JOHN EMBRY

The time for gold 'to go ballistic' approaches

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A fascinating occurrence took place in the gold market at the end of February and it went virtually unremarked at the time. According to data available on the website of Canadian bullion dealer Kitco, gold made an all-time monthly closing high at US$669.35 per ounce, eclipsing the previous record of $666.75 at the end of September 1980.

I suspect it went unnoticed because most observers tend to focus on the spike high above $800 per ounce, which was a two-day phenomenon in the middle of January 1980. Gold, subsequently, corrected rapidly and closed that month at $653. For those who follow monthly charts, this was a highly significant bullish development and represents yet another stage in gold's relentless rise.

However, it attracted the attention of the powers that be, who most certainly do not want gold to stand out as an obvious alternative to paper money. Their ultimate dilemma is captured in the prescient words of the venerable investment-letter writer, Richard Russell, who recently observed that "a government can get away with the illusion that paper is wealth, but in the end, too much paper is always created, and with that action the illusion falls apart."

Nevertheless, the central banks and their allies continue to battle mightily, and in February resorted to aggressively shorting gold on the COMEX to the extent that the open interest reached a record high.

Then, a crackdown on speculation in China triggered a 9.6 per cent decline in Chinese stocks in one session. The contagion in world markets created an environment in which the shorts could once again rout the long speculators who at this stage must feel as if they are being beaten like a rented mule.

The result was a US$50 drop in the gold price in less than a week. All sorts of fatuous commentary appeared, explaining the carnage, but once again, it was purely and simply another blatant example of the big boys throwing their weight around. Fortunately, it means absolutely nothing in the long run and, in the short term, it ensures that the central banks are going to use up their rapidly shrinking gold reserves much more quickly.

I firmly believe that gold has moved to a new plateau just as it did in the 1970s. And it is highly unlikely we will ever see prices fall below $600 per ounce again.

New floor

I suspect time will confirm that gold's correction in the summer of 2006, from a high of US$730 in May to US$565 in late June, represented the last significant change that permitted investors to buy gold appreciably below $600. The new floor is now in that area and the upside potential is at least several multiples of $600, which to my mind, represents a pretty good risk-reward ratio.

In reality, it isn't the price of gold that changes but the value of the paper currency in which it is denominated. I have made the case many times that paper money is being seriously debased and I think my position is strongly supported by the recent spate of money-supply growth numbers that have emerged from around the world. The idea that the world is awash in liquidity is certainly reinforced by the following annualized growth rates for money supply:

- Eurozone M3: up 9.0 per cent;
- United Kingdom M4: up 13 per cent;
- China M2: up 15.9;
- South Korea M3: up 10.6 per cent;
- Australia M3: up 13 per cent;
- Russia M2: up 48 per cent.

A group in the U.S. has gone to the trouble of reconstructing the discontinued M3 data and concluded that it is rising comfortably more than 10 per cent. In light of these numbers, should it really come as a surprise that gold is under steady accumulation?

However, the crux of the matter is still the availability of central-bank gold to plug the yawning gap between demand and mine-and-scrap supply. In that regard, the position of the U.S. is critical because the U.S. Treasury allegedly controls the largest gold reserves on the planet. But, there are questions about whether gold is really there, given the fact that there hasn't been a public audit since Eisenhower was president in the 1950s.

Adding even more intrigue were the changes in nomenclature in 2001 that affected 94 per cent of the Treasury's gold. Until early that year, the reserves held at Fort Knox, West Point and the Denver Mint were categorized as "Gold Bullion Reserves." Then they were arbitrarily redesignated "Custodial Gold Bullion."

The ink was barely dry on that designation, when in June of that year, they were reclassified as "Deep Storage Gold." Given the speculation about whether the reserves are still physically in place, this exercise in semantics raised the red flag among skeptics. If gold was indeed there, why not classify it as "Gold Bullion Reserves" as had been the case for decades?

Key moment

Invoking the term "Deep Storage Gold" led some to suggest that the U.S. had been active in a program of gold swaps whereby deliverable bars of gold had been swapped for gold that has yet to be mined.

Only the U.S. government officials directly involved know the answer for sure. But given the rampant chicanery in the opaque world of gold, this certainly raises suspicions and reinforces my view that we are very, very close to that key moment when there could be insufficient central-bank gold available to meet mounting demand. As I have said before, that is when the gold price is going to go ballistic.

Turning to stocks, an interesting opportunity is unfolding in Mexico, a country which hosts numerous silver deposits. Silver Eagle Mines (SEG-TSX, $1.49, 416-361-1101, www.silvereaglemines.com) is exploring and redeveloping an historic silver property in Zacatecas.

The company controls the fully permitted Miguel Auza property with mineral rights to over 100,000 acres. There are 17 known silver-bearing veins that have been previously mined in just a two-kilometre-square portion of the property. From one vein alone, the Calvario, the company anticipates ramping up production to over two million ounces in the next several years, but the real attraction of the stock is the potential of the nearby structures.

Management is headed by Terry Byberg, who has worked for many years in mining and regards this as perhaps the finest prospect he has come across. In my opinion, he is putting together an exceptional mining team, which is a real asset in the current environment where talent is hard to come by. With a market cap of less than $50 million, this appears to be an overlooked situation with the leverage that I look for in the silver market.

John Embry is chief investment strategist at Sprott Asset Management. Sprott funds may hold above-noted securities. For Sprott fund holdings, see www.sprott.com. *The opinions expressed in this article are those solely of the author.*

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