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winter 2010

The Refined Investor

2010 - The Case for Gold in the New Decade

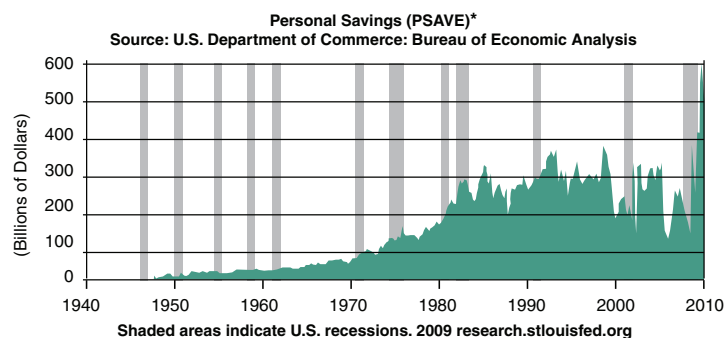
By Tony J. Anzalone, CFA

The new decade has begun and investors look to their new calendars with unsure footing of what lies ahead. We stare at the economic terrain and see a jagged path caused by a recession that has lasted 27 months and by all records is one of the longest in the last 70 years. We are engaged in two wars. The dollar is weakening by the day. Our economy languishes as confidence remains low, the deficit climbs, and U.S. unemployment remains around 10%.

Gold has been one of the bright stars in investments over the last decade delivering over 14.2% annualized return during the period. Recently, gold made history breaking \$1,200 an ounce and after some minor year-end selling still remains near that level. As the metal enjoys this historical moment, can a case still be made to buy and/or hold this investment at these prices? The answer, I believe, rests on the next step regarding these key economic realities.

Inflation

Inflation is often defined as "too many dollars chasing too few goods." Gold has historically benefitted from this scenario but the year will probably begin with minimal, if any, inflation. The reason will be that only half of the above definition has been fulfilled. Dollars have been pumped into the system either directly through the treasury or indirectly through stimulus and bank injections. However, these dollars have not resulted in the chasing part. Individuals and businesses alike are behaving cautiously as a greater percentage of discretionary dollars are used for debt reduction and increased savings.



*Personal Savings is defined as the amount of personal income that is not consumed. Note the dramatic increase in savings beginning in 2008.

Over 70% of the U.S. economy is based on personal consumption, the rest is the sum of business investment, and government expenditures including defense. For personal consumption to spike (*chasing*), increased consumer confidence and job creation are key.

At some point, whether slowly or swiftly, the business cycle will move from trough to peak. Meaning, job creation, increasing personal incomes and improved confidence will drive economic expansion. Similar to the mid 80's and mid 90's, old spending habits may very well resume as money and low interest debt are made freely available. Increasing consumption with ample supply of cheap dollars should ultimately result in inflation. It is at this point the Federal Reserve will have a difficult decision to make. Raise short term rates and possibly stall a recovery or keep rates low and deal with inflation later. Based on recent history, the Fed is likely to keep rates low through a recovery and risk inflation. This scenario will certainly help gold ascend to new levels.

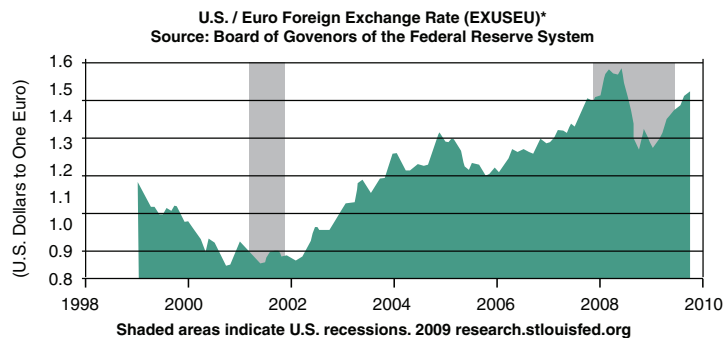
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FidelityTrade Incorporated[®] is a full-service precious metals company specializing in the sales, trading, custody, and delivery of precious metals bullion products for individual, commercial, and institutional clients worldwide.

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U.S. Dollar

One of the fundamental drivers that pushed gold prices during the last half of 2009 has been the relative weakness of the U.S. dollar. The unofficial dominate world currency is testing the will and patience of our global partners who rely on a stable and strong currency. As the U.S. struggles to pull itself out of recession while pursuing other domestic and international priorities, debt grows to new levels. This untenable behavior creates uncertainty among our global peers with respect to our currency. The recent gold purchase by the Indian central bank for \$6.7 billion could be a sign of the uncertainty with our currency as a store of value.

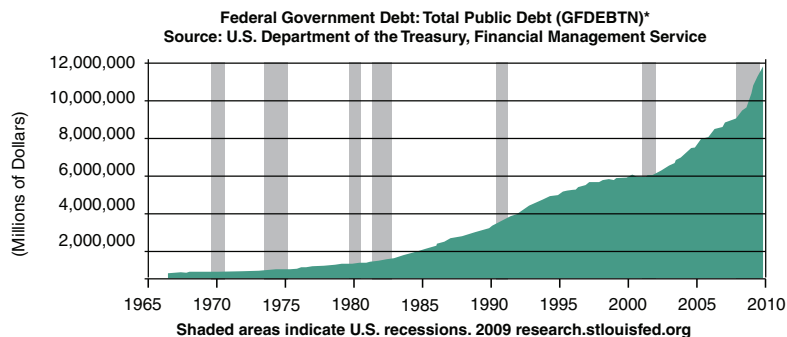


*With the exception of a flight to the dollar during the height of the financial crisis, since 2002 the U.S. dollar has been steadily declining in strength relative to other currencies.

The dollar has some serious dilemmas to deal with in the next decade. As the world questions the validity of having the U.S. dollar as the premier global currency, America will likely focus on domestic priorities over international concerns. Cheap abundant dollars will aid in the recovery domestically and should give a boost to our exports; good news for Detroit. Globally, the central banks around the world might reconsider their holdings in dollars and reposition towards gold.

Is Solvency Important?

The next buzz word in geo-economics will be *solvency*. In 2008, U.S. debt to GDP reached an all time high of 73%. In 2010, this ratio is likely to be near 95% and will continue to rise. The U.S. will reach a point where payment on the interest of our current debt will only be possible through the issue of new debt.



* Total Public Debt is the sum of all securities outstanding including U.S. T-Bills, Notes and Bonds. By the end of 2008, the total U.S. debt was \$10.6T compared to GDP of \$14.4T.

Recently, Moody's Investor Services maintained that the U.S. will keep its Aaa rating, albeit barely. The catalyst which keeps us rated on the top tier in the midst of our deteriorating public finances is our ability to incite change.

"... (the U.S.) may test the Aaa boundaries, but which display, an adequate reaction capacity to rise to the challenging and rebound."†

But what if the buyers of our debt do not have the same confidence in our reaction capacity? Simple, they will demand higher rates to offset their perceived risk. If the world demands higher rates while the U.S. is locked into a low rate methodology, this disconnect could uncouple the financing machinery that all parties were counting on remaining intact.

"If you come to a fork in the road, take it."
— Yogi Berra

The Crossroads for Gold

Gold has enjoyed a wonderful ride and has certainly reasserted itself as a key investment of the last decade. After achieving such impressive gains over the years, is there still room for more? The answer should be yes if these issues continue on their current path.

Inflation:

If the Federal Reserve determines inflation is a better risk given our economic realities, gold should find new legs as the historical inflation hedge scenario plays out.

The Dollar:

The weakened dollar does have advantages domestically. However, if the global economies beat us out of the chasm from which we have all fallen, the dollar will suffer to the benefit of gold.

The Economy (U.S.):

How we manage our debt is more important now than in any time in our history. After all, the world is watching. For better or worse, there is a symbiotic relationship between the Aaa economies and the rest of the world. Perhaps no better explanation of this than a 90-day T-bill that pays 0% interest selling out in minutes. The safety and solvency of the U.S. government as an "institution" has value.

If the perception of that value was to suddenly change; if the \$3 trillion transacted every day in foreign exchange markets were diverted to other investments, watch gold ascend as the dollar and the U.S. as an institution fall further in to chasm.

†Source: Moody's Investors Service, LLC. "Announcement: Moody's comments on Aaa-Rated Sovereigns as Global Economic Recovery Begins". December 8th 2009.

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