Lear Capital, Inc.

insight

Forecast, Views and Analysis on the Economy and Precious Metals

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"If money is your hope for independence you will never have it. The only real security that a man will have in this world is a reserve of knowledge, experience, and ability."
– Henry Ford (1863 - 1947)

GOLD-BACKED DOLLAR PUTS 'FAIR VALUE' AT $10,000 AN OUNCE

BY DAVID WILSON

The "fair value" for gold exceeded $10,000 an ounce recently, according to calculations by Dylan Grice, a global strategist at Social Generalee. That value is based on the price at which each dollar in the U.S. monetary base would have been backed by an ounce of the precious metal. The formula shows gold has the potential to jump more than fivefold as its price catches up with the surging amount of money in the U.S. economy.

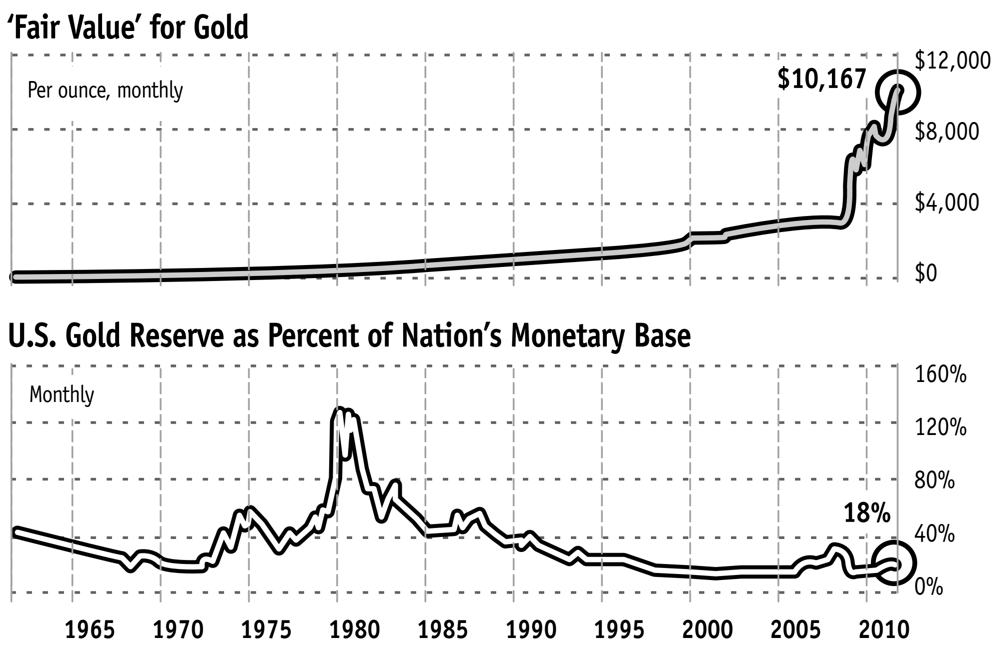
The chart below shows the price at which each U.S. dollar in the monetary base, compiled by the Federal Reserve, would have been backed by an ounce of gold for the past half century. International Monetary Fund data on the country's gold reserves were used in the calculation.

Grice, based in London, identified this price as the metal's "fair value" in a report. Recently, it has exceeded $10,000 an ounce, as depicted in the chart's top panel.

The bottom panel tracks the value of U.S. gold holdings, based on the spot price, as a percentage of the monetary base for the 50-year period. Its proportion was 18 percent of the $2.66 trillion in the economy. The latter figure was more than triple the amount three years earlier, reflecting efforts by the Fed to spur economic growth.

"There is a demand for an honest currency," Grice wrote. "The last time honesty was perceived to be so scarce — in the 1970s gold mania — the dollar was over-backed by gold. If it happened then, why not again?"

U.S. gold holdings peaked at 131 percent of the monetary base in January 1980, when spot gold climbed to $850 an ounce after a more than 14-fold advance in the preceding decade. The high equals about $2,330 an ounce in today's dollars, according to a Labor Department calculator.



SOURCES: Federal Reserve, International Monetary Fund

THE COMING CURRENCY CRISIS

BY BUD CONRAD

Poor Ben Bernanke. The greatest financial train wreck in history is going to happen on his watch, and it will be mostly his predecessor's doing. But not the work of Alan Greenspan alone. The Washington elite and their compulsively clever counterparts around the world have set the US (and global) economy up for a currency crisis of gargantuan proportions.

When?

Soon.

To explain why this seems inevitable and unavoidable, let's look at the data. First, there are the deficits. They're big, and they're three.

Deficit 1 - The Government's

The lamest deficit excuse, a story left over from the 20th century, is that government can use borrowed money to stimulate the economy. It can't. While it's true that government can spend borrowed money to encourage particular favored activities (the ones with the right political connections), the borrowing dampens the rest of the economy by depriving it of capital.

What's worse is that the favored activities are usually of the wasteful, rat-hole variety: wars; regulatory agencies; fatter subsidies for uneconomic farming; more complex Medicare programs; and bigger budgets for public schools that don't teach and for colleges that teach whining. Meanwhile, commercial projects that add real wealth get cut off from the capital they need or have to bear the added costs that come from the government competing for investor funds. And so the government is left with more debt to pay and a smaller economy for its tax collectors to feed on.

It's not rocket science. Arithmetic is the same for a government as for the guy driving a Mercedes on a Volkswagen budget: Spending more than you make, let alone more than you will likely ever make, leads to ruin. The only difference is that it takes governments longer to get there.

And if we're not there yet, we are getting very close. The US government has run up a

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WIKILEAKS DISCLOSES THE REASON(S) BEHIND CHINA'S SHADOW GOLD BUYING SPREE

Wondering why gold at $1850 is cheap, or why gold at double that price will also be cheap, or frankly at any price? Because, as the following leaked cable explains, gold is, to China at least, nothing but the opportunity cost of destroying the dollar's reserve status. Putting that into dollar terms is, therefore, impractical at best, and illogical at worst. We have a suspicion that the following cable from the US embassy in China is about to go not viral but very much global, and prompt all those mutual fund managers who are on the golden sidelines to dip a toe in the 24 karat pool. The only thing that matters from China's perspective is that "suppressing the price of gold is very beneficial for the U.S. in maintaining the U.S. dollar's role as the international reserve currency. **China's increased gold reserves will thus act as a model and lead other countries towards reserving more gold. Large gold reserves are also beneficial in promoting the internationalization of the RMB.**" Now, what would happen if mutual and pension funds **finally** comprehend they are massively underinvested in the one asset which China is without a trace of doubt massively accumulating behind the scenes is nothing short of a worldwide scramble, not so much for paper, but every last ounce of physical gold...

From **Wikileaks:**

> *CHINA'S GOLD RESERVES*
>
> ***"China increases its gold reserves in order to kill two birds with one stone"***
>
> *"The China Radio International sponsored newspaper World News Journal (Shijie Xinwenbao)(04/28): "According to China's National Foreign Exchanges Administration China's gold reserves have recently increased. Currently, the majority of its gold reserves have been located in the U.S. and European countries.* ***The U.S. and Europe have always suppressed the rising price of gold. They intend to weaken gold's function as an international reserve currency. They don't want to see other countries turning to gold reserves instead of the U.S. dollar or Euro****. Therefore, suppressing the price of gold is very beneficial for the U.S. in maintaining the U.S. dollar's role as the international reserve currency.* ***China's increased gold reserves will thus act as a model and lead other countries towards reserving more gold. Large gold reserves are also beneficial in promoting the internationalization of the RMB****."*

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truly horrific debt of $8.2 trillion. That's $28,000 for every man, woman, and child in America. By itself, the debt would be a serious but not catastrophic problem for the economy. But unfortunately, it is not a stand-alone problem. It feeds other problems, including - among others - inflation.

Debt and Inflation

Just how is the government's budget deficit inflationary? The answer is partly political and partly economic.

The political part is simple. Government debt makes inflation attractive for politicians. Inflation is a slow-motion default - a default on the installment plan - that reduces the real burden of servicing the debt and leaves more resources for the politicians to play with. Inflation is especially attractive for them when the debt is owed to foreigners, who don't get a vote. Politicians bemoaning inflation, those responsible at any rate, cry on the outside while laughing on the inside.

The economic part is more complex. Because the deficit handicaps all the industries that aren't being bottle-fed by government spending, much of the economy will tend to languish - which is a signal for the Federal Reserve to expand the money supply. It is the increase in the money supply that directly causes inflation.

And there's a second chapter. The government finances its budget deficit by selling IOUs. In the case of the US, the IOUs are primarily short term, especially US Treasury bills. From an investor's point of view, the T-bills are an interest-earning substitute for cash. So a government deficit decreases the demand for dollars themselves - and that reduction becomes a second, independent source of price inflation.

If the US were alone in the world, that would be the end of the story. All the T-bills (and T-bonds) would be sold to people in the US, so that the government deficit would be offset by private saving. The deficit would give the economy nothing worse than a low-grade fever — chronic but unspectacular inflation accompanied by a stunted growth rate.

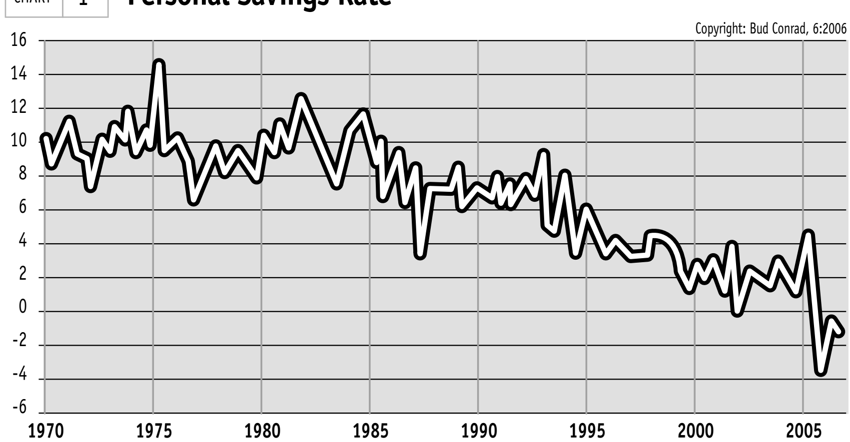
But the US isn't alone in the world, and it isn't just another country, so there is more to the story. It is the US's singular role in the world economy that will turn US deficits into global economic disaster.

The world functions on a dollar standard and has done so since the end of World War II. The USD is accepted as cash in most countries. Many millions of foreigners rely on it as a second currency and use it as a store of value. And the US dollar is the world's de facto reserve currency: It is used by central banks to back their local currencies. The volume of dollars and dollar-denominated assets accumulated by foreigners during the reign of the dollar standard is staggering and without historical precedent. Any move away from the dollar would be... well, problematic.

Deficit 2 - The Public's

Americans used to be savers. Not any more. Chart 1 shows a stark picture. As recently as 1990, Americans on average saved about 7% of their income (which allowed them to buy up much of the debt the government was issuing). But the savings rate fell over the 15 years that followed, hitting zero in 2005. Unlike in China, where the average savings rate is said to be 20% (some unofficial reports have it as high as 40%), or even in some European countries where it is reported at 10%, the savings rate in America is now negative.

CHART 1 **Personal Savings Rate**



The debt Americans have been building up isn't just a number that sits on a balance sheet. And it isn't spread evenly through the population and through the economy. It is concentrated in one area, residential real estate. And it is concentrated in an unstable fashion - thanks to the government's efforts to stimulate the economy.

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After the equities boom faltered and the US economy showed signs of weakening in 2000-2001, the Fed started cutting interest rates and worked its way almost to zero. Americans borrowed and spent as never before. Anyone who didn't own a house borrowed to buy, increasingly with no money down or with interest-only loans. Those who already owned a house borrowed against it to buy furniture, cars, boats, yard-wide televisions, and trips to Hawaii. And the process didn't stop with just one round. Empowered by ultralow mortgage rates, people bid up the prices of existing houses, allowing their owners to draw even more spendable cash at the refinancing window - or to use their equity to bid on an even more expensive house, or even second and third homes, in the process taking on even bigger mortgage commitments and pushing home prices ever higher.

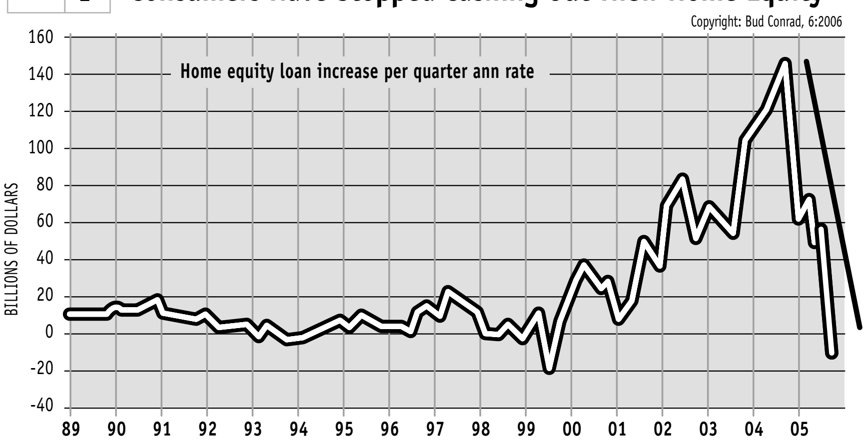
So it's not just the US government that is in debt, but also individual Americans who have racked up $8.7 trillion in home mortgages (many with adjustable rates that are now rising) and $2.2 trillion in consumer credit ($36,333 per person).

Bub-Bub-Bubbling Along

We all know there's been a housing bubble. But with interest rates now rising - the Fed has hiked rates without a break in the last 16 FOMC meetings - what comes next?

The housing boom is over. Prices have softened in many areas and in others prices are beginning to decline. The reason? Interest rates have risen to a point where mortgages no longer look like free money. The refinancing market, which is a good barometer of how high or how low rates "feel" to the public, shows this in emphatic fashion in Chart 2. Borrowers have gone on strike, and without borrowing, the best the US real estate market can do is to tread water.

CHART 2 **Consumers Have Stopped Cashing Out Their Home Equity**



Yes, the housing boom is over, but the story of the housing boom isn't. The mortgage debt is still there, saying "FEED ME" every month. If interest rates keep going up...

1. Home buyers will cut back on what they are willing to pay, so prices will decline.
2. Homeowners will see their equity shrink and then disappear. Mortgage lenders will swallow huge losses as many home owners default.
3. Homeowners with adjustable-rate mortgages will be squeezed; and
   a. Many will be forced to sell, so prices will decline; and
   b. The rest will cut back on consumer spending in order to keep their houses and so will push the economy toward recession.

The Federal Reserve has been letting interest rates rise because it is concerned about the prospect of inflation. But the unraveling of the real estate market, if interest rates keep rising from here, is so automatic, so ugly, and so obvious that the Federal Reserve must know what the consequences will be if they push rates much higher. The Fed might choose to tolerate a little more inflation rather than risk a deep recession. Too bad that's not the only decision they face.

Deficit 3 - At the Water's Edge

The US government is running a chronic deficit, going deeper and deeper into debt. The US public is running a deficit, going deeper and deeper into debt. So where is the credit coming from? The short answer is that it's coming from nearly everyone who isn't an American and isn't dirt poor.

The longer answer is that the US has been able to tap into a river of foreign credit by virtue of the third deficit: the trade deficit. Foreigners, in the aggregate, sell about $2 billion per day more of goods

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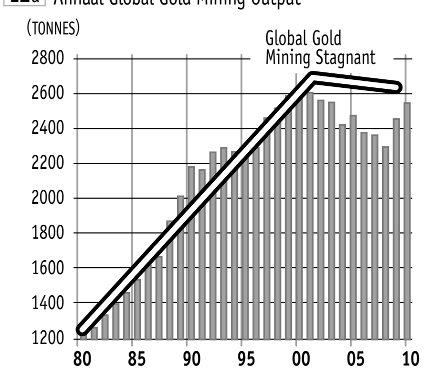
CHARTING DAVID ROSENBERG'S THESIS: "NO GOLD BUBBLE UNTIL $3,000"

"Breakfast with Dave" from David Rosenberg is a veritable chartapalooza, the inspiration for which appears to have been the "reversion to the mean" theme. Below, however, one section that is unique: that dealing with gold, and more specifically, why in Rosenberg's opinion gold is still quite cheap and why it is trading at about 50% of what the Gluskin Sheff strategist would consider bubble value. As Rosie says: "we have liked gold for a long time and we remain very constructive. It is more than just a hedge against recurring bouts of global financial volatility. The growth rate of gold production is roughly stagnant while the growth rate of fiat currency in most parts of the world continues to accelerate. It's all about relative supply curves - the supply curve for bullion is far more inelastic than is the case for paper money. It really is that simple." Indeed it is: when one strips out all the fancy talk, mumbo jumbo, and syllogistic gibberish out of modern economic theories, be they neo-classical Keynesianism (or, god forbid, just classical), chartalism (sorry, infinite debt-money issuance won't work: in two years we will all see why), or any other attempts to reduce a broken imbalance in supply and demand propped up by the "invisible hand", it is all about supply and demand. Sure enough, one thing we have an infinite supply of is fiat money, and the resulting debt necessary to "back it up." As for demand, well that's another matter. With gold: it is just a little inverted.

So here are Rosie's charts many of which we have presented in the past, but always good to see once again.

Gold, viewed from the prism of Supply and the US monetary base:

CHART 12a **Two Reasons to be Bullish on Gold:** (1) Annual Global Gold Mining Output



Source: Geological Survey, World Gold Council, Haver Analytics, Gluskin Sheff

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Perhaps now is a good time to remind readers what will happen if and when America's always behind the curve mutual and pension fund managers finally comprehend that they are massively underinvested in the one best performing asset class.

From **The Driver for Gold You're Not Watching (via Casey Research)**

You already know the basic reasons for owning gold — currency protection, inflation hedge, store of value, calamity insurance — many of which are becoming clichés even in mainstream articles. Throw in the supply and demand imbalance, and you've got the basic arguments for why one should hold gold for the foreseeable future.

All of these factors remain very bullish, in spite of gold's 450% rise over the past 10 years. No, it's not too late to buy, especially if you don't own a meaningful amount; and yes, I'm convinced the price is headed much higher, regardless of the corrections we'll inevitably see. Each of the aforementioned catalysts will force gold's price higher and higher in the years ahead, especially the currency issues.

But there's another driver of the price that escapes many gold watchers and certainly the mainstream media. And I'm convinced that once this sleeping giant wakes, it could ignite the gold market like nothing we've ever seen.

The fund management industry handles the bulk of the world's wealth. These institutions include insurance companies, hedge funds, mutual funds, sovereign wealth funds, etc. But the elephant in the room is pension funds. These are institutions that provide retirement income, both public and private.

Global pension assets are estimated to be — drum roll, please — *$31.1 trillion*. No, that is not a misprint. It is more than twice the size of last year's GDP in the U.S. ($14.7 trillion).

We know a few hedge fund managers have invested in gold, like John Paulson, David Einhorn, Jean-Marie Eveillard. There are close to twenty mutual funds devoted to gold and precious metals. Lots of gold and silver bugs have been buying.

So, what about pension funds?

According to estimates by Shayne McGuire in his new book, *Hard Money; Taking Gold to a Higher Investment Level*, the typical pension fund holds about 0.15% of its assets in gold. He estimates another 0.15% is devoted to gold mining stocks, giving us a total of 0.30% — that is, less than one third of one percent of assets committed to the gold sector.

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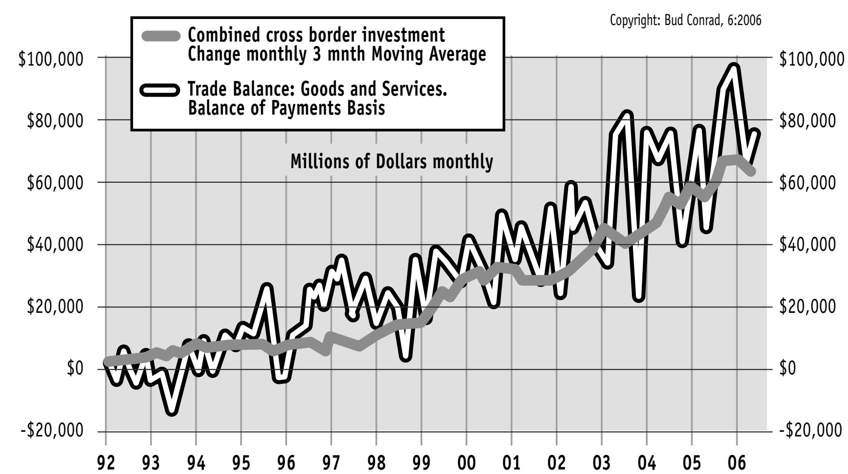
and services to Americans than they buy from Americans. The Americans, in the aggregate, make up the difference by selling investments to foreigners, most conspicuously US Treasury bills. Chart 3 illustrates this two-way street and shows how rapidly the traffic has been growing.

CHART 3 **Net Investments by Foreigners and the U.S. Trade Deficit**



Why This Can't Go On

If you have a very good credit rating, you may be carrying credit cards with limits of $10,000, $20,000, or perhaps much more. But however good you may look to lenders, there is a limit to how much they are willing to lend. And however good the US may have looked to lenders in the past, there always were limits to what it could borrow. The difference between then and now is that today the US is straining those limits.

Two elements determine how far foreigners will go as lenders to the US. The first is akin to a credit test. The second is a portfolio consideration. It is becoming increasingly difficult for the US to satisfy either of them.

Foreigners will accept T-bills and other dollar-denominated IOUs only so long as they believe US borrowers can make good on their debts. The concern is not primarily about explicit defaults. It is about the likelihood of a slow-motion default via inflation. It is a concern about the future value of the dollar. Confidence that the dollar will hold its value is strained with every increase in the US budget deficit (which increases the US government's incentive to inflate) and with every increase in the overall level of US debt to foreigners (which encourages the public's tolerance for inflation).

It would take a phenomenally slow person, say, a central banker, to have much faith in Uncle Sam's good credit when the US can't pay its current bills by a very wide margin - and has trouble saying "no" to new spending plans. But even the faith of a central banker must have its limits.

Perhaps the central bankers haven't yet seen Chart 4, showing the Government Accounting Office's latest projections of US federal government red ink. Based on straightforward assumptions that (i)

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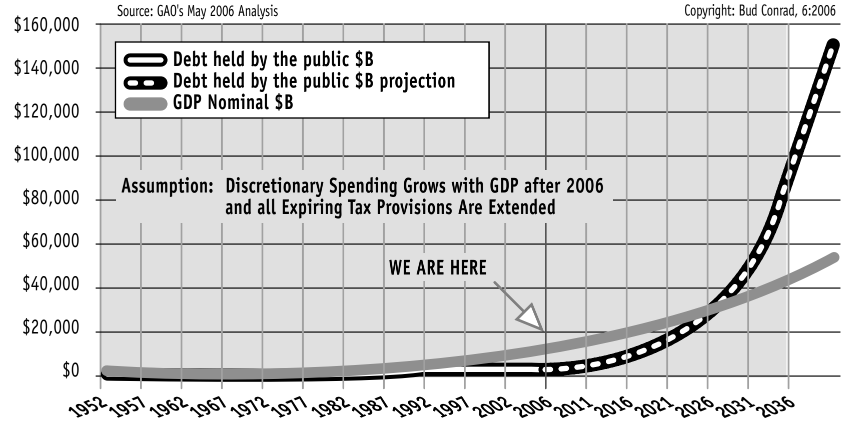
CHART 4 **Projects U.S. Government Debt Will Grow More Than GDP**



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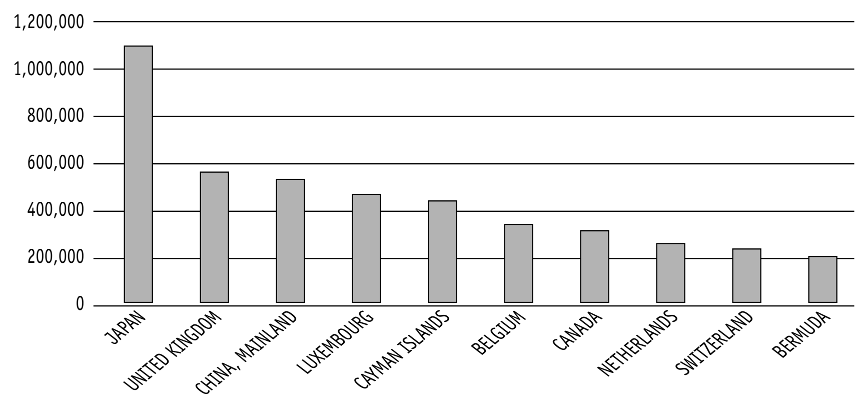
regular income tax rates continue; (ii) the alternative minimum tax is adjusted; and (iii) discretionary spending grows with GDP, the projection for spending, and thus the budget deficit, flies off the map. By 2040, the yearly deficit grows from the current 3% of GDP to 40%!

The second element in the calculations of foreign lenders is a portfolio consideration. Owning too much of anything is worrisome. So even if the risk of the dollar losing its value were modest (which it no longer is), as foreign holdings of dollar-denominated securities grow, the risk eventually becomes intolerable.

Chart 5 shows foreign holdings of US investments. The numbers are enormous. Japan alone has bet over $1 trillion on the dollar's ability to hold its value. That's enough to breed uneasiness in any portfolio manager. And the numbers keep growing because the US keeps importing goods by the boatload and paying with dollar-denominated IOUs. The breaking point is getting closer at a rate of $2 billion per day.

CHART 5 **Foreign Holdings of All U.S. Investments as of June, 2005 $M**



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Relying on the Kindness of Foreigners... Who Hate Us?

The great irony is that the US is counting on foreigners to invest $2 billion *per day*... at a time when we are not winning many hearts and minds abroad. The counterproductive and unwinnable war in Iraq is just the unhappiest part of the current picture. Among other reasons why hatred for Americans is rising are:

1. We maintain military bases that locals don't welcome, and not just in Islamic countries. Many Germans feel that their country is still occupied after a war that ended before they were born. The US keeps troops in over 130 countries, where most people are no happier to see them than Americans would be to see Russian or Iraqi soldiers shopping at their hometown WalMart.
2. The US earnestly attempts to impose government-issued "American values" on others. Bush says he wants to democratize Iraq - with no regard for whether the Iraqis want to be "democratized" or not and with no thought to what actual practice will slither out of the slogan. We chastise others, including China, about their human rights record, but our words now appear hypocritical given the heavy-handed US occupation of Iraq and the indefensible existence of the Guantanamo gulag.
3. The US helps governments run by dictators and murderers stay in power, and surviving victims remember. They won't forget that Saddam Hussein was once an ally. Iranians who hate Americans don't do so because they hate Calvin Klein underwear, but because they felt oppressed by our former protégé, the Shah. The same goes for many current US allies in "the 'stans," the most noticeable recent example being Vice President Cheney's trip to Kazakhstan to cozy up with that country's ruling despot. The pattern long held true in Latin America; the effectiveness of anti-American political rhetoric for politicians like Chavez, Morales, and their ilk should come as no surprise.
4. We talk about freedom and free trade, but the threat of massive violence seems to be the main tool of our diplomacy, and US subsidies for farmers don't provide much of a free-trade lesson to Third-World farmers.

In short, the American global cop, far from harvesting the gratitude of a world made safer, is perceived as a hypocritical and plundering thug - hardly the sort of thing that makes foreigners line up to invest in America.

US heavy-handedness abroad and the ill will it inspires are dangerous for many reasons, including their effect on the US dollar. War in Iraq and saber-rattling over Iran are driving the price of the oil and other imports up in the US, which increases the trade deficit, which adds to the pile of dollar-denominated IOUs

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"NO GOLD BUBBLE UNTIL $3,000"

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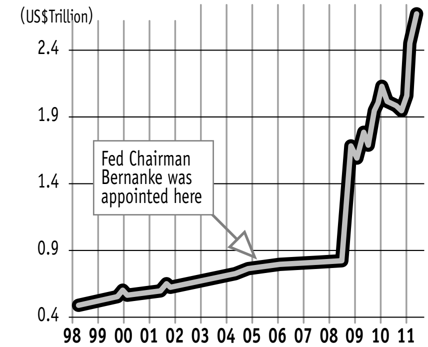
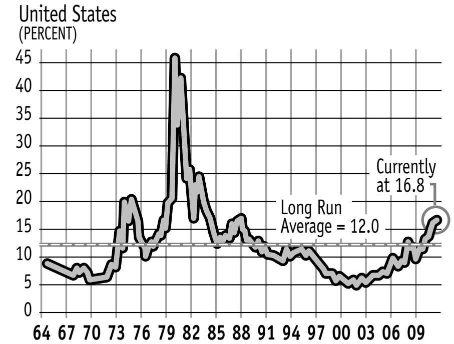
CHART 12b **Two Reasons to be Bullish on Gold:** (2)
U.S. Adsjusted Monetary Base



Source: Geological Survey, World Gold Council, Haver Analytics, Gluskin Sheff

Gold and M2: "Whether you normalize gold by the money supply or the CPI, the bull market has a long way to go. By my estimates, this does not even turn into a bubble until we get north of $300 an ounce."

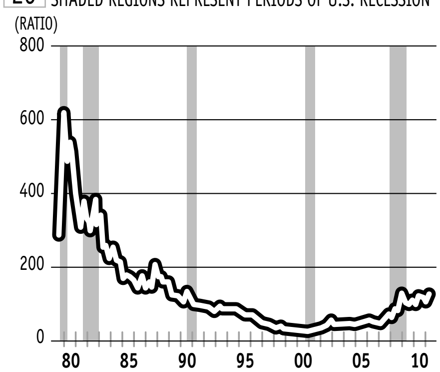
CHART 13 **The Ratio of Gold Price to M2 Money Supply: The Bull Market in Bullion Has Farther to Run**
United States



Source: Haver Analytics, Gluskin Sheff

More: "when gold hit its bubble climax in 1980, it got to 5x the level of the S&P 500; today gold is 20% higher. No bubble in this chart, yet anyhow."

CHART 26 **The Ratio of Gold Prices top S&P 500**
SHADED REGIONS REPRESENT PERIODS OF U.S. RECESSION



Source: Haver Analytics, Gluskin Sheff

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WIKILEAKS

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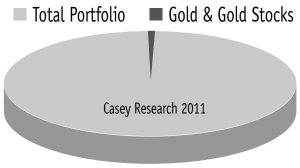
Percentage of Gold Holdings in a Typical Pension Fund



Source: Teacher Retirement System of Texas as reported in "Hard Money" by Shayne McGuire

Shayne is head of global research at the Teacher Retirement System of Texas. He bases his estimate on the fact that commodities represent about 3% of the total assets in the average pension fund. And of that 3%, about 5% is devoted to gold. It is, by any account, a negligible portion of a fund's asset allocation.

Now here's the fun part. Let's say fund managers as a group realize that bonds, equities, and real estate have become poor or risky investments and so decide to increase their allocation to the gold market. If they doubled their exposure to gold and gold stocks — which would still represent only 0.6% of

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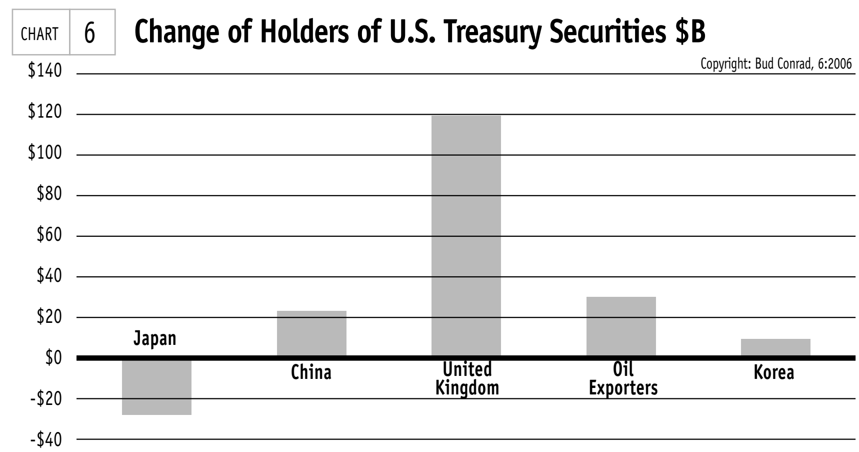
held by foreigners. And the same belligerence confirms in many Middle-Eastern minds that the US is driven by an anti-Islamic agenda. It gives them a non-financial motive for embracing alternatives to the dollar: the euro, the yen - anything not made in the US. Other foreigners see the belligerence as more evidence that the US government is a reckless spender and heedless of the consequences of its growing debt.

When the Drums Stop

The foreigners who hold all those dollars are getting restless. Chart 6 below shows recent changes in foreign holdings of US Treasury securities. The pattern is shifting.



It is striking that, in keeping with its official statements, Japan (the largest foreign holder of US Treasuries) has indeed begun lightening its load of American paper. This is not an "if" or a "maybe," but a real and very significant shift... *happening now*.

Other changes are happening, not major dollar dumping yet, but rumbling. Look at the UK bar - it has more than made up for Japan's negative number in recent months. That's interesting in and of itself - why the UK?

The UK, like Luxembourg and the Cayman Islands, two other major sources of US debt buying, is a financial way station for international transactions - particularly from the Middle East. We suspect that the spike in UK purchases reflects a desire by investors in the Middle East to avoid dealing directly with the US - Arabs with a lot of oil money who don't want their US-based assets exposed to rising anti-Muslim sentiment, for example - but who are not yet ready to dump the dollar altogether. It's an important sign. It indicates a shift in the attitude of the most sophisticated elements of the Muslim world away from thinking of the US as a financial safe haven.

And there's more. Consider this statement from Mr. Yu Yongding, an official of the People's Bank of China:

Regarding the need for China to reduce its holdings of US dollar reserves: Firstly, in the first stage we must reduce accumulation, then later we should reduce our reserves... [China and Asian countries] don't need that large an amount, more than $2 trillion, of foreign exchange reserves... Then, all East Asian countries have tremendous foreign exchange reserves and they all want to get rid of them, but if you do this then you cause competitive devaluation, not of their own currencies, but of the US dollar. So we should do this in an orderly fashion. If Asian countries moved too fast, everyone would lose... It would be utterly unfortunate if Japan sells a proportion [of their reserves] that causes problems. Then China panics and China sells a proportion - it would be very damaging.

Mr. Yu articulates the anxiety shared by other central banks: a desire to unload excess, overvalued dollars that is checked by the fear of triggering a cascading fall in the dollar. They won't tolerate life in this box forever. All it will take is for one central bank's governing body to get spooked, to decide that it had better get out of the dollar before everyone else does. The stampede will be unstoppable, and the dollar's foreign exchange value will tumble.

Where will all that money go? The euro? The yuan? The ruble? The one thing that seems certain to us is that a significant fraction will go into gold, not only as an investment but as a means of wealth protection. Just a few days ago, Mr. Yu was quoted in the press saying: "We need to use some of the reserves to buy other assets such as gold and strategic resources such as oil."

We don't know which central bank will be the first to tiptoe toward the exit or when it will try. The process may already have begun. But we do know that important changes are already taking place among US trading partners. The US government's daydream of spending its way to prosperity may not last the year.

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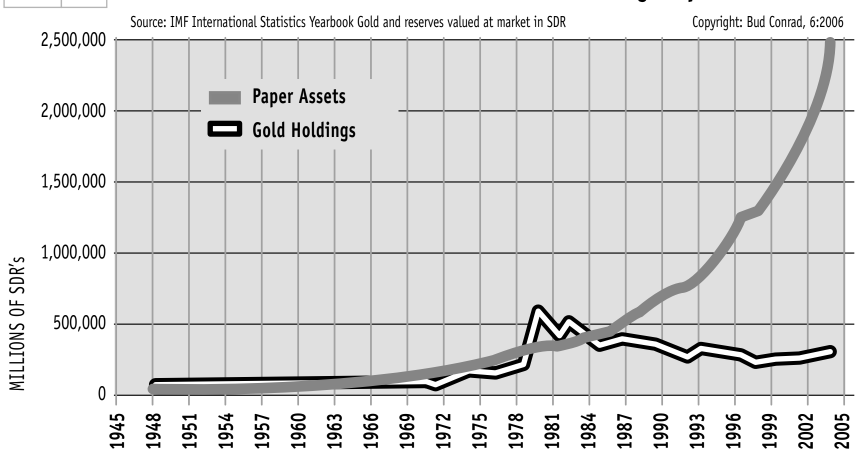
The End of the Dollar Standard

Central banks won't be the only players. The millions of people around the world who use the dollar as their second currency will join in. And for most of them, "the dollar" doesn't mean Treasury bills, it means $20 bills, $50 bills, and $100 bills. The collapse in the foreign-exchange value of the dollar sparked by foreign central banks unloading their excess holdings will undermine everyone's confidence in the dollar's usefulness as a store of value. Private foreign investors will flee the dollar, further reducing its foreign-exchange value. And most of that privately held cash will flow back to the US as more fuel for price inflation. The dollar standard will be dead.

CHART 7 **Worldwide Central Bank Reserves Are Mostly Paper**



The consequences will be of historic proportions.

How "historic"? As you can see in Chart 7, if the world's central banks backed their currencies with gold, it would send the price up (in current dollar equivalents) to many thousands of dollars per ounce - easily $5,000 or more.

But wouldn't central banks fight against such a rise in gold? Wouldn't they sell some of their tons of bullion to cash in on higher prices or out of a desire to keep the price from rising further?

Our friends at GATA make a compelling case that the central banks don't actually have as much gold as they say they do. But even if that's not the case, all the gold holdings the central banks report still are nowhere near enough to back their currencies. Note that, as a percentage vs. paper, gold now makes up only .04% of total central bank reserves.

Again, if the dollar proves to be unreliable as a backing for other currencies, what are central banks going to replace it with? Even if they move en masse to the euro, a global crisis is hardly a time for central banks to sell off the one hard asset they have.

And, as discussed in previous editions of *IS*, all modern currencies are empty promises. If the dollar is an "I Owe You nothing," the euro is a "Who Owes You nothing?" What central bank would want to back its paper with more paper in the midst of such a world-wracking crisis of faith in paper?

With the political uncertainties that surround the other contenders - not to mention the object lesson of the spectacular collapse of the USD, when it happens - we believe the world will eventually stumble back onto a gold standard. That could happen in as little as a decade. In the interim, they may flirt with the euro, the yen, or other tissue papers, but not enthusiastically and not for long.

Virgins Are Safe This Time

Is there anything the US government can do to stop the train wreck? Earlier governments tried sacrificing virgins to the gods to ward off disaster, but the practice seldom worked and isn't likely to be revived. The Federal Reserve could try raising interest rates still higher, high enough to convince foreign central banks to hold on to their dollar investments, but that has about the same chances of working as tossing gold-laden virgins into deep, water-filled sinkholes did. It might protect the dollar standard for a while, but it would turn residential real estate into a financial graveyard and trigger the depression the Fed is trying to avoid. Of course, the Fed could fight a contraction in the economy... by lowering interest rates. But that would bring on a flight from the dollar and a more rapid end to the dollar standard. There is no way out.

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"NO GOLD BUBBLE UNTIL $3,000"

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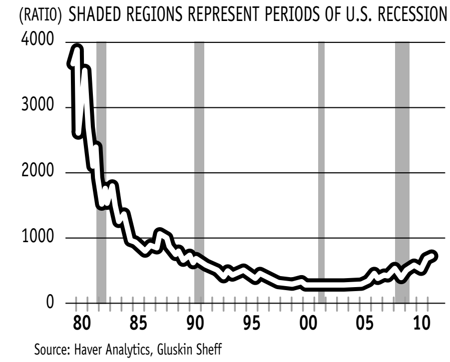
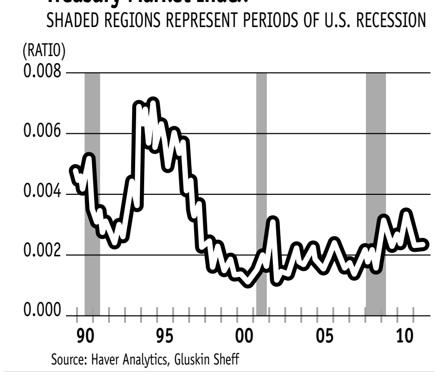
"The story is just as valid when gold is measured in "bond index" terms (using the Ryan labs historical data for treasuries)

CHART 27 **The Ratio of Gold Prices to the Treasury Market Index**



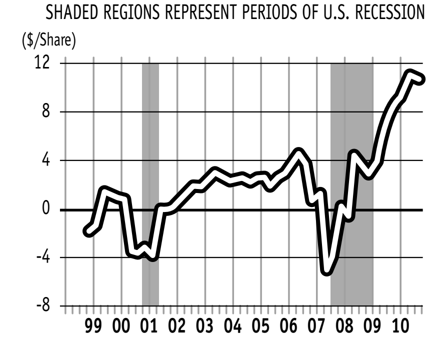
"Gold market cap in S&P 500 is $26 billion... only 0.2% of the entire market"

CHART 28 **The Ratio of Gold Prices to the Treasury Market Index**



And the last observation: "gold company EPS has been blowout with earnings rising 34% in the past year and 220% in the past two years."

CHART 29 **S&P 500 - Gold: Diluted Earnings Four Quarters Total**



WIKILEAKS

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their total assets — it would amount to $93.3 billion in new purchases.

How much is that? The assets of GLD total $55.2 billion, so this amount of money is 1.7 times bigger than the largest gold ETF. SLV, the largest silver ETF, has net assets of $9.3 billion, a mere one-tenth of that extra allocation.

The market cap of the entire sector of gold stocks (producers only) is *about* $234 billion. The gold industry would see a 40% increase in new money to the sector. Its market cap would double if pension institutions allocated just 1.2% of their assets to it.

But what if currency issues spiral out of control? What if bonds wither and die? What if real estate takes ten years to recover? What if inflation becomes a rabid dog like it has every other time in history when governments have diluted their currency to this degree? If these funds allocate just 5% of their assets to gold — which would amount to *$1.5 trillion* — it would overwhelm the system and rocket prices skyward.

And let's not forget that this is only one class of institution. Insurance companies have about $18.7 trillion in assets. Hedge funds manage approximately $1.7 trillion. Sovereign wealth funds control $3.8 trillion. Then there are mutual funds, ETFs, private equity funds, and private wealth funds. Throw in millions of retail investors like you and me and Joe Sixpack and Jiao Sixpack, and we're looking in the rear view mirror at $100 trillion.

I don't know if pension funds will devote that much money to this sector or not. What I do know is that sovereign debt risks are far from over, the U.S. dollar and other currencies will lose considerably more value against gold, interest rates will most certainly rise in the years ahead, and inflation is just getting started. These forces are in place and building, and if there's a paradigm shift in how these managers view gold, look out!

I thought of titling this piece, "Why $5,000 Gold May Be Too Low." Because once fund managers enter the gold market in mass, this tiny sector will light on fire with blazing speed.

My advice is to not just hope you can jump in once these drivers hit the gas, but to claim your seat during the relative calm of this month's level prices.

□

THE COMING CURRENCY CRISIS

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Future Uncertain?

If we're right about a coming monetary regime change, it's hard to imagine a future for the US that isn't grim, with plenty of harm splashed around on its trading partners: inflation... currency crisis... dollar crash... government instability... internal conflict for scarce resources... welfare system collapse... skyrocketing unemployment... taxes raised on a population burdened with an uncompetitive US economy... dollar down 40%... 60%... 80%?... emergence of competitive economic battles on too many fronts: China, India, Japan, Russia - and on too many military fronts. End of empire/Fall of Rome redux... the Greater Depression.

We are already seeing extreme volatility in emerging markets as the hedge funds beat a hasty retreat for liquidity. Get used to it.

Remember, never before in history has the unbacked paper currency of a single country been used as the de facto reserves of the world's central banks. We are truly in Terra Incognita, uncharted territory - and a hair trigger away from a currency crisis that, once begun, will quickly spin out of control.

Gold Is the Past... and the Future

At our recent Chicago conference we polled the audience to see if anyone of the 300 attendees could name the five natural reasons that Aristotle gave as to why gold is money. Despite having regularly mentioned those reasons in these pages - and offering a prize - not a single attendee had enough confidence in his or her understanding to stand up and recite the five reasons. So, here they are again: It has intrinsic value (it's valuable in many uses); it's convenient (houses are not easily portable); it's divisible (the Mona Lisa isn't); it's durable (wheat rots); and it's consistent (diamonds have different grades that are not always easy to see).

Even if the regime change we foresee takes decades to come about, the softest "soft landing" imaginable will still be very painful, with repeated flights from paper currencies. That is why we have been saying that gold isn't just going through the roof, it's going to the moon. And given the signs - particularly the housing bubble popping on the sharp point of higher interest rates and the increasing moves on the part of foreigners to distance or divest themselves of dollar-based assets - we believe the fireworks are going to start sooner rather than later.

As to what speculators - what anyone - should do, it doesn't really matter whether the fall of the dollar precipitates the level of crisis we expect. The steps we advocate are reasonable for anyone who doesn't want to get hurt by a currency crisis: buying physical gold (and silver - both are still relatively cheap in inflation-adjusted dollars); getting a useful portion of one's assets into a stable country outside of the US (preferably one with no involvement in the "War On Terror/Islam"); and investing a fraction of one's portfolio in gold stocks.

That these moves are also the same as those you need to make for realizing enormous profits is not a coincidence but a reflection on our times.

One More Observation

Government deficits, trade deficits, and losses in the dollar's value tend to move together, a point made clear in Chart 8 which shows what happened after the US abandoned the gold standard.

CHART 8 **Government Red Ink, the Value of the US Dollar, and U.S. Trade Balance Moving Together**