GOLDCORE

Insight

AS THE CRISIS DEEPENS, GOLD FLOWS EAST

Chris Sanders

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Preface

As keen observers of the gold markets globally we have witnessed, not just recently, but over a protracted period of time, a movement of gold from west to east. This large scale, migration-like movement is not confined to private purchases but central banks are also net buyers and this transfer of gold is taking place on a scale not witnessed before.

The recent drop in gold prices has been a very welcome fillip to the central bank buyers. Already committed to their gold purchasing programmes, the recent short selling of gold futures on COMEX on 12th and 15th April has proved to be a bonus with a discount of over 18% immediately available off the gold price. The sudden fall in the price of gold also proved to be a gift to other investors as small denomination bars became difficult to source in India, Singapore, Japan and China

Chris Sanders in this month's ***Insight***, *'As Debt Crisis Deepens, Gold Flows East,'* demonstrates that the perilous debt crisis facing the US, the EU and Japan is illustrated by the difference in oil consumption between Asia and the West. The former, exemplified by China and India, is still increasing its consumption growth. The latter, basically the OECD, has been using less oil each year since the crisis began in 2008. According to Sanders, this is unsustainable. The OECD's deepening recession is evidenced by its falling oil use while the fragility of the export dependent and imported energy dependent East's growth prospects suggests that its real growth rate is about to peak or already has.

Another point raised by Sanders is that the real crisis facing the developed world has been masked by the manipulation of the consumer price index indices, primarily in the U.S. We will return to this subject in some detail in a future edition of ***Insight***.

The big picture is clear: The dollar pegged currencies of the east are buying gold in significant quantities and it shows no signs of abating. If anything, if Sanders is correct, the transfer of gold from west to east will intensify. The sheer scale of quantitative easing being pursued by the U.S. has led to dollar inflation being exported to those dollar pegged countries and the purchase of both gold and silver is key to protecting the future wellbeing of their respective currencies and economies.

We do not endorse the opinions of guest contributors but where we find an argument interesting and potentially valuable to our clients and the public in helping to protect and grow wealth, we share it.

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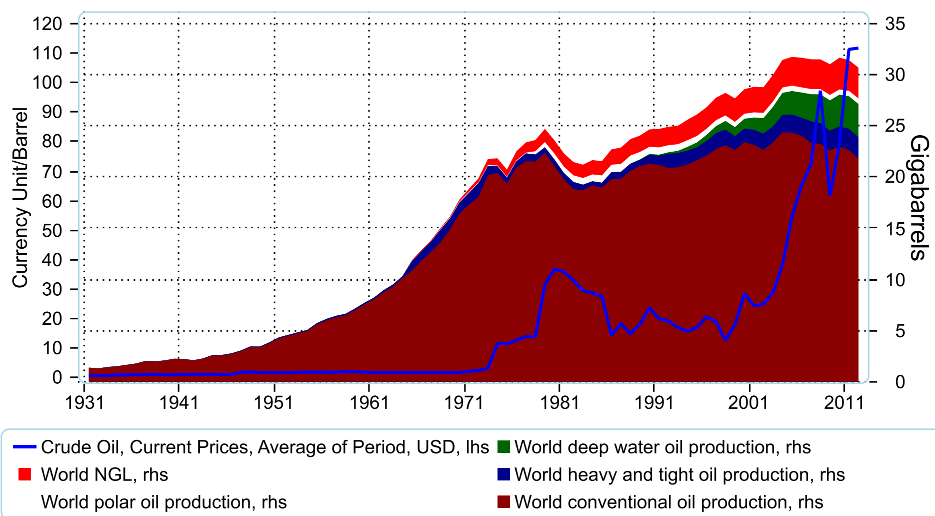
Crisis: the new normal

The parlous state of world financial markets has been underlined in the last few months with the selloff of all asset classes: stocks, bonds, commodities, and of course, silver and gold. We are just about due for a crisis.

We have had them like clockwork over the last thirty years. 1981-82, 1987, 1994, 2000-01, 2008-09: the intervening periods have been between six and seven years. But today there is an additional factor: the world faces a severe energy shortage that caps real growth prospects. Any realistic "solution" to this is intergenerational, making that light at the end of the tunnel very dim indeed for most adults alive today. One doesn't electrify a transportation network overnight, or even in ten years.

World conventional and unconventional oil production and price

Campbell 2012, EIA



Sanders Research Associates Limited 07/2013

In spite of a huge rise in the price of oil, world oil production has been unable to climb. The production plateau is bounded on the upside by what the world economy can bear in terms of a price rise and on the bottom by what most businesses and people can afford to pay. This regime has ruled since the global conventional oil production peak in 2005, and there is no sign of this ending.

Hopes for a decisive technological breakthroughs are just that – hopes.

Progress has been and is being made in materials, power transmission, energy storage and renewable power generation and one major economy – Germany– has committed to phasing out its nuclear power generation capacity completely and shifting to 100% renewables generation within the next couple of decades. This is a brave and probably shrewd move. Internationally the energy conundrum has aspects of the prisoner's dilemma problem. The first major player to successfully make the switch to renewables will be the technology provider of choice to everyone else.

In a zero sum game, someone has to be the loser

What is at stake is illustrated by the difference in oil consumption between Asia and the West. The former, exemplified by China and India, is still increasing its consumption growth. The latter, basically the OECD, has been using less oil each year since the crisis began in 2008. This is unsustainable. The OECD's deepening recession is evidenced by its falling oil use while the fragility of the export dependent and imported energy dependent East's growth prospects suggests that its real growth rate is about to peak or already has.

Complicating matters is the zero interest rate policy and quantitative easing now being pursued across the OECD.

This has further exacerbated a forty year growth of income and wealth disparities that is displaying its tangible face in huge unemployment and underemployment rates and widening hunger as the unemployed fall out of the social safety nets that we have become accustomed to depending on to alleviate the human cost of recession.

These in any event are being reeled in everywhere even while taxes and user fees multiply and rise. The reality of ZIRP and QE is that they are starving real business of investment incentives and destroying the consumption base on both of which growth depends.

This is a subsidy of the core of the money system, the largest international financial institutions. Subsidy it may be, but it is proving an effective if cruel way of reducing oil consumption. It has also preserved for the time being the capital structure of the industrial world by inflating the nominal value of the world equity and bond markets.

In the US, at least, this has received considerable help via stock buy backs. Nothing could illustrate the real outlook better when you think about it: if business prospects are so good why are so many corporations returning cash to their shareholders via buy backs, while an overwhelming proportion of insider trades are sales?

Unfortunately, business prospects are not good at all.

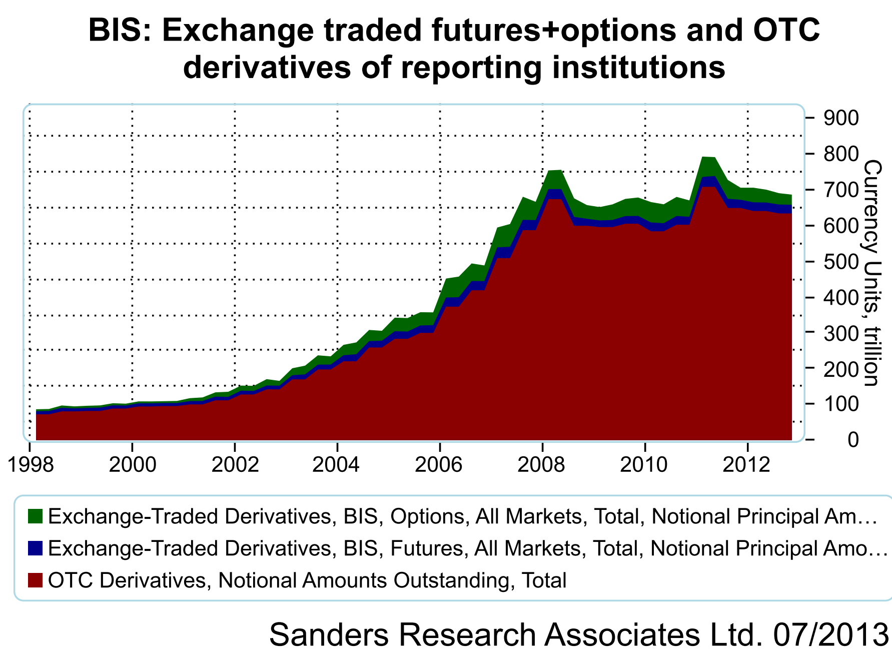
They couldn't be when you consider that the marginal sources of petroleum and petroleum substitutes have very low net energy yields relative to conventional oil (or for that matter to conventional gas). At the margin, as I and many others have pointed out in the past, this means that the marginal unit of energy consumed in the process of powering economic activity is costing society at large exponentially more energy to produce that marginal energy for consumption. This is at odds with continued growth in the world population as well as with trends in finance.

The business model: speculation

The population issue is self-evident; the finance issue is less so.

At its heart is the fact that over the last forty or fifty years the corporations that were the core of the big banks' business model have ceased to need the banks to access finance. The upshot has been a shift in the banks' business models from banking to regulatory and legislative capture to enable massive increases in leverage.

Notably this has included vast increases in non-transparent, off-balance sheet derivatives the nominal value of which – reported to the Bank for International Settlements – dwarfs the banks' capital base. When times were good and markets rising, the fees and spreads associated with the derivatives book were a marvellous boost to earnings per share.



Today, with the growth outlook so poor the prospect of a material adverse shift in the value of the derivative book's value is a dead cert and renders the value of the bank capital base nil. If the purpose of ZIRP and QE is to enable the banks to enjoy a balance sheet-repairing interest rate spread on the yield curve we are in for a very long wait.

Complicating the bank rescue effort is the impact of these policies on the world pension and insurance industries. Pension funds are stuffed with "zero risk" government bonds that don't pay enough to fund current and future liabilities.

Those like CALPERS in the US that have become more adventurous in the search for yield and return by increasing their bets on the hedge fund industry are effectively betting the ranch on a dead horse. I can't envisage any way that this can end well.

When the data is bad, make up the data

Analysts of the situation appear to fall broadly into two camps: deflationists who rightly fear the unemployment and demand destruction inherent in QE and ZIRP and hyper-inflationists who equally rightly fear the unrestricted debt monetization inherent in QE.

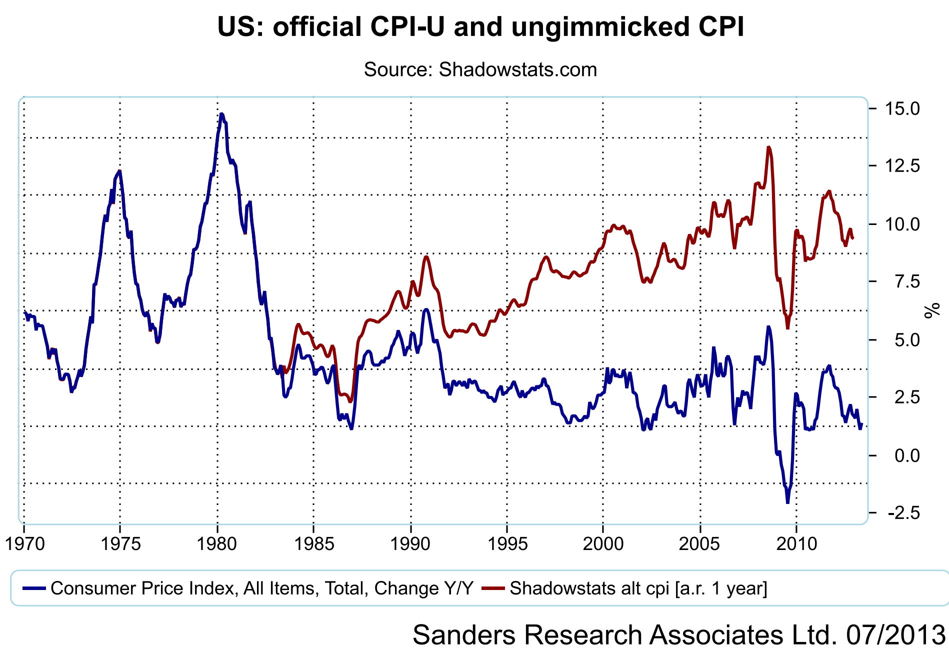
We can safely ignore those who support this suicidal socio-political policy mix as being more interested in attending Davos with eye candy on their arm or securing an elite sinecure than in working to maintain social stability and the broadest possible survival rate in the challenging decades to come.

The truth is that what we are seeing is the destruction of the world monetary system in the most thorough way imaginable. This is not exactly deflation nor inflation. For more than forty years since the "opening" of China by Kissinger and Nixon, wealth has been siphoned out of the West by the assumption of ever more leverage. No majority in any western industrial democracy would have voted for this, hence the need for "free trade" agreements the consequence of which has been the effective disenfranchisement of organised labour.

Nor could it have happened had governments and markets not colluded in the progressive vandalising of government economic statistics. Beginning with the Reagan administration, which exchanged the housing component of CPI for something called "imputed rent" during the housing bubble of the early 80s, and given an intellectual veneer by the Boskin Commission during the Bush the Elder administration, headline US consumer price inflation (CPI-U) has been deliberately and systematically understated.

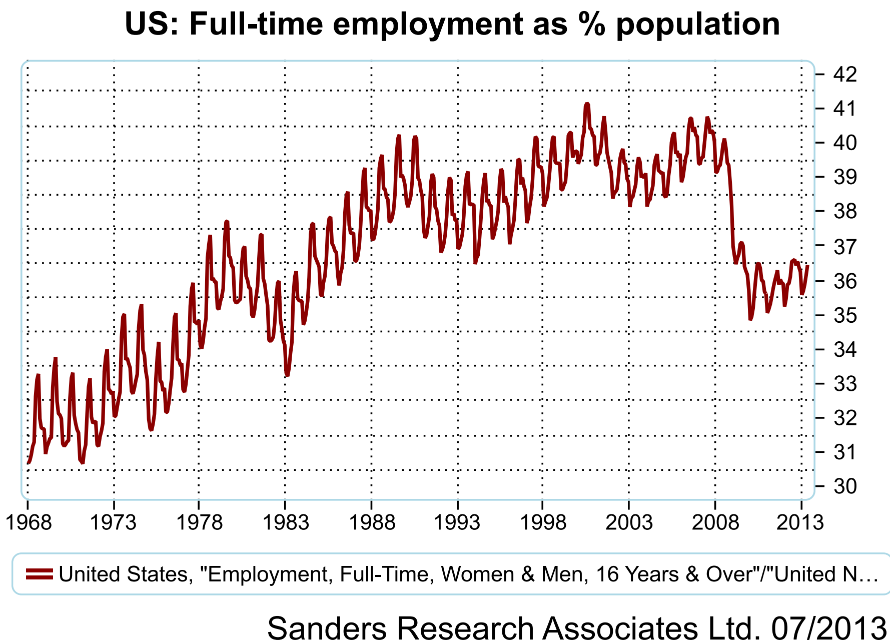
This has served several purposes. First it reduces government liabilities in programs such as government pensions and social security that are indexed to the inflation rate. Second, it serves to increase the net present value of financial assets and thereby encourage public investment in the markets, the better to keep the bull running.

The abuse of hedonic measurement, which seeks to assign a value to qualitative improvements in products, substitution of CPI components with the highest prices on with "equivalents" that are cheaper on the assumption that consumers will switch in response to price signals are two tricks of the trade.



Nor is the abuse of data confined to the CPI. In recent years employment and unemployment measurements have been inflated and deflated respectively by not counting those who are so "discouraged" that they stop looking for mainstream employment and counting those with multiple part time jobs as though they have as many bodies as jobs. A better measure is employment as a % of the population, not an arbitrarily defined "work force."

There has been no improvement since 2008. Indeed, employment has stagnated since the late 1980s.



Gold and silver: huge demand meets too much leverage

The upshot of all this is that over the last three decades what began as a trickle of gold and silver moving east has become a flood. This is precisely what one should have expected. Loose and looser American fiscal and monetary policy has led to the export of dollar inflation to those countries – notably China – that have pegged their currencies to the dollar.

The obvious consequence of higher prices abroad has led to higher demand for precious metals as a store of value in the same countries.

Western bullion banks have responded enthusiastically over the years to this demand – a little too enthusiastically it appears as they have given many of their western customers IOUs for gold that is ostensibly in their vaults and for which they charge storage fees. As we are now learning, this appears to have been the rule, not the exception.

As the shortage of metal becomes more acute in the West and more "clients" like Germany and Venezuela demand delivery, gold in storage with supposedly secure facilities such as JP Morgan and the COMEX is fleeing as fast as it can. The crisis that supposedly ended in 2009 is entering a new and dangerous phase.

Banks leveraged everything else; so too their clients' gold. Asked for it, they can do nothing but offer cash in return based on the published price, which is set by the London bullion banks and the COMEX. With delivery delays of some four months these days for bullion in size that's no joke.

And many people imagine that the four hundred tonnes equivalent of paper gold sold on the COMEX on April 12th was sold by speculators. Pigs fly daily, it seems, at the COMEX.

With this sort of behaviour apparently the norm, making up bespoke inflation, employment and unemployment rates to suit seems like a schoolboy prank. For those of us standing on the side-lines with savings to protect, it's not a prank of course.

All the more reason to buy gold and silver and store it where the banks can't get it.

Chris Sanders

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About GoldCore Insight

GoldCore Insights are periodical essays published by GoldCore that are intended to inform, create debate and raise awareness not only on our core business of precious metals but also on macro-economic and other important global issues. Since its founding in 2003 GoldCore has fostered relationships with a growing panel of market commentators and experts around the globe. It is our firm intention that this panel will be leveraged to bring you insights that offer a different perspective to the mainstream press.

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