Liberty's Outlook

Volume 11 Issue 9 Liberty Coin Service's Monthly Review of Precious Metals and Numismatics September 7, 2005

2004—Huge Gold Shortages Continue!

P. 3. U.S. Treasury: "If, during a time of war, the President expressly chose to restrict the hoarding of gold or silver, he could do so."

The gold market has shown substantial strength in the past month, at the same time that silver temporarily offered investors an unexpected bargain buying opportunity. For details, see the specific discussions later in this issue.

I don't know if markets will get any quieter over the next several months, so let me take time this month to review the current fundamental supply and demand factors of the gold market.

Gold's Track Record

While it may seem 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 the most important factors determining the trend in prices.

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 reference to historical activity.

Understanding that there is a lot less precision in the figures than might be desired, the important thing is to ascertain trends from year to year, using a consistent methodology.

The most respected researchers of gold fundamentals are the CPM Group and Gold Fields Mineral Services (GFMS). 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 that are different than both firms.

However, their basic conclusions are almost identical:

In 2004, gold supplies fell far short of meeting demand—approximately 14.3 million ounces. This is a continuing trend that should last at least another three years!

Even though the price of gold is up 75% from is bottom in the second half of the 1990s, I believe that gold is likely to reach much higher levels in the next two years!

Gold Supply And Demand 2003-2005
(Millions of ounces)

Category	2003	2004	2005(projected)
Supply			
New Mine Production	65.0	62.1	64.0
Recycled Scrap	29.4	27.4	27.7
Government Sales (net)	17.6	12.4	13.8
Transitional Economies	17.0	18.0	18.0
Total Supply	129.0	119.9	123.5
Demand			
Jewelry	69.5	70.0	71.4
Private Investment	50.2	40.4	42.6
Industrial Applications	9.3	9.5	9.5
Mine Hedge Buybacks (net)	10.0	14.3	10.0
Total Demand	139.0	134.2	133.5
Net Shortage	(10.0)	(14.3)	(10.0)
Shortage as a % of supply	*7.8%*	*11.9%*	*8.1%*

Data sources: CPM Group and Gold Fields Mineral Services

Here's why.

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

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

At any time, there are existing mines that close after exhausting their economically recoverable gold ore. There are also new mines going into production on a regular basis.

Well-managed mining companies constantly develop new mines to replace the output lost from depleted operations. They also seek to extend the lives of existing mines. Mines have veins of varying purity. When prices are higher, the lower-purity veins are worked. If prices fall, production shifts to the higher-quality 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 in 2004 fell to its lowest levels since 1996! Some mines

Inside this issue:

(Continued from page 1)
closed because their marginal cash costs were too high. Exploration and development activities also declined because of the low gold prices.

South Africa (11.0 million ounces in 2004) remains the world leader in gold production, although it is producing less than one-third of what it was 35 years ago.

In 2004, the United States passed Australia to become the second largest producer. China placed fourth, Peru fifth, Russia sixth, and Canada was the seventh largest producer. Indonesia saw production drop by 30% from 2003 because of a collapsed wall at one mine. It fell to be the eighth largest producer. Rounding out the top ten producing nations in 2004 were Uzbekistan and Papua New Guinea.

Mine production fell in most of the major producing nations in 2004. Only China and Papua New Guinea had significant increases.

With gold prices up sharply in the past 3-1/2 years, mining companies have aggressively expanded their exploration and development activities. The number of operating mines should surge in the 2006-2008 time frame. Production in 2005 is expected to rise from 2004, in part because the collapsed wall at the Indonesian mine has been repaired.

However, even though mine production should be higher in 2005, it will hardly make a dent in covering the long-term shortage.

<u>Recycled scrap:</u> Higher gold prices led to record levels of gold recycling in 2003. These supplies fell somewhat in 2004 as recycling activity in India declined significantly. Whereas the price-sensitive citizens of India once considered a gold price of $400 to be too high, they now are eager net purchasers of gold at current levels.

Although India is the largest source of recycled gold, this activity still amounts to less than 1% of the privately held gold in that country. It is also dwarfed by private gold demand in India, which accounts for about 20% of the worldwide total.

<u>Government and central bank sales and leasing:</u> Even though the Washington Agreement on Gold was renewed last September, increasing the total annual gold sales permitted by 25%, the amount of official gold sales dropped 30% from 2003!.

Still, the 12.4 million ounces sold in 2004 represents a very active level of net sales. Without this supply, the gold shortage would have been even larger!

The Swiss finished their five year sales program early in 2005. In 2004, it sold 9 million ounces of gold. The only other nations to liquidate over a million ounces in 2004 were Portugal, France, Norway, and the Philippines. Argentina was the largest official net purchaser of gold in 2004.

Although Germany and France are selling modest quantities of gold, there is no apparent source of gold to meet the 16.1 million ounce annual quota allowed by the Agreement.

In the past two years there has been some talk of possibly having the International Monetary Fund dispose or swap part of its gold holdings to raise funds for poor nations. However, the uproar from such nations whose gold industry would suffer (for example, Mali's gold exports are its largest source of foreign exchange) ended discussion about any sales. If anything is done, it will likely be through a bookkeeping entry that does not result in the sale of any gold.

<u>Summary:</u> 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 that most of this will simply replace depleted mines that close. Only a much higher gold price will encourage enough supplies onto the market to bring the market closer to balance.

Demand: Because of its high value, gold is almost purely a financial metal. Its use as an industrial metal has grown over the years. Industrial demand in 2004 was the highest ever, but it is expected to be topped this year.

The main use for gold is as a luxury jewelry item. It is normally sensitive to higher prices, such that demand drops as prices go up. However, the general public in India and other major gold consuming nations generally accepts gold at current levels. As a result, total ounces of gold demand for jewelry is increasing slightly. Although jewelry demand is still 25% below levels of the 1998 peak, the higher gold price means that the total dollar value of jewelry demand is currently at all-time record levels!

In 2003, investment demand for gold soared to hits highest levels since 1967, the last full years that the U.S. government redeemed dollars for gold to private parties. Last year came in as the second highest year of investment demand since 1967. Since the price of gold averaged 12% higher in 2004 than in 2003, the value of investment demand in 2004 nearly matched the year before. In 2005, we may set a new record for the value of physical demand.

Beyond the demand for physical gold, 2004 saw an all-time record for investor demand for paper contracts on the New York Comex. The Comex open interest grew to exceed the 1979-1980 boom levels. The value of trades on the London Bullion Market Exchange was higher in June 2005 than for any month since February 2000!

Above and beyond the investment demand is the demand from the mining companies to close out their pre-sold gold contracts.

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 exceeded the costs of leasing the gold—as long as the price of gold did not rise above the price at which they sold the leased gold. The mining company would repay the lease out of future production, having a net effect of increasing current supplies.

This acceleration of gold supplies helped hold down prices, leading mines to make substantial profits from their hedging operations. As leases expired, they were often renewed rather than paid off.

However, such hedging carries risk. If the price of gold rises during the lease period, the company will have sold its gold for less than it might have received, upsetting shareholders.

Since the Bank of England concluded its gold liquidation in 2001, the price of gold has been trending upwards. Mining companies have been clobbered with lower profits or even outright losses from the hedging activities.

To minimize economic harm, the mines are now aggressively closing these pre-sold contracts by delivering gold or by outright buybacks.

In 2004, about 20% of all new gold mine production was used to close out pre-sold contracts. In the same way that the initiation of the contract increased gold supplies, the closing of the hedges has reduced supplies (or increased demand). The effect has helped boost the price of gold.

At the end of 2004, the gold mining industry still owed about 57 million ounces in hedge contracts, almost equal to one year's worldwide production. As of June 30, the outstanding contracts totaled about 54.5 million ounces.

CPM Group does not include hedge activities in their analysis of the physical gold market. They state that these contracts have never resulted in the actual

(Continued from page 2)
release or repurchase of physical gold onto the market. I disagree. It is true that over the long-term these paper contracts are closed and have a net zero effect. However, they do have a significant impact on the short to intermediate-term markets. Just as hedge contracts helped drive down gold too far several years ago, we are now in a multi-year period when price rises are higher than they would have been—just to end up where the market would have been all along.

Inventories: Here are the nations with the largest central bank gold holdings as of April 2005:

Country	*Millions Oz*
United States	261.5
Germany	110.4
France	94.7
Italy	78.9
Switzerland	41.5
Japan	24.6
Netherlands	23.2
China	19.3
Spain	16.8
Portugal	14.9

The International Monetary Fund holds 103.4 million ounces of gold; the European Central Bank has 23.1 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. Almost another billion ounces are held for private investment. 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 current out on lease (and declining over time), Researcher Frank Veneroso considers this figure much too low. By his calculations, the correct figure may be as high as 75%! The amount of privately owned gold out on lease is insignificant.

At any time, there is always some privately-held investment gold that is being liquidated for financial reasons. In general, however, individual gold investors are long-term holders. They tend not to sell when prices are high, they just stop adding to their holdings.

In sum, even though there are large inventories of gold held officially and privately, neither are likely to flood onto the market if prices rise.

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

1) Inflation Hedge. Owning gold as protection against the ravages of government inflation is an historic reason for owning gold. Researchers split on how well gold has performed as an inflation hedge over the centuries, yet it has worked reasonably well over the course of a single lifetime. With the huge federal budget deficit and trade deficit, we are already starting to see higher inflation levels. Inflation may accelerate in the coming months, barring a collapse in the real estate market.

2) Alternative Asset. Gold is popular because it often performs counter to paper assets. In effect, it is insurance against the fall in the value of the U.S. dollar or poor results in other market sectors. From the end of 2001 to now, gold has clobbered the performance of American stocks, no matter which index you use.

3) Safe Haven. Over the course of history, governments have fallen and banks have failed. 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) are alive today because they owned enough gold to buy their way out of their homelands. Residents of New Orleans and other areas devastated by Hurricane Katrina would be in better financial shape today if they had some gold hidden in their home that they could have grabbed as they fled the coming storm. Gold in your hand is worth a lot more than a balance in a checking or savings account that you cannot touch because the bank is closed.

4) Commodity. When the prices of commodities in general are strong, gold tends to be strong with them. For example, over the past 35 years, an ounce of gold could purchase an average of 15 barrels of oil. Today, it will only purchase about 7 barrels. Just to match the average oil/gold ratio, the price of gold would have to rise to more than $900.

5) Savings. There are many parts of the world that simply do not have local banks or brokerages where people can save or invest. Tangible assets fill the void, with gold being one of the most popular forms because of its liquidity, compact size, and durability.

6) Currency Hedge. Currency values fluctuate. If the U.S. dollar continues to fall, do you necessarily want to hold Euros or yen? Gold is not subject to currency risk.

CPM Group has charted each of these six reasons as to whether they are positive reasons to own gold each year. What they have found is that years where at least four of these factors make gold an attractive purchase, the price of gold almost always rises significantly in the next year. The one exception occurred when five of six factors were positive in 1999, but the gold price was stagnant in 2000 because of the all investor liquidation after the Y2K scare fizzled out.

In 2002, five of six factors were positive; gold in 2003 averaged 17% higher than in 2002. In 2003, five and one-half factors were positive: gold averaged 12% higher in 2004.

In 2004, all six factors were positive for the first time since 1979. Gold this year is averaging more than 7% higher than 2004, with mostly higher prices expected over the remainder of this year.

Right now, five and one-half factors are positive. Expect gold to be significantly higher in 2006.

Investors are drawn to gold during times of uncertainty. There were plenty or worries even before Hurricane Katrina struck. Katrina could be the spark that causes a couple other problems (like inflation!) to blow up. It would take almost a complete successful resolution of every economic problem to keep the price of gold from rising sharply over the next two years. On the other side, there is little prospect for much of a drop from current levels as major buyers are comfortable that today's prices are bargains.

I do not think it is realistic that peace and prosperity will break out across the world soon. To protect yourself, I recommend that 2.5-10% of your net worth be held in the form of physical gold. Plan to hold onto it indefinitely, because the world will always have more worrying uncertainties.

U.S. Treasury Acknowledges It May Be Able To Limit Ownership Of Gold And Silver

Seven months ago, I shared the contents of a letter from the U.S. Treasury where the author acknowledged that the Treasury lacked any statutory authority to compel the private sector to turn in gold.

At the time I noted that if the government were fully intent on getting its hands on gold, there were almost certainly other provisions in the law that would make that possible.

In a letter dated August 12, 2005 to Chris Powell, an officer of the Gold Anti-Trust Action Committee, Inc (GATA),

(Continued on page 4)

(Continued from page 3)
Sean M. Thornton, the U.S. Treasury Chief Counsel for Foreign Assets Control acknowledged that the U.S. Code could allow the U.S. president to restrict "hoarding" of gold and silver during time of war.

This law originated from the Trading with the Enemy Act of 1917 and is now 12 United States Code Section 95a.

Thornton discussed at length that this provision does not come into effect until after Congress first makes a declaration of war, then the president issues an executive order. The scope of how far-reaching the "hoarding" may be restricted would be up to the president's discretion. Among the factors that the president would likely consider before taking such action "is the fact that the U.S. government now mints and issues gold and silver coins to meet public demand for both numismatic and investment purposes."

Thornton's letter also discusses the possibility that the president might also interfere with ownership of stock in gold and silver mining companies where some shares might be owned by foreign nationals or foreign governments whether or not they are at war with the United States.

The letter concludes by reassuring Powell that the government would consider the impact of any such orders on the domestic economy and well as on foreign policy purposes.

Copies of this letter may be downloaded or printed from the GATA website (www.gata.org).

Rare Coins Strong

During August, LCS purchased a number of big-ticket coin collections, including the first coin for which we paid a six-figure amount. Although some parts of the market are soft right now, generally in areas we had warned you to avoid, the overall rare coin market is definitely strong.

As collectors and dealers learned that we had fresh inventory, they descended on our store ready to buy. Our rare coin sales in August were perhaps the highest of any month in more than 25 years!

Gold and Gold Coins

Gold closed today at $444.75, up $13.25 (1.8%) from five weeks ago.

The strength of the gold market, even with the Fed interest hike four weeks ago, is a sign that gold may finally building enough of a base to top $450 to stay. In the past month we have enjoyed a sharp increase in gold trading, both buying and selling.

From a World Gold Council news release today, physical gold demand in the first half of 2005 was 21% higher than the first half of 2004 by weight, and 29% higher by dollar value. The second quarter of 2005 was the sixth consecutive quarter of demand exceeding the year earlier period. Jewelry, industrial, and investor demand are all higher. Second quarter 2005 demand in India set an all-time record for any quarter!

The Month

Gold Range	$15.00	3.4%
Net Change	+8.00	
Silver Range	.59	8.1%
Net Change	-.23	
Gold/Silver Ratio		63.1
Net change		+3.1
Platinum Range	36.00	4.0%
Net Change	-5.00	
Platinum/Gold Ratio		2.03

Date	Gold	Silver	Platinum
Aug 03	436.75	7.28	910.00
Aug 04	437.75	7.23	903.00
Aug 05	437.00	7.13	903.00
Aug 08	434.75	7.00	899.00
Aug 09	434.75	7.01	906.00
Aug 10	436.50	7.06	905.00
Aug 11	445.50	7.17	918.00
Aug 12	446.00	7.08	921.00
Aug 15	442.00	6.95	899.00
Aug 16	446.00	7.02	887.00
Aug 17	440.00	6.98	885.00
Aug 18	439.50	6.99	888.00
Aug 19	437.00	7.00	885.00
Aug 22	438.00	7.05	889.00
Aug 23	439.00	6.96	893.00
Aug 24	437.00	6.92	895.00
Aug 25	438.00	6.84	893.00
Aug 26	437.25	6.74	893.00
Aug 29	437.00	6.73	901.00
Aug 30	431.00	6.69	885.00
Aug 31	433.75	6.78	890.00
Sep 01	442.00	6.96	899.00
Sep 02	444.00	7.00	907.00
Sep 05	closed		
Sep 06	444.00	7.03	907.00
Sep 07	444.75	7.05	905.00

London Silver Market Premium To New York Silver Market = 3¢

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

The low-premium best buys continue to be the Austria **100 Corona** (3.5%), South Africa **Krugerrand** (3.7%), and U.S. **American Arts Medallion** (3.7%). I prefer them to the U.S. **American Eagle** (5.5%) and Canada **Maple Leaf** (4.9%) even though both of these coins are now available at lower premiums. Among smaller coins, the **British** Sovereign (7.7%) is a low-cost choice.

Common-Date U.S. Gold Coins averaged a bit lower this month, despite higher gold prices. **Better-Date U.S. Gold Coins** are still flying out of our inventory, at sometimes eye-popping high prices.

From a West Coast Dealer, we acquired the nicest group of **Early Date Canada Gold Rarities.** Several of these coins are among finest surviving specimens of their dates. See our offer for details.

Silver and Silver Coins

Silver ended up today at $7.05, a drop of 23 cents (3.2%) from lat month.

Very little silver has been liquidated over the past month, while physical demand has soared. As a result, premiums have increased among all forms that sell close to bullion value.

The best buy remains the U.S. **90% Silver Coin** (4.2%). It has the lowest cost per ounce of silver content, the greatest divisibility, and is also the most liquid. The **100, 10, and 1 Oz Ingots** (6.7-7.8%) have an advantage of occupying slightly less space.

Common Mint State Morgan and Peace Silver Dollars keep getting stronger, while the Carson City Mint and other Morgans like the 1895-O issues that had led the pack are now languishing.

A Michigan dealer recently sold us the largest group of **Mint State Pre1967 Canada Silver Dollars** that we have seen in some time. We took advantage of the temporary dip in the silver price a couple weeks ago to squeeze the lowest possible price, and pass the savings on to you.

Liberty's Outlook is published monthly by Liberty Coin Service, 300 Frandor Ave., Lansing, MI 48912. Telephone: National 800/527-2375 Fax: 517/351-3466 Website: www.libertycoinservice.com, E-mail: path@libertycoinservice.com Patrick A. Heller, Editor. Subscriptions are available at $79.00 per year (12 issues). Send subscription orders and changes of address to the above address. All information is derived from sources believed to be reliable, but accuracy cannot be guaranteed. No guarantee of profitability of any investment or recommendation contained herein is made or implied. Liberty Coin Service has been a dealer in rare coins and precious metals since 1971. The publisher, its principals and associates may, from time to time, have a position in items recommended here.