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LONGWAVE group

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

WINTER WARNING

ALL THAT GLITTERS IS GOLD

Over the millennia, dating back to the time of ancient Egypt in 3150 B.C., gold has always been highly prized by mankind. Indeed, whether used for ornamentation, or as a medium of exchange, gold has a long history as a store of value.

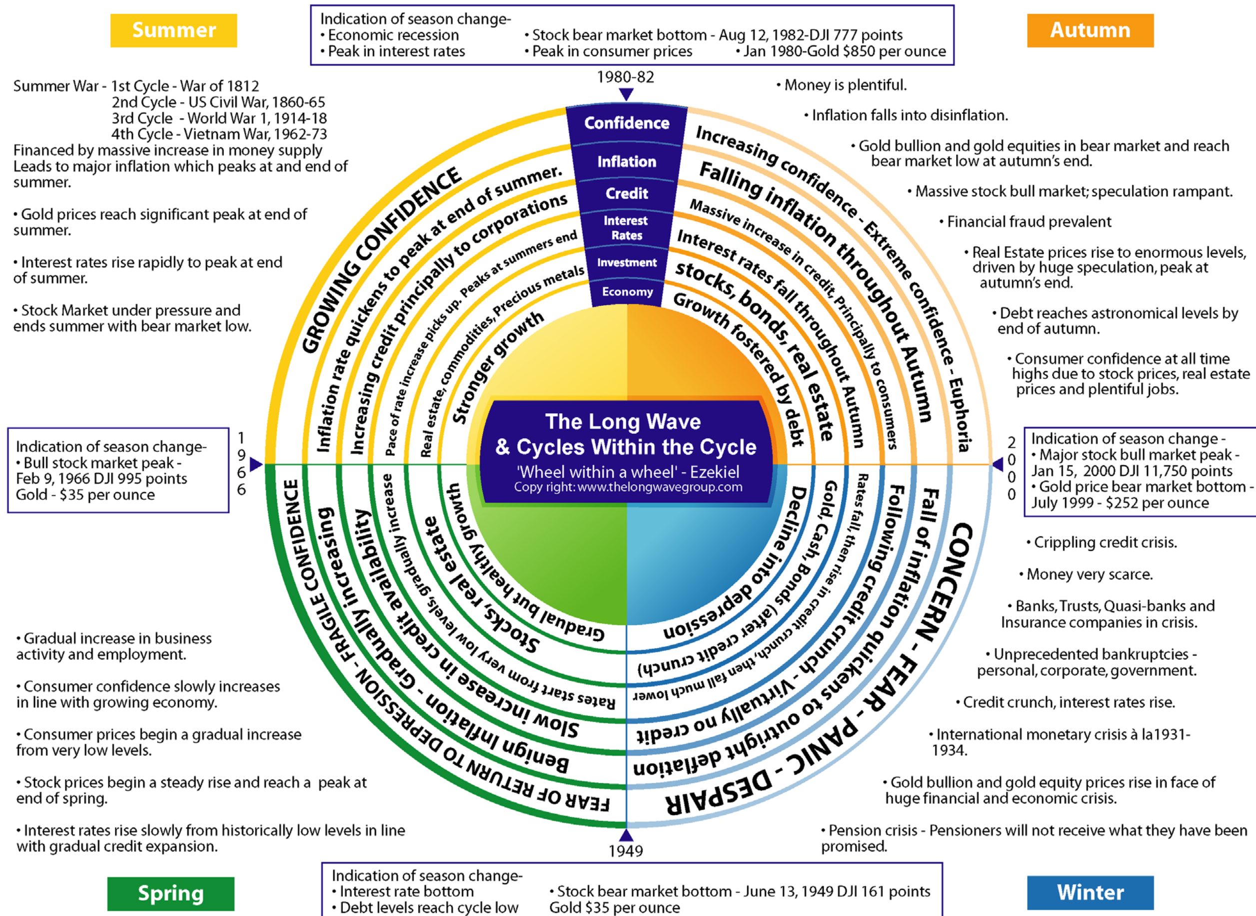
Gold has withstood the test of time in terms of its density, malleability and lustre. The price of gold was first standardized in 1717 by Sir Isaac Newton, then Britain's Warden of the Royal Mint. In coinage and as backing for paper (fiat) money, gold's value has fluctuated with world crises and market forces. When no longer pegged at $35 (U.S.) per ounce after 1971, gold became a freely traded commodity. Gold is money! Gold represents wealth and for many reasons, this has never been truer than at the present time. Gold is currently trading at a price of $1,065 (U.S.) per ounce and LongWave Analytics is forecasting that gold bullion will climb to the $4,000 (U.S.) level per ounce and beyond over the next few years.

The entire world is now in an economic depression which always occurs at this point in the Longwave Cycle. The cycle is approximately 60 to 70 years - essentially a 'lifetime'. Thus, each point in the cycle is a new experience, something we have never lived before during our adulthood.

An understanding of the Longwave Cycle, however, enables us to identify where we are in the cycle. More importantly, this understanding allows us to recognize each season in the cycle and, critically, it allows us to determine the move from one season to the next. That determination enables us to make correct investment decisions. There are good and bad investment mediums appropriate to each of the seasons. Typically, investments that perform well in one season do poorly in the following season.

In the Longwave cycle there is always a deflationary depression and this occurs in the winter of the cycle. The onset of winter is signaled by the peak in stock prices which ends the biggest stock bull market of the cycle. During the Longwave winter, debt is purged, which causes huge stress and significant bankruptcies to creditors and debtors alike. In order to protect ourselves from the financial and economic onslaught that ensues, we buy precious metals, particularly gold and the gold equities of producers and explorers.

Gold is the only financial asset that is not someone else's liability, and all paper money is simply debt. When the economic and financial systems are collapsing, people turn to gold because it's the only financial asset that they can trust. They lose all trust in paper currencies; that is, fiat money and all assets valued in paper money (stocks, bonds and real estate) except precious metals companies, since the underlying assets of these companies are the metals themselves. Most people only equate a rising gold price to a rise in inflation, but the price of gold also appreciates during a deflationary depression because investors turn to gold as the ultimate money. People did that during the Great Depression of the 1930s and they are doing it now. However, the real panic buying of gold lies ahead, since the banking system faces renewed pressures as the debt bubble, particularly in America, continues to grow. In point of fact, during a deflationary depression, gold is the most liquid asset.



In addition to investors losing their faith in fiat currencies, there are other reasons why gold will perform well over the next several years and why investment risk in gold will be minimal during this time. So much of the world's gold supply has been mined within the last 50 years that the globe's richest deposits are fast being depleted in South Africa, Australia and the United States; new discoveries are becoming rare. The world's largest mining companies are now aggressively pursuing gold on a global basis. Giant Newmont Mining now operates open pit gold mines on five continents - from the rainforests of eastern Indonesia to the mountain ranges of Peru and to the lowlands of Ghana. The challenge for large producing gold companies like Newmont is the replacement of their annual gold production. Newmont produces approximately 7 million ounces per annum. To replace these ounces, it must effectively discover approximately 8 million ounces every year since production is never 100% of the gold mined. This is an impossible task. There have been very few discoveries of this size over the past several years. Furthermore, the timeline from discovery to production is approximately 10 years. This means that large gold producing companies ought to have a significant discovery in the pipeline every year. (We do like Agnico Eagle's growth profile.)

In August 2009, a majority of European central banks entered into a new agreement to lower the ceiling on annual sales of gold bullion, from the current limit of 500 tonnes to 400 tonnes, over the next five years, beginning October 1st. Meanwhile the Swiss central bank announced that it has no plans to sell gold bullion in the foreseeable future. In addition, last month the Executive Board of the International Monetary Fund approved gold sales in a size strictly limited to 403.3 metric tons at a time, representing 1/8 of the Fund's total holdings. Managing Director Dominique Strauss-Kahn states that "these sales will be conducted in a responsible and transparent manner that avoids disruption of the gold market." These announced IMF sales have always been introduced as a means to hold down the price of

gold. This charade has been ongoing since 1978 and has only temporarily capped the ongoing upward move in the gold price. Anyway, one must suspect that the IMF may not have the gold it purports to hold.

In recent days, we have witnessed the price of gold futures appreciate to the record high price of $1,065 (U.S.) per ounce. The primary engine of this current price surge is the steady, inexorable decline in the U.S. dollar. As stated in our Winter Warning of September 28th. – The American Greenback Will Be Cast into the Hazard, since March of this year the U.S. Dollar Index Future – Spot Price, which Intercontinental Exchange Inc. uses to track the American currency against the yen, euro, Swiss franc, British pound, Swedish kroner and Canadian dollar, has steadily fallen by nearly 15% to the 76 level. Investors are finally beginning to understand that the U.S. dollar is not the safe haven they perceived it was even a few years ago and concurrently, neither are U.S. Treasury notes and bonds. Given the American national debt and deficit problems, from both a fundamental and technical perspective, the U.S. greenback still has the potential for considerable downside. Ergo and by axiom, gold bullion has significant upside potential to $1,500 (U.S.) per ounce over the short to mid-term time horizon of 1 – 2 years and $4,000 (U.S.) per ounce over the longer term.

While the dollar continues to decline against all other major currencies, we must remind ourselves that these currencies, like the dollar, are fiat too; in most cases better managed than the dollar, but paper none the less. As such, they are not viable monetary alternatives to the dollar. Paper money is in an unparalleled crisis. Never in history has the entire world been subjected to fiat money. The experience of all fiat currencies is their ultimate demise.

Given gold's recent activity, predictably, other analysts and strategists in the investment community have bounded into the fray. "Gold demand is coming almost exclusively from the investment side" commented Eugen Weinberg, an analyst at Commerzbank. "Gold reaching an all-time high is attracting new investment. This momentum can take us to even $1,100 (U.S.) an ounce. As long as we don't see a sustainable rally in the U.S. dollar, I don't think gold's rise will stop." Nicholas Brooks, head of research and investment strategy at ETF Securities (Exchange Traded Funds), states "The surge in demand for gold does not appear to be short term in nature, since we have been seeing very rapid growth of investor holdings of gold through our ETCs (Exchange Traded Commodities) for over a year now."

Put Not Your Cart Before The Horse

During this recent surge in gold activity, there appear to be many investors getting aboard because they fear a return of the demon inflation. They perceive that many economies are on the road to recovery from the recent economic downturn and credit crunch, thus they are looking for an insurance policy as a hedge against an inflationary outbreak. As previously mentioned, gold can also appreciate in value within a deflationary economic environment. While inflation may rear its ugly head at some juncture well down the road, it is a deflationary outlook that Long Wave Analytics is embracing as the most realistic probability to unfold over the near to mid-term time horizon. Witness the Japanese deflationary experience which is still unfolding.

Understanding inflation and deflation is critical to making the right investment decisions. Strictly speaking, inflation is simply an increase in the supply of money and deflation is a decrease in the money supply. Most financial advisors are now calling for inflation to resume and even hyper-inflation to run rampant in the United States, because of the Federal Reserve's current effort to circumvent deflation by excessive money printing. We are of the opposite, and certainly the minority, view. We believe that central banks will be unable to forestall deflation and that when it arrives, it will be unprecedented in magnitude. This conclusion is based upon three factors:

- Once the debt bubble is unwound, it is deflationary in nature because it is painful and results in bankruptcies on both side of the ledger. Actually, it takes money out of the system and during our Kondratieff winter, trillions of dollars of debt will be expunged. Total debt in the United States is now approximately $58 trillion. If we exclude government debt, which is approximately $15 trillion, this leaves $43 trillion of consumer, corporate and financial debt underpinning the U.S. economy. How much of that is destroyed is anyone's guess, but it is likely to total at least $22 trillion. This money is effectively destroyed.

- Under these circumstances, banks won't lend money. Those banks that survive bankruptcies, and most won't, will conserve it. Consumers and corporations won't be able to borrow money, even if they so desire.
- The velocity of money will essentially come to a standstill, since there will be none to spend. Money will be hoarded, either under the mattress, or in banks that consumers believe will survive the debt deflationary onslaught. During inflation, as in the 1970s, the velocity of money increases as people spend today, rather than pay higher prices tomorrow. In deflation, as in the 1930s, those few people with money curtail their spending in the knowledge that prices will be lower tomorrow, next month and next year. As the early 19th Century saying goes 'money like manure, does no good till it is spread'.

Between October 1929 and April 1933, despite the desperate efforts of the Federal Reserve to reflate the economy, money supply contracted by 28%. The argument today - supported by Ben Bernanke, the current Federal Reserve chairman - is that the Fed didn't do enough at that time. Speaking at a 90th birthday dinner for Milton Friedman (another proponent of the 'do nothing Fed' during the Great Depression,) Mr. Bernanke stated, "I'd like to say to Milton and Anna (Anna Schwartz, who co-authored with Milton Friedman, A Monetary History of the United States), regarding the Great Depression, you're right. We did it. We're very sorry, but thanks to you, we won't do it again." This interpretation is at best false and at worst dishonest. All strenuous efforts by the Federal Reserve to overcome deflation failed because the amount of money coming out of the economy, through bankruptcy and bank failure, overwhelmed the Federal Reserve's attempts to reflate.

In his book, America's Great Depression, Murray Rothbard uncovered the erroneous reasoning of those who subscribed to the Fed's inactivity at the time. "If the Federal Reserve had an inflationist attitude during the boom, it was just as ready to try and cure the depression by inflating further. It stepped in immediately, to expand credit and bolster shaky financial positions. In an act unprecedented in its history, the Federal Reserve moved in during the week of the crash (the final week of October, 1929) and in that brief period added almost $300 million (U.S.) to the reserves of the nation's banks. During that week, the Federal Reserve doubled its holdings of government securities, adding over $150 million (U.S.) to reserves and it discounted about $200 million (U.S.) more for member banks … As a result, the weekly reporting member banks expanded their deposits during the fateful last week of October by $1.8 billion (U.S.), a monetary expansion of nearly 10% in one week …" pp.191.

We are gold bulls and deflationist but most gold bulls are inflationist. How do we explain this dichotomy? During inflation, the price of gold rises along with all other 'things', such as out-of-print comic books, art, antiques, etc. Why? Because as we have just explained, during inflation the price of everything rises and people buy today because prices are cheaper than they will be tomorrow. In these times, gold is viewed primarily as a commodity, although it does still perform a minor monetary role versus the dollar, which is being debased through monetary inflation. In the inflationary summer there is absolutely no threat to the banking system because debt is not that high and there is no threat to the economy because money is plentiful and easy to access. So, when the threat of inflation passes, as in 1980, the prices of gold, commodities, comic books and antiques fall.

However, deflation is another kettle of fish, since it comes about through the destruction of the financial system and the economy, because of the bursting of the debt bubble. When that occurs as in 1873, 1929, and now, there is fear and panic. In all panics, there exists an instinctive will in all of us to survive and succour loved ones. We instinctively turn to the people and things we trust. When it comes to money, people always go to gold. It was thus during John Law's Mississippi scheme in 1720, when following the crash, the run to gold by French investors was enormous; so much so that the government tried to outlaw the ownership of gold on pain of death. Eventually, the French government's rule on paper money was quashed in favour of gold. Similarly, during the French Revolution, when the revolutionary government introduced the paper Assignat, French farmers refused payment in paper money for their produce. Like always, the paper money system collapsed and gold replaced it.

The same is true of the American Confederate dollar. The over zealous printing of paper money always leads to monetary inflation, which is then followed by monetary deflation and a demand for gold as real money. This was true of the early 1930s when the great credit expansion of the 1920s collapsed, bringing down the entire U.S. banking system with it. As American banks failed, the race to own gold

grew exponentially. The trust in paper money, which was responsible for financing the proliferation of debt in the 1920s, was shattered. As the U.S. economy and stock market collapsed, the flight from paper to gold gathered momentum. Indeed, by the time that President Hoover was about to leave office, his Treasury Secretary told him that the U.S. was running out of gold to support the dollar. One of the first things that his successor, President Roosevelt did upon arriving at the White house in March, 1933, was to denounce the gold hoarders and confiscate their gold, in order to replenish the U.S. Treasury.

This only fuelled the alternative method to own gold, which was via the ownership of gold mining shares. All that was left of money fled to invest in gold equities. Capital flowed to gold producers and exploration companies throughout North America and South Africa. In Canada, the Abitibi greenstone belt, Red Lake, and central British Columbia became the main areas of focus for exploration and many mines in these locales were financed into production. We've come full circle. These same areas are garnering dollars for exploration and many significant discoveries have been made. New discoveries will accelerate, since money flows almost exclusively to gold during these deflationary times. In the United States, gold exploration is centered in Nevada and to a lesser extent in Alaska. Moreover, throughout the U.S., so much money flowed to gold during the 1930s that, according to the U.S. Bureau of Mines, by 1940 there were 9,000 operating gold mines in America.

We are now in the Kondratieff winter deflationary depression and in this time frame, gold will become the money of trust. Fiat or paper money will become totally discredited. We believe Antal Feteke, who recently penned an article entitled "The Supply of Oxen at the IMF," posted at www.lemetropolecafe.com, where he wrote, "Only the gold basis will tell you whether you can reasonably expect physical gold to be available tomorrow and the day after. Or, whether it is more likely that one day soon, we wake up to find that 'gold is no longer for sale at any price.' Gold mines will hang out the notice: 'Holders of dollars need not apply'. This is going to be the exact replica of what happened to holders of assignats, mandates, Reichmarks and more recently, Zimbabwe dollars."

The coming scarcity of physical gold will lead to much higher gold prices, and like the 1930s following President Roosevelt's confiscation of gold, investment in gold companies will become the principal means to obtain an ownership in the physical metal itself.

How the Stock Prices of these Companies Appreciated During the Great Depression

	Homestake Mining	Annual Dividend	Dome Mines	Annual Dividend
Gold Price Fixed at $20.67 (U.S.) per ounce				
Low 1929	$ 65.00	$ 7.00	$ 6.00	$1.00
High 1930	83.00	8.00	10.37	1.00
High 1931	138.00	8.45	13.50	1.00
High 1932	163.00	10.60	12.87	1.30
High 1933	373.00	15.00	39.50	1.80
U.S. President Roosevelt Raises Gold Price to $35.00 (U.S.) per ounce				
High 1934	$ 430.00	$30.00	$46.25	$3.50
High 1935	495.00	56.00	44.87	4.00
High 1936	544.00	36.00	61.25	4.00
High 1937	430.00	18.00	57.25	4.50

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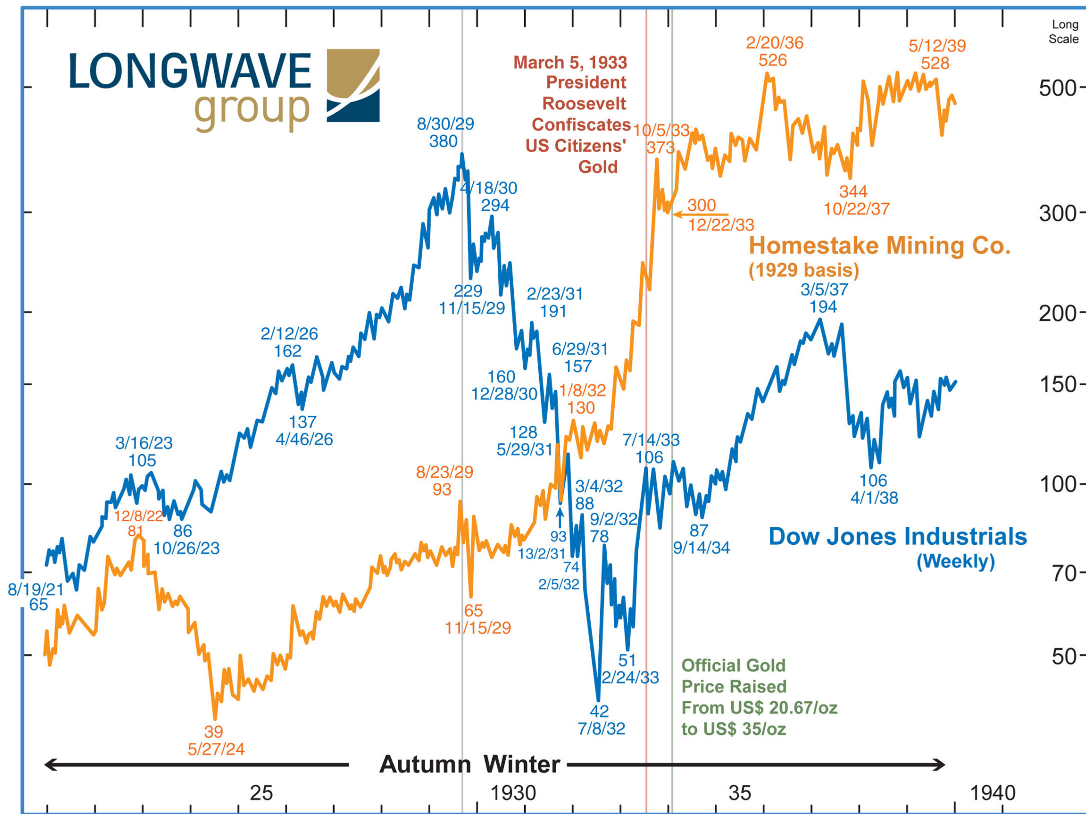
Homestake and the DJIA 1921 through 1940



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The next Winter Warning, "Why DOW 1000 Is Not A Silly Number".

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