GOLD & ENERGY ADVISOR

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"The Fed's Rate Cut has Rippled Through the Global Economy—and the World's Central Banks are Trapped!"

"The Fed has fired the first shot in an international battle. Other nations will be forced to respond, whether they like it or not.

"The 'competitive currency devaluations' have begun! This is bad news for many asset classes, but great news for us!"

- **Why nobody wants a strong currency any-more**
- **What most people don't know about the dollar and inflation**
- **Five reasons why the gold bull is just getting started**

The Dow just hit another all-time high. This was triggered by the release of the minutes from the Fed's mid-September policy meeting.

Apparently, during this meeting Fed officials predicted weak economic growth in the coming months.

So why would stock traders be cheered by bad economic news? Because bad reports mean the Fed will probably cut rates again. Supposedly, that will be good news for stocks.

In today's markets, bad news is now good news. If that thinking strikes you as backwards… that's because it *is*.

The Fed's outlook, and its recent decisions, do indeed have significant implications for our economy. And a further rate cut would probably boost stocks a little bit. But that's only a sideshow when compared to the bigger effects of the Fed's actions.

Let's take a look at what's coming, and how to profit from it. We'll start with…

How The Fed has Doomed the Dollar—and Other World Currencies Too

Last month, I wrote about the Fed's recent rate cut.

With the dollar at all-time lows, the Fed would normally be trying to rescue our currency with higher rates. But the Fed is lowering them instead.

This simultaneously encourages lending, and discourages saving. Both effects are inflationary, obviously. Therefore, the dollar is going to weaken even further.

What about the world's other currencies? The Fed's actions will affect them too.

Of course, the Fed's decisions to change US interest rates can't affect other currencies directly. But the world's central banks will be forced to respond to the Fed's rate cut by weakening their own currencies.

THE GOLD AND ENERGY ADVISOR

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The Race to the Bottom

In today's global economy, nobody wants a strong currency.

This is a fairly new problem. For most of human history, this wasn't true. Healthy economies used to base their currencies on gold. This not only made the currencies strong, it also automatically corrected economic problems.

Any nation that consumed more than it produced would experience a net outflow of gold. This had many positive effects:

- It provided a definite (and early) warning that there was a problem.
- Citizens and businesses would see their cash reserves falling. This would discourage consumption.
- A mild deflation would occur inside the nation's borders. Prices of raw materials would fall. This would encourage production (especially for exports).

As production increased, consumption would decrease. Eventually, balance between the two would be restored.

Conversely, nations that produced more than they consumed would see the opposite effects. They would see a net inflow of gold, which would stimulate a mild inflation inside its borders. This would make imported goods cheaper than domestic goods, which would stimulate trade. Again, the imbalance would eventually go away.

So gold-backed currencies were a boon for international trade. They not only made trade easy, they kept the national economies balanced.

As a result…

Prices remained stable for *centuries*!

In today's inflationary world, we've all forgotten what a balanced economic system looks like.

Just consider how life used to be when everybody used gold. In the United States, the cumulative CPI (consumer price inflation) from 1820 to 1913 was ***zero***.

Inflation Means the Government Wins, and We Lose

Why are governments so addicted to inflation today?

Because inflation allows politicians to steal from their citizens. And the citizens don't even notice.

Here's an example. Let's say the US government were to double the amount of dollars in existence tomorrow.

Prices would soon double in response. When everybody has more money to spend, demand rises, and pushes up prices.

So the amount of overall purchasing power in the economy wouldn't change. Once everything rebalanced, the dollars in circulation would still buy the same amount of goods and services as before.

But there's a problem here. Everybody who had dollar-denominated instruments (savings accounts, CDs, money markets, etc.) would lose half the purchasing power of their savings. Where did this purchasing power go?

It seemed to vanish. But this is impossible—purchasing power can't just disappear.

What actually happened is that the government took it.

When the government creates money, that money isn't distributed directly to us citizens. Instead, it flows into the economy through spending. When the FBI agent receives his paycheck… when the scientist receives his federal research grant… when the defense contractor receives payment for military hardware… those dollars are received, and then spent into the economy by their recipients.

But here's the key. The government creates the new dollars, and spends them at full value. The dollars don't fall in value until after they flow into the economy and exert their inflationary effect.

So in this example, the government gets double the value from the dollars than the population does. (I used "double" as my example to make it easy. But the same is true whether the money supply is inflated by 100 percent in one year, or only 1 percent. Either way, we lose the value, and the government gets it.)

Obviously, the lost purchasing power isn't confiscated directly by the government. But when the government does something that allows it to spend more, and the citizens to spend less, it's the same effect.

That's why politicians are addicted to our inflationary system. They can steal from us citizens over and over again, and most of us don't even understand what's happening.

Our only defense is to take our savings out of dollar instruments, and put them into assets like gold—assets that increase as the dollar decreases.

In England, the average price of consumables rose less than 0.4 percent from 1210 to 1940. In the United Kingdom overall, consumer prices actually *declined* from 1800 to the end of WWII. Other nations flourished as well.

Unfortunately, those days are gone.

By imposing fiscal discipline, gold provided wealth and prosperity for the world's citizens. Unsurprisingly, though, government leaders chafed at this discipline. They preferred to spend whatever and whenever they wanted. So, during the 20th century, Western governments began to abandon their currencies' ties to gold.

Today, all Western currencies float freely. No longer are they based on gold. Instead, they're based on… nothing.

Under today's economic system, currencies are no longer tethered to a common foundation. Therefore, they can rise and fall relative to each other.

This summer, the US dollar sank to new lows versus the euro. It also hit parity with the Canadian dollar, which last happened 30 years ago. And this was *before* the Fed's rate cut, which will cause the greenback to plunge further still.

This will make American exports cheaper for foreigners to buy. Therefore, our export sales will go up. Conversely, Americans will buy fewer foreign imports, since they will be more expensive for us now.

As the dollar falls, our imports go down, and our exports go up. This is great news for America, right? Of course, foreign governments don't like this prospect at all. Our profit will be their loss.

As an example, consider Airbus, the giant European airplane manufacturer. According to the UK

Latest prices as GEA goes to press—October 19, 2007

Comex spot contract: silver $13.67, gold $762
Nymex spot platinum: $1,438, palladium $369
Nymex Light Sweet Crude Oil $89.00

Silver coins		Dealer will buy at this price	Dealer will sell at this price
100 1 oz. silver American Eagles		$1,397	$1,475
100 1 oz. common rounds		$1,367	$1,465
$1,000 face value US pre-1965 coin bag (circulated)		$9,100	$9,800
$1,000 face value US circulated silver dollar bag (VG or better)		$11,200	$11,800
US Morgan silver dollars	PCGS MS64	$45	$51
	PCGS MS65	$116	$129
	PCGS MS66	$220	$245

Platinum coins

U.S. Platinum Eagle:	1 oz.	$1,434	$1,468
	1/2 oz.	$717	$734
	1/4 oz.	$358	$367
	1/10 oz.	$143	$147

Gold coins

US Gold Eagle:	1 oz.	$770	$790
	1/2 oz.	$385	$395
	1/4 oz.	$188	$195
	1/10 oz.	$76	$80

US $20 double eagle:

Liberty	Raw	MS60	$800	$900
	NGC	MS63	$1,030	$1,130
	NGC	MS64	$1,580	$1,690
	NGC	MS65	$3,900	$4,500
Saint Gaudens	Raw	MS60	$800	$840
	NGC	MS63	$885	$915
	NGC	MS64	$970	$1,020
	NGC	MS65	$1,240	$1,340

Prices provided by Finest Known

Telegraph, every 10-cent rise in the euro versus the dollar costs Airbus €1 billion.

As another example, look at Japan. Its economy contracted 0.3 percent in the second quarter, and wages have fallen for eight months in a row. The Japanese desperately need larger export markets, and a dollar that's falling relative to the yen is *not* good news.

So how will world governments respond to the Fed's weakening of the dollar?

They'll Devalue Their Currencies Too!

As Eurogroup chair Jean-Claude Juncker recently warned, "We have begun to have great concern about the exchange rate of the euro."

The Fed's action has put tremendous pressure on world governments. To stay competitive in world trade, they are now forced to keep their currencies weaker than they'd otherwise prefer.

This means lowering their own interest rates, or at least not raising them when they would otherwise have done so. It also means allowing gold to soar upwards against their currencies.

For many years now, Western governments have tried to suppress gold's price. Every time the price popped up, a central bank would announce a bullion sale, and drive the price back down. We've seen this over and over again. The most recent example was this past April, when the European Central Bank sold 37 metric tons. (Gold was threatening to breach €500 per ounce.)

But that game is over now. The Fed's action has forced the rest of the world to drive their own currencies down, and let gold leap up. As a recent Citigroup report said:

"Central banks have been forced to choose between global recession or sacrificing control of gold, and have chosen the perceived lesser of two evils…We believe that the policy resolution in the credit crunch will take the form of a massive, extended 'Reflationary Rescue,' in a new cycle of global credit creation and competitive currency devaluations. This could take gold to $1,000 an ounce, or higher."

Think about that phrase: "competitive currency devaluations." Governments will be racing to see who can drive their currencies the lowest! How high can gold's price go under these conditions?

Why This is Just the Beginning

The dollar has slid amazingly far in just the last couple of years. But its slide is only beginning.

First of all, Congress still refuses to face reality. We need to slash federal spending, but the spending orgy in Washington just gets bigger every year instead.

As one disgusting example, look no further than good ole' Ted Stevens, the Republican Senator from Alaska. You might remember that he championed the infamous "Bridges to Nowhere" back in 2005, making American taxpayers pay $452 million for bridges to uninhabited Alaskan swampland. He's also being investigated by the FBI for corruption charges.

Despite all this, Senator Stevens is now directing the United States Navy to spend $84 million on a ferry to Alaska's Port MacKenzie. The port is already accessible by car (it's only a two-hour trip), but the good Senator thinks that's not good enough. He thinks the American taxpayers—that's you and me—should pay $84 million to get a ferry running to the Port, to save his constituents a little time.

But how many constituents are we talking about? Only 40 people—the employees of the Port's two businesses. Stevens is making us spend over $2 million per employee, to save 40 Alaskans a few minutes of driving time.

Would you buy an investment with a chart like this? This is the performance of the United States dollar over the last six years, compared to other major currencies. (And these currencies themselves were depreciating via inflation!)

The dollar has lost 93 percent of its value since WWII. This means it now takes a full dollar to buy what **seven cents** *used to buy then.*

Furthermore, thanks to the Fed's actions, we can expect another leg downward from here.

Truly this man has no shame. And that's my point—*nobody* in Congress has any shame, or common sense for that matter. That's the reason our national debt is approaching $120,000 for each family of four in this country.

Then there's our swelling trade deficit. We buy far more goods and services from the rest of the world than we produce for them. Our overall deficit is now $764 billion, which is a new record. That's over 6 percent of GDP, making us the second-worst country in the world. (Only Greece is worse. And the Greeks have an excellent excuse—their mountainous country has few natural resources, other than beaches and sunshine.)

The International Monetary Fund is warning that a substantial dollar decline will be necessary to bring our trade deficits under control. <u>Some analysts say it needs to fall another 20-40 percent</u>.

Personally, I think this won't be enough. This scenario assumes our trade deficits will be fixed with a weaker dollar. This is partially true, but there's more to the story than this.

Just look at China. Our trade deficit with China last year was over $232 billion. That was up by $31 billion from 2005, which was larger than the entire deficit just 12 years ago.

Our wise leaders in Congress blame this on China's monetary policy. The Chinese peg the yuan against the dollar. Therefore, as the dollar has fallen in value, the Chinese have been devaluing their yuan as well. This prevents the US from getting an exchange-rate advantage in trade with that country.

Congress periodically threatens to punish the Chinese with sanctions if they don't stop this "unfair" currency policy. However, currency exchange rates are only one part of the forces that affect prices. There are also other forces such as:

- Supply and demand.
- Differences in technology.
- Different resources of labor and capital.

For proof of this, just look at the euro and the British pound. The Chinese yuan floats against them both. Therefore, it has fallen against them both over the last couple of years.

Our leaders in Congress believe that nominal exchange rates control trade. If this was true, then Chinese exports to Europe should have soared. But they haven't.

China's endless flood of exports is driven by China's endless supply of cheap labor, not by the yuan's exchange rate.

Nevertheless, Congress seems too clueless to realize this. This means our government will drive our dollar into the toilet, trying to accomplish an impossible goal.

Plunging Dollar, Soaring Gold

Gold is hitting prices not seen since January of 1980.

Just like the late 1970s, all currencies are depreciating versus gold today. Since the beginning of 2002, gold is up 69.8 percent in euro terms, and 266 percent in dollar terms.

Some commentators say this is just a temporary blip. If the world's currencies were really inflating, they say, then we'd see higher consumer price inflation.

But they're wrong for several reasons. First of all, as I've discussed before in *GEA*, the government's CPI numbers are falsified today.

Second, gold has always been a leading indicator of inflation, while CPI is a lagging indicator. There hasn't yet been time to see heavy inflation in the CPI reporting.

Third, the bloodbath in the US housing market will depress the CPI figures. We can easily have monetary inflation and a housing depression (and thus a 'low' CPI) all at the same time.

Perhaps the most exciting news for gold investors is that even if the dollar doesn't fall further, gold is *still* looking wildly bullish anyway! That's because…

What is a Dollar, Anyway?

A dollar used to represent a certain quantity of gold or silver. You could bring a dollar to the Mint and get one-twentieth an ounce of gold in return. In effect, the green piece of paper was just an 'IOU' for valuable metal.

Unfortunately, President Roosevelt defaulted on the IOUs in 1933. He confiscated everybody's gold, and banned the further exchange of dollars for gold. The dollar went from an "IOU gold" to an "IOU nothing." Before, citizens had used dollars in trade because they were receipts for something valuable. Now they had to pretend the receipts were still valuable, even though they were no longer receipts for anything.

Interestingly, other governments could still exchange dollars for metal. Everybody could exchange American dollars for American gold *except* American citizens.

Then, in 1971, President Nixon finished the default that Roosevelt had begun. He "closed the gold window" to the rest of the world too.

All over the globe, world governments and central banks had hoarded dollars. A greenback was easier to store than gold, after all. And the one was equivalent to the other—until Nixon slammed the redemption window shut. Now the world's governments have their own piles of "IOU nothings."

(As bad as Roosevelt was, at least he only screwed America. Nixon did the entire world.)

Today, the dollar is still (reluctantly) used by world governments. The US has the biggest economy in the world, so it makes sense to have the currency that allows easy trade with America.

The problem with this new system is that it relies on the fiscal restraint of US politicians. As we inflate our currency, the value of the dollars that foreigners have accumulated will plunge.

Two thirds of all central bank holdings are in US dollars. Thus, foreign government reserves have bled out tremendous amounts of value in the last couple of years as the dollar has fallen.

That's why central banks are increasingly looking to sell dollars and buy gold.

According to the International Monetary Fund, dollar reserves in central banks are now down to 41 percent. Back in 2000, dollars made up 55 percent of all foreign exchange reserves. That's a fall of one-third.

Meanwhile, many central banks have announced plans to increase their gold reserves. Russia, India, and China are all examples of this.

Gold is Soaring for Non-Monetary Reasons as well

I don't recommend gold as only an "anti-dollar" investment. If that's all you wanted, you could get that more directly by shorting the dollar on the forex markets.

No, the yellow metal is also an excellent investment in its own right. Let's look at its fundamentals.

Last year, gold's mining supply was 2,106 tons. Demand was 3,374 tons.

Thus, demand exceeded mining supply by 1,268 tons. Put another way, mining production supplied only about 60 percent of demand. (The rest came from scrap recycling and sales from the official sector.)

Right away we see that the physical gold market is under tremendous pressure. Gold's price rise in the last couple of years isn't a speculatory bubble, or a temporary over-reaction to a falling dollar. The metal's supply/demand deficit is very real.

And here's where the story gets exciting…

Despite gold's price rise, the physical deficit isn't subsiding!

Normally, a rising price would suppress demand, and encourage production. But according to the World Gold Council's most recent statistics, neither is happening for gold. This means the gold bull has a long way to run yet!

Let's look at demand first. The largest source of overall gold demand is fabrication (jewelry, dental, and industrial uses). And despite gold's soaring price, fabrication demand has exploded upwards.

Last year, industrial & dental demand hit an all-time record of 452 tons. Meanwhile, jewelry sales were a whopping $42 billion.

And this year, demand is *still* surging up. In the first half of this year, overall fabrication demand hit 1,502 tons: that's 18 percent higher than the first six months of 2006.

Meanwhile, gold's supply is *falling* instead of rising. In 2005, total supply was 4,025 tons. That fell to 3,541 last year. So far in 2007, it's been 1664: an annual rate of 3,328 tons.

A lot of this is due to falling mine production. Gold mines produced 2,464 tons in 2005, 2,106 tons in 2006, and have totaled a mere 918 tons in the first half of 2007. That's an annual rate of only 1,836 tons, which would mean a fall in mining production of over 25 percent in just two years.

This is shocking, when you think about it. Gold's price has doubled in the last four years. Yet

In the last few years, gold mines have been hit with a 'perfect storm' of problems. For one thing, their energy costs are soaring.

There's also a growing amount of pressure to reduce the environmental impact of mining operations. Related to this, many countries are growing reluctant to allow new or expanded mines. Even when permits are granted, they are taking longer to achieve. And the recent tunnel collapses in South Africa's gold mines highlight the need for safer working conditions.

All this means mining operating costs are soaring, and their cumulative production is falling.

Portfolio Update

In Update #407, we gave instructions for subscribers who wrote options against Devon Energy (DVN) and Pioneer Natural Resources (PXD).

We rolled up our DVN options to the next month and strike price. We closed the October $70 calls (symbol DVNJN) and sold to open the November $75 calls (DVNKO).

We also rolled up our PXD options to the next month. We closed the October $45 calls (PXDJI) and sold to open the November $45 calls (PXDKI).

In Update #408, we gave instructions for subscribers who wrote options on Talisman Energy (TLM) and Cimarex Energy (XEC).

We rolled up our TLM options to the next month. We closed the October $15 calls (TLMJC) and sold to open the November $15 calls (TLMKC).

We also rolled up our XEC options from October into December. We closed the October $35 calls (XECJG), and sold to open the December $35 calls (XECLG).

the physical market is getting tighter instead of looser!

Falling supply + rising demand = a long-lived bull market!

Five Reasons Why Gold's Price Will Keep Soaring

So far in this issue, we've seen how the world's major currencies will continue to trend downwards. We also saw that gold's continued tightness means continual upwards pressure on its price. These are the first two reasons to expect a long bull market.

The third reason is that historically, gold and oil tend to track each other during bad economic times. A study by Salomon Brothers showed that between 1970 and 1980, gold and Saudi light crude both had annual compound returns of exactly 31.6 percent. As I've explained in past issues of *GEA*, oil prices will be under severe upward pressure for the next several years. This indicates high gold prices as well.

The fourth reason is an increase of investment demand. Last year, investor demand accounted for 643 of 3,374 tons: about 19 percent of total demand. That's up slightly from 2005, which was 16 percent. But it's nowhere close to historic highs.

When inflation gets bad, investors stampede into gold. For example, investor demand reached 30.1 percent in 1979. In 1973 and 1974, the OPEC oil shock drove investor demand to 40.3 and 60.3 percent, respectively.

Once the competitive currency devaluations really get going, investors are going to get serious about protecting themselves. Let's say investor demand only reaches 35 percent. That would be a demand for 1,184 tons of gold, which is an increase of 541.5 tons over today.

This new demand would be more than 25 percent of current mining production (which is already grossly inadequate to meet world demand). Obviously, gold's price would blast upwards.

The fifth and final reason for a sustained bull is also related to investors. There's been a landmark shift in the gold market.

For the first time since 1933, private investors now own more gold than the world's central banks. Thanks to private purchases and official sales, private holdings are now an estimated 1.1 billion ounces, compared to central bank stocks of less than 1 billion.

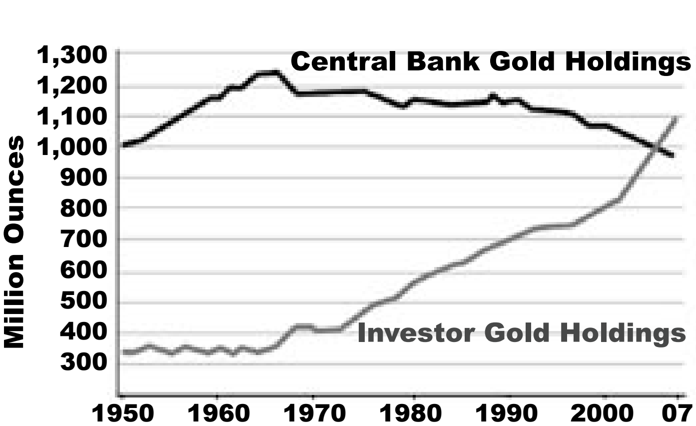
So why is this important? Because, as I mentioned earlier, central banks have been suppressing gold prices for 20 years now. But they're running out of gold to sell—and running out of 'ammunition' in their battle to keep gold down.

Conversely, investor ownership is bullish for gold. As analyst Michael Checkan has noted:

"Global investors typically adhere to the "buy and hold" approach…there have been only three years since 1965 where investors were actually net sellers of gold on a global basis:

- 248 tons in 1970;
- 6 tons in 1972, and;
- 22 tons in 1995."

In summary…



For the first time in many decades, private investors now own more gold than central banks. Data source: CPM Group

I believe gold's doubling in price is just the beginning.

I started *GEA* back in early 2004, in response to changing economic trends. Gold was still in the $300s, and oil was at $36. Everybody laughed when I said these investments were going to soar.

Well, here we are just 42 months later. Nobody is laughing anymore. Oil has more than doubled, smashing through its price records, while gold is up 86 percent.

But we aren't finished yet—not by a long shot. I believe oil and gold both have long bull markets ahead of them!