NEW, IMPROVED CONFUSION ON GOLD & SILVER

"The major monetary metal in history is silver, not gold."
*-- **Milton Friedman***

In his Feb. 2, 2006 lewrockwell.com article, http://www.lewrockwell.com/north/north436.html, "Buy Silver Or Gold?" Dr. Gary North answers, Don't buy silver – or at least, don't buy much. With all due respect to Dr. North, his article was filled with rather large factual errors that lead to wrong conclusions.

Fact is, over the life of the present precious metals bull market silver promises a much greater return than gold, say, 400%. What's more, unless your investment strategy is "dipped in cement," you will shun Dr. North's idea of "core holdings." Rather, you will pile up as many ounces as you can by swapping back and forth from gold to silver as often as you can.

IT HAPPENED WHEN?

Dr. North writes,"In June, 1963**,** the government passed legislation severing the legal connection between silver certificates and silver." This is an error. That legislation was not passed until June, 1967, allowing a year for holders to redeem circulating certificates in silver.

On the other hand, the shortage of silver coin was by 1963 already becoming obvious, thanks to the rise of coin-operated vending machines and the government's longstanding policy of selling silver at below-market prices.

Throughout the Fifties the federal government *created* high silver demand by selling silver at a below market price, 90 cents. It was, by the way, also below the *statutory* $1.2929 price. The government began that period with history's largest silver hoard, over three billion ounces accumulated between 1933 and 1963, and over 2 billion left in 1959,). Roosevelt's silver market manipulations had accumulated most of this. His ill-conceived and worse-executed scheme to raise the silver price wreaked havoc on the world market and finally forced China off the silver standard and into the Depression with the rest of the world. After World War II the government began feeding the huge silver hoard to silver users as a long term subsidy.

DEMONETIZATION

Dr. North contends that silver was demonetized in 1963, but in fact that happened nearly 100 years earlier, in 1***8***73. Otherwise, the tricks the government pulled in 1963 would never have been possible.

By 1934 both silver and gold were in a similar state of "demonetization." Governments had officially stopped using them as money, but the world – those troublesome individual human beings – still regarded them as money, as they do today. This regard waxes and wanes directly with public confidence in central bank *fiat* money. True, central banks still hold gold as "reserves," but in the same way housewives hold a toilet brush – reluctantly and at long arm's length.

Given the history of *fiat* money, and its performance in this century, it is hard for rational people not to conclude that *fiat* money is nearing the end of its spectacularly pernicious run. If it collapses altogether, then the dollar will disappear, and the elitists who run the US and its money supply will return to silver and gold – but only after their *fiat* money has impoverished the rest of us.

WHEN DID SILVER BOTTOM?

Dr. North also writes, "[Silver] then fell for the next 23 years**, bottoming at $4. 67 in January, 2003.**" My bewilderment disables me from guessing how Dr. North arrived at this price and date for silver's "bottom."

During the 1990s silver made a very long bowl-shaped bottom, a very reliable bottoming pattern. On 22 February 1991 silver hit its low, $3.59, and on 1 March 1993 posted a double bottom at 3.60. On 27 November 2001 it made one last visit back toward that level, closing at 4.065 (all are closing prices).

Why Dr. North chose January 2003 and $4.67 as the "bottom" utterly mystifies me. The low close for January 2003 came at 4.765 on 14 January. From a technical standpoint the bottom came on 27 November 2001 at 4.065.

A FAILED INVESTMENT?

Dr. North writes, "Gold is perceived as a money metal that is used by central banks. It is used by Asians as an inflation hedge. Silver has lost that perceived value. So, silver is more volatile. There was nothing to prevent its fall after 1980."

So silver is dead as an inflation hedge? Among Asians? Maybe Dr. North ought to inform those millions of Indian farmers who still store most of their wealth in silver.

On Dr. North's statement hangs all our investment strategy. If it is *true* that the world has turned it back on silver as an inflation hedge – or, better stated, as "money" – then we ought to shun silver for gold. But if this statement is *false*, we ought to buy *both* and form a bimetallic strategy that leverages both metals' strengths in our favor. (Remember that I call "monetary demand" demand for silver as silver, which some call "investment demand.")

Besides, Dr. North's statement is also false *historically.* Look at silver's history from 1873 to 1980. Once U.S. demonetized silver in 1873, followed closely by Germany, then huge monetary demand was removed from silver and its price entered a long decline. The gold/silver ratio (the number of ounces of silver required to buy one ounce of gold) *rose* (remember, silver is becoming *cheaper* against gold, so it takes more silver ounces to buy a gold ounce). By 1914 it had climbed from 16:1 to 41.19:1. During World War I Indian monetary demand kicked in, dragging the ratio down to 15.49 in 1919. From there silver entered a long decline (monetary demand was shrinking) until the ratio peaked at 100:1 in 1941.

After a long period of government-fixed prices, monetary demand revved up again in the early 1960s. Even Dr. North himself confesses that he was driven by monetary demand for silver in 1963.

Which brings us to the one key necessary to understanding silver and gold: ***It is not industrial but monetary demand that drives the price of silver and gold crazy.*** Once you understand that, you'll stop worrying about the silly yearly supply demand surveys.

According to Dr. North "There was nothing to prevent [silver's] fall after 1980." ***Of course not.*** Fed chairman Iron Paul Volcker screwed interest rates up to 25% trying to suck monetary demand away from metals, so silver's price fell. Does that surprise anyone? Matter of fact, gold's price fell, too, from the same cause. From its 1980 peak to its 1991 bear market low, silver lost 93%. From gold's 1980 peak at $850 to its bear market low of 253.70 in August 1999, gold lost 70%. Since bear markets generally lose 50% to 95% of their foregoing bull market peak, both these are merely normal performances.

IS THE SUPPLY GAP ARGUMENT FALSE, TOO?

Dr. North writes, "For almost the entire 23 years of its price decline, there were bullish silver brokers who kept talking about the huge gap between low silver production and high silver consumption. Here is my question: If that argument led to losses for 23 years, why should anyone believe the same argument today? There was a negative correlation for most of those 23 years between that argument and the price of silver."

Zoot alors! Again, this is very strange. Dr. North has the period all wrong. Nobody has been claiming a supply shortfall for 23 years (1980-2003?), but only since 1989. The years before 1989 were *surplus* years when more silver came to market than fabrication consumed.

At least, they showed that way in "official figures" until the "officials" changed the figures. Truth to tell, there aren't any "official" figures, only figures from Gold Fields Mineral Services (GFMS) and CPM. Until 1995, when GFMS took over, CPM Group compiled the yearly *World Silver Survey* for the Silver Institute. Contrary to Dr. North's implication, the numbers for the entire series of years change *very* much from yearly survey to yearly survey, enough lately to render them ridiculous and just about worthless. By the very nature of that survey, the "figures" can never be more than sophisticated guesses, interpolations, and inferences. And in all fairness, the world silver market is far too vast and diverse for anyone to track each & every transaction.

So *all* the figures available for silver supply and usage are very *un*official. Fixing those numbers is like shooting skeet off the back of a bass boat in a thunderstorm. What makes the figures even more baffling is that GFMS revises them *all* every year.

Roughly, here's what has been happening with silver supply and demand. About 1989 supply began to fall short of fabrication demand, resulting in a "structural deficit" (fabrication demand greater than mine supply and recycled scrap). That shortfall has persisted ever since. Depending on which yearly survey's figures you take, the shortfall averaged 100 million ounces (moz) per year for a total of 1,515 moz 1989 – 2004. The shortfall has ranged from 1.9% of silver used in fabrication (1989) to 20.2% (1994), or about 12% of yearly fabrication demand. (Using the 2004 figures, which GFMS jimmied and jived considerably from the 2003 figures.)

These shortfall figures may jump and vary, but the inference remains that about 1.5 *billion* ounces of silver was burned up from 1989 through 2004.

How then (Dr. North asks indignantly) could silver's price remain so low in face of that demand pressure? *Simple.* About one billion ounces *excess* to demand had come to market from 1980 through 1989. That excess had to be worked off before the price could rise. Now that has happened. One billion ounces excess less one and a half billion ounces shortfall leaves half a billion ounces shortfall – *more or less.*

Two observations are needed here. Dr. North may not see any plausible explanation for silver's long price lethargy while facing such a shortfall, but in fact traders know that commodity shortfalls can persist for long periods without price adjustments. Oh, the price always adjusts *eventually,* but not with mechanically predictable precision. It's a market, and markets are made of humans, and humans are mysterious. Besides, we can never exhaustively know all the factors in any market.

Second, *commodity demand does not drive the prices of gold and silver.* Write this in your book, *yea*, grave it upon your walls.

Both silver and gold are "industrial metals" in the sense that both have some uses that are not monetary. But industrial demand and supply change only *slowly* over time. The price of gold won't shoot up 25% in one year because gold jewelry suddenly becomes fashionable and women begin buying more necklaces. Rather, the real price mover for both metals is *monetary demand* that hits at the margin and changes suddenly and massively when confidence in *fiat* money wanes. Think of the way crowds move, swayed by fashions, rumors, and panics. The same humanity is what *really* moves silver and gold.

GOLD LEASING & THE CARRY TRADE

In the last 10 years or so gold's price has been most strongly influenced by the "gold carry trade." Through private bullion bank acting as middlemen, central banks have loaned gold at ridiculous rates, 1.5% and lower. Borrowers could borrow gold, sell it into the market, and invest the proceeds in risk-free government bonds paying 5% or more. *Back up the truck: free money!* And if this gold "carry trade" suppressed gold's price, well, the central bankers weren't crying, since they needed to do that to hide their inflation anyway.

And although Dr. North seems unaware of it, at hands of the same bullion banks a *silver* carry trade has also flourished, only more so. *If* central banks actually hold all the gold they claim (32,000 metric tonnes) and roughly 800 moz of silver exists in Comex, Tocom, and European dealer stocks, then we can estimate that for every ounce of gold there is one ounce of silver. Plainly, there's not nearly as much silver as everybody thinks, and it is steadily being consumed.

"No central bank holds silver," says Dr. North. Right, and that's one of the greatest arguments in silver's *favor*, since it makes it harder for central banks to manipulate silver.

"Finally, if the bullion banks are ever asked to repay the gold, the gold bullion market faces a day of reckoning: massive buying by shorts (bullion banks) or else the widespread awareness that central banks do not have as much gold to sell off to keep down its price. Both events would drive up the price of gold. There is no comparable upward pressure for silver."

Dr. North errs. There has been a massive silver carry trade. The massive short covering rally that will hit gold thanks to the carry trade will hit silver just as hard, or harder. Only since silver is a smaller, thinner market, the short covering panic will drive silver's price farther and faster.

THE GOLD/SILVER RATIO:
PHANTASMAL OR FAITHFUL?

"There was a close correlation [between silver and gold] for many decades: 15 to one. That was because this ratio was set by Federal law. It was a price control. Gresham's law always took over. "

Dr. North has it upside down. It has been *centuries*, not decades. Before the 20th century, governments were setting a price by chasing the market. But let me start at the beginning.

Since memory runneth not to the contrary and as history records, there has always been a system of bimetallism using both metals as money. Bimetallism enables both metals to be valued by an independent yardstick: the other metal.

In early Egyptian times (3200 BC) it took as little as 2.5 ounces of silver to buy an ounce of gold, or as much as 10 ounces (1,000 B.C.). Until New World silver supplies began pouring out after 1492, the ratio ranged from 7.5:1 to 12:1. In 1497 the Spanish mint ratio was fixed at 13-1/3:1. By 1641 it had climbed to 14:1, then 16:1 in 1690. By 1785 it was 15:1 in France, 15.5 in Great Britain, and 16:1 in Spain.

With deliberate purpose in 1792 the newly formed US government set its gold silver ratio at 15:1 *lower than the world market*, to draw silver into the country. The lawmakers viewed silver as the more useful of the two metals, since it was the metal mostly used in domestic trade, while gold was used chiefly in international trade. The first US congress by the Coinage Act set the ratio at 15:1.

But rather than skewer themselves on a fixed price scheme, they set up a *symmetallic* system where silver was the country's official money, with supplementary gold coins *valued in silver.* From time to time the gold coins' size could be raised or lowered according to changes in the world market ratio, while the silver coin remained unchanged. (This was actually done in 1834, without cheating a single person, but that's another story.)

Plainly, from 1500 to 1873, government "price fixing" kept on chasing rather than setting the market. Adding New World silver to world supply raised the ratio (lowered the silver value against gold) nearer to the natural occurrence ratio. (In the earth's crust is found about 17 times as much silver as gold.)

Any ratio movements from 1941 through 1963 are virtually meaningless since government fixed the gold price and the US government was selling silver out of history's biggest stockpile. Only after gold's price began to move in the London market and the US silver market re-opened in 1963 (Roosevelt had suppressed it in 1934) does the ratio begin to resemble a market-determined price.

Then we find that in a bull market the ratio sinks toward 16:1 and lower (14.59 in 1967). *Hey, wait* -- we already knew that from the World War I rally. That also took the ratio below 16:1 in 1919. In the 1980 bull market blow-off the ratio sank again beneath 16:1.

So how can we understand Dr. North's categorical assertion, "[T]he gold/silver ratio as a forecasting tool produced only losses, 1980 to 2003."

Could any statement fly more squarely in the face of the facts? I know of no single market forecasting tool (other than the equally reliable Dow Jones Industrial Average measured in gold dollars) that more accurately forecasts the primary trend. Without the ratio dropping, there is no bull market in metals; without the ratio rising, no bear market. *Period*. Like every other market or indicator, the ratio zigs and zags, and on any particular day in a 20 year bull market, the ratio might drop. Its long term trend, however, will solidly follow -- indeed, point out -- the metals' primary trend.

The ratio topped in 1914 at 41.16 and bottomed below 16:1 in 1919. From there it rose to 100:1 in 1941, then fell until it touched below 16:1 again in 1967. Climbing to 47 in 1973, it then dropped below 16:1 again in 1980. Silver fell from 1980 until the ratio hit 100:1 again in 1991, and dropped to 40:1 in 1998. It climbed from there until June 2003, topping at 82, and has since dropped to around 58 today.

When any commodity returns to the same levels two, three, or four times during 100 years' trading, I begin to suspect a pattern. And while past performance is no guarantee of future, a reasonable man would bet that from 1991's 100:1 we are headed toward 16:1 before this bull market ends, say, 10 years from now.

If gold reaches $1,250 (a modest target only 5 times its bear market low) and returns to a gold/silver ratio of 16:1, silver would reach 78.80. In other words, it would outperform gold 400%.

After the gold/silver ratio hits 16:1, only a person who habitually draws to inside straights would believe metals were going to keep rising. To anyone familiar with the primary trend, the ratio has not been forecasting error, but perfect accuracy.

GOLD/SILVER SWAPPING STRATEGY

Dr. North also decries swapping back and forth from silver to gold. However, that's the only investment strategy that enables an investor to increase the ounces he holds while waiting for prices to rise. Besides, the size of the gains is more than enough to overwhelm the tax disadvantages (since 1984 the IRS has refused to treat exchanges of gold for silver and vice versa as "like kind exchanges.").

For example, a ratio move from 62 to 46, less a generous 10% for transaction costs, brings a 15.1% gain. If income tax gobbles up half the gain, that still leaves 7.55%, a respectable gain for no more effort than swapping silver for gold. And the alternative is *zero* gain.

STORAGE PROBLEMS

Finally Dr. North warns that silver is heavy, bulky, and trouble to store. True, true, I will admit that he's got me there.

Still, but it will seem a lot *less* trouble at $78.80 an ounce.

-- Franklin Sanders

Franklin Sanders has been brokering physical silver and gold since 1980 and trading metals even longer. He publishes a monthly financial newsletter, "The Moneychanger." In 1993 he wrote Silver Bonanza for Jim Blanchard, and in 2004 published Why Silver Will Outperform Gold 400%. For more information visit his website at www.the-moneychanger.com, where you can sign up for his free daily gold & silver market commentaries. He lives on a farm near Dogwood Mudhole, Tennessee amidst a mob of children and grandchildren.