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INVESTMENT STRATEGY and RESEARCH
A division of Oppenheimer Asset Management Inc.

INVESTMENT STRATEGY

October 26, 2009

US Strategy Weekly

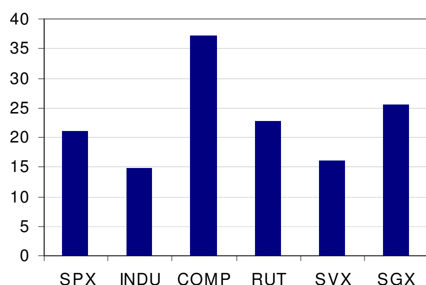
Our Thoughts on the Recent Gold Rush

US Strategy – S&P 500 Sector Weightings

Sector	Opinion	%Weight
Consumer Discretionary	MW	9%
Consumer Staples	UW	8%
Energy	MW	12%
Financials	MW	15%
Health Care	OW	14.5%
Industrials	OW	11.5%
Information Technology	OW	22%
Materials	MW	3%
Telecom Services	MW	3%
Utilities	UW	2%

Source: Oppenheimer Asset Management Investment Strategy & Research
Key: Opinion: Investment Strategy Sector Opinion; %Weight: Recommended sector weighting versus current S&P 500 actual percentage weight.
UW: Underweight
MW: Market Weight
OW: Overweight

Major Market Index Performance, Year-to-date



Source: Oppenheimer Asset Management Investment Strategy
Prices as of 10/22/09

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Gold optimism is misplaced

The most bullish gold arguments are centered on concern about the US dollar and the strength of US economic growth – investors believe both will remain weak for years to come and that gold is the logical hedge. While we would agree that weak US economic growth would certainly be a reason to be bullish on gold, we do not agree that gold is a proper hedge for dollar weakness. And we continue to believe that US economic growth will continue to surprise to the upside in coming months. In addition, the fundamental backdrop for gold does not appear to support current levels.

The impressive multi-year rally in the metal appears stretched

Gold has been in an impressive multi-year uptrend since late 2001, bringing current prices to all-time highs. However, gold bulls hasten to point out that inflation-adjusted levels remain below all-time highs. While we appreciate the historical context, it is not a strong argument for continued optimism, in our view. There have been only two other times since 1970 that inflation-adjusted gold prices have been this high. Unfortunately, those moves proved to be short-lived, as prices quickly peaked, then exhibited significant multi-year declines.

Gold is traditionally a hedge against inflation and economic weakness…

Historical data appear to support the notion that gold can perform reasonably well during periods of inflation and recession. Therefore, it would behoove investors to increase exposure to gold when inflation is rising or the economy is in recession. Consequently, it appears that the outlook for inflation and economic growth is at odds with a bullish stance on gold – inflation is expected to remain subdued, while the economy is expected to return to growth in coming years.

…but not against US dollar weakness

Investors have been increasing their exposure to areas perceived to be a hedge against the weakening US dollar and gold has been one of the more popular choices lately. While this strategy has worked so far in 2009, we believe this trend is being driven by momentum as opposed to traditional investment dynamics. In fact, the US dollar and the price of gold have exhibited only a relatively weak negative correlation since 1970.

Fundamental trends for gold are troublesome

Over longer time periods, underlying fundamentals typically determine the value of any asset, in our view. That is what is so troubling to us about the ascent of gold prices. When you examine gold supply and demand trends, they do not appear to support current price levels. Mine production has remained stable while consumer demand has dropped sharply. Yet, investment-related demand has surged, a potential indication of a speculative bubble.

Our thoughts on the recent gold rush

We recommend that investors consider reducing exposure to gold within portfolios…

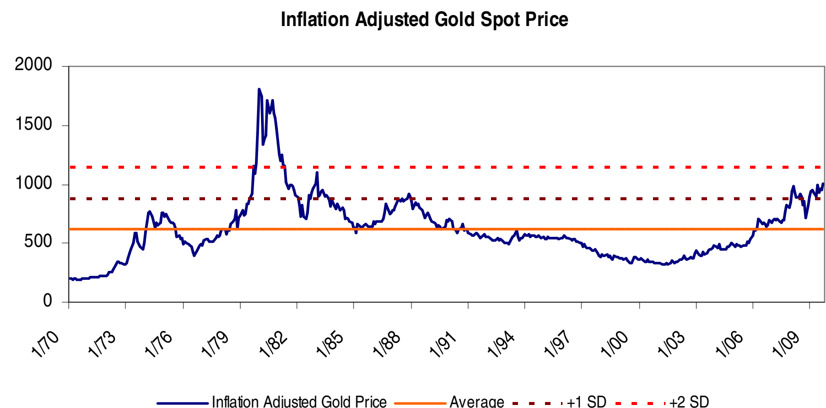
Given the continued strength in the price of gold, we have received a fair number of questions from investors regarding our outlook for the commodity. To be sure, many investors have capitalized on the dramatic increase in gold prices. However, current prices are at all-time highs (with inflation-adjusted levels well above historical averages) and we believe it is reasonable to question whether prices will be able to maintain their momentum. In our conversations, the most bullish gold arguments are centered on concern about the US dollar and the strength of US economic growth – investors believe both will remain weak for years to come and that gold is a logical hedge. While we would agree that weak US economic growth would certainly be a reason to be bullish on gold, we do not agree that gold is a proper hedge for dollar weakness. And we continue to believe that US economic growth will continue to surprise to the upside in the coming months even though high levels of unemployment will likely linger for some time. In addition, the fundamental backdrop for gold (i.e., supply and demand trends and inflation outlook) does not appear to support current levels. Furthermore, the significant increase in gold investment-related positions over the past several years worries us, since this is typically a main ingredient of the formation of a speculative bubble. Therefore, we are extremely cautious regarding the direction of gold prices and would advise investors to take profits at current levels.

The impressive multi-year rally in the metal appears stretched

…since it appears that the recent rally may be approaching a peak.

Gold has been in an impressive multi-year uptrend since late 2001. In fact, the ascent has sharply accelerated during the past two years, bringing current prices to all-time highs. Gold bulls hasten to point to inflation-adjusted levels, which remain soundly below the all-time highs exhibited in the early 1980s, to justify their optimistic stance. While we appreciate the historical context, it is not a strong argument for continued optimism, in our view. As Chart 1 illustrates, the inflation-adjusted price of gold is now firmly above one standard deviation from its historical average, which we view as abnormally high. More important, there have been only two other times since 1970 that inflation-adjusted gold prices have managed to sustain a move above the one standard deviation barrier – both occurring in the early 1980s. Unfortunately, those moves proved to be short-lived as prices quickly peaked, then exhibited significant multi-year declines (in both nominal and inflation-adjusted terms). For example, it took only three months for gold prices to peak following a one standard crossover and 27 months to trough during those periods.

Chart 1: The Price of Gold Appears Stretched



Source: Oppenheimer Asset Management Investment Strategy, Wall Street Journal, Bureau of Labor Statistics

Short-term gains give way to longer-term losses

As Table 1 illustrates, the returns were quite strong in the initial months following a one standard deviation crossover, averaging well above 40% (note that returns in the 10/79 to 1/80 period heavily skewed those results). However, both periods exhibited a prolonged period (27 months) of hefty declines (greater than 20% annually) following the peak. In other words, short-term "trading" gains gave way to longer-term "investment" losses, in our view. Yes, gold prices have been able to sustain a reasonable move above the one standard barrier for 9 months currently, adding fuel to bullish arguments, but we question their resilience, particularly against today's tame inflation backdrop.

Table 2: Economic Forecast Snapshot

	2009	2010	2011
Real GDP (yoy %)	-2.5	2.4	2.8
CPI (yoy %)	-0.4	1.9	2.2

Source: Bloomberg Consensus

Table 1: Return Analysis When Gold Crosses + 1 SD

		Holding Period Return				Annualized Return	
	Months to Peak	Nominal	Inflation Adjusted	Avg. CPI	Months to Trough	Nominal	Inflation Adjusted
10/79	3	70.9%	64.8%	13.5%	29	-25.8%	-32.2%
10/82	3	18.0%	18.3%	4.3%	25	-23.3%	-26.2%
Average	**3**	**44.5%**	**41.5%**	**8.9%**	**27**	**-24.5%**	**-29.2%**
1/09	**?**	**8.6%**	**6.8%**	**-0.9%**			

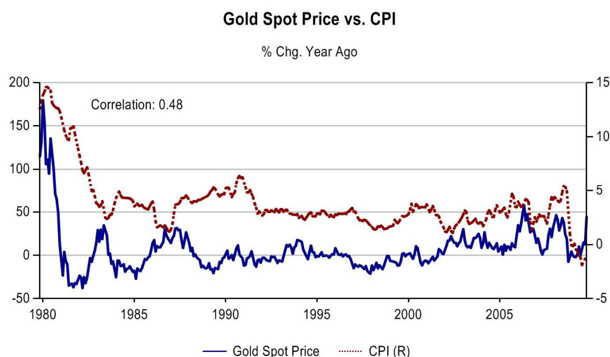
Source: Oppenheimer Asset Management Investment Strategy

Gold is traditionally a hedge against inflation and economic weakness…

A benign inflation and improving economic outlook is likely to weigh on the price of gold.

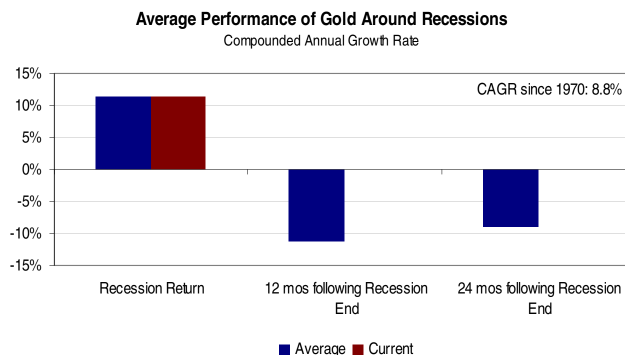
Gold has traditionally been used as a storehouse of value to hedge against disruptions such as inflation and economic weakness as opposed to an increase in value (e.g., stocks, bonds) by investors. Although this premise is sometimes debated, history appears to support this conclusion – when adjusted for inflation the long-term average annualized return of gold is roughly equal to the average 3 month Treasury bill rate (i.e., risk free rate). Historical data appear to support the notion that gold can perform reasonably well during periods of inflation and recession. For example, year-over-year changes in the price of gold and the CPI rate have exhibited a relatively strong positive correlation of 0.48 since 1970 (see Chart 2). In addition, as Chart 3 illustrates, the return on gold during recessions is roughly 3% higher than its historical average. Therefore, it would behoove investors to increase exposure to gold when inflation is rising or the economy is weakening. Consequently, it appears that today's outlook for inflation and economic growth is at odds with a bullish stance on gold – inflation is expected to remain subdued, while the economy is expected to return to growth in the coming years (see Table 2). A recovering economy is particularly challenging for gold, since returns are historically significantly negative, on average, for up to two years following the end of a recession.

Chart 2: Gold Typically Works Well as an Inflation Hedge



Source: Oppenheimer Asset Management Investment Strategy, Wall Street Journal, Bureau of Labor Statistics

Chart 3: Gold Performs Well During Recessions



Source: Oppenheimer Asset Management Investment Strategy, Wall Street Journal

…but not against US dollar weakness

The US dollar is not a useful indicator for gold investment decision making.

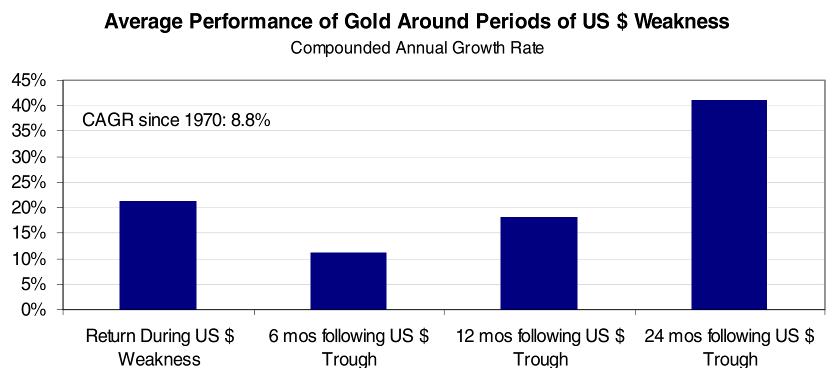
The US dollar has become progressively weaker since early March, although it has managed to remain above the multi-year lows established in April 2008. Concerns regarding US economic growth and the ballooning budget deficit have been largely to blame. While economic prospects have improved significantly over the past few months, there is still a fair amount of skepticism regarding the strength of the US dollar. As a result, investors have been increasing their exposure to areas perceived to be a hedge against the weakening US dollar and gold has been one of the more popular choices lately. While this strategy has worked for investors so far in 2009, we believe it is prompted by momentum rather than traditional investment dynamics. Our work shows that the US dollar and the price of gold have exhibited only a relatively weak negative correlation since 1970 (-0.2). Furthermore, our analysis indicates that the relationship between the two is somewhat tenuous. Yes, gold returns are typically well above average during periods of dollar weakness. However, as Chart 4 illustrates, gold returns remain well above average even when the US dollar begins to appreciate following periods of weakness. Therefore, we do not believe the trajectory of the US dollar is a useful tool for making investment decisions based on gold exposure.

Crude oil redux?

The similarities between current gold arguments and crude oil arguments from summer 2008 are cause for concern.

The similarities between current bullish gold arguments and those put forth for crude oil during the summer of 2008 are cause for concern, in our view. Much like then, few investors today are willing to accept the possibility of a significant pullback in the commodity. More important, conversations have moved away from the fundamental backdrop to things like momentum and dollar weakness to justify future gains (as they did for crude oil during the summer of 2008). Although we do not anticipate as violent a pullback for gold, we simply do not believe that the fundamentals support current price levels. As always, we believe it is important for investors to focus on fundamentals in their investment decision making process and avoid the temptation to chase performance.

Chart 4: The Trajectory of the US Dollar is Not A Useful Indicator for Gold



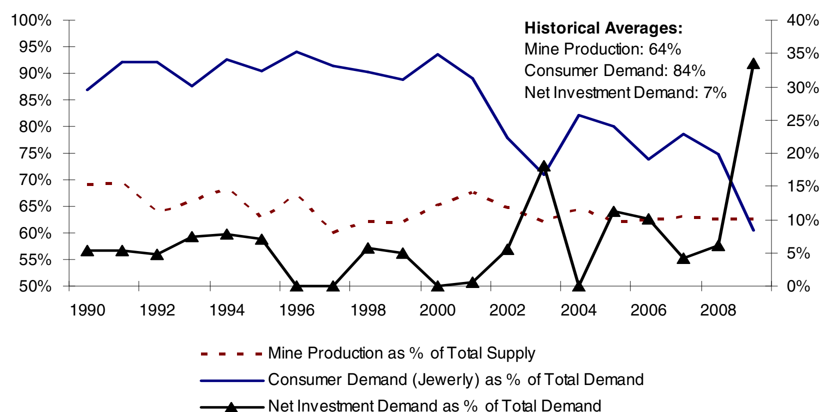
Source: Oppenheimer Asset Management Investment Strategy, Wall Street Journal

Fundamental trends for gold are troublesome

Gold supply and demand trends do not appear to support current price levels.

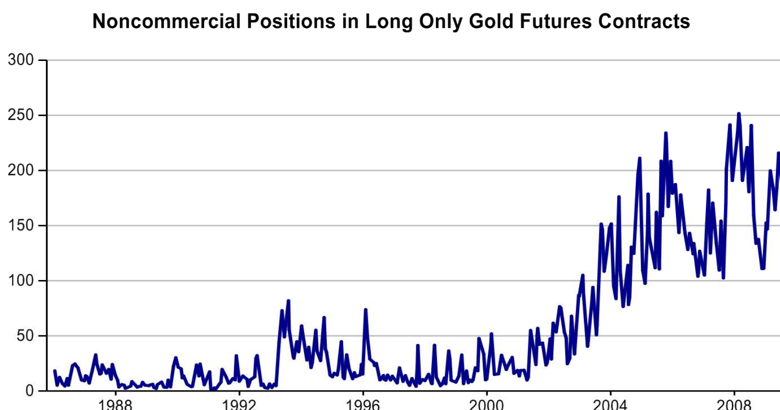
Over longer time periods underlying fundamentals typically determine the value of any asset, in our view. That is what troubles us about the ascent of gold prices. When you examine gold supply and demand trends, they do not appear to support current price levels. True, gold mine production has remained relatively stable since 1990, with production levels ranging from 60% to 70% of total world gold supply (see Chart 5). However, demand trends have changed quite a bit, particularly over the past several years. Consumer demand (e.g., jewelry, dental) has fallen significantly since 2004. For the greater part of the past 15 years, consumer typically represented about 84% of total gold demand, yet current levels are roughly 65%. In addition, net investment-related demand for gold has increased exponentially over the past 18 months, with levels surging to 35% of total demand versus an historical average of 7%. We believe this increase is due largely to investor speculation, and positions in noncommercial long-only gold futures spiking to all-time highs appear to support this notion (see Chart 6). We are particularly concerned about this trend, since it is usually associated with the formation of a speculative bubble. Furthermore, recent trends are eerily similar to those exhibited in long-only crude oil futures during the summer of 2008.

Chart 5: Gold Demand Trends Suggest Speculative Imbalances



Source: GFMS Ltd.

Chart 6: Gold Speculation Has Hit All-Time Highs



Source: Commodities Futures Trading Commission

Performance Statistics

Recent US Strategy Topics

Date	US Strategy Weekly
10/19/2009	Don't Be Fooled By Staples' Valuations
10/12/2009	Still Too Early For Small Cap
10/5/2009	3Q Earnings Preview
9/28/2009	Making Sense of Market Valuation
9/21/2009	Industrial Sector Themes
9/14/2009	Repositioning Sectors into 4Q
9/8/2009	Fears Regarding the Consumer Overdone
8/24/2009	Seasonal Patterns Actually Favor the Market
8/17/2009	Q2 Earnings Review
8/10/2009	Addressing the Housing Market Situation
8/3/2009	Shifting Focus To Value Over Growth
7/27/2009	The Recovery is Changing
7/20/2009	After Beta Trade, Focus On Quality and Value
7/13/2009	Dividend Consistency Matters
6/29/2009	Buy the Biotech Dip
6/22/2009	Industrial Selectivity
6/15/2009	Low Quality Trade Ahead of Itself
6/8/2009	We Remain Optimistic on US Equities
6/1/2009	Time for a Discretionary Breather
5/26/2009	Materials' Weak Fundamentals Being Ignored
5/18/2009	The Rush to Become Market Weight Financials
5/11/2009	Health Care Is a Contrarian's Dream
5/4/2009	Technology Fundamentals Being Rewarded
4/27/2009	Large Cap Over Small Cap, For Now
4/20/2009	Unwinding the Negativity
	US Portfolio Strategy Update
9/14/2009	Changes in the Tactical Portfolio
	US Strategy Monthly
10/7/2009	October Chartbook
9/9/2009	September Chartbook
8/6/2009	August Chartbook
6/10/2009	June Chartbook
5/12/2009	May Chartbook
	US Strategy Update
7/16/2009	Q3 Outlook
4/14/2009	Q2 Outlook

Major US Indices

Index	1W	1M	3M	6M	12M	YTD
DJ Industrial Average	0.2	2.6	10.9	24.8	18.3	14.9
DJ Transportation	-2.2	-0.9	11.5	25.7	9.5	11.5
DJ Utilities	0.7	0.8	1.3	17.4	10.2	3.5
NASDAQ 100	0.6	1.7	10.3	28.4	42.5	45.5
NASDAQ Composite	-0.4	0.9	10.1	27.8	34.0	37.3
Russell 1000	-0.4	1.8	11.8	26.8	23.8	22.8
Russell 1000 Growth	-0.1	2.4	9.9	25.2	30.3	29.5
Russell 1000 Value	-0.7	1.3	13.9	28.3	17.0	16.0
Russell 2000	-1.6	-1.2	11.8	28.1	22.2	22.8
S&P 500	-0.3	2.0	11.6	26.2	21.9	21.0
S&P 500/Citigroup Growth	0.4	3.1	10.5	25.5	29.4	25.6
S&P 500/Citigroup Value	-1.1	0.7	12.9	27.0	14.0	16.1
S&P Mid Cap 400	-0.5	0.9	14.3	29.2	34.1	32.1
S&P Small Cap 600	-1.6	-0.2	11.3	26.7	20.5	20.5

Source: Oppenheimer Asset Management Investment Strategy. Prices as of 10/22/09

S&P 500 GICS Sectors

Sector	1W	1M	3M	6M	12M	YTD
Consumer Discretionary	-0.1	2.2	13.7	24.3	39.6	32.0
Consumer Staples	0.1	3.5	7.7	22.5	12.6	10.1
Energy	0.9	7.1	13.8	25.8	30.1	16.7
Financials	-1.9	-0.2	23.2	40.1	5.2	22.2
Health Care	-1.0	0.4	4.1	21.9	12.3	9.0
Industrials	-0.8	-0.6	16.6	25.4	15.1	14.5
Information Technology	0.4	3.1	10.7	29.8	44.1	49.9
Materials	-1.1	0.4	12.6	29.4	35.3	41.3
Telecommunications Services	-0.1	-1.8	-1.5	0.6	11.5	-6.5
Utilities	1.0	1.5	1.3	18.3	10.7	2.8

Source: Oppenheimer Asset Management Investment Strategy. Prices as of 10/22/09

S&P 500 - Top & Bottom 10 Performing Industries, Trailing Week

Top 10	1W	1M	3M	6M	12M	YTD
Health Care Technology	15.4	13.9	47.6	42.7	28.1	16.0
Real Estate Management & Development	7.0	9.6	38.1	91.0	152.7	215.3
Personal Products	5.9	11.0	20.4	54.7	29.3	45.9
Machinery	5.2	6.5	22.2	37.4	50.7	36.4
Office Electronics	4.4	-12.8	1.6	35.0	0.6	0.8
Thrifts & Mortgage Finance	3.8	2.0	2.5	5.9	-15.6	-11.1
Internet Software & Services	3.4	8.1	18.5	38.0	53.6	71.2
Consumer Finance	2.0	5.7	24.6	60.6	32.5	63.3
Household Products	1.9	2.8	4.7	20.5	4.8	-0.3
Automobiles	1.8	11.8	17.8	43.9	82.0	125.2
Bottom 10	**1W**	**1M**	**3M**	**6M**	**12M**	**YTD**
Industrial Conglomerates	-6.0	-6.3	24.5	30.0	-7.3	5.3
Airlines	-5.5	-5.8	20.1	17.9	-25.4	3.8
Biotechnology	-5.3	-4.4	-4.7	9.0	3.2	-7.1
Diversified Financial Services	-4.9	-3.1	26.5	47.4	-11.1	25.3
Wireless Telecommunications Services	-3.1	-9.1	-8.6	-4.9	10.2	40.7
Distributors	-2.9	-3.4	7.7	8.3	9.5	-0.1
Containers & Packaging	-2.4	-0.4	5.5	34.1	28.9	23.7
Internet & Catalog Retail	-2.3	0.3	12.0	20.2	95.1	94.7
Construction Materials	-1.9	-7.4	10.5	1.9	4.5	-24.6
Semiconductors & Semiconductor Equipment	-1.9	0.5	4.3	27.8	40.8	44.8

Source: Oppenheimer Asset Management Investment Strategy. Prices as of 10/22/09

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