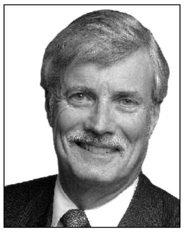
Manipulation of gold's price obvious when it falls in stunningly bullish situation

By John Embry



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The gold market continues to perplex observers who do not understand the extent of intervention in the market by those with an agenda that has nothing to do with maximizing returns. As a prime example in mid-July, the yellow metal experienced a plunge which took it from over US$660 an ounce to nearly US$600 in barely more than a week. Those who believe that gold is a free market cited corrective action, following a US$100 rise from the June lows. Why this doesn't wash is that it occurred in the face of stunningly bullish fundamental developments for gold on the geopolitical and financial fronts.

Ultimate safe haven

Geopolitically, the worst conflagration in the Middle East in many years was unfolding as Israel bombed and invaded Lebanon in response to provocation by Hezbollah. Superimposing this development on the continued deterioration in Iraq, the nuclear controversy in Iran, and the strife in Gaza, made a sharp downward move in gold appear extremely counterintuitive. I believe, gold is the ultimate safe haven, not something that should fall almost 10 per cent in what is turning out to be a much more dangerous and chaotic world.

Making things even more bizarre was the fact the decline occurred in the wake of Federal Reserve Chairman Ben Bernanke's semi-annual comments to Congress in which he essentially backtracked on his resolve to bring inflation to its knees. Instead, he suggested the economy was showing signs of deceleration that would result in less inflationary pressure.

The market immediately deduced that this would lead to a pause or a total cessation in interest rate hikes in the U.S. Such a development would be decidedly unfriendly for the U.S. dollar whose continued levitation has depended on the perception of widening interest-rate spreads in favor of the buck.

In a normal market, gold would have rocketed higher, not slumped dramatically. In reality, this all coincided with Henry Paulson's official installation as U.S. Treasury Secretary, and it was suggested in some quarters that he wanted to show the gold market who is in charge.

In addition, the powers-that-be want to discourage the notion that gold is the go-to asset in times of strife, so price rises have to be aggressively resisted at such times. Thus, the irrational correction ensued, but with insufficient physical supply available to sustain the weakness, gold rallied smartly into August and quickly regained lost ground.

On the subject of insufficient physical gold availability, there is an interesting situation unfolding with the European Central Banks Gold Sales Agreement (formerly known as the Washington Agreement). Under the terms of this arrangement, European central banks are limited to a maximum sale of 500 tonnes per annum between 2004 and 2009, with no carryover if the limit isn't reached in a given year. As I write, there are less than eight weeks left to achieve the quota in the 2006 fiscal year, which ends Sept. 26, and total sales are slightly over 70 per cent of the permitted maximum.

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This leads to one of two conclusions: either the central banks are losing their appetite for selling a very undervalued asset or they have been holding gold in reserve to bombard the market at the appropriate time.

Given the strength in the gold market to date, one would have thought they would have struck by now, so perhaps the first reason is more plausible. Time will tell, but if they don't meet the quota, it is extremely bullish for gold because it would highlight the growing inability of central banks to fill the yawning gap between expanding demand and falling mine supply.

Switching topics, I don't think investors should underestimate the potential impact of stagflation on the gold market. Stagflation describes the economic state of little or no growth combined with intensifying inflationary pressure.

There are strong indications that the U.S. is entering just such a period. With the consumer appearing tapped out and the housing and auto markets in disarray, a sharp slowdown or actual recession is on the horizon.

However, inflation is alive and well, driven by exploding credit creation, which has to be sustained to avert deflation, rocketing commodity prices (the most important of which is energy that impacts so many aspects of the economy) and the inevitability of a sharp decline in the U.S. dollar that will lead to imported inflation.

Stagflation was the economic backdrop during the decade of the 70s, the last great period for precious metals, and appears to be raising its ugly head once again. It essentially creates a conundrum for the central bank as to which evil to combat, a weakening economy or rising inflation.

This time I think the Fed will be forced to focus on saving the economy, given its inability to withstand serious monetary tightening because of excessive debt leverage. Stagflation, historically, has been good for gold but this time it could be extremely good, given the Fed's limited options.

This has not stopped the usual suspects from denigrating gold. The Economist, an estimable publication on most other topics, published an article recently that was essentially laudatory in describing the prospects for a number of other commodities. However, it lumped gold in with other more "mundane metals," which were not attractive, stating that gold is "valued not for its scarcity" and that it "is dearer than it has been for decades yet jewellers and industrialists would need years to use all the world's stock." This is the same observation that the establishment press has been communicating for years and the facts contradict it.

Jeffrey Christian, head of the metal consultants, CPM Group, who was once with the Goldman Sachs subsidiary J. Aron, generally comes at gold with a negative slant and, in December of last year, was projecting an average price of US$479 in 2006. He now acknowledges that gold could move higher but it is, nonetheless, overvalued and should average US$500 in the long term.

In my opinion, if you examine the fundamentals (the dramatic increase in mining costs, the huge existing supply-demand gap, the shrinking central-bank reserves, the unfolding worldwide credit explosion and concurrent currency debasement, gold's undervaluation in comparison to oil, and the intractable geopolitical problems), it is highly unlikely that gold will ever trade at US$500 per ounce, let alone average US$500 over any significant future period of time

With respect to gold shares, they have started to come to life but volumes remain relatively small, reflecting both the summer doldrums and a lack of conviction. However, the market is currently paying for drilling success and, in a rising gold-price environment later this year, I suspect speculative fervor will spread more widely in the sector.

Minefinders Corp. (MFL-TSX, $9.25, 604-687-6263, *www.minefinders.com*) has just announced a new fully engineered pit plan that incorporates nearly 2.5 million ounces of gold and 127 million ounces of silver at its Dolores deposit in Mexico. This appears to be a robust project with a 15-year mine life, but what particularly intrigues me is the silver leverage, which the market may not yet fully appreciate. My views on silver have not changed and I think it is a more explosive picture than ever. Minefinders could be a major beneficiary of higher silver prices.

John Embry is chief investment strategist at Sprott Asset Management. Sprott funds may hold above-noted securities. For Sprott fund holdings , see www.sprott.com.