



9th November 2009

## Indestructible

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- Paul Mylchreest, ‘Thunder Road Report’, 15<sup>th</sup> October 2009.

“Expect other nations, including those in the Middle East, to follow the lead of Hong Kong in bullion repatriation. This is a slow-release earthquake in both bullion and currency market terms.. Taking delivery is just not the done thing in bullion ownership. If it were to become a trend, then life in the COMEX warehouse coordination office and at various custodial banks in London is likely to become quite interesting.”

- Ned Naylor-Leyland, Cheviot Asset Management, October 2009.

“I don’t think the question really is what is gold worth but what are currencies not worth.”

- Shayne McGuire, Director of Global Research at the Teacher Retirement System of Texas, October 2009.

Having certainty about financial markets is difficult at the best of times, but right now it is impossible. Robert Shiller, Yale professor and co-creator of the S&P Case-Shiller Home Price Index, is intelligent enough to own up to huge uncertainty about the future. In an interview with Fox Business last week, he confessed,

“I am terribly conflicted. This is the most uncertain time that I can remember. Things are violating the laws that I learned.. The whole country is experiencing an upsurge but I don’t know what to make of it.”

We are living in a giant experiment, surely the grandest science project in the history of money. There is a pervasive sense that we have emerged from the worst financial crisis since the Great Depression – asset markets, after all, are going through the roof. But while we know that economic laws are of dubious value, they have been largely cobbled together from the laws of physics, which are iron clad. The law of conservation of energy, for example, states that energy can neither be created nor destroyed; rather, it can change its form. Politicians and central bankers appear to believe that money, on the other hand, can be created without limit and without serious consequence. The gold price, for one, is arguably flashing a warning sign that such

belief in fact carries serious consequences. Consider the following statistics, compiled by Eric Sprott and David Franklin, which relate to US government debts. The figures cited are shown in **trillions** of dollars.

Comparison of US Government Obligations						
Valuation Date <sup>7</sup>	Social Security Unfunded Obligations <sup>8</sup>	Medicare Trust Funds A,B,D Unfunded Obligations <sup>9</sup>	TOTAL Unfunded Obligations	US Debt <sup>10</sup>	COLUMN A Total US Government Obligations	COLUMN B Total Federal Obligations (GAAP) from Shadow Government Statistics <sup>11</sup>
2009	\$15.1	\$88.9	\$104.0	\$10.7	\$114.7	\$74.6[12]
2008	\$13.6	\$85.6	\$99.2	\$9.2	\$108.4	\$65.5
2007	\$13.6	\$74.3	\$87.9	\$8.6	\$96.5	\$59.8
2006	\$13.4	\$70.5	\$83.9	\$8.1	\$92.0	\$58.2
2005	\$11.1	\$68.1	\$79.2	\$7.6	\$86.8	\$53.3
2004	\$10.4	\$61.6	\$72.0	\$7.0	\$79.0	\$49.5

Source: Sprott Asset Management LP.

Footnotes:

- 7 We used January 1 valuation date for Social Security Medicare and US Debt Outstanding. GAAP estimates are provided by Shadow Government Stats using fiscal year end.
- 8 Social Security Administration, Office of the Chief Actuary (August 2009) UNFUNDED OBLIGATION AND TRANSITION COST FOR THE OASDI PROGRAM by Alice Wade, Jason Schultz and Steve Goss. Open group unfunded obligation for the infinite future projection period beginning at valuation date. Retrieved from: <http://www.ssa.gov/OACT/NOTES/ran1/>
- 9 U.S. Department of Health & Human Services. Centers for Medicare and Medicaid Services. Taken from Medicare Trustees Report for each year. All figures through the infinite horizon. Retrieved on October 20, 2009 from: <http://www.cms.hhs.gov/ReportsTrustFunds/>
- 10 Treasury Direct. The Debt to the Penny and Who holds it. Calculated for January 1st in each year. Retrieved on October 19, 2009 from: <http://www.treasurydirect.gov/NP/>
- 11 Shadow Government Statistics (October 9, 2009). No. 250 General Outlook and Trade Data Update. Retrieved on October 20, 2009 from: <http://www.shadowstats.com/>
- 12 Estimate from SGS

As Sprott and Franklin point out, they don't mean to pick on the US in isolation. Plenty of other western governments (the UK: one step forward, please) have thrown caution to the wind in bailing out the banks and cannibalising the future. The US merely represents the epicentre of the financial crisis. And the sums involved are gigantic. Bank loans have declined by \$1.7 trillion as of June 2009; over 7 million have lost their jobs since 2007 (source: BLS); the US Federal Reserve has injected over \$2 trillion into the economy having increased its balance sheet by the same degree; the Fed has also lent upwards of \$9 trillion to persons and corporations it refuses to identify..

There is, perhaps, a danger in treating gold as a special case within an environment in which almost everything is rising in price. (One exception is Gilts, of which more later.) Nevertheless, we would suggest that there are fundamental reasons for the surge in gold, amongst them growing fears by individual, institutional and sovereign investors about the real value of fiat currencies, most notably the US dollar. The supply of gold is finite; the supply of dollars, to all intents and purposes, effectively infinite. Certainly, the US authorities are printing dollars as if they were going out of

fashion. Which, of course, they are. But the price of gold may also be rising for some technical reasons. Analyst Paul Mylchreest has recently posited two scenarios:

Alternative 1:

“On average there is more than one ownership claim on each gold bar conforming to London Good Delivery (LGD) standard on the “pool” of gold which acts as liquidity for the massive OTC gold trade based in London. Essentially, the market operates on a fractional reserve basis, but if a sufficient number of market participants become concerned about this and there is a stampede to take delivery of physical bullion, there is a risk of market failure. Such a process could be delayed by central banks lending gold to the market, although this would likely be obvious by a spike in gold lease rates, or by a much higher gold price in order to encourage holders to sell bullion. In this scenario, the gold price could soar at any time and the gold market, which is subject to little regulation, is basically an accident waiting to happen;

Or

Alternative 2:

“There is far more gold bullion held in private hands than is acknowledged by current industry estimates. It is the large amount of additional gold on top of known gold stocks which provides sufficient liquidity to support the high volumes traded through London. The most likely source for this gold dates back to the Japanese conquest of Asia from 1894-1945 when Japan is alleged to have looted the gold and valuables of 12 nations – it is best known as the story of Yamashita’s Gold. If true, my analysis shows that particularly heavy volumes of this gold may have been laundered into the London market during 1986-90 and the mid/late 1990s. In this scenario, the continued evolution of the gold bull market could be more protracted, if supplies of this gold continue to enter the market periodically.”

Mylchreest addresses the implications of each option in turn. If it turns out to be Alternative 2, “it just means the authorities can keep the fiat currency party going for longer, but eventually the party has to end”. If Alternative 1, however, “the next phase in the gold bull market will be a religious experience for anyone unfortunate enough to be short of gold”.

Gold could, of course, simply be rallying on the back of the generalised flood of liquidity into financial assets.

But not all markets are created equal. While the prices of most financial things have been rising lately, the Gilt market has not been invited to the party. Ten year Gilts have seen their yields spike from 2.90% in March 2009 to over 3.90% now. That equates to a fall in price of over 8%, and has occurred during the period of extraordinary quantitative easing. This begs the question of what will happen to Gilt prices once QE ends (if it ever does). But the persistence of relatively low Gilt yields shows how government intervention can support fundamentally unattractive assets, at least in the short term. Government intervention, through QE, has now managed to distort all asset markets. This makes investment of any sort a little like playing chicken with the government. ‘Greater fool theory’ holds that investors make the most of a rising market because there is always a ‘greater fool’ who will end up being the buyer of last resort. The government has proven to be the ‘greater fool’ throughout the financial crisis. Whether government ends up being the ‘greater fool’ after the equity market rally is another question altogether.

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9th November 2009.

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