Thunder Road report

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This issue:

Gresham's Law Squared - gearing up for Game Over

(If any member of your portfolio should die whilst in the shelter, put them outside, but remember to tag them first for identification purposes)

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Gresham's Law Squared – gearing up for Game Over

It's getting serious, Gresham's Law is kicking in and this isn't any "run-of-the-mill" Gresham's Law either – it's "Gresham's Law Squared". Not only is there huge hoarding of gold and silver, but it is being compounded by the simultaneous transformation of the gold and silver markets themselves. Having been dominated by paper claims to bullion, all that matters now is ownership of the physical metal itself. The price of gold and silver on your Bloomberg screen is actually a HYBRID price of physical bullion and a larger amount of "paper" bullion, e.g. unallocated gold and silver, exchange traded futures, OTC derivatives and some ETFs. The paper bullion price and the metal price are still the same, but this market structure (which had successfully channelled much of the demand away from physical metal) is now breaking down.

Amateurs...

When the screen price accurately reflects the prices of physical gold and silver per se, they will need to be FAR higher than you see today. Right now, the frontline in the battle between "real" money and paper currency is in the silver market, but most remain blissfully unaware of the significance of what is taking place. The world's financial system, as currently configured, is falling apart. The vast majority, including bankers and brokers (who should know better), don't appreciate it – a sort of tragi-comedy really. The bubble this time is in the money, so nobody will be spared. Buying gold and silver is the fear AND greed trade!

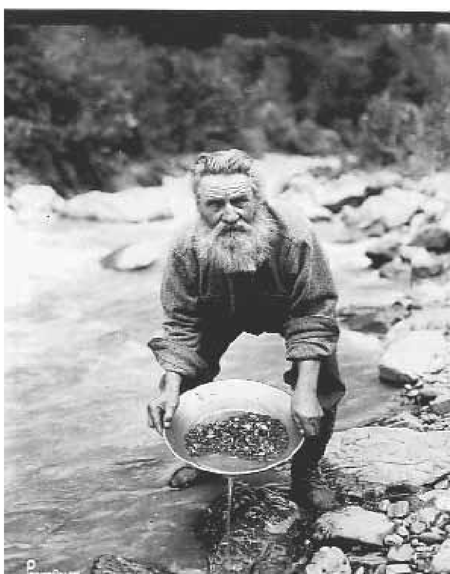
So here we are, waiting for the "event" which triggers a loss of confidence across the system. Will it be a sovereign, a US state, a bank, QE3 or QE5, the oil price, Chinese fixed investment, a false flag event (a convenient distraction/excuse) or a revolution? When it happens, the speed at which capital will move in today's over-liquefied world will take people's breath away. Where will it go? This is the global end of normal (baby) so that, first and foremost, it will go into the strategic assets - gold/silver, energy, food/agriculture, rare earths, etc, (as well as the equities of the financially strongest economies).

Bernanke's QE2 is nothing short of economic warfare, in the form of a wave of inflation, directed at the rest of the world and even his own population (at least anybody without a large stock market, commodities or precious metals portfolio). This inflation is not temporary, as per the false reassurances, it's baked in. Here is Martin Armstrong recently talking about the US budget deficit:

"A friend of mine on Capitol Hill, among others there, tells me there is no solution whatsoever until there is a MAJOR crisis"

In response, creditor nations have no other choice than to cut purchases of US Treasuries (China is selling), leaving the Fed increasingly standing alone. Rampant or hyperinflation results from the complete loss of confidence in a currency and we are being steered in this direction by the gentlemen above. Sure, they are smartly dressed, well educated (kind of) and pretend to know what they're talking about with their carefully worded "policies". It's all NONSENSE. All they're doing is leading us down a well-trodden path which has happened time and again throughout history.

In the meantime, there is evidence that the correction in gold and silver prices during January/ early-February-2011 only accelerated the process of Gresham's Law Squared. In this scenario, buying some junior gold and silver exploration & development plays could translate into "Gresham's Law Cubed". These stocks should have the greatest leverage to bullion prices in the medium term if they execute well and big funds, as well as retail investors, increasingly buy in. Examples from the 1970s prove this in spades – I wish I'd owned the "5,000 bagger". I've cut back some positions in some major gold and silver companies to fund small positions in a string of these (admittedly risky) juniors. I already had positions in ECU Silver and Fortuna Silver mines, which are development plays/early producers, and I've bought some South American Silver, Bear Creek Mining, Vista Gold, Minco Silver, Gold Bullion Developments, Arian Silver, Axmin, PC Gold and Majestic Gold.



Like wild dogs which have been cornered, our central banking friends are likely to strike back at some point, since gold and silver are their mortal enemies. So expect the unexpected. The enemies of gold and silver are twofold, benign economic conditions and rising real interest rates. The former is not on the horizon, so they might try to bluff the market into believing the latter - for a while anyway. We all know that they are well behind the curve on inflation. So don't be surprised if, for example, a manipulated Non-Farm Payrolls (unemployment) report out of the US is used as the catalyst for a (small) coordinated rate rise across the US, UK and Europe. The problem for these gentlemen and their political brethren is their insane policy of trying to solve a debt crisis with MORE DEBT. We are already past the point of no return in the current monetary system and anything other than a very modest rise in rates will only bring systemic collapse sooner rather than later. Hu Jintao was only stating the obvious on 17 January 2011 when he said that the dollar reserve system is a "product of the past". The bark of these wild dogs (and "monetary drug dealers") is much worse than their bite.

If you think about it, the whole basis of world finance and the world economy as we know it - and all those millions of forecasts for corporate earnings and economic data generated by legions of analysts in investment banks - are based on one critical assumption. It all hinges on the "greater fool theory" continuing to apply to buyers of US Treasury bonds (and the debt of other western governments along with Japan) and that a demonstrably insolvent US government can continue to find "investors" prepared to lend it gargantuan amounts of money. Kick away the rotting foundations beneath the world's reserve currencies and everything changes.

Junk: the investment vehicles formerly known as "risk-free" US Treasury bonds and UK Gilts

Do you remember the bit in the movie, "The French Connection", where the mobsters bring in "Howard the chemist" to test the purity of the smuggled heroin. Howard puts his apparatus together, heats up the "testing material", and comments as he watches the mercury rise:

"Blast off: one-eight-oh...Two hundred: Good Housekeeping seal of approval. Two ten: US government certified. Two twenty: lunar trajectory, junk of the month club, sirloin steak. Two thirty: Grade A poison...(the mercury finally hits 240) Absolute dynamite! Eighty nine per-cent pure junk. Best I've ever seen."

How about "Triple A-rated" poison instead of Grade A poison?

Just as "strange women lying in ponds distributing swords is no basis for a system of government" (quoting Monty Python), the greater fool theory shouldn't inspire confidence in our current financial system, but it should inspire a response. Gresham's Law is global, are you in or out?

STOP PRESS

1. David Morgan (www.silver-investor.com) on shortage in the wholesale silver market:

David is one of the most level-headed, as you will see from his comments below, and well-connected silver analysts. This is what he had to say on 21 February:

"But the real key is are we short on the commercial side, the 1,000 oz. bar size. And I spent a great deal of time this morning talking to the top of the pile, you might say, on the wholesale side. From what I've been able to determine, it looks as if we are now in that situation. I don't want to get everybody over-excited but it seems as if, from really good sources, and I source it in two places, one in North America and one in Europe, there is more demand on the commercial bar side than they are able to produce currently. So that implies a shortage. I would certainly throw in the towel. We always said there would be a day when the physical market would take over anything in paper. That would manifest in prolonged backwardation, which is what (James) Turk is saying. How long it lasts is another question. These type of things usually get over done for a while, so what do you do? The answer I would give is try to stay calm. If you were going to put in 'x' amount, I would divide that by half. I hate people chasing markets because of excitement. A couple of months from now things could cool off...There are situations which come up in markets which no one can anticipate."

2. COMEX delivery:

A friend of mine stood for physical delivery of a small number of contracts in the December 2010 silver contract. He paid a visit to the (very large) bullion bank to find out when he would receive his metal since it was already paid for. The employee of the bank said that my friend was not

permitted to enter the vault and (very interestingly) that the bank was no longer allowing the employee to enter the vault either. Now why would that be? My friend was told that in order to take delivery of his silver, he would need to fill out a form which would then have to be processed through the bank's compliance department. It was supposed to take a week, but that was more than five weeks ago.

This sudden need for secrecy regarding bullion vaults/delivery on the COMEX was confirmed by a contact of Jim Willie's (of the Hat Trick Letter):

"I hear stuff from a guy who has handled deliveries for several commodity firms for decades. I have known the guy for almost two decades, and he will say how stuff does not make sense. But when pressed in recent days, he completely clams up. It makes one wonder if he worries about more than his job. If I get something definitive, I will send it your way. In fact, I was talking to the guy the other day to update some storage charges on a little amount left in PM/COMEX vaults. He clammed up immediately, despite normally being extremely chatty."

3. Off-market buying of gold and silver: the "on-fire" Jim Willie again from another source:

"There is also massive precious metal buying going on in off-market transactions. This goes all the way to low-grade raw gold buying, especially by the Chinese who outbid everyone and then illegally export the raw gold under the cover of their diplomatic missions. The volume is hundreds of $millions every day, seen from my vantage point."

It's certainly plausible, i.e. that China is buying dore bars, i.e. partially processed gold bars, directly from gold mines before they enter the over-burdened refining sector.

4. GATA's "Stalker source":

Information from the Stalker source that was a significant factor in the call on silver in the Thunder Road from 5 September 2010:

"JUST IN: Heard from our STALKER source. He has picked up a new account which is a German conglomerate of some sort. Nothing new to report on gold, however 'THE London trader' is finally getting into silver and his reason is what is significant. His clients, which have had little to no interest in silver in the past, now want to get onboard. Perhaps this is one of the reasons silver is trading so differently these days. AND, if his clients (which have made so much money because of the brilliant trading and market acumen of the London trader) now want in on silver, other major newbie investors to silver most likely are doing the same thing."

We all know what's happened to the price of silver since then. Here is the latest (I have my fingers crossed):

"Our STALKER source called and said that their brilliant London trader told him his big league clients are not adding to their gold and silver positions money-wise (not taking money out either), but instead have been mobilizing funds to put into gold STOCKS. If many more finally do the same, they could really explode from present levels."

When Two Tribes Go To War

"Let's go…" I've been working on a couple of in-depth pieces of research, but felt compelled to write about something where I think the concept remains poorly understood. An immensely powerful version of Gresham's Law is playing out RIGHT NOW, but it's not just the normal version of Gresham's Law, this is effectively Gresham's Law Squared. Everybody knows the usual definition of Gresham's Law:

"Bad money drives out good"

The more valuable and credible money is hoarded and taken out of circulation, while the less valuable is used in everyday transactions. Here is some profound wisdom which I came across recently:

"Legal tender laws mandate the medium of exchange, but they DO NOT AND CANNOT NAME THE STORE OF VALUE. For that they rely on credibility management by institutions like the Fed and CNBC...And it is the monetary store of value that is on the move, not the medium of exchange."

Sir Thomas Gresham was born in Milk Street in the City of London in 1519. He was a banker and goldsmith and subsequently inherited his father's banking business. He became known as "the greatest merchant in London". Besides being the adviser to Queen Elizabeth I, it was his idea to build a central exchange in the City of London, the Royal Exchange, subsequently opened by the queen in 1571. This is the Royal Exchange today (now converted into a shopping mall):

Here is a great quote from Wikipedia (hedge fund salesmen kindly take note):

"During the 17th century, stockbrokers were not allowed in the Royal Exchange due to their rude manners, hence they had to operate from other establishments in the vicinity, like Jonathan's Coffee-House."

The first documented referral to the concept of Gresham's Law was by the Athenian playwright, Aristophanes (450-385 BC), in his play "The Frogs" when he wrote:

"the full-bodied coins that are the pride of Athens are never used while the mean brass coins pass hand to hand."

In the Roman Empire, increasing costs of the military and the exhaustion/subsequent loss of the mining province of Dacia led to debasement of the coinage. By the third century AD, gold had largely been diverted from use in transactions and functioned as a store of wealth. Hoards of silver coins from that era found by archaeologists typically contain denarii, which had a higher silver content than the later (and baser) antonianii.

In the fourteenth century, Nicolas Oresme the philosopher, economist, mathematician, astronomer, physicist, Bishop of Lisieux and advisor to Charles V of France (a talented guy) wrote his "Treatise on the Origin, Nature, Law, and Alterations of Monies". This was effectively the foundation piece on money in the political economy – and most of it has stood the test of time. His 700-year old warning against governments printing money to bail out the "Too Big To Fails" still rings true today:

"And if he should tell the tyrants' usual lie, that he applies that profit to the public advantage, he must not be believed, because he might as well take my coat and say he needed it for the public service."

Gerald Celente was very forthright recently about where he thinks the situation is headed:

"They're keeping the Ponzi scheme going. We wrote in a Trends Alert when this whole TARP nonsense started, when they gave the people the big lie that we had to bailout the 'Too Big To Fails', that when the bailout bubble burst, they will lead us to war. The bailout bubble is bursting."

Here is Oresme's formulation of Gresham's Law about bad money driving out good:

"such alterations and debasements diminish the amount of gold and silver in the realm, since these metals, despite any embargo, are carried abroad, where they command a higher value. For men try to take their money to the places where they believe it to be worth most. And this reduces the material for money in the realm."

During the 1690s, English coinage was decimated, or "hammered" to use the correct terminology. Silver coins were "clipped" and the silver exported to Holland, where it fetched a higher price.

As per Gresham's Law, new and better quality coins were hoarded or exported for bullion, while the degraded coins were used for everyday transactions. In 1696, a monetary crisis forced Britain into the re-coinage of its silver currency. Charles Larkin explained in his paper "The Great Re-coinage of 1696 – Developments in Monetary Theory" that:

"The English Great Re-coinage of 1696 was one of the great monetary events in history. The English currency, a bimetallic standard based on the weight and fineness of the coinage, was debased in order to pay troops in the Netherlands during the Nine Years War. By 1695 almost 50% of the specie content was missing from coinage in circulation, causing a monetary crisis. The May 1695 actions of demonetisation of England's debased coinage and the issuing of new full-weight coin were instrumental in the creation of the British Gold Standard. This national monetary standard became the International Gold Standard during the nineteenth century."

The recoinage didn't go smoothly – the Royal Mint was unprepared for the scale of the task and the Bank of England defaulted:

"England's economy stopped for most of 1696, resulting in massive unemployment, poverty and civil unrest"

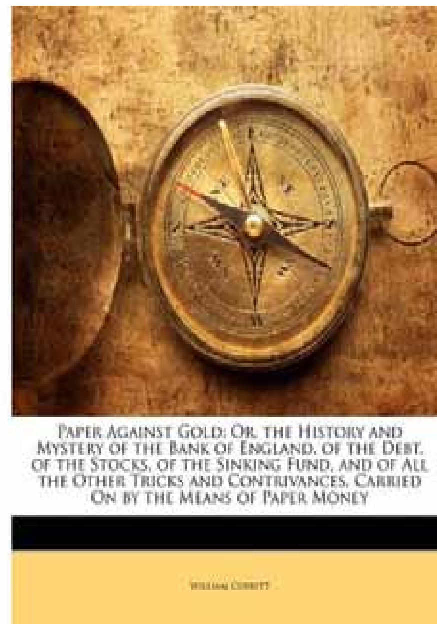
During the re-coinage, gold became the medium of exchange and, due to relative overvaluation of gold versus silver in Britain, silver continued to flee the country in exchange for imported gold.

There was another example of Gresham's Law in Britain which led to the Bank of England defaulting (again) when it ran out of gold with which to convert its banknotes in 1797. Predictably, the government came to its rescue with the Bank Restriction Act, which made the default legal and sheltered the Bank's directors. This is from Wikipedia:

"The banknote was overprinted by the British government after they declared war on revolutionary France in 1793. Due to increasing military expenses, the government began printing more banknotes, which they expected the Bank of England to exchange for gold should the banknote bearer request it. By the end of the war in 1814, the banknotes had a face value of 28.4 million pounds of gold, yet was backed by only 2.2 million pounds of gold, which caused the currency to depreciate by 30%"

That's not quite correct, as the price level in Britain increased by just over 80% during 1793-1814.

The following quote is from William Corbett's beautifully titled book published in 1834 "Paper against Gold: Or, the history and mystery of the Bank of England, of the debt, of the stocks, of the sinking fund, and of all the other tricks and contrivances, carried on by the means of paper money."



Source: Amazon

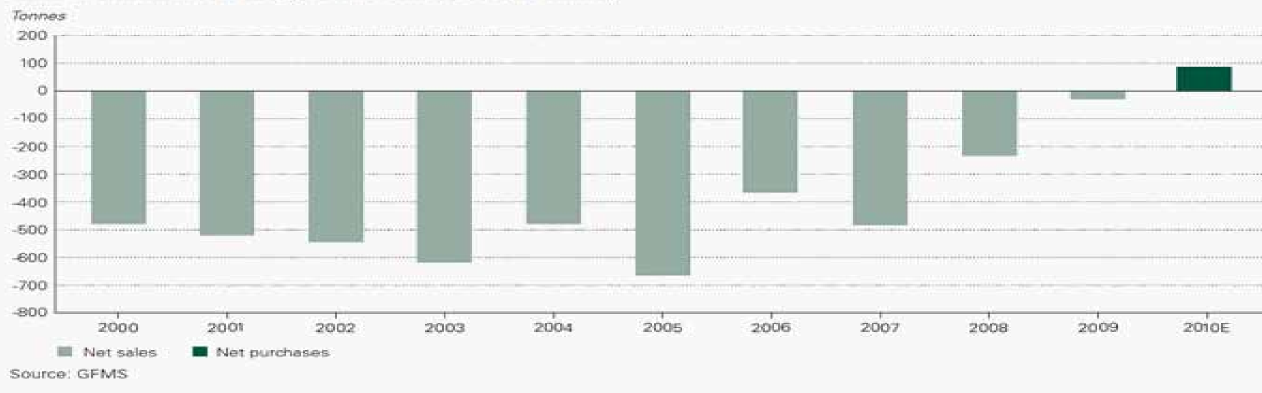
"for then it was evident, that all the taxes would be paid in paper; that the Government would receive nothing but paper; that the Bank could get nothing but paper from the Government; that whatever gold went out of the Bank would never return to it; and, of course, that the Bank would in a short time, be unable to pay its notes in gold, if called on for that purpose to any great extent."

This Cobbett quote sums up the approach of "Game Over" for the current monetary system:

"But gold and silver will, in the long-run, revolt against depreciation (of paper), and separate from the value of paper; for the progress of all such systems appears to be, that the paper will take command in the beginning, and gold and silver in the end."

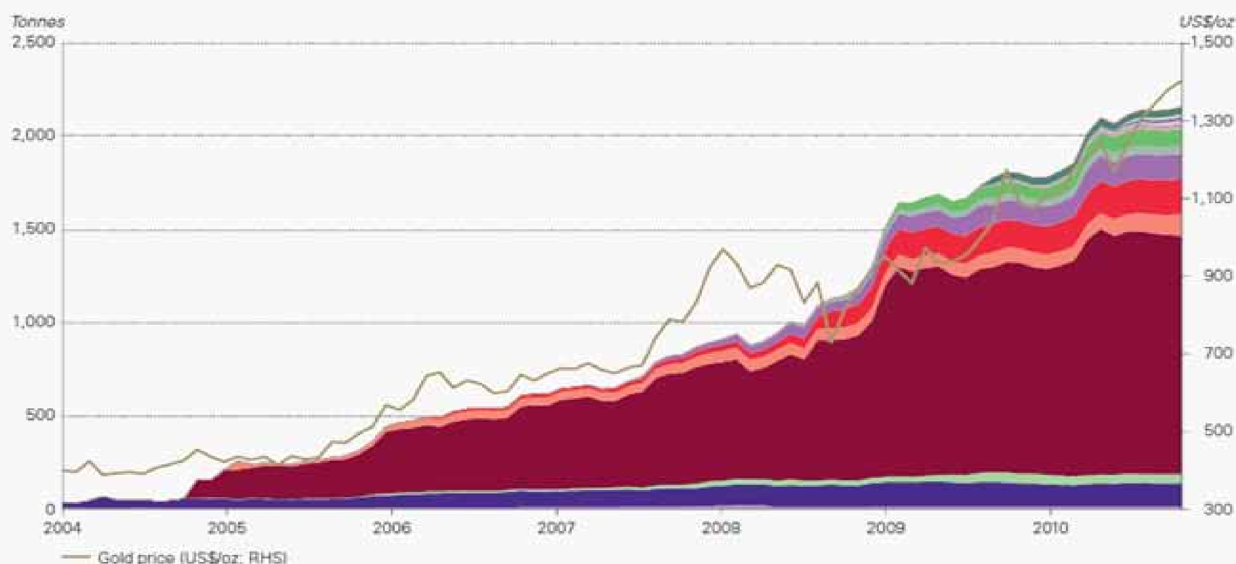
Same old, same old…it's a well-trodden path, as I said earlier. Back to the current crisis and we are experiencing the usual hoarding of gold and silver and evidence of Gresham's Law occurring is prevalent across the world. Here are some either very significant and/or recent examples:

- China stunned the financial world in 2009 when it announced that its gold reserves were 1,054 tonnes – 76% higher than the 600 tonnes it had been reporting since December 2002;
- India bought 200 tonnes of gold from the IMF in November 2009;
- In June 2010, Saudi Arabia suddenly announced that its gold reserves were 322.9 tonnes, which was more than double the previously reported 143.0 tonnes;
- In January 2011, the First Deputy Chairman of the Central Bank of Russia, Georgy Luntovsky, announced that Russia planned to buy more than 100 tonnes of gold each year;
- Central banks turned net buyers of gold in 2010 – the first time for 21 years (that's the official story anyway, I suspect some have far more gold than they let on) - see chart below:



Source: World Gold Council, GFMS

- Investment in gold and silver through ETFs (Exchange Traded Funds) has risen dramatically. The chart below shows how gold held (allegedly anyway) by ETFs has increased from almost zero in 2004 to 2,167.4 tonnes by the end of 2010.



Source: World Gold Council, GFMS

- Since 2008, the Chinese government has been promoting the ownership of gold and silver to its people as discussed in earlier Thunder Roads. Data for 2010 shows that China's net imports of silver in 2010 were c.3,500 tonnes, up by a factor of nearly 4 from 2009. China was a net exporter of almost 3,000 tonnes as recently as 2005. An official of China's Industrial and Commercial Bank (said to be the world's largest bank by market value) recently gave an extremely bullish interview on gold and silver demand to Reuters:

"ICBC…sold about 7 tonnes of physical gold in January this year, nearly half the 15 tonnes of bullion sold in the whole of 2010, said Zhou Ming, deputy head of the bank's precious metals department on Wednesday. We are seeing explosive demand for gold. As Chinese get wealthy, they look to diversify their investments and gold stands out as a good hedge against inflation,'…Zhou said there was also voracious demand for silver, with the bank selling about 13 tonnes of physical silver in January alone, compared with 33 tonnes in the whole of 2010."

- There was a similar story across other Asian countries. Sales were so strong in India during Q410 that the Reserve Bank of India authorised seven more banks to import bullion. According to the WGC, it "expects the impact of this measure to be visible during 2011".
- The US Mint sold 6.42m one ounce Silver Eagle coins in January 2010. This was more than 50% higher than the previous monthly record of 4.26m in November 2010.
- A short anecdote relayed indirectly from a US source is that there is a trend for uber-wealthy Americans to build their own vaults under their homes to store bullion. So, not only are they buying large quantities of bullion (to justify vaults), but they don't trust the banking system either (and I don't blame them).

At the same time as this conventional hoarding is taking place, the forces of Gresham's Law are being compounded in ways which are less visible. In "Uses and Abuses of Gresham's Law in the History of Money", Robert Mundell argues that:

"The correct expression of Gresham's Law is: 'cheap money drives out dear, if they exchange for the same price'."

This precisely captures the compounding effect of Gresham's Law which is taking place. The spot prices of gold and silver on everybody's Bloomberg screens are a hybrid price of a relatively small amount of physical metal and a far larger amount of paper claims, i.e. paper gold and silver is trading at the same price as physical gold and silver. GATA's Adrian Douglas and myself (and others too) have highlighted the "fractional reserve" nature of gold and silver markets for some years now. Recapping briefly, this takes several forms:

- The world's biggest gold and silver market is the LBMA where the average daily volume of gold traded (number of ounces "transferred" x 4) is approaching US$100bn and for silver US$11-12bn. Historically, over 95% of LBMA trading has taken place in the form of "UNALLOCATED" gold. Unallocated gold is an unsecured claim on a pool of gold in bank vaults. The pool of gold belongs to the bank as part of its working capital. This contrasts with allocated gold where gold bars are specifically segregated in the name/ownership of the customer. Anybody with unallocated gold who is not transferring it into allocated is insane in my view. The LBMA is primarily a massive amount of paper trading suspended above a smaller pool of physical bullion (think of musical chairs when there are far fewer chairs than participants).
- On the COMEX futures market in New York, average daily turnover of gold and silver contracts was equivalent to 23.6m oz of gold and 357m oz of silver (Janaury 2011 data). This compares with dealer inventory held in COMEX warehouses of 2.82m oz. of gold and 42m oz. of silver, and the latter is falling dramtically as shown chart below. The vast majority of traders don't intend to stand for delivery – at least while the futures market functions normally, but silver is currently in backwardation (discussed below). In short, the vulnerability of the COMEX is obvious vis-à-vis the risk from being overwhelmed by demand for physical bullion.

COMEX - silver inventory held by dealers

- The latest BIS data for OTC derivatives at the end of June 2010 showed US$417bn of outstanding notional value for gold derivatives.
- Finally, some gold and silver ETFs are not backed by bullion and the extent of the backing of even the largest ones is frequently questioned.

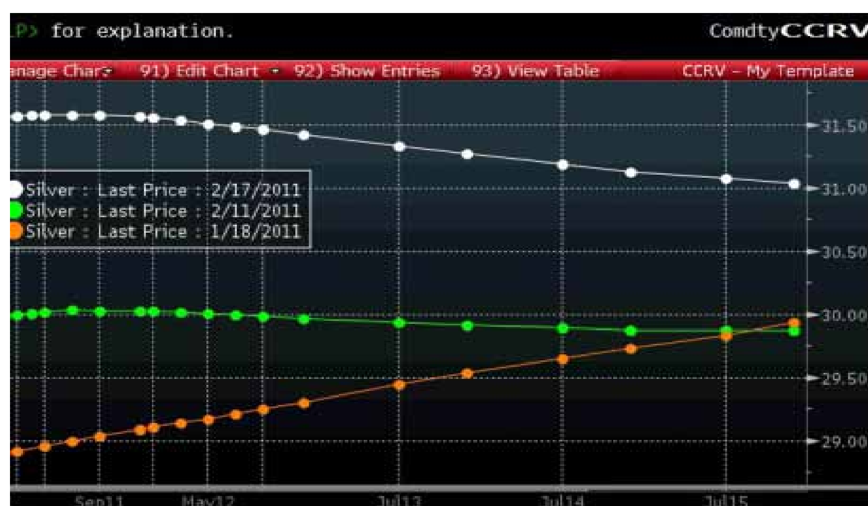
The fact is that the existing structure of the gold and silver markets, based predominantly on paper substitutes, is breaking down. Besides increasing demand for gold and silver, both physical bullion and paper claims, there is a simultaneous increase in the demand for settlement to be made in actual physical metal, which adds the "Squared" part to Gresham's Law. Let's consider some evidence of this:

The situation on the LBMA is kept deliberately opaque and (under-) regulated by the bullion banks themselves with the tacit support of the Bank of England. However, we can glean just how tight the physical bullion markets are in relation to paper bullion via the "basis". The basis is the difference in the spot price and the nearest futures price. Gold and silver almost trade in "contango", i.e. where the nearest futures price is above the spot price due to their very high stocks/flows ratio. Backwardation implies a higher spot price versus the nearest future and, theoretically, free profits for investors.

For those unfamiliar with the concept of backwardation, it's very straightforward. If we assume that the spot price of silver for immediate delivery is US$30.00/oz and the price of the near month in the futures market is US$29.50/oz, i.e. silver is in backwardation. I could sell an ounce of silver at US$30.00/oz in the spot market, put the cash on deposit for a month to earn interest, and arrange to buy back my ounce of silver in futures market in a month's time for US$29.50/oz. Importantly, after the sale of my ounce of silver in the spot market, I would not (normally anyway) be concerned about the ability of my counterparty in the futures market to obtain the silver to deliver back to me at the end of the month, given the very large level of silver stocks in existence. My profit on this theoretical trade would obviously be US$0.50 plus the interest from placing the cash on deposit for a month. Consequently, if silver IS trading in backwardation, it suggests that traders are afraid that if they sell silver in the spot market and arrange to buy it back via a futures/forward contract, their counter-party on the LBMA or COMEX may struggle to return the metal on the specified delivery date.

The world experts on the gold and silver basis are Sandeep Jaitly (www.bullionbasis.com) and Professor Antal Fekete. In his latest report, Sandeep explained how gold moved temporarily into backwardation during the second half of January before returning to contango this month – the maximum backwardation being 0.4% on 20 January 2011. The silver basis remains in backwardation, as does most of the futures curve. Here is a great chart from Tyler Durden at Zero Hedge which shows how silver futures flipped from contango on 18 January 2011, to almost flat on 11 February and into backwardation on 17 February.

Silver futures curve



Source: Bloomberg, Zero Hedge

On 9 February 2011, the Financial Times published another curiously well-timed attempt at calming the investment fervour in the silver market. According to the FT, there is nothing unusual happening in terms of the backwardation. It seems that several silver miners decided to hedge some of their future production by borrowing (leasing) the equivalent amount of physical silver which was sold into the market. The miners will then deliver back the same amount of to the bullion banking counterparty at the hedged price from their future production. It was this sudden requirement to borrow silver which apparently caused the backwardation. It also provided a great opportunity for headlines and sub-headlines to strike fear into silver investors.

“Miners hedge against fall in silver”

“Fears that precious metals will peak soon”

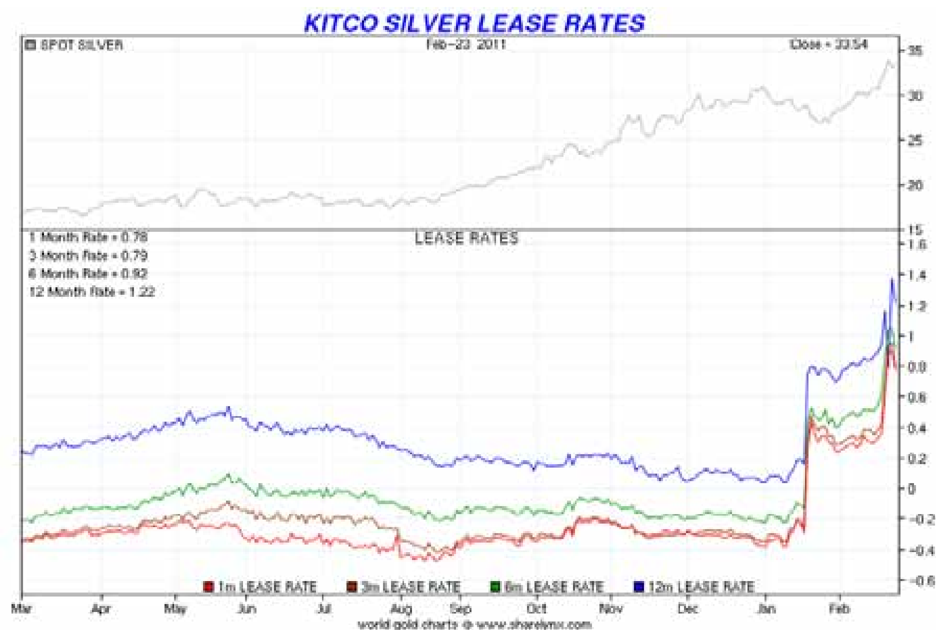
“Market is pushed into backwardation”

It’s all very interesting except that I don’t think that much of their argument stands up to scrutiny.

- It mentions five silver miners as having hedged. These will be mining companies where silver is either irrelevant (like BHP – despite it being the world’s largest silver miner) or is a by-product of zinc or copper mining (like Xstrata, Teck Resources and Kazakhmys – all of whom are in the top 20 silver miners). These companies have v. close links with governments and the major investment (bullion) banks and would probably need little arm twisting.
- Any major primary silver company would risk a shareholder revolt if they hedge the price of silver after the billions of dollars of losses suffered by the likes of Barrick and AngloGold Ashanti, etc. It’s only going to happen if they are “strong-armed” behind the scenes.
- The hedging has probably been done synthetically, using paper contracts in the OTC derivatives market, rather than borrowing/leasing physical bullion. Some of Barrick Gold’s hedges were set up this way. And anyway, why disturb the physical silver market when it’s really tight anyway?

My guess is that the rise in lease rates (i.e. the price of borrowing physical silver) reflects the desperate need find silver to settle LBMA trades in London, Zurich and on the COMEX.

Silver lease rates



Source: Kitco

But let’s say I am wrong and physical silver was leased and sold into the spot market for hedging purposes.

In that scenario, shouldn't we have seen a different trend in spot and futures prices? The spot price should have moved lower versus futures prices, removing the backwardation. Instead, the spot is above the futures price. I think there's a real problem in the silver market and the spike in lease rates reflects efforts to find physical silver to keep the market functioning as normally as possible. Setting up hedging contracts with producers like BHP, et al, ensures that the large bullion banks will take delivery of that silver as it is mined. It gives them more control to ensure that physical silver goes to what they deem the "right" places.

Professor Antal Fekete **Sandeep Jaitly**

Antal Fekete has been predicting the shrinkage in contango in precious metal futures markets for many years. Here is a comment from a 2006 essay, "The Rise and Fall of the Gold Basis":

"My own explanation is that the shrinking contango and the persistent fall in the gold basis is a measure of the vanishing of gold into private hoards. Monetary gold together with the output of the gold mines is disappearing."

He then commented on silver:

"As a further refinement I call attention to the silver basis which, if my analysis is correct, will fall first. Not because monetary silver has been 'consumed', as trumpeted by the cheerleaders of the get-rich-quick crowd. It hasn't. But, as the silver basis shows, silver is going into hiding even faster than gold. Why? Basically because central bankers have less scope for bluffing in the silver market. The cupboard is bare and the kitty is empty when they are looking for more silver."

Events are unfolding as Antal Fekete predicted. Here is GATA supporter Dave Kranzler last week on gold:

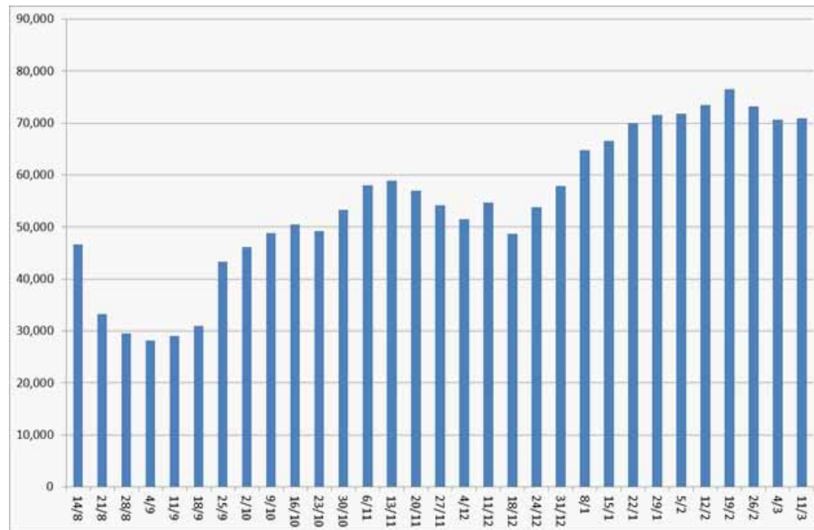
"I spoke to a 'most' informed bullion dealer yesterday to get his take on all of this. He said we still don't have true backwardation yet until we get a price inversion from spot to March. Sure enough, I pulled up the Comex gold futures settlement prices from yesterday and there was contango from Feb to July - only a penny but it was there. He said 'most of the heavy lifting has been done towards a true backwardation' but we're not quite there yet."

We are not there yet, but if gold and silver backwardation becomes permanent, it will likely signal the beginning of the end for today's fiat currency system and dollar hegemony.

There has been huge debate about the concentrated short positions on COMEX in both gold and especially silver, where the manipulation has been ridiculously heavy-handed. CFTC Commissioner, Bart Chilton, acknowledged it publicly. While the opaque LBMA is the most important market for price discovery, it's worth contrasting the COMEX data for the last major upward move in the silver price, from August 2007 to March 2008 with the current bull market which began in August 2010.

In 2007-08, you can see from the CFTC's Commitment of Traders data below for the "Commercials" (bullion banks) shows how they continued to sell into the price rise, increasing their net short position, until they broke the conviction of the longs – the price peaked at US$20.92/oz on 17 March 2008.

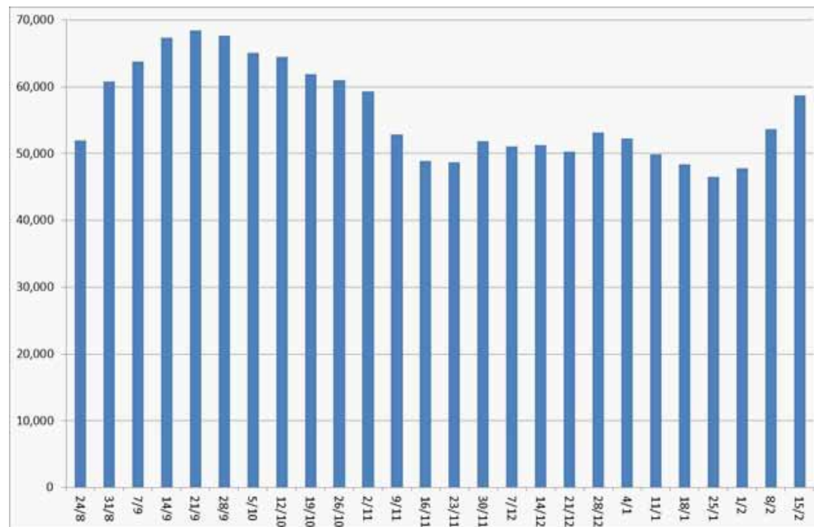
Net short position of the "Commercials" 2007-08 silver bull market (no. contracts)



Source: CFTC

Fast forward to the current bull market and, for the first few weeks, the same thing happened – the Commercials increased their shorts as the price began to rise. But then a funny thing happened during the week ending 21 September 2010 – the Commercials stopped increasing their shorts and began to buy them back – this trend broadly continued through to the end of January 2011.

Net short position of the "Commercials" 2010-11 silver bull market (no. contracts)



Source: CFTC

What was the significance of the week ending 21 September 2010? It might have been the FOMC statement released that day containing the additional comment that the Federal Reserve:

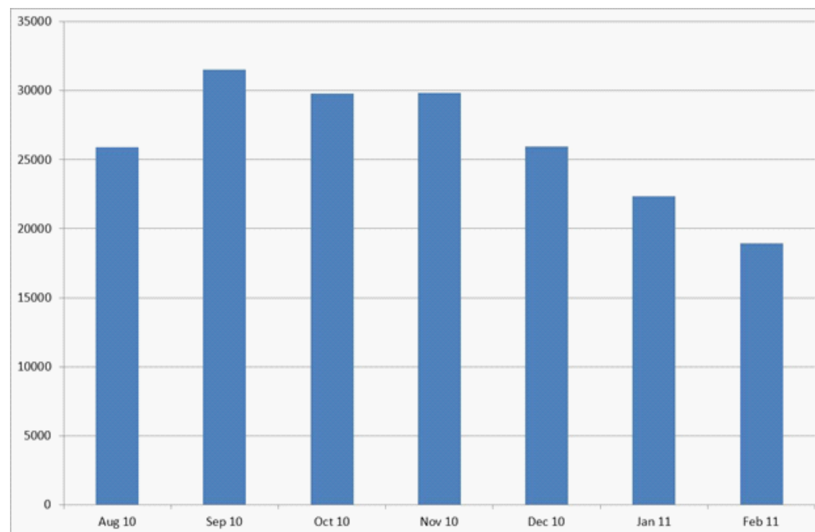
"is prepared to provide additional accommodation if needed to support the economic recovery"

QE2 was then a certainty and gold and silver began to move up sharply. Even the recent upturn in the Commercials' net short has been largely due to increased shorting by the smaller banks, the "raptors" as Ted Butler calls them.

The chart above shows the net short positions for the Commericals in aggregate. What is more interesting is the "paper shenanigans" by the biggest "concentrated" shorts on the COMEX, where the reduction in the net shorts has been much more dramatic. The CFTC publishes the Bank Participation Report on a monthly basis which highlights the positions of the big US banking shorts, i.e. JPM and possibly HSBC. After an initial increase in September 2010, the big shorts have cut their net short position by 40% from 31,527 contracts

down to 18,935 in early February, i.e. from 157.6m oz to 94.7m oz.

Net position of "Big Shorts" in 2010-11 (no. contracts)



Source: CFTC

There is a further unusual aspect of the current bull market in silver. "Managed Money", i.e. large institutional funds, have not participated in the big move up in the silver price until very recently – at least on COMEX - during late-2010. Between the end of September 2010 and late-January 2011, they cut their net long positions by more than 60% as shown in the next chart:

Net short position of "Managed Money" 2010-11 silver bull market (no. contracts)

Source: CFTC

It seems to me, therefore, that the key drivers of this bull market in silver are the big paper shorts "getting out of Dodge" and most likely (because there is no transparency) massive buying of physical silver in London, i.e. "the paper to physical" trade in the bullion markets which is the "Squared" part the current Gresham's Law phenomenon.

Finally, here is a quote from the World Gold Council regarding activity gold trading in China during 2010:

"Investment activity in China remained high. Physical delivery at the Shanghai Gold Exchange totalled 836.7 tonnes in 2010, with 236.6 tonnes delivered during Q4. Moreover, physical delivery as a percentage of trading volume had increased to 33% by the fourth quarter, as Chinese investors sought to get hold of gold bullion."

Aside from Gresham's Law Squared, there is one further issue relating to silver which is worth mentioning. While gold is a national security issue for the US, I'm increasingly coming to the view that silver is too. Several years ago, Professor Antal Fekete, proposed (in opposition to independent silver analyst, Ted Butler, at the time) that the big COMEX short positions ultimately belonged to China. His argument was that these net short positions were literally the tip of the iceberg, i.e. hidden behind the short position on COMEX was a far larger LONG position in physical silver held by the Chinese.

The argument was that as the bull market in silver unfolded, the short position on COMEX could be traded to generate additional income, i.e. selling into price spikes, buying back on weakness. Over time, the strong fundamentals for silver (a combination of monetary debasement by central banks and rising industrial demand) would assert themselves in a substantially higher price, but the gross return from capital appreciation AND trading, would be much greater. Recently, a new angle has emerged in the debate, i.e. that China only swapped its silver temporarily with US interests and it is the latter who have used this silver for their ends.

Ted Butler and Canadian derivatives trader, Harvey Organ (harveyorgan.blogspot.com) are also now speculating that the short position on COMEX does indeed derive from Chinese silver. This is from Ted Butler last month:

"A number of you have inquired about my speculation that it may be Chinese counterparties on the short side of the OTC silver swaps assumed by me to be held long by JPMorgan. The gist of the queries center on what possible motivation would Chinese interests have in being short silver, especially since there have been many reports of China's government encouraging its citizens to buy silver and gold. Please remember it is not so important who the counterparties are, but what is the legitimacy of their holding a concentrated OTC silver short position that is being transferred to the COMEX…I did not pick interests in China out of the thin air. As the largest producer of silver in the world (mine plus refining), it would sound plausible for them to be short (but never to the extent it has reached on their surrogate COMEX position held by JPM)."

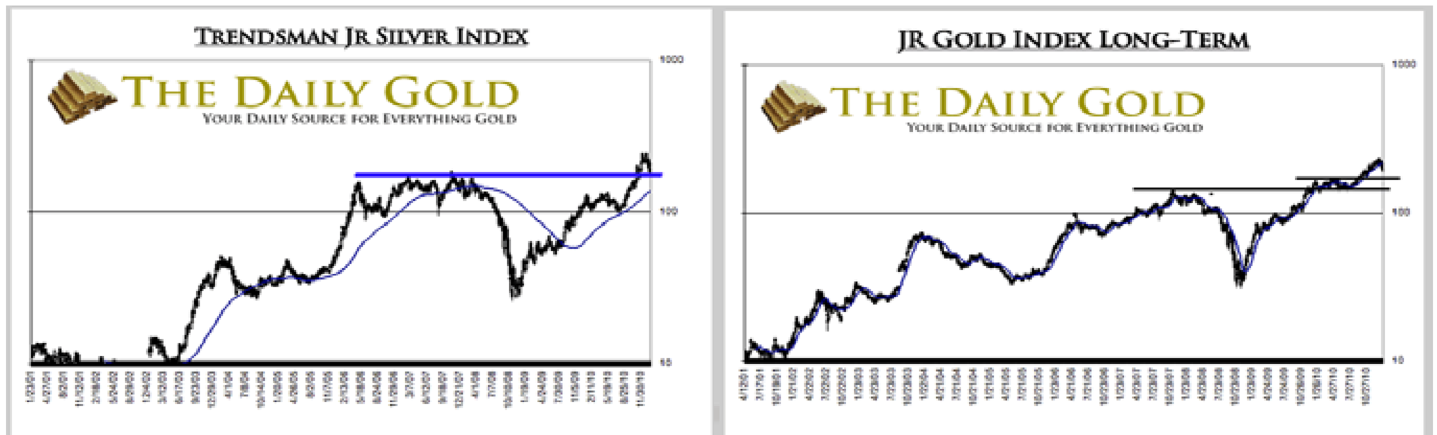
And this from Harvey Orgon's latest letter to the CFTC commissioners:

"Mr O'Malia was the lone dissenter on your latest vote voicing his concern that the swap books on JPMorgan once opened would be a shock and that the CFTC would not know how to handle the situation. It has been my contention all along that the major short, is in reality the Chinese government who lent their hoard of silver in support of the suppression of gold. It would be difficult to suppress gold while allowing silver to advance in price. The gold was supplied by central authorities. The USA ran out of silver in 2003 and in order to receive most favoured nation status, the Chinese have done a swap with the USA with a date certain to re-swap. It is quite conceivable that the Chinese have asked for their silver back but were refused as global supplies for silver are vanishing."

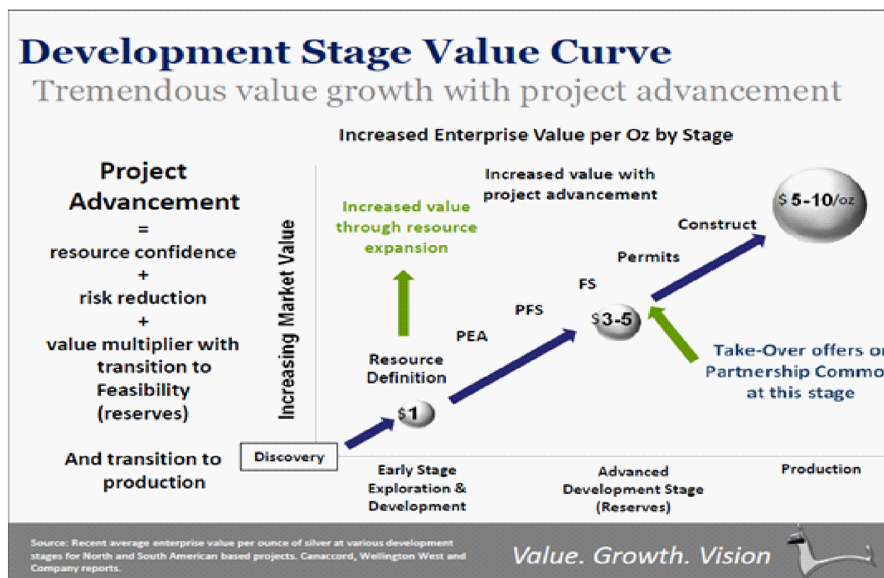
So according to this argument, physical silver was swapped with the US in return for fiat dollars or some other collateral. The US used the silver in its price manipulations of recent years, but China wants its physical silver back. The silver has gone, but the US told the Chinese they can keep the dollars – only China wants its silver. There is certainly logic to this argument, i.e. the US needed silver (having sold off its own stockpile) and the Chinese had probably been left with a hoard of silver post the abandonment of its silver standard in 1935 and the subsequent revolution. A major stand-off with China and the continuing importance of defending the credibility of the dollar would certainly justify national security status and explain the outrageous and brazen behaviour of the CFTC in not dealing with the obscene short position and manipulation of silver on COMEX. This was after CFTC Commissioner Bart Chilton's statement that the silver market had been subject to:

"repeated efforts to influence prices…There have been fraudulent efforts to persuade and deviously control that price. Any such violation of the law in this regard should be prosecuted."

Moving on to what I've done with my portfolio. I want to show you four charts – the first two are from Jordan Roy-Byrne from an article he published, "When and How Will the Gold Bubble Begin", on The Market Oracle Website on 1 February 2011. It shows how his junior gold and silver indices appear to be testing support having broken out in the latter part of 2010:



Now here is a good chart from a South American Silver Corp. showing how the valuation of silver companies, in terms of Enterprise Value (market cap. + debt) per ounce of silver in the ground, typically increases as it moves from early exploration through to production.



Source: South American Silver Corp.

While this process can take 5-10 years, the valuation can increase by a factor of 5-10x AND you would expect the amount of silver resources/reserves to steadily increase as the company continue to drill.

That's the good news, there are many potential sources of bad news. For example, the mining economics might not work, targets can slip, "inferred resources" (i.e. silver believed to be present from a limited amount of exploration) might not actually be there, capital raisings might not be efficiently deployed by management, political risk, etc.

There's a big difference to analysing the likes of Anglo American and Rio Tinto (which I used to do) and picking winners in the VERY RISKY junior space. It made sense to adopt the shotgun strategy, realising that some will fall by the wayside, in the hope that a few are big winners. For what it's worth, these are the ones (in no particular order) that I'm holding currently:

South American Silver (SAC.TO): Potential for large, low cost silver mine at Malku Khota in Bolivia. It is also a play on growing demand for indium for technology applications. Pre-feasibility is expected this year. Bolivia might not be everybody's first choice but majors like Pan American and Coeur D'Alene have silver mines there. There is also a possible large copper/gold deposit in Chile with the initial resource estimate planned for late-2011. EV/silver resources valuation is off the chart to the downside. SAC's management owns 15% and Sprott is a holder.

Bear Creek Mining (BCM.V): the (very) bold mission is to build a "large cap silver mining company producing 15-20m ounces of silver per year by 2014". There are two projects which are both in Peru. The first is due onstream in 2012 (c.5m oz. p.a. – feasibility completed) with the larger one expected in 2014 (10-15m oz. p.a. – feasibility expected in Q311). The company also has an earlier stage silver/gold project. There are 321m proven and probable silver reserves and c.800m oz of resources for a market cap of US$800m.

Vista Gold (VGZ): This company has 17.9m oz of gold resources, 12.98m oz of which are Proven & Probable/Measured & Indicated (P&P/M&I), rather than more risky Inferred Resources. There are two major projects, Concordia in Mexico (2.1m oz. of the 12.98m oz.) and Mount Todd in Australia (5.1m oz.). The feasibility study for the former is complete and permitting awaited, subject to environmental issues. Feasibility for the latter is due later in 2011. These projects could have annual gold production of 383,000oz. p.a. The market cap of VGZ is US$180m, giving a valuation per P&P/M&I gold of c.US$15/oz.

Axmin (AXM.V): has gold exploration projects in Africa (CAR, Sierra Leone, Mali, Senegal and Mozambique). In the first half of 2011, AXM expects to complete the feasibility study and get project financing for its Passendro gold project in the Central African Republic. The market cap of c.US$130m compared with P&P/M&I resources of 3.4m oz. for Passendro alone gives a market cap per oz of less than US$40. Production is expected to begin in late-2012 and average 203,000 oz. p.a.

Minco Silver (MSV.TO): holds 90% of Fuwan silver project in southern China which has a feasibility study, a majority of the required permits and has arranged financing. Initial production of the mine is expected to be 5.5m oz. per annum. The market cap of US$310m compares with probable and indicated resources of 93.5m oz., i.e. about US$3/oz.

Gold Bullion Development (GBB.V): is an exploration play focusing on the Granada Gold Property in Quebec on the site of a former mine. The "Cadillac Trend" region has produced many multi-million ounce gold deposits. Drilling during 2007-10 has encountered ore grading from 0.60-1.62 g/t. A new phase of drilling began in November 2010 and four additional properties were acquired nearby. A preliminary model (albeit non-43-101 compliant) outlined potential for 2.4-2.6m oz. The market cap is US$112m.

Arian Silver (AGQ.V): is producing silver, lead and zinc at its recently opened San Jose mine in Mexico. San Jose has total silver resources of 42.8m oz., although only 9.0m oz. are currently indicated (the remainder are inferred). The deposit is only 10% explored and recent drilling has shown high silver grades (up to 834g/t of Ag). AGQ's management believes the potential could be at least 20mm oz Ag.There is a further silver-gold exploration project. The market cap is US$185m. Sprott is a major shareholder.

PC Gold (PKL.TO): is redeveloping the Pickle Crow mine in Ontario. The mine closed in 1966 because mining had become uneconomic – back then gold was fixed at US$35/oz – not because it ran out of gold. During 1935-66, Pickle Crow produced 1.45m oz. The management believes there is at least 1.0m oz at good grades and has had numerous drilling successes. The aim now is to deliver a NI 43-101 compliant resource estimate. The market cap is US$61m.

Majestic Gold (MJS.V): is developing the Song Jiagou gold project in China, the first phase of which came onstream last year. Production is estimated at 93k oz. by 2015. The NI43-101 resource statement showed 2.7m oz., of which 1.2m oz. is indicated, and the market cap is US$100m. The management team includes Chinese nationals with strong links to state institutions.

Obviously, we are ten years into the current bull market and some stocks have already risen by multiples. However, we have certainly not reached the mania stage yet. I came across an article written in December 2003 by Edward Gofsky titled "The 21st Century Gold Rush: How High Can Gold and Silver Stocks Go? Higher Than You Might Think!!" Gofsky went to his local library and started researching stories on the gold and silver market in the financial press from 1972 onwards. He found that:

"There were a few articles about gold from 1972 to 1975…"

Which sounds like what's happening now.

"…but the real big stories didn't really get published until around 1978-79 and especially in January 1980, the final blow off top in both gold and silver."

But here is where it gets more interesting:

"What I found was absolutely shocking. In 1975, most or all of the gold and silver stocks were trading under $2 (and) most were penny stocks under $0.50. Even with gold up 400% from the 1972 low of $60 to the 1975 top of $200, most of the gold and silver shares did little to make anyone notice, especially the mass public who had no idea what was going on."

Then he says:

"Let me give all you fellow gold and silver investors and people reading this essay who are thinking about buying some gold and silver shares a few examples of the kind of gains that were made in the gold and silver market a generation ago"

I've put some of the examples found by Gofsky into a table:

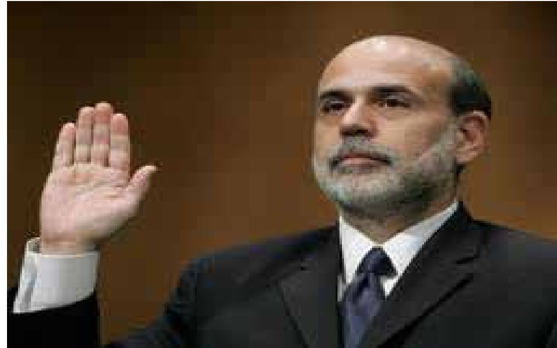
Stock	Share price low	Share price high
Lion Mines	7 cents	$430
Bankeno	$1.25	$430
Wharf Resources	40 cents	$560
Steep Rock	93 cents	$440
Mineral Resources	60 cents	$415
Azure Resources	5 cents	$109

Source: Edward Gofsky

While the central bankers and politicians continue to steer us in the direction of hyperinflation, the disinformation and/or ignorance is reaching new levels:

2003: **"They're not even (within) 100 miles (of Baghdad). They are not in any place. They hold no place in Iraq. This is an illusion"**

2011: **“We are not printing money and there is no inflation.” (paraphrasing)**



Here is a superb example from Mervyn King, governor of the Bank of England, in a speech he gave on 25 January 2011. The capitals are mine in order to emphasize what he’s missing:

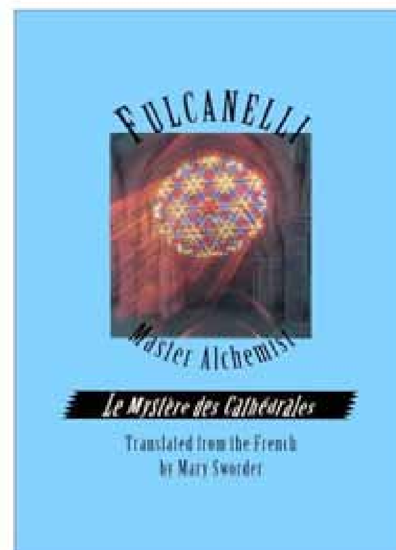
“In contrast, unhappy economies are very different from each other, as we have seen in Europe recently. In Ireland, the problem was the size and in**DEBT**edness of excessively large banking and real estate sectors. In Greece the problem was different – years of weak control of spending led to an unsustainable level of public **DEBT** concealed by misleading statistics. And in Portugal, delays in announcing measures to tackle the budget deficit led to a loss of confidence among some investors and a sharp rise in the cost of financing the national **DEBT**.”

Let’s spell it out for Mervyn King: **“It’s the DEBT, stupid.”**

The debt bubble is getting bigger and bigger and it WILL explode, just like previous debt bubbles. The mistake, which is made over and over again, is to confuse sustainable economic activity, driven by savings, investment, innovation, high employment, etc, with unsustainable economic activity, driven by cheap credit, extreme levels of debt and deficit spending.

Things aren’t always what they seem!

Notre Dame in Paris is obviously one of the finest examples of a Gothic cathedral. But if you’ve read Fulcanelli’s famous book, “Le Mystere des Cathedrales” (The Mystery of the Cathedrals), which rocked the esoteric world of Paris when it was published in 1926, you begin to understand how the builders of Notre Dame (and the other Gothic cathedrals) incorporated clues to a completely different and (still) secret branch of spirituality - which was heretical to the all-powerful Catholic church (I am Catholic by the way) - in the architecture and symbolism. They are books in stone. The last chapter in Fulcanelli’s masterpiece, which was not included in the book’s first edition, is a little “thought-provoking” too (!).



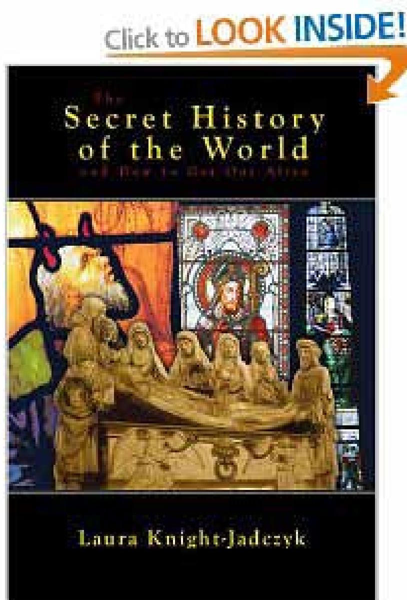
Indeed, you can't make it much more obvious that put an image of alchemy (below left) right next to Notre Dame's front door!

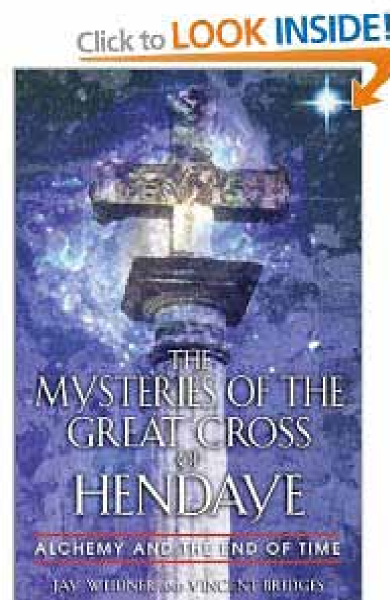
"In the place of honour, facing the parvis, alchemy is represented by a woman, with her head touching the clouds. Seated on a throne, she holds in her hand the sceptre, the sign of royal power, while her right hand supports two books, one closed (esotericism), the other open (exotericism). Supported between her knees and leaning against her chest, is the ladder with nine rungs - scala philosophorum..."

Or a particular sculpture high up on one of the facades (below right).

"a large and striking stone relief of an old man. That is he - the alchemist of Notre Dame"

Trying to decipher Fulcanelli's masterpiece is not easy, but there are authors who have made some progress in this difficult task.





Source: Amazon

Talking of doors, I'd bought the FT (a rare event – must have been synchronicity) on 30 September last year and nearly dropped my morning cup of tea reading it. On page 4 was a picture of the front doors of the Bank of England in amongst a story about the gilts market and the UK economy. On each door is a caduceus (a wand or staff entwined by two serpents surmounted by wings):

The caduceus, which was the staff carried by Hermes, is open to many interpretations, one of which is described by Rosemary Ellen Guiley:

"The association of the caduceus with gold and the powers of transmutation made it a symbol of the philosopher's stone in alchemy. In alchemy the entwined serpents take on the additional symbolism of masculine and feminine forces, which must be in balance for transmutation to occur."

Wikipedia outlines another one:

"the caduceus is also recognised as a symbol of commerce and negotiation, two realms in which balanced exchange and reciprocity are recognized as ideals."

Arguably relevant to today's financial markets, it adds:

"The caduceus is also used as a symbol representing printing"

Hermes was the messenger of the gods, but he was also, according to Wikipedia, patron of the "cunning of thieves".

Two weeks ago, before I met a former Redburn Partners colleague for lunch, I took a quick detour via the Bank of England to look at these doors. Unfortunately, the doors opened inwards and there was a security guard standing outside on the pavement.

"Can I look at your door please?"

"No"

"I don't want to go in, I want to look at your door?"

"No. You can go to the museum, it's round there."

"I don't want to go to the museum, I just want to look at your door."

I didn't mention the Bank of England's crimes against humanity in the gold market (!) and even proffered my brief case towards the security guard, so she could have checked whether I was a suicide bomber. I was wearing a smart black jacket, dark trousers and polished black shoes, although my shirt had several buttons undone revealing the "CBGB's" T-shirt, which might have been the problem. Anyway, a compromise was reached where I kept back and gazed at each of the doors briefly from a distance of several feet. We both agreed that they were very impressive and probably weighed several tonnes.

There is an air pocket the size of the universe underneath this (alleged) recovery. Besides debt, the other "growth killer" is inflation. Inflation with high unemployment and slowly adjusting wages will increasingly damage the illusion. Growth killers squared!

There will be an event (there always is) which will lead to a sudden loss of confidence. Will it be a sovereign, a US state, a bank, QE3 or QE5, the oil price, Chinese fixed investment, a false flag event (a convenient distraction/excuse) or a revolution? In December 2009, before Greece and Ireland nearly went nuclear, I wrote a TRR titled "Waiting for the Creditanstalt moment", harking back to the collapse in the Austrian bank in 1931 which set of the second phase of the Great Depression. Beginning in Austria, fleeing capital brought

down the European and British banking systems and sovereign default across the whole region. It then spread to the US, where the banking system collapsed during 1931-33 and ultimately led to the devaluation of the US dollar, even though the US was the world's largest creditor nation of the time.

When a similar thing happens in today's over-liquefied world, the sudden tsunami of capital flows will take people's breath away. Shock and awe!

"When you hear the air attack warning, you and your family must take cover at once"

"Do not stay out of doors. If you are caught in the open, lie down"

"If any member of your family should die whilst in the shelter, put them outside, but remember to tag them first for identification purposes."

For younger readers, FGTH were really big for a couple of years in the 1980s! In monetary terms, when "two tribes" go to war, hard money always wins (!). In the various extended mixes (with names like "Annihilation" – with the quotes above – and "Carnage"), FGTH sampled Patrick Allen's voice from the British government's instructional film, "Protect and Survive", about what do in the event of a nuclear attack.

"Mine is the last voice you will ever hear, don't be alarmed"

Ironically, the problem in today's financial markets is that there is not enough alarm. There are one or two (!) signs that all is not well and you can reel off a few of them in a nanosecond:

- Western governments are insolvent along with that of Japan;
- Martin Armstrong: "A friend of mine on Capitol Hill, among others there, tells me there is no solution (to the deficit) whatsoever until there is a MAJOR crisis";
- China is selling US Treasuries;
- The Wikileaks revelation that Saudi Arabian oil reserves might be over-estimated by more than 30%;
- Food stocks are at historic lows and the climate is going increasingly "whacky";
- The Fed needs a house price recovery to save the banks and broaden the wealth effect to those who don't have large stock portfolios. The problem is that real estate is a leveraged asset and leveraged assets aren't going to be stellar performers in a debt crisis - especially when so many (in the US anyway) are under water on their mortgages and there is a large overhang of inventory;
- Inflation is a regressive tax, hitting people on lower incomes far harder than the rich - and the world is largely populated with the former;
- There are riots across the Middle East and North Africa and even some signs of unrest in China.

There is huge economic and social change in progress, but it makes the FAICS (fast asleep intelligent citizens) too uncomfortable to consider it. The mainstream financial media doesn't help (with kudos to Dire Straits):

"Now look at them yo-yo's, that the way you do it,

*You talk the b*llocks on CNBC.*

That ain't working, that's the way you do it"

There are few exceptions appearing on that network - Maurice Pommery (Strategic Alpha), Ben Davies (Hinde Capital), Marc Faber (GB&D), Jim Rogers (bow ties) and Jim Rickards (Omnis) are the only ones I can think of. The majority of those who I like to read, or listen to, are NEVER invited on. Why doesn't CNBC interview James Dines, Gerald Celente, representatives of GATA (Gold Anti-Trust Action Committee), Ted Butler, Tyler Durden (Zero Hedge), Jim Willie, Rob Kirby, Jim Sinclair, John Williams, Chris Martenson, Jim Puplava, Ronni Stoeferle, Dylan Grice, Mike Krieger or Rich Guthrie? Why doesn't Maria Bartiromo stop

interviewing politicians and central bankers - pathological purveyors of untruths at the best of times - and interview Martin Armstrong? Fort Dix is a heck of a lot closer than Davos after all.

Ed Lazear made what was (at least) his third appearance on CNBC for 2010 on 30 December. Ed Lazear was chief economic advisor to George W. Bush from 2006-09, i.e. in the final "super-incubation" period of insanity before the current crisis exploded in 2008. The biggest event of his career, advising (allegedly) the most powerful man in the world on economic policy and he missed it completely. Incredibly, it doesn't stop him showing his face on global TV. Do you know what he's doing these days? He's teaching economics to students at Stanford University. According to its website, Stanford is "recognized as one of the world's leading research and teaching institutions". It's not hard to see why the same mistakes are made over and over again and why markets and economies behave in cyclical fashion.

Author: I started work the month before the stock market crash in 1987. I've worked mainly as an analyst covering the Metals & Mining, Oil & Gas and Chemicals industries for a number of brokers and banks including S.G. Warburg (now UBS), Credit Lyonnais, JP Morgan Chase, Schroders (became Citibank) and, latterly, at the soon to be mighty Redburn Partners.

Charts: Thanks to barchart.com, LME, timingcharts.com, kitco.com, kitcometals.com.

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