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Gold breaks \$800

Managing risk, Hedging strategies for a hot market

Not standing in front of moving locomotive

As I begin this Issue, Gold has broken over \$800 with its sights set firmly on the all time nominal high of \$850. The price has risen 25% just from the August lows and the HUI Index is up 50%. COT data-watchers and chart readers alike have been confounded by the gold's continued strength. The mid-cycle correction I anticipated failed to appear. Fears of rising food and fuel inflation are partly to blame. But the main culprit remains a crashing U.S. Dollar, spurred on by terrible third quarter results flowing from the big banks the realization that Housing sector is nowhere near a bottom. All this combined is causing many to question the health of America's financial system.

What's really noticeable lately is how the *mainstream* is really starting to see now what is at risk here. It's no longer just the **Doug Caseys** (*Crisis Investing*) or **Jim Puplavas** (*Financial Sense Online*) of the world who are calling for the biggest economic setback since the Great Depression. I was amazed watching a pretty mainstream weekly debate program on PBS this past Sunday morning (*McLaughlin*). First topic off the top was concerns over the U.S. financial system, crashing banks and the dollar and runaway Gold prices.

One of the four debaters, one-time presidential candidate, **Pat Buchanan**, was actually *bragging* about how much gold he owned. Two of them were indeed asserting that the U.S. Financial system is at serious risk. It doesn't pay to be bearish because the vast majority of the time, the market is moving up. It's not good to cry wolf too often. Who's to say after all, that the current market turbulence isn't just like all the other half dozen or so minor pull backs over the past few years, only to lead to new highs within a few months?

Can you believe that? The public is finally starting to get it. The nasty truth is being exposed for all to see. The biggest debt bubble in history has burst and nothing can stop it from running its course. And Gold is working out to be about the best beneficiary - the proverbial safe haven after all.

To be sure, all the technical indicators are showing gold is over bought and the US Dollar Index is oversold. So I would be cautious about adding new positions going forward. See the charts above; notice how they have both moved all the way from the very bottoms of their respective trading channels, almost to the tops in just three months. That's a long way to move in a very short time. We should expect to see sharp reversions to the mean without notice.



On the other hand, we don't want to start under weighting gold too much yet because for one, it's too early in the season - small caps and gold tend to do their best in Q1 or Q2. Second, gold is taking on a life of its own now, and we don't want to stand in front of a moving locomotive. It seems to be suggesting it's capable of a melt-up, something like what the Internet stocks did in 1999 to March 2000. We certainly don't want to be jumping off and then back on that train at higher prices and higher risk.

So, if we don't want to sell our gold stocks now, what other alternatives are there to mitigate risk?

Strategy #1: Proper positioning based on seasonality

For one, **we should gradually stop buying as these charts approach the top of their channels.** This is hard for people to do, because, the positive reinforcement they receive when they take profits encourages them to plunge right back into the market. If you are doing this and finding yourself fully invested by the time the seasonal high rolls around in the first or second quarter, you're setting yourself up to give a good portion of it back. Second, or shall I say in the first place, **you should discipline yourself to load up on your core gold positions during the seasonal lows,** usually June through August, when there is less competition for these same stocks.

In fact, *the time for preparing for risk, is well before that risk arrives,* by deliberately using the seasonal cycle. Look at the charts of **Goldcorp, Newmont, Barrick.** They all bottomed in the summer, but not by coincidence. Use seasonal positioning as your first line of defense against risk.

But what can we do *right now* to mitigate risk, as it rises?

Strategy #2: Buy highly uncorrelated, leveraged assets

One thing you could do is to purchase modest amounts of some kind of highly “*uncorrelated*” assets - which move in the opposite direction of your gold stocks if the price of gold were to fall. Preferably, these would be also be leveraged, to take advantage of short, sharp selloffs, and to reduce the amount needed to devote to this “insurance” to offset the paper losses.



Two ways that come to mind are: 1. **ETF's** and 2. **(Put) Options.** We illustrated **two specific examples** in balance of this article, with prices as of November 7th. Interestingly, on November 12, or a mere three trading days later, the ETF example we used (see the chart above) **jumped by close to 9.5%.** Three days later on November 15, a **Put Option we mentioned rose by an amazing 66% in a single day!** So in a very short time we are already seeing examples of the potential benefits of strategic hedging.

To purchase the entire November Issue which includes specifics about the hedging strategies we are referring to or learn more about EGS, visit: www.emerginggrowthstocks.ca.

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