

# Credit-creation mechanism appears to be broken

By John Embry

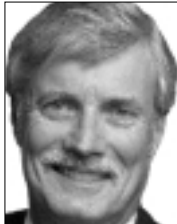
In the early part of 2008, gold and silver responded powerfully to the economic and financial turmoil unfolding in the U.S. Gold reached an all-time high of just over US\$1,030 on March 16, while silver comfortably exceeded US\$21 per ounce for only the second time since the Hunts attempted to corner the market in the late '70s.

However, both metals soon ran into a brick wall as the anti-gold gang made yet another stand. Veteran commodity trader Dan Norcini, an associate of the legendary gold savant Jim Sinclair, perhaps described the situation best when he wrote in early March (before gold hit four figures):

"Someone has nailed a big lid on gold and refuses to let it out of the box. There appears to be a near panic among the gold price managers to keep this thing below \$1000 no matter what happens to the dollar. The dollar literally went into a freefall after the horrendous payroll number hit but gold could not break through the wall of selling that almost instantaneously appeared above the gold market."

Make no mistake, there is a concerted effort to suppress the gold price. The central banks are worried about the message being sent by a sharply higher gold price while their bullion bank allies are agonizing over mounting losses on their outlandish short positions. All one has to do is observe what is going on in other commodity markets (oil, platinum, palladium, etc.) to appreciate the extent to which the gold and silver prices are being restrained.

To be fair, given the depth of the financial problems in the system, some might deem it appropriate to manage markets in an attempt to smooth the waters. However, I submit that from the very



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outset, the suppression of precious metals prices was one of the major contributors to the financial mess that we find ourselves in today, so an ongoing replay solves nothing and seems equally ill advised. I firmly believe that obscuring the truth in either economic matters or financial markets is ultimately a very bad idea. It merely postpones the eventual day of reckoning, and in the interim leads to severe misallocations of capital.

In my opinion, deception abounds at present. The U.S. authorities appear to have continuously misrepresented the inflationary impact of their fiscal and monetary excesses by distorting the published inflation statistics, primarily via hedonic accounting and substitution. All the while they have pointed to the well-behaved gold and silver prices as further evidence of supposed price stability in order to fool the public. Unfortunately, this spawned an environment of ridiculously low interest rates, excessive leverage and an explosion of noxious derivatives and structured products, the aftermath of which is now threatening to bring the system to its knees.

I find it almost laughable that economists are still debating whether the U.S. economy is in recession yet or whether a recession can be avoided. In my opinion, when one looks closely at the data, it virtually screams that the economy has been in recession for several months. Perhaps a more appropriate question at this time is whether the recession can be contained or are we fated to experience something materially worse.

I am a great believer in the Austrian School of Economics, whose doctrines make infinitely more sense to me than all the rest of the economic theory I have been exposed to. One of the key underlying precepts of the Austrian School is that all economic cy-

cles are based on credit creation and destruction.

In addition, as economic growth cycles mature they require more and more credit creation to create the same amount of real GDP growth. It wasn't that long ago that it took one dollar of credit creation to create a dollar of real GDP growth. Recently, it has taken five dollars of credit creation to create a dollar of real GDP growth.

**Five dollars of credit  
creation now needed to  
create a dollar of  
GDP growth**

This helps to explain the explosion in the ratio of outstanding debt to real GDP in the U.S., a figure that has reached levels never remotely approached before. In fact, we have experienced the worst credit excesses in living memory in this cycle. Now that the credit-creation mechanism appears to be broken, is it any wonder that the Fed is giving every impression of panic? Without sufficient credit creation at this juncture, the economy could simply implode.

Events in the financial sphere are almost surreal today. Perhaps nothing demonstrated this more than the sad fate of Peloton Partners, a well-regarded London hedge fund managed by some ex-Goldman Sachs whiz kids. In late January, they were basking in the glow of having won a number of awards for their outstanding performance in 2007. Roughly a month later they were out of business. Their highly leveraged mortgage-backed security fund went from being worth \$2 billion to being totally worthless in a matter of days, while their more mature \$1.6 billion multi-strategy fund is being wound up with significant losses to the participants.

It has become readily apparent that this is far from an isolat-

ed example. In response, in mid-March a group of central banks pledged to provide hundreds of billions of dollars to stricken financial entities and were prepared to accept numerous impaired assets as collateral. One wag termed this "the monetization of bankruptcy."

The central banks spun it a different way, suggesting that it was "intended to promote liquidity in the financing markets for Treasury and other collateral and thus to foster the functioning of financial markets more generally." That's all well and good, but the problem is not simply a liquidity issue; it is a matter of solvency, and that is a much dicier subject to deal with.

One can be assured of only one thing going forward and that is the introduction of any number of innovative actions to keep the system afloat. These initiatives will most assuredly result in a virtual blizzard of paper money being created.

Ben Bernanke, prior to his appointment as the head of the Fed, discussed his views on combating deflation and suggested the unlimited use of printing presses to create money. As fatuous as the proposal may have sounded at the time, it appears as if that day may have arrived. It is my considered opinion that gold will only become more and more valuable in this environment and one can't own enough of it.

Having said that, it is not inconceivable that it might take awhile to get through the US\$1,000 level with conviction, as this is a very significant number that central banks and their allies may defend mightily. Nevertheless, gold will trade past US\$1,000 and stay there, and this could herald a dramatic shift in the market's behavior.

There is often a huge psychological change of outlook that accompanies any asset that achieves a milestone price. I clearly remember the experience of the Dow Jones Industrial Average

back in the early '80s when the index finally broke through 1000 after 16 long years in a trading range beneath that level.

I was a money manager in those days rather than a gold specialist, and I recall the enthusiasm that the event engendered. It took awhile before most people believed, but it eventually underwrote a 12-fold move in the next two decades.

I don't think that parallel should be ignored as gold gears up to aggressively exceed the US\$1,000-

per-ounce level. The central banks are acutely aware of this and I anticipate their making the equivalent of Custer's Last Stand. I fully expect that the same fate that befell Custer awaits the central banks in their ultimately futile attempt to quell the gold price.

Turning to gold stocks, the performance in juniors has been abysmal, to put it mildly. One U.S. fund manager, who is much more statistically adept than I am, calculated that the junior gold shares are trading some eight standard devi-

ations below where they should be based on the current gold price.

In partial explanation, I have heard from reputable sources that U.S. hedge funds have a trade on in which they have shorted gold juniors against the senior gold stocks, which seems plausible given the current remarkable valuation spread between juniors and seniors. It was further suggested that a lot of the shorting of juniors was naked (i.e. selling short without bothering to borrow the stock).

If this is indeed true and the

gold price performs as I expect, there will be a day of reckoning for the shorts and an explosive move in the juniors. Considering how cheap they are currently, that would be more than appropriate.

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*John Embry is chief investment strategist at Sprott Asset Management. Views expressed are those solely of the author and should not be considered an indication of trading intent of any investment funds managed by Sprott Asset Management Inc.*