



## **The Bullish Outlook For Gold**

### **December 2006**

I met an old salty broker from Cleveland back in 1981 during the last gold bull market, who was a gold bug. As I tried to tell him something about gold he smiled at me and said I needed to get a book called "The Golden Constant" by Roy Jastrom. It was a scarce book at the time and I had to order it special. This California professor had painstakingly gone through an enormous amount of empirical data to make a very simple point. Gold prices accurately reflect commodity prices over a long period of time and with little variation. He had statistics going back to the 1700's in the US, but more interestingly, back four hundred years in Britain. Apparently, there is a centuries-old trading house in London with all these records. On lengthy charts he showed gold prices versus the prices of a carefully chosen commodity basket. The ratio of prices looked almost like a flat line. Gold did have its moments where it was above and below for up to ten years but it always seemed to return to the same value as the basket of commodities in real terms. In this respect, gold is an excellent storage of value in real terms. This then begs the question, is gold money?

Defining money has become more abstract and even elusive since I left graduate school, but money has certain undeniable characteristics. First, it must be a storage of value, and hopefully a value that a large population believes and respects. Second, the more easily it can be transferred into another monetary form, the more money-like it is. Third, a price that is widely agreed upon also is important. Fine art has value, and is relatively liquid, but the current price is not consistently agreed upon. Real estate falls short as well on the liquidity issue. Securities are pretty close, but they are restricted as to where they trade, when, and there is a settlement delay. All three of these things are changing, but without an exchange to trade them, it would be difficult to find someone to buy your stock at home over the weekend. I would submit that securities have evolved to "appear" to be like money without truly being so. On the basis of liquidity, agreed value, and ease of trade without wide spreads or commissions, gold stacks up quite well. In a world where modest instead of zero inflation is now considered optimal, gold should do well since its value does not erode in real terms.

The basis for gold as value is clearly a function of its beauty as jewelry. Independently, civilization after civilization has valued it this way from ancient Egypt to the ancient Americas as well as China, etc. It is shiny, pliable and does not combine with other elements or oxidize. This attraction as jewelry is as strong as ever today and the key to this attraction is women. For centuries, women have collected jewelry as a status symbol, but more importantly, as insurance. A woman's jewelry is considered hers, not



his, and if anything happens to the husband, she has her jewelry. This is not to be considered lightly; in cultures such as India, jewelry is the only thing a woman can count on if the family is from modest means. Look at the chart below and notice where the bulk of demand comes from for gold.

	World Gold Supply and Demand (in tonnes)*											
<b>Supply</b>	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006E	2007E
Mine Production	2,375	2,493	2,542	2,574	2,591	2,621	2,588	2,592	2,470	2,519	2,570	2,470
Gold Scrap	644	631	1,105	615	616	713	840	943	848	861	943	848
<b>Total Supply</b>	<b>3,019</b>	<b>3,124</b>	<b>3,647</b>	<b>3,189</b>	<b>3,207</b>	<b>3,334</b>	<b>3,428</b>	<b>3,535</b>	<b>3,318</b>	<b>3,380</b>	<b>3,513</b>	<b>3,318</b>
<b>Demand</b>												
Jewelry	2,830	3,287	3,164	3,132	3,196	3,001	2,653	2,477	2,613	2,712	2,400	2,650
Industrial & Dental	386	419	393	412	451	363	357	381	410	420	430	440
Bar & Coin retail	307	504	347	449	348	373	387	313	396	409	450	450
Central Bank Purchase / (Sales)	(279)	(326)	(363)	(477)	(479)	(520)	(547)	(617)	(469)	(656)	(476)	(450)
ETF's								39	133	203	200	200
<b>Total Demand</b>	<b>3,244</b>	<b>3,884</b>	<b>3,541</b>	<b>3,516</b>	<b>3,516</b>	<b>3,217</b>	<b>2,850</b>	<b>2,593</b>	<b>3,083</b>	<b>3,088</b>	<b>3,004</b>	<b>3,290</b>
<b>Surplus / (Deficit)</b>	<b>(225)</b>	<b>(760)</b>	<b>106</b>	<b>(327)</b>	<b>(309)</b>	<b>117</b>	<b>578</b>	<b>942</b>	<b>235</b>	<b>292</b>	<b>509</b>	<b>28</b>

This table shows many interesting statistics. One is the lack of new supply out of mines in recent years in spite of the recent increase in price. It should be noted that a rapid increase in many commodities such as metals, oil and gas take a few years before any new supply can come on-stream. At these prices one would expect new supplies of gold to be forth coming in future years, but the other commodities that have recently increased in price and the economic growth of emerging nations will keep demand growth from slowing anytime soon. Remember, gold as a reflection of other commodity prices should participate in what many are calling "The Commodity Decade." The rapid growth in India and China and others has kept demand for copper and oil well ahead of new supplies and this could continue for years. Rising GDP in China and India will keep jewelry demand growth quite strong as their economies continue to create the largest emergence of world population into the middle class we will ever witness. What happens when these people start to think of their jewelry as an investment as the price is rising? Gold is far from the bubble phase but it could happen over the next five years.



I would also focus your attention on what I might term “core” supply and demand for gold. I do consider scrap as a legitimate source as this is an ongoing process of the world usage, but Central Bank selling is simply a holder transferring ownership. The United States has 8,134 tonnes of gold and has the top fifteen government holders have 22,243 tonnes. Number fifteen, the United Kingdom has 311.2 and number two, Germany, has 3,428. The last three years of Central Bank sales represent almost eight percent of these top fifteen’s total holdings. What if they decide to hold off because the price seems to be rising? In any case, they are buyers and sellers, not suppliers. I therefore consider only mine production and scrap as the true increase in supply. Likewise, I consider only jewelry and industrial use as the true long term demand. These numbers look like this:

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Industrial & Dental	386	419	393	412	451	363	357	381	410	420	430	440
Total Demand	3,216	3,706	3,557	3,544	3,647	3,364	3,010	2,858	3,023	3,132	2,830	3,090
<b>Surplus / (Deficit)</b>	(197)	(582)	90	(355)	(440)	(30)	418	677	295	248	683	228

\* Hill, John and Wark, Graham. "Gold: Seeking Macro & Demand-Side Catalysts".  
Industry Note: Metals and Mining. October 2, 2006.

The recent price rise is due to investors buying in the form of ETF’s and coins. The point is, as “core” supply and demand turns into a deficit, the price could move strongly up increase demand for ETFs and decrease, temporarily, Central Bank selling. A gold price above \$1,000 an ounce sounds very reasonable to me.

Silver is trickier. Silver is more volatile than gold and therefore should outperform in a large move to the upside. In 1981, the price ratio of gold to silver got as low as 14x. That ratio today is over fifty. Yes, the ratio will come down as the metals rally but the long term trend favors gold. In the 1700’s the gold silver ratio was pegged at seventeen. Since 1970 gold has dipped below twenty-five times silver only once. Long term, gold is a better investment since in the long run the gold/silver ratio rises. On the next move up, however, the more volatile silver should have a bigger run.



Now before you get too excited, beware of stones, like diamonds. Diamonds are not a rare element like gold but are simply compressed carbon. Besides the many synthetic diamond look-a-likes, real diamonds are now made synthetically. This puts an effective price cap on them. De Beers for years has sucked up excess supply to prop the price. There are rumors that there are as many diamonds in the De Beers vault, uncut, as there are in circulation. It is a manipulated market. Their ads are very telling. Buy her another ring to tell her you love her again. Buy a pendant. Buy a ring with three stones at once. As beautiful as they are, diamonds are not good investments. Buy your lady a nice engagement ring, maybe earrings to match, and load her up with gold.

Gold has recently declined to a level that represents a good entry point, around \$600 an ounce. It could stay in the doldrums a while as the economy continues to slow but when the Fed starts to re-inflate and decrease interest rates, it should react favorably. As the economy picks up in 2007, it should be off to the races. One way to invest in gold is to buy the gold ETF, symbol GLD. Each share represents one tenth of one ounce. Buying gold mining shares can be even better because if they increase production on top of a rising price of gold, the stock should outpace gold. Our preference here is Barrick Gold, ABX. This is a good buy below \$30 a share. Our small cap name is Minefinders, MFN.

The rise of India and China as economic powers will create the largest entering middle class in world history. The culture of gold jewelry is strong in both countries. As their economies grow, there should be a sharp increase in demand for gold. Last year, India's jewelry demand was up 18%. After a long period of little change in jewelry demand, this should create a shortage of gold, tipping investors and central banks to be buyers, creating a long upward move in the metal.

Peter D. Scholtz

