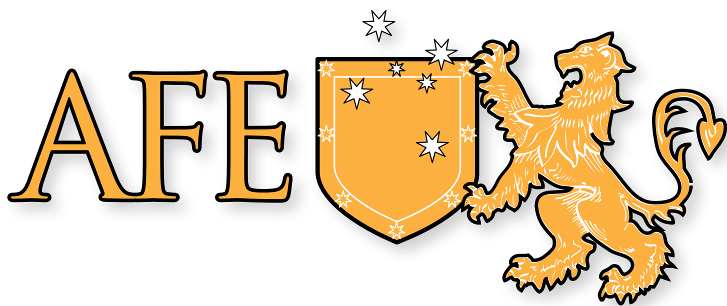

GLOBAL INSIDER

Issue #32 - September 2011
by Alex Stanczyk
www.anglofareast.com/global-insider

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GLOBAL GOLD PRICE DRIVERS - SEPTEMBER 2011

By Alex Stanczyk

Once again we pause to view the global financial picture and take a close look at factors that may indicate if gold has reached the top of its 11-year bull market. Here at AFE, we are all heavily invested in our own product, that is, physical gold and silver, and therefore have an interest in knowing when the metal is reaching its top just as our clients do. It is, of course, always important to make sure that we isolate emotion from analysis, for it is the emotions of greed and fear that drive many investors to make poor decisions with their hard-earned wealth.

Our view is that while we are witnessing a correction and sideways consolidation in the short term, gold holds strong potential over the long term as fundamentals are stronger than ever.

GEOPOLITICAL

The most powerful fundamental driver in the gold market today is the massive and unserviceable mountains of sovereign debt throughout the western financial system coupled with a paper currency, which is the reserve currency of the world, which can be issued and abused by a single government. These massive levels of debt, combined with sluggish economic growth, force central banks around the world to 'print' unprecedented numbers of dollars and other currency in order to pay the bills, try and stimulate the economy, engage in an ongoing war to devalue national currencies, and inflate away the debt burden with an intentional plan of currency devaluation. The United States' so called "strong dollar policy" could be described in reality as nothing more than a 4% target rate of inflation over 10+ years. If the US can do this, it can cut the debt in half in terms of real purchasing power by devaluing the buying power of each dollar. This is nothing more than a stealth tax effectively siphoning off the wealth of citizens to pay for profligate and irresponsible government spending.

> "It is a cruel thought, that, when we feel ourselves standing on the firmest ground in every respect, the cursed arts of our secret enemies, combining with other causes, should effect, **by depreciating our money**, what the open arms of a powerful enemy could not." – Thomas Jefferson[1]

A recent entry at the website of Mr. Jim Sinclair[2] sums up the debt of the US particularly well:

Here is why S&P downgraded the US credit rating:

- U.S. Tax revenue: $2,170,000,000,000
- Fed budget: $3,820,000,000,000
- New debt: $ 1,650,000,000,000
- National debt: $14,271,000,000,000
- Recent budget cut: $ 38,500,000,000

Now let's remove 8 zeros and pretend it's a household budget:

- Annual family income: $21,700
- Money the family spent: $38,200
- New debt on the credit card: $16,500
- Outstanding balance on the credit card: $142,710
- Total budget cuts: $385

I am often asked, "When do you see gold going down?" My answer is, "As soon as western nations get their financial houses in order, pay down their debts, and develop a stable global reserve currency system that cannot be abused at will by politicians addicted to spending." By the last, I mean issuing massive amounts of new money (debt) which then compete for real goods forcing all prices up globally including gold. I do not consider this to be any time on the immediate horizon, because the problem is deeply structural and systemic. Couple this with the fact that history shows politicians usually act in their own best interests under times of duress, and we have a situation that will likely not have the political resolve to put an end to it until we are faced with true catastrophe. We will continue to watch for positive signs, but we are not holding our breath on this.

Of course, the US is not alone in this quagmire. The Eurozone is currently in the midst of a slow motion sovereign debt train wreck of Biblical proportions. CDS spreads are indicating the market has priced in a 98% chance of a Greek debt default. Should this occur, we will see a scramble to recapitalize European banks as many banks hold Greek debt on their balance sheets. Should Greece default, these banks will instantly go into the red and be forced to scramble for capital or fail.

In the words of Josef Ackerman who heads the largest bank in Europe, Deutsche Bank:

> "It is an open secret that numerous European banks would not survive having to revalue sovereign debt held on the banking book at market levels."[3]

The Germans have already been busy making preparations to reliquefy their banking system, which only goes to show you that they consider Greece's default a realistic if not likely event. The end result is that we are looking at more than $400 Billion USD worth of what will probably end up as additional Quantitative Easing (QE) in the Eurozone. As we have mentioned before, QE efforts globally since 2008 have only proven to result in higher prices of food, fuel, and gold. We are still experiencing serial mini-catastrophes, and I would suggest that the crises of 2008 never really ended, it was simply extended.

Many of the world's financial professionals go on as if all of this is not even occurring, almost like ostriches with their heads in the sand hoping that if they pretend it isn't there, then the whole debt thing will just go away. I say this from personal experience travelling the earth and speaking to managers of large funds, pensions, and institutional money: professional managers of money might want to ask themselves if they have a strategic plan here instead of just handing a large chunk of their portfolios to their favorite Hedge Fund manager and praying. Many Hedge Fund Managers still lost their clients around 18% in 2008.

CURRENCY WARS ARE ALIVE AND WELL

Today we find ourselves in a situation with governments around the world engaged in a real-time currency war. The reasons for this go back almost 100 years in the making, but the net effect is that we have a global monetary system that uses a single nation's currency (the USD) as the reserve currency of the world in which most commodities are quoted, traded, and global commerce is settled in. The US enjoys a privilege whereby it can create an infinite amount of money to pay its bills while other countries of the world cannot. When the US creates more money, it causes its own currency to lose buying power which makes US goods cheaper on international markets and improves exports for the USA.

Consequently, in relation to the USD, other currencies then rise in value, these countries export, and tourist markets suffer. Another effect is that when currencies remain strong during times of economic stress, investors like to park their cash reserves in strong currencies, which creates a problem for the country with the strong currency as local inflation skyrockets. In turn, each country is forced to print money (or buy other currencies with money they print to do so), which again creates an overall global effect of devaluing currencies globally. This insane series of actions creates a "race to the bottom" where all countries are effectively trying to compete to have the worst currency.

This policy hurts savers the most as wealth and savings are effectively siphoned off because their currencies are constantly losing real buying power. Commodities in this environment naturally rise, which is part of the reason gold is rising – the other reason being that gold isn't just a commodity; during economic cycles where governments insist on destroying the value of their own currencies, gold rises because it retains and gains in purchasing power while all paper currencies lose purchasing power.

For those of you interested in the history:

> The Federal Reserve System was enacted in 1913. At the time, at least 40% of note issuance was required to be backed by US reserves in gold.
>
> In 1944, the United States signed the Bretton Woods Agreement. This agreement essentially put the entire world on a gold exchange standard. The US Dollar was declared the world's reserve currency and was exchangeable by the central banks of other nations for US gold at the official rate of $35 per ounce. The dollar was "as good as gold."
>
> The Bretton Woods system appeared to be a brilliant idea, only it had one major flaw: The supply of gold in the US reserves was limited, but the amount of dollars the US could print was not. Over time, the nations of the world continued to exchange dollars for gold, and the US gold reserves dwindled from over 700 million ounces in 1944 to a bit over 285 million ounces in 1970.
>
> In 1971, President Nixon formally severed the USD from gold by defaulting on the Bretton Woods Agreement and 'closed the gold window' by ending dollar convertibility into gold. This created a unique situation in the history of mankind; for the first time ever, the entire world began operating on a purely paper monetary system with the US Dollar as the world's reserve currency backed by nothing but the promises of the US Government.

While there are many examples of how central banks are engaging in currency wars, the most recent major development was when the Swiss Central Bank released a press statement that it will:

> "No longer tolerate a EUR/CHF exchange rate below the minimum rate of CHF 1.20"[4]

This is in effect a policy statement of a Franc to Euro peg at 1.2. Further, the SNB has stated, **"The SNB will enforce this minimum rate with the utmost determination and is prepared to buy foreign currency in unlimited quantities."**

Gold is now the last safe-haven currency. The fact that all currencies continue to devalue against gold is a strong argument to include gold in a portfolio if for no other reason than to maintain buying power in cash reserves and also when a portfolio goes to cash for defensive reasons.

CENTRAL BANKS ARE BUYING

Central banks are now net buyers of gold after 20+ years of selling it.

> Aug. 24 (Bloomberg) -- Central banks, net buyers of gold for the first time in a generation, are likely to retain their holdings even if they need to raise cash to counter an escalating debt crisis, according to Morgan Stanley. "Once they've sold, that's it, and buying back would be extremely expensive," said Peter Richardson, chief metals economist at Morgan Stanley Australia Ltd., who's studied metals markets for 20 years. "They would rather have the backing of a rising asset within their reserve portfolios than use it to reduce debt."

Gold Price % Annual Change — Sunday, August 21, 2011

	USD	AUD	CAD	CHF	CNY	EUR	GBP	INR	JPY
2002	24.7%	13.3%	22.8%	5.7%	-	6.4%	13.1%	23.9%	-
2003	21.1%	-8.5%	0.6%	7.6%	-	1.7%	9.9%	14.8%	-
2004	5.4%	1.4%	-2.1%	-3.5%	13.6%	-3.1%	-2.4%	0.5%	3.7%
2005	20.0%	28.9%	15.4%	37.8%	21.3%	36.7%	33.0%	24.2%	37.6%
2006	23.0%	12.6%	23.0%	14.2%	18.7%	10.6%	8.3%	20.8%	24.4%
2007	30.9%	18.3%	12.1%	21.7%	23.3%	18.4%	29.2%	16.5%	22.9%
2008	5.6%	31.3%	30.1%	-0.1%	-2.4%	10.5%	43.2%	28.8%	-14.4%
2009	23.4%	-3.0%	5.9%	20.1%	23.6%	20.7%	12.7%	19.3%	26.8%
2010	27.1%	13.3%	21.3%	15.4%	22.8%	37.1%	31.4%	22.3%	11.4%
2011	30.1%	27.4%	29.7%	9.7%	26.5%	21.0%	22.1%	33.2%	22.1%
Average	21.1%	13.5%	15.9%	12.9%	18.4%	16.0%	20.1%	20.4%	16.8%

GOLD IS NOT IN A BUBBLE

I want to tell you a story from my recent trip to San Francisco. Last week I spoke on a panel for the Opal Real Assets conference in SFO. The event was attended by "Public and Corporate Pension Funds, Family Offices, Insurance Companies, Fund of Funds, Endowments, Foundations, Sovereign Wealth Funds" - in short, a lot of managed institutional money and wealthy families. The opening speech was by a Nobel Prize winning economist (some of you may think this is great while others may snicker).

I have been to many events like this so far this year and have observed a common theme among them all; that institutional money seriously believes gold is in a bubble, that everyone else to the right and left of them is already in gold, that the opportunity is past, it is only rising on speculation, and that there is no underlying fundamentally good reason for the price to be what it is.

On our panel, I addressed this issue by pointing out the following:

1. The DOW closed 1980 at 963.99 and is currently well over 10,000. For gold to have a similar performance, gold would have to pass $8500 per ounce.

2. In previous bull markets, gold as a percentage of global assets has been from 20%-28%. Today this number is approximately 1%.

3. The typical institutional portfolio is 60% equities, 30% bonds, 10% alternative investments and .15% physical gold, if they hold any gold at all.

The best part of all this was at the end. I asked to see a show of hands of anyone who had more than 5% of their personal portfolio invested in gold or gold-related investments. NOT A SINGLE HAND WENT UP. I then said to the group, "Everyone take a good look around...that does not look like a bubble to me."

I think it important to note the observation of Mr. Shayne McGuire[5]. Shayne manages a $500M USD fund and has assisted Texas University in securing $1.5B in physical gold. He points out in his book, Hard Money, that if just 1% of the $70 Trillion USD that institutions hold in bonds found its way into gold, it would be like trying to stuff an elephant into a mailbox. There simply isn't enough gold to go around at these prices. According to Mr. McGuire, price discovery would force gold to over $10,000 per ounce under such a scenario.

GOLD IS RISING ON STRUCTURAL AND SYSTEMIC FUNDAMENTALS - NOT SPECULATION

As I have already mentioned, the first driver of the global gold market is western nation debt. The second driver is the move towards wealth protection. Many in the western world believe that gold is moving based on speculation, but this view often misses the fact that the majority of investment demand in gold is coming from India and China. In the first part of 2011, 57% of global gold demand was India and China alone, not speculators from the west. Some point to India imports as jewelry, but it is important to understand that in India and China, gold jewelry is viewed culturally as a means of wealth preservation as opposed to a fashion statement.

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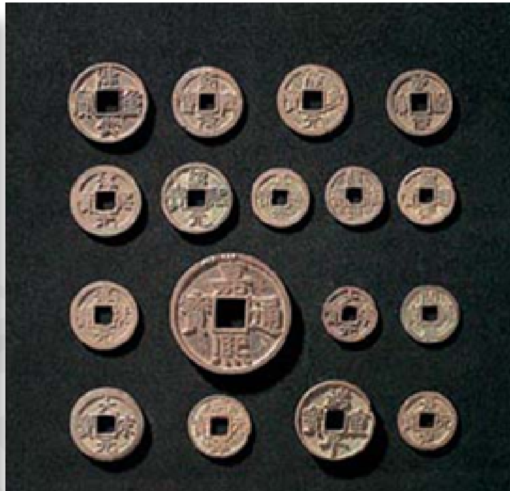
The Chinese culture in particular has citizens with savings rates as high as 40% of income. This is vastly different than the typical western citizen who has a debt-based financial structure. It is not far-fetched to say that your typical western citizen has a mortgage, two car loans, up to ten credit cards, and a student loan to top it off. It is therefore understandable that those in the west might not grasp this fundamental. The Chinese have some of the first recorded examples of paper money dating back to the Song Dynasty in the 7th century AD when paper certificates were issued against coin kept in official custody.

It would be wise for us to factor this into our analysis, because adding close to 1 billion new consumers who are trying to protect their savings versus inflation in what they have viewed for centuries as real money (gold) will logically have an impact on demand this time around.

> “Many Chinese investors and consumers see price corrections as buying opportunities. The view that gold is an enduring store of value is firmly rooted in Chinese cultural traditions,” said Hou Xingqiang, a gold analyst at Jinrui Futures.[6]



GOLD IS MONEY

Meme - Noun /mēm/
1. An element of a culture or behavior that may be passed from one individual to another by nongenetic means, esp. imitation.

The most common urban myth among financial professionals regarding gold is actually a meme that was started by Warren Buffet. No disrespect to Mr. Buffet, but if you had sold Berkshire Hathaway in 2003 and bought gold instead, your investment would have performed more than 350% better over the last 8 years.

Said another way, the Chinese have over a thousand years of experience ahead of the US in terms of the effects, benefits, and also negatives of paper money systems. There is a deep culturally embedded appreciation for gold and silver’s ability to protect wealth versus inflation when paper money supply is exploding. Perhaps the most important aspect of this trend is that in the last bull market from 1965-1980, the Chinese did not even participate. It was illegal for Chinese citizens to buy gold at the time.

In other words, the problem when a person like Warren Buffet says something is that people tend to take it at face value and then repeat it without necessarily thinking it all the way through. I would suggest that it is very dangerous to stop thinking in this environment.

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The urban myth is this: Gold is a poor investment because it does not produce a return or a dividend. This is usually tossed into a conversation about gold as if it is some brilliant observation. It's really great when an intelligent person says this, because it actually proves my point. There is only one other thing in the financial world that behaves in precisely the same manner, and that is money. . The USD does not produce a return or a dividend either, unless you invest them or lend them to someone.

This is exactly what money is supposed to do - temporarily store wealth until deployed. I have heard otherwise intelligent people belittle gold saying gold has no utility; all you do is hoard it and sit on it. If I said the same thing for USD, you would think I was an idiot, because that is exactly what everyone on the planet does with money.
Donald Trump has recently accepted a down payment for one of his commercial property rentals in the form of gold bullion.

> "The legacy of gold as a precious commodity has transcended to become a viable currency and an accepted universal monetary standard. Central banks around the world are holding gold as a reserve asset. It is also a terrific, potentially lucrative diversifier in a portfolio…" – Donald Trump[7]

I recently read of one analyst pointing to this and saying, "See! Gold really is in a bubble!" Of course, what it might mean is that gold is being used as money once again as it has for over 5000 years of human history. How quickly we humans forget.

Perhaps the biggest clue we have that gold is money is the fact that central banks hold it. They do not hold copper, sugar, or cotton. They hold gold. Actions speak louder than words. As of July 2011, the US holds 74.7% of its foreign exchange reserves in the form of gold.[8]

The Swiss have recently moved towards a referendum that will make it illegal for the Swiss National Bank to sell any of Switzerland's gold reserves and to move the gold from Switzerland.[9]

PROPER USE OF GOLD IN A PORTFOLIO

Once an investor comes to the conclusion that gold is currently behaving as money and not as a commodity in this global economic environment, it is then clear how gold might fit into a portfolio. Instead of comparing gold to bonds, commodities, or equities, gold should probably be compared directly against other currencies. In this regard, one could point to the fact that it costs money to store, protect, and insure gold, but I would suggest that the typical 1% per annum cost of doing this is far below the opportunity cost of holding bonds in a negative interest rate environment. If the CCI index is averaging 14% gains per year, what that is really telling us is that the market considers the loss of buying power in the USD to be approaching this number versus the government-reported statistics.

All portfolios hold a cash component; why not hold some of this in gold? It is as liquid as any other currency with a 24-hour global market. When you compare gold's performance versus nine of the top currencies globally over the last decade and then average it, you will see that gold has performed on average 17.1% better than all currencies in real purchasing power for the last ten years running.

There may be a time when it is deemed wise to lower exposure to equities and bonds and sit tight in cash. At this point we must ask the question, which form of money is going to hold value the best? Another question that a prudent money manager might consider is, "Do you have a strategic plan in place to deal with currency devaluation and systemic risk?" If not, perhaps it's time you should.

Until next time,

Alex Stanczyk

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