trades.

Investors from around the world benefit from timely market analysis on gold and silver and portfolio recommendations contained in *The Gold Speculator* investment newsletter, which is based on the principles of free markets, private property, sound money and Austrian School economics.

The question for you to consider is how are you going to protect yourself from the vagaries of the higher prices and economic uncertainty? We publish *The Gold Speculator* to help people make better decisions about their money. Our Model Conservative Portfolio gained 66.7% in 2010, and 55% for 1Q2011. Subscribe at our web site www.thegoldspeculatorllc.com with credit card or PayPal ($300/yr) or by sending your check for $290 ($10 cash discount) The Gold Speculator, 614 Nashua St. #142 Milford, NH 03055