VOTED THE WORLD'S BEST INVESTMENT ADVISORY

Investor's Digest of Canada

August 21, 2009 Vol. 41, No. 15

All things considered, gold's been 'spectacular'

Anyone who has been patiently accumulating gold, using the orchestrated dips as opportunities to buy aggressively, has done exceptionally well to date. Thus it seems somewhat odd that, in the face of this enviable track record, the sentiment in the gold market is presently dominated by apathy as investors focus on the manufactured stock-market rally and the faint hopes for economic renewal.

John Embry

As a matter of interest, the current consolidation in gold under US$1000 per ounce for the past 16 months is following a repetitive pattern, seen twice before in this bull market. Gold was capped at US$450 an ounce for a 20-month period, commencing in mid-January 2004 and extending through September 2005, and then exploded to US$725 in the next 10 months. Following a subsequent vicious takedown that was strongly rumored to be U.S. government mandated, gold was then capped at US$700 for the 16 months leading up to September 2007, before rocketing to US$1000 in a mere six months.

Then, following the Bear Stearns meltdown that roiled financial markets in March 2008, gold was once again taken to the woodshed, trading down to just above US$700 at its nadir in October last year and has been consolidating under US$1000 ever since. I strongly suspect that the current bout of suppression is about to come to an end very shortly and that gold is on the cusp of a historic break-out above US$1000 per ounce. This should propel it into the US$1200 to US$1500 range, at which point it is highly unlikely that it will ever trade below US$1000 per ounce again.

That is a bold assertion but, as I have stated on several previous occasions, this isn't about gold, rather it is all about the value of paper money in which gold is quoted. Gold has been a constant store of value for millennia while numerous incarnations of paper money have come and gone, all of them without exception being debased to the point of worthlessness.

We are now experiencing the very same phenomenon with the fiat-currency system in place today. There are numerous red flags but, suffice to say, an estimated US$5 trillion funding requirement for the world's governments in the next 12 months is very symptomatic of the problem. There are not remotely enough available savings globally to deal with this issue, so quantitative easing or, less politely stated, unlimited money printing is here to stay.

In the face of this, a recent comment by Fed Chairman Ben Bernanke during Congressional testimony seems to have been conjured up in fantasyland.

"We also believe that it is important to assure the public and the markets that the extraordinary policy measures we have taken in response to the financial crisis and the recession can be withdrawn in a smooth and timely manner as needed," he stated, "thereby avoiding the risk that the policy stimulus could lead to a future rise in inflation."

What a joke! Any serious attempt to withdraw a significant amount of stimulus by either raising interest rates or shrinking the Fed's balance sheet would almost certainly crater the economy in its current fragile state.

It seems somewhat odd that, in the face of this enviable track record, the sentiment in the gold market is presently dominated by apathy as investors focus on the manufactured stock-market rally and the faint hopes for economic renewal

The depth of the U.S. financial malaise may have been best captured by Neil Barofsky, the inspector general of TARP (the Troubled Asset Relief Program) when he estimated that the bailouts, bank rescues and other economic lifelines could end up costing the U.S. federal government as much as $23.7 trillion. If that number seems daunting, it should because it represents 175 per cent of the current-year GDP in the U.S.

This makes Bernanke's observation some 18 months ago when he stated that the subprime crisis was contained seem particularly ludicrous today and calls into question his judgment. In any case, given his nickname of Helicopter Ben, which derives from his unfortunate comment years ago about dropping money from helicopters to forestall deflation, any suggestion from him about withdrawing stimulus in the current circumstances should be taken with a large grain of salt.

However, the true smoking gun in the current destruction of the value of paper money remains OTC derivatives, which are continuing to poison financial balance sheets worldwide. Estimates of the outstanding notional value of these ìweapons of mass financial destructionî range from US$592 trillion to US$1.4 quadrillion, depending on the source, but what difference does the actual number make? All you have to know is that unconscionable amounts of money are going to have to be created out of thin air simply to keep the financial system from imploding. The very prescient Jim Sinclair, who foresaw these problem years in advance, recently summed things up succinctly:

"There is no escape from the hyper-inflationary result of the infinite quantity of money being created to

fill the void of value in the now more than one quadrillion dollars worth of value-less OTC derivatives created between 1991 and 2009."

One of the primary reasons that gold hasn't already reflected the above circumstances in its price has been the western central banks' willingness to expend their finite gold reserves to the extent necessary to restrain gold and to reduce its attraction relative to financial assets. This sinister plan has worked reasonably well to date although they have been forced to stage a grudging, managed retreat since 2001. However their actions have both masked and contributed to the huge gap between natural gold demand and mine and scrap supply. Thankfully, their interventions may be nearing an end, not by choice, but by necessity.

At the same time that eastern central banks, which are awash in U.S. dollars, have unequivocally stated their intentions to purchase gold for the sake of diversification, the western central banks appear to be scraping the bottom of the barrel. This is evidenced by the virtual drying up of European central bank gold sales under the Central Bank Gold Agreement (originally known as the Washington Agreement) and by the presence of significant quantities of coin-melt gold in the market, which can only come from dwindling U.S. reserves. It would be hard to overestimate the positive impact on the gold price that the future absence of central bank supply is going to create.

This is occurring at the same time that mine supply continues to fall and I expect this circumstance to be ongoing for some time. During a period when many existing mines are being rapidly depleted and the somewhat better pricing environment is permitting a cutback in high grading, fewer discoveries of gold are being made. Those discoveries tend to be lower grade, are generally in less hospitable locations, particularly geopolitically, and are going to require staggering amounts of capital to develop. Thus, the economics of gold exploration alone virtually ensure significantly higher gold prices, aside from all the other positive fundamentals.

They say a prime attribute of all great investors is patience, but I must confess that the gold market is trying the patience of even the most stoic gold supporters. That is exactly the game plan of the anti-gold cartel. Fortunately, in the end, the fundamentals always win out and that eternal truth ensures that gold is on the launching pad for a moon shot.

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