



THE DYNAMICS OF THE GOLD & SILVER MARKETS?....EXPLOSIVE!

Adrian Douglas

This week gold closed above \$1000/oz for the fourth consecutive week and made another all time weekly high close. But the top-callers have come out in their droves declaring that gold is in a bubble that is about to burst, and because the recession has been declared as over there is no reason to hold such a safe-haven asset. All that is nonsense and I will explain why. The dynamics unfolding in the gold and silver markets are nothing short of explosive.

The dynamics are different for gold and silver so I will start by discussing gold.

Gold is a unique substance. It is about the only thing on the planet that is bought and stored and never consumed. Almost all the gold ever mined in history still exists above ground. The purpose of gold is to act as a store of wealth. This singularity of gold makes it susceptible to a scam that was first perpetrated by the goldsmiths in the 16th century. The goldsmiths realized that customers would buy gold and leave it for safe keeping in their vault. This meant that they could show the same gold bar to many customers and sell the same gold bar many times over. This was the early form of the concept of fractional reserve banking where banks only retain 10% of the money on deposit gambling that no more than 10% of the money will ever be called upon to be paid out.

This basic scam is at the center of modern gold market manipulation. Paper substitutes for gold are sold instead of real gold through derivatives, futures, pooled accounts, ETF's, gold certificates etc. I estimate that each actual physical ounce of gold has been effectively sold 20 times over or more. To be able to maintain this Ponzi scheme some real gold is required because some investors or jewelers demand real gold. For the scam to be sustained there must always be plentiful physical gold for those who want it. This physical supply has been met from mine supply and central bank leasing and selling. The market is in effect a giant inverted pyramid with a huge paper gold market being supported above a small amount of physical gold at the tip of the inverted pyramid. The scam can continue until there are indications of a shortage of physical gold. If the twenty or so claimants of each oz of real gold demand their gold then there is the potential for a squeeze like has never been seen before in history.

To lend support to the idea that all the gold in the world has been sold several times over I cite the case of Morgan Stanley who were sued in 2005 for selling non-existent precious metals to their customers. They even had the audacity to charge storage fees! They settled the class action suit out of court but no criminal charges were ever filed against them. If Morgan Stanley was doing this you can bet that it is the tip of the iceberg. As further evidence just look at the monster OTC derivatives market. Standing at approximately \$1,000 trillion it is multiples of the liquidated value of all the assets in the world and all currency in the world. Clearly derivatives must be selling some sort of claims to assets that can not be fulfilled because there are not enough underlying assets.

The price discovery of gold has been almost exclusively achieved through the shuffling of paper gold promises between investors and bullion banks on the COMEX with very little real gold ever changing hands. The situation is changing. Some big entities are now demanding physical gold. These entities are almost certainly countries not individuals, such as China, Russia, India, Venezuela, Iran the Gulf States to name but a few. This demand for real gold, instead of paper substitutes, is putting a strain on the gold market. Paul Walker, CEO of GFMS, recently said the price of gold was going up because of “large lumpy transactions in a market with a degree of illiquidity”. Roughly translated this means that there are large demands for physical metal which the market is struggling to meet. That is a Cartel apologist’s limp wristed reference to the explosive dynamics that I am defining!

The supply that feeds the bottom of the inverted pyramid to support the gold price suppression via a paper market is drying up. Mine supply has been declining for almost a decade and this year central banks became net buyers of gold for the first time in 20 years. The stress in the physical market is starting to show to those who are paying attention. For example, the London PM Fix is coming in at historic highs day after day, the contango in the futures market has contracted dramatically, the US mint is routinely suspending production due to shortages of metal. But most importantly we are seeing astute investors display a growing preference for real bullion. A couple of months ago Greenlight Capital, the large hedge fund, switched \$500 million of investment in GLD to physical gold bullion. The supposed gold holding of GLD has not grown to a record high despite a record high gold price. Apparently Germany has requested that its sovereign gold held by the NY Federal Reserve Bank be returned to Germany. Hong Kong has requested the same of the Bank of England that stores its sovereign gold. Robert Fisk, a respected journalist for the UK’s Independent newspaper, reported this week that the Arab oil producing states, Japan, Russia and China have been holding secret talks to replace the dollar as the international reserve currency and as an accounting unit for trade. He reports that the basket of currencies they propose instead of the dollar would include gold! If gold is going to regain its monetary role then you can understand why those in the know want actual physical bullion. There are some very real and

significant signs that a run on the bank of the Gold Cartel for physical gold is commencing.

Meanwhile most investors and analysts are focused only on the net short position of the Commercial traders on the COMEX which has reached an historically high level, and has in the past signaled the onset of a major correction. However, such market observers are only watching a side-show of the main event. The main event is all about a growing tightness in supplies of gold in the physical market. I don't think the Commercial net short position of 800 tonnes is that important; what is important is that the world's stockpile of 140,000 tonnes may have been sold several times over. In all likelihood half of the supposed 30,000 tonnes of Central Bank stockpiles have been sold at least 20 times over. The gold short position could well be 300,000 tonnes (15,000 times 20) against a total world inventory of only 140,000 tonnes, much of which is not available to the market. Could you think of a more bullish scenario? If you think that such business practices could not be tolerated I can hold up the example of the airlines who regularly and knowingly oversell the seats on their flights expecting that not all passengers will show up. Bullion bankers oversell their inventory of gold knowing that only 10% of the customers will ever ask for it, just as the goldsmiths did.

One can not discuss the gold market in isolation as it is linked to the dollar and Treasury debt. The major impetus behind the suppression of the gold market was to maintain a strong dollar despite massive over-issuance of the currency. This has allowed the US to live beyond its means because the rest of the world accepts the home-made funny money as payment for goods and services! Lawrence Summers, in a study he made when he was a Professor of Economics at Harvard titled 'Gibson's Paradox and the Gold Standard' showed that in a free market gold and real interest rates move inversely to each other. However, since 1995 the US has had low gold prices and low interest rates. In the absence of a Gold Standard this could only have been achieved by surreptitiously fixing the gold price through market manipulation. This was the essence of the "strong dollar policy" of Robert Rubin, the mechanism of which was never explained to the public.

The dynamics of the silver market are different. About 90% of physical silver production is used for industrial applications. Only 10% is purchased for investment. Clearly paper substitutes for silver can not be used in industrial processes. The investment market is suppressed by paper silver substitutes as described above with respect to the gold market. It is this market, specifically the COMEX futures exchange, which controls the price of silver. The very low price of silver over the last 30 years has encouraged large holders of silver to dishoard it. After all, who wants to pay costly storage fees for something that is of low and declining value and very bulky to store? This dishoarding has filled the gap between silver production and industrial demand which runs at over 200 million ozs annually. Much of the investment demand has been met with paper

substitutes and scams that are variations on the one that was perpetrated by Morgan Stanley described above. Because of the suppression of the price of silver it has been uneconomic to recycle most industrially used silver, with the exception of that used in the photographic process. This has meant that most industrially used silver finds its way into land fills. All the existing above ground silver is now less than 1 billion ozs. Considering that just SLV ETF alone claims to have over 250 million ozs of silver it is reasonable to estimate that investors have been sold something of the order of 5 billion ozs of silver. But how much is supported by real physical silver? If the same oz of silver has been sold 20 times over, as per my estimate in gold, then only 250 million ozs of investment silver bullion exist. This means that 4.75 Billion ozs of silver could potentially be demanded in a market where only 1 billion ozs of stock pile exists and mining supply is already oversubscribed to the tune of 200 million ozs annually. One can probably add to this picture that investors who can not easily find physical gold will come looking to buy physical silver. What is even more bullish is that the industrial users will not sit idly by watching a manic silver grab. They will join in the fray because they can not remain in business unless they have silver inventory. They will try to stockpile at a time of acute shortage.

The dynamics of the gold and silver markets are bullish beyond anyone's wildest dreams. This is no longer about whether the commercials will knock down the price by selling more contracts short. This is about a lot of market participants who have been content in the past to hold precious metal paper substitutes who now increasingly will want to own real bullion. This has been happening slowly but will gather pace like a rolling snow ball. Because in the last 30 years most investors have trusted the brokers, dealers and bullion banks to actually have the metals that have been sold there has been no "run on the bank". This is now changing. Many indications point to significant supply stress building.

Why are the entities that hold the largest short positions on the planet custodians of the bullion depositories for the largest ETF's? That's like putting a sex offender in charge of the Children's Day Care Center or Bernie Madoff in charge of your company pension fund! The argument against holding physical bullion yourself has always been the risk it might get stolen while in your possession. However, the risk of holding bullion substitutes might be that it has already been stolen or never existed!

The precious metals market is now akin to a game of musical chairs with perhaps only one chair for every 20 players. It might be prudent to follow in the footsteps of Germany, Hong Kong, China and Greenlight Capital and get your chair BEFORE the music stops.

If the physical markets for precious metals lock up due to shortages then the short squeeze will be of epic proportions; it will be something to tell your grand children about. Needless to say it will be a better story for your grandchildren if you are on the right side of the trade!

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