

Gold – Cutting Through the Proverbial!

By Adrian Douglas

I read so many reasons why investors should not invest in gold. But when you cut through the proverbial most of them turn out to be the very reasons why gold is such a good investment! The anti-gold rhetoric is usually more revealing of the dismal lack of understanding on the part of the analyst than it is about gold as an investment. We will look at many of the things that are commonly said and cut through the proverbial:-

1) Gold has no use

This is almost true. Gold has quite a few uses in industrial applications such as for corrosion resistant electrical contacts, electronics, dentistry, brazing alloys, etc. But the uses represent very few ounces and it is nearly all recyclable so there is no net consumption of gold.

So we can agree that gold is not mined specifically for an industrial application. It is mined as a store of wealth. The function of gold is to store wealth so as such it has no “use”. In this sense I am employing the word “use” to mean an application where gold is consumed. If it had a significant use it would compete with its function as a store of wealth. (We will look at the special case of silver later on).

It is often said that gold is “used” in jewelry. This is not true. Most of the gold jewelry by weight that is sold in the world is 18 carat or higher. It is a store of wealth that can also be decorative and portable. In the Eastern hemisphere gold buyers like to be able to carry it around with them while in the West gold buyers like to keep it in vaults. But the purpose of storage of wealth is the same. This gold jewelry can be sold back to dealers just as easily as a gold bar or a gold coin. Very little gold by weight is sold in “trinkets” which is cheap jewelry that uses low carat gold plating.

2) All the gold ever mined is still available above ground making gold a risky investment

It is true that almost all the gold ever mined still exists above ground. This goes back to point #1 that gold is not consumed. This does not make gold a risky investment; on the contrary it shows that no wealth stored in gold has ever been lost in the whole of human history. This can not be said if you had stored your wealth in shares of Enron or the Louisiana Company or the South Sea Company or Bear Stearns etc. All the shares that were ever issued no longer exist, because the companies no longer exist...much to the chagrin of the investors!

The function of gold is to be hoarded. The fact that almost every ounce ever produced has been hoarded and is still hoarded today means that gold is fulfilling

perfectly its function! Gold can be “hoarded” to store wealth with no detrimental effects on normal economic activity. This is because gold has “no use” so hoarding it has no impact on industry. If on the other hand, people were to hoard all gasoline production, the economy would come to a stand-still.

Detractors of gold will cite the fact that there are 130,000 tonnes of gold above ground. The implication is that a large amount of this can be dumped on the market. All the Picasso’s ever produced are still on earth. If you owned a Picasso would you be afraid that all the Picasso’s would be dumped?!

What one has to remember is that gold is for accumulation. Dumping of thousands of tons of gold therefore is inconceivable. When some hoarder of gold sells gold the buyer is going to hoard it! So even if a lot of gold were to be sold it would just be accumulated by someone else.

When the Bank of England sold 300 tonnes of gold it was viewed by many analysts as negative for gold because the Bank was dishoarding. What was not emphasized was that somebody else bought it and it is hoarded somewhere else!

Gold Doesn’t Pay an Interest

This criticism is unadulterated deception.

NOTHING can act as a store of wealth AND earn interest. You can loan out your gold and get paid an interest but now it is not a store of wealth because it has gone. It has become a receivable; a liability. If it is not returned then ALL your wealth will have been lost.

It is the same with currency. If you deposit your currency in a bank in an interest bearing account the currency will be loaned out to other customers. It is not a store of wealth because you may not get your currency returned if the bank defaults. Interest can only be earned on reserves if they are mobilized...but then they are not reserves! Gold has to be compared with dollars under the mattress, not with dollars on deposit. Neither pay interest.

Why does anyone accumulate gold? If you want to store wealth, which means the reserves are NOT put to work, then accumulating gold is much more preferable to accumulating a fiat currency. A fiat currency will nearly always have an increasing supply of more than 3% per year. With time this inflates away the purchasing power of any currency that is stored under the mattress. The purchasing power of gold is almost constant as the amount of new gold mined each year is small compared to the total above ground stock.

By paying interest on deposits and publishing government massaged price inflation indicators, such as the CPI, deceptively leads people to the wrong conclusion that they can beat inflation with the interest earned.

Gold is a Barbarous Relic

This is the misquoted statement of John Maynard Keynes. He actually referred to the “Gold Exchange Standard” as a barbarous relic, not gold bullion. Any way many gold detractors love to misquote Keynes to prove their point. The only way to buy gold is to exchange something for it. Typically this is the national currency of the country you are in. This means that because the ONLY function of gold is to store wealth, the price of gold reflects the comparative attraction of having reserves in gold or in the national currency.

This is why governments hate gold. Gold is the arbiter of their dismal lack of self-discipline with regards to over-issuance of fiat currency. A price rise in any other commodity can be explained away. For example, a rise in crude oil can be spun positively saying this is due to rising demand because the economy is doing so well, as opposed to more paper dollars chasing fewer barrels. i.e. inflation!

A rising gold price means that it is less and less attractive to hold the currency. It is as simple as that.

Gold is no longer a safe haven! It hasn't even kept pace with inflation in recent years.

It is true that the gold price is currently more than 50% below the price it should be if the price were adjusted for even the Government's grossly understated measure of inflation. This implies that free market forces are being suppressed in some way.

The majority of the 130,000 tonnes of gold that exists is held by “hoarders” who are storing wealth to protect it against the ravages of mismanaged national currencies. If this were the only source of gold then the price would be orders of magnitudes higher than today. Why? Because a potential hoarder would have to offer a large amount of fiat currency units to persuade another hoarder to dishoard. When an “old master” goes to auction, art collectors must bid high prices to get it from the collector who owns it. If a famous artist is alive his work can be bought at a much lower price than will have to be paid in the market after he dies because the artist does not want to collect his own work. On the contrary he wants to sell it. When the artist dies the prices rise rapidly because then the only source of supply is from people who want to accumulate art.

The only source of additional gold is from mining. Just like our analogy of the art world, the miners do not want to hoard gold. They want to sell it.

But just like our art analogy the artist is dying! Figure 1 shows that gold mining production has peaked. South Africa, the previous largest producer, saw gold production decline 13.6% in 2008 and is now producing at the lowest rate in 86 years. This should have made the gold price go up in leaps and bounds especially when fiat currency issuance has gone into over-drive in a vain attempt to prop up flagging economies which has boosted demand for gold.

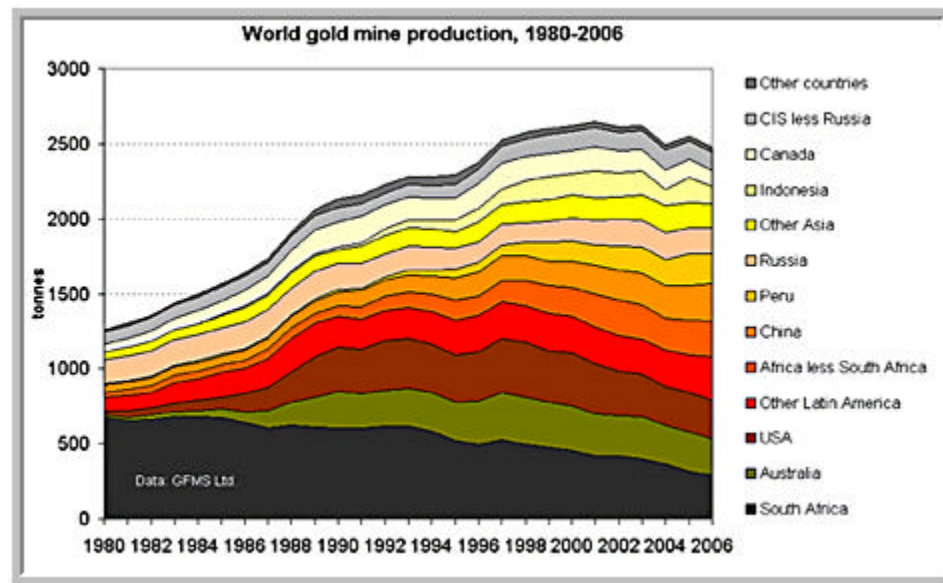


Figure 1

If the price of gold has not risen in line with the massive increase in fiat currency in the face of declining mine supply then some other supply is compensating for this. The only other major source of gold is from the Central Banks. GATA estimates that Central Banks have dishoarded over 50% of their gold reserves through surreptitious leasing and selling of gold in the last 15 years – that translates to 15-18 thousand tons.

There exists another two classes of participant in the gold market. People who do not want to store their own wealth but want to speculate on what the gold price will do depending on other people wanting to store their wealth. These participants deal in derivatives such as futures and options. Then there are the people who want to store their wealth in gold, and believe that they are doing so, but they purchase some sort of gold substitute.

Central banks dishoarding translates to around 1250 tonnes of gold on average each year. This alone compared to a peak in mine output of 2500 tonnes per year is a massive supply. However, this is not the whole story. By using this supply to back short selling in the futures market the amount of apparent extra gold supply can be made to look astronomic. Only about 5% of futures contracts stand for delivery. This means that 1000 tonnes of gold can be used to sell 20,000 tonnes of gold futures and still be able to deliver on 5% of them! You can imagine how this suppresses the price of gold!

Governments and Central Banks work together. They want to be able to take a part of the wealth of their citizens without direct taxation. Inflating the currency supply is the age old method. Modern day central bankers are much smarter criminals than their counterparts of yesteryear. They not only inflate the currency but they intervene in markets to try to hide their scam. This is what is behind the so called "strong dollar" policy instigated by Robert Rubin. Since 1995 the money supply has been recklessly increased (and is now going into turbo-charged overdrive to bail out the banks) but the gold price has been suppressed to mask this fraud. Foreigners have been duped into selling real goods in exchange for dollars based on the belief that the dollar market value was its free market value.

Just like all scams the gold price suppression will come to an end. In a recent article by Paul Craig Roberts he said:

"How long can the US government protect the dollar's value by leasing its gold to bullion dealers who sell it, thereby holding down the gold price?"

<http://www.counterpunch.org/roberts02242009.html>

As he was Assistant Treasury Secretary under Reagan I would guess he is well connected enough to know this to be true as GATA has shown by a mountain of evidence over the last ten years.

But the bankers got greedy. This scam was not just used to mask inflation and provide cosmetic surgery on the dollar. The bankers have leveraged on this "sure thing" with trillions of dollars of exotic instruments called derivatives issued in unregulated OTC markets. The financial world has transformed into a bloodsucking parasite that is many times bigger than the host animal...the world's productive economy! In monumental misguided policy the US Government and many other governments are choosing to print trillions of dollars and other paper currencies to continue to feed the parasite instead of letting it die or mutate back to a small symbiotic parasite.

Many people are recognizing the urgency to move their wealth into gold to protect themselves from the debilitating hyperinflation that will be wrought upon us.

These investors want to own physical gold. Retail gold outlets are having difficulty finding available supply. Government mints are rationing supply. The Wall Street Journal recently reported that more investors are taking delivery on futures contracts. Deliveries on gold contracts rose to 4.5% in December from 3.4% the previous year.

<http://online.wsj.com/article/SB123552294962865061.html>

The suppression of the gold price relies on the fact that speculators who trade futures contracts for settlement of their gains in cash far outnumber the number of investors that want to hoard physical gold to store their wealth. Just at a time when Central Banks have dishoarded more than half their gold, massive demand is showing up. The leverage through the use of futures will be of no use against people who want the real thing. As the suppression becomes more and more unsustainable the price of gold will rise to reflect the true desirability of physical gold compared to an over-issued dollar, free of the distortion of a massive trade in unbacked paper gold promises.

No significant portion of the 130,000 tonnes will come to market. The price will be governed by how many trillions of dollars chase after just 70 Million ounces of declining annual production.

Although this article was essentially to address myths about gold I will also make some observations about silver. In silver the situation is different. Silver has many industrial uses. These uses "consume" silver. Of the 900 million ozs of annual demand less than 10% is hoarded for investment purposes. Industrial use has for many years depressed the price of silver but that will soon change.

If a large mining industry has developed to be able to output 900 Mozs per year then even a 50% increase in investment demand could easily be accommodated as this would only mean a 5% increase in total silver mine output. But here is the dirty little secret. Mine output is NOT 900 Mozs. It is only 675 Mozs and declining. So 225 Mozs are supplied from silver that has been mined in the past and had been hoarded as a store of wealth. This deficit between supply and demand is generally accounted for in various official statistics as coming from recycling. If this were true then how do we account for the fact that stocks of above ground silver have dropped by 90% in the last 70 years? In the 1940's there were 10 billion ozs of silver above ground. Half were owned by the US Government. Total above ground stockpiles have dropped to 1 billion ozs and the US Government has none. Clearly recycling has not been filling the entire gap between mine output and demand; previously mined stock piles have been filling the gap otherwise there would still be 10 billion ozs in stockpiles! Of the 1 Billion ozs of silver in stock piles less than 400 Mozs are available for purchase.

Just like in gold, silver prices are suppressed by leveraging physical supplies of silver on futures exchanges. The silver short position on the COMEX is almost one year of global silver production. Typically less than 5% of futures trades were settled in physical silver. In December this rose to 7.3%. As more investors take delivery it is not difficult to imagine that 200 Mozs of extra silver supply could be demanded this year. This would take global annual demand to 1.1 Bozs. Seventy percent of silver production comes as a byproduct of base metal mining. The global economic contraction is dramatically reducing base metal demand. It would not be unreasonable to assume that silver production will drop by, say, 12% to 600 Mozs. How can 1.1 Bozs of demand be met with 600 Mozs of mine

output and 400 Mozs from stockpiles? Even if this year it is just possible clearly next year it will not be!

Because all the gold ever mined still exists if an investor is prepared to pay a high enough price he will be able to buy gold. In silver almost all the silver ever mined has been consumed! There is no price that will allow anyone to buy it back. But unlike gold, silver has essential uses. This means that the competition between users and investors will drive silver prices to unimaginable highs. Just last year Rhodium reached a high of \$10,000/oz having been at \$300/oz just five years earlier. This epic price move did not make the front page of any news publication. So when we talk of epic moves in the precious metals that will make front page news we are necessarily talking about very big multiples!

The precious metals market dynamics boil down to this: In the past it has been possible to satisfy investor demand for precious metals with a small amount of bullion and a large amount of paper substitutes. In doing so the price of precious metals has been suppressed. The motive was to have an artificially overvalued dollar to allow payment of international bills for imported goods and pay for military adventurism. The global imbalances created by this scam have ultimately led to the current collapse of the house of cards. The global response is to fight the over-issue of currency, debt and derivatives with more currency, debt and derivatives. As a result more and more investors want to protect their wealth by purchasing precious metals. The gravity of the crisis has frightened so many investors that fewer and fewer are willing to accept paper substitutes. This is occurring when Central banks are running low on gold and global mine output is in terminal decline. As this perfect storm hits it will make the Madoff scandal look like someone stole the money from the Boy Scout Summer Camping Trip Fund.

Precious metals are a store of wealth. The market price of these metals has been suppressed. The unwinding of this scam will offer not only wealth protection but unimaginable multiplication in purchasing power.

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