U.S. on cusp of its biggest bailout ever

By John Embry

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Gold and silver have now weathered another vicious price takedown that began in mid-July and culminated exactly one month later. It was a rout that was extremely reminiscent of the price debacle experienced in May-June 2006. In that instance, gold fell 21.7 per cent in a month while silver plunged 33.6 per cent in the same time frame. In the aftermath, it was alleged by a Washington state senator that the U.S. administration had ordered that the price of gold be savaged because the rapidly rising price was sending the wrong message (i.e., the right message but not one they wanted out there).

The recent price collapse closely mirrored that of two years ago, with gold falling 20.2 per cent in a month and silver plummeting 33.6 per cent. This could be viewed as a coincidence, but I suspect something more intentional. This time around, things are so bad financially, economically and geopolitically that it is highly improbable that a price drop of this magnitude in precious metals was a random event. There are numerous reasons to believe this, but two particularly compelling ones should suffice:

The unprecedented shortage of physical gold and silver bullion, with many gold and silver coin and bullion dealers reporting that it is nearly impossible to access physical product. To emphasize this point, the U.S. Mint announced that it was forced to suspend sales of American Eagle gold coins and was refusing orders from coin and bullion dealers, ostensibly because demand was overwhelming supply.

The revelation that near the mid-July peak in the gold price and in the immediate aftermath, three U.S. banks increased their short position on the Comex from 7,787 contracts (778,000 ounces) to 86,398 contracts (8,639,800 ounces). Gold was in the process of dropping over US$150 per ounce as this was occurring. To put this in perspective, three U.S. banks shorted more gold in a very short period of time than all the world's gold producers dig out of the ground in a month.

As I have stated previously, a decline in precious metals prices in a period of declining commodity prices and a rising U.S. dollar is to be expected. However, a virtual price collapse is preposterous and reeks of manipulation, particularly in the face of very compelling fundamentals and extreme physical shortages.

Without question, one of the key fundamentals pertains to the extent of the rot in the U.S. financial system. This may not have been apparent to the average investor if he had listened to the observations of the powers-that-be in the U.S. financial hierarchy, Treasury secretary Henry Paulson, Fed chairman Ben Bernanke and any number of CEOs of major U.S. financial institutions.

Paulson boldly stated in March 2007 that U.S. economic growth was healthy and the housing market was at or near the bottom. In June of that same year, Bernanke was quoted as saying: "fundamental factors—including solid growth in incomes and relatively low mortgage rates—should ultimately support the demand for housing, and at this point, the troubles in the subprime sector seem unlikely to seriously spill over to the broader economy or the financial system."

In March, 2008, Paulson was at it again, reassuring the public by stating: "our markets are the envy of the world," while then going on to emphasize his belief in the strength of U.S. financial institutions. Similarly, the heads of failing financial institutions constantly told the public that their capital was adequate and no further injections would be required, often just weeks before announcing another massive, dilutive financing.

These individuals who should be as well informed as anyone on the planet, in my opinion, either possess very poor judgment or have been totally disingenuous.

On the other hand, a person who has gotten it right throughout this whole unfolding mess is Nouriel Roubini, an NYU professor who has his own economic consultancy. For the past two years, he has warned about a bursting housing bubble, a collapse in sub-prime, the resultant banking problems and the implosion of Fannie Mae and Freddie Mac, all of which in his mind would be precursor to a U.S. recession that would be the worst since the Great Depression.

So what does Mr. Roubini think about the health of U.S. financial institutions today? He estimates the financial crisis will lead to credit losses of at least $1 trillion and more likely closer to $2 trillion and that we are in the second inning of a severe, protracted recession that will entail a systemic banking crisis that will see hundreds of U.S. banks going belly up. So much for Mr. Paulson's recent assertion about the soundness of U.S. financial institutions.

In an attempt to save the financial system, Washington policymakers seem more focused on rescuing the miscreants at the expense of those who played by the rules and eschewed get-rich-quick schemes.

If Mr.Roubini is correct, and his prescience to date demands considerable respect, the vast majority of U.S. financial institutions have, in reality, negative equity at this moment, and we are therefore on the cusp of the biggest bailout and concomitant debasement of currency that the U.S. has ever experienced.

Putting an exclamation point on this is a recent comment by Yu Yongding, a former adviser to China's central bank and a man reputed to be very influential among Chinese government officials. Mr. Yu stated succinctly that, "If the U.S. government allows Fannie and Freddie to fail and international investors are not compensated adequately, the consequences will be catastrophic. If it is not the end of the world, it is the end of the current international financial system." Considering the fact that the Chinese own some $376 billion worth of U.S. agency debt, mostly in Fannie and Freddie paper, this is not a comment to be taken lightly.

There is a terrible irony to this inevitable and impending bailout. It will most assuredly undermine the value of the U.S. dollar and most U.S. financial assets and, unfortunately, could take a fearsome toll on Americans who did the right thing in the past few years. Those U.S. residents who have dutifully paid their mortgages on time, didn't max out their credit cards, faithfully put money into their retirement funds and even attempted to save for the future are getting hammered, and it may only get worse.

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Currently, responsible Americans are seeing their house prices implode while the income they receive on their savings isn't remotely keeping up with the inflation that is relentlessly understated by U.S. authorities. What they have to look forward to is a sharp drop in the U.S. dollar that could greatly diminish their living standards and could ultimately lead to some form of hyperinflation and the chaos that accompanies it.

As a result of this, I believe a strong commitment to precious metals is particularly warranted at this time in view of the remarkably depressed prices, courtesy of the anti-gold cartel and their ongoing nefarious practices.

We are at an extremely important moment in history, and a brilliant observation by a gentleman named Daryl Robert Schoon perhaps sums it up best: "Never before has money been debased on such a grand scale. Never before has so much debt been owed and never before have monetary authorities been so helpless to control the destructive forces they themselves set in motion."

What was left unsaid is the risk being created by the entirely ludicrous amount of derivatives in the system, a quantity that is growing exponentially and is now approaching, if not exceeding, a quadrillion dollars in notional value. Warren Buffet referred to them as "weapons of mass financial destruction" when they were a mere fraction of the current amount. To my mind, the only obvious antidote to combat the foregoing is gold and silver bullion. High quality precious metals equities, particularly the juniors, should also do well in the environment I see unfolding.

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