Introduction to Session Six: 
Closing & Summary

Jeremy Charles
LBMA Chairman

Good morning ladies and gentlemen. We now reach the last lap, and I am delighted to see so many of you here this morning, which I am sure is a reflection of the enviable reputations enjoyed by each of the three speakers in this final session. I hope you have been as interested, stimulated, and occasionally amused by everything you have heard as I have been. We are greatly indebted to all the speakers and to the session chairmen for the time and effort they have devoted to updating, improving and deepening our understanding of so many aspects of our markets. These are after all what make precious metals an endless source of interest to those in the markets and those who use it.

We have enjoyed fantastic hospitality over the last couple of days, especially from our Swiss friends, and also in the form of some members’ events which have given us more opportunities for networking in the most pleasant and relaxed surroundings. Many thanks to all of those who have generously sponsored these events.

Before introducing our speakers I would like to say a special thanks to the Public Affairs Committee and its chairman Tim Wilson for all the time, thought, and planning that went into the programme for this conference. Thanks also to the LBMA Executive, whose hard work over the past year has allowed us to enjoy such a great conference, and particularly to the two younger members of the team, Belinda Elliott and Debbie Sirkett, who together have done a tremendous job both in the run up to the conference and here in Montreux.
Thank you very much Jeremy, and a very good morning to you all. Thanks very much for having me; I have certainly enjoyed what I have heard here so far. I should start off by stalling a little bit by saying that, as an economist, I am not sure that I have got anything specific to say to you that you do not know about the outlook for gold and precious metals prices. Much of what I hope I will be able to get through during the next 25 minutes or so effects the context in which decisions that you make about the sector in both the short and long term. I am going to start by talking about some of the central issues to do with the cyclical outlook and what is going on in the global economy, and I am going to finish pretty abruptly with a comment on Indian demographic change. Then if we have got time I will have some questions.

We are going to talk about the twin pillars of precious metals demand, which are demographics and economics. Basically, one of these pillars is obviously the cyclical context I was referring to before, which, generally speaking, I would say is unequivocally negative for your sector. The second pillar is demographics, which includes not just population ageing but other demographic factors such as urbanisation. But some of the demography that is involved as globalisation takes an increasingly Asian flavour. Unless we kill it off for one reason or another, it suggests that there may be – and I stress may be because I do not think it is anything we can say for sure – some positives in here for precious metals, at least from a five to ten year view.

I am conscious of course that the long run trends of real commodity prices have not been particularly encouraging. The only caveat I would say by way of introduction is that the demographics outlook that we face is unique. There are no historical parallels, except possibly after the Black Death in the 15th century, and not even I was around then, so I am afraid I cannot really say.

However there are some interesting aspects that we can investigate for the purposes of future outlooks, which include the negative correlations that might exist between gold and precious metal prices and real equity returns, and demography has a lot to say about real equity returns – also possibly inflation; inflation, as I say, in the long term. I really do not think that the inflation risk that we read about nowadays in the newspapers and in reports amounts to anything terribly serious, but in a demographic context, the consensus view is that ageing societies are going to be characterised by deflation. I have reason to believe that it may not be quite that simple. It may be that we actually face some inflationary problems as societies age, which I will come to briefly.

Beginning with Conclusions

I am going to start, as I said before, with key conclusions, and then I am going to finish very abruptly, when we get that far, on Indian population changes.

The first conclusion is that I think that this year marks a transition from a relative value world that we have been in for the last five years to what I would call a macro moment. The moment may go on for two or three years, not just a few months. The relative value world is a world where investment decisions are basically driven by carry and valuation. A macro moment is very different. Some asset prices you may think are cheap or relatively cheap next to other assets, but actually valuation counts for nothing. In a macro moment, the outcomes and standard
deviations of outcomes can be quite a lot bigger than they normally are.

The second observation or conclusion is that suddenly, monetary policies around the world have become a lot less predictable. In the relative value world, we look at risk and all of our banking institutions and financial institutions were very good at pricing risk. We have great models. What we cannot price is uncertainty, and I think the world is right now – both in an economic and a political sense – by uncertainty. The central banks, what I have called the four horsemen, have all effectively told us that they are trying to lower growth. That was not the case six months ago, or even a year ago. Then it was a question about normalisation or coming back from the exceptionally low interest rates of 2002 and 2003 and so on, but the US, the Bank of Japan, the European Central Bank, other European central banks like the Bank of England, Swiss National Bank and the Rijksbank and the PBC all basically have told us very openly that they feel that inflation risks are now of such concern that they have to take the kinds of measures that markets are now discounting. I do not know whether they are actually chasing shadows, to be honest.

I am reminded, when I was looking at the context of the carry trade that a lot of people are interested in, that the last serious tightening cycle the Japanese went through was in 1989-90. In a year they raised interest rates from 2.75% to 6%. At the time, they said the reason they were doing this was because they were worried about economic overheating and about the rise of inflation, and at that time, Japanese consumer prices were rising at about 2.5% a year. A year later, when they had raised interest rates to 6%, Japanese consumer prices were rising at 2.5% a year. What they were really chasing was asset inflation. Of course they adopted completely the wrong tools to deal with that. I suspect there is something very similar going on now, although of course there are great dissimilarities. America’s banking sector is not Japan’s in 1989 and so on and so forth. But in the attempt to get a grip on asset prices – and in the absence of regulations which actually made life a lot easier many, many years ago – in some respects, central banks just have to take this big mallet to attack this issue that they think is really important. I am not saying it is without foundation; I just think it is too simple.

The third conclusion is that a growth slowdown is now a consensus view. I do not think anybody has issues with that. The issue that I think we are going to spend a lot of time thinking about over the next few months is the context and pattern of that slowdown, especially the possibility of a hard landing recession kind of scenario in the United States, which I think is very likely.

The fourth is that slower growth around the world, which may not just be a six month phenomenon, but may go on for a couple of years at least, is going to unmask the structural issues that we have been talking about for some time. This perceived inflation threat, whether it is asset prices or goods and services, the currency – US dollar – which you just heard quite a lot about, and volatility which we have not really had much for the last three or four years, and which is suddenly beginning to spike up. I suspect this is just the beginning.

Ageing in Emerging Markets

On the question of demography, key conclusions are as follows. Population ageing obviously in the OECD area is well understood. What many people do not really appreciate is that there are some very major emerging markets which are ageing almost faster than they are in the OECD. I rank China and Russia amongst them. However I do include India and the Middle East, since from the point of view of gold those are two very important areas which I am sure you are very concerned with. The idea is that in ageing populations, income growth, GDP growth, however you want to measure it, is basically going to slow down. We will see changes in demand, but the changes in demand I suspect are going to be for pension assets and for health care provision and the kind of things that you would automatically think of when you think about ageing societies. Not, I suspect, precious metals per se. I may be wrong, but that is my perspective on the 50 year view.

For the time being, I would add, high spending, pre-retirement cohorts (because the 50-65 year olds are really now in the ascendency in terms of dominating population structure) and urbanisation in emerging markets, particularly insofar as it affects housing and infrastructure, will continue to dominate. I am not being apocalyptic at all about the next few years.

Donald Rumsfeld is well known to you, I am sure – I am very grateful for the press conference he gave at the Pentagon in 2003 because I have milked this ‘known knowns, unknown knowns’, and whatever else quite a lot since then. I think it is quite apt when we come to talk about this kind of subject matter and global forecasting. Mostly, people talk about known knowns; that is easy and we can all do that. We know interest rates are going up, we know there is going to be a
slowdown, we know that risk premiums are rising, investors are more anxious, the dollar is a beneficiary, because everybody goes back to base currency, and for a lot of people the dollar is a base currency, and that generally speaking, equities are still cheap relative to most other asset classes – at least on valuation grounds. That is easy.

The known unknowns are a little more complicated. How high will interest rates go? What will be the manner of the dénouement or unravelling of the credit boom or the asset bubbles around the world? What sort of landing is in prospect? Will other countries in Europe and Asia be able to pick up the slack that the Americans will give to the world as consumer demand tapers off? These are tricky questions. We know the questions to ask, but it is hard to put the answers to them.

Then of course, there are unknown unknowns, about which I will speak only very fleetingly. I am not going to address the issue of globalisation and reactions to globalisation around the world in this particular formal part of the presentation, but demography is a huge unknown unknown. We just do not know what is in store as time moves on. Fortunately, it is a very slow-moving phenomenon, albeit one of some significance.

The Cyclical Picture

I will try to capture this cyclical picture first. The cyclical risks are growing. I do not think that is new to anyone. One of the cyclical risks that I think is important is about energy security – insecurity I should say – about the implications of the peaking in conventional oil production everywhere from the US, which has already done that, to the North Sea, Mexico, Russia, some of the largest Middle Eastern oil fields, etc.

There is credible evidence that geologically speaking, conventional oil production is maxed out. Unconventional oil will obviously come in time, but only with time and money. At $70 dollars a barrel, there has been no demand destruction to speak of. That makes the central banks’ issues today much more problematic. What price does it take to destroy demand? Is it $70 or something higher? We do not know, but as other things evolve in the housing markets and capital goods markets, we may find that the rise in oil prices, which so far we have dealt with in a benign way, becomes a little more problematic.

The second issue is about US mid-cycle maturity. This cycle is now five or 5 1/2 years old. That makes this expansion pretty much middle-aged. Middle-aged cycles tend to get vulnerable to external shocks and internal contradictions. It is not surprising that the question most people have is the degree to which, and whether and when this mid-cycle maturity is going to roll over into a recession. Obviously, higher interest rates, higher fuel costs, and the loss of housing as a driver for the economy do not portend particularly brilliantly for the cyclical outlook. There are these residual concerns about inflation which you are well aware of, and which I alluded to before. There is this issue about whether central banks are chasing shadows. I am not saying they are not without substance, but maybe they are not the real issue.

Uncertainty about monetary policy is a huge issue, especially Japan’s end of quantitative easing. There is lots of discussion about the carry trade, how big it is, and whether you can track and trace it. Most investors or hedge finds take this as an act of faith. Of course the Japanese carry trade is a fact of life. Try to find that evidence in the numbers – it is very difficult to find and quantify. My own efforts at doing this, I have to say, almost start and stop at a
detailed disembowelling of the Japanese balance of payment numbers, which do show that in 2005 there was a 10 trillion outflow of financial capital. Not all of that was to do with carry trade. It is very difficult to say how much of it was specifically leverage, and how much of it was foreign exchange swaps etc. Clearly, it is a big number, and the unwinding of this carry trade as the yen eventually goes up and as Japanese interest rates go up is going to be pretty important.

Clearly, this raises the issue of policy error. That is what we macro people live for from one decade to the next. I do not mean this in a joyous way, but macro outcomes are what we are trained to look for, and policy error is a very integral part of that. China is a very interesting case in point. Obviously, 10% GDP growth still continues amok, but things are starting to change in China. Credit expansion is the number one enemy for the People’s Bank of China (PBC), higher reserve requirements were recently introduced and it is probably not the end of the story, and subtly, in the 11th five-year programme, which is a programme not a plan, China’s policy emphasis is shifting towards social and equity issues. I do not mean equity as in stocks, but equity, rural poverty, income distribution and so on. That tells us something about a softer outlook for Chinese growth in the future.

All of this together means very high stakes for global growth, and low volatility, low risk are for the time being, a thing of the past. I suspect we will have more to come on this.

I thought I would throw this in; it is the front page story of the Financial Times – ‘Central banks warned on inflation’. Basically, it cites some very interesting stuff from the BIS’s annual report. Central banks will have to move faster to raise interest rates because global inflationary pressures are rising and the economy remains vulnerable to a bang of market turbulence. They talk about the nagging, longer-term threat of unwinding these huge trade imbalances which could undermine economic activity and contribute to unwelcome disinflation, and whimper of slow growth for an extended period’. To be honest with you, whatever their 10-20 year outlook, these are the things that are going to preoccupy us over the next 12-18 months. I know sometimes the BIS has a reputation of ringing the alarm bell unnecessarily, but it is never without some foundation and substance. It is probably worth taking a look in more detail at what these guys have written.

**Monetary Policy and Bond Market Conundrum**

The Federal Reserve, as you know, remains very focused on resource utilisation and potential inflationary pressures. Obviously, a Federal Funds hike this week is well priced; it is not going to be a surprise, and we are well on the way to pricing of 5.5% rates in August. There are some investment banks and private banks that have forecasts of Federal Funds up at 6%, but I think that where this stops depends on what happens to core inflation.

**Core inflation** is now 2.3% because of base effects from last year, and because of unfortunate timing for poor Mr Bernanke, who is the new kid on the block. There is an element of rental inflation that is going on that has not finished yet. Because housing has become so expensive in metropolitan areas in the US, a surge in demand for rental accommodation is pushing up rents, and because of the way that imputed rent is calculated in the consumer price index (CPI), it is going to push up core inflation. We have had three months of 0.3s on core CPI, which is actually edging this rate up to 2.3%. It probably goes up to something like 2.5-2.8% by August or September.

The closer we get to 3%, the more you will see Federal Fund forecasts of 6% because of a very simple formulation about how monetary policy is supposed to work. It is basically a function of inflation plus some expected inflation, and a risk premium. With a 3% or 2.8% core CPI, it is very difficult to see Federal Funds going to 6%. This amounts to overkill. I would argue that even at 5%, that is enough. But I do not make policy, and they do. They are certainly of the view that they have forecasts of Federal Funds up at 6%, and the unwinding of this carry trade as the yen eventually goes up and as Japanese interest rates go up is going to be pretty important.

The Treasury market has obviously seen yields climb up to 5.25% with fears of a 0.5% rate hike and about where the tightening cycle will end etc. Nobody talks about the bond market conundrum anymore. Yields have moved away from those very low levels, and obviously, with the dollar at some risk, I am not saying that there is any risk of some further upside in bond yield movements, but I think it is a kind of a spike. I cannot see bond yields climbing very much and before long, perhaps before the end of the year, it would not be a surprise to see the market begin to discount an easing cycle, even though it may take some time before that happens. That aside, there is also, in my view, a demographic ceiling on bond yields. Effectively what happens is...
because of the actions of pension funds and market participants trying to gear up for the liabilities, because pension funds are going to have to pay out, there is huge asset allocation support for bond markets whenever yields rise. The US is the next biggie once the legislation clears Congress at the end of this year.

Briefly, and I perhaps do them a bit of injustice, I think and we think that European Central Bank (ECB) rates are going to climb up to 3.25-3.5%. You may have seen today the IFO index in Germany came out strongly above expectations on most readings, backed up by business surveys in most other countries. For this year, I think the European expansion looks okay, and it is just one of the things that is going to induce the ECB to carry on tightening, and the Bank of Japan (BOJ) ditto – probably in the next few months.

The US economy is the main focus. The American economy is shifting down gears to something like 3%. Housing this year will take away about 1% of GDP growth, and it cannot be made good, either by exports or by government spending, or by capital goods. There is really nowhere to hide as this housing market begins to roll over.

We have talked about the breaks on the expansion. The consumption picture is absolutely key. Consumption is about 71% of GDP; it is three standard deviations above the long-term average of 65.25%. The US consumer is about 23% of the global economy. Asian consumers are about 12%, and European consumers are a little more than that.

I think it is very unlikely that the rest of the world’s consumers are going to step up to the plate as the US consumer gradually – or abruptly – withdraws temporarily. My own view is that growth and momentum is going to slow and it will not be that long, in human rather than market terms, before people start to talk about growth momentum sliding down to 2% or less, and then people will talk about recession much more liberally. That is when the futures markets in federal funds and Eurodollars will start discounting the next phase of the interest rate cycle, which is the down move.

The dollar looks increasingly vulnerable. How many times have you heard that in the last three years? But I thought Niall Ferguson summed it up very well yesterday; there is a paradox. The US is the world’s biggest debtor, it’s accumulating liabilities at a rate of knots, and yet it is a currency that people turn to and not from at times of financial crisis, which is strange. Nevertheless, and for as long as the dollar remains better bid, which is the situation at the moment, as the US economy rolls over and its interest rate expectations change again, this deficit is going to finally have its day in court. I think that is the point at which the US dollar is going to succumb to some further downward pressure. The federal fund rate is going to peak somewhere between 5.5-6% in the second half of this year as the ECB and BOJ are continuing to gradually raise rates. Certainly for a while, it will look as though European, Japanese and Asian economic performance is still robust. How they perform in the wake of a US downturn and recession is an issue for 2007. Obviously, if there is a US recession, everybody will have to suffer the consequences of sliding US import demand and growth generally will become much more subdued.

You have already heard a little bit about Asian and OPEC central banks continuing to diversify. In fact, there are statements out in the press this morning from senior PBC officials and someone from the Arab Monetary Fund which can only be interpreted as ‘we are looking for ways to decouple our national economic interests from the US dollar, US policy dependence, US inflation and so on’. These guys
are not going to do anything to rock the market, but certainly I would imagine that over the next few years, this will be a continuing theme.

**Currency Forecasts**

The formal forecasts of UBS Investment Bank look for the dollar to drop to around 1.30 against the euro and 100 against the yen by the end of this year. Slightly faster RNB appreciation is expected, but no mega-change at all, and next year, EUR/USD 1.40 and JPY, 190. Insofar as people can forecast foreign exchange rates, these numbers look good enough. Obviously, what we always get wrong is the timing character, and so forth, so there is a possibility that it happens quicker. Perversely, I think the next big move may happen just as the external deficit is beginning to improve because of the implications; a US slowdown means a lower US trade deficit. A lower US trade deficit means smaller capital inflows, which means the dollar and dollar assets have to re-price. That is the logic behind that comment.

**Key Issues in Demography**

Basically, demography, or ageing populations, is about a number of things. It is about falling fertility, it is about increasing longevity, and changes in the age structure of the population. But the big one that we really care about in a macroeconomic context is fertility. Obviously, as today’s working population moves into retirement, there simply just are not enough babies coming into the workforce to make good the gap. Then you have these problems about dependency that you read about, pension liabilities, who will pay, etc.

That is the issue, and it is not just one for rich countries; it is also a huge issue for China, who will see its labour force starting to fall in 2009, which is the same year Germany’s labour force will start to roll over as well. The prospect over the foreseeable future is that the labour force in China will begin to fall year by year for as long as we can currently forecast. This is not something that is widely appreciated, but it is a fact – absent acts of God and higher fertility – which will not happen quickly.

There are offsets to the age structure and labour force changes. But in the absence of those offsets, we should expect over the long haul in aging societies, somewhat slower economic growth, weaker consumption rates, lower consumption rates, low or lower real rates of interests, and flat yield curves. Relative to a baseline study, which I’ve done recently about what happens to equity markets, equity market returns and emerging markets rise up to about a third more than the baseline under demographic assumptions before they start tapering off, and in industrial countries, equity markets are okay relative to baseline over the next five or seven years, but then they start to weaken off after that. There is a clear asset allocation involved for investors between emerging markets and industrial country equities, which is just going to build on the small changes they have made in recent years.
In 2005, Japan and Italy were the oldest countries in the world by population and by 2030 – 2050, they will be incredibly old; the over-65s are going to account for 70% of the labour force. All of those people you see in hoodies on street corners will not be there anymore; it will be you and me playing chess.

India, Turkey, and Brazil do not face an ageing problem until about 2035. They stay relatively young because although fertility rates are falling everywhere, there they are still pretty high. India has a fertility rate of about 3.2 children per woman of child-bearing age. In Russia and China, there are major problems. Russia’s low rate is compounded by the fact that they have an appalling public health problem, about which President Putin addressed the Federal Assembly two weeks ago – highlighting declining population, poor health, and so on.

What does this mean? It means that many emerging markets are going to be taking very overt policy decisions in the next few years between growth and welfare. China has already started and I think that is going to continue. The idea that our emerging markets will be faster growing markets over the next 10 years, I do not have an issue with. Whether they are going to be fast growing in the 8-12% per annum basis is highly dubious. There will be overt policy measures to try to address social inequalities and the possibility of impoverished ageing, which is a very real prospect for countries like China.
We can defer some of the effects of ageing by increasing immigration. It is not going to happen in very many countries in the foreseeable future though. We can raise the participation rate by making people work longer – up to 65, 66, or 67, which most governments will do. And, we can try to do something to increase the employment of women and workers aged over 53 and 54, which outside of Scandinavia is appallingly low in most places. There is clearly some potential to make headway there, but it requires government to do that.

There is a discussion about urbanisation that I have to cut short. The population of the less-developed world is going to grow at just over 2.1% per annum, compared with the world average of 0.5%, and their urban populations are going to grow by 2.3% per annum compared with the world average of 1.8%. Urbanisation and basic materials have been very popular themes. I often wonder whether this is a matter of fundamentals driving market explanations or the other way round. Certainly there is an intuitive appeal, that if you have to build more cities, transportation systems, sewage systems, construction buildings, apartments etc., then your use of basic materials is going to pick up. It is not unique. It happened in Europe in the Middle Ages, 19th century Germany and America, post-1945 Japan, Korea, and Taiwan, and now in China and India. They are all examples of rapid urbanisation coinciding with upward pressure and demand for basic materials. The critical issue actually is supply. If we face constrained supply conditions for a few years, then maybe the outlook is okay. In the long run, supply and demand will catch up with each other. It is probably not different this time, but there are issues that we think about a lot, such as the ownership of raw materials, nationalisation of resources – Latin America is getting the Americans very exited for example – climate change, which is a $16 trillion investment programme over the next few years, and so on.

The Middle Kingdom is becoming middle aged and middle-market very quickly. In China, 37% of the population is aged over 40. By 2009, it will be 44%, by 2014 it will be 50%, and by 2024, almost 64%. That is how quickly China is ageing.

India, by contrast, is different demographically. Now, one third of the population is aged under 15; by 2030, all those people will move into the dynamic, thrusting young consumer/worker age group. They could all end up being unemployed and being hacked off unless there is genuine change in terms of Indian government reform.

You should not believe the stories that say that emerging markets are going to be an easy gold mine for the next 20 years, because it does depend on social and economic policies – making sure that these people are not only in society, but working and contributing and so on.
Gold - Commodity, Currency, Store of Value

Anthony S Fell
Chairman, RBC Capital Markets

Good morning, ladies and gentlemen. It’s been a great conference and I am delighted to be able to participate.

I think we can all agree the past six months have been an interesting time in the gold markets, with the rapid run up to $729 an ounce on May 12th and the recent 25% downdraft to a low of about $545. When you get a volatile market like this, the important thing is to keep the big picture in mind. In the early 1970s, prior to the big upswing over that decade, the price of gold was incredibly volatile: up or down as much as 10% in one day. In 1974 and 1975, there was a 44% downward correction from $187 to $104 just prior to the big move to $850.

All of this points to the fact that gold is not for short-term traders but rather for serious long-term investors. I learned long ago that you can’t forecast gold prices on a short-term basis.

Now my topic is “Gold – Currency, Commodity, Store of Value”.

Which is it?

The answer is all three, but gold bullion is primarily a currency and a store of value and is a hedge against paper money and inflation. As an economic consultant in 1966, Alan Greenspan wrote: “In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. Gold stands in the way of this insidious process.” Unquote.

Don’t measure the dollar against the euro, or the euro against the yen, but measure all paper currencies against gold, because that’s the ultimate test.

At Royal Bank of Canada, we trade gold bullion off our foreign exchange desks rather than our commodity desks because that’s what it is – a global currency. As J.P. Morgan said in 1913, “gold is money and nothing more.” It was Alan Greenspan who said in 1999 testimony before the US House Banking Committee that “gold represents the ultimate form of payment in the world.”

Gold bullion is the only currency worldwide which is freely tradable and which is unencumbered by vast quantities of sovereign debt and prior obligations. Gold bullion is the one investment and long-term store of value which cannot be adversely impacted by corrupt corporate management or incompetent politicians – each of which is in ample supply on a global basis. As a currency and a store of value, gold has stood the test of many centuries. As a commodity, gold has little intrinsic worth because of limited industrial use.

So where are we in the big picture?

In the decade of the 1970s, with accelerating inflation and rising interest rates, the price of gold bullion rose 2,300% and peaked at $850 per ounce in 1980.

After Paul Volcker, arguably the greatest central banker who ever lived, wrung inflation out of the system by taking interest rates to the mid-teens in 1980, inflation, interest rates and the price of gold declined for two decades, bottoming out at $255 in April 2001. It was a vicious twenty-year bear market.

At the current level of about $590, gold has risen 230% over the last five years. Looking ahead, it is my view that gold bullion is now in the very early stages of a long-term secular bull market which will carry it to much higher levels over the coming decade.
I don’t think there is any point in speculating how high the price of gold might go during the course of this cycle because no one can be that precise. Suffice to say I anticipate a material increase to levels well above all previous highs.

When reflecting on the long-term outlook for gold, it is important to fully appreciate that we now live in a world of fiat paper money. The last vestiges of the gold standard disappeared around 1970 after the London Gold Pool was overwhelmed by foreign central banks and private investors rushing to convert their US dollars for gold.

The 25% gold backing of the US dollar was removed and in 1971 President Nixon said, enough is enough, closed the gold window and declared that the US would no longer convert dollars for gold. We had moved into the modern world of fiat paper money. Just as a reminder, fiat paper money, according to the Oxford Dictionary, is inconvertible paper money made legal tender by government decree.

The real question over the longer term is – how much confidence do you have in politicians and central bankers to maintain the purchasing power of their currency?

Since the US moved to fiat money in 1971, the dollar has lost 80% of its purchasing power. Since the Federal Reserve was established 93 years ago, the dollar has lost 98% of its purchasing power.

The new fiat US dollar system has only been in place for thirty-five years. Not long when you consider the sad and sorry record of fiat paper money through the past century or two. I would say the jury is very much out on this new system.

In the United States, the Democrats tax and spend and the Republicans reduce taxes and spend. President Bush has not vetoed one spending bill during his time in office. In recent years there has been absolutely no fiscal or monetary discipline in the US. When the crunch comes, unless you have a Paul Volcker, the record clearly shows that politicians will always opt for inflation over deflation.

It was Lyndon Johnson, President of the United States from 1963–1969, who sowed the seeds of the vast inflation of the 1970s when he pushed ahead with his “War on Poverty” and “Great Society” programs during the Vietnam War.

Guns and butter. Does this sound familiar?

Looking ahead, the pyramid of consumer and government debt which has accumulated in the US will force the Fed to respond very aggressively to any economic slowdown or the slightest whiff of deflation. The watchword is, “a little inflation is a good thing”. Problem is, as politicians come and go, you can’t control it.

What will the record of the fiat US dollar be in another 20 or 30 years? Recent history does not augur well.

Why do I forecast much higher gold prices? Several fundamentals are at work.

After a decade of fiscal and monetary excess, I believe the broad sweep of the US dollar will be significantly lower for the coming five to ten years. Down against other currencies, especially Asian currencies, and down against gold.

Notwithstanding a modest rally last year, the trade-weighted US dollar has been in a downtrend since February 2002, and the overall loss is now about 28%.

The next stage of the decline could be gradual, like the last four years, or it could be precipitous – like the mid-1980s, when it fell 47% in the less than three years.

It is my view that the US economy is headed for a slowdown later this year, and there is better than a 50/50 chance of a recession in 2007 led by a housing slowdown. A year from now the Federal Reserve may well be reducing rates rather than increasing them. In a declining US rate environment, there is a real risk of a broad move out of dollar-based assets.

I believe the US consumer boom over the past few years has been artificially stimulated by:

- The Bush tax cuts of 2001 and 2002
- Massive spending on two wars
- A prolonged period of record low interest rates in the US
- Two trillion dollars plus of home equity financing
- A declining US personal savings rate
- A major build-up of fiscal deficits in the US, which now range between a quarter and half a trillion

and finally
• An ongoing trade deficit exceeding three-quarters of a trillion annually.

It’s been a grand party, but it’s winding down.

You could write a book about any one of these factors, but in the aggregate they spell big trouble for the dollar – and the markets are in denial. In the four years ended 2005, consumer spending in the US has been growing at about twice the rate of per capita income. This consumer boom has not been driven by rising incomes, but rather by incredibly low interest rates and increased consumer borrowing.

The total US debt burden has increased from 160% of GDP in 1982 to approximately 320% at present, more than double, and one has to ask – how high is high? Can total debt go to 400% of GDP or even 500%? No one knows.

Similarly, US household debt has increased from about 45% of GDP to over 80% over the same period. Again, one has to ask; how high can this go?

Some experts believe we have a credit and debt bubble, but it’s impossible to say. Rising debt levels are like blowing up a balloon – you never know when it’s going to break.

In addition to rising debt levels, the US personal savings rate has declined dramatically in recent years from 6% to 8% of disposable income to less than zero last year.

Over the past decade there has been significant debasement of the US currency, and there is now a vast surplus of US dollars and liquidity on a global basis.

What has caused this? Apart from an escalating trade deficit, most of the credit must be given to the US Federal Reserve, with the Bank of Japan in a strong supporting role. Over the past 15 years, every time there has been a financial or economic crisis around the world, rather than let the disciplines of the market work and wring out excesses, the Fed has injected large quantities of liquidity and credit and lowered interest rates to bail out the system.

It started in October 1987, just after the stock market crash, when the Dow Jones fell 23% in one day. Newly-appointed Fed Chairman Greenspan sharply lowered interest rates and increased liquidity.

This was followed by the US Savings and Loan debacle – again, lower interest rates and more liquidity. That was followed by the emerging market bubble in 1994, which led to the Mexican crisis. Another bailout. Then we had the Thai baht crisis of 1997, the Russian default and the demise of Long Term Capital Management in 1998.

The Fed increased global liquidity in 2000 to protect against Y2K. Then, with the breaking of the stock market bubble in 2001, the Federal Reserve reduced the Fed funds rate thirteen times to a record new low of 1%.

The Bank of Japan has contributed greatly to this euphoric environment and global liquidity with its five-year program of pumping extra cash into the economy, keeping its benchmark lending rate near 0% while at the same time accumulating hundreds of billions of US dollars and facilitating the yen carry trade.

Excess liquidity flowed into commodities and emerging markets, driving credit spreads to record lows. So the current global glut of US dollars is the cumulative impact of all of these stimulative events.

These injections of liquidity and low interest rates have been short-term fixes for long-term fundamental problems, and in my view, the whole exercise will have a distinctly unhappy ending.

They have just delayed the inevitable.

The US is over-extended militarily and financially, the consumer is tapped out and there is a growing lack of confidence in its leadership. Financial and foreign exchange markets hate a power vacuum such as now exists in the United States and are asking – is anyone in charge?

Iraq is looking increasingly like Viet Nam.

The fundamental issue is that the centre of gravity of global economic and financial power is shifting steadily to Asia and to China in particular. Global central bank foreign exchange reserves now total $4.4 trillion, of which an incredible 63% are held by ten Asian central banks.

Central bank foreign exchange reserves have risen dramatically over the past five years, which raises the question: how much is enough? Some central banks, especially in Asia, would appear to have reserves far in excess of what is actually required by any normal definition.

China’s foreign exchange reserves passed the $900 billion mark last month and China is now on course to accumulate more than $1 trillion in
foreign exchange reserves before the end of this year – primarily US dollars.

The US annual trade deficit – now running at a rate of more than three-quarters of a trillion annually, or 6.3% of GDP – is a huge concern. It’s not prudent for the United States to depend on foreign bond buyers to finance domestic consumption.

Asian countries produce low-cost goods which are shipped to the United States; the US ships dollars back to Asia and then the Asians purchase US treasuries. One could say this is a gigantic international PONZI scheme, and while it has worked so far, we have never seen anything on this scale before.

I do not think this model is viable or sustainable. Asian central banks will not want to accumulate US dollars at the current rate. There is no free lunch. Virtuous circles like this, where everyone appears a winner, always come to an unhappy ending and this one will be no different.

We have never before experienced imbalances in global trade and foreign exchange reserves of the current magnitude – not even close. Major currency realignment is coming, and the longer it is delayed, the more the risk of a crisis. You can’t hold back the tide. The ingredients are here for major trouble in global financial and foreign exchange markets.

For those who want to dig a little deeper into global trade imbalances and the risks related thereto, there was an excellent presentation by Malcolm Knight, General Manager of the Bank for International Settlements at the Brussels Economic Forum just a month ago – well worth reading. Governor Lodge at the Bank of Canada has been expressing the same concerns.

For all these reasons, I believe the stature and reputation of the US dollar as a store of value has been greatly diminished and undermined over the past decade. It will never regain the outstanding reputation it had fifty years ago.

In light of all this, I believe gold bullion will gradually re-emerge as an accepted alternative asset and investment.

Notwithstanding the recent downdraft in the gold price, the price of gold has been in a clear uptrend against the US dollar, the euro, the yen, the Indian rupee and the renminbi. This trend will continue and accelerate as events unfold.

It’s worth noting that during the recent sell-off in the gold price, the seven exchange traded funds have had net sales rather than net redemptions – quite extraordinary – and a portent of things to come.

I also believe that some central banks and major investors with a long-term time horizon will gradually look more favourably on gold bullion as a core alternative investment.

It should be noted that some central banks have a substantial gold allocation in their foreign exchange reserves; others have little or none. The US, Germany, France and Italy have over half of their reserves in gold. China and Japan have only 1%, and India only 4%.

There are now indications that some Asian central banks and a few others as well which have large holdings of US dollars would like to diversify their reserves.

But how?

Some central bank holdings of US dollars are so large that it is extremely difficult to diversify in a meaningful way without causing major disruption. In many countries central bank foreign exchange reserves are far too concentrated on the US dollar and should be diversified to more closely approximate their external liabilities.

The only really viable paper currency alternative to the US dollar is the euro. While the euro is a young currency and the one size fits all, the monetary policy of the ECB has yet to stand the test of time. I expect the euro, along with gold bullion, will play an increasingly important role in central bank reserve allocation.

Over the past five years some central banks have been selling bullion, and we should be grateful to them for affording us an opportunity to buy at bargain prices.

As a result of sales over the past many years, the relative size of central bank holdings, which now stand at about one billion ounces worth $590 billion, has declined dramatically over the decade. The market cap of Exxon and General Electric is substantially larger than all the gold reserves held by all central banks. Central bank gold holdings, once feared by investors, are quickly becoming the equivalent of random noise in the marketplace.

At this time one wonders if some central banks wish they had not been sellers at less than half the current market price. One also wonders, with the US dollar becoming increasingly suspect and the lack of viable alternatives, if some central
banks may decide they should be buyers of gold rather than sellers.

Let me ask you this. It would never happen, but if the US were to announce that the dollar was once again convertible into gold at $600 per ounce, how long would their gold stock of 260 million ounces worth about $156 billion last?

I think the answer is self-evident.

Another factor is that I believe that over the past decade there has been a substantial increase in systemic risk in the global financial system, which has benefited greatly from an extended period of incredibly low interest rates and easy credit.

History shows that such an environment can, and usually does, foster a degree of complacency. In the financial and investment business, memories are short and every generation has to learn the hard way.

Leverage in virtually every area of the financial markets has increased. Financial products are now infinitely more complex.

We have perhaps 7,000 unregulated hedge funds around the world with assets of approximately $1 trillion, and there are most assuredly some time-bombs waiting like the Long Term Capital debacle. Hedge funds are great, but we should always remember the only perfect hedge is in the back garden of the Imperial Palace in Tokyo.

There is, at present, an unwarranted optimism that the business cycle is a thing of the past, that central bankers with infinite wisdom are in firm control and will be able to thread the needle between inflation and deflation and that we will never again have another major global foreign exchange or financial crisis.

Well, I don’t believe it, and the record shows that gold bullion represents a solid store of value in times of economic and financial distress.

Also, over the coming decade, gold production will be static to declining, while governments around the world continue to increase the money supply at a rapid rate.

The arithmetic is compelling.

Total gold production since the beginning of time is estimated at 5 billion ounces valued at about $3 trillion now scattered around the world in jewellery, artefacts and gold bars in safety deposit boxes. Annual gold production is now running at about 76 million ounces, which means that the above-ground stock of gold is increasing at about 1½ % per year.

In contrast, governments and central banks around the world are probably printing money and creating credit at the annual rate of 5 to 10% per annum.

The US Federal Reserve stopped publishing the M3 money supply numbers last February. At last report M3 amounted to over $10 trillion and was growing at an annualised rate of about 8%. It’s not surprising they stopped publishing these numbers.

Recently in China the money supply has been increasing at a rate of 18%. These numbers dictate that gold prices are destined to go much higher.

Major gold companies are not replacing reserves and new discoveries are extremely rare. Investors forget that at most gold mines you have to move 35 to 40 tonnes of dirt and rock just to get one ounce. On the other hand, fiat paper money can, and usually is, printed at will by computer.

It’s quite interesting if you’ve noticed what’s happening to paper money. Not so many years ago millions of dollars seemed like a lot of money.

Then we started talking about hundreds of millions and then we were thinking in terms of billions. Then a billion became petty change, and we started to talk in terms of hundreds of billions, and now you hear the word trillion more and more. The next stage will be hundreds of trillions.

A month or so ago an old master painting was auctioned in New York for $94 million. Just based on common sense, we have to ask ourselves – is that painting really worth $94 million, or has the US dollar become just like so much confetti?

I think we know the answer.

Finally, there is a great deal of scepticism about the future of gold, which is a very positive factor. Investors forget that bear markets start when the skies are blue and bull markets start when there is despair and apathy in the air.

At present most major investors now regard gold and gold shares with apathy and even distain, and are vastly underweight the sector or have none at all. The vast majority of investors are so
short-term orientated that they just don’t see the big picture unfolding.

When the price of crude oil bottomed out at $10.70 a barrel on Christmas day in 1998 and the front cover of the influential *Economist* magazine was forecasting a glut of oil and $5.00 oil, you couldn’t give oil or gas stocks away. Now – just six years later – with the price up by 700% everyone loves oil at $70.00 the barrel and you hear talk of $100.

What a difference a few years can make.

As we all celebrated New Year’s in 1971, when the ten-year US Treasuries yielded 6%, little did we know that a decade later they would yield 15.4%.

Similarly, with the price of uranium at $7 a pound at the end of December 2000, you couldn’t give away either uranium or uranium stocks. Now that uranium has increased by 640% to $45 a pound, investors are driving uranium stocks to all-time highs.

The market just didn’t see it coming – it happens all the time.

So in summary, ladies and gentlemen, it is my view that, after a 20-year bear market, the past few years represent a major positive turning point in the fundamental long-term outlook for gold bullion.

Gold is a hedge against inflation, and as a result of the excesses of the past 15 years I believe there is more inflation in the pipeline than is generally anticipated – perhaps quite a bit more – just like the 1970s.

With respect to inflation, you have to ask yourself if you believe the inflation numbers published by various countries, including the United States.

In the US the reported inflation rate is now in the range of 2½ to 3%, but my intuition tells me that it is actually much higher. The Consumer Price Index has been re-jigged many times over the past 30 years. Additions and deletions have been made and judgments with respect to the quality of products and services included in the index.

I have not done the work myself, but have recently read a serious study which calculates that if the US Consumer Price Index were calculated today exactly as it was in 1970, the rate of inflation would be running in the range of 8%. I believe any surprises on the inflation front will be on the upside.

To some extent, I regret to say that all paper currencies are becoming somewhat suspect, and accordingly, it is my view that gold bullion, rather than being the barbarous relic described by John Maynard Keynes, may well become the asset of choice for many investors over the coming decade.

I have always been told to buy quality assets which are vastly undervalued and which have been ignored by the market place for a prolonged period.

Notwithstanding the modest rise in gold prices over the past few years, that is where gold bullion is today and it represents a great opportunity.
Closing Session

Questions and Answers

Q – Participant: How far do you expect the dollar to fall in 2007?

A – Tony Fell: I would be more pessimistic. I think we are in for a decline in the trade-weighted US dollar of at least another 25% over the next two or three years. I am not sure that solves the problem. This is going to be a further, significant decline.

Q – Participant: Do you believe that liquidity in the market is sufficient to allow central banks to diversify into gold?

A – Tony Fell: There would be those in the room who know a lot more about liquidity in the gold market, but I will state the obvious; there is $3 trillion-worth of gold in the world at the moment and at $600 dollars an ounce, to diversify your reserves meaningfully into bullion, the answer would be no, but at $800 or $1,000 an ounce, liquidity is going to increase quite dramatically. At some point here, I believe some central banks are going to start to increase their gold allocation and buy it in the market place and that will result in higher prices. Gold is either going to be re-monetised by central bank buying or by private buying. It is going to be re-monetised by either one. The liquidity will be there, but it will not be there at this price; it will be there at a higher price.

I do not understand why if these central banks want to sell they do not first offer it to another central bank. If you want to reduce your holdings, I am sure there are banks that would like to increase, and it would be a very efficient way of doing it. I also think that one central bank would not want to sell to another central bank for whatever reason. The first concrete evidence that there is this one central bank in a meaningful way, will cause a lot of re-thinking in the central bank community.

Q – Participant: You were both touching on the liquidity in the markets, and in particularly, liquidity creation in Japan. I was interested in your opinion, because most liquidity being created by the BOJ was actually sitting on the balance sheets of the commercial banks and did not find its way through to the economy. Now that they are removing those funds from the balance sheets, do you think this will have a big impact on the market?

A – George Magnus: Yes, I do. One of the complexities of this is that if you look at the balance sheet of the Japanese banking system, you cannot find any evidence that this liquidity added to credit expansion. It did a lot of things; it improved the counterpart creditworthiness of Japanese banks, and it helped them address issues to do with non-performing loans and all the issues we know they have had in the last several years. But it certainly did not go into credit extension to Japanese residents and companies.

It is a bit like going to a murder scene or trial. The prosecution can only rely on circumstantial evidence, and the defence can only rely on character witnesses. We do not actually know what the truth is, but the probability, looking at the balance of payment numbers, was that there was a very considerable outflow of this liquidity through the banking system to global markets. Certainly the enormous expansion of foreign exchange swap business last year found its way into Indonesian equities or commodities. Ergo, I think the withdrawal of this liquidity is going to have repercussions. It is not an accident that the first wobbles in financial markets happened in March and April, which just happens to coincide with the biggest slump in Japan’s monetary base that has ever happened. My conclusion is: be warned. This has not ended yet, and the knock-on effects of the withdrawal of liquidity will continue to reverberate for a while.

Q – Participant, Financial Times, Germany: You talked about the changing demographics. What effect it will have on the demand for precious metals?

A – George Magnus: I am not sure that I have a view about what happens as people get older. In rich countries, I suspect that discretionary spending is probably going to be under huge pressure. The things ageing baby boomers are going to spend their money on are what analysts now call ‘life experience consumption spending’ which is a day at the spa or a trip to Fiji.

There are two other issues that would interest me to the extent that I would have anything specific to say about the precious metals market. The first is that as the middle class begins to expand further, and per
Capita incomes rise in China, India and other emerging markets, I would say that there is the potential for investment demand and jewellery demand, which is going to be of some benefit of the sector. My own feeling about this – and it is not an expert feeling at all – is whether the expansion of the middle class in the emerging markets in the next 20 years is going to be more substantial in terms of wealth creation than the expansion of the OECD middle class after 1945. I do not think so. For most of the last 50 years, real commodity prices have come down. I am not sure; there may be occasional spikes here and there, but I do not know whether it is a durable phenomenon.

The thing I do think has some staying power is the idea that as urban growth continues, and as people move from low-wage, low-productivity agriculture into higher-wage, higher added-value manufacturing and service businesses in emerging markets, there will be some direct benefit in terms of demand for construction materials and everything that goes with it. So long as there is a supply constraint, I think that has to be to the benefit of the sector. Once you have built the mines and are extracting the output, presumably demand and supply fall back into balance again. That would be my position.

**Q – Tony Fell:** Is the United States understating its inflation rate? I have not done any specific work on this, but I have read studies that say that the way the CPI is calculated has been constantly modified and re-jigged year after year for the last 25-30 years. The one study I did look said that if that index was calculated now in precisely the same way as in 1970, the US inflation rate would be about 7.5%.

**A – George Magnus:** I am not sure about the exact number. Certainly the big change in the composition of the housing component in the CPI in the beginning of the 1980s has had an unfortunate effect. It meant that inflation over the last five years would have been a lot higher, and the Federal Reserve might have acted a lot sooner. Now, they have to reap this particular harvest, which is this unfortunate thing about rental inflation that I have just mentioned. A lot of people that I speak to, especially in America, say 2.5% does not tell me anything about the inflation that I pay for the goods and services that I consume. I think that is a misnomer not just in the US, due to this hedonic pricing they use, but also in other countries in Europe as well. It is probable that it is understated, but I am not sure what difference it makes to markets because we try to understand what central banks are going to do, and central banks behave in response to the measured and popularly accepted measures of inflation. The rest is speculation and we will never know. You are probably right – it is understated, but I do not know whether it is 7% or 5%.

**Tony Fell:** I would just make the comment that many labour contracts are indexed to the CPI and social security payments are indexed to CPI, so one might think there is a vested interest in keeping the CPI inflation and how it is calculated at a low level.

**George Magnus:** I think that is unequivocally true. ■
Conference Summary and Close

Kamal Naqvi
Director, Institutional Fund Sales, Barclays Capital

Good afternoon. Last year’s conference was a seminal point for the LBMA. We had been concerned in the past with how to make the LBMA conference more relevant to the market. One way to make it relevant is to make the price move!

What was happening before last year’s event? Yes, we were in a bull market, but it was not all that spectacular – the price was stuck somewhere around $400 – 460 for a good period of time. All of a sudden, after last year’s conference – bang, we decided to become bulls; we decided that central banks were going to BUY!

Even within the LBMA community, there was a beast lurking within – the beast of bullishness. If you are surprised by that, the ultimate evidence that there is indeed a beast lurking within us is surely that even Andy Smith – our well-known market analyst turned hedge fund player – was converted onto the bull side. Yesterday he actually managed to talk about a “super cycle” in commodities without erupting in laughter. Clearly things have changed.

We will now have some quick fire voting. What type of company do you work for?

You are all still mostly commercial banks and dealers, so you have not changed from last year! Good to see that you’re still here, though.

Next question: what do you think will be the most significant supply and demand factor affecting the gold price?

Investment demand. It seems we did not need to hold the debate last night after all; we could have just posed the question to you and that would have been more than sufficient.

This was the answer from last year, and to the percentage, it’s almost exactly the same. It just shows you how things have not changed in terms of our view of what is driving our market.
Next question: do you agree that Australia was robbed by those cheating Italians in yesterday’s match?

There are some cruel people in this market – I knew that. When I was an analyst, that never would have happened; when you are on sales, life is much tougher.

Opening Session

The Swiss National Bank, which of course became famous during the 1990s for its selling programme, opened our conference strongly. The content of the speech was consistent with their selling decision, but Dr Hildebrand added that they actually achieved $17 above the average price – clearly some very impressive trading took place there.

Unfortunately, there was no comment this year that they were going to be buying gold. I was waiting eagerly for them to say ‘actually, we messed up, it should not have been a 1,300 tonne sale; we will go long, at least to 1,300 tonnes’. Sadly, it did not happen this year – maybe next year.

This is the answer given last year to the question of what we, the market, believed the amount of gold sold by central banks in 2007 would be.
Slightly less than 500t; a little less bullish than last time. Given the central bank selling that we see out of the ECB, this does mean that some of you are quite optimistic, and expect to see some buying. Some of you are, in fact, wildly optimistic.

Niall Ferguson followed my theme of using film clips. He brought us through history and gave an excellent historical context for the gold standard, and discussed whether or not it should come back.

One point he made was not that he was a massive gold bear, but he argued that gold was not particularly a hedge against inflation, but negatively correlated against real returns on stocks. That theme came back again in the investment session.

Not that surprisingly, we see the US dollar at quite a high level. Oil and other commodity prices came into the next session in terms of the way you see money flow come into commodities as a whole. This was last year’s response.

The main point he made was that although it may not seem that way, particularly over recent weeks, this world is actually much less volatile than what we have seen before, even compared to the period where we had the true gold standard in the late 19th century. Now we are dealing with a situation where you have low volatility in terms of inflation, relatively low volatility in terms of growth, but high growth as well. This point was again made by George Magnus and Tony Fell – you do have this paradox, particularly with the US being a debtor empire.

While he made the point that you could still see the trade deficit grow, the ceiling is unknown. We did not push him any further on what the implications would be once we hit the ceiling. Maybe that is a topic for next time. His conclusion was that we will not be going down the yellow brick road – not that many people in this audience believed we would – but his underlying tone was not as negative towards gold as we have seen from some historians/academic in the recent past.

The next question is, what do you think will be the most significant factor affecting investment in precious metals over the next three years – inflation, oil and commodity prices, the US dollar, or global insecurity?

Not that surprisingly, we see the US dollar at quite a high level. Oil and other commodity prices came into the next session in terms of the way you see money flow come into commodities as a whole. This was last year’s response.

Compared with last year, you can see less dependency on the US dollar. Interestingly, from where I sit now on a trading desk, I actually see a divergence of gold against the US dollar actually being likely to stimulate investment interest in gold.
Next question: who do you think is the most influential investor? We didn’t ask this question last time, but we had many people asking about what they believed to be the major movers of the price on a day-to-day basis. Do you believe it is central banks, hedge funds, commodity trading advisors (CTAs), which means technically orientated funds, institutional interest or retail? Start the voting now.

Hedge funds. I guess that is not very surprising, although in fact they might be a little surprised – in particular the ones who have not been trading that often recently would be quite concerned by the fact that we believe they are still defining the price direction. It is interesting to see that the technically driven CTAs do not seem, at least to us, to be moving the market despite how regularly they are in it. Institutions are getting blamed, which brings us quite nicely to the next session: investment.

Session 2: Investment

Investment is the amazing story – actually it is the definition – of this commodity super cycle. We have witnessed a massive increase in investment, particularly into commodity indices. There are only rough estimates that all of us in the banking community have put together. The market for these estimates is somewhere between $90 and $120 billion. Either way, it is a large amount of money that started from very zero a decade ago. There is an ongoing debate that all of us are having about what impact this is having on the market. Clearly, it must be having some.

As Arun mentioned, at least according to the Goldman Sachs Commodity Index (GSCI), which is still by far the most popular of the indices, the share for precious metals in indices is quite low. The interesting thing about the indices is firstly that you are seeing more and more of them. Just yesterday, Merrill Lynch decided that there were not enough indices and added a new one of their own. Second, we are also seeing a lot of variations on the indices. Recently, for example, there was a big influx of people wanting to go into the GSCI, but going for the light energy version, which has a lower energy component, to have a more even spread across the complex.

A chart I put together shows the only way to have a relatively real time analysis of flows is to track the information you get monthly about the US commodity index tracking mutual funds. This data is the derived inflow per month from when they started, basically in 1997 until May06. As you can see, we have started to see some outflows.

A very big question for all of us is what happens now; have people had enough? Has the recent volatility, the level of prices and the recent correlation with other asset classes significantly damaged the argument for commodities? My own personal opinion is no. I still think that people who have spent three years convincing their board that commodities are the thing to be in are not looking to change that quickly. However, we are definitely seeing an element of profit taking from the retail side. That is quite evident. Secondly, the big push at the moment, from a number of these pension funds, is to look at variations of indices in other products. As a result, you are going to see a more influential move from this sector across the forward curve of the commodities markets. Arun touched on that as well.

We then talked about the private investor. I thought this was brilliant – in fantastic Swiss style, with no numbers at all. You can almost pick and choose whatever number you want. There have been extraordinary stories recently, in particular one about Iran buying in the region of 200 tonnes and holding it here in Switzerland. I am not sure into which segment that comes, but I am sure it is in there somewhere. You have certainly seen a growth of interest. One of the interesting things that Andreas mentioned was generational concerns – the son who wants to
sell the gold and the father who still believes: a nice Swiss compromise, going the 50/50 route. It will be interesting to see whether that will be a factor going forward in other markets.

A new question: does the LBMA audience believe that commodities are: 1) a strategic asset – something you consistently hold, not necessarily in the same percentage, in your portfolio, assuming you are a pension fund; 2) a tactical asset – you just buy it when commodities are looking strong and sell when you think they are going to come down, or; 3) it is all a lot of rubbish, it’s no different to art – as Niall intimated – and is not a genuine asset class at all and really should be avoided by pension funds? Start the voting.

Do you believe that commodities are:

1. a strategic asset - i.e. justify a portfolio weighting 65%
2. a tactical asset - i.e. should only be traded 23%
3. not a genuine asset class 12%

Clearly, all the banks with investor clients were desperately pressing (1).

We then talked about gold versus equities. This becomes more and more interesting given that gold equities really have not done as well as we would have thought, particularly not over recent months, given where prices have been.

We had a very interesting discussion about the relative risks and returns of the two. I always like things to be simple; I thought this chart was quite cool in terms of where you go with gold versus various types of equities. Once upon a time, you also would have had hedged versus non-hedged equities, but we all know now that hedging is a sin, so clearly there is no space for that in our equity grid anymore.

Then Albert talked about the US. It is a paradox that you see quite a lot of investor interest in commodities, particularly speculative interest – for want of a better word – in gold out of the US, yet physical demand has been extremely poor, despite 9/11, despite concerns about the dollar and concerns about inflation. It is another paradox, yet Albert is very confident that we are going to see a huge surge in numbers. We will be watching the US coin mint data very carefully for that massive increase. I have to say that I will believe it only when I see it.

**Session 3: Mining**

Pierre Lassonde talked about basic resources and the significant increase we are seeing in demand for basic materials – which George has also mentioned – and the fact that we are still facing many significant risks in meeting this demand. Not only did Pierre run through a whole raft of concerns, but we had an even bigger list. You know things are complicated when you have these sorts of diagrams – that suggests that this is an extremely difficult area. Suffice it to say, you are talking about a lot of issues, of which many of us are aware.

As a result, both Pierre and Ben were somewhat sceptical about David Cox’s expectations of growth in mining output. Obviously, Tony was equally concerned. This is a big issue. When you look at the projects out there, and assess as an analyst what projects are going to come on and where, one of the big difficulties is working out whether things have changed in terms of the way in which you bring on projects. Pierre argued that the time for going from the feasibility stage into the start of the building of a mine has gone
from nine months out to four to five years. On that basis, you would be talking about a big push out in projected output arrival from current projects.

 Showing how difficult it is when you are an analyst to come up with the numbers, Antaike is not only concerned about the future but have even revised recent history by somewhere in the region of 800 tonnes, which is not insignificant.

They are talking about growth in silver production in the region of 1,200 tonnes over the next three to four years. That obviously leaves the question of who is going to buy it all, which was taken up this morning. At least out of China, you are talking about a very significant growth in silver supply. Generally, the issue for China is whether we are going to see a big supply reaction across a range of commodities.

What do you think is the biggest challenge facing mining in general, not necessarily gold? Do you believe it is reserves, input costs, geopolitical risk, environmental requirements or the anti-mining lobbying that we are seeing in a variety of guises?

There is a fair spread across those answers, except for lobbying.

Session 4: Debate: Jewellery vs. Investment

The debate was not as fiery this year as last year, which was probably not a bad thing, although I thought the point where Paul Walker called Andy ‘a bigger prick’ was quite amusing. We had the motion that the house believes that jewellery is more important than investment. The two sides were, as always, passionately opposed to each other.

Kelvin made two excellent points. The first was that, if you look at short-term price direction, the questions and answers we have had earlier seem to suggest that investment has led to a huge amount of price volatility. Also, we have seen that investment is not one way; people sell as well. Perhaps unsurprisingly, the plummet of prices towards $250 has been blamed not on hedging by gold miners but on speculators short selling the market.

Asking who buys the gold when the investor decides to sell, he then also added the point about how important it is therefore to not just assume that jewellery demand will always be there, using the graphic example of Japan, where we saw a massive fall off.

Whether or not that was directly related to promotion – or the lack of it – remains an open debate, but it is certainly a very stark example that jewellery demand is not necessarily a constant, just because it is the largest segment of demand. All of us have a role to play in promoting it further.

Andy disagreed, and made the point that in terms of the big fall off we have seen, which was price related and has other factors, in terms of jewellery demand versus investment and that the net offtake investment has increased
significantly, as we know. He decided to change the way we look at supply and demand; it is actually all investment, either inflows or outflows. Colouring it by any other definition basically misses the point.

Jewellery is for the birds/bears

Paul Walker, after he called Andy a prick – and obviously other people wanted to say that as well – then decided that a number of us were, too. I really appreciated having a review of Economics 101 myself. What he ended up showing us was that the answer to it was in his table.

Chris Thompson then gave a speech and decided that time limits were not going to be applied. Did you get a sense that in retirement he does not have enough people to talk to? He argued very strongly that investment was the key, because of the massive oversupply of stock. There is the ever-present threat that the large stockholders – particularly the central banks, but the general population as well – may well sell a huge amount. Whether you grow demand by 100 tonnes or lose 100 tonnes of it annually, that does not do nearly enough to confront that threat.

The answer to the question of whether or not you agreed with either side showed an extremely impressive shift. Either Andy’s persuasive use of sexual innuendo and photos shocked people into voting for him, or perhaps Chris beat them down by continuing to talk for so long – in any case, it was a very successful victory for the argument that investment is far more important than jewellery.

Session 5: Fabrication & Industrial Demand

Most of you were there, so I will not talk too much about this morning’s session. Suffice it to say that I personally desperately needed the silver pills and was very keen on finding some anti-smelling silver socks, but sadly was unable to get either. I particularly liked the silver-based house. Talk of a boom or a potential bubble in the housing market could surely be defined by a house made of silver!

Then we had PGMs, another area with a fantastic array of demand outlets. The demand outlook for the PGMs generally is very compelling going forward.

Of course, there are not so many industrial uses for gold in terms of volume, but watches are a clear area. As we are here in Switzerland, it seemed only right to have a discussion about watches. There are lots of units of watches being sold; I had never realised how many. Two noteworthy points here were: 1) size – you are seeing watches becoming bigger and bigger; I do not know what that means about people’s vanity or, indeed, anything else; 2) an interesting comment was made about palladium. Although palladium has not featured much, the potential increased interest in palladium usage is one thing to watch further, not least because it is better for the Swiss watch manufacturers’ margins.

Moving lastly to small gold bars: people still buy them. Although nobody thinks that moves the market anymore, this is interesting because, as Mehdi mentioned, it is not a static market where
people buy the same thing all the time. Even in somewhere like India, the type of bar can change dramatically. We are also seeing the very successful rise of branding.

**Price Forecasts**

Let’s talk about relative optimism on demand: in percentage terms, which of the four main precious metals do you believe will show the fastest growth over the next three years, from this year onwards: gold, silver, palladium or platinum? Vote now.

Platinum wins, certainly not a huge surprise, but not by a huge margin; the votes are surprisingly evenly spread across the options.

We are nearly there, I assure you. We’ll go into the price forecasts. I just thought I would remind you of what we voted for last time. We were all basically bullish for most of the precious metals, but as it turned out, nowhere near bullish enough.

Let us see how we go this year. We will start with palladium. You are trying to predict the price at the time of your next conference, which will be November 2007. You should key in the number – for those who believe it’s going over $1,000; you’ll have to restrict yourselves.

Somebody really is bullish. Overall reasonably neutral with a slight bullish side, which is not unlike last year, although we were way too pessimistic last year.

Could you do it again for platinum: key in the price for November 2007?

This is very clearly bullish, given where prices are today. Unsurprising if you have very strong demand outlook, as we clearly do, so the price is going to follow. The average here is $1,305.
Next, give the price for silver – between $2 and $40 – for November next year.

I did expect to see more bulls. Have you not heard of the ETF? This vote is somewhere in the region of $9 – $10. My ETF buyers will be most upset by that conclusion.

Last, give the price in dollars for gold between $100 and $1,000 for November next year.

Good to see some bulls; glad you are holding very clearly to the more bullish side. That is interesting because the overall tone of this year’s conference was not as bullish as last time, but clearly, people are still optimistic. Personally speaking, the interest I see in gold, even from clients who are not typically interested in trading gold, is unequivocally and significantly increasing. While we see concerns about inflation, about the dollar, about geo-politics, I strongly believe we will see further interest.

Here are the results from last year.
One final question, the most important one of all: who do you think is going to win the World Cup? No one vote for Italy.

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For a second there, I thought it would be a classic forecast. Brazil: we really are consensus followers in this market, are we not?

| Brazil 41 | Germany 28 | Argentina 26 | England 15 | Ukraine 6 | Spain 5 | Italy 4 | France 3 | Portugal 3 | Ghana 3 |

Ladies and gentlemen, before I leave you, one last point. Next year’s conference will be later in the year; it will be in November, in Mumbai.

It has certainly been a passionate belief of mine that the bullion market should go to India, notwithstanding the difficulties that some of you may or may not experience while you are there. I thought you might need a little bit of a prelude, a little bit of a taster, a little bit of an introduction to the country.

I was thinking very seriously about how I was going to end this speech. Watching a Bollywood film, I came across the following clip and figured it was a very nice starter for you as you contemplate going to Mumbai next year. It covers greetings; it covers strange customs; it covers weddings; and it covers gold. You may find that the view on gold is slightly different from the typical one. That is the interesting thing about visiting somewhere in India: you will find your own story. Ladies and gentlemen, I will bid you farewell. I hope I see you in Mumbai in November next year. Thank you very much for your attention. ■