Is Now the Right Time for Gold?

by Michael J. Kosares

From time to time I update this essay - the nuts and bolts of which first appeared in my book, "The ABCs of Gold Investing: Protecting Your Wealth Through Private Gold Ownership" almost seven years ago. Some might find it odd that I update the same essay on a regular basis, but the fact of the matter is that the message hasn't changed since the book was written, and the remedy for most investors - gold ownership - still outweighs all other remedies available. Judging also from the number of requests for reprint permission, this short analysis remains a popular educational tool with a great many investment advisors across a spectrum of specialties.

Since the last time *Disturbing Trends* was updated - in September, 2004 - it has become evident that the tendencies summarized did directly affect the U.S. economy (though at the time only a handful realized just how pervasive those conditions would become), and many of the outcomes predicted did actually come to fruition. For one, the government fiscal and trade deficits *did* intensify as predicted until the phrase 'twin deficits' became part of the daily financial vernacular. The decline of the dollar *did* "prove to be the most dangerous and devastating disturbing trend for the average American investor *and* the one most directly linked to a bull market in gold." And the strong dollar policy *did* become "a thing of the past" right down to Alan Greenspan's apparent and very public abandonment of it in his Congressional testimony of February 11, 2004.

In short, these disturbing trends did not go away like many politicians, Wall Street analysts and university economists predicted, but marched relentlessly on. Former Chairman of the Federal Reserve Paul Volcker recently put it this way: "[U]nder the placid surface, there are disturbing trends: huge imbalances, disequilibria, risks -- call them what you will. Altogether the circumstances seem to me as dangerous and intractable as any I can remember, and I can remember quite a lot. What really concerns me is that there seems to be so little willingness or capacity to do much about it." He also remarked that the nation is "skating on thin ice." We invite you to delve into this latest version of *Disturbing Trends: Is Now the Right Time for Gold?* Though the analysis and the uncertainties it underscores should be cause for concern, there is a commonly available remedy - gold ownership - which has a long history of balancing such risks and offering protection against the uncertainties to which they give rise. MK

Disturbing Trends

1970 - Present (4/27/05 or nearest)

Item	1970	Present	Change
Population	205 million	295.97 million	+ 44.3%
Median Income	$9,867.00	$43,300.00	+ 439.0%
Fed Expenditures	$198.6	$2543.5	+ 1,280.7%
Fed Interest Paid (annual)	$16.2	$180.7	+ 1,115.4%
Accumulated Fed Debt	$380.9	$7769.0	+ 2,039.6%
Budget Deficit (annual)	$14.4	$412.55 (2004)	+ 2,864.9%
Fed Debt Held by Foreigners	$12.4	$1995.8	+16,095.1%
Trade Deficit	Balanced	$717.2 (projected)	
Consumer Price Index	37.8	193.3	+ 511.3%
Money Supply (M3)	$618.3	$9532.8	+ 1,541.7%
Purchasing Power of Dollar	$1	$.195	- 81.5%
DJIA	744.10	10,151	+ 1,364.1%
Gold	$36.02 (avg.)	$435.00	+ 1,208.3%
DJIA (one year 4/27)	10,478	10,151	- 3.2%
Gold (one year thru 4/27)	$396.25	$435.00	+ 9.7%

Monetary figures in billions and rounded.

Is buying gold now comparable to buying it at $35 in 1968? Are the right elements in place to fuel a rise comparable to what happened in the 1970s when gold rocketed from the $35 benchmark to almost $900 per ounce? *Is now the right time for gold?*

Many top notch analysts say that it is:

"Gold is the trade of the decade. . .Therefore, go to the gold window and trade overpriced US assets for gold." - Bill Bonner, *Daily Reckoning*

"Against a backdrop of corporate scandals and plunging stock markets, the price of gold has climbed by about 20 per cent in the past 18 months. Mining companies' profit margins have grown and anyone with a nest egg of bullion bars is feeling a little safer." - *Financial Times*

"This is a new era for gold. Investors in gold have been waiting for 30 years for this development. . .a signal last seen in the early 1970s, before the last great gold market."
- Market Analyst Ned W. Schmidt

"Gold is the buy of a generation." - Walter Murphy, Merrill Lynch chief analyst

"Gold has been the only real money for 5,000 years and there will be a frantic move to buy it. We are at the very early stages." - Richard Russell, *Dow Theory Letters*

And that's just a sampling.

Over just the past few months analysts from financial giants Morgan Stanley, AIG International, J.P. Morgan and Bear Stearns have all come out in favor of gold ownership. Quietly, the gold price is moving. Since bottoming in the $255 range, gold has risen as high as the $455 range before settling back and seemingly gathering itself for the next push up. Gold's primary trend is unmistakably to the upside.

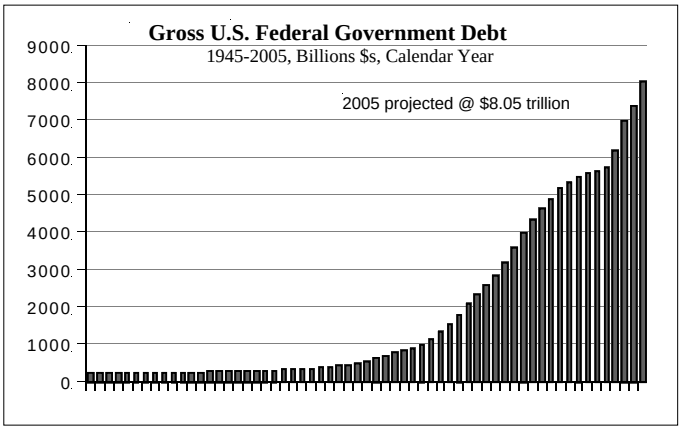
Below we offer some concise but valuable background on what we believe to be the five the most important and potentially damaging of the Disturbing Trends now at work in the U.S. economy. These are the trends which have the experts worried and the public moving to gold in numbers not seen since the 1970s. Most of these problems have been with us for a very long time, bubbling just below the surface while the nation basked in the glow of the 1990s stock market boom. Now with the economy worsening and the nation on a war footing, these trends have accelerated with renewed force. Any one of the Disturbing Trends outlined below could propel gold over the $500 mark. Taken as a group, they could provide impetus for the greatest bull market in gold's long and illustrious history.

The politicians and Wall Street hope that these deteriorating numbers will disappear. The press tries to ignore their relevance in its headlong attempt to maintain confidence in the markets and the economy. But it is foolish to believe that these Disturbing Trends are going to suddenly go away. The greater likelihood is that the cycle has turned and that things will only worsen.

Disturbing Trend #1
The Alarming Growth in the U.S. National Debt

The accompanying graph illustrates the reincarnation of an old nemesis and Disturbing Trend -- alarming growth in the national debt. I am not referring to the 'federal deficit' which is more an article of fiction than fact, but the actual additions to the national debt -- a bookkeeping reality reported by the Treasury Department daily but neglected studiously by the mainstream press.

That figure at this writing (4/27/05) stands at over $7.769 trillion. As you probably know, the debt clock just keeps on ticking inexorably, so the federal debt figure is likely to be much higher by the time you read this report. At the current rate of growth, the national debt should exceed the $8 trillion mark before the fiscal year is over. For a short while in the 1990s, it looked like this particularly troublesome problem had been reasonably tamed, but along came the military build-up in the war against terrorism coupled with rising entitlement payments and election-year politics and out the window went fiscal restraint. $600 billion of the $7.769 trillion was added in fiscal year 2004 alone -- the largest increase on record. If the current rate of Washington red ink were to remain consistent, the federal government by the end of fiscal 2005 could add nearly $1 trillion to the national debt in a single year -- a landmark figure few in government are apt to discuss on the campaign trail.



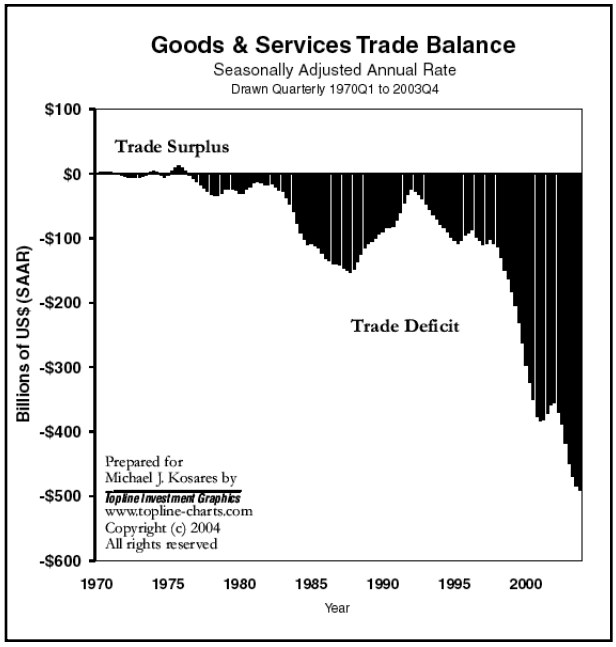
Under the circumstances -- an on-going war against terrorism including now the prospect of a semi-permanent military presence in Iraq and Afghanistan coupled with an assortment of domestic economic woes -- this Disturbing Trend is not likely to go away anytime soon. In a speech before the Council on Foreign Relations recently, Alan Greenspan said: "The general view is that, as the Fed funds rate gets closer and closer to zero, that at zero we are out of business." That is not the case." The Fed, he went on, "could buy other U.S. Treasury securities with varying terms of maturity to pump cash into the financial system and stimulate economic activity." The Federal Reserve chairman, in essence, has given the federal government the green light to spend whatever it wishes and the federal government has taken him on it. The Fed's magic checkbook will cover the overspending dollar for dollar -- an incentive for Washington to run the federal debt through the roof. In the 1970s, that policy led to double-digit inflation and raised the ominous spectre of a complete dollar breakdown. Last time the United States got away with it. This time around we may not be so lucky. Already foreign governments and central banks are making noise about exiting their U.S. government bond positions. When the talk becomes reality experts believe a dollar crash could become a reality.

Disturbing Trend #2
The Alarming Growth in the Trade Deficit

U.S. exports and imports were roughly in balance in 1970. In 1992, the trade deficit ballooned to $36.5 billion. By 1995, it had grown to $105 billion. By 2000, it had mushroomed to an incredible $378 billion. The estimate for 2005 is $490 billion or more. Few can remember the last time the United States ran a trade surplus (which was 1975). Fewer still can remember a time when we were not beholden to Asia and Europe to prop up our bond market by trading their dollar balances gained for our government debt. In the process, the United States has gone from being the greatest creditor nation on earth to being its largest debtor.

Recently, Japan inaugurated one of the strangest economic policies in modern history. Under the auspices of the Bank of Japan (its central bank) Japan began supporting the U.S. dollar with open market purchases that registered off

the charts. Richard Duncan, the former International Monetary Fund economist who wrote the bestseller - *The Dollar Crisis: Causes, Consequences and Cures* - called this policy "the most aggressive experiment in monetary policy ever conducted" and "the most audacious endeavour to conjure wealth out of nothing since John Law sold shares in the Mississippi Company in 1720." John Law, the infamous French finance minister that almost broke the country, generated one of the most wealth-destructive runaway currency inflations in history. One of the unhappy results of Japan's run-with-the-wind dollar support policy is that the dollar is being held hostage by foreign financial interests, who can move against it at any time by simply selling off their bond holdings. To say the least, this puts American stock and bond investors in a precarious position.



Not a day goes by that some analyst or pundit somewhere warns of an impending collapse of the U.S. dollar. Financial interests worldwide are already moving to protect themselves against such an occurrence by slowly but surely withdrawing their support from the U.S. stock and bond markets. Many ask where it will all end. The jury is still out, but with record trade deficits being rung up month after month, and with each plateau being greeted with collective indifference in Washington and New York, the impending verdict is clear. This is another Disturbing Trend sure to wreak havoc with the dollar and investor portfolios in the months to come.

Disturbing Trend #3
The Stock Market's Downward Spiral

Since November 2001 - with the exception of the current election-related counter-trend - the gold and stock markets have been headed in diametrically opposite directions. The stock market is generally regarded by knowledgeable money people as a highly overvalued asset grouping with too much risk, and gold, on the other hand, is viewed as greatly undervalued and in the beginning stages of a long-term, secular bull market. Richard Russell, the highly regarded editor of *The Dow Theory Letters*, has won international plaudits and a wide following by correctly and consistently forecasting the direction of both markets over the past few years. He says the Dow Jones Industrial Average and gold will cross in the 2000 to 3000 area.

Those who put faith in a quick recovery and a rapid return to the halcyon days of the 1990s need to consider history. Typically the downward stock market cycle is not two to three years in duration but twelve to fifteen. For example, the highs achieved in 1929 were not revisited until post World War II. And in case you think that might have been an aberration, the bull market high of 283 in 1966 was not breached again until 1983. In early 2000, the Dow Jones Industrial Average peaked at 11,750. If stock market history is a teacher, we can expect the DJIA to revisit 11,750 sometime after 2010! In the meantime, the current uptrend in stocks is viewed by many as a dead cat bounce, a bear market rally, that appears more like the early 1930s sizzle that ended in the mid-1930s fizzle than a renewed bull market.

Analyst John Hathaway of Tocqueville Funds explains why this Disturbing Trend in the stock market may be with us for a long time to come:

> "These days, it is hard to identify whatever it is that represents business as usual. Norms go out the window during turbulent markets. Most would admit that the '90's mania was an aberration. However, few appear to be ready for the mania's aftermath. Business cycle upturn or not, the credit cycle is on the wane.The mechanisms, institutions, and economic policies that mis-allocated capital are still functional but under siege. They are under siege because markets are balky, economies flaccid, and faith shaky.
>
> The Fed can continue to intervene to affect market behavior to achieve a desired effect for a brief period, but it cannot make lenders lend,consumers spend, or businesses invest. The bubble's aftermath will progress at whatever pace and to whatever extent is necessary to liquidate the preponderance of bad investments. Based on history, the pace will be measured in years and perhaps decades."

Disturbing Trend #4
The Disappearing Real Rate of Return

The real rate of return is defined as what remains on savings or money market yields after taxes and inflation are subtracted. A currency which carries a positive real rate return tends to attract capital; a negative or low real rate of return encourages liquidation. And, it isn't just savings accounts that are affected when a currency goes sour, stocks and bonds are affected as well.

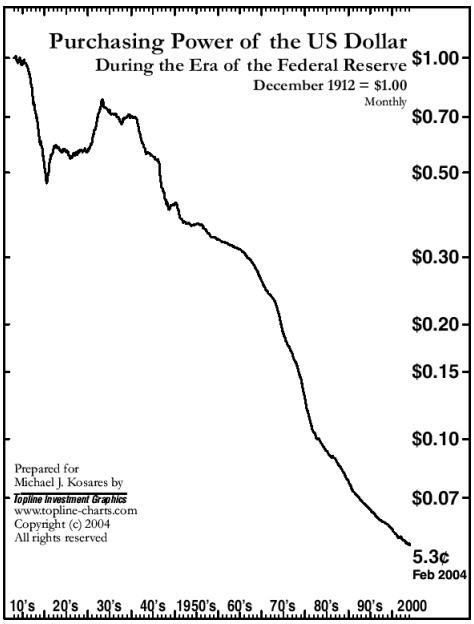
Recent Labor Department reports show inflation in the 6% to 7.5% range annualized - and that's if you believe the government-produced inflation numbers. Be that as it may, with savings and money market yields now just over 1%, the real rate of return on the dollar has disappeared even at the low end of reported inflation rates. And with oil and gasoline prices expected to stay at the current out of the box levels, an accelerating inflation rate is now being factored into the investment equation. Already, the negative real rate of return has caused international investors to move out of the dollar and into alternatives like the euro.

Foreign debt hangs like a sword of Damocles over the American economy. As our table shows this disturbing trend has shown the highest growth rate of them all. At this writing, foreign governments, institutions and individuals hold a collectively almost $2 trillion of U.S. paper -- one fourth of the national debt. Japan alone holds $700 billion and mainland China almost 200 billion. How money men and politicians in Tokyo and Beijing think has become a major consideration for Wall Street. The financial world holds its breath while the foreign held debt rises day after day, month after month, year after year.

The Federal Reserve's long-term interest rate policy, coupled with Alan Greenspan's assurance that the Fed will monetize the federal debt, signals that the strong dollar policy is a thing of the past. This particular Disturbing Trend -- the disappearing real rate of return and its effect on savings, stocks and bonds -- will be a portfolio fact of life for a long time to come.

Disturbing Trend #5
The Long-Term Decline of the U.S. Dollar

Would you own a stock that performed like the item represented in the graph below? The dollar is a currency in crisis. It has been steadily debased in fits and starts since the Federal Reserve was created in 1913. The 1913 dollar is now worth less than 5¢ in purchasing power. The 1945 dollar is now worth less than 10¢. The 1970 dollar is now worth 19.5¢. The 1985 dollar (during a time when we were told repeatedly inflation was benign)is now worth only 58¢. To show you how far we've come in so short a time, consider this statement in



November, 2002 from Federal Reserve governor Benjamin Bernanke when asked about the tanking U.S. economy and fears of a deflation were running high: "The US government has a technology called a printing press -- or, today, its electronic equivalent -- that allows (the Federal Reserve) to produce as many US dollars as it wishes at essentially no cost." How many of us would have ever imagined a statement like that being uttered by a member of the Federal Reserve? And now that same Benjamin Bernanke is being touted as the most likely successor to Alan Greenspan as chairman of the Federal Reserve. In essence, when you couple Bernanke's statement with those of Alan Greenspan mentioned earlier, the Federal Reserve is suggesting that it will blow the dollar out of the water if necessary in order to save the economy.

Referring to the trends highlighted in this report, Alan Greenspan (in a different incarnation long, long ago), once warned that "these trends cannot extend to infinity." Sooner or later, there will come a day of reckoning and when it arrives the damage to the average investor portfolio will be devastating. Though no investor will escape unscathed, those who have prepared for the inevitable will at least weather it. Of the five Disturbing Trends covered here, the long-term decline of the dollar in all likelihood will prove to be the most dangerous and devastating for the average American investor and the one most directly linked to a bull market in gold.

Enter Gold

Now you know the essential reasons why experts believe that this is the right time for gold. Going back to the introduction to this advisory, I believe that Merrill Lynch's Walter Murphy summed up gold's prospects nicely when he said:

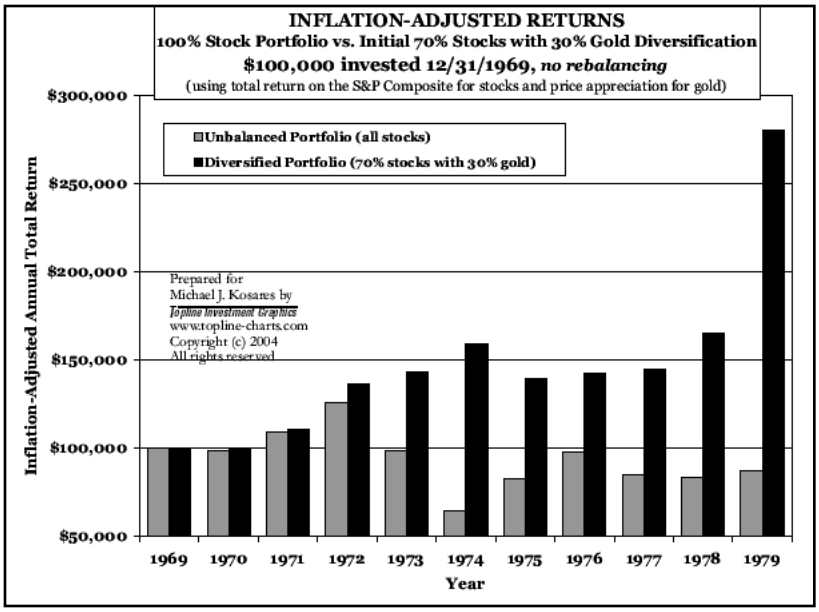
"Gold is the buy of a generation."

The primary trend of gold is unmistakably to the upside. Bottom line, every portfolio should contain gold as an insurance policy against the possible demise of the U.S. equity markets and the dollar. However, with the long-term economic cycle now signaling the potential for a secular bull market, it is also time to begin thinking about gold for its investment possibilities over the medium to long term.

The Power of Gold Diversification

History shows that a prudent diversification can go a long way when stocks enter a primary bear market. Few would argue against the generally held perception that gold protects against inflation, deflation and/or stagflation and in whatever order they come. Stocks, on the other hand, do not do well during currency crises -- events usually accompanied by any one (or combination) of those three maladies.

The graph just below represents two model portfolios during the 1970s, the



last time the United States experienced a currency/inflationary crisis. One theoretical portfolio (in grey) invested 100% in stocks (without a gold diversification) and the other (in black) invested 70% in stocks and 30% in gold. Much like what's going on in the United States today, the 1970s were characterized by a dollar devaluation and crisis. This in turn spawned an oil price spike and rapid, double-digit inflation in almost all goods and services. Unemployment and bankruptcies also soared and the misery or stagflation index (inflation added to the unemployment rate) rose to all-time highs. The 1970s were one of the most destructive financial periods in modern American economic history.

Each portfolio started with $100,000 invested. The all-stocks portfolio did well until 1972, when Wall Street began to react to the dollar crisis. By 1973, the diversified portfolio (with gold breaking to the upside pushed by the building inflation rate) was worth more than the all-stocks portfolio. By 1979, at the peak of the crisis, the diversified portfolio rocketed to $334,500 (over three times where it started in 1970) while the all-stocks portfolio could manage a value of only $111,775 -- a meagre 1% annualized return on investment over the period studied. The gold price used for the 1979 valuation was the $300 average, not the $875 top.

The Disturbing Trends table on page one illustrates the developing divergence in stocks and gold. Over the entire period from 1970 to present stocks have garnered similar returns with stocks appreciating 1364% and gold 1208%. However over the last three years while gold has appreciated on an average of roughly 15% per year stocks have been sideways to down. Prominent analysts, as we mentioned earlier, now see gold in the beginning stages of a secular bull market; and stocks well-along in a secular bear market. The indicators point to gold diversification as a key move at this juncture likely to pay dividends as the financial cycle runs its course.

Gold Coins:
The Best Choice for Portfolio Protection and Potential Profit

If you want to protect your portfolio against inflation, deflation, stagflation, stock market weakness and potential currency problems, *and* participate in potential profits resulting from a bull market in gold, the best option is gold coins. Gold coins owned outright are the only portfolio item that will serve you in all seasons and under most circumstances. They track the gold price up and down, are very liquid, and are usable under the most dire financial and economic circumstances.

The specific types of gold coins you purchase depends upon your goals. Your advisor at USAGOLD/Centennial Precious Metals can help you choose what best

suits your needs. In general, if you want basic protection there's nothing like gold bullion or gold bullion coins (picture left), such as the U.S. Eagle, Canadian Maple Leaf or South African Krugerrand. If you want to add an extra layer of protection against government intervention in the gold market -- including potential capital controls and confiscation (a possibility during currency crises) -- you should consider a selection of the lower premium European and U.S. pre-1933 gold coins, such as the U.S. $20 gold piece, British Sovereign (pictured above), Swiss Helvetia, or the Dutch Guilder, which are also liquid and track the gold price.

Conclusion

We live in uncertain times. The disturbing trends outlined here illustrate not only how deeply entrenched these economic problems have become, they suggest that the only way out is for them to simply run their course. The best protection for the average investor is to include gold in his or her portfolio as a hedge and insurance in case these uncertainties magnify to a full-blown financial crisis. Many people have asked me over the years how these trends could become so much a part and parcel of the American economy. I think the following quote from Alexander Tyler provides a more incisive analysis than anything I could provide:

> "A democracy cannot exist as a permanent form of government. It can only exist until the voters discover that they can vote themselves money from the public treasury. From that moment on the majority always votes for the candidates promising the most money from the public treasury, with the result that a democracy always collapses over loose fiscal policy followed by a dictatorship. The average age of the world's great civilizations has been two hundred years. These nations have progressed through the following sequence: from bondage to spiritual faith, from spiritual faith to great courage, from courage to liberty, from liberty to abundance, from abundance to selfishness, from selfishness to complacency from complacency to apathy, from apathy to dependency, from dependency back to bondage."

In such a milieu, gold stands out.

Michael J. Kosares is the author of the widely read introduction to gold ownership, The ABCs of Gold Investing: How to Protect and Build Your Wealth with Gold, editor of the weekly online USAGOLD Market Update, and president of USAGOLD - Centennial Precious Metals, Inc. A highly respected figure both within the industry and publicly, he has over 30 years experience in the gold business.

USAGOLD-Centennial Precious Metals
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