VOTED THE WORLD'S BEST INVESTMENT ADVISORY

Investor's Digest of Canada

September 25, 2009 Vol. 41, No. 17

Gold is entering a strong seasonal period

By John Embry

John Embry

Gold's price action during the dog days of August could charitably be called desultory with stout resistance being encountered anytime the price approached US$960 per ounce. The constant presence of a non-profit maximizing seller (i.e. government, central bank or their respective agents), albeit frustrating, was not at all surprising in view of the ongoing tenuous financial and economic situation and the unfolding positive developments in the gold market.

The steady flow of massive U.S. Treasury auctions have recently been added to the long list of events that require aggressive gold-price suppression. Gold is now always knocked down as these are occurring to create the impression that all is well on the inflation front. Fortunately, due to the inherent strength in the gold market, the price is rebounding ever more quickly once an auction is completed.

On a much more constructive note, there are increasingly more positive signs emanating from the central-bank front. The most bullish was the revelation by the World Gold Council that the world's central banks collectively accumulated 14 tonnes in the second quarter, which I believe is a first since at least 1987.

The importance of this cannot be overemphasized because, in the absence of central-bank supply, the gold price can do nothing but move higher in the future. As a follow up to this, it was revealed that Russia had bought nearly 20 tonnes in the month of July, its largest purchase yet in an ongoing accumulation program.

To complete the trifecta, the European central banks renewed their Central Bank Gold Agreement (formerly the Washington Agreement) with a lower annual sales quota of 400 tonnes, effective the end of this month. In reality, I believe this is just window dressing because, to date in the current fiscal year, they had sold only 144 tonnes out of an allotted quota of 500 tonnes with only a month to go. More importantly, virtually all of the signatories to the agreement have either already sold down to minimal levels or have stated their intentions of not selling anymore.

This probably shouldn't come as a great surprise in light of the fact that their previous sales of nearly 4,000 tonnes at materially lower prices under the previous two agreements don't look particularly clever in retrospect.

Switching to technicals, gold's 200-day moving average exceeded US$900 per ounce. for the first time in history on Aug. 19. This is very significant because it occurred at a time when gold has a powerful reverse head and shoulders pattern in place that projects a dramatically higher price.

Strong price pattern

A similar pattern in the fall of 2007 presaged a quick move from US$700 to US$1,000 per ounce. The fact that this is all occurring at a time when investor sentiment in the gold market is remarkably subdued further reinforces my view that everything is aligned for a significant rise to record price levels.

The evolving financial backdrop is certainly supportive of just such an occurrence. In late August, the U.S. authorities ruefully admitted that federal budget deficits over the next 10 years would total US$9 trillion, a 27 per cent increase over previous estimates due to the belated recognition that real growth would be lower and unemployment higher during the period.

In addition, there is the problem of the unfunded liabilities for Social Security and Medicare, which are now thought to be approaching the unfathomable amount of US$100 trillion.

I don't think that most people can even remotely comprehend these numbers, so it might be more instructive to break them down on a per capita basis. The estimated cumulative federal deficit for the next 10 years, which incidentally I believe is wildly optimistic, amounts to roughly $30,000 for every person in the U.S. and nearly doubles the existing burden. The unfunded liabilities are in the neighborhood of an unreal $300,000 per head.

When compared to the incomes and accumulated wealth of the citizenry, these numbers confirm the essential bankruptcy of the U.S. In reality, these obligations will either be reneged upon or inflated away and, irrespective of the avenue chosen, the U.S. dollar is toast.

This reality has not been lost on the Chinese who, at this point, are the U.S.'s largest creditor. There was an important meeting in Washington between senior American and Chinese officials in late July to discuss American plans to address this issue.

The Chinese sought reassurance that the Americans could rein in their profligacy and pointedly asked whether the U.S. could "properly handle the impact of the dollar supply on the domestic economy and the world economy as a whole." In response, the U.S. Treasury Secretary Timothy Geithner pledged that the U.S. will shrink its budget deficit over the next few years and boost national savings.

Unfortunately, carrying out this pledge is going to be difficult if not impossible. Nouriel Roubini, the prescient economist, perhaps summed it up best in a recent *Financial Times* op-ed piece, when he observed that if governments were to "take large fiscal deficits seriously and raise taxes, cut spending and mop up excess liquidity soon, they would under-

mine recovery and tip the economy back into stag-deflation (recession and deflation)."

The depth of the American malaise is perhaps best illustrated by the July federal budget deficit of $180 billion, a number that exceeded actual government revenues during the month by $25 billion. This conclusively demonstrates that with revenues covering only 46 per cent of expenditures, the fiscal process in the U.S. is clearly out of control. What astounds me is there are still buyers of American debt, considering the predicted future deficits, their inflationary implications and the extremely low interest rates on offer.

While on holiday in Alaska last month, I had the distinct pleasure of re-reading Adam Ferguson's fascinating book *When Money Dies: the Nightmare of the Weimar Collapse*, written in 1975 but nearly impossible to obtain today. The author exhaustively chronicles Germany's descent into monetary hell following the First World War. Two things stood out to me and they were the German monetary authorities' failure to realize that their frantic money creation was the root cause of the hyperinflation which ensued and the public's resolute optimism and continued embrace of increasingly worthless financial assets until it was too late.

The monetary solons of the era, Haverstein et al, kept focusing on the symptoms; the cratering German mark internationally, the accelerating domestic inflation and the apparent chronic shortage of money to deal with the conditions, rather than acknowledge that the unlimited money printing was the real issue. Thus, they just kept creating more and more money, routinely adding zeros to the currency, until a devastating hyperinflation totally destroyed the system.

While it is almost impossible to conceive that such an event could occur in modern American, there are some disquieting similarities. Fed Chairman Ben Bernanke recently reiterated that interest rates would remain at minimal levels for the foreseeable future and that, if necessary, quantitative easing would remain in effect. He then confidently stated that there was little likelihood of higher inflation occurring as a result. I would beg to differ and, in support of my view, I quote from a brilliant study on gold by Erste Bank in Vienna, Austria:

"The strongly expansive policy being followed by central banks and the resulting money creation at historic levels as well as the massive expansion of government debt levels around the globe might make inflation THE problem of the coming years."

I couldn't agree more. I believe that inflation is ultimately a monetary event and, by extension, a currency phenomenon, so I draw very little comfort from Mr. Bernanke's soothing words at this time.

Fed chairman's role

It is worth noting that the very same Mr. Bernanke has just been reappointed Fed chairman for another term, a development which must have come as a considerable blow to President Obama's current chief economic adviser, Lawrence Summers, who reportedly was lusting after the post. One wag may have gotten it right when he opined that the best thing about Bernanke's reappointment was that Summers didn't get the job. On a more sober note on the subject, Stephen Roach, the chairman of Morgan Stanley Asia, made what I believe to be the most germane observation on the whole issue when he wrote in the *Financial Times:*

"This is a very short-sighted decision. While America's head central banker deserves credit for being creative and courageous in orchestrating an unusually aggressive monetary easing, it is important to remember that his pre-crisis actions played an equally critical role in setting the stage for the most wrenching recession since the 1930s."

If things don't work out for Helicopter Ben in the future (and I, for one, don't believe they will), he and his totally discredited predecessor Alan Greenspan will justifiably be held in equal disrepute.

To conclude, the gold market is coming into a strong seasonal period, the fundamentals are impeccable, the technical condition is strong and sentiment subdued. These conditions should foreshadow a successful assault on the US$1,000 per ounce level well before year-end.

John Embry is chief investment strategist at Sprott Asset Management.

© Copyright 2009 by MPL Communications Inc., Reproduced by permission of *Investor's Digest of Canada*, 133 Richmond St. W., Toronto, ON M5H 3M8