Gold by Yellow Capital – Haydn Ellwood

Back in October 2010 I wrote an article published in the financial broadsheets titled '***Gold : where are we now, and where are we going?'*** The purpose of this article was to give my thoughts around the then high gold price [$1,320] – I never predict or give forecasts of where I think the price is going to be by a certain date. This is a fool's game, or more commonly an analyst's profession. I merely research, make a decision and back it with conviction. On a regular basis [and perhaps in moments of doubt] I review the factors that originally lead me to believe the decision to buy gold or advise on buying gold was the correct one. This article confirms my opinion. One word of caution 'If you think you can speculate with gold, gold derivatives and time the market, be prepared to for the worst'

The fundamental reasons that initially lead me to believe that gold would be favourable to hold over the longer term were amongst the most basic economic principles learned in Economics 1 by any first year student.

Firstly, after two decades of 'hibernation' meaning yes a 'bear' market in gold, mining companies where forced to cut back on exploration and expansion of gold fields. Margins were tight and free-cash-flow was scarce. Much of their proven and probable reserves were more than often sold forward 'hedged' to banks to raise capital for mine development, exploration and even sometimes working capital. This under-investment into the gold mining sector is what created the biggest opportunity and hence bull market in gold and gold mining equities that was to follow. Consider the following - it takes an average of 10 years to get a mine operational and to produce gold. That's a decade before more supply can be added to an extremely large demand. Basic economics teaches that supply and demand are related in the following way: The point at which the supply and demand curves cross on a graph determine the price. When supply is low and demand is high, the price of X will increase. This is extremely basic and forms the first basic principle in the factors that indicated a favourable outlook for gold.

Second was the phenomenon of cycles. Everything, I believe happens in cycles. World stock markets crash or dip severely roughly every 4.5yrs, property tends to have longer cycles due to its illiquid nature and tends to be at least 9yrs to 15yrs if one measures peak to trough. Economies experience regular cycles of recession, depression, growth and expansion. Looking at it from a macro view, the Russian economist Nikolai Kondratieff studied western capitalist markets and discovered the super cycles of ups and downs which he named after the four seasons. These economic cycles are extremely long, lasting 40 to 60 years. My belief is that we are coming to the end of a winter season (which is the darkest and most unproductive season), but as my good Dr friend and hypnotherapist Dr. W. Naude explained to me in his book 'Relax we are only visiting this planet' – one cannot experience light without darkness, or happiness if you have not experience sadness. They are on the same continuum – much like a bull and bear market. The universal phenomenon of action and reaction, cause and effect are equal and act in opposite directions. Ok, enough of the crazy stuff.

Based on the cyclical phenomenon that exists in our universe, gold experienced a twenty year bear market from 1981 to 2001 and is likely to experience a bull market of twenty years from 2001 to 2021. It is highly likely that this cycle will be interrupted or sabotaged by speculators that are large enough to create chaos. These speculators are hedge funds, futures traders, probably the FED and numerous other central banks working in unison to rather sell credit [which, by the way is far cheaper to create by entering zeros on a computer screen; than excavating a mine pit and digging up one gram of gold for every 1000 kilograms of rock before spending more resources on crushing and processing all to produce a nugget of gold].

While these two basic fundamental factors indicated a favourable outlook for gold, we were handed a gift from the politicians of most western countries. You see, in order to please certain parts of any democracy to ensure your vote is secured for another term, politicians embark on spending and borrowing to satisfy their constituents, all in the name of social mobility, taking resources away from a productive capital pool known as 'wealth generators' through taxes and providing grants, benefits and services at extremely inefficient cost levels.

The U.S. and most Western European countries followed this program of borrow, borrow, and borrow (no doubt, advised by Keynesian economists to borrow more to pick up the slack when the velocity of money slowed or the private sector was unwilling or unable to deliver sufficient demand). Then came 2008, the U.S. pumped in a cool $1.2 trillion, to stimulate the economy. Please remember gold and the US$ are negatively correlated. The more US$ in circulation, the more US$'s it will take to buy an ounce of gold. This brings back the simple economic lesson of supply and demand.

In a previous article I wrote on Gold, I explained that if or when gold reached its inflation adjusted price of $2.,400 +/- an ounce, and it's stellar annual percentage increase exceeded that of US$ money supply (creation) it would become subject to overvaluation and enter troubled territory. That looks unlikely in the current situation of sovereign debt levels and risk of default. Other factors such as real (positive) interest rates would also give gold significant headwind. That looks unlikely given the anemic world economic outlook.

I do, however, base my decision to be long gold over the longer term (meaning 5yrs plus) on the original and most basic concept and for which gold was mined over 2000 years ago. Gold is money; it is the common numerator in the exchange equation. Fiat money is purely a promissory note which 'promises' to pay the bearer on demand a fixed sum of gold. No matter how or which way you look at it, accepting an 'IOU' from a bankrupt person who promises to pay you by robbing Peter is a secure as the deck of cards upon which all derivatives are based.

Expect Governments to steal from the public by inflation, default or higher taxes. See your Pound buy you less goods every year.

Conclusion

Western Governments are dealing with a solvency crisis not a liquidity crisis. Money printing is the only way politicians believe they can cure the patient. Austerity measures don't win elections, only brave and patriotic leaders would embark on political suicide. Expect further devaluation of currency and my guess is one major default before or during 2012.

Till then I will hold gold in its physical form.