

Speech to The Silver Summit 2006

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GOOD MORNING:

It is a distinct pleasure to address you this morning on one of my favorite subjects, and I would like to thank the organizers of the Silver Summit for giving me this opportunity. For a metal often unfairly derided as the poor man's gold, I cannot tell you how impressed I am by the richness of intellectual independence exhibited by so many of you here today. It is a breath of fresh air within financial markets that seem increasingly dominated by a lemming-like refusal to deviate from conventional wisdom.

As many of you may know, I am rabidly bullish on the prospects for precious metals and have been for a number of years. The good news is that we have barely scratched the surface of this bull market and the better news is that I believe we are currently on the cusp of the next sharp up leg.

When people ask me where we are in the bull market, my response is that we are currently digesting the first stage, where we true believers made a lot of serious money while the public remained blithely unaware. I believe that the second leg of the bull market is about to unfold, in which the public will both recognize and drive precious metals towards all-time real highs.

I speak of gold and silver almost interchangeably in that I think they are currently both subject to many of the same influences, of both the economic and trading variety. I do, however, believe that silver will ultimately have materially greater upside potential, due to severely depleted inventories, new uses for the metal, and what can only be described as an enormous short position. The reasons for my optimism seem self-evident. However, much of the investing public has failed to appreciate the opportunity to date and their discovery of these reasons will fuel the second leg of the bull market.

The primary factor underpinning what will turn out to be spectacular upside in gold and silver will be the impending erosion of faith in paper money. The noted French philosopher Voltaire got it right some 200 years ago when he observed that, "Paper money eventually returns to its intrinsic value - zero." There are two tightly linked explanations for this conclusion. Literally speaking, paper money is inherently worth very little, relying on the continued faith of citizens to accept fiat currency as an acceptable method of payment and a reasonable store of value. No less than Alan Greenspan once warned against this faith continuing without interruption. Testifying before the U.S. Congress in 1999, the former Fed chairman expressed his belief that,

...gold still represents the ultimate form of payment in the world. It is interesting that Germany in 1944 could buy materials during the war only with gold, not with fiat, money paper. And gold is always accepted and is the ultimate means of payment and is perceived to be an element of stability in the currency and in the

ultimate value of the currency and that historically has always been the reason why governments hold gold..

Greenspan confined his comments to gold, but I believe the same stabilizing qualities typified by gold are also exhibited by silver.

From the first observation that fiat currency is inherently worthless, we can also understand its more consequential failings. Because governments can create paper currency at essentially no cost, and given the political imperatives that drive deficit spending, the structure of today's monetary system provides little obstacle to the ongoing debasement of currency.

This truth can be obscured for long periods of time, as the spectacular results in paper assets during the 1980s and 1990s certainly attest. However, my sense is that the decades-old bull market in financial assets is largely behind us. We now find ourselves on the slippery slope of a runaway credit expansion needed to sustain the debt build-up that went before. It is not a stretch to say that at this point, there is no turning back. Either credit creation continues to accelerate, or the U.S. economy in particular risks a dangerous lapse into deflation. An outrageous asset party could quickly morph into a vicious debt hangover.

Given the debt pyramid that has already been constructed, it will take greater and greater additional credit to generate a dollar of real GDP growth with each passing year. This could portend hyperinflation somewhere down the road, but I suspect that policymakers will judge this preferable to a deflationary collapse that could rival the 1930s. Indeed, Fed Chairman Ben Bernanke is an expert on "The Great Depression" and I doubt very much that Helicopter Ben wants to preside over its sequel. So despite admirable efforts to portray himself as an inflation hawk, Bernanke's academic work on the Depression firmly entrenches him in the dove camp.

But if Bernanke comprehends the dynamics of deflation, it is less obvious that he and financial markets are similarly cognizant of the risks posed by derivatives. Warren Buffett had the misfortune of having to unwind some relatively minor derivative positions in an insurance company acquisition by Berkshire Hathaway, and later described these financial instruments as "Weapons of Mass Financial Destruction." Some people argue that the proliferation of derivatives is akin to the tail wagging the dog. I would go further, and say that the tail may be swinging the dog around the room and bouncing it off all four walls. The notional amount of derivatives in the system today is preposterous, and raises the scary possibility that we have learned nothing since the Long Term Capital Management fiasco of 1998. With the notional value of derivatives now measured in hundreds of trillions, the mind boggles. What financial calamity a significant counterparty failure could reveal is yet to be seen.

At this point, suffice it to say that reported statistics on derivatives bear no resemblance to the world economy. Buried in a recent U.S. Office of the Comptroller of the Currency report was the fascinating revelation that J.P. Morgan Chase's derivatives book grew from a notional value of just over \$48 ¼ trillion in the 4th quarter of 2005 to \$53.75 trillion in the first quarter of 2006. To put this in perspective, the growth of \$5.5 trillion is equivalent to approximately 44% of annual U.S. GDP. In addition, Morgan Chase's outstanding book is over *four times* the

country's annual GDP. And although the largest player in derivatives markets, J.P. Morgan Chase is far from the only one.

This begs an obvious question: What is the purpose of these derivatives? For the longest time, my impression has been that the outsized use of derivatives relates not only to legitimate hedging activity, but also aids efforts to manage various markets. Whatever their purpose, the danger inherent in huge derivatives books seems clear. Past Fed Chairman Alan Greenspan was a leading apologist for derivatives, and would point out that only a very small portion of their notional value is ever at risk. Nevertheless, if even 1% of the Morgan Chase derivatives book is at risk, that would be extraordinarily significant when compared to its underlying equity. Thus, I tend to be very skeptical if a government official attempts to rationalize the explosion in derivatives. They may be the smoking gun that all is not well with the financial system.

The realization that both the financial system and its reserve currencies are shaky will lead to an inevitable loss of faith and confidence in paper money. This will drive people out of paper assets into tangibles. Despite the recent appreciation in the price of commodities, we have seen nothing yet. Their rise over the past few years has occurred because of favourable supply-demand imbalances. During this time, the faith in paper money has remained intact, as evidenced by the ongoing strength in the bond market. Patience, as always, is required, but a loss of faith in paper currency will be the biggest driver for gold and silver prices.

However, it is only one of several positive factors. Surging demand and stagnant supply have already driven many commodities up, and I certainly don't see this dynamic changing any time soon. The great news for silver is that above ground stocks, which for years weighed on the market, now appear to be seriously depleted. I'm not sure that the market fully recognized the impact of the above ground inventories, particularly those controlled by the Chinese. Their depletion represents a watershed bullish inflexion point. At the same time, important new uses for silver, particularly in the medical field, should easily sustain demand. There are others more qualified to speak on this particular subject, but allow me to say that I don't see fabrication demand for silver to be any sort of negative in the foreseeable future.

However, investment demand for silver will be another important new positive for the metal. I don't think one can overestimate the impact of the silver ETF over time as a powerful new force for demand. There are those who worry that the silver residing in the ETF may be used to influence the market at key moments, but I see that possibility as a minor negative when compared to the access the vehicle provides to the public to invest in silver. My partner Eric Sprott and I have been huge investors in physical silver, but it isn't the easiest thing to deal in or store. Thus, a lot of investors, both institutional and individual, who would otherwise not bother, now have a vehicle that makes it incredibly easy to get involved. As the second leg of the precious metals bull market gets underway, I think the silver ETF will really ramp up demand. In effect, investors can now own the metal with the same ease with which they would purchase a stock.

On the mine supply side of the equation, higher prices are expected to lead to greatly increased supply. If only it were so easy and simple. What goes largely un-remarked is how difficult it is becoming to get a mine into production. The cost of everything that goes into mining, both the variable and fixed expenses, has

exploded. In addition, the availability of competent personnel-miners, engineers, and geologists-is becoming a larger and larger issue. One close friend of mine, who runs a mining company in Canada, used the word “frightening” to describe the situation. He anticipates a dramatic increase in compensation for mining personnel across the board.

Another factor to consider is that in so many instances, silver is a by-product of base metal production. As you are all acutely aware, base metal prices have done spectacularly well. Yet they are much more dependent on the health of the international economy than precious metals, which will increasingly be seen as currencies rather than commodities. While I remain bullish on commodities in general over the long term, I strongly suspect that we could see a severe economic dislocation in the not-too distant future. This could damage the demand and price prospects for base metals. On the plus side, lower base metal prices should constrain production, which in turn would limit fresh supply of silver by-product.

Turning to geopolitics as a positive contributor to precious metals demand, I think the situation in the Middle East is arguably as tenuous as it has been anytime during my lifetime. Considering how long I’ve been around, that says a lot. With Iran seemingly progressing to eventual possession of nuclear weapons, the prospects for mayhem in that region are far higher than any rational human being would consider manageable. The implications for the oil price remain dramatic, despite the current quiescent period, and my partners at Sprott Asset Management think that oil is headed for triple digits. If oil production cannot rise materially from current levels, then growing demand in India and China alone should render this an easy call.

This has very positive implications for precious metals, which are already seriously under-priced compared to oil. If the average ratio of the price of oil to gold that has prevailed since 1971 were in effect today, gold would be close to \$1000 and silver would probably be at least \$20.

Perhaps even more important than oil, the U.S. dollar reserves that are piling up in central banks throughout the Middle East, Asia and Russia are going to be diversified into other assets, and I know gold and precious metals will receive more than passing consideration. Gold flows to where the wealth is being created. Not surprisingly then, bullion is leaving North America and Europe and heading for Asia. As Russia and China gain in economic strength, these trends will intensify. Gold and, by extension, silver, will increase dramatically in price in all paper currencies, but most particularly in the doomed U.S. dollar.

I’ve talked about the prospects for silver as an investment, but at this point I’d like to switch gears somewhat. In my opening today, I made reference to the lemming-like unwillingness of the mainstream financial world to deviate from conventional wisdom. As it pertains to silver, this herd mentality has manifested itself in two important, interrelated respects. First, mainstream investment professionals and press outlets cannot bring themselves to regard silver as money. Historically, this seems absurd. The Silver Institute notes that in 700 B.C. Mesopotamian merchants used the metal as a form of exchange. Not to be outdone, both the ancient Greeks and Romans employed currencies with substantial quantities of silver. More recently, the English sterling exhibited the stabilizing quality that silver contributes to the monetary system. Fast-forward to

today, and Hugo Salinas Price is endorsing a silver-backed currency for Mexico. Far from being a relic, silver seems poised to reassert itself.

In short, it is near impossible to ignore the longevity of silver's role as money. By contrast, the ancient empires would regard today's stockpiling of U.S. dollars as potentially useful for hoarding ink, but an exercise in wealth-preserving futility. This recognition is increasingly important in an age of depreciating paper currencies, confined to ongoing debasement by the twin burdens of accumulated debt and future government obligations. No less than Ben Bernanke has boasted that the U.S. government can create an unlimited supply of dollars via the supposed magic of the printing press. We should all give thanks that silver's value cannot be eradicated by the same means. If anything, the allure of precious metals will soar as investors come to realize the decline of fiat money.

It is exactly due to silver's historic role as money, and in particular the metal's relationship to gold, that governments and their allies have an interest in suppressing its price. This silver market manipulation, understood as part of a larger pattern of increasing market intervention by central banks, is the second major fact ignored by mainstream commentators. It is also the subject that will shape the remainder of my talk today.

I am concerned not simply that the price of silver is being tampered with, but that silver's natural allies mostly combat this activity with stone-cold silence. In the face of obvious price-fixing, the response is a neglect that is tantamount to aiding and abetting the manipulators. My abiding hope is that this silence will abate, that the silver community can summon the courage to stand up for themselves and their product, all the while permitting silver to reclaim its rightful role as money.

As some of you are no doubt aware, my colleague Andrew Hepburn and I have written two studies on market manipulation for Sprott Asset Management. Let me first discuss our 2004 report, "*Not Free, Not Fair: The Long-Term Manipulation of the Gold Price*". We carefully documented every major piece of evidence indicating that the gold market was unfairly influenced by the manipulative trading activities of central banks and well-connected bullion banks. Understanding that the subject was controversial, we provided a litany of footnotes to support our claims. It was our explicit wish that the investment community would engage our material, by either challenging our report on its merits, or accepting its conclusions and publicly voicing disapproval at the management of gold's price.

Neither occurred. Privately, we received very positive feedback from those inclined to the manipulation viewpoint. We have informed reasons to believe that some of the most well-known gold industry executives reside in this camp. Discretion demands that we not publicize our private indications in this regard, but fortunately the public record is sufficiently bountiful to show that the industry does not consider the allegations to be baseless.

In May 1999, John Willson, then chief executive of Placer Dome was quoted by the *Financial Times* as follows:

I find it difficult to believe, given what (Alan) Greenspan said in the middle of last year, concerning the central banks intention to maintain a low gold price, that there is not some concerted action going on between central banks to hold inflation down through holding down the price of gold.

Willson was not alone. Also in 1999, in response to persistent rumours that Gold Fields had recently sold forward large quantities of gold, the company issued a press release denying such actions. The statement quoted company chairman Chris Thompson asserting that,

These rumours appear to be emanating from New York-based bullion dealers. The seeming explanation for these unfounded and persistent rumours is a desire by the short end of the market, or the dealers, to talk the gold price down. We do not wish to be associated with these efforts.

Approximately a month after this press release, the *Sunday Times* of London quoted Thompson to the effect that “there was a large amount of circumstantial evidence that investment banks were involved in a plot” to depress gold prices. Later that year, AngloGold spoke of the industry’s role in achieving the September 1999 Washington Agreement, which limited European central bank gold sales and leasing. In an interview with the U.K. *Independent* newspaper, an AngloGold spokesman was quoted as acknowledging that, “[F]or a long time we, as producers, saw people manipulating our market and had no part in the game.” The spokesman’s suggestion was that this realization underpinned industry efforts to secure the central bank accord. Even charitably assuming this is true, the silence of the gold industry after the Agreement cannot be overlooked. Gold may be rising, but gold’s suppression has intensified. The gathering courage displayed by the gold industry in 1999 has disappeared. In its place, the silence of 2006 reigns supreme.

It’s one thing for people who believe a market is rigged to remain silent for fear of recrimination. What was so startling about our report on gold manipulation was the widespread refusal of detractors to publicly challenge our central thesis. Not one mining company publicly said we were wrong. Not one investment bank said we were wrong. And no central bank said so either.

Statements by central bankers that have surfaced since we published our report likely explain official reticence on the subject. First, in a speech delivered in 2005, William White, Head of the Monetary and Economic Department of the Bank for International Settlements, admitted that a major objective of central bank cooperation was “...the provision of international credits and joint efforts to influence asset prices (especially gold and foreign exchange) in circumstances where this might be thought useful.”

When, you might ask, might joint efforts to influence gold prices be useful to central banks? To answer this, one only need venture into the published memoirs of Paul Volcker, former chairman of the Federal Reserve. Discussing a multilateral agreement in the 1970s to adjust the exchange rates of the yen, European currencies, and the dollar, Volcker remarked that,

Joint intervention in gold sales to prevent a steep rise in the price of gold, however, was not undertaken. That was a mistake. Through March, the price of gold rose rapidly, and that knocked the psychological props out from under the dollar.

As John Brimelow, a very perceptive gold analyst, has delicately articulated, “One can infer that the mistake of allowing gold an unrestrained voice at times of policy shifts was subsequently guarded against.”

Volcker’s statement has important contemporary implications. On May 14 of this year, the *Guardian* newspaper reported the following:

The International Monetary Fund is in behind-the-scenes talks with the U.S., China and other major powers to arrange a series of top-level meetings about tackling imbalances in the global economy, as the dollar sell-off reverberates through financial markets.

Almost to the day, the price of gold peaked at \$720 an ounce. A good source of mine was told that around this time, the U.S. government ordered the gold price taken down, evidently fearful of the implications of bullion’s rise for financial markets.

Evidence pointing to surreptitious market interventions by governments is not confined to the gold market. In the course of conducting research for the second Sprott report, this one on stock market manipulation, my associate Andrew Hepburn uncovered a highly revealing statement by former Clinton advisor George Stephanopoulos on ABC’s Good Morning America. Speaking as a correspondent in the aftermath of September 11, Stephanopoulos described the government’s efforts to prevent a free-fall when trading resumed. After listing a few conventional means of preventing a panic, he stated:

And perhaps most important, there’s been – the Fed in 1989 created what is called a plunge protection team, which is the Federal Reserve, big major banks, representatives of the New York Stock Exchange and the other exchanges, and there – they have been meeting informally so far, and they have kind of an informal agreement among major banks to come in and start to buy stock if there appears to be a problem.

They have, in the past, acted more formally.

I don’t know if you remember, but in 1998, there was a crisis called the long-term capital crisis. It was a major currency trader, and there was a global currency crisis. And they, at the guidance of the Fed, all of the banks got together when that started to collapse and propped up the currency markets. And they have plans in place to consider that if the stock markets start to fall.

Stephanopoulos is not the only well-connected individual to have revealed this essentially unspoken interventionism. In the lead-up to the Iraq war, the Japanese Secretary of the Cabinet told a news conference that, “There was an agreement between Japan and the U.S. to take action cooperatively in foreign exchange, stocks and other markets if the markets face a crisis.”

I trust I have established that despite free market rhetoric, today’s major markets are susceptible to government intrusion. With this in mind, the recent price action in precious metals has been particularly suspicious. On the day after Labour Day, gold surged \$14.00, silver rose sharply then mysteriously slumped, and the un-hedged Gold Index (the HUI) staged a powerful breakout. I closely watch the positioning on the Japanese futures market, the Tocom, which is considerably more transparent than its American counterpart, the Comex. Despite this robust

unfolding strength in precious metals, there had been an ongoing aggressive build-up of short positions in gold by the usual suspects on Tocom, the large Japanese banks and one large American investment bank. At the same time, Comex floor sources reported that on the day gold rose \$14.00, a large seller blocked the advance of the gold price at \$648 on the December futures contract by selling indiscriminately until the buying was finally exhausted. The next day, gold was driven down, forcing the speculative buyers to unload their positions. For five consecutive days, gold was pounded. The thinner silver market was correspondingly annihilated on Comex, falling over \$2.00 per oz. in a three-day period and continuing to fall in the aftermath, with the percentage loss reaching nearly 20%.

This decline, in a very short period of time, in a market with a physical shortage, is bizarre. But it is not without precedent. Often when Comex opens, both gold and silver are smashed in unison, with the downdrafts looking identical. In addition, the two metals are routinely crushed in quiet periods on the Access Market. The violent attempts to sell gold and silver through key support levels is not indicative of profit-maximizing longs unloading positions, but instead demonstrates orchestrated movements.

Why this is disturbing to me, other than the fact that it does not appear to be legitimate price action, is the fact that three or four traders hold over 80% of the Comex silver short position. Ted Butler, a gentleman who knows as much or more about the silver market than anyone that I have ever encountered, believes this represents manipulation and I agree with him. The size of the paper short position in silver in relation to the size of the physical market, whether relative to available inventories or annual production, is outrageous, particularly when this short position is concentrated in so few hands. If the longs called for delivery, where is the silver going to come from? If the short positions were smaller, wouldn't it be axiomatic that the silver price would be much higher?

It is tempting to believe that the manipulation of precious metals markets is aimed at garnering illicit profits for certain traders. But I think this misses the larger point. Gold is widely seen as a barometer of economic health, and silver is tightly connected to its more expensive cousin. Thus, as gold analyst Reg Howe has observed, "Any efforts to affect interest rates through the manipulation of gold prices cannot safely ignore silver." In this regard, my sense is that the recent clobbering of silver is a case of the metal being an innocent bystander in a greater conflict. To the extent that the silver price runs free, it may also free the gold price from the shackles of government influence. Think of silver as the well-meaning witness whose observations must be silenced.

But despite the repeated mugging of silver, those responsible for ensuring its safety have abrogated their duty to protect the metal. The Commodities Futures Trading Commission continues to allow manipulation to occur, despite the howls of ordinary investors. Yet the CFTC is not the only possible defender of a free silver market. In particular, the captains of the silver industry, those mining companies engaged in its production, refuse to publicly confront these lingering allegations of market manipulation. This is not acceptable. As someone who oversees a large precious metals fund, I cannot tell you how frustrating it is to witness this obvious manipulation. I feel like the newscaster played by Peter Finch, in that classic movie

from years ago, NETWORK, who would rant on air: “I’m mad as hell and I’m not going to take it anymore”.

It is further distressing to watch the mining companies suffer in silence, adamantly refusing to call the emperor on his lack of clothes (or, his large short position) and demand appropriate remedies. If you take but one message from my talk, let it be this: It is time that the era of silent collaboration in the precious metals markets ends. If you are not vocally and publicly against the silver manipulation, your reticence is facilitating its continuation.

There is a tendency in financial markets to ignore questions of right and wrong. Many companies and investors seem to believe that so long as they are positioned correctly, what happens behind the scenes is but an irrelevance. If we see the economy as a mere vacuum, this view might hold currency. But markets are about more than trading paper. They involve outcomes that affect the daily lives of ordinary citizens. In silver, I am talking about the best interests of shareholders, of miners, and of the communities engaged in the metal’s production. All these stakeholders have needlessly suffered due to the manipulation of the silver price. And all stand to benefit should investors and the industry muster the determination to end the meddling. Today I ask you to do just that.