GOLD & ENERGY ADVISOR

Vol. III, No. 8 $19 August 2006

"Gold and Oil: How Much Longer Will They Go Up?"

"This month: a topic you rarely hear about in the media, but one that has a massive impact on your investments. We've profited from it so far, but how long will it continue?"

James DiGeorgia, Editor

- **The bull market in commodities, and its effect on the GEA portfolio**
- **Famed analyst predicts at least nine more years for the bull**
- **The Saudis: covering up massive oil problems?**

Precious metals and energy. They've soared in the last few years—and we've profited handsomely as a result—but why are they doing this?

More importantly, will they *keep* doing this, or will the rocket ride end soon?

This month, I'm going to take a different angle than usual.

In past issues, I've talked about the specific reasons gold and oil will continue to surge upwards. I'll give some more reasons in this issue too.

(Oil has sagged a bit as I write this. However, short-term price swings are irrelevant. Long-term, the bull will continue.)

Anyway, there's a broader context that I don't usually talk about. Gold and oil aren't the only commodities that have shot up lately. *All* commodities are in a strong bull.

Most investors don't pay much attention to commodities, and it's easy to see why. It's much more exciting to talk about a hot new stock than to discuss pork bellies or wheat contracts.

But here in *GEA*, we're all about making money… and right now, commodities are where the action is.

This action is very relevant to us. (No, I'm not going to start recommending pork bellies!)

Instead, I'm going to talk about the commodities bull overall, and how it affects the specific investments that we focus on in *GEA*: precious metals and energy.

Why should we care about commodities?

Most investors have trouble even spelling the word "commodities," never mind investing in them. But it's not a complicated market.

Commodities are things that can be bought in bulk for resale or use as raw materials. The list includes steel, corn, lumber, beef, cotton, sugar, coffee, soybeans, and more.

Gold, silver, and oil are all traded on commodities markets. And the overall market has a definite effect on the various commodities within in. When the market itself is bullish, it exerts a bullish force on the individual commodities too. This force doesn't dominate the performance of each commodity, but it does have some impact.

Obviously, the investments we follow here in *GEA* are more than just commodities. Gold, for example, has a monetary role in world affairs. Oil has a political aspect (entire wars have been fought for it). But nonetheless, a bull market in raw materials will still affect these investments, since they're all traded as commodities.

Here's another way to look at it. When most commodities are going up—when most foodstuffs and raw materials are increasing in price—it means the purchasing power of the US dollar is going down. If it requires more dollars to buy lumber, and tea, and soybeans, and natural gas, it means the dollar is devaluing against "real" stuff. So the prices of all commodities will tend to go up, even the ones where supply and demand are well-balanced. Without bearish forces actively driving them down, the commodities will go up automatically, just to reflect the falling value of the dollars needed to buy them.

Of course, it works the other way too. A bear market in commodities means that either the US dollar is strengthening (unlikely in today's economy), or that investors are more interested in other types of investments (stocks, bonds, whatever). Either way, all commodities will be affected by the trend.

That's why it's so important to ask: have the gold and oil bulls been aberrations? Is the overall commodity market bearish, and working to suppress gold and oil? Or are commodities bullish instead, providing solid support for gold and oil for years to come?

THE GOLD AND ENERGY ADVISOR

EDITORIAL STAFF

James DiGeorgia	*Editor*
Spiros Psarris	*Associate Editor*

PUBLISHING STAFF

Chuck Aultman	*Subscriber Services*
Angela Leonard	*Marketing Manager*

The **GOLD & ENERGY ADVISOR** is published 12 times a year by The Silver & Gold Report, LLC, 925 South Federal Highway, Suite 500, Boca Raton, Florida 33432 (800-819-8693 or 561-750-2030). Subscription rates: Single issue, $19. One year (12 issues), $189. Two years (24 issues), $279.

The new rip-snortin' bull market in commodities

It turns out that gold and oil are not freaks among their fellow commodities. You won't hear much about this from the bubbleheads in the financial media—they seem to think their main job is to peddle funds and stocks, and ignore all other investments. But raw materials in general have been booming.

There are lots of reasons for this. First of all, it's natural and expected. Bull markets always follow bear markets—the cycle is as inevitable as breathing.

Since the early 1980s, commodities (especially precious metals) were in a long, rock-bottom depression. It lasted almost an entire generation. Now we can expect the opposite to be true—a long, prolonged bull market.

I'm not the only one who believes this, of course. I recently read a great interview on this subject with famed analyst Jim Rogers. (If you haven't heard about Jim, he's not only a best-selling financial author and Columbia University professor, he's also made his clients a ton of money. Rogers' Quantum Fund partnership with George Soros led to a gain of 3,365% in ten years, and his International Commodities Index is up 263% since inception in 1998.)

Rogers believes that we're still at the beginning of a massive bull market in commodities. He pointed out that previous commodity bulls have lasted at least 15 years, and have gone as long as 23. Our current one started in 1999, just six years ago. So Rogers expects this bull to last at least until 2014, maybe even until 2022.

He also mentioned that so far, only a few commodities have even approached their all-time highs (zinc, oil, aluminum, copper, lead, and tin).

In fact, most commodities aren't even close to their all-time highs. Gold is more than $100 under its record. Silver is 75% below its top price. Sugar is 80% below, corn 50% below, cotton 60% below, coffee 75% below, and the list goes on.

Rogers noted that overall, especially when you adjust for inflation, the prices of most commodities are only about 10-20% of their all-time highs. There's tremendous room to the upside.

Yes, it's not too hard to see why commodities will continue to soar. Bullish fundamentals are all around us. For example, there's…

Voracious consumption in China

With one-sixth of the world's population (1.3 billion people), and a rapidly modernizing economy, the Chinese appetite for commodities seems insatiable.

It takes lots of raw materials to build all those new cars, factories, and skyscrapers. And the Chinese are building at a blistering pace. China's economy has averaged more than 9% growth per year for the last decade, hitting a staggering 17% last year. It's on track to expand 10% or more again this year.

According to the Worldwatch Institute, 6,800 new cars hit Chinese streets each day. No surprise then that crude oil imports rose by 15.6% in first half of the year. Other materials are disappearing too: China accounts for around 40% of the world's cement market, for example.

And this voracious appetite for commodities shows no sign of slowing down. If anything, it promises to increase instead.

For example, China's Ministry of Land and Resources recently announced its five-year plan to start stockpiling mineral reserves: uranium, copper, aluminum, manganese, crude oil, and other "urgently needed" raw materials. So the Chinese are not only going to buy materials for current consumption, they're also going to increase their buying and start hoarding.

This is great news for commodity prices!

Commodities go up, stocks go down?

Commodities tend to move inversely to stocks. When raw materials are cheap, companies can manufacture cheap goods, and tend to flourish. When materials are expensive, manufacturing companies have higher expenses, and struggle.

So great news for commodities tends to be bad news for stocks—at least, those stocks which aren't producing the commodities. The producers themselves will obviously do well, like the oil companies in our portfolio.

Carnage among producers

Commodity producers are extremely sensitive to world prices for their products.

When commodities go through a prolonged depression, like they did until recently, many producers are ruined. Even the survivors have to fight to make it through the tough times. What *doesn't* happen during this period is a lot of capital investment into infrastructure.

Farmers stop buying tractors and combines, and might even be forced to sell part of their lands. Gold and silver companies stop looking for new ore deposits. Oil firms stop drilling for more reserves. Everybody gets along with what they already have, as best as they can.

When the bear market finally breaks, and a bull begins, the producers take years to recover. Even though profits start to increase, there's probably lots of debt incurred during the bear that has to be repaid. More importantly, the production infrastructure has been sorely neglected, and needs to be upgraded.

All of this requires money, and time. It can take

Latest prices as GEA goes to press—August 24, 2006

Comex spot contract: silver $12.33, gold $621.35
Nymex spot platinum: $1224, palladium $340
Nymex Light Sweet Crude Oil $72.35

Silver coins			Dealer will buy at this price	Dealer will sell at this price
100 1 oz. silver American Eagles			$1,255	$1,425
100 1 oz. common rounds			$1,150	$1,350
$1,000 face value US pre-1965 coin bag (circulated)			$8,400	$8,850
$1,000 face value US circulated silver dollar bag (VG or better)			$11,000	$13,500
US Morgan silver dollars		PCGS MS64	$45	$65
		PCGS MS65	$110	$140
		PCGS MS66	$280	$375
Platinum coins				
U.S. Platinum Eagle:		1 oz.	$1,224	$1,325
		1/2 oz.	$620	$720
		1/4 oz.	$310	$395
		1/10 oz.	$123	$195
Gold coins				
Australian Kangaroo			$615	$647
British sovereign (Kings)			$125	$168
(Elizabeths)			$125	$168
Canadian Maple Leaf			$615	$680
Credit Suisse 1 oz. gold bar			$610	$645
Mexican 50 peso Centenario			$725	$800
South African Krugerrand			$610	$647
US Gold Eagle:		1 oz.	$589	$620
		1/2 oz.	$295	$325
		1/4 oz.	$145	$168
		1/10 oz.	$58	$68
US $20 double eagle:				
Liberty	Raw	MS60	$600	$775
	NGC	MS63	$800	$1,200
	NGC	MS64	$1,800	$1,950
	NGC	MS65	$4,150	$5,950
Saint Gaudens	Raw	MS60	$625	$725
	NGC	MS63	$800	$900
	NGC	MS64	$1,000	$1,100
	NGC	MS65	$1,100	$1,450

Prices courtesy of Universal Coin & Bullion
(800) 459-COIN (2646)

years, even a decade, for an industry to recover. That's why commodity bulls last so long. Even though prices are going up, the producers can't increase their production significantly for a long time. It takes years for supply to increase enough to meet the demand and bring the prices back down.

Rip-roaring commodities and the *GEA* portfolio

All of the forces I've described are going on today in precious metals and energy.

Gold mines are increasing their production as much as they can, but they're falling far short of meeting demand. Gold was in such a slump during the 1990s that many mines were driven out of business, and most of the rest shut down their exploration programs almost completely. The survivors mined their existing deposits without finding significant new ones.

Today, the old deposits are being played out, and there aren't any new deposits to replace them. It can take a decade to bring a deposit from discovery to production, and miners couldn't start looking until the bull market began a couple of years ago. So we can expect another five, seven, or even ten years before world mining production really ramps up significantly.

Meanwhile, gold demand is strong. The combination of sagging supply and surging demand is why gold has added hundreds of dollars to its price in the last couple of years, and why we can expect hundreds more in the years to come.

What about oil?

All the market forces I've described apply to oil, too. This alone tells us that oil prices are likely to stay strong.

But there are some additional forces acting on oil besides these. Vitally important ones, as it turns out. So let's leave our discussion of commodities in general, and focus specifically on oil.

Many analysts dismiss oil's recent highs as short-term aberrations. The price is being driven by emotion, they say. The BP announcement to close down the Prudhoe Bay pipeline, another terrorist attack in Nigeria, trouble in the Middle East…those are the reasons for oil's price, they say.

But they're wrong. First of all, in a healthy market, short-term aberrations shouldn't affect the market over the long term. But oil prices have been in the stratosphere for over a year now, and show no sign of letting up.

This alone should tell us there's a fundamental problem.

Emotions flare up, and then subside. Prices do likewise if emotions are their driving force. But oil prices aren't behaving like this.

What's behind oil prices then? Like anything else, the price of oil is driven by supply and demand. Which of the two is the primary force today?

Well, it's not demand. Yes, demand is strong, and has increased steadily over the years. But the important word is "steadily"—for decades, oil consumption has gone up almost every year, and it hasn't had any unusual jumps lately. So the leaps in oil's price can't be from demand.

That leaves supply. And this is indeed the source of our problem today. Analyst Daniel Yergin of Cambridge Energy Associates has described it well: he says we're in a "slow-motion supply shock."

All the biggest producers in the world, and some of the smaller ones, are having trouble producing oil. Last month I told you about Russia, the world's second-largest producer. This month, let's examine some of the others.

Lies and Deceit in Saudi Arabia

The Saudi oil minister recently confirmed that his country's production had fallen in the past few months. When asked why, he gave a ridiculous excuse. He said Saudi Arabia is deliberately cutting back on production because it can't find enough buyers for its oil.

What? There aren't any buyers? *Sure*, there aren't. That's why the price of oil reached an *all-time high* recently—because nobody is buying any. What kind of a stupid answer is that?

Obviously, it's the kind of answer you give when you don't want to tell the truth, but are running out of excuses.

In past issues of *GEA* I've told you about reports that Saudi oil production is in serious trouble, especially at Ghawar (the biggest field in the world, producing five percent of the world's oil all by itself).

It's not surprising that the Saudis are trying to cover this up, but it looks like they won't be able to do this for much longer. Their lies are becoming more and more obvious.

Violence in Nigeria

The troubles continue in Nigeria, the world's eighth-largest oil exporter. Various groups of militants are still attacking government and foreign oil interests, in an effort to gain political autonomy. The militants are angry over years of government corruption and oppression, and are now fighting back.

The nicer militant groups are "only" blowing up oil structures and taking hostages (usually foreign oil workers). Their stated goals are to cut oil production by certain amounts (usually 20 or 30 percent).

On the other hand, one of the nastier groups has said, "*All* pipelines, flow stations and crude loading platforms will be targeted for destruction." Of course, destroying the primary source of income for their own country would be counterproductive, but they don't seem to care.

As a result, the oil industry in Nigeria has been disrupted and partially destroyed. The militants' combined efforts have taken hundreds of thousands of barrels of oil off world markets.

Unfortunately, this situation is getting worse instead of better. An already bad situation is deteriorating rapidly, and Westerners are being warned to flee the country. Yet another African country is descending into chaos in that war-torn continent, but this time a significant portion of the world's oil supply is going with it.

That's grim news for world oil markets, and sadly, even worse news for the Nigerian people who are caught up in this growing war.

The small fry: not so small anymore

As American and European oil reserves dwindle, the West is increasingly dependent upon foreign oil.

We tend to worry about our large suppliers: Saudi Arabia, Russia, and others. And there's certainly lots to worry about.

However, more and more, the small fry are throwing their weight around too. As world oil markets grow more and more desperate for crude, even the small producers are getting tremendous leverage. And they're using it against us.

Oil producing countries are doing things they wouldn't have dared to do a few years ago, and we're helpless to stop them. Lately there's been a growing trend where these countries are "nationalizing" Western oil interests, which is a nice way of saying "stealing."

Western oil companies have invested billions in oil exploration around the world, and then developing the reserves that they find. They've done this in expectation of selling the oil later. Of course, the proceeds would be shared with the host countries who allowed them to explore and build there.

What's happening instead is that the host countries are grabbing the oil fields and infrastructure for themselves, without reimbursing the companies for the billions they've invested.

For example, Venezuela recently took over two oil fields from France's Total SA and Italy's ENI SpA. In May, Bolivia nationalized its natural-gas industry (the second largest in South America). In Peru's recent presidential election, the candidates were promising to "renegotiate" contracts and impose windfall taxes on foreign oil and mining companies.

Thanks to tight oil markets, the oil-producing countries have the leverage to get away with this. For example, Exxon Mobil recently refused to knuckle under to Venezuela's demands for tens of millions in newly-invented "back taxes." In retaliation, the company was kicked out of a $3 billion regional petrochemicals project.

This is an alarming trend for three reasons.

First of all, it's obviously a criminal act to steal billions of dollars in equipment from the company that paid for and installed it all.

Second, it reduces the incentive for oil companies to explore for and develop new oil reserves. Most of the promising areas for oil in the world are in politically unstable places.

Why spend the money to find oil if it's just going to be stolen from you anyway? So this will reduce the oil that comes to market long-term.

Third, it reduces current oil production as well. Over and over again, we've seen that when a host country nationalizes foreign oil assets, oil production plummets afterwards.

The Western oil workers leave (sometimes they're chased out at gunpoint)—and the locals don't have the expertise to operate the infrastructure, nor can they explore for more oil as well as the big international companies can.

Plus the host governments that do this are usually run by Communists or criminals. The resulting corruption and incompetence always results in local oil production falling like a stone.

We've seen it happen again and again: in Iran, Mexico, Venezuela…the list goes on and on. Nationalization has always been bad for local oil production.

So each time another oil field gets nationalized, the world's oil supply takes another hit, for both the short term and the long term.

Portfolio Updates

In Update #219, we took profits and sold our shares in Diamond Offshore (DO).

For subscribers who own Ensco International (ESV), we also recommended selling the August $45 calls (ESVHI).

In Update #220, for subscribers who own the Anadarko August $42.5 calls (APCHV), we legged into a spread with the August $45 calls (APCHI) by selling them.

In Update #225, we recommended a limit order to buy Chevron Corp. (CVX) at $56, for subscribers who did not already own the stock.

In Update #227, we rolled up our options in Encore Acquisition (EAC). We bought back our August $25 calls (EACHE), and sold the December $25 (EACLE) options to open.

In Update #229, we took action on some of our option positions:

- We bought back and closed our August $30 calls on Bill Barrett Co. (BBGHF), and sold the September $30 calls (BBGIF) to open.
- We let one options contract that we wrote on Noble Energy (NE) expire. For the other, we bought to close our August $65 calls (NEHN), and sold the September $65 calls (NEIM) to open.
- For Anadarko Petroleum (APC), we bought and closed our August $45 calls (APCHI), and sold the September $45 calls (APCII) to open.

In Update #230, we gave recommendations for subscribers who had written options on ESV, ATW, XEC, and APC.

We allowed the calls on Ensco International (August $45 calls, symbol ESVHI), Atwood Oceanics (August $45 calls, symbol ATWHI), and Cimarex Energy (August $40 calls, symbol XECHH), to expire, and kept the premiums.

For Anadarko Petroleum (APC), we closed the August $42.50 calls (APCHV), and we exercised the August $45 calls (APCHI).

Civil War in Iraq

Iraq is probably the most promising area in the world for future large oil discoveries. It has excellent potential in its geology and its location in the world, plus it's relatively unexplored.

Also, much of its existing available production is off-line, thanks to the ongoing war there. Even just restoring Iraq to its former level of production would ease the strain on world markets.

But Iraq is getting worse instead of better, as I'm sure you already know. The Sunni and Shiite conflict is turning into an open civil war.

As I wrote in *Global War for Oil*, Iraq isn't really a country: its boundaries were arbitrarily drawn by the British after World War I. This was not only arrogant but stupid, and the consequences have been disastrous.

The Sunnis and Shiites have hated each other for over a thousand years. Forcing them into sharing a nation together just can't work. And for most of Iraq's history, it hasn't worked. Until Saddam took over, Iraq was continually at war with itself. The only reason Saddam was able to stop it was that he was a murderous thug who tortured and killed anybody who might disagree with him.

But now he's gone. Our hopes of installing a democratic regime there is sheer fantasy. These people already hate each other, and each side wants revenge for the many atrocities done by the other. And this gets worse every day.

How are they going to get along after US soldiers leave? How will they erase the memories of their fathers and brothers, who were kidnapped, tortured to death, and their bodies dumped alongside the road…or their mothers and sisters who were killed in random mortar attacks…or their children who were slaughtered by car bombs and snipers?

All this murder and mayhem is happening in a culture where grudges are not forgiven or even forgotten. No, they're avenged immediately if possible—otherwise, they're nursed and remembered for generations afterwards, until revenge can actually be wreaked.

All we've succeeded in doing is creating a bloody mess right smack in the middle of the largest oil-producing region of the world. One that threatens to pull in other combatants (Iran on the Shiite side, Saudi Arabia on the Sunni). The *best* we can hope for is that Iraq is alone as it descends into anarchy.

<u>Not</u> good news for the world oil supply.

A new use for gold

As new uses for gold are discovered, demand for the yellow metal will continue to increase.

Here's an interesting one announced recently. Scientists in the UK have discovered that "nanoparticles" of gold can be used in the war against terrorism and even ordinary crime.

These particles are tiny: just 1/5000th the width of a human hair. The researchers have found that the particles can be coated with specific sugars and made into biological detectors. The sugar that's used determines what substance the particles will detect.

Let's say the FBI gets a report that terrorists are planning to attack a city's water supply. Some poisons, especially biological agents, are so potent that a cupful can kill thousands of people. But it's difficult to detect so little poison in a large body of water.

Using this new technology, law enforcement officials can take a sample of the water and mix it into a solution of the gold nanoparticles that's been tailored to detect whatever poison is suspected. The pure particle solution is red in its normal state, but the molecules of the targeted substance will bind to the particles and turn the solution blue.

Law enforcement officials are excited about this new technology: not only is it far more sensitive than current methods, but portable detectors are finally possible. (Today, samples have to be taken on the scene and sent back to a lab for analysis.)

Plus, officials can use this method in a wide variety of other ways: not only to detect poisons and toxins, but also bacteria and viruses. It will also be useful at crime scenes: for example, analyzing sweat, fingerprints, or other biological material a criminal leaves behind.

Insanity in Iran

Iran is also a primary oil producer in the world, and a significant producer of natural gas. But as an Islamic theocracy, Iran's economy is backwards and getting more so.

Its oil infrastructure is crumbling and deteriorating. And the mullahs don't seem to care. Certainly, we can't expect Iran to increase its supply of oil to the world.

Worse than that, the Iranians are determined to start a crisis of their own, as I've mentioned before.

The mullahs are now only one step away from having nuclear weapons. Iran's former President Rafsanjani just announced that Iran has successfully enriched uranium and reached "industrial production." (The world media were shocked by this announcement, but I told you about it here in *GEA* over a year ago.)

The United Nations has finally decided to pretend to do something, and has set an August 31 deadline for Iran to stop this work. Unsurprisingly, Iran has scoffed at this. Iranian President Ahmadinejad has proclaimed that Iran is "fully mastering the nuclear fuel cycle…No one can take it away from us."

Now that Iran has enriched uranium, all that's left to do is to metallize it and fit into a warhead. They already have the delivery systems (ballistic missiles). The metallization process isn't easy, but then again Iran has lots of more-experienced friends eager to help it out (like Pakistani nuclear scientist Abdul Qadeer Khan who has coached Iran in its quest for weapons).

Who wants to guess what will happen once the mullahs get nukes? Remember, this is the country whose nutjob President says he wants to "wipe Israel off the map." He reiterated this again recently, in a meeting of Islamic leaders in Malaysia: he said the "main solution" to the crisis in Lebanon was to "eliminate the Zionist regime" and destroy Israel.

Of course, the Israelis are already nuclear, and have no intentions of quietly absorbing a missile strike without fighting back. This situation is truly frightening: possible nuclear war in the Middle East.

But surely rational thinking will prevail? Don't count on it. Ahmadinejad is flat-out crazy. He just wrote an open letter to President Bush that contained the following:

"Those with insight can already hear the sounds of the shattering and fall of the ideology and thoughts of the liberal democratic systems. We increasingly see that people around the world are flocking toward a main focal point—that is the Almighty God [Allah]… My question for you is, 'Do you not want to join them?'"

In January, Ahmadinejad told a crowd of theological students that "Islam is not confined to geographical borders, ethnic groups and nations. It's a universal ideology that leads the world to justice."

He's openly proclaimed his belief that an Islamic messiah is coming soon, to impose Islam on the entire world. Of course, radical Islam teaches submission of non-believers 'at the point of the sword' if necessary, which in modern terms would be a nuclear-tipped missile.

This guy with nukes at his disposal is a scary prospect.

We can pray that this whole situation will resolve peacefully somehow. My point for now is that whatever happens, our energy crisis isn't going away.

A strong argument for gold

The Iranian situation is obviously bullish for gold as well. Gold is always the investment of choice when massive political disruptions are threatening.

In addition, there's the recently-discovered plot to blow up trans-Atlantic planes with liquid explosives. This argues for gold in your portfolio as well.

Obviously, the terrorists haven't gone away. Their movement is actually growing in certain ways, and we shouldn't let down our guard against them. More on this in future issues.

Why we invest the way we do

Gold and oil continue to be the preferred investments in our current environment.

So what's the best way to buy them? Obviously, we have oil stocks in the *GEA* portfolio. But I get emails from readers asking me why we don't have mining stocks too.

There are several reasons why our portfolio is structured the way it is. One of the biggest is valuations. I just don't like any gold or silver companies right now. And I won't recommend overpriced stocks.

Another reason is the nature of gold itself. Gold protects you when other investments crash. Since mining companies are stocks, they often behave as stocks and get hit when the broader market goes down, even when gold and silver themselves are going up.

Yes, many gold commentators point to mining stocks as "leverage" to gold's price. You can profit more from the stocks than from gold itself, they say.

Sometimes this is true. But all too often, it isn't. And a gold coin in your hand can't be taken from you by a stock market crash, or a currency inflation, or a large bond default. If anything, it's more likely to go *up* in value in these circumstances.

Physical gold is still the best way to invest in the yellow metal. That's I like it, that's why I own it, and that's why I recommend you own it too!