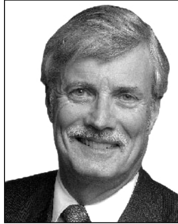
Despite Fed talk, there'll be no more rate hikes

By John Embry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Gold experienced a choppy, somewhat directionless summer, although considerable volatility was certainly in evidence. This was not surprising in that summer is generally characterized by thin markets due to vacations, ennui, etc. Those who would prefer to see precious metals markets contained had a relatively easy task effecting their plan.

However, fall is now upon us, and with the fundamentals for gold and silver looking particularly robust, I would be very surprised if gold didn't resume its uptrend with the 1980 all-time high of US$850 per ounce as the initial target. Silver may actually possess even greater upside potential in the near-term.

However, it will not be an unimpeded trip, and the words of Donald Kohn, a long-time governor on the U.S. Federal Reserve Board and presently vice-chairman, are worth considering. He is regarded as more of an "inflation hawk" than the chairman, Ben Bernanke, and when addressing the U.K. House of Commons in July on the subject of the unwinding of global imbalances, he stated:

"Continued strong demand for dollar assets will be critical to keeping that unwinding smooth and not disruptive. The Federal Reserve can contribute by being sure the public remains confident that the purchasing power of their dollar assets will not erode unexpectedly. As long as inflation expectations remain contained, relatively faster growth of the prices of imported goods for a time would be associated with only a temporary bulge in inflation and would result in a needed change in relative prices. The lesson from the 1970s, however, is that an unchecked or permanent increase in inflation would only feed back adversely on demand for dollars. Such an unmooring of the anchor of price stability could only elevate the odds on abrupt changes in interest rates and asset prices, instability in the U.S. economy, and disorder in global adjustments."

There you have it in a nutshell, the essential Fed strategy: deal with the containment of inflationary expectations rather than combat inflation itself, because of the deflationary implications.

Gold is regarded as a key inflationary barometer, thus it too must be contained. However, the sad reality is that mounting inflation is unavoidable if a financial implosion in the U.S. is to be averted.

This became abundantly clear with the release of the annual evaluation of U.S. financial conditions provided by David Walker, the U.S. Comptroller General. In 2005, the nation's total exposure with respect to future liabilities reached $46.4 trillion, markedly above the $20.4 trillion in liabilities five years earlier and a staggering four times current gross domestic product. The least painful method of dealing with this emerging financial catastrophe is by debasing the dollars in which it is denominated. Hyperinflation anyone?

Of more immediate concern is the rapid deterioration in the housing market, the economic lynchpin south of the border. Robert Toll of Toll Brothers, a leading home builder, recently said that in his 40 years in construction, he has never seen a slump like the current one.

This will imminently require reflationary steps, so I strongly suspect that, despite what the Fed says, we have seen the last of any interest rate hikes. I am equally sure that Fed spokesmen will seek to obscure this reality in order to sustain confidence in the dollar, a factor which Kohn acknowledges is paramount in avoiding an unpleasant unwinding.

The Achilles heel in this whole neat scenario could well be the gold price, which looks poised to move dramatically higher irrespective of Fed actions. We are dealing with a classic demand-supply imbalance as investment demand for gold mounts against a backdrop of weakening mine supply and dwindling central bank reserves.

The Chinese, Russians, and Arabs know full well that the massive quantities of U.S. dollars that they hold and continue to accumulate are going to be debased and, as a partial antidote, are purchasing gold. This phenomenon alone virtually guarantees an escalating demand-supply imbalance that can only be rectified by dramatically higher gold prices.

This potential is not going unnoticed by certain sophisticated speculators. The well-connected European bank, UBS, has noted a growing demand for gold call options dated December 2006 at strike prices over US$1,000 per ounce with additional appetite for longer-dated options at strike prices up to US$2,500 by late 2007.

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Anyone committing capital to these types of vehicles clearly has a very strong point of view on the opportunity in gold over the next 18 months.

A senior gold executive who appears to have emphatically joined the bullish camp is Ian Telfer, the irrepressible head of Goldcorp. He is currently predicting a surge to over US$800 an ounce over the next two years, modest by my standards, but outrageously optimistic in comparison to most of his fellow gold CEOs. They remain, in my opinion, remarkably myopic on the subject of higher gold prices.

One observer did suggest that Telfer would have to have that opinion to justify the "outlandish" premium that Goldcorp offered in its $8.6 billion bid for Glamis Gold. In response, I would say that people criticizing Telfer should be careful because his previous audacious acquisitions in his Wheaton River incarnation prior to the Goldcorp merger looked expensive at the time but turned out to be strokes of genius.

While I tend to share critics' views that the price Goldcorp paid for Glamis seemed excessive, I temper my criticism with the observation that the gold price that I anticipate in the not too distant future could make this union between Goldcorp and Glamis look like another brilliant maneuver. What Telfer has created is the go-to gold stock for conventional institutional investors and their support should comfortably lift the merged entity to unimagined levels as the gold bull market unfolds.

However, I don't make my living favoring the household names although I somewhat ruefully remember owning over 10 per cent of both Glamis and Goldcorp in my funds at the Royal Bank when they were emerging gold companies at the outset of the bull market in 2001. Today, the gold fund has no exposure to either, believing that much greater value exists further down the precious metals food chain.

Two names which currently intrigue me are **Premier Gold** (PG-TSX, $0.98, 807-346-1668) and **Great Panther Resources** (GPR-TSX\VEN, $2, 604-608-1766, *www.greatpather.com*). The former is a recent spinoff from Wolfden Resources and represents an interesting gold play in Red Lake.

With the current success being enjoyed by Southern Star and Exall Resources in the area, this is an inexpensive vehicle which may possess similar potential at depth. It already has a resource on one of its Red Lake properties and also has an exciting prospect located along the main iron formation that hosts the Goldcorp-Kinross operated Musselwhite mine. Chairman Ewen Downie has a proven track record at Wolfden, and he has hired Steve McGibbon, formerly the chief geologist and exploration manager for Goldcorp's Red Lake Division, as the company's chief operating officer.

Great Panther is an exciting silver operation in Mexico. Under the capable leadership of Bob Archer, the company expects to have annualized production of four million ounces of silver equivalent by the fourth quarter of this year with a target of 12 million ounces of production by 2010.

Given its current production and the prospectivity of its existing land package, particularly in the Guanajuato district, these ambitious plans seem achievable. With my oft-stated enthusiasm for silver, I am constantly on the outlook for promising silver plays and Great Panther seems to have the necessary requisites.

John Embry is chief investment strategist at Sprott Asset Management. Sprott funds may hold above-noted securities. For Sprott fund holdings, see www.sprott.com.

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