

# WHY OWN PHYSICAL GOLD & SILVER

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I have spoken to many ordinary people about investing in gold and I have noticed how people's eyes glaze over and they clearly have difficulty understanding why gold is the investment opportunity of a life time. For those who understand the market well, and live it and breathe it as I do, we make the mistake of blaming the listener as being "clueless", "brain-dead", "stupid" and a long list of other insults.

If the message of what an extraordinary investment opportunity gold represents is not understood by the listener then it is the fault of the messenger. There is no other excuse! If the listener understands the message but refuses to accept it or understands it, accepts it, but doesn't take action then perhaps some of those epithets are justifiable!

I speak to many precious metals investors who complain that they have tried constantly to persuade friends and family members to invest in gold but to no avail...if we can not convince those who know us well what chance do we have with total strangers?!

When you tell the average person that gold is "real money" he looks at you with a quizzical grin, wondering how he can swipe a gold eagle through the card reader at his local Safeway supermarket. And when you talk to him about avoiding "counter-party risk" he thinks you are talking about protected sex and can't think what this has to do with gold! When you get deep into how the gold market is rigged with derivatives and Central Bank gold leasing he is starting to wonder which maximum-security facility you escaped from and is looking for a break in the conversation to go get another hot-dog from the BBQ!.

I am going to attempt to explain gold (and also silver) in very simple terms of one syllable that most people will be able to understand. So hold off on going to get that Hot Dog from the BBQ and listen up:-

We can class what people buy into two main categories

- 1) Consumables
- 2) Collectables

Consumables are, as the name implies, all the things we need in life and that we consume. This includes things like milk, bread, butter, gasoline, electricity, water etc. It also includes, under my definition, things like TV's, computers, furniture, appliances, cell phones etc. These are not normally thought of as consumable

but they essentially are because they are used for a certain amount of time (might be many years) and eventually they are discarded as junk.

If we do not earn much money all our wages go on “consumables”. If we earn in excess of our basic living needs we have the capability of buying “collectables”. The most obvious “collectable” to accumulate if we have excess earnings over basic needs is “cash”. But there are many “collectables” we can acquire such as fine art, rare cars, vintage postage stamps, first edition books, fine wines, diamonds, real estate, shares, bonds, silver, gold etc.

### How is the cost of a “consumable” determined?

In simplistic terms it is the cost of manufacture plus the profit the market will “allow” the manufacturer to make.

### How is the cost of a “collectable” determined?

In simplistic terms it is the cost of production plus a scarcity premium. The concepts are shown graphically in figure 1.

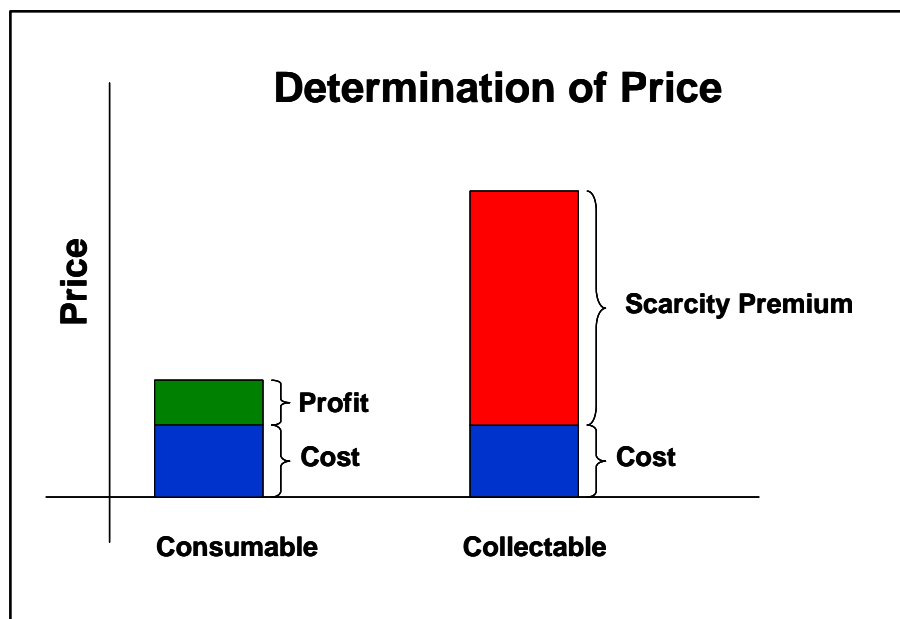


Figure 1: Determination of Price

For a consumable there can be no long term “scarcity premium” because the market would not tolerate it. If consumers went to buy their bread and found the bakeries were sold out and the bakers offered to bake some more bread for 100% markup on the usual price there would be riots in the streets! There can be short term scarcity premiums if there are disruptions to supply such as strikes or natural disasters etc. Because there are nearly always a large number of suppliers to supply consumable items, and the goal of all suppliers is to fully

satisfy all demand, the profit is squeezed by abundant supply and competition to somewhere between 1-10%.

Collectables are items that people like to “hoard” or “collect”. Typically because many people like to collect them the demand is higher than supply so the price includes a large “scarcity premium” over and above the cost of manufacture of the item. The scarcity means that, under normal circumstances, it is not possible to oversupply the market and furthermore suppliers have no motivation to satisfy all demand. Rolls Royce has no ambition to have everyone in the world driving a Rolls Royce. The low supply and high demand maintains high scarcity premiums. A Rolls Royce might sell for \$600,000 even though it only cost \$200,000 to make it. That means there is a \$400,000 scarcity premium that buyers are willing to pay to get such a limited edition car and perhaps wait 3 years to get one. This would not be tolerated if the car was a “consumable” everyday car. No one would wait 3 years for a Honda Accord nor pay 200% scarcity premium for it!

Taking another example, a Picasso painting may have cost Picasso \$100 to produce but it may now sell for \$50 million because so many art lovers appreciate Picasso’s work and as the artist is dead the supply is limited to what he produced in his life.

It is interesting to note that consumables can become collectables. For example the Model “T” was Henry Ford’s first mass-produced car that sold for less than \$1000. It is no longer manufactured and most have long ago been scrapped. A model “T” Ford would now sell for hundreds of thousands of dollars!

Occasionally collectables can become consumables. In the 1800’s Aluminum was a precious metal, more expensive than silver and selling for several dollars per ounce. There was no commercial process at the time that could mass produce it. It was highly sought after as a collectable. There was a large scarcity premium in the price. When an industrial process was invented that made it available in millions of tons per year it became a consumable selling for a few cents per ounce, which was barely above the cost of production.

Stocks are collectables. The cost element in figure 1 can be equated to the true value of the company stock (based on assets, liabilities and profit generation potential etc) while the scarcity premium will rise and fall depending on how much investors want the stock. When a mania develops, as in the dot.com era, so many people chase so few available stocks that the scarcity premium can go to ridiculous levels. If the company truly has great fundamentals then the price can be maintained because the value of the company increases as the scarcity premium decreases thereby maintaining the price. If the company has no fundamentals, then when investors start to run for the exits the flood of available stock makes the scarcity premium go to zero or even negative...in other words stocks can sell at a discount to their true value because there is a huge surplus of supply over demand.

### **What makes things collectables?**

This is pure democracy at work. The people decide. There is no point in wasting energy wondering why people like to collect postage stamps or fine wines or Elvis Presley recordings. If they like them and want them that is all that matters.

### **But not all collectables are created equal.**

Most collectables are man made such as postage stamps, first edition books, fine wines, fine art, fine jewelry, muscle cars, vintage cars, custom houses etc. Most of these collectables need an “expert” to assess the authenticity, quality and value. A few “collectables” are made by nature such as precious metals, diamonds, rubies, pearls, gemstones etc. Precious metals are unique in that they do not need an expert to assess them. One ounce of gold is one ounce of gold. On the other hand the quality of one carat diamonds vary enormously and may even be zirconium fakes.

Many collectables are not appreciated by a wide community of buyers. Many people would not appreciate the value of a bottle of Chateau Latour or a Ming Vase if they found one in their basement. Some people might even refuse to buy a rare painting by a lesser known artist if you were offering it for \$50 while almost everyone on the planet would accept to buy 1 oz of gold for \$50.

### **Gold stands out as a very special collectable.**

In 6000 years of recorded human history gold has been desirable as a “collectable” and it still is today. This is truly amazing. There were no postage stamps, muscle cars, first edition books, fine wines, fine arts 6000 years ago. But there was gold. And 6000 years later man still lusts after this “collectable”. It is the most durable collectable ever. It is the collectable of all collectables because it has universal appeal to almost everyone on the planet and has been for all of history. It doesn’t need an expert to assess it. It is so dense at 19.3 times the density of water, and it is so malleable that even an amateur can recognize its distinctive feel in the hand. It is extremely difficult to make convincing imitations...lead is only half the density and is the wrong color.

Gold is very scarce. There are only 140,000 tons above ground which is all the gold ever mined. It is not consumed so all the gold ever mined is still in existence somewhere. That is equal to  $\frac{3}{4}$  ounce per person on earth, or as is popular these days, just enough to fill two Olympic size swimming pools.

So gold is the most desirable collectable on earth and it is very scarce. You would then expect it to be selling at a price equal to its cost of manufacture plus a large scarcity premium. Surprisingly gold has been selling at or below its cost of production for almost 15 years! How do we know this? We know because the major mining companies of the world hardly make any profit. This means they sell gold for the cost of production. This means gold is being priced as if it were a

loaf of bread! It is as if you told Da Vinci "I will give you \$900 for your labor and materials if you could please paint the Mona Lisa for me"! Who would refuse such a deal (other than Da Vinci!)? So why would anyone refuse to buy gold?

**How could the scarcity premium in gold have been annihilated such that it sells for cost?**

The demand for gold is approximately 4000 tonnes per year. However, the supply from mines and recycling is only 2500 tonnes. What's more because gold has been selling for approximately the cost of production, mine supply is declining at 10% or so per year. With such a large gap between supply and demand the scarcity premium should be very high instead of being zero. The only logical conclusion is that there is no scarcity. How is this possible? Western Central banks have been surreptitiously supplying their gold hoards to the market, without reporting it, to fill the gap between supply and demand. They have also encouraged the supply of paper substitutes for gold (such as Exchange Traded Funds, pool accounts, futures contracts etc) that many people have been prepared to accept as proof they own gold without actually verifying themselves. This has suppressed the price of gold with the result of boosting the apparent value of the dollar and keeping interest rates low which has allowed the US to live beyond its means for 15 years, importing far more than it exports. This has distorted almost every market in the world and this is now starting to come unraveled with disastrous consequences.

The fraudulent interference in the markets has a certain shelf-life just like the Madoff Ponzi scheme. The Western central banks have just about exhausted the stock of gold they are prepared to part with. The general public is increasing dramatically its demand for physical gold because of the financial turmoil as can be witnessed by the mints around the world now rationing gold and many retail outlets being sold out. Many people are now so scared of the risks in the financial world that they are less and less accepting paper substitutes for gold and they are demanding the real thing. All this is creating massive demand for gold at a time when Western Central Banks have depleted reserves and the mines are experiencing rapidly declining output. The World Gold Council reports that investment gold demand rose 64% in 2008. What do you think is going to happen to the scarcity premium? Yes! It will sky rocket. No collectable sells below its cost of production for extended periods so the downside is almost non-existent yet the upside is huge.

There is another competing collectable...the US dollar. The US dollar has a very low cost of production. It is a fraction of a penny per thousand dollars. It has a large scarcity premium because the US Dollar has enjoyed the privilege of being the reserve currency of the world and so there has been high demand for its use in international trade during the economic expansion of the last 15 years. Furthermore, the Federal Reserve has manipulated the dollar's apparent scarcity with respect to gold by over-supplying the gold market with Central bank gold. Just recently the gloves came off. The financial crisis is so dire that the Federal

Reserve announced on March 18 that they will implement “quantitative easing”. This is a euphemism for printing money. The FED has in the last year committed almost 10 T\$ of extra money supply into a system that had 15T\$. The availability of dollars is accelerating at a frighteningly exponential rate just at a time when world economic activity is slowing and the role of the dollar as the reserve currency is being called into question. Clearly we are entering a new era where the dollar supply will be much larger than demand. With trillions of new dollars being created and demand diminishing, the dollar will be anything but scarce! It doesn't take a rocket scientist to work out that the US dollar is going to transform from a collectable to a consumable. It will lose its ENTIRE scarcity premium and its buying power will be related to its cost of production i.e. a fraction of a penny per thousand dollars.

Figure 2 shows what happens when a currency loses its entire scarcity premium. It becomes a consumable and in this photograph from the famous Weimar Republic hyperinflation of 1923 bank notes are being burned as a cheaper alternative to firewood! The paper had a higher calorific value as a fuel than it had purchasing power as a currency!



**Figure 2: Burning banknotes instead of firewood**

The old expression “cash is King” is only applicable under a gold standard. Bank notes under a gold standard don’t have any value per se, they are proof of ownership of gold, but they can be used as currency as they will be accepted by other people as payment. The dollars can be exchanged at the bank at any time for gold. So “cash” is King only when the banknotes represent a holding of gold. If you own a house the “title deed” document doesn’t have any value per se, it only proves you own the house which is the asset of value. The fiat currency system we have had since 1971, when the last link to gold convertibility of dollars was severed, is like using Property Title Deeds as money but where the corresponding houses to these titles have not yet been built! Eventually the market will value the Title Deeds at their cost of production, close to zero, not at the value of a house. It will be no different for the dollar.

As the scarcity premium of dollars start to sink, along with the closely related financial instruments, US Treasury Notes, people will want to exchange these “collectables” before they reach the buying power of a “consumable”. The most likely collectable they will turn to is the collectable of all collectables, gold, and its closely related cousin, silver.

**The scarcity value of gold will soar as supply fails to meet demand.**

Because gold is a collectable that is desirable by almost everyone on the planet it is what can be described as “real money”. You would find it difficult to pay for things you want to buy with postage stamps or fine wine but gold is so desirable that people will accept gold as payment instead of currency. Eventually as the scarcity premium of the currency gets destroyed they will only accept gold or preferentially accept it, despite how difficult that is to believe right now!

**Finally let’s look at silver.**

Silver used to be a pure collectable just as gold is. However, in the last 50 years many industrial processes have been developed that need silver. Just like Aluminum, silver passed from being a collectable to being a consumable. Well not quite. No one collects Aluminum as a precious metal anymore while 10% of demand for silver is for investment. The problem has been the 90% that has been demanded as a consumable. This brought the price of silver down to the cost of production plus a small or zero profit. The entire scarcity premium disappeared. As we discussed earlier the goal of suppliers of consumables is to ensure there is no shortage. However, there is a dirty little secret. Silver is scarce and getting scarcer! The demand for silver has exceeded mine supply by almost 250 million ozs per year for many years such that an above ground global stock pile has been reduced from 10 billion ozs in the 1940’s to less than 1 billion ozs today. Of the 1 billion oz only 300-400 million ozs are “available” for sale. This means that there is only about one more year left where the gap between demand and supply can be met with above ground stocks. Mine supply is declining especially as 60% of silver comes as a base metal mining by-product

and base metal mining has contracted with the economic contraction. The bottom line is that silver is close to transforming from a consumable to becoming once more a collectable with a very high scarcity premium within the next 12 months or so. This is comparable to what has happened to the Model "T" "Fords! Considering there is no substitute for silver in its industrial applications the scarcity premiums could go to unimaginable levels and not only be sustainable but go higher! Of course silver will still be used in industry but the industrial users will have to get accustomed to the price of their essential metal being governed by the scarcity premium. They will have to treat it as a collectable and recycle almost 100% of the silver they use instead of it being lost in landfills around the world and thereby being "consumed". 100% recycling will become economical because of the huge scarcity premium silver will command.

Gold and silver are highly prized collectables that are selling like ordinary consumables at just above their cost of production. Through market manipulation and interference their scarcity premiums have been annihilated through surreptitious supply that can not be maintained. Just like consumables their prices can not go meaningfully lower because no one produces real things at below cost for long. There is a near certainty that they will regain their collectable status soon and acquire massive scarcity premiums in line with their true supply and demand fundamentals as demand increases and central banks stop selling gold, and even start buying it instead.

Meanwhile, the US dollar will lose its "collectable" status and lose its vast and undeserved "scarcity premium" to eventually have a buying power equal to its cost of production. Does it take a rocket scientist to work out that the best trade of a life time is to exchange US dollars or other fiat currencies for gold and silver NOW? You will divest of something that will rapidly lose its scarcity premium and buy something that will rapidly gain a huge scarcity premium.

Some investors may be concerned that perhaps they have missed the bull market in precious metals because gold has risen from \$255/oz to \$1000/oz while silver has risen from \$4/oz to a high of 21/oz. This rise in the metals only reflects the increased costs of extraction. There is no scarcity premium included. No bull market will ever finish before very large scarcity premiums have developed. Investors have missed almost nothing. The major gains are still ahead.

Is that too difficult to understand?

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