

FUNDAMENTAL VIEW ON METAL MARKETS - Part VI



“SILVER JOINS GOLD AS A CURRENCY NOW THAT GOLD PRICES BECOME MORE COSTLY”

A new gold backed currency will be measured in fractions of a gram/\$100.00 (US)

by Larry W. Reaugh

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As we begin 2011 gold is having another dramatic correction, followed by silver. This is a short term correction as the dollar strengthens and the gold price drops, the next move will see it trading at \$1450/oz. with silver at \$35/oz. It has been 25 months since I published my first issue of “Fundamental View on Metal Markets” - December 9, 2008, since that time (as predicted) we have seen a dramatic upswing in the consumption and price of metal commodities. At year end copper had broken its all time high traded at \$4.42/lb. from \$1.36/lb. in December of 2008. A new high of \$6.00/lb. in the next 24 months is a real possibility. Silver which has traded at a disconnect with gold for several years has regained its status as a precious metal and ended the year at \$31.50/oz. Other metals traded well above their 2008 lows. Gold traded at \$1420/oz. and is the leader here, closely followed by copper. Gold is the longest lasting currency in the world with a 5000 year history. Governments cannot create gold like they can other currencies from paper or linen. One only has to look back at the prolific increase in the supply of paper currency world wide to ask ‘when the value of such currencies does collapse, what will the new currency be?’ Obviously gold, but trading and purchasing of goods and services on a world scale makes it impractical to be used as a means of exchange.

Once again governments will issue new currencies directly backed by gold as was the case of the United States in 1932 or indirectly as evidenced by the bullion holdings of central banks world wide. Those central banks have liquidated their bullion holdings over the past 15 years. This doesn’t make sense does it? We all know where the gold sales came from, central banks, bullion banks lending gold to producing gold mines (over 100 million ounces) at ridiculously low interest rates and the mining companies selling the gold forward to invest in bonds at 6%, thereby acting like investment banks while keeping gold prices low. As I said, we all know who the sellers were, but who knows who bought all this gold? Certainly we know countries like China, India, and Russia are increasing their gold holdings but were not doing so when all that gold was being sold at or near the cost of production from 1996 to 2002.

Very smart investors hold that gold and when the free-world is forced to issue a new currency the smart-money will control the new gold backed currencies. Where does that leave the gold price?

In 1932 gold was pegged at \$32.00/oz. Every U.S. dollar was backed by gold. Populations have exploded since then with consumables multiplying in the thousands. I believe a new currency will be backed in the ratio of less than a gram for each \$100 bill printed. The future price of gold will not be \$1000/oz., \$2000/oz. or \$3000/oz. but somewhere north of \$4000/oz.

The dynamics are totally different now. The economies of the Western World survive by the printing of new money and the supply of cheap but durable goods from China. That is why we are not in hyper-inflation. Over the past 15 years, items we purchased in the 80’s have reduced in price by 20% to 70% thanks to cheap imports. This can not continue but bodes well for all the precious metals. For safety buy the precious metals, for speculative gains buy the shares in precious and base metal companies, the greater the risk the greater the potential gains.

In my earlier letters I reported on several mine shut downs, most of those are back into production today. Companies that were loaded with debt and on the brink are now stellar performers. The markets went down rapidly and also increased rapidly over a short period of time. This is the nature of bull markets and is definitely the nature of *this* 30+ year bull. It is interesting that several deposits either shut down or were scheduled for shut down are now producing more ore than previously. As the price of the metals continues to rise the size of ore bodies keep expanding. Virtually all deposits that were uneconomic several years ago are now healthy producers, lowering cut-offs and increasing throughput has morphed seemingly depleted resources into ore grade in the 100’s of million of tons. This is true for precious, base and specialty metals. The best place to find new resources is to explore near shut down mines.

The increased price of various commodities has increased the resources available for exploitation. This simple phenomenon has to be addressed when looking at the fundamentals of supply and demand. Tired brownfield projects have gained a new lease on life and in some cases companies are expanding their production facilities to maintain or increase their levels of production. This does not mitigate the need for new resources as eventually the lower grade material will be depleted as well. This is the era for low grade deposits whether it is precious, base or specialty metals.

All metal prices will continue to head north, especially benefitting low grade deposits. Technology and mining methods beginning in the 1950’s has enabled us to mine low grade deposits, specifically in gold and copper. The high prices of metals has expanded operations to exploit lower grade material; compounding the return on lower grade deposits only maintains the production side of the equation, new resources will have to come on line to meet the emerging BRIC (Brazil, Russia, India, China) countries demand for metals.

As the year 2010 came to an end metal commodity markets moved up dramatically heralding in the best year yet in 2011. The caution here is there will be corrections through-out 2011, some mild, others severe, for a short time. The good news is prices will continue to climb for years to come. Prices are now

over or near historical highs in precious and base metals with a ways to go for specialty metals as follows:

Commodity	⁽¹⁾ Peak Prices Prior to Nov/08	Nov/08 Prices	Dec 31/10 Prices
Gold	\$1,025/oz	\$750.00/oz	\$1,422.00/oz
Silver	\$21.00/oz	\$9.00/oz	\$31.50/oz
Copper *	\$4.05/lb	\$1.36/lb	\$4.42/lb
Aluminum *	\$1.45/lb	\$0.65/lb	\$1.10/lb
Nickel *	\$23.30/lb	\$3.95/lb	\$11.29/lb
Zinc *	\$2.05/lb	\$0.47/lb	\$1.10/lb
Lead *	\$1.75/lb	\$0.41/lb	\$1.16/lb
Molybdenum	\$39.00/lb	\$8.75/lb	\$16.00/lb
Manganese Metal	\$2.85/lb	\$1.05/lb	\$1.52/lb
Cobalt	\$49.75/lb	\$16.00/lb	\$19.50/lb
Magnesium	\$2.70/lb	\$1.51/lb	\$1.44/lb
Oil	\$145.00/barrel	\$41.00/barrel	\$91.40/barrel

⁽¹⁾ Denotes this super cycle

* LME stock piles have increased significantly with the exception of copper (which has dropped 40%) and aluminum since November, 2008.

As is the case with rare earths, China controls the production of some of the specialty metals such as Electrolytic Manganese (97.5%), Vanadium (37%), Magnesium (85%) and Tungsten (81%) to name a few. Quotas have once more been put on rare earths by China and the policy to control molybdenum production in China morphs them from a net exporter to a net importer, this should start driving the moly price upwards.

Chinese producers of electrolytic manganese (EMM) are currently establishing ventures offshore to facilitate the production of EMM. This is the result of scarce resources of carbonate ore within the country which has allowed China to produce it at a cost of about \$1.00/lb. before 20% export duties.

What we have to be concerned with is that China is the largest producer of rare earths, EMM and a large percentage of the specialty metals, and is also the largest consumer. It's not that China wants to cut exports, as their own industry becomes more technically advanced they require more and more of their own production. Remember that they are the largest producer as well as the largest consumer. It is time the mining industry and governments became pro-active and not reactive to looming shortages or the free world will be stymied by the lack of material such as rare earths and specialty metals currently controlled by China.

The BRIC countries are the new emerging economies, with China's gross domestic product (GDP) rising 1506% and India GDP 455% since 1980. The U.S. and Europe's GDP has grown 110% and 75%. Since the last super cycle in metals beginning around 1950 world populations have exploded from 2.3 billion to a current 7 billion people with less developed countries accounting for the majority of that growth.

The BRIC countries account for almost 3 billion of the new population which is driving the new "Super Duper Bull Market" we see in all commodities today. During the last Super bull the countries driving it primarily the U.S., Europe and Japan, populations were about 20% of the existing population in today's bull market.

The U.S. still has the strongest GDP in the world but is a long way from the time it consumed over 70% of all world production.

When we look at how the world scales have tipped, the metal demand only becomes stronger each year. Existing resources will not be able to keep up with demand from BRIC Countries especially China and now India is beginning to have an impact on metal consumption.

As we move into 2011 precious, base and specialty metals will continue to strengthen as demand becomes relentless. Gold, silver and copper have broken their previous highs in this bull with aluminum, nickel, zinc, lead, molybdenum, manganese, magnesium and cobalt having a ways to go before reaching and surpassing their previous highs.

As in the case with silver which traded at a disconnect from gold until the past three months junior metal stocks with good assets are being viewed positively for the first time since 2007.

Gold and metal companies either in production or having large resources are becoming expensive for investors. A lot of juniors have smaller resources and trade like green field exploration plays. These companies have not had any appreciation for their assets and over the past few weeks the market has reached down and begun to accumulate these companies. The same holds true for those companies having resources in the specialty metal sectors.

Bull markets are notorious for vicious swings on the upside and downside, but I do not see a major correction in metals in the next 4-5 months and view 2013 and 2014 as being the years in which we may see a corrections of any size. For the long term we still have at least 20-25 years of this metal bull.

To my readers I wish you a Happy and Prosperous New Year. From time to time, I'll be updating this article, and if you'd like to receive those updates, please send an email to: lwreaugh@goldrea.com.

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