Ramblings

The recent spate of takeovers of Canadian iron ore properties is eye-catching. Prices being offered for projects, which only a few years ago would have been dismissed out of hand, are breathtaking. Developments elsewhere in the resource space are not too shabby either.

The reasons can only be Malthusian. Everybody, including ourselves, has underestimated the pull for resources from the non-Western world. Producers themselves have underestimated it. And, on top of potential supply problems with minerals, the world of agriculture is experiencing unprecedented strains. It doesn't really matter why, it is what it is. Finally, unrest on the Arab street bodes very well for oil, particularly Canadian oil.

In any historical model these trends would point to higher interest rates, but with nearly all Western countries pushing close to bankruptcy, higher interest rates are just not on. These governments are all carrying so much debt — Western debt levels are up roughly 50% in just the past three years — that higher rates would damage their budgets more than anything else. We don't always credit governments with great clairvoyance, but they are rarely suicidal.

Western countries have another, huge, problem. Wealth creation has been significantly supplanted by the service sector — consumption instead of production, spending instead of saving, zero sum trading in all sorts of junk, taking in one another's washing and so on. By extension, Captains of Industry have in large measure been replaced with Captains of Finance. And not traditional finance where Massey Ferguson needs money for a new harvester plant but, rather, casino finance, condo finance or structured note finance. If there isn't enough paper to churn in the one acre trading room, well, create some more varieties of paper or, better still, more derivatives. The NY Times recently suggested "finance captures 29% of the entire American private sector." (Canada would be worse.)

Now we are paying the price and President Obama has appointed the GE President, Jeff Immelt, a champion of wealth creation (we quoted his message to shareholders several months ago), to try to help get America back on track. But it won't be easy, and meanwhile the Lords of Finance are running things. They are now the elite, and Mr Immelt will have his hands full.

One of the better books* on the credit implosion was by Gillian Tett who pointed out that "areas of social silence are crucial to supporting a story that a society is telling itself, such as that of the credit boom." She quoted French sociologist Pierre Bourdieu who said "the most successful ideological effects are those which have no need of words and ask for no more than complicit silence." The Lords of Finance can do no wrong. Sort of a latter day version of the Emperor's new clothes.

Today this complicit silence still applies to a) the conduct of policy makers, b) most aspects of Euroland and a long list of other basket case countries, c) the idea that austerity is a panacea, d) any and all aspects of the entire monetary system, including the need for one, e) the need for wealth creation and f) anything good about gold.

Surprisingly, gold started the year down $100 whereas we had expected plus $100. Maybe that's just normal market behaviour, maybe we were due for a shakeout or maybe the market reacted to the renewed bearishness of the world's most important gold market consultancy which (nearly always) advances lots of reasons for the gold price to decline. Today they suggest rising scrap sales in North America, falling jewellery demand in Mumbai and, the old standby, projected increases in mine supply. Variations on these themes have characterized their comments for decades. And they have been wrong for decades.

Scrap sales (probably at less than 50 cents on the

* "Fool's Gold"

dollar) won't last whereas Oriental purchases of small bars (at a 15 percent premium) will probably last for decades. Jewellery sales are down for sure, but so what? Investment buying is more than offsetting declines in jewellery. And left uncommented on is the buying activity of Eastern central banks. Their purchases have led to substantial net central bank purchases of gold after fifty years of nearly continuous net sales. Gold as money has taken over from gold as a commodity.

As for mine supply? It peaked in 2001 and has just recovered to those levels. It may creep up for a year or two, but 80% of gold is now mined from open pits, deeper and deeper, with grade weaker and weaker. Costs are up well over the official inflation rate and currency moves (such as Brazil, Canada, Chile and South Africa) hurt as well. To convert an open pit mine to an underground mine would require cash flow of a magnitude the industry can only dream of. All the people who forecast higher production have probably never built a mine or even been underground; they probably take guidance from the ever-optimistic mine promoters. But talk is cheap, gold is scarce.

And why the bearishness of the world's most important gold market consultancy? Maybe it's because some big central banks and commercial banks, banks whose self-interest would be served with lower gold prices, provide financial support.

But why do some banks, or countries, have this antipathy towards gold? Do they really think that trashing gold can enhance any of the major currencies? Haven't we descended below the point where the redemption, the rehabilitation, of any currency is no longer a possibility? God only knows, we will never hear of Maastricht or Gramm-Rudman again unless comedians start using them in jokes.

After the recent gold price break there are lots of people commenting on what's bad about gold so we will touch upon some of the things that are good about it:

1) President Roosevelt's deliberate 70% increase in the gold price in 1933 (for which he was roundly criticized) was a major factor in lifting his country (and the world) out of depression.
2) Higher gold prices today would help many poorer countries around the world pay ever higher prices for food.
3) Higher gold prices would also help gold-producing countries (particularly in Africa and South America) buy lots more stuff from the US and help its terrible trade deficit.
4) And higher gold prices today would directly help the US, where production has run from 1.7 mil ounces in 1970 to 1 mil in 1980, 9.5 mil in 1990, 11.3 mil in 2000 and 6.9 mil ounces in 2009. Without higher gold prices the production trend will remain down — just look at the behaviour of the big US-based gold-producing companies — and how can this be in US interests? Given a fair price, and only given a fair price, the US industry has lots of potential.
5) And the US says it has far more monetary gold reserves than any other country.
6) Unless they are latter day Rip Van Winkles, economists must know that, sooner or later, there is at least a chance that gold's monetary role may be enhanced. The US should be working towards twisting this to its advantage.

Higher gold would bring benefits to many people all over the world, but Canada would rank well up the list. Canada's production is well down and Canada's balance of payments is also rapidly going in the wrong direction. Canada needs help much as the US does, but Canada has done its best to discredit gold. Besides being the only G8 country to have no gold, Canada displays a pitiful lack of appreciation for its roots and the role gold has played in our history.

By way of example, the mighty Hollinger mine, besides producing 14 million ounces, bankrolled Noranda which then went on to build a dozen other mines, smelters and so on. Then Hollinger provided the seed money for the huge iron ore complex in Labrador (the railroad to serve it was the biggest railroad job in North America since the crossings of the Rockies). The Dome mine bankrolled other mines as well as Dome Petroleum. McIntyre invested in Falconbridge and it's pretty safe to say the quest for gold opened up Northern Canada. The Canadian government retreat at Meech Lake, incidentally, was given to the government by one of Hollinger's founding families.

The Ontario Northland railway was built to service prospectors and de Havilland (now part of Bombardier) developed STOL (short takeoff and land) aircraft (bush planes) to service prospectors. These bush planes provided a market for Pratt and Whitney Canada (south of Montreal), one of the few Canadian subsidiaries of an American company not to pull up stakes in recent years.

From the Yukon to Yellowknife to Newfoundland gold has been a big part of Canada's heritage and the sooner we cut the umbilical with the anti-gold banking crowd in London and New York, and start thinking about where our national self-interest lies, the better.

For whatever reasons, iron ore and all industrial metals have seriously outperformed gold in the first month of 2011. They should continue to do well, but it's hard not to see gold doing better. Under no circumstances will the dollar ever be defined in units of iron, nor will all the obfuscation, winks and nods from the elite change the ugly realities marauding throughout the system.

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