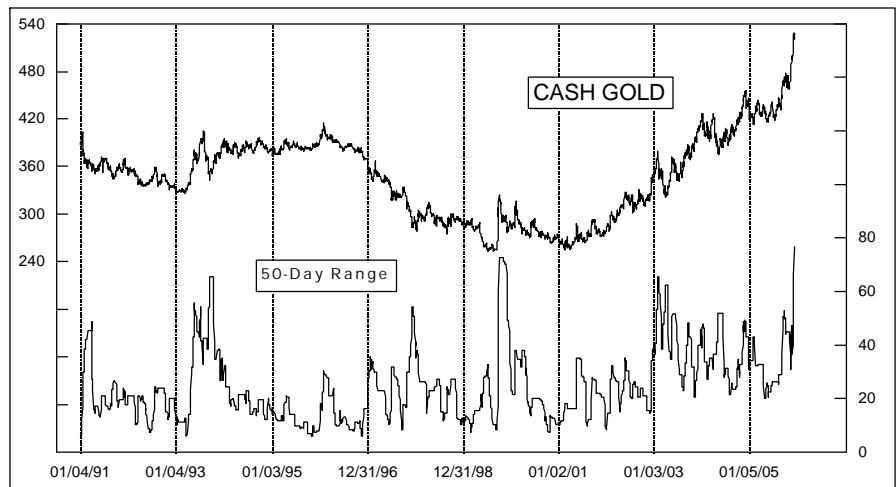


Blowoff Top In Gold an Historic Event

In a couple of years, people are going to be looking back and asking each other, "Do you remember that big gold blowoff back in '05?" Then they'll co-opt the line uttered by thousands of Texas oil men, and say, "Lord, just give me one more of those gold bubbles and I promise not to screw it up this time."

Our mission at this point, as analysts and investors, is not to decide whether this is a blowoff top or not. The market has made that pretty clear in the past few days. Instead, our mission is to figure out what this means for the future, and not to get misled by contrary signs which might pop up to confuse us in the near future.

The top chart on this page shows the cash price of gold compared to its 50-day high-low range. A couple of things are worth noting as we start out. First, gold tends to make more rounded bottoms, and more spiked tops. This is



the opposite of the stock market, for example, which tends to have quiet, rounded topping action and panicked, violent and volatile conditions at bottoms. Second, seeing a big range over a 50-day period like we have right now is a condition that reflects that spiky top nature of gold prices. Such high readings tend to only appear at important price highs.

That chart also allows us to see that the recent run up from the congestion

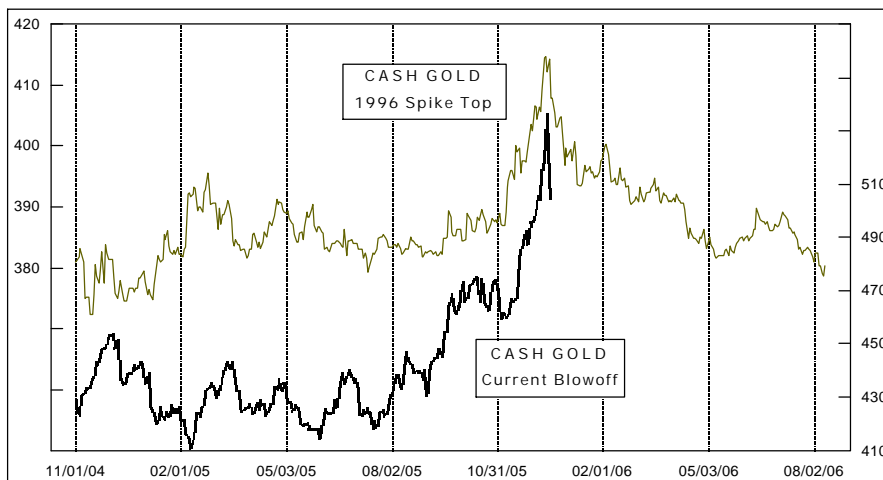
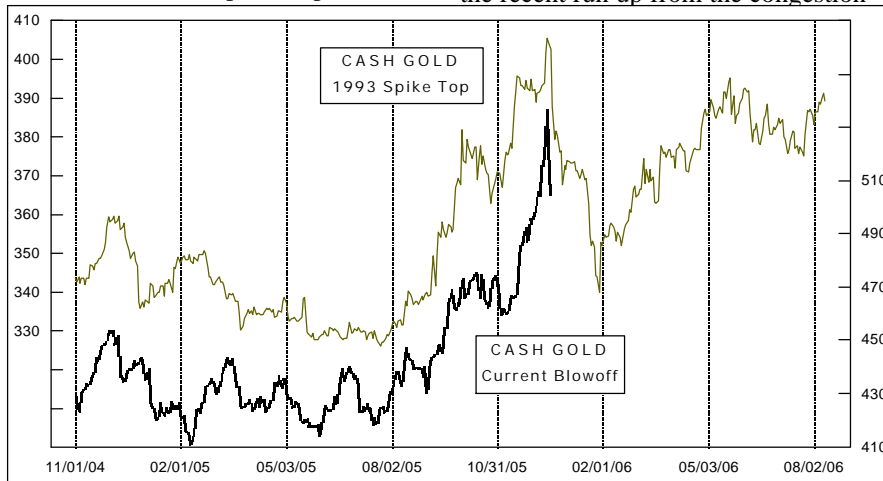
earlier this year at around the \$420 level dwarfs any of the other price structures in this 15-year chart history. Clearly, something unusual has just taken place, and now we get to see the after effects.

The point to understand about blowoff tops is that once the blowoff is completed, then what follows is a thorough dismantling of most or all progress that had been made on the way up. Each of the different blowoff tops varies somewhat from one to the next, but the common thread among them is that the slope of the decline after the top is very much symmetrical to the slope of the advance on the way up.

The middle chart compares the current gold price top to the blowoff top of Aug. 2, 1993. The lower chart shows a comparison to the Feb. 5, 1996 top. These comparisons allow us to see that the chart structures leading up to the blowoff top were similar to the current structure in both cases. It is reminiscent of the way that a pole vaulter traces out his steps beforehand on the runway, so that each time he approaches the vault the steps are nearly the same.

Most notable is the hesitation structure which formed during October and early November 2005. It closely matches a similar choppy sideways structure that formed in May and June 1993, leading up to that final Aug. 2, 1993 top. It also resembles another choppy structure which formed December 1995 ahead of the final run up to the February 1996 top in the lower chart.

In each of these cases, the selloff which followed was very severe. 1993's example saw a quick downside hit, perhaps too quick because it

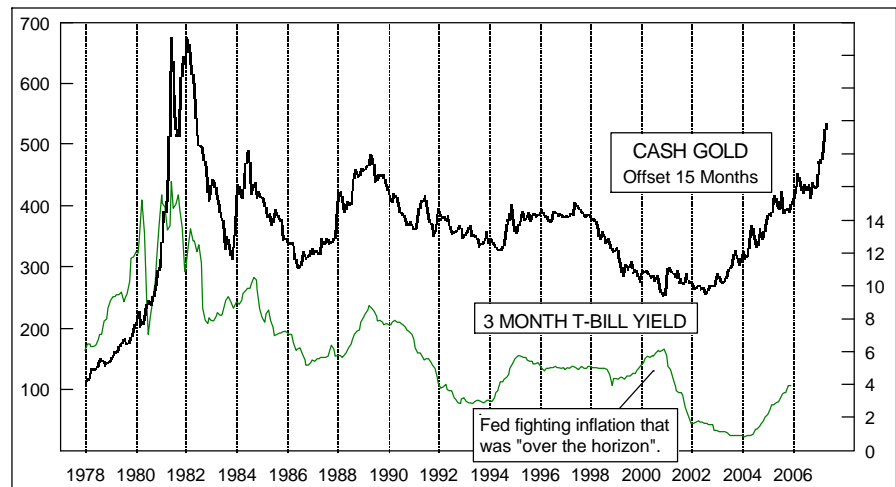


exhausted all of the selling pressure in just a couple of months. That selloff still erased nearly all of the gains that the gold bulls had needed 5 months to build, and did so in only a two month decline.

The 1996 blowoff top also saw its rapid drop immediately after the price high, losing about 2/3 of the magnitude of the rally in just 6 weeks, but then proceeding to give away the rest of it and more over the months that followed. In that 1996 case, the more gradual selling kept the selling pressure from washing out all at once, which kept the downtrend going for longer.

If the 2005-06 instance is like either of those prior examples, then we can count on a huge decline between now and mid to late January. We have already seen a big price drop in just the first two days, but that is just a down payment. To erase the entire run up to the blowoff top would mean a return to the \$420/oz area. That's not a prediction or an objective, just a statement of how much more downward movement is yet to be done to completely erase the run up to the blowoff. Erasing the run up to the blowoff is the mission of the post blowoff decline.

Now, if you don't care at all about gold prices, or gold as an investment, then you have probably already quit reading this by now. But just in case you are still hanging on, waiting for the "so what" moment of insight, then this final chart is what ought to make you care. It compares the monthly cash price of gold to the 3-month T-Bill yield. The difference is that we have slid the gold price pattern forward in this chart by 15 months, in order to show how gold acts as a leading indication for short term interest rates.



Gold actually serves as a leading indication for inflation, but short term rates respond to inflation which is what makes this relationship work.

The rise in gold prices that we have just seen has not yet been fully reflected in short term interest rates. Certain members of the FOMC might think that they are almost done raising the Fed Funds Rate target, but they are going to realize in 2006 that inflation pressures compel them to continue raising short term rates further than they thought.

We may not see the equivalent magnitude of blowoff in short term rates that we have just seen in gold prices, but the upward pressure on interest rates should continue for about the next 15 months. Blowoff tops in 1984 and 1993 saw corresponding rises in short term rates, even though the gold uptrend was relatively short-lived. The 1996 blowoff top which we show for comparison above was actually fairly small in terms of gold price movements, so its effect on interest rates was much more muted.

The Fed erred in early 2000 by

thinking it was smarter than the market, and trying to fight inflation which was not yet evident but which was thought to lie "over the horizon". Once they realized their mistake, they had to overcompensate by drastically cutting rates all the way down to 1%. Those low rates, and the ponderous rate at which the Fed has been "removing policy accommodation" have had the result of creating the tremendous amount of excess money that has been driving gold prices upward. That excess money will gradually get converted into price inflation over the next 14 months, to which the short term rates will be rising in response.

Bottom Line: The blowoff top we have just seen in gold should mark the end of the up move, and now the expectation is for most of those gains to be erased over the coming weeks and months. Inflation and rising interest rates will still be with us for another 15 months, in response to this gold spike. Resist the temptation to buy gold as a hedge against that coming inflation, as that opportunity is already passed.

THE McCLELLAN MARKET REPORT

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