PART ONE

DEMYSTIFYING THE GOLD PRICE

John Katz

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Introduction: Why Gold?

> ‘The recognition of risk management as a practical art rests on a simple cliché with the most profound consequences: when our world was created, nobody remembered to include certainty. *We are never certain; we are always ignorant to some degree*.’
>
> Peter L. Bernstein: Against the Gods – The Remarkable Story of Risk

> ‘We have entered the third millennium through a gate of fire.’
>
> Nobel Laureate Kofi Annan, United Nations Secretary General 2001

Unbiased Research

How do you decide if and when you should buy gold when opinions on its future value can be poles apart? Pundits at one extreme forecast an inevitable dollar crash that ends with a ‘bonfire’ of all paper currencies and global financial meltdown. Gold, they say, will be the most sought after asset on the planet and it is going to be priceless. Sceptics at the other extreme say it belongs ‘on the neck, in teeth and on the pinkie’. But it is obsolete in the information age and past its sell by date as a monetary asset. They say it won’t be worth much to anyone except a jewellery manufacturer or a dentist. Most commentators call it a safe haven investment. But many brokers with experience of gold rush frenzies that ended in tears remind us that the system of outright gambling in financial markets, politely called spread betting, was invented to give punters a chance to play the volatile gold price. In their opinion gold is a speculative punt and is not an investment.

Opinions at the extremes tend to be flawed. As an unbiased analyst I am neither gold bull nor bear, pundit nor sceptic. Working from the grey area between the extremes I have analysed when owning gold makes sense and when it doesn't and when gold prices do or don't make sense. Answers to key questions raised are not always clear cut. But there is no doubt about why the mythical treasure at the end of the rainbow is always a pot of gold and never a few truckloads of copper, zinc, coffee or anything else. Gold is the great universal consolidator of value. A million dollars of gold priced at $600 an ounce weighs only 104 pounds and will fit in a safe deposit box. A single 400 ounce gold bar is worth $240 000. A kilogram about the size of a golf ball $21 000. A one ounce gold coin $600. Even a five gram slither, marketed with a certificate of authenticity, is over $100.

This book has origins in research on investments insulated against financial market risks. The research started in September 2001 shortly after the 9/11 terrorist attacks in the US. Gold was on the agenda as a legendary safe haven in troubled times and, subject to price, it still is. In Part One of this book 'Demystifying the Gold Price' I review what motivates people and organisations to own gold, who buys it and the factors that influence how much they are prepared to pay. Gold used to be officially 'the measure of all exchangeable value' and 'the scale to which all money prices are referred'.[1] Over the twentieth century, as the US became the global superpower, the dollar assumed more and more of gold's traditional role in the international monetary system. After US President Richard Nixon severed all links between the dollar and gold in 1971 the dollar also usurped gold's role as the universal measure of value. Gold is now another alternative investment with a different risk reward profile to financial assets. Owning it in good times can be as rewarding as watching paint dry. But, because it comes into its own whenever there is uncertainty, owning some gold is something to keep in mind when we make risk management plans.

Nowadays, of course, we can introduce hedge funds and other modern investments into our portfolios. Indeed the world's top financial brains have been producing a seemingly endless stream of derivatives and other financially engineered structures that not only reduce risk exposure but are expected to make us money at the same time. Among the brilliant academic economists now also engaged in hedge fund management is Andrew W. Lo, Finance Professor at the prestigious Massachusetts Institute of Technology's Sloan School of Management. Working at the cutting edge of information technology he is devising a programme that will simplify risk management. All you will have to do is punch a range of information personal to you into a computer with data on the risks you can and can't tolerate. An algorithm will then tailor a portfolio for you suitably hedged against unwanted risks. The Professor acknowledges his plans still sound like science fiction and it will be ten years before his programmes are up and running.[2] To be sure technology has already revolutionised the way we invest and will continue to. But, when it comes to making the strategic decisions, we will remain in the driver's seat. Just as we are when we drive a car with automatic cruise control. The cruise controller doesn't decide whether to travel on an A or B road or whether to drive at fifty or seventy miles an hour. We do.

While the Professor empowers his computers we can and must empower ourselves to manage risk more effectively. By understanding the challenges we are facing in the twenty-first century we can position ourselves to deal with any adverse consequences. This book is a compilation of analysis and information on twenty-first century financial risks and on gold as an alternative investment that can limit risk exposure. Commentary and analysis that follows is supported by links to reliable sources of current information. But there is no link to any information source on when an unexpected crisis is going to happen. Even the Professor's algorithms will never have that link. The legendary billionaire investor Warren Buffett has repeatedly warned that derivatives are weapons of financial mass destruction. But nobody can tell if or when the multi trillion dollar derivatives market will be further disrupted by another unexpected crisis. Or when anything else unexpected will happen. Warren Buffett, Andrew Lo, you and I, along with everyone else on the planet, will find out about an unexpected crisis at the same time after it has happened. But some of us will have made better plans than others to deal with the consequences. Remember it was only ten years ago when the hedge fund Long-Term Capital Management run by Nobel Prize winning economists collapsed. Roger Lowenstein's book *When Genius Failed*, details how a group of élite investors engaged with financial derivatives created a trillion dollar hole in the international banking system that brought world financial markets to the brink of imploding.[3]

If ever a derivatives crisis or other mishap roils financial markets again hedge fund protection could prove to be as useless as holding all your eggs in a basket in your right hand when you trip over your left shoe lace.

The Stateless Money Franchise

I first heard gold spoken about as a 'franchise' from an advertising professional who told me I would understand it better if I looked less at economics textbooks and tried more to understand why people everywhere in the world trusted it. She urged me to focus on the remarkable franchise that comes with the word gold through its umbilical links with money and wealth. I could agree with her about these links. But I asked if she wasn't over egging the symbolism of a single word. No, she replied, the word gold in marketing and advertising is magic. Only economists think of the gold standard as a monetary arrangement that no longer applies. In the real world the gold standard has always been shorthand for the finest qualities for anything and everything from personal ethics to butter on a supermarket shelf or Rolls Royce jetliner engines. Then, to dispel my doubts about the commercial power of a single word, she reminded me of the time when, with a word, the jewellery tycoon Gerald Ratner torpedoed the share price of his company and ended his career as chief executive. While telling his success story to an audience of marketing professionals he quipped that some of the cheap wares sold in his shops were crap. Wallmart, she assured me, sell similar cheap jewellery ranges to those Mr Ratner mentioned. But they are enormously successful because they don't sell crap. She urged me to look at their web site and see for myself how they engage the magic of gold to embellish their cheap jewellery. And, yes, they do associate their wares with the mystique of gold. The jewellery they sell is made from 'the oldest precious metal known to humankind, with lustre and remarkable properties that have allowed it to be crafted into the world's most coveted and exquisite jewellery'.[4] Nevertheless for about $20 they offer two pairs of '10 karat shiny yellow gold ear ring hoops'. That's how the masters engage the gold franchise to market trinkets made from thin metal tubes with a little gold content. Their marketing is so successful that they were at one time the biggest distributors of gold in the United States, the second biggest user of gold in the world. India is the biggest.

Gold has unique properties that underpin demand for jewellery, gold as an investment and its stateless money franchise. France's President General Charles de Gaulle spoke flamboyantly about these qualities in a campaign he launched in 1965 against dollar hegemony. Gold backing for the dollar was eroding. It no longer looked like the 'better than gold' global currency it was at the end of World War II when the US owned 80% of the world's monetary gold. Instead it was starting to resemble Mr Ratner's jewellery. President Richard Nixon's Treasury Secretary John Connally said as much when he told European bankers: 'The dollar is our currency but your problem.' Campaigning for a return to the classic gold standard De Gaulle declared: 'There cannot be any other criterion, any other standard than gold. Oh yes! Gold which never changes its nature, which can be shaped into bars, ingots or coins, which has no nationality and which is eternally and universally accepted as the unalterable fiduciary value par excellence.' The General's campaign failed soon after it was launched. Whatever weaknesses there were with the dollar he had no viable alternative to offer to dollar hegemony. But he had one lethal weapon in his armoury. He was entitled under the post World War II Bretton Woods arrangements to demand that settlements of balances with the United States must be made with gold. In 1971, when demands from France and other European countries were draining America's gold reserves, Nixon summarily severed all links between the dollar and gold. In the jargon of the day he 'closed the gold window' and consigned the last remnants of the monetary gold standard to history. Currencies started to trade in open markets independently of each other. Gold, no longer money or a currency, started to trade as a commodity. But it is often still labelled a quasi currency or stateless money. I prefer the stateless money label because it associates gold with its role as a universally recognised store of value over thousands of years.

The heyday of dollar hegemony came at the end of the 20th century with the Pax Americana after the Cold War ended. Peter Bernstein's classic book *The Power of Gold – the History of an Obsession* was published in 2001.[5] Cynical on gold's traditional monetary role surviving into the twenty-first century Bernstein concluded:

> the most striking feature of this long history is that gold led most of the protagonists of the drama into the ditch. . . . Midas . . . Croesus . . . Charles de Gaulle, and the gold bugs of the 1980s all were fools for gold, chasing an illusion. . . . Gold and its surrogates make sense only as a means to an end, to beautify, to adorn, to exchange for what we need and really want.

After the millennial stock market collapse and 9/11 Bernstein changed tack. Acknowledging in a 2002 interview that he never thought he would again recommend investors to hold positions in gold he went on to say:

> Gold has this magic quality in the worst of times as a store of value because it is stateless money . . . Gold strikes me as an extraordinary asset as a hedge to-day. You can't hedge using the US dollar because if anything is going wrong that's the thing that is going to be going the most wrong. That is what you would want to have gold for.

In 2005 Bernstein again publicly advised investors to hedge against hyperinflation with gold and in February 2008, in a video interview with the Financial Times when gold was already trading above $900 he again endorsed its utility as a hedge against extreme outcomes.[6,7,8]

The most ringing recent endorsement of gold's stateless money franchise came from Alan Greenspan in 1997 when, as Chairman of the US Federal Reserve, he was the world's most powerful central banker. In testimony to a Congressional Committee he advised against selling any of America's gold in Fort Knox because 'gold still represents the ultimate form of payment in the world. Fiat money in extremis is accepted by nobody. Gold is always accepted.'

Crisis and Financial Market Risk Insurance

It is highly improbable, but not impossible, that in our lifetimes we will experience the unthinkable. A terrorist, military, economic, nuclear, environmental or financial market disaster that disrupts banking and civic systems and leaves us dependant for survival on owning something that can readily be exchanged for things we need to survive. In that situation nothing will be as useful as gold.[9] We know that over the centuries owning some in times of crisis saved many families from starvation and despair. Calamities in the twentieth century included two World Wars, the Cold War with the threat of nuclear confrontation, serial regional wars and several episodes of hyperinflation. The best remembered hyperinflation was in the German Weimar Republic in 1923 when the value of the currency was totally obliterated. Economic and social chaos followed. In its wake came the Nazis and World War II. Currently post Saddam Iraq is experiencing inflation of over 70% with its new currency – and that is after decimation in the value of its old currency only a few years ago. Zimbabwe is experiencing hyperinflation of over hundreds of thousands percent. Granted, comparing Iraq or Zimbabwe with a major international power like Germany is not comparing apples with apples. But Iraq has amongst the world's largest oil reserves and should be prospering. Zimbabwe is richly endowed with resources and was prospering until a few decades ago.

Most of us find it unthinkable that anything catastrophic will happen to us. We don't warm to the idea of hoarding gold as protection against our paper money becoming worthless. Yet, as risks to our personal safety and financial security have magnified since 9/11, we would probably consider some crisis insurance if it was on offer from a conventional insurer. To give effective protection the insurer will have to be in a position to settle claims instantly after a crisis and, if necessary, to settle in gold or another precious metal. Preferably gold. No insurer could guarantee that. And if promises on those lines were made in the sales puff the policy small print would certainly provide otherwise. For insurance against the unthinkable we have to own and possess gold. Stateless money that will keep its value even in the worst of times. Keeping even a small amount in your personal control will afford instant protection whenever you need it. Larger holdings in secure warehouses in any of the world's major financial capitals can be arranged with organisations that simplify all aspects of buying, storing and selling at low costs.[10]

You know your circumstances and must assess how you would deal with the consequences of an unthinkable disaster. I can't call the odds for you. The eccentric seventeenth century French mathematician and philosopher Blaise Pascal is remembered for his studies on gambling and calling the odds for a wager on the existence of God. He argued that you have to think about the consequences when you die if you made the wrong choice in your lifetime about the existence of

God. If there is no God it will be immaterial if you lived your life sinfully or righteously. But if God exists the difference will be profound. You will have the possibility of salvation if you lived a righteous life. But if you lived a sinful life you face eternal damnation. Needless to say salvation is preferable to damnation. Pascal abandoned high living, philosophy and mathematics and went live in a monastery.[11] His wager has been ridiculed in a religious context. But his conclusion that the best bet is the one that protects you from dire consequences is worth taking on board. Pascal was concerned with eternal damnation. We are concerned with poverty, distress and even starvation for our families.

If you own gold bought as insurance you can sell it if the time comes when you expect blue skies will be with you for the rest of your life. The insurance may even be free if you get more than it cost to buy and hold. If you get less, the loss will represent the cost of the security that came with owning it. Or, instead of selling, you could bequeath it to your heirs for their protection.

A Niche Investment

As a scarce natural resource gold is a small niche investing opportunity in a gigantic \$150 trillion pool of financial assets.[12] As it lasts forever and does not degrade, almost all the 150 000 tonnes of gold mined since the days of the Pharaohs are believed to still exist somewhere on the planet as jewellery, bullion, coins, artefacts or scrap (to convert tonnes to ounces, etc., see page 275). If it was re-smelted into flat tightly stackable bars it would all fit in a square cube with about 18 meter sides. That is all six sides each about three meters shorter than the length of a tennis court. Priced at \$600 an ounce the cube will be worth about \$3 trillion. Fabricated gold objects and scrap are constantly re-smelted back into bullion and traded back onto the market. If the price is tempting enough it is guesstimated that as much as half the world's above ground gold stock could find its way back to the market and then be accessible to investors. This half includes gold in the manufacture and supply chain of jewellery manufacturers and other fabricators, gold bullion in storage vaults held for national treasuries, central banks, organisations, gold funds, companies and individuals as well as similar items and personal jewellery and ornaments kept in safe deposit boxes, jewel boxes or under mattresses. But regardless of how high the gold price might climb the other half of the world's stock of mined gold is not going to find its way back to the market. This half includes national and artistic treasures, religious artefacts, jewellery masterpieces, heirlooms and treasured personal possessions. If the broad-brush estimates used above are reliable, all the above ground gold in the world potentially accessible to central banks and investors is worth about \$1.5 trillion.[13] About 1% of the pool of financial assets. Financial assets are growing at over 7% a year and are expected to reach $200 trillion by 2010. Mining only adds 2% to 2.5% a year to the world's gold stock. By 2010 it may be worth $2 trillion. Still only about 1% of financial assets. Over the years the disparity in growth rates and the law of large numbers will widen the gap between the value of the pool of global financial assets and the world's stock of gold.

Scarcity keeps gold valuable. Unlike paper money it can't be printed to order. Currencies not backed by precious metals or other 'specie' have a bad record of ending up worth less and less over the years and eventually even ending up worthless. The dollar lost over 98% of its purchasing power in the twentieth century. Other major currencies fared no better. The Nobel Laureate Economist Professor Robert Mundell tells us currency erosion is nothing new. After kings and other potentates first introduced coins as substitutes for ingots of precious metals over two millennia ago it did not take long before they started to water down their precious metals content. Mundell concludes 'the conventional wisdom that coins were first stamped to confirm their weight and thus provide a convenience for their subjects is sheer nonsense . . . the earliest function of coinage was profit for the state'. The ancients, he notes, 'succumbed to the fiscal temptation of replacing intrinsic money with overvalued currency. But they did not know when to stop. How far could the precious metals be replaced without running the risk of inconvertibility, depreciation and inflation?'[14] Questions on rather similar lines to those being asked again about the dollar and other fiat currencies.

Squaring a Valuation Circle

Gold's safe haven credentials in times of hyperinflation are not in question. But it is a myth that it is always a safe haven and always a good hedge against inflation. Unless prices are rising rapidly over short time frames it can be a poor indicator of inflation and, if it is bought at an unrealistic price, it can't be a safe haven. Consider the plight of anyone who still holds gold bought in 1980 when a speculative frenzy catapulted prices to peak above $850. Allowing only for consumer price inflation they will need almost $2000 in 2006 to recover the $850 paid in 1980, without any return on capital for over a quarter of a century. Almost $10 000 will be needed if, instead of a consumer price index, the Dow Jones Industrial Average is the comparative yardstick. The Dow was under 1000 in 1980 and closed above 23 000 at the end of 2007. Gold looks even more like the poor relation if real estate prices in London, California or other favoured locations are used for comparison. Well over $25 000 will be needed to match an outlay of $850 in 1980.

As gold is a sterile asset that pays no interest, yields no dividends and costs money to keep, there is a valuation circle to square before it can qualify as an investment – unless it is bought at a price low enough for a realistic prospect of profit from a sale at a higher price. Otherwise the circle can only be squared if indirect benefits come with ownership. With gold jewellery benefits can be the pleasure of wearing it and transferring wealth with it. With gold bought as crisis insurance the benefit is obviously protection. And when it is introduced into a portfolio of financial assets the benefit comes from spreading risk by not having all your eggs in the same basket. A rising tide lifts all boats and when sentiment in financial markets is positive gold prices may also be strong. But when sentiment is negative money usually flows in the direction of gold and prices tend to rise. The gold price is expected to soar if financial markets run into serious trouble.

Leading Questions on Reasonable Prices

In India, China and other societies where it is still culturally associated with money, wealth, savings and security people may still be as unquestioning about gold as they are about religion. They just believe in it. If the price is a mystery – perhaps so much the better. Families traditionally accumulate savings by hoarding valuable gold jewellery, coins and gold bars and in many interpretations of Sharia law, regardless of what happens to the marriage, jewellery remains the property of the wife. It is not unusual for a bride in prosperous Saudi Arabia to wear a few kilograms of gold jewellery. But in the West we are not believers. We are sceptics. Investing can only make sense when prices are reasonable. We can speculate on an asset with a mysterious price. But we can't invest in it.

There are two sides of the gold coin for investors. One side is for gold as a commodity and the other for gold as a financial asset or stateless money. A useful perspective on the two sides of the coin comes from this unscientific remark made by Professor Andrew Lo: 'Physics has three laws that explain ninety nine percent of the phenomena and economics has ninety nine laws that explain three percent of the phenomena.' As a commodity, gold is in the physical domain where cause and effect relationships are transparent. Research on gold as a commodity is focused on the mining industry and demand from mainly jewellery manufacturers. But as a financial asset or stateless money it is in the domain of economics and macroeconomics where cause and effect relationships are opaque. The main research focus for this side of the coin is on the dollar. It has usurped gold's role in the monetary system and the US economy commands the world economic stage. Outcomes and expected outcomes for the dollar and the US economy are likely to affect the gold price and not vice versa. The tail can't wag the dog.

Part One 'Demystifying the Gold Price' includes this Introduction and a further nine chapters presented as essays with analysis and an associated leading question. The first five chapters are background information on gold and legacy global monetary arrangements from the twentieth century:

1 Introduction: Why Gold?
2 The Gold Mining Industry: *What gold price gives producers a worthwhile profit?*
3 Gold Supply and Demand: *Do central banks still need gold and does gold still need central banks?*
4 The Rise and Fall of the Gold Standard: *Did gold cause the great depression?* and
5 The Dollar Standard and the 'Deficit without Tears': *Is the dollar again America's currency and everyone else's problem?*

The next five chapters address the twenty-first century economic uncertainties that have come in the wake of 9/11. The distinguished French Arabist commentator Gilles Kepel described 9/11 at the time as a 'seismic event with incalculable consequences (that) exposed the fragility of the United States empire, exploded the myth of its invincibility, and called into question all the certainties and beliefs that had ensured the triumph of the American civilisation in the twentieth century'.[15] President Bush responded with vigorous military and economic initiatives.

6 The Economic Consequences of 9/11 and George W. Bush: *For how long will Asians go on lending for Americans to go on spending?*

Chapters 7, 8, 9 and 10 examine different scenarios that may play out on the world economic stage, how they can affect us, what we can do to insulate ourselves from adverse outcomes and when gold can be usefully introduced into our risk management strategies:

7 The End of Cheap Oil, 'Chindia' and Other Tipping Points to Instability: *Will alternative energy come to the rescue?*
8 Globalisation and Global Economic Rebalancing: *Can the International Monetary Fund avoid global financial meltdown?*[16]
9 Gold Prices: Inflation, Deflation, Booms and Busts: *Do trees grow to Heaven?*
10 Investing Choices: *What gold?*

There are times when owning physical gold is a suitable investment but physical gold is always sterile. By contrast gold mining shares can also be growth investments and owning shares that invest in gold mining shares can be more rewarding and more tax efficient than owning physical gold via shares in an Exchange Traded Fund. Part Two of this book written by Frank Holmes, the Chief Executive and Chief Investing officer of US Global Investors takes the reader through the day to day disciplines and processes of managing and optimising investments in gold mining shares. In the following chapters he includes analysis on gold fund strategies, supply and demand for gold, mining costs, investment timing, stock picking, investment monitoring and the resources that are needed to successfully manage investments in gold mining companies.

The Goldwatcher blog on www.thegoldwatcher.com will continue commenting on developments relating to the contents of this book and serving as a supplementary information resource with up to date data and information.

Credible Analysis and Commentary

The media buzzed with excitement when the gold price jumped to $535 in December 2005, its highest level in nearly twenty-five years. In an article in *The Guardian* newspaper headlined 'Gold Sparkles as Never Before' Pierre Lassonde, the President of Newmont Mining, one of the world's biggest gold mining companies and at the time the driving force behind the industry's marketing initiatives, commented 'the market is hot and it's going to get hotter'. Simon Weeks, the Chairman of the London Bullion Market Association, cautioned 'when the froth dies down I think people will take a step back and say we are overextended'. I was quoted in the same article commenting that the run up to $500 was expected. Financial assets tend to revert to mean and the long-term inflation adjusted average price for gold at the time was $540.[17] Yet there was chatter at the time that the next stop would be $1000. A target no analyst would take seriously without a major crisis as a catalyst.

Since January 1994 the London Bullion Market Association (LBMA) have sponsored and published annual forecasts from respected analysts on gold, silver, platinum and palladium with the analysts' reasons for their conclusions.[18] Twenty-nine analysts contributed to the LBMA forecast for 2007. Their averaged expected gold price was $720, about 16% higher than the $603 average chalked up in 2006. But there were big differences between the highs, lows and averages in the individual contributions.

The highest and lowest forecasts for 2006 were:

Analyst	High	Low	Average
Norman Ross: The Bullion Desk	$760	$520	$618
Jeffrey M Christian: CPM: New York	$580	$425	$479
Outcomes for 2006	$725	$525	$603

The 2007 forecasts by Norman Ross, the most bullish and accurate forecaster in 2006, and Jeffrey Christian, the most bearish, are revealing. Norman Ross remained bullish and forecast gold would trade in a range between $580 and $850 and average $716 over the year. This comment accompanied his prescient forecast:

> We remain manifestly bullish for gold. Over the last five years gold has notched up a successive 23%, 25%, 5%, 20% and now a 23% rise; for 2007 we expect the gold price to rise by a comparatively modest 18% with a possible spike to an all time high of$850. Whilst a weakening US dollar, stagnating mine production, buoyant oil prices, ongoing geopolitical tension and the spectre of inflation may provide a positive backdrop we expect that sentiment will also be supported by institutional investor demand growth . . . However the fragmentation of the gold market that follows in consequence may well lead to increasing problems with liquidity and thus price volatility is also expected to remain high.

Jeffrey Christian who was bearish in 2006 turned bullish for 2007. He forecast that gold would trade in a range between $550 and $850 over the year and average $616. In his opinion:

> The gold market remains very tight on a physical basis. Mine production is not increasing as rapidly as had been expected due to bottlenecks in starting new mines and expansions. These are coming on stream but they are coming more slowly than had been expected by the mining industry. Central bank sales meanwhile are declining as central banks have sold much of the gold they wish to sell. This tightening of supply has run into investment demand that has remained high, and risen, reaching record volumes in 2006. While investment demand may cool somewhat in 2007, investors are expected to find enough economic and political developments around the world to keep them interested in gold as a safe haven.

The average gold price in the forecasts made for the LBMA for 2008 is $860 and over half the analysts expect the price will at times be over $1000.[19]

Analysts are agreed on the tight supply and demand dynamic for gold. However there is no support among them for the conclusions published by the French investment bank Cheuveux in January 2006 that challenged the consensus belief that the world's central banks and monetary authorities still owned about 30 000 tonnes of gold they were free to deal with in any way they chose to.[20] Cheuveux's studies concluded that over half the disclosed central bank holdings were already allocated to forward sales commitments leaving unencumbered holdings of only about 15 000 tonnes. Cheuveux no longer publish analysis on precious metals and it has not been possible to update their opinions but they suggested in their report that gold prices could spike to $2000 or even higher if central banks were put under pressure by traders aware of their forward sales commitments, or if anxieties about the US economy grew and concluded with the astute observation that 'gold comes out of hiding when the risk of a financial crisis in terms of inflation or deflation rises'.

The annual LBMA forecast is a useful base for access to analysis on gold inside a current year and, as they publish their forecasts going back three years, we can also assess the consistency of any analyst. Credible analysis is also published by other accessible and at times more current sources. The US Funds Website covering funds managed by Frank Holmes is also a treasure chest of analysis and current information.[21]

US Deficits and Missions Possible and Impossible

Frustrated by economists who hedged their bets with the characteristic caveat '. . . on the other hand' American President Harry S. Truman once demanded 'give me a one armed economist'. From 2001 to 2006 President Bush never had that problem. His appointees were there to do his bidding. If they had other ideas their appointments ended. A few months before the November 2004 US Presidential elections, Martin Wolf, an associate editor of the *Financial Times* and its chief economics commentator expressed the concerns held by many economists about the Bush administration when he wrote:

> Let's be blunt about it. The US is now on the comfortable path to ruin. It is being driven along a road of ever rising deficits and debt both external and fiscal, that risk is destroying the country's credit and the global role of its currency . . . Politicians wait until crises hit. Statesmen foresee them and act to prevent them. What is the chance of such a statesman emerging after the election? Almost none, I fear.[22]

By mid 2006 not only was Bush's misguided 2003 announcement of 'mission accomplished' in Iraq tarnishing his image but economists were also convinced he would be unable to enlist the support of an internationally respected Treasury Secretary to steer the US off the road to ruin. In April 2005 Bush surprised markets with an announcement that he was nominating as Treasury Secretary Henry Paulson, the Chairman of investment bankers Goldman Sachs.

Paulson is no one armed economist. He would not have accepted the responsibilities of public office without assurances on his authority and the general expectations were that he commanded the skills and stature to negotiate internationally and domestically on behalf of the US. I first became aware of his exceptional talent in 2000 when I was commissioned by the *Sunday Business* newspaper to write an article on Goldman Sachs's first year as a public company. There was no doubt then about the direction in which he would steer the company and I expected that if anyone could get to grips with the runaway US deficits he would. However, by the end of 2007, Paulson was humbled by the investment banking crisis that came in the wake of the housing bubble deflating and was unable to secure bi-partisan support for initiatives to correct the nation's deficits and get the US economy back on a safe course.

We tend to underestimate the risks that come with US financial deficits. This extraordinarily revealing analysis on the risks was given in 2001 by Robert McTeer, at the time President of the Dallas Federal Reserve:[23]

> What is my opinion of the current account deficit? . . . To some extent, the world has long been willing to hold the excess dollars that we put out by buying more than we sell to the rest of the world. And we get sort of a free ride. Sort of like we're in a poker game and we never have to cash in our chips. . . . The problem will come when people change their mind about all that and they've decided, maybe suddenly, that the world has too many excess dollars. . . . I don't know exactly what would happen, but it wouldn't be good. But we've had the potential for that to happen for several years now and it hasn't. Most of the countries that own a lot of the dollar balances don't have any real incentive to trigger a crisis like that. They would perhaps be hurt as much as anybody else by such a crisis. What is it they say: 'If you owe the bank a little money, you've got a problem. If you owe it a lot of money, the bank's got a problem.' We might be in that situation.[24]

In 2004 Richard Fischer, Robert McTeer's successor at the Dallas Federal Reserve, also played down concerns in financial markets about the widening US current account gap. He said it reflected robust US consumption, a key factor driving export growth in the rest of the world, and asked:

> Where would the world be if Americans did not live out their proclivity to consume everything that looks good, feels good, sounds good, tastes good? . . . We provide a service for the rest of the world. If we were running a current account surplus or trade surplus, what would happen to economic growth worldwide and what would be the economic consequences? So I think we are doing our duty there.

Though McTeer's and Fischer's comments were brash and unconventional for central bankers, and were certainly not the kind of remarks Paulson would have made, there were some truths in what they had to say. Now, as investors, we have to concern ourselves with what is bound to happen as Americans find they can't afford to 'live out their proclivity to consume everything that looks good, feels good, sounds good and tastes good' and when eventually McTeer's 'free ride' poker game comes to an end and the poker chips have to be accounted for. Will the US have the money to pay everything it owes, or be able to borrow if it hasn't got the funds to settle up, or will it just print dollars as necessary to clear the books? And what should we be doing now to protect ourselves from the vicious circle of value destruction that will follow if the US gets into funding difficulties?

The former US Comptroller General, the Hon. David Walker, has this advice to give: 'Keep in mind the passengers on the Titanic had a smooth ride and a great time until the very moment the ship hit the iceberg.' Walker is the public official responsible for auditing the US Federal accounts. He has added up the numbers and is anxious and militant. Multi trillion dollar debt burdens threaten America's role as the world's most powerful economy and prospects for the world economy and impose a 'birth tax' on future generations. From 2000 to 2005 explicit and implicit commitments by the US Government more than doubled from $20.4 trillion to $50.5 trillion.[25]

Most of us can't make any sense of $ signs followed by trailing banners of zeros. This analogy gives some insight into the enormity of the numbers: One billion seconds equals 32 years. One trillion seconds equals 300 centuries. Walker has been conducting a 'wake up campaign' to get public support for solving problems that won't be solved, 'until the majority of the people believe you have a problem that needs to be solved'. He is committed to making sure that no serious candidate for the US Presidency in 2008 will be able to duck financial realities in his or her electoral campaign. The best he expected from his initiatives before the next Presidential election was to 'slow the bleeding'. For someone warning that on its present course the US could go broke, it looked rather like rearranging the deck chairs on the Titanic. Since 5 January 2007 when President Bush's political opponents, the Democrats, took control of the US Senate and House, Walker's comments will have had more clout.

The Road to Global Economic Rebalancing

Questions about the solvency of the US have been asked before. Often. And we don't take them seriously. Whatever the challenges, we expect that the resilient US economy and the robust dollar will always come out on top. But Walker is not the only informed expert sounding the alarm. In a study published by The Federal Reserve Bank of St Louis in July 2006 Professor Lawrence J. Kotlikoff of Boston University warns against scoffing at the notion that the US could go broke. His analysis, in line with other credible research, warns that unless the US economy, and with it the world economy, is pulled back from the brink the unthinkable will happen. Kotlikoff's calculations reveal that providing for unfunded entitlement commitments and paying off the existing US deficit will require either an immediate doubling of personal and corporate income taxes, a two thirds cut in Social Security and Medicare benefits or some combination of the two. Fortunately he is not addressing an imminent crisis. His analysis, like Walker's, is intended to warn policymakers that the ship of state on its present fiscal course is heading for the rocks. It is not yet too late for course corrections by the United States and the world's other major economies.

On the positive side Paulson, Walker and other dedicated public office holders have enhanced influence with political power in the United States split between the Bush administration and legislature. The US is the global superpower, its economy has formidable strengths and the global economy has experienced above trend growth. The world's great powers are committed to economic growth and global institutions, including the International Monetary Fund, exist to support cooperation. Paulson, by profession an investment banker with a consummate knowledge of global capital markets, has skills in his profession and as a politician and statesman. He was expected to shine a spotlight on domestic and international commitments, initiate a programme of strategic co-operation with China, encourage currency re-alignments and open markets but he has so far been unable to secure bi-partisan cooperation on entitlement and fiscal reforms. And, again on the negative side, the US is no longer as it used to be the world's largest creditor. Instead it is the world's largest debtor, borrower and spender.

The appreciation of China's currency the US seeks may not be in China's or its own interests. Protectionist sentiment has been growing in the US. Parallel issues on world trade are unresolved. Domestic constituencies have radically different priorities to reconcile. Implementing major policy changes in the US now won't be possible until a new President is elected in 2008 with a clear mandate for change. And, for some time after the US 2008 Presidential elections, the fallout from wars in Iraq and Afghanistan and other conflicts in the Middle East will continue to destabilise the region and disrupt world oil supplies. With the euro now well established as an international currency, countries with vast international reserves also have an alternative safe haven currency to the dollar for the first time since the dollar came to dominate global currency markets over half a century ago.

If we look ahead over the next decade the probability of a global economy less dependent on a runaway US balance of trade deficit is high. But the probability of outcomes that don't result in a substantial dollar depreciation are extremely low. As are the chances of any quick fixes. The road to global rebalancing is likely to be a multi decade marathon with competitors fighting it out over the distance.

Why Gold Makes Sense Now

Analysis in Chapter 8 'Globalisation and Global Economic Rebalancing' reveals how the US current account deficit has more or less financed itself up to now. Central banks of dollar surplus countries have been buying the surplus dollars coming into their countries to prevent their domestic currencies from appreciating. Then, to earn interest on their money, they have recycled their dollars back into US dollar denominated investments. This explains why Robert McTeer could say ' . . . we get sort of a free ride. Sort of like we're in a poker game and we never have to cash in our chips.' But because the US can't keep on going deeper and deeper into debt forever the game can't go on forever. The day for settling up will inevitably come sooner or later. The advent of Sovereign Wealth Funds in dollar surplus countries will also have to be factored in to future expectations on creditors' intentions and plans to limit their losses on dollar holdings.

Gold bugs expect that when the time comes for settling up Dr Ben Bernanke, now the US Federal Reserve Board Chairman, will recklessly print money and pay whatever the nominal amount of the debt is with a devalued currency. They have been convinced this will happen since 2002 when, shortly after being appointed a US Federal Reserve Governor, Bernanke gave a speech titled 'Deflation: Making sure it won't happen here'. This sentence from his 5000 word speech was provocative: 'but the U.S. government has a technology called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost.' Bernanke certainly made it crystal clear that, if necessary to stop deflation taking hold, the US will print as much money as is necessary. Few economists will disagree it would be the right thing to do. However, while the idea that Bernanke is committed to an irresponsible course is wide of the mark, adverse developments following the US sub prime mortgage and associated unregulated shadow banking crisis suggest Bernanke will continue to find it necessary to print money to fend off deflation.

Bernanke's opinion in April 2005 that the time for settling up with international creditors was not imminent. In a speech 'The Global Saving Glut and the U.S. Current Account Deficit' he made the case that over the past decade globalisation and a 'global saving glut' have been behind the increased US current account deficit. In his opinion the US deficit was 'the tail of the dog' responding to globalisation, rising asset prices worldwide and increased personal incomes and savings. But he also emphasised that 'the current pattern of international capital flows – should it persist – could prove counterproductive. Most important, for the developing world to be lending large sums on net to the mature industrial economies is quite undesirable as a long-run proposition.' His conclusion, particularly after the word 'however,' is worth taking on board: '[f]undamentally, I see no reason why the whole process should not proceed smoothly. *However,* the risk of a disorderly adjustment in financial markets always exists, and the appropriately conservative approach for policymakers is to be on guard for any such developments.'[26]

As investors and savers we are also policy makers and must be 'on guard' for developments that affect us. In his Global Savings Glut speech Bernanke acknowledged that to repay foreign creditors, as it must someday, the United States would need 'large and healthy export industries'. Surely that will be a mission impossible without a substantial fall in the exchange rate of the dollar. And can we afford to bet on no 'disorderly adjustment' roiling financial markets – or should we take 'an appropriately conservative approach'? Martin Wolf has warned of 'a brutal and sudden correction' if at any time the rest of the world decides that its holdings of dollar claims are excessive. In his opinion: 'the chance of a hard landing, with unpredictable political consequences in the United States and among its creditors though not 100% is not zero either'.[27]

Owning some gold bought at a reasonable price can be useful to spread risks and insulate assets from damage caused by a financial crisis. In 1934 when gold was still the universal measure of value and the US Treasury could not meet its commitments President Franklin D. Roosevelt devalued the dollar to gold by 47%. After President Richard Nixon ran into trouble in 1971 and reneged on all commitments to gold the market price of an ounce of gold rose within a decade from an average of $35 to over $600. Nixon imposed a surcharge of 15% on all imports to force negotiated dollar devaluations of more than 20% against other currencies. In 1985 President Ronald Reagan's Treasury Secretary James Baker negotiated the Plaza Accord with Germany, France, Britain, Canada and Japan that made it possible for the floating dollar to fall 30% over the next two years. The current round of global rebalancing may be resolved with a 'soft landing' but, if history is anything to go by, the dollar and other currencies are on course to losing purchasing power.

Should we be looking back at history? After all the author Thomas Friedman sees globalisation as having changed the world so radically that he has written a best selling book titled *The World is Flat*. The chapter in his book 'The Unflat World' explains that, actually, everything hasn't changed. Here is a key paragraph:[28]

> But another barrier to the flattening of the world is emerging . . . a natural resource constraint. If millions of people from India, China, Latin America and the former Soviet Union who were living largely outside the flat world start to walk onto the flat world playing field at once – and all come with their own dream of owning a car, a house, a refrigerator, a microwave and a toaster – we are going to experience either a serious energy shortage, or worse, wars over energy that would have a profoundly un-flattening effect on the world.

Insight into the Post 9/11 World and the Jihad against America

To better understand 9/11 and its aftermath we have to look beyond Osama bin Laden and Al Qaeda. The US had enemies in many quarters prior to 9/11 including the scattered community of 'Afghan Arabs' who joined the Afghan jihad against Soviet Russia in the 1980s. It's ironic that they were funded largely by the CIA and others to join the Afghan Mujahideen but, after Soviet Russia was defeated, they were totally ignored. I draw attention to them because they are among elements that were dangerous before 9/11 and still are.

In his book *Taliban*[29] Ahmed Rashid, a journalist who has covered Afghanistan for over a quarter of a century, tells us that between 1982 and 1992 some 35 000 Muslin radicals from 43 Islamic countries in the Middle East, North and East Africa, Central Asia and the Far East joined forces with the Afghan Mujahideen fighting a guerrilla war against Soviet Russia. Tens of thousands more foreign Muslim radicals came to study in madrassas in Pakistan. Eventually according to some estimates as many as 100 000 Muslim radicals came in contact with jihadists in Pakistan and Afghanistan. It's worth pausing here for a moment and noting that among the 100 000 radicals were a significant number of potential warriors in a holy war, Mujahideen, terrorists, insurgents or whatever else they may be called at different times.[30] In Afghanistan the camps where they lived, studied and trained became virtual universities for Islamic radicalism. Yet neither the CIA nor the intelligence organisations of other countries funding the Afghan jihad against Soviet Russia considered the consequences of bringing together thousands of radicals from all over the world until, as Rashid reminds us, American citizens 'woke up to the consequences when Afghanistan-trained Islamic militants blew up the World Trade Centre in New York in 1993, killing six people and injuring 1000'.

Funding for the Afghan jihad came from several sources – mainly Saudi Arabia, Pakistan and the United States through the CIA. Saudi Arabia supported the jihadists for religious reasons and as a way to get disgruntled radicals out of their own communities. Pakistan funded them to cement its position at the centre of the Islamic world and the United States funded them so that they, instead of American soldiers, would fight the Soviet Union.[31] Robert Gates, a former Director of the CIA and now the United States Defense Secretary, writes in his book *From the Shadows* that in 1985–1986 'we began to learn of a significant increase in the number of Arab nationals from other countries who had travelled to Afghanistan to fight in the Holy War against the Soviets . . . We examined ways to increase their participation, perhaps in the form of some sort of international brigade but nothing came of it.' It's not surprising nothing came of that idea but the following comment from Mr Gates beggars belief: 'Years later, these fundamentalist fighters trained by the Mujahideen in Afghanistan would begin to show up around the world, from the Middle East to New York city, still fighting their Holy War – only including the United States among their enemies. Our mission was to push the Soviets out of Afghanistan. We expected post-Soviet Afghanistan to be ugly, but never considered that it would become a haven for terrorists worldwide.'[32] Did Mr Gates really think the band of religious zealots fighting the Soviets were modelling themselves on a Boy Scout Brigade committed to upholding Western values of liberal democracy? Surely not.

Gilles Kepel tells us the militant Islamic Palestinian University Professor Abdallah Azzam was a key figure among the Afghan Arabs. Mr Gates and everyone engaged in the issue must have known that Azzam, funded again directly by Saudi Arabia and indirectly by the CIA, had founded a 'Bureau of Services Maktab al-Khidamat', for the foreign Mujahideen in 1984. Azzam made no secret of his extreme views. He was a spiritual father of the global jihad with a mission to educate and promote the cause of militant Islam. His publication *Al Jihad*, distributed throughout the Arabic-speaking world, was translated into English and other European languages.

Azzam decreed that defending the land of Muslims was each man's most important duty and the faithful committed a *capital sin* if they did not participate in the Afghan Holy War. After victory in Afghanistan, he wrote, 'the jihad will remain an individual obligation until all other lands which formerly were Muslim come back to us and Islam reigns within them once again. Before us lie Palestine, Bukhara, Lebanon, Chad, Eritrea, Somalia, the Philippines, Burma, South Yemen, Tashkent, Andalusia . . . Our presence in Afghanistan today does not mean that we have forgotten Palestine. Palestine is our beating heart. It comes even before Afghanistan in our minds, our feelings and our faith.'[33] His long-term goal was the re-establishment of the Islamic Caliphate. In 1924, the Ottoman Sultan was relieved of his role as Caliph of the Islamic world by Turkish arch-secularist Mustapha Kemal, bringing an end to any sort of central authority in Islam. Muslims, in Azzam's opinion, should not wait for the re-establishment of the

Caliphate to pursue jihad. On the contrary jihad was the 'safest path' for the establishment of the universal leadership of the Caliphate.[34]

Osama bin Laden first met Azzam when he was taught by him at a University in Saudi Arabia. Though from time to time there were disagreements between them they worked closely together in Afghanistan and, after Azzam's assassination in 1987, bin Laden took responsibility for Azzam's organisation, the precursor to Al Qaeda. In 1998 religious groups associated with bin Laden and Al Qaeda endorsed Azzam's fatwa: 'The ruling to kill the Americans and their allies – civilians and military – is an individual duty for every Muslim who can do it in any country in which it is possible to.' Bin Laden, obviously seeking access to weapons of mass destruction, declared: 'It would be a sin for Muslims not to try to possess the weapons that would prevent infidels from inflicting harm on Muslims. Hostility towards America is a religious duty and we hope to be rewarded for it by God.' In the early 1990s Egyptian intelligence reported that he was training a thousand militants, a second generation of the Arab Afghans, to bring about an Islamic revolution in Arab countries.

Filling in the dots between Azzam, bin Laden, Al Qaeda and 9/11 reveals a sequence of events that, if written in a novel, would be dismissed as too fanciful to be credible. The tale includes the activities of a cocaine smoking, womanising US Congressman and committee chairman Charlie Wilson who played a unique role in garnering support for the Afghan Mujahideen. The film Charlie Wilson's War released in 2008 is based on the book *Charlie Wilson's War*.[35] A Faustian pact that was also made when Richard Perel, Under Secretary of Defense in Ronald Reagan's government, committed support for the Afghan rebels while Osama bin Laden and Ayman al-Zawahiri were in training camps in Pakistan and Afghanistan undergoing a makeover as freedom fighters against the Soviet army. In a recent interview Gilles Kepel commented that Americans don't want to be reminded that help from the Reagan administration made jihadism possible, then and now, and jihadists don't like to be reminded that without the shoulder borne Stinger Missiles supplied by the US the Soviet forces would never have been defeated.[36]

The above comments on the jihad against America are important for investors. When George Bush is no longer in office a new President may have the charisma to inspire a new understanding with militant elements still committed to a jihad against 'the great Satan'. But, even after George Bush's many misjudgements, let's remember that since 9/11 the US has been at war and it's not a war that it started. In managing our affairs we have to draw the line between the pre 9/11 world when the US was at peace and the post 9/11 world with the US at war, and currencies of countries engaged in war tend to be weak.