

THE GOLD DISCOVERY LETTER

A News Letter focussed on Gold Discoveries and critical drivers for Gold

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Gold & Inflation

EDITORIAL

by Eric Hommelberg

"If you are lucky enough to buy into an exploration company that makes a discovery, you can effectively buy your own auto teller machine. Some of these things are just phenomenally profitable."

John Bridge
Senior Gold Analyst
at
J.P. Morgan Chase & Co

Inflation seems to be the tune of the day lately since both CPI and PPI exploded to levels not seen in almost 30 years. Is Inflation really picking up steam indeed ? Or should we trust Sir Alan Greenspan that inflation is not a problem these days and won't be in the nearby future either. But what can the FED do to stop inflation ? Could a monthly 0.25 increase in short term interest rates fight Inflation indeed ? What about rising oil prices and its impact on inflation ? What about adding a trillion dollars to the system in a single year, isn't that inflationary ? Well, enough questions here, lets' try to figure out what is going on here and why :

Since this is an update on chapter III of the Gold Drivers Report let's start off with the highlights of that chapter :

Highlights chapter II Gold & Inflation April 2005

Highlights :

- Inflation is picking up steam, consumers do notice already for a long time.
- Rising oil prices are a significant contributor to higher Inflation
- CPI is lagging oil tremendously today. History says that such an Extreme won't stay there for a long period of time. Since Higher oil prices are permanent, CPI will catch up.
- PPI continuously higher than CPI for almost two years now doesn't bode well for the CPI. CPI will catch up.
- Future fiscal liabilities exceeding \$50 trillion requires a budgetary resource which only inflation can provide.
- Government still insists that there is no inflation, their statistics are getting comical.
- Gold is the ultimate hedge against inflation

So that was April this year. Are things getting any better ?

Discussions re inflation are sometimes very entertaining since it all depends on what you call inflation.. Some people argue that inflation is a monetary phenomena only and they're backing up their argument with a dictionary... It says that inflation is an expansion of money supply which could eventually lead to higher consumer prices. So higher consumer prices is a consequence of inflation and not the cause.

Well fair enough but you'll never know when higher PPI/CPI levels will be popping up due to a dramatic increase of money supply, it can take years...





When for example the US money supply increased by 100% from 1965 to 1974, it caused an inflation rate in the US which averaged 9.2% per year from 1973 to 1981.

And looking at the numbers now we see that the US money supply has doubled again from 1995 till today , see chart below. It could be very well the case that higher CPI rates which we're witnessing lately could be the result of the tremendous increase in money supply from 1995 till today. But there's more. The view that only an increase in the money supply can generate higher consumer prices is a view which I don't subscribe to. Sure, a dramatic increase in money supply will cause higher consumer prices since more dollars will be chasing the same amount of goods. But also a decline in the goods to be chased will lead to higher prices. I'm talking about the human being's key resource which is oil !

What I mean is that we don't need to see an increase in money supply to see higher oil prices.

We're witnessing today a demand driven bull market in oil which already caused oil to triple in price in just two years only. The scary thing however is that this increase in price won't be temporary since the world is heading towards 'PEAK-OIL' at an alarmingly high speed. Oil industry expert Matt Simmons says that we could be at the peak of world oil production here and now already. If that horror-scenario turns out to be true then we should prepare ourselves for oil prices heading towards \$200 before the end of this decade. (Matt Simmons just warned last week that oil could double to triple this winter to the \$125 - \$190 range due to severe shortages...) Why is this so important ? Simple, higher oil prices will lead to higher PPI/CPI rates.

Just think about it, you simply can't produce any item without the availability of energy. So when the price of energy goes up producers will be faced with higher costs of production. Sure enough sooner or later they have to pass through those increased costs to the end user (consumer)

In fact that is already happening :

Energy costs seeping into consumer prices, and produce aisle

Associated Press
Midland Reporter-Telegram
10/23/2005

By Bob Keefe

You already pay more to drive and to heat and cool your home.

Now get ready to pay more for just about everything else.



Prices for all sorts of goods made from oil and natural gas by-products are expected to rise in coming months as petrochemical shortages and high costs left in the wake of the Gulf Coast hurricanes begin filtering through the economy.

The list of affected products is almost boundless: Polyester shirts and plastic garbage bags. Carpets and cleaning supplies. PVC pipe and parts for automobiles.

Then there are the containers: Milk jugs and Coke bottles, Styrofoam cups and cheese wrappers; packages for hot dogs and even those disposable plastic bags most of us carry home from the grocery store.

Finally there are the indirect effects, such as farmers' higher costs for petroleum-based fertilizer, pesticides and herbicides that could lead to price increases in the produce aisle.

"I would expect consumers to start seeing it show up in everyday packaged items as early as this month," said Pat Furey, a commodities analyst with Ariba Inc., a procurement management consulting company. END.

You may wonder why Wall Street isn't worried at all about rising inflation. Simple, because all they care about is core inflation which is almost non-existent... The government just takes out the biggest contributors to a rising inflation which is energy and food. Well, very convenient, who needs food and energy anyhow...

All other CPI components can be massaged to almost nothing by means of hedonic adjustments. PIMCO's managing director Bill Gross called the CPI numbers 'A con job', he said :

"For instance, prices of desktop and notebook computers declined by 8% a year during past decade. The WSJ reports but because the machines computer power and memory have improved, their hedonically adjusted prices have dropped by 25% a year since 1997. No wonder the core is less than 2% with computers dropping that much every year." END.

Needless to say Bill Gross doesn't believe the official CPI statistics.

Another market veteran who doesn't believe those statistics is Jim Sinclair, he calls these government CPI statistics completely bogus, he reported on his site JSMineset.com on October 21

Real inflation is orders of magnitude higher than the Made in Hollywood indices suggest.

The inflation coming at us has no precedent in any one's life now investing or trading including me. It is not an insular money supply management event but a product of massive international currency intervention and a Fed-sponsored world-wide liquidity expansion that cannot be reversed. END.



Nevertheless more people are waking up to the fact that something funny is going on with those CPI numbers. The New York Times reported :

If You Don't Eat or Drive, Inflation's No Problem

By DANIEL GROSS

Published: October 23, 2005

"ASIDE from the stuff that's becoming more expensive, like food and energy, there is no problem with inflation in the economy. That's the message economists want us to take from recent inflation reports."

Further more The NY Times quoted Ann L. Owen, associate professor of economics at Hamilton College in Clinton, N.Y., and a former economist at the Federal Reserve who said :

"If high energy costs persist, and if they continue to rise, they may ultimately seep into the core," END.

Well, it seems that Professor's Owen's forecast already came true, look at the press releases below and surprise surprise higher CPI/PPI numbers due to higher energy costs...

U.S. inflation at 25-year high

By *Rex Nutting, MarketWatch*

Last Update: 8:45 AM ET Oct. 14, 2005

WASHINGTON (MarketWatch) - U.S. consumer inflation surged at the fastest pace in more than 25 years in September, rising a bigger-than-expected 1.2%, the Labor Department said Friday.

A record 12% rise in energy prices fueled the historic jump in consumer price index . END.

OK, so a record 12% rise in energy prices fueled the historic jump in CPI.

The PPI numbers weren't any better...

PPI surges 1.9%, most since 1974

By *Rex Nutting, MarketWatch*

Last Update: 4:04 PM ET Oct. 18, 2005

WASHINGTON (MarketWatch) - U.S. wholesale prices rose a larger-than-expected 1.9% in September, the biggest jump in 31 years, the Labor Department said Tuesday.

Price increases were led by a 7.1% rise in wholesale energy prices, the biggest jump in 15 years. Food prices also soared, rising 1.4% on a record 49% increase in egg prices. END.



Let's repeat once more what Prof Owen said :

"If high energy costs persist, and if they continue to rise, they may ultimately seep into the core," END.

Conclusion : Higher energy prices will worm its way into the entire system which in turn will lead to higher PPI/CPI rates.

It goes far beyond the scope of this article to discuss PEAK-OIL and the end of cheap energy but readers interested could read chapter VIII of the Gold Drivers Report 'GOLD & OIL' which makes a strong case for permanent higher oil prices. If \$60 oil / barrel already caused the highest PPI/CPI numbers in almost 30 years it ain't hard to imagine what \$200 oil /barrel will do in a few years time...

So after all we see that we have two powerful forces at work these days which both could fuel inflation dramatically in the years to come.

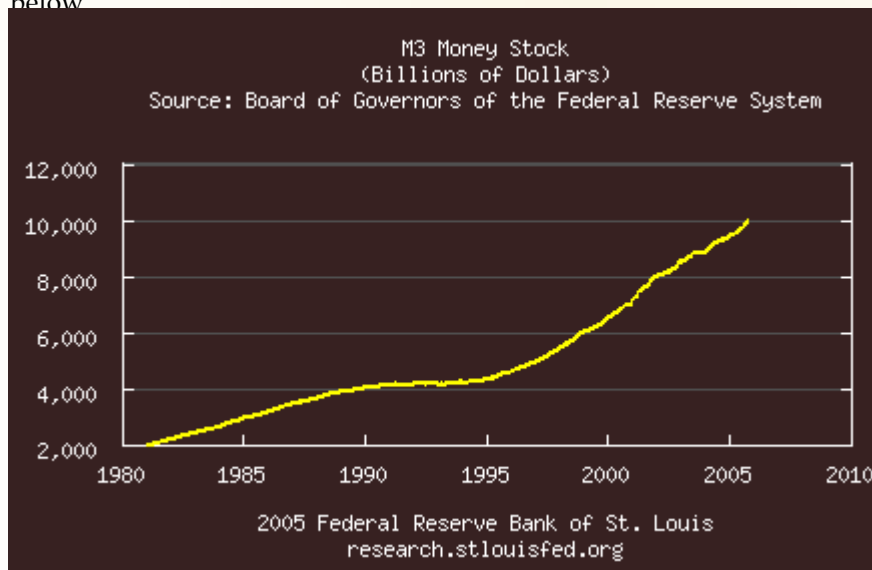
- Sharp increase of money supply (doubled over the last 10 years)
- Sharp increase of energy prices (almost tripled over the past three years)

Now let's turn to some charts since they tell more than a 1000 words...

Sharp increase of US money supply :

As said before the US money supply doubled from 1965 to 1974 which was followed by an averaged inflation rate of 9.2% per year from 1973 to 1981.

Again from 1995 to 2005 the US money supply has doubled, see chart below

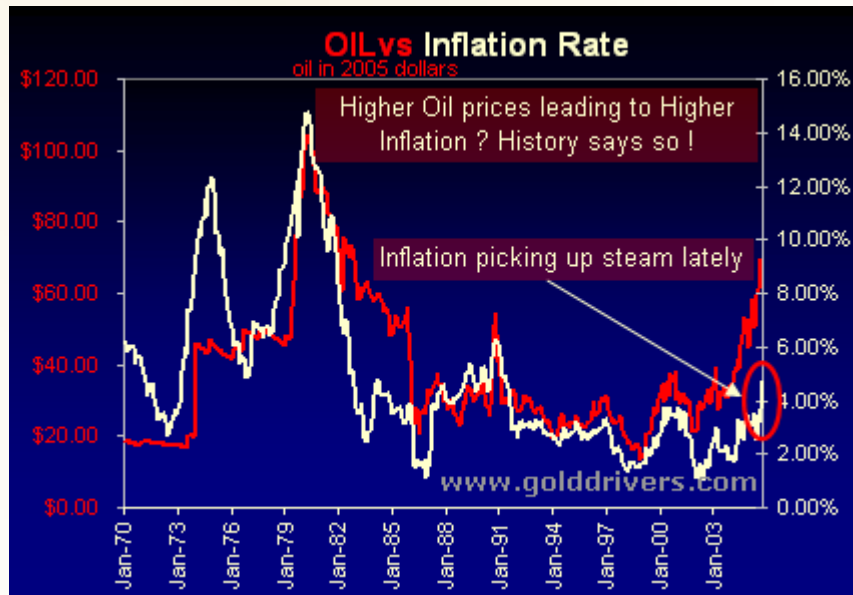




The doubling of the US money supply during the 1965 – 1974 period wasn't without consequences. Sure enough inflation took off. Does history repeat itself ? Will we be witnessing another multi-year inflation growth after another doubling of the US money supply over the 1995 – 2005 period ? The recent jump in PPI/CPI rates, does it mark the beginning ?

Sharp increase of energy prices

What does history say about rising oil prices and inflation ?
The chart below tells it all :



This chart confirms the thesis that higher oil prices will worm its way into the entire system which in turn will lead to higher Inflation rates. Also clearly visible is that finally the Inflation rate (derived from CPI) is catching up with the higher oil prices..

So if the inflation rate is picking up steam indeed what could that do for gold ?

Well, since gold has a reputation as being the ultimate hedge against inflation gold should do well. The chart on next page tells it all :



This chart confirms the thesis that gold is a perfect hedge against inflation indeed !

If the recent spike in the inflation rate will hold and go north from here gold should be catching up soon ...

Highlights :

- Inflation took off after the US money supply had doubled from 1965 to 1974 leading to an averaged inflation rate of 9.2% per year from 1973 to 1981.
- US money supply doubled again from 1995 to 2005, first signs of accelerated inflation in recent published PPI/CPI statistics.
- Higher energy prices will worm itself into the entire system which will eventually reflected in higher PPI/CPI statistics.
- Higher energy prices are not the result of an oil crisis but of an demand driven bull market in oil.
- The end of cheap energy has arrived
- Higher energy prices → higher inflation numbers → higher gold prices.
- Ever increasing energy prices on top of an explosion in the US money supply (doubled in 10 years) is a dangerous mix. An Inflation tsunami could be the result which will send gold prices to levels unimaginable today.

- END -

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<http://www.golddrivers.com/GDRUpdates/gdrupdates.htm>



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No need for readers already on our mailing list to reply

Comments and feedback are welcome at:

Eric Hommelberg
The Gold Drivers Report

E-mail: ehommelberg@golddrivers.com
Web-site: www.golddrivers.com

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