Liberty's Outlook

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Highest Investor Demand For Gold Since 1967!

It has been all too long since I did an in-depth review of gold's fundamentals: supply, demand, inventories, and investor psychology. With markets quieter in the past month than they were earlier this year, it's a good time to take a fresh look.

The physical gold market is much larger than that for silver. Annual new supplies are worth about $50 billion at current prices compared to less than $5 billion for new physical silver supplies. Because of its relatively large size, it is more important to financial markets than silver, and its movements tend to be smaller and slower.

For example, when silver hit $8.20 four months ago, that was a 103% increase in the previous 28 months. Over the same period, gold was up *only* 53%.

While it seems like almost everything in the global economic and political arena has some effect on the price of gold, I consider the long-term physical supply and demand fundamentals to be one of the most important factors underlying an eventual trend in prices.

As you might imagine, much of the gold market is shrouded in secrecy. Information from so-called transitional economies that were formerly the communist bloc has to be inferred by comparison to historic activity.

In India, experts' calculations of the quantity of recycled gold in 2003 vary widely. For that figure, we used 11.3 million ounces as stated by the respected precious metals research firm CPM Group, though others estimate this figure considerably lower or higher.

So, understanding that there is a lot less precision in the figures than might be desired, the important thing in ascertaining trends is to compare year-to-year changes using a consistent methodology.

The most respected researchers of gold fundamentals are the CPM Group and Gold Fields Mineral Services. Their approach to analyses differ. As a result, they come up with different calculations of supply and demand, from which I have extracted the above totals which are different than both firms. But their basic conclusions are almost identical:

In 2003, gold supplies fell far short of meeting demand—approximately 10 million ounces. This is a continuing trend that should last at least another two to three years.

Even though the price of gold is up about 50% from its bottom in the second half of the 1990s, I believe that gold is likely to reach even higher levels in the next two years!

Let's look at the track record.

Gold Supply And Demand 2002-2004
(Millions of ounces)

Category	2002	2003	2004 (projected)
Supply			
New Mine Production	64.5	64.1	63.8
Recycled Scrap	26.0	29.4	26.2
Government Sales (net)	10.9	15.1	13.0
Transitional Economies	17.0	17.0	18.0
Total Supply	118.4	125.6	121.0
Demand			
Jewelry-non-investment	79.1	74.9	74.4
Jewelry-investment	3.7	7.5	7.0
Private Investment	26.5	33.9	30.1
Industrial Applications	9.1	9.3	9.5
Mine Hedge Buybacks (net)	14.0	10.0	10.0
Total Demand	132.3	135.6	131.0
Net Shortage	(13.9)	(10.0)	(10.0)
Shortage as a % of supply	*11.7%*	*8.0%*	*8.3%*

Data sources: CPM Group and Gold Fields Mineral Services

Gold's Track Record:

Supply: New gold supplies primarily come from mining operations. In addition, supplies come from recycling operations and from government and central bank sales and leasing. Because of the difficulty in ascertaining whether gold supplies from transitional economies come from current mining operations or from old inventories, it is listed on a separate line from other mining production.

Mine Production: Most mine production from other than transitional economies comes from publicly held companies that regularly report (tout!) their results to the public.

At any time, there are existing mines that close because economically recoverable gold ore has been exhausted. Similarly, there are always new mines going into production.

Well-managed mining companies have an incentive to develop new operations to replace the output lost by depleted mines. They also seek to extend the life of existing operations. Mines have veins of ore of varying purity. When prices are higher, the low-purity veins are worked. As prices fall, production shifts to the high-purity veins.

It takes years for the exploration and development of new gold mines. As a result of lower gold prices in the late 1990s, mine production from other than transitional economies fell to its lowest levels since 1997. A number of mines simply closed because their operating costs (the marginal cost to extract an ounce of gold) were too high. Investments in exploration and development dropped a few years ago, with the result that there are few new mines coming into production now to replace other mines that have been worked out.

South Africa remains the world leader in newly mined gold, although its mature industry is on the decline. Production there

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has dropped 40% in the past decade! On the other hand, as the technology advances, new sources of gold are being found around the globe, a trend that will likely continue.

Here are the top gold mining nations in 2002 (the last year for which comprehensive statistics are available):

Country	*Gold Production (Millions of Oz)*
South Africa	12.7
United States	9.6
Australia	8.7
China	6.1
Russia	5.5
Peru	5.1
Indonesia	4.7
Canada	4.3
Uzbekistan	2.8
Ghana	2.2
Papua New Guinea	2.1
Mali	1.8
Brazil	1.6
Tanzania	1.3
Chile	1.3
Argentina	1.0

Mine production has been declining for the past several years in the well established countries such as South Africa, United States, Australia, and Canada. It has been rising in China, Russia, Peru, Indonesia, Ghana, Papua New Guinea, Mali, Tanzania, and Argentina.

With gold prices rising for the past 30 months, mining companies have sharply expanded their exploration and development activities. As a result, expect to see a surge in the number of mines beginning operation in the 2006-2008 time frame.

Existing mines that were closed because of low gold prices are not simply reopened once the price rises enough to cover costs. Mine operators need some confidence that the higher prices will continue, so that the capital costs of reopening a mine will be covered. As a result, only a few mines have resumed operation in the past two years. More will go back into production in the next two years if prices remain at current or higher levels.

Because of the long time it takes for mine output to respond to higher prices, global production in 2004 is likely to rise only about 1% from 2003 levels, only covering a tiny fraction of the continuing supply shortage.

Recycled Scrap: Higher gold prices in 2003 encouraged the recycling of a record amount of gold, almost 50% higher than in 1980 when gold hit $800!

However, much of the gold in "weak hands" was sold in 2003. Although recycled scrap will stay at high levels in 2004, it is expected to decline more than 10% from last year.

In India, which accounts for more than 1/3 of the recycled gold, recycled gold mostly comes from trade-ins used to help pay for the purchase of new gold jewelry. Thus, a higher level of supply from recycling in India is partly offset by a higher demand.

Private ownership of gold in India now exceeds 1 billion ounces, roughly one-fourth of all gold in the world! Although it may sound impressive to say that almost 10% of the world's gold supply comes from recycling in India, it barely represents 1% of the gold held in India. The amount of recycled gold is also dwarfed by private demand in India, which accounts for about 20% of worldwide demand!

Government And Central Bank Sales And Leasing: Official sales (net of purchases) in 2003 were the second highest in the past decade and were among the highest since the United States ceased redeeming dollars for gold to private parties in 1967!

The Swiss accounted for about two-thirds of the sales as part of their five year program to cut their gold reserves in half. This program is scheduled to be finished around the end of 2004.

The only other nations to sell more than $500 million of gold in 2003 were Portugal, South Africa, and The Netherlands.

Next month, the 1999 Washington Agreement on Gold (WAG) expires. This agreement limited the amount of gold sold by governments and central banks to an average of 12.8 million ounces per year among the signatory nations and others who announced they would work within the limits (which included nations holding about 85% of all official reserves).

Earlier this year, a five year renewal of WAG was announced. To help cover the continuing gold shortages, the average annual sales limit was raised to 500 metric tons (16.1 million ounces).

Despite that higher limit, there is almost certain to be a decline in official gold sales in 2004 and beyond. Only four nations and the International Monetary Fund (IMF) have enough reserves to potentially help supply significant quantities of gold over the next five years.

A few years ago, the IMF proposed selling some of its gold to provide aid to poor nations and was shot down because that would hurt the value of gold exports from a number of developing nations. I doubt that any of its gold holdings will be liquidated in the next five years.

The United States and Italy have made no statements about possible gold sales. There have been some statements from Germany and France about possibly selling some gold, but they tend to come from departments other than those who actually would control whether gold would be sold.

In Germany, it appears that any gold sale proceeds could not be used in the way that the government would prefer, reducing the appeal of selling gold. France, which has been one of the staunchest advocates of a strong gold position, would face a public furor if it were to sell gold reserves.

Thus, even though official sales will remain strong in 2004, though at lower levels than 2003, there is a real possibility of a sharp fall in supply in 2005 and beyond.

The gold shortage could be even larger if China continues to add to its gold reserves. The Chinese government acknowledged that it has increased its gold reserves about 50% over the past few years, but only revealed this information well after the fact. Several analysts suspect that China is actually purchasing much more gold, using a tiny fraction of its mushrooming foreign exchange reserves to do so. If China is adding 5-7 million ounces of gold reserves each year, this would give a sharp boost to the gold price.

Not only did the WAG cover official sales, it also restricted leasing activity to pre-existing levels. This was considered psychologically important in limiting the flow of gold at the time, but has been rendered obsolete by the market. First, the low gold lease rates have discouraged activity, as they yield barely covers the risk of capital loss. Second, as the gold mines have been reducing their forward gold sales, demand for leased gold has fallen dramatically (contributing to the low lease rates).

Summary: Although mines now under development could add as much as 12 million ounces of new supplies annually by 2008, there is every reason to expect a decline in supply in the next few years, thus maintaining the gold shortage levels. As I see it, only much higher gold prices might encourage enough recycling and official sales to bring the market closer into balance.

Demand: Because of its high value, gold is almost purely a financial metal. Still, its use as an industrial metal has gradually grown over the years. Industrial demand in 2003 was the second highest ever, topped only by pre-recession 2000. In 2005, industrial demand could set an all-time record.

The main use for gold is as a luxury jewelry item. It is sensitive to higher prices. In 2003, demand for non-investment jewelry fell more than 11.6% in countries outside of India, Turkey, the Middle East, and Southern Asia, but increased over 28% in the latter nations.

In 2004, demand for gold jewelry in the United States, Europe, and other nations is expected to increase, so that total non-investment jewelry demand should almost stabilize after two years of double-digit percentage declines.

In some parts of the Middle East and South Asia, gold jewelry is literally considered a store of wealth, much as a savings account in the United States. It is sold on the basis of gold value rather than at a high premium for craftsmanship. It is more accurate to consider such jewelry

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sales as part of investment demand rather than as consumption of luxury goods.

In 2003, investment demand for gold soared to its highest levels since 1967, the last full year that the U.S. government redeemed dollars for gold to private parties.

Beyond the demand for physical gold, 2003 was also a record year for investor demand for paper contracts for gold. The volume of gold traded on the New York Comex in 2003 approached all-time record levels, with the number of open contracts almost as high as it was at the peak in the 1980 boom. Comex options trading of puts and calls were and are near the record levels set in late 1999 as part of the Y2K fears.

Though investor demand may drop slightly in 2004 because of higher prices, the dollar value of investor demand may top 2003! The reasons for this strong demand are discussed below.

For several years in the 1980s and 1990s, gold mines could profitably borrow gold, sell it at current prices, avoid the risk that prices would be lower in the future, and earn interest on the cash proceeds that was higher than the cost of the lease—as long as the price of gold did not rise above the price at which they sold the leased gold. They mining company would then repay the metal out of future production, effectively increasing current gold supplies. This increase in gold supplies helped hold gold prices down, enabling the mines to make significant profits from hedge activities. As leases expired, they were often rolled over into a new lease.

These extra profits from hedge activities were so inviting that many large mining companies jumped into the act. In 2001, the amount of pre-sold gold topped 18 months worldwide gold mine production!

However, hedging carries risk. If gold prices rise during the lease term, the mine will have effectively sold its product at below market levels, incurring the wrath of shareholders.

Since the Bank of England concluded its gold liquidation in 2001, the price of gold has been trending upwards. The mining companies have been clobbered with lower profits and even losses from hedge activities. To minimize the damage, they began aggressively closing out their hedge contracts, either by delivering metal or through outright buybacks of open contracts.

In response to shareholder furor, major gold mining companies such as Newmont and Barrick have adopted no-hedging policies. As current hedges expire, they are not being renewed.

In 2003, about 15% of all new gold mine production was devoted to closing out pre-sold gold contracts. Just like the initiation of the contract increased gold supplies, the closing out of these contracts effectively increased gold demand (or reduced supply). The effect has been to help boost the price of gold.

At the end of 2003, gold mines collectively still owed about 66 million ounces in hedge contracts, slightly more than one year of worldwide production. The largest position was held by Barrick Gold Corporation, which owed 15.5 million ounces, or more than three years production!

In the first quarter of 2004, another 2.8 million ounces (net) of hedge contracts were closed. Expect the mines to continue reducing hedges for the next several years.

CPM Group does not include hedge activities in their analysis of the physical gold market. Its research associate told me yesterday that they consider them to be paper contracts not affecting supply and demand. I disagree. While it is true that over the long-term these paper contracts will be closed and have a net zero impact on supply and demand, they have had and will continue to have an enormous impact in the short– to intermediate-term. Just as hedge contracts helped drive down the price of gold too far several years ago, we are now in a multi-year period when price rises are higher than they otherwise would be—just to end up where the market would have been all along.

Inventories: Here are the nations with the largest central bank gold holdings at the end of 2003:

Country	*Millions of Oz*
United States	261.6
Germany	110.6
France	97.3
Italy	78.9
Switzerland	53.2
Netherlands	25.8
Japan	24.6
China	19.3
Spain	16.8
Portugal	16.6

The IMF holds 103.4 million ounces of gold; the European Central Bank has 24.6 million ounces.

Of the roughly four billion ounces of gold mined in all of history, just under one billion ounces are held by governments, central banks, and official agencies, perhaps 900 million ounces are held as an investment (210 million ounces in France, 150 million ounces in India, 140 million ounces in the U.S.), and the balance is in the form of jewelry and fabricated products.

Some official holdings are out on lease. The best estimate by Gold Fields Mineral Services is that 15-25% of official holdings are currently out on lease (and declining over time). Researcher Frank Veneroso considers this figure much too low and that the correct figure may be as high as 75%! Insignificant quantities of privately-held gold are out on lease.

There is always some privately-held gold being liquidated at any time for investment and financial considerations. However, a general trend is that individual gold investors are long-term holders. On average, they do not sell when gold prices are high, they simply stop adding to their holdings. I discuss the reasons why below, but the basic result is that private gold inventories are less likely to be liquidated when prices are high than are other investments.

In sum, even though there are large inventories of gold in official and private hands, there is little prospect of the market being flooded with supply if prices rose.

Investor psychology: Investors purchase gold for a variety of reasons:

1) Inflation Hedge. Owning gold as protection against the ravages of government inflation is a historic reason for owning gold. Although research studies are split on how well gold has served as an inflation hedge over the centuries, in the course of a single lifetime it works reasonably well. With the massive U.S. government budget deficits, there is every reason to fear the rise of inflation in the next 24 months.

2) Alternative Asset. Gold is also popular because it often performs counter to paper assets. In effect, it represents insurance against poor results in other market sectors. For instance, from the end of 2001 to the end of 2003, gold clobbered the results of the American stocks, no matter which index you used for a benchmark.

3) Safe Haven. Over the course of history, governments have fallen and banks have failed. But an ounce of gold in your hand is still an ounce of gold next year. A number of Southeast Asian refugees (including several LCS customers) owe their lives to the fact that they owned enough gold to buy their way out of their homeland.

4) Commodity. When the prices of commodities are generally rising, gold tends to go right along with them. Current high oil prices, for instance, provide extra cash flow in the Middle East, where gold demand is stronger than many parts of the world.

5) Savings. There are many parts of the world that simply do not have institutions like banks or brokers where people can save or invest. Instead, tangible assets fill the void, of which gold is a popular form because of its liquidity, compact size, and durability.

In many Islamic countries, it is difficult to put assets into interest-bearing accounts. In many of these same nations, it is also not safe to hold large amounts of cash. Australia's Perth Mint has a gold certificate program that is flourishing with customer demand from such countries. As it sells certificates, it puts a corresponding quantity of physical gold into vaults.

6) Currency Hedge. Currency values fluctuate. If the U.S. dollar is falling, do you necessarily want to hold Euros or Yen? If you hold gold, you avoid all currency risk.

CPM Group has charted each of these six reasons as to whether they are a positive reason to own gold each year. What they have found is that years where at least four of these factors make gold an attractive pur-

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chase, the price of gold almost always rises significantly in the next year. The one exception was that five of six reasons were positive in 1999, but the gold price in 2000 was barely higher than 1999 because of all the investor liquidations.

In 2002, five of six factors were positive; the gold price in 2003 averaged 17% higher than in 2002. In 2003, five and one-half factors were positive; with the price thus far in 2004 averaging well over 10% above last year's average.

In 2004, all six factors are positive, for the first time since 1979. In 1980, the average gold price was almost double that of 1979. I just cannot see gold hitting $800 next year, but a climb into the high $400s or even over $500 is entirely possible.

Investors are drawn to gold during uncertain times. There are certainly a lot of uncertainties worrying investors now. Among them are 1) the risk of surging inflation, 2) terrorism, 3) the Iraq war, 4) volatile stock and bond markets, 5) government budget deficits, 6) an "is it or isn't it" economic recovery, 7) falling currency values, 8) shaky banks, 9) the huge market of derivatives, 10) how much will official gold sales decline in 2005, 11) the possibility that China may be acquiring more gold reserves than they have revealed, and 12) the possibility that official gold reserves may be out on lease at much higher levels than most analysts think.

If only a couple of these potential problems blew up, that could be enough to spark a real surge in gold prices. On the other side, it would take almost a complete successful resolution of each of these items and nothing new coming up on the horizon for the price of gold to drop much from today's levels.

I consider the prospect of peace and prosperity breaking out across the world to be unrealistic. As protection against the world's calamities, I recommend that investors put 2.5-10% of their net worth in gold (along with a like amount for silver as I discussed last month) as insurance. And hold onto it, because the world will always have worrying uncertainties.

Rare Coins Harder To Find

There's not much room for rare coin market discussion this month. The market is so strong that even the newly released 2005 edition of *A Guide Book Of United States Coins (*the famous *Red Book*) has a number of so-called retail prices lower that we would be willing to pay to buy coins. For instance, it lists the 1797 $10.00 Heraldic Eagle in Choice About Uncirculated condition at $22,000. A few weeks ago, we paid $23,000 for such a coin. The 1909-S VDB Lincoln Cent in Extremely Fine lists for $750; we paid $885 for one two weeks ago.

In strong markets, an experienced coin dealer can help guide you through the minefields of which coins are worth prices higher than catalogs reflect and which should be available at catalog value or less. The top five traders here at LCS have a combined two centuries of watching rare coin markets. We can give your our useful opinions about value compared to some other dealers where the person you talk to may simply be an order taker reading from a script.

Also, in this strong market, it can be almost impossible to find any sizeable group of coins. That happened to us in the past month. We simply do not have enough of any bargain purchase to offer you in large quantity. However, we have been digging out a wide variety of smaller lots of gold, silver, and other coins and paper money. See our offers for details.

The Month

Gold Range	$20.75	5.2%
Net Change	-10.25	
Silver Range	.62	10.1%
Net Change	+.62	
Gold/Silver Ratio	57.9	
Net change	-7.9	
Platinum Range	38.00	4.8%
Net Change	+38.00	
Platinum/Gold Ratio	1.97	

Date	Gold	Silver	Platinum
Jul 07	402.25	6.11	793.00
Jul 08	407.75	6.42	805.00
Jul 09	407.00	6.45	810.00
Jul 12	407.75	6.52	816.00
Jul 13	401.75	6.37	805.00
Jul 14	405.00	6.60	814.00
Jul 15	403.75	6.65	812.00
Jul 16	406.50	6.71	819.00
Jul 19	405.50	6.59	823.00
Jul 20	401.75	6.60	831.00
Jul 21	397.00	6.40	824.00
Jul 22	395.00	6.42	824.00
Jul 23	390.25	6.33	814.00
Jul 26	390.25	6.23	810.00
Jul 27	387.00	6.23	803.00
Jul 28	389.00	6.36	799.00
Jul 29	387.00	6.34	816.00
Jul 30	391.00	6.55	818.00
Aug 02	391.75	6.61	826.00
Aug 03	394.00	6.67	829.00
Aug 04	392.00	6.73	831.00

London Silver Market Premium To New York Silver Market = 1¢

Gold, silver and platinum quotes are working spots at 2:45 EST/EDT each day, quoted in U.S. dollars per troy ounce.

Gold and Gold Coins

Gold finished today at $392.00, down $10.25 (2.5%) from last month.

When gold dropped to $390 in late July, demand picked up noticeably. Demand for physical gold is so strong at current levels that I doubt it can decline much from current levels over the next few months.

Among bullion-priced issues, the low premium leaders are still the Austria **100 Corona** (3.5%), South Africa **Krugerrand** (3.7%), and U.S. **American Arts Medallions** (3.9%). In smaller coins, the British Sovereign (7.6%) remains the lower premium favorite.

U.S. Gold Coins fell slightly with lower gold prices, which I expect to be a temporary bargain buying opportunity.

Silver and Silver Coins

Silver closed today at $6.73, up 62¢ (10.1%) from four weeks ago.

When silver reached $6.50 in mid-July, a mini-wave of liquidation set in. When prices dropped later in the month, a surge in buying kicked in.

Now that the weak hands have liquidated at $6.50, I doubt that we will see much being sold below $7.00. I still expect to see silver back up over $8.00, though maybe not until after the November elections.

The best value in silver remains U.S. **90% Silver Coin** (3.5%), which has the best liquidity, divisibility, and lowest cost per ounce of the most popular forms. Also worth considering are **100, 10, and 1 Oz Ingots** (7.1-8.9%) for those with limited storage capacity.

LCS Staffers Share Numismatic Knowledge

LCS employee Dany Rothfeld has long been an award-winning exhibitor at coin conventions. Now he has another feather in his cap. The just released *2005 Standard Catalog of World Coins* acknowledges Dany for his contributions to this year's edition. His work led to significant improvements in the listing of coins of Israel.

Dany joins General Manager Pat Heller as a contributor to the current edition of a major numismatic reference book. Pat is acknowledged in the 3rd edition of *National Bank Notes*, which came out several years ago.

Inventory Manager Paul Manderscheid's two latest research essays in *The Junk Box*, the publication of the Michigan Token and Medal Society, discussed the merchant tokens from Manistee, Michigan and Civil War tokens from Lansing, Michigan. They were favorably reviewed in the latest issue of *Coin World*.

Paul is currently helping with major revisions to two token catalogs.

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