



# CENTRAL GOLD-TRUST

## Sprott Asset Management's Fundamental Reasons to Own Gold

BY: JOHN EMBRY, PRESIDENT OF SPROTT ASSET MANAGEMENT INC., MAY 23, 2003

### **1. Existence of a huge and growing gap between mine supply and traditional demand**

Gold mine supply is roughly 2500 tonnes per annum and traditional demand (jewellery, industrial users, etc.) has exceeded this by a considerable margin for a number of years. Some of this gap has been filled by recycled scrap but central bank gold has been the primary source of above-ground supply.

### **2. Mine supply is anticipated to decline in the next three to four years**

Even if traditional demand continues to erode due to ongoing worldwide economic weakness, the supply-demand imbalance is expected to persist due to a decline in mine supply. Mine supply will contract in the next several years, irrespective of gold prices, due to a dearth of exploration in the post Bre-X era, a shift away from high grading which was necessary for survival in the sub-economic gold price environment of the past five years and the natural exhaustion of existing mines.

### **3. Large short positions**

To fill the gap between mine supply and demand, central bank gold has been mobilized primarily through the leasing mechanism, which facilitated producer hedging and financial speculation. Strong evidence suggests that between 10,000 and 16,000 tonnes (30-50% of all central bank gold) is currently in the market. This is owed to the Central Banks by the bullion banks, which are the counter parties in the transactions.

### **4. Low interest rates discourage hedging**

Interest rates are low and falling. With low rates, there isn't sufficient contango to create higher prices in the out years. Thus there is little incentive to hedge and gold producers are not only not hedging, they are reducing their existing hedge positions, thus removing gold from the market.

### **5. Rising gold prices and low interest rates discourage financial speculation on the short side**

When gold prices were continuously falling and financial speculators could access Central Bank gold at a minimal leasing rate (0.5 - 1% per annum), sell it and reinvest the proceeds in a high yielding bond or Treasury bill, the trade was viewed as a lay-up. Everyone did it and now there are numerous stale short positions. However, these trades now make no sense with a rising gold price and declining interest rates.

### **6. The central banks are nearing an inflection point when they will be reluctant to provide more gold to the market**

The Central Banks have supplied too much already via the leasing mechanism. In addition, Far Eastern Central Banks which are accumulating enormous quantities of US Dollars are rumored to be buyers of gold to diversify away from the US Dollar.

### **7. Investment demand for gold is accelerating**

People seeking an alternative to paper currencies and financial assets motivate investment demand for gold. Products like Central Gold-Trust are being designed to more easily facilitate this demand.

### **8. Negative real interest rates in reserve currency (US Dollar)**

There has been a very strong historical relationship between negative real interest rates and stronger gold prices. Negative real short interest rates seem to be a fact of life for some time in the US.

### **9. Dramatic increases in money supply in the US**

US authorities are terrified about the prospects for deflation and are on record saying that they will print whatever amount of money is required to forestall it. This represents classic monetary debasement, the perfect situation for gold.

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## 10. Staggering current account – budget deficits in the US

The deterioration of the financial situation in the US is alarming. In the space of 2 years, the federal government budget surplus has been transformed into a yawning deficit, which is expected to exist for years. At the same time, the current account deficit has reached levels, which has portended currency collapse in virtually every other instance in history.

## 11. A weak US dollar is very good for gold

There has been a very strong inverse relationship between the price of gold and the value of the US Dollar. With the dollar looking weak and vulnerable, the gold price is expected to be a major beneficiary.

## 12. Gold is increasing in popularity

Gold is seen in a much more positive light in countries beginning to come to the forefront on the world scene. Prominent developing countries such as China, India and Russia have been accumulating gold. In fact, China with its 1.3 billion people recently established a National Gold Exchange and relaxed control over the asset. Demand for gold in China is expected to rise sharply and could reach 500 tonnes in the next few years.

## 13. Gold as money is gaining credence

Islamic nations are investigating a currency backed by gold (the Gold Dinar), the new President of Argentina proposed, during his campaign, a gold backed peso as an antidote for the financial catastrophe which his country has experienced and Russia is talking about a fully convertible currency with gold backing.

## 14. Limited size of the total gold market provides tremendous leverage

All physical gold in existence is worth somewhat more than \$1 trillion US Dollars while the world's shares of gold mining companies are worth less than \$60 billion US Dollars. When the fundamentals ultimately encourage a strong flow of capital towards gold, the trillions upon trillions worth of paper money could propel gold and gold shares to unfathomably high levels.

## Conclusion

Gold is under-valued, under-owned and under-appreciated. It is most assuredly not well understood by most investors. At the beginning of the 1970's when gold was about to undertake its historic move from \$35 per oz to \$800 per oz in the succeeding ten years, the same observations would have been valid. The only difference this time is that the fundamentals for gold are actually better.

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“Focus on commodity-oriented cyclical and special situation stocks, says Eric Sprott...  
stocks are better than bonds and gold is better than both, he says.”

ERIC SPROTT, CEO OF SPROTT ASSET MANAGEMENT INC.  
*FINANCIAL POST*, OCTOBER 23, 1999

“...bullion will benefit from the continuing economic and financial fallout from ‘maniacal’ stock market.”

ERIC SPROTT, CEO OF SPROTT ASSET MANAGEMENT INC.  
*NATIONAL POST*, MAY 5, 2001

“I think precious metal prices are just about to have a very large move.”

ERIC SPROTT, CEO OF SPROTT ASSET MANAGEMENT INC.  
*GLOBE AND MAIL*, JANUARY 17, 2002

“I have no difficulty imagining gold getting between \$500 and \$1,000 (US) an ounce in two to four years.”

ERIC SPROTT, CEO OF SPROTT ASSET MANAGEMENT INC.  
*GLOBE AND MAIL*, MAY 25, 2002



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