Lessons of History...

There are some advantages to getting older, one of which is, if you are lucky, that past memories can help today's analysis. Not always, and usually with a few twists. But today we will bet that the gold market is similar in many ways to 1972.

1) The run-up from 1961, the year of the creation of the Gold Pool by eight major Western Central Banks to maintain the gold parity at $35, to 1972 was characterized by (official) Central Bank sales of well over 100 million ounces, vociferous anti-gold propaganda and a gold mining industry caught in a difficult cost/price squeeze.

   Likewise in the past decade Western Central Banks (officially, forget the conspiracy stuff) have sold over 150 million ounces, officialdom has continued to denigrate gold, and the gold mining industry has not generated the cash investors had hoped for.

2) 1972 was the year when Western Central Banks gave up their effort (see above) to put a lid on the gold price and it looks as though European banks (see above) have again given up trying to stabilize gold in 2009. With BRIC countries all buying gold, reserves depleted and no serious reserve currency to turn to, it appears most Western Central Banks are re-thinking the role of gold. We think most Eastern Banks have always liked it.

3) Gold shares were very popular, even frothy, in the mid to late 1960s as investors concluded that the $35 parity could not be maintained for long, regardless of official promises. They were right, but they didn't expect officialdom to throw away a very successful monetary system and embark on a programme to demonetize gold. The gold price languished and, by 1972, all but die-hard investors had given up on gold shares. Nobody had any idea gold was on the threshold of a twenty-fold increase in price.

   We have had a similar sequence recently. After roughly a decade of euphoria, the huge success of various ETFs and far too much wild-eyed promotion of shares (some good, some bad), the general attitude towards gold has become apathetic. This time propaganda runs: "Well, gold is now $1100. That's enough. You guys ought to be happy." Some precious metals funds are now being redeemed. And the idea of a ten-fold or twenty-fold gold price increase seems beyond comprehension to most. Just as in 1972.

4) Mine supply is only one factor in the gold price equation, but over the sweep of decades it matters. 1972 was a turning point. Production of gold (then about 80% from underground) peaked as higher prices motivated those mines that had survived the $35 era to treat lower grade ore. But even with a soaring gold price, underground miners struggled. Too much economic damage had been inflicted during the previous decade.

   The advent of the open pit mine (now about 80% of gold production) in the 1980s led to steady increases in gold supply through the 1980s and 1990s to a new peak which was reached in 2001. Now, once again, grade is falling and mines are struggling. Industry earnings are for the most part illusory and mine supply of gold now appears in terminal decline.

   Nobody seems to care, but, with underground production having peaked forty years ago, and open pit production having peaked ten years ago, the historical perception of gold being scarce should soon regain traction.

5) Paul Volcker et al set policy in 1972 and he and the same sort of crowd continue to set policy today. After forty years they still don't seem to understand supply and demand.

6) There were very few gold derivatives in 1972 (and, by extension, no meaningful short positions) whereas today there are hundreds of millions of ounces represented by derivatives (as contrasted to gold in the basement). Data as to the net long or net short position is murky,

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but many bullion players assume there is a significant net short position.

7) Mining politics, always a problem, are probably more of a problem now than in 1972. Production then was about 70% from South Africa whereas now it comes from all over the world. Most countries are steadily grinding up taxes, power costs and regulations. And when one country increases the squeeze, it's an excuse for others to follow. Talk in investment circles is cheap, but actually putting a mine into production is tougher than ever.

8) Officialdom did not see inflation as a problem in 1972 nor does it see it as a problem now. We did and we do.

The comparison between now and 1972 is not perfect, but the similarity feels very real. The market's indifference to what could be the most explosive story in financial history screams out. Interestingly, in the years following 1972 almost nobody made serious money in the gold market – the time never seemed quite right to invest. It will probably be the same again – fighting City Hall is never easy.

Gold isn't alone in looking good. In view of the situation in Detroit, the housing market and the general economy, one might think $2½ would be a good price for copper. Yet here we are at $3½. Inventories don't seem to matter and China is a bit of a mystery. Are they buying copper as an investment or to use in cars, construction and so on? We'll guess half and half. Iron ore and other markets are similar. Going forward the investment factor appears set to be a permanent part of the commodity scene.

This raises the real question. The world is split between the Western world on the one hand and the rest of the world (R o W) on the other. For more than a century the Western world (less than a billion people) has consumed perhaps 90% of the world's copper, oil, steel, in fact pretty well everything. Now the R o W (over five billion people) is clearly consuming far, far more of everything – probably well over fifty per cent of the world's steel, for example. But the production side of the equation hasn't changed much, pretty well across the board. Except for gold where, as mentioned above, serious decline is taking place.

These changing realities, plus the tons of money governments have thrown at the system, have contributed to the strong performance of gold and other commodities in recent years. Now stronger governments are throwing tons of money at weaker governments and weak currencies, rather like giving alcoholics free cases of whiskey. It sure looks like easy money for a long time and a Malthusian commodity market.

Rather than fight the tide like King Canute, we should embrace it and take advantage of it. Not all commodities will move together – stick to the best. Just imagine what would happen if a mere ten percent of the money currently going into bonds were instead to go into gold. As in 1972, the real move has yet to begin.

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