U.S. Global Investors Special Report

Two Key Drivers of Gold Demand: **Fear Trade and Love Trade**

Wall Street has been calling gold a bubble since 2005 when prices hit $500 an ounce and gold's continued 30 percent rise to record levels in 2010 has given media naysayers added ammunition to downplay the yellow metal's intrinsic values.

Whenever you have negative real interest rates coupled with increased deficit spending for social welfare, gold tends to rise in that country's currency.

Interestingly, despite gold's run, it has still been a laggard compared to many other commodities. In fact, gold didn't even place in the top half of the commodities world in 2010. Against a basket of 14 commodities from aluminum to wheat, gold's 29.5 percent return placed it eighth. Palladium took the top spot with a 96.6 percent return, followed by silver with an 83.2 percent return.

We see two main drivers of gold demand: The Fear Trade and the Love Trade.

Fear Trade

The fear trade is what you often hear about from the media and the gloom-and-doomers. The fear trade is driven by negative real interest rates—where inflation is greater than the nominal interest rate—and deficit spending. Whenever you have negative real interest rates coupled with increased deficit spending for social welfare, gold tends to rise in that country's currency.

In the U.S., with the second round of quantitative easing, or QE2, in full force, we're in the middle of an extended period of negative real interest rates that will likely last through 2011. The Federal Reserve is acutely aware that if interest rates should spike, it would be catastrophic for America's economic recovery. Given the elevated number of home foreclosures and high unemployment, the Federal Reserve won't risk a relapse by raising interest rates any time soon. The government is also unlikely to cut spending or welfare support during the healing process.

The Congressional Budget Office has set the U.S. deficit estimate for 2011 at $1.5 trillion. History suggests governments will devalue their countries' currencies before they cut government spending and use additional bureaucracy as a solution to high unemployment. Whatever measures are taken to trim the deficit, it will likely be a long, slow process.

Love Trade

The love trade is significant and unique to gold. People buying gold out of love and demand for jewelry was the biggest contributor to gold demand in 2010, accounting for 54 percent of the total.

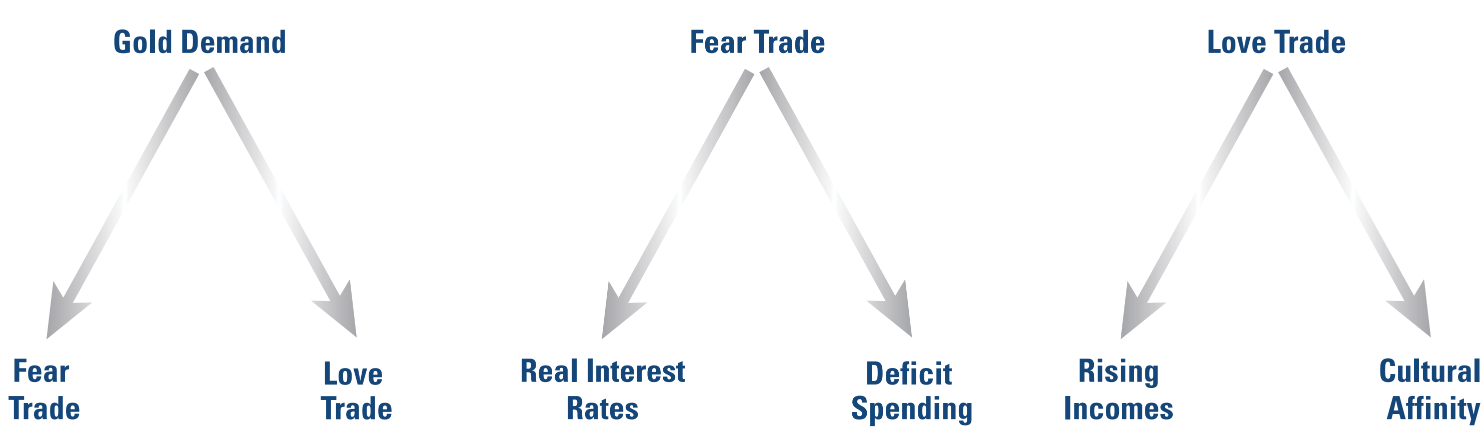
Demand for gold in emerging economies is rising and remains the biggest component of the demand equation. The four strongest markets for gold jewelry demand (India, Hong Kong, China and Russia) accounted for 60 percent of the entire jewelry market in 2010.

Those in emerging markets are especially amorous of the yellow metal. It is customary in most emerging countries to give gold as a gift to friends and relatives for birthdays, weddings, and to celebrate religious holidays. This is why gold has strong seasonal characteristics.

Over the past four decades, September has been the best time for gold in terms of its month-over-month price appreciation. The strong period for gold begins with the Muslim holy month of Ramadan. Next comes India's post-monsoon wedding season, and in November there's the Diwali Festival of Lights, one of India's most important festivals. During the fall, jewelry makers in the U.S. and Europe stock up on gold inventory in advance of the Christmas shopping season. And in China, there are two significant gold opportunities: the week-long National Day celebration starting October 1, and the Chinese New Year in the early part of the following year.

Ignited by Diwali, Indian jewelry demand rose 47 percent on a year-over-year basis

The Two Main Drivers of Gold Demand:



For the Love of Gold

during the fourth quarter of 2010. For the year, Indian jewelry demand rose 69 percent to surpass peak levels set back in 1998.

Historically savvy gold buyers, India's influx of buying implies an expectation that gold prices still have much higher to go. The World Gold Council (WGC) says that "Indian consumers appeared almost universally to expect that the local gold price was likely to continue rising."

In Hong Kong, gold jewelry demand rose 26 percent to hit a 10-year high, according to the WGC. In China, buyers didn't shy away from record-high gold prices either. Purchases of gold jewelry accelerated 25 percent during the fourth quarter leading into the Chinese New Year. In December, the Shanghai Gold Exchange reported that China imported five times more gold in 2010 than 2009, and that was just during the first 10 months of the year.

The rise in Chinese gold demand goes hand-in-hand with a rise in average incomes for Chinese citizens. Last year, 20 million migrant workers in China saw their incomes rise 24 percent. Compare this to the U.S. where the job market has shown some signs of life, but continues to sputter.

With these higher income levels, many in China's middle class are looking to gold as a means for long-term savings and a possible hedge against inflation. The success of the WGC's gold accumulation plan is an example. It allows Chinese consumers to purchase small amounts of gold on a routine basis to build a portfolio.

With more than 1 million participants, the program has been so successful in its first year that the WGC and its domestic partner, ICBC, are launching a new program to encourage the gifting of gold bars. Gold bars as small as 10 grams can be stamped with the Chinese symbol for joy and given to one another.

This trend is just getting started. Currently, the E-7 countries—which refer to the most populous seven emerging economies—hold nearly half of the world's population but make up less than 20 percent of global GDP. The G-7 industrialized nations are a mirror of this; they host 11 percent of the world's population but control more than 50 percent of the global economy.

What is important to remember when looking at the history of gold is that in the 1970s, the world's population was only 3 billion and China, India and Russia were isolationists with no significant global economic footprint. Today, we have witnessed an awakening of epic proportions. Many of these emerging

E-7 and G-7 Population vs GDP

E-7	Population (million)*	Nominal GDP (bn USD) 2009*
China	1324	4985
India	1157	1310
Indonesia	240	540
Brazil	199	1572
Pakistan	181	167
Russia	140	1231
Mexico	111	875
Total	3352	10679
	49% of world total	18% of world total

G-7	Population (million)*	Nominal GDP (bn USD) 2009*
USA	307	14256
Japan	127	5068
Germany	82	3347
France	64	2649
UK	62	2175
Italy	58	2113
Canada	33	1336
Total	734	30943
	11% of world total	53% of world total

Source: U.S. Global Research
*As of December 2009

Demand for gold in emerging economies is rising and remains the biggest component of the demand equation. The four strongest markets for gold jewelry demand (India, Hong Kong, China and Russia) accounted for 60 percent of the entire jewelry market in 2010.

economies are averaging over 6 percent GDP growth and personal incomes are rising around 8 percent. In addition, emerging economies are home to 27 percent of the world's purchasing power, according to economic research firm ISI Group.

These countries are growing with free market policies and massive infrastructure spending. In the 1970s, gold rose on the fear trade and the cold war. Today the world is significantly different: The love trade drives gold.

Outlook for 2011

Gold will be interesting to watch as a barometer of good and bad government policies. In countries such as China, where the embrace of free market principles has ushered in economic growth, gold demand levels should remain strong.

It is by no coincidence that 30 years after Deng Xiaoping took office in China and began instilling the concepts of free markets, the country has grown to become the world's second-largest economy behind the U.S.

If countries such as China and India continue to grow by 7 to 9 percent a year, the corresponding rise in incomes should keep the fire of the love trade burning. In this scenario, gold can continue to slowly appreciate.

It's impossible to predict where gold prices will be at the close of the year but we think they could double over the next five years. This would mean roughly a 15 percent return, if compounded annually. However, it will by no means be a straight line. Volatility is always inherent in commodity investing. It's a non-event for gold to go up or down 15 percent in a year—this happens the majority of the time. For gold stocks, the volatility is even more dramatic—plus or minus 40 percent, historically.

We have always suggested that investors consider a 10 percent weighting, split between gold bullion and gold stock funds, and rebalance their portfolios each year to capture the volatility and not chase return. Since gold was up almost 30 percent in 2010, it could easily correct from its peak by 10 to 15 percent. Investors looking to either add to or initiate new positions in gold must be aware of this volatility and use it to their advantage. When it comes to managing portfolios, we believe gold stock investors need to be active, not passive. Use sharp selloffs as cheap entry points and make sure to rebalance those portfolios in order to lock in profits.

Investing in Gold Through U.S. Global Investors

Gold is a portfolio diversifier. Since it has not been highly correlated with other financial assets, its inclusion in a diversified portfolio may provide protection against inflation and economic instability. Mining companies with growing reserves, production and cash flow also offer capital appreciation potential.

We have a history as pioneers in portfolio management in this specialized sector. The Gold and Precious Metals Fund (USERX) is the first-no load gold fund offered in the U.S. Our team brings valuable background in geology and mining finance, important to understanding the technical side of the business. The fund focuses on producers, companies currently pulling gold or other precious minerals out of the ground. These companies, often called "seniors," generally have the largest market caps in the mining sector. The World Precious Minerals Fund (UNWPX), which is also available in Institutional Class (UNWIX), complements our Gold and Precious Metals Fund by giving investors increased exposure to junior and intermediate mining companies for added growth potential.

U.S. Global Investors is a boutique investment advisor specializing in gold, natural resources, emerging markets and infrastructure opportunities around the world. The company, headquartered in San Antonio, Texas, manages 13 no-load mutual funds in the U.S. Global Investors fund family, as well as funds for international clients, and is publicly traded on the Nasdaq under the symbol GROW. Frank Holmes has served as company CEO since purchasing a controlling interest in 1989 and has served as chief investment officer since 2000.

For more information on the company and its products, visit our website at **www.usfunds.com.**

U.S. Global Investors