

MARKETS AT A GLANCE

SPROTT ASSET MANAGEMENT LP

Beware Counterfeiters

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Long time readers know that we have written about gold many times over the last ten years, starting with an October 2001 article entitled “All that Glitters is Gold”. We first invested in the precious metal based on the belief that central bank sales were filling a fundamental supply deficit that existed in the gold market. We also wrote that if you believed in gold as a financial instrument you might envision a gold price appreciation of 45% to US\$400 per ounce, or even higher, as investors sought to protect their wealth in the ‘bear market’ that followed the 2000 stock meltdown. What a difference nine years have made. In 2010, Central Banks are now close to becoming net buyers of gold while mine output continues to decline. With major indices returning nothing to investors over the last ten years it has been a lost decade for stocks but an excellent decade for gold.

Gold’s recent appreciation in US dollars has led some market commentators to question its fair value. This is nothing new for gold – it has been criticized and downplayed as an asset ever since it came off its previous peak in 1980 of US\$850 per ounce. In our view, however, it is not gold’s value that is in question; it is the value of paper money.

Let us consider the supply and demand fundamentals of paper money. Clearly, the supply of paper money is technically infinite. This has, of course, not always been the case. For millennia, money was commodity based - its value was linked to goods produced from land and labour. It was impossible to counterfeit wheat, nickel, copper or other commodities and therefore impossible to counterfeit money. Money was viewed as a link to, or representative of, productive capacity. If you had money, you had the right to trade it in for something real, and therefore possessed real wealth.

Historically, gold, principally because of its preciousness, has been the commodity into which paper money has been convertible. Each paper note represented tangible, stored gold and included a promise to convert that piece of paper into a specific quantity of gold on demand. That “promise” provided an inherent protection to the holder and ensured that governments couldn’t print money indiscriminately.

The link between paper money and gold has been lost for many decades. With respect to the US dollar, the world’s reserve currency, it was severed during the last century during two stressful economic periods. The first official break took place during the Great Depression. The second break took place during the Nixon-era in the 70s. These events are instructive and warrant brief consideration.

While there are several contributing factors to the Great Depression, it was the money supply growth in the preceding years under the supervision of the Federal Reserve that was, in our opinion, the greatest contributor. The Federal Reserve System was created in 1913 on a promise of stabilizing the

banking system. What followed instead was an unprecedented growth in fractional reserve banking, as well as the money supply, which helped fuel the roaring 20's. The aggressive money printing created inflated values in bonds and stocks, which peaked in 1929. When the market began its precipitous slide, and the public began to realize that stock and bond values were artificially high, the populace began to convert its cash holdings into gold. The government lacked the ability to satisfy that demand and was thus forced to renege on the currency's founding promise of gold convertibility. It's important to point out that without this original promise of convertibility for citizens, the currency may never have been adopted.

In 1933, *The Gold Reserve Act* was passed by Congress and formalized into law the breaking of the gold standard. This law provided for a controlled-currency issue through the Federal Reserve System which was non-redeemable in gold. Although the link to anything tangible had been broken, the citizens had little choice but to continue using these non-redeemable dollars as a medium of exchange. The currency had already been broadly accepted, proven convenient and a perception of safety had already become entrenched.

After forty years of continued dollar printing, in August, 1971, President Nixon effectively declared the US dollar to be a completely "fiat" currency by refusing to allow foreign governments to convert their US dollar holdings into gold. The right of conversion which had been granted under the post World War II, Bretton Woods agreement could not be honoured because of decades of money supply expansion. The original 'promise', which had vaulted US dollar to its status as a global reserve currency and a stable store of value, was now completely broken.

These historical events resulted in a world in which all currencies are fiat; they are not backed by gold or any other tangible asset. The supply is infinite. In fact, the production of today's newly created paper money in relation to historical commodity-based money is akin to counterfeiting. A US dollar printed today has no ties to anything tangible and as a result carries only four cents of the equivalent purchasing power of a gold-backed dollar of 1913. It is ironic that in a poor choice of wording on Wikipedia, the definition of counterfeiting states that "it is usually pursued aggressively by all governments." It is only because the evolution of money has occurred slowly over generations that the obvious flaw with fiat currency is not widely understood.

The demand for paper money in its various forms has remained, in our view, surprisingly high. The public has, for the most part, been content to trust paper money and hold it in various forms (cash, money-market funds and bonds), even without any yield. Presumably, this is because it is perceived as being "safe". Bonds continue to be viewed and treated as highly conservative and ultimately "safe" monetary instruments. We are of the view that long-dated government bonds are one of the most speculative asset classes commonly held today. In order to truly value a long-dated government bond one must speculate what its future proceeds will be able to purchase in real goods and services. A prospective purchaser must try to determine the expected "real return". In the current environment of excessive government deficits and increased debt issuance, we feel certain that long-term bond holders will be disappointed. Quantitative Easing, a radical form of monetary policy which allows for the direct printing of money by central banks in order to purchase government debt (or other undesirable bonds of even lower quality) will ensure all varieties of paper money will not enjoy nearly as much purchasing power in ten or twenty years as they do today. We believe the yields being offered today on such instruments, when compounded over their duration, will prove to be immaterial considering the total loss of purchasing power suffered by their holders.

We are gold investors because we have made a specific and calculated bet against paper money. Simply put, we are betting against paper money as a store of value. We believe its supply will continue to increase. We do not believe that the world's major governments have any stake left in protecting it.

Government debt loads have grown so massive that printing them away has become obligatory - there is no longer any other feasible option left. In our view, the savers of the world should already be outraged by the dilution they have been forced to suffer at the hands of the Central Banks. Are we to infer that the limited reaction of savers to the combination of zero interest rates and debasement of currency is a result of “learned helplessness”?

For those that don't accept savings dilution as the ordinary course of business, how do investors protect themselves from this loss of purchasing power? We feel a conservative approach would be to ignore nominal prices entirely and focus on building real wealth with a strong weighting towards tangible investments. As currencies are debased it is 'relative values' that investors should use to make investment decisions, since nominal prices can be distorted. In the case of gold, it is pointless to debate its value in US dollars. There is no longer any tie between the two and it's clearly the value of paper money that should now be on trial, not gold. In future editions of Markets at a Glance we will continue to explore the investment themes and businesses that we feel that meet this strong relative valuation criteria.

We also wanted to prepare our readers and clients for the next leg of the gold bull market as it will prove to be extremely volatile. Gold bull markets are unique in that buying becomes driven by both fear and greed. Gold is quickly moving into the hands of those who are unwilling to gamble on fiat currencies or bonds as a store a value. The new owners of gold are unconcerned with its lack of yield but instead are focused on its historic ability to preserve wealth and its unquestionable value. Given the difficulty we have valuing paper money, it becomes extremely difficult to come up with a reasoned price target for gold. Today's gold market is significantly different from the gold market of the 1970s for two reasons: 1) Central Banks are more likely to be buyers of gold today and 2) They clearly have little ability to dramatically raise interest rates with the massive increases in government issued debt. Thus, it is easy to envision a similar twenty-five fold increase in the gold price that was seen between 1970 and 1980, which would result in a gold price today above \$6,000 per ounce. We expect the often quoted “1980 inflation adjusted high” of approximately \$2,200 to be achieved in short order. These targets may well prove to be irrelevant, however, as the quality of our lives will be more greatly impacted by the continued evolution of our money and how the general public chooses to value it, or not.



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