CHAPTER 1

GOLD REMAINS THE STANDARD

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"Give me control of a nation's money and I care not who makes its laws."

—Mayer Amschel Bauer Rothschild, banker (1744–1812)

Eric Sprott is a Canadian money manager who manages over $4.5 billion through various Sprott companies, mutual funds, and hedge funds. Having heard Eric speak on numerous occasions and having read a great deal of his written analysis, I can say that his numerous awards for investment analysis and fund management over his 35-year investment career are richly deserved. While the amount of money Eric manages as well as his long investment career may make Eric look like a Wall Street regular to some, his unconventional and contrarian thinking, as well his views of the important role that gold plays as wealth insurance, clearly put him on the outside.

Originally published in *Markets at a Glance* on October 14, 2005, as "Gold Remains the Standard."

Eric coauthors a monthly investment strategy article, "Markets at a Glance," where he discusses his views and expectations regarding global financial markets and economies. Looking through the archives of his newsletter contained on the Sprott Resources website, www.sprott.com, one can't help but be impressed by Eric's forecasting abilities and the investment results he's realized. To cite just one example, as of October 2009, the Sprott Canadian Equity Fund had achieved a 10-year return of over 23 percent per annum.

Although the article below was written over four years ago, I included it in this book because it explains why you should invest in gold. An understanding of Eric's timeless messages—"gold is the ultimate flight-to-safety investment vehicle" and "the upside for gold is quite tremendous"—are essential to any investor.

There were a couple of interesting headlines this week singing the praises of our favorite metal. On the front page of Wednesday's *Investor's Business Daily* was the headline: "As Gold Nears an 18-Year High, Some See Signal of Inflation Rise." Similarly, in Tuesday's *Wall Street Journal* was the headline: "Stocks Fall Amid Auto-Sector Woes . . . Gold Price Shines." Indeed, during times of financial anxiety and strain, signs of which are becoming increasingly apparent to everyone, gold remains the one and only go-to investment that can protect people's otherwise heavily weighted paper portfolios. With the price of gold up $40 per ounce since the end of August, it would appear that gold is once again starting to gain traction not only in the media, but in the hearts and minds (and safety deposit boxes) of investors.

All this, of course, makes perfect sense to us. In our view, gold is the ultimate flight-to-safety investment vehicle. We won't be going into all the reasons to own gold in this article. Seventeen such reasons can be found in our "Fundamental Reasons to Own Gold," written by John Embry, which can be found on our website at www.sprott.com. Rather, we would like to dream a little and speculate on what the price of gold *could* be if a financial crisis/panic were to ensue. Although our analysis is not rocket science, it does show that the upside for gold is quite tremendous given the troubles in the financial world we see developing.

FINANCIAL CRISIS

The first question that needs to be asked is: Is a financial crisis likely? To this we would answer: Most definitively **yes**. Furthermore, it's not necessarily a crisis *per se* that is needed to send gold soaring; but rather, just the *fear* of one is sufficient. We see many reasons to be fearful in this environment. Many stock indices are now down almost 10 percent from their highs of a few weeks ago. Interest rates have been on the rise, with 10-year Treasury yields up almost 50 basis points in the past six weeks. Corporate yield spreads are widening due to the well-publicized bankruptcies in the auto and airline sectors. Energy prices are high and likely to go higher. Retail sales have been coming in weak. The real estate market is starting to crack. The consumer is spent, and sentiment numbers have been horrid. Plus, to add insult to injury, everywhere there are signs of inflation. Let's face it, the current macroeconomic environment is not conducive to rising asset prices—quite the contrary. Except for gold, one of the only asset classes to have a negative beta to the broader markets.

For those witnessing how their portfolios are performing in September and (so far in) October, suffice it to say things haven't been pretty in the paper world lately. So what's an investor to do? Many advisors and influential letter writers are now recommending a gold weighting of 5 to 10 percent in portfolios. This is something unheard of in the past 20 years, a time when financial (paper) assets held sway, and gold was trashed as a "barbarous relic" of medieval times that serves no useful purpose in a modern technologically advanced society. But the times they are a-changing! Slowly but surely, and in spite of efforts to suppress it, gold is starting to acquire mainstream appeal. A testament to this is gold's recent run up in price against **all** currencies, not just the U.S. dollar. It is no longer the case, as it has been in the past couple decades, that gold's desirability was only in the eyes of the gold bugs. But we ask: Is it even possible for *everyone* to have a 5 to 10 percent weighting in gold? Is there enough gold to go around to meet such a demand? Not by a long shot, but with one caveat: only if the price of gold goes up by multiples from here. We'll run some calculations by you later to show what we mean.

TURNING BACK THE CLOCK

But first, let's turn back the clock to 1980. For those of us old enough to recall, this was the last time there was widespread financial panic that led to a frenzied flight to gold. Back then inflation was on the rise. Interest rates were heading skyward. Geopolitical risks were aplenty, once again centered in the Middle East with Iran. The prospects for the economy were dim. There was stagflation (weak economy and rising prices). Sound familiar? Stock markets were mired in a prolonged bear cycle. Last but not least, the gold price spiked above $800 per ounce. Greed and fear were in the air.

Some may think we're cheating by using 1980 as our reference point, given that that was the all-time high for gold. True, we've had financial crises since then, namely the crash of 1987, the savings and loan crisis, LTCM, the Asian flu, and the tech/telecom bust. But none of them really led to a flight to gold, thanks to the copious amounts of liquidity generated by central banks the world over. With all the inflationary pressures that exist today, such a nefarious liquidity injection can no longer be attempted without severe consequences to global currency values. Not to mention the fact that nothing kills the real value of financial assets quicker than inflation. It is our opinion that both scenarios (central banks print to save the day, or they don't and let the financial bubbles unwind) play into gold's hands and are highly bullish for gold going forward.

So could history repeat itself à la 1980? If it does, the gold price is unlikely to stop at just $800. $800 goes nowhere near as far today as it did back then. Let's dream a little and compare some financial metrics of today versus then. Needless to say, the paper world has gotten a lot bigger since 1980. According to the Federal Reserve website, money supply as measured by M3 has risen from about $2 trillion in 1980 to $10 trillion today. That's a fivefold increase. For gold to hold its stature relative to money, it is similarly likely to increase by fivefold from what it was in the 1980 financial panic. That implies a price of $4,000 per ounce. Not bad!

Housing prices are another indicator of the mound of paper built over the years. According to the OFHEO housing price index, U.S. housing prices have tripled since 1980 (with some markets such as New York, California, and Massachusetts going up by a factor of five).

This index understates the true appreciation in housing prices because it is based on mortgages issued by Fannie Mae and Freddie Mac, which have upper limits. Be that as it may, for gold to keep pace with housing prices as measured by this index, it needs to go to $2,400 per ounce. We'll take that, too.

Now here's where things really start to get interesting. The size of global equity markets in 1980 was $1.4 trillion. Today that value is in excess of $30 trillion! Global equity markets have grown over 2,000 percent in the past 25 years. What would the price of gold need to be to have kept pace? $16,000 per ounce.

GOLD IN THE FUTURE

Finally, let's see what happens if everyone tried to have a 5 percent portfolio weighting in gold. As we already mentioned, global equity markets are about $30 trillion. The bond and fixed income markets are twice that at $60 trillion. Then we have bank assets of $40 trillion. (These numbers are from the IMF's 2004 "Global Financial Stability Report.") This equates to a total investable pool of some $130 trillion, 5 percent of which is $6.5 trillion. The gold equity market is currently a paltry $50 billion, so right off the bat we note that it's nigh impossible to have gold stocks comprise 5 percent of even the global equities portion. To do so, gold equities would need to increase in value by a factor of 30. Even we aren't that bullish!

What about gold bullion itself? Here's where it gets tricky. The value of all above-ground gold is roughly $1 trillion. However, not all of it is for sale. Much of it is tied up in the vaults of central banks or lent out and thus owed to central banks. There is also much gold (the vast majority even) that has been "consumed" in the form of jewelry and thus is also not readily for sale. But let's assume, for the sake of argument, that **all** gold ever produced is made available for sale (i.e., Fort Knox gets gutted and everybody melts wedding rings). Even under this conservative scenario (let's call it the low case), the price of gold will need to increase by 6.5 times to $3,000 per ounce in order to comprise 5 percent of all financial assets. In the high case where only the 80 million ounces that are mined in a year get put up for sale (not realistic but let's just go there), then the implied price of gold needs to be $80,000 per ounce.

It only gets better if people decide to have a 10 percent weighting in gold . . . but let's stop there! Doubtless the gold bugs are already excited as is.

This may all seem a little cheeky—we've already admitted to not being rocket scientists. But taken for what it is, the analysis does seem to show that gold could have explosive potential from here. We're not saying that gold will go to these levels and stay there (though in a hyperinflation/money printing scenario, that is certainly a possibility). What we are saying is that in a financial panic that morphs into a rush to gold, the price of the glittery metal can easily attain heretofore unseen levels.

In conclusion, gold has more upside than just about any other investment we can think of in this market at this time. Investors will turn to gold for safety in a period of financial weakness. What alternatives are there? When paper valuations are shown to be based on a flimsy house of cards, people will turn to what is sturdy, weighty, and real. We'd like to finish off with a quote from our friend James Turk:

> The gold standard may be dead . . . but gold remains the standard.