GOLD & ENERGY ADVISOR

Vol. V, No. 2 $19 February 2008

"The Unprecedented Gold Bull Market of 2008: Getting Stronger All the Time!"

"The ongoing gold bull is acting strangely. Normally as prices go up, supply would rise and demand would fall.

"But that's not happening in the current market. Instead, supply is falling, and demand is rising. The metal's fundamentals are even stronger now than they were when this massive bull market began!"

James DiGeorgia, Editor

I recently sent you a Bonus *GEA* Issue via email. (If you didn't get it, you can log into our website at www.GoldAndEnergyAdvisor.com to access it.)

In it, I mentioned I'm updating my popular book, *The New Bull Market in Gold*, to reflect gold's new price target of $2,500. I also gave you the revised Chapter One.

This month, it's time for Chapter Two, discussing gold's supply and demand fundamentals. Some people might think this topic is a little dry, but hang in there—its implications are *very* exciting!

So here's Chapter Two!

As we saw in the last chapter, gold has multiple factors that influence its price.

Of the ten reasons I expect gold to reach $2,500, nine of them are bullish forces related to gold's financial value. However, gold is first and foremost a physical asset.

Therefore, before we discuss the metal's financial aspects, we should first discuss the physical supply and demand fundamentals of gold.

Three Sources of Supply, Two Sources of Demand

The above-ground supply of gold increases slightly every year. All the new metal comes from gold mining operations. The world's gold mines can be divided into three categories:

- **Primary mines.** These are mines with the principal purpose of extracting gold from the Earth.
- **Secondary mines.** These generate gold as a byproduct of mining other minerals.
- **Waste reclamation.** These operations process waste from older mines, reclaiming gold which was formerly uneconomical or impossible to obtain. Modern technology has made it possible to process material that was waste to previous miners, even extracting particles of gold that are invisible to the naked eye.

These three sources of gold are fascinating topics in their own right, but we'll combine them for our purposes in this chapter.

Along with mined gold, the gold market also has two other sources of supply. In industry lingo, 'secondary supply' represents the recycling of old jewelry and industrial scrap. There are also 'official transactions': the sale of gold from official stocks such as government and central bank reserves.

The world's above-ground inventory of gold is unchanged by both secondary supply and official transactions, but these do supply gold to the market. Therefore, they impact gold's price, and we will include them in our analysis

THE GOLD AND ENERGY ADVISOR

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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.

In 2007, an estimated 119.3 million troy ounces of gold came to the market. Of that, 82.8 million ounces came from mines, 27.5 million ounces came from secondary supply, and the remaining 9 million ounces came from official transactions (mostly sales from central banks).

The chart below shows the composition of gold's total supply. Mining supply is further broken down into major Western suppliers, vs. the rest of the world. As you can see, South African mines are still the largest individual source of gold supply. More on South Africa later.

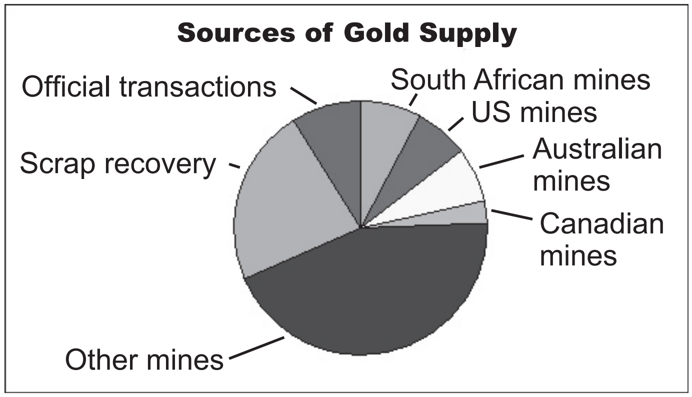

Figure 2.1: Sources of gold supply

On the demand side, gold has two primary sources: fabrication demand, and investors.

Fabrication demand is a broad category; it includes anything made from gold. The primary types are:

- **Electronics** (gold wire, edge connectors, electrical contacts, etc.)
- **Dental uses** (gold fillings, inlays, crowns, and bridges)
- **Medical uses** (gold-plated stents, gold-membraned drug delivery microchips, gold-compound drugs, plus gold wires and circuitry in pacemakers, ventilators, and other biomedical equipment)
- **Jewelry**
- **Other industrial products** (gold catalysts, nanoparticles, and other uses).

The second source of demand comes from investors. Again, this is a broad category. It includes the sale of government coins like United States Gold Eagles, rounds and medallions from private mints, and bullion bars. It also includes shares in the various Gold Exchange-Traded Funds which have sprung up on the world's stock exchanges.

Total demand in 2007 was 119.3 million troy ounces. Jewelry was the largest source of demand, at 69.1 million ounces. Next was investor demand, at 39.7 million ounces. Fabrication demand was third at 10.5 million ounces.

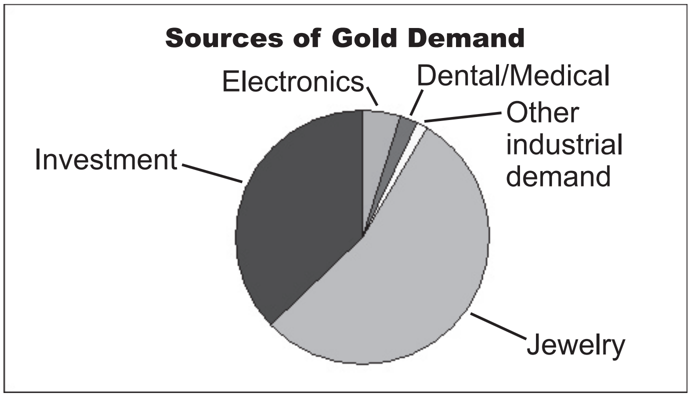

Figure 2.2: Sources of gold demand

By the way, you might have noticed something. I've listed central banks as a source of supply, and investors as a source of demand. Can't central banks sometimes buy gold (thus becoming a source of demand instead of supply), and investors sometimes sell it (thus supplying instead of demanding)?

Yes, they can. But both situations are rare. Official transactions have created net purchases of gold only once in the last 20 years (by 5.3 million ounces in 1988).

Similarly, investors have been net sellers of gold only once during the last 30 years (by 700,000 ounces in 1995). So it makes sense to treat official transactions as supply, and investor activity as demand.

Declining Supply, and Surging Demand

In many ways, the current gold bull has acted strangely.

A mined commodity like gold should have very predictable reactions to changes in its price. For example, if the price falls, mining supply should decrease.

Here's why. As mines obtain less revenue from their production, the less-profitable mines begin to struggle. Eventually, they will be shut down completely. Global gold production will fall.

As for the mines that stay open, most of them will decrease their production. Their higher-cost deposits will become less attractive to work, if they remain profitable at all. So managers will stop those operations, focusing instead on the easiest-to-work deposits that can still be profitable at lower prices. Again, gold production will be hurt.

Obviously, the opposite should be true if gold's price rises. Deposits that were formerly non-economic to work suddenly become profitable.

In addition, more investor money becomes available for exploration and development of new deposits. If gold's price stays high for several years, production should ramp up considerably.

As for demand, it too should move according to gold's price. The more expensive gold gets, the more expensive it is to use in fabrication.

Similarly, you would expect investors to start considering other asset classes as gold's price rises. So it would seem that gold demand should rise and

Portfolio Update

In Update #449, we recommended buying options on Pride International (PDE): 1 contract of the April 2008 $25 calls (PDEDE). We also recommended shorting a put on Transocean Inc (RIG): we sold short the Feb. $130 put (RIGNF).

In Update #451, we issued instructions for subscribers who sold the ESVAK options against their Ensco International (ESV) positions. We allowed the options to expire, and kept the $4 premium.

In Update #453, we recommended selling Ensco International (ESV) at the market value of about $52.74. Our adjusted cost basis after option writing was $36.17. This gave us a return of 45.81% since May of 2006.

In Update #456, we took profits on our PDEDE (Pride International) option. We made 7.6 percent in 13 days.

In Update #458, we issued instructions for subscribers who wrote options against their ConocoPhillips (COP), and Devon Energy (DVN) positions. For both, we rolled up our February calls to March calls.

In Update #459, we hedged our Apache Corp (APA) position. We sold the $100 March calls (APACT).

In Update #464, we issued instructions for subscribers who shorted the RIGNF. We covered our short by buying the Transocean February $130 put (RIGNF). We made a profit of $435 per contract.

In Update #465, we legged into a spread for our Gulf Island Fabrication (GIFI) July $30 calls (GQIGE) We sold the April $25 calls (GQIDE).

In Update #466, we went long two ETFs (exchange traded funds) that short the energy markets. We bought 100 shares of MACROShares Oil Down Tradeable Shares (DCR) and Ultrashort Oil and Gas Proshares (DUG).

In Update #468, we issued instructions for subscribers who sold the XECCG options against their Cimarex Energy Co. (XEC) position. We rolled up the March $35 call options (XECCG) to the June $35 calls (XECFG).

Latest prices as GEA goes to press—February 22, 2008

Comex spot contract: silver $18.00, gold $945.72
Nymex spot platinum: $2,165, palladium $509
Nymex Light Sweet Crude Oil $98.90

			Dealer will buy at this price	Dealer will sell at this price
Silver coins				
100 1 oz. silver American Eagles			$1,868	$1,969
100 1 oz. common rounds			$1,756	$1,828
$1,000 face value US pre-1965 coin bag (circulated)			$12,302	$12,527
$1,000 face value US circulated silver dollar bag (VG or better)			$13,450	$13,950
$1,000 face value 40 percent US silver (AG/G)			$5,060	$5,288
US Morgan silver dollars		PCGS MS64	$48	$52
		PCGS MS65	$127	$137
		PCGS MS66	$260	$280
Platinum coins				
U.S. Platinum Eagle:		1 oz.	$2,120	$2,205
		1/2 oz.	$1,057	$1,123
		1/4 oz.	$526	$576
		1/10 oz.	$208	$243
Gold coins				
US Gold Eagle:		1 oz.	$953	$965
		1/2 oz.	$468	$494
		1/4 oz.	$233	$250
		.		
US $20 double eagle:				
Liberty	Raw	MS60	$960	$985
	NGC	MS63	$1,485	$1,515
	NGC	MS64	$1,745	$1,785
	NGC	MS65	$4,600	$4,700
Saint Gaudens	Raw	MS60	$970	$995
	NGC	MS63	$1,100	$1,125
	NGC	MS64	$1,185	$1,210
	NGC	MS65	$1,525	$1,565

Prices provided by Finest Known

fall inversely to gold's price.

Strangely enough, none of this has been true during the current gold bull.

As I write this, the metal's price has been surging for about seven years now. Yet supply and demand have not behaved as expected. Yes, we have seen changes in some categories of supply and demand. Nevertheless, the overall fundamentals for gold are stronger now than they were back in 2001!

Let's look at each category, to see what's going on.

Mining Supply is Declining

Global mining supply peaked in 2001 at 82.5 million ounces. It has declined somewhat since then.

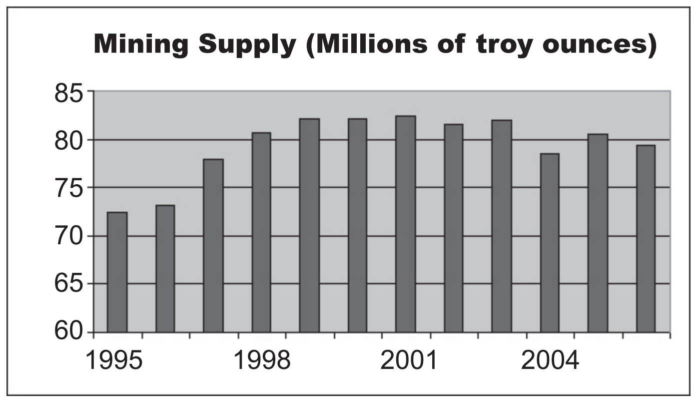

Figure 2.3: Global mining supply peaked in 2001, and has declined since.

Ironically, 2001 marked the beginning of the current gold bull. So mining supply has fallen, even as the price has risen.

This is the result of several factors. Much of it comes from the plunge in South Africa's gold production. The deep hardrock mines in South Africa have historically been a major source of gold for the world. In 1984, for example, this country produced 46 percent of global supply.

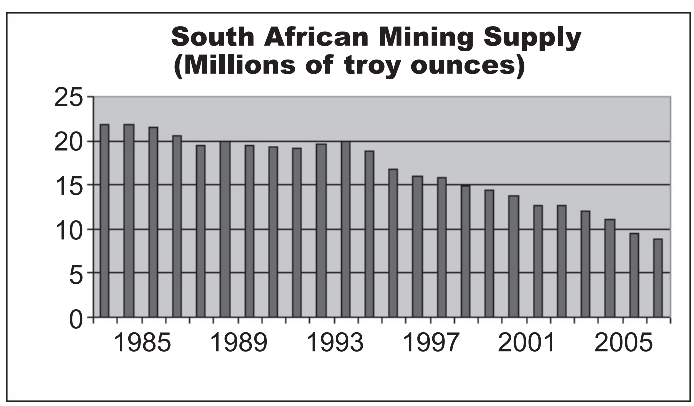

Figure 2.4: South African mining supply is declining

But the South African supply is drying up. Their deposits are nearing exhaustion in some cases. Plus, the country's power grid is inadequate to supply the nation's needs. Brownouts and power outages are a growing problem.

Also, the gold mines are huge. Some of them are several miles deep. This makes mining not only difficult, but very dangerous.

A couple of decades ago, mining workers were treated very harshly. They were forced to work in dangerous conditions with little thought for their safety. Today, as part of the broader movement toward human rights in the country, workers have it much better. (The work is still dangerous, but far better than before.)

Fortunately, this has been a long-term trend rather than an event. Over the last few years, working conditions have been slowly improving in South African mines.

One side effect of all this has been a rise in operating costs. Better and safer working conditions have made production more expensive. (Actually, costs are rising to where they should have been all along, if proper consideration had been made for the workers.)

So we see that South African deposits are being exhausted, and operating costs are rising. These two factors mean that over the last 25 years, South African production has fallen by more than half.

What about other countries? Around the world, production has been suffering. There are several reasons for this:

- Increased awareness of worker safety, as in South Africa.
- Declining production from mature deposits.
- Political uncertainty and hostility toward mining in many Third World countries.
- Increasing awareness of environmental issues.

That last point deserves fuller explanation. For the most part, environmentalists have never been friendly toward mining. After all, an operating mine is a smelly, dirty, dangerous place.

Large pits and mine shafts are sunk into the Earth, producing large heaps of rubble. Generators and power plants belch smoke into the air. Sometimes, trees are cut down so new roads can be carved through the wilderness. For hardrock mines, the local water table is often affected as well. On top of all this, some mining operators have failed to repair any of the damage when their mines are played out—they just abandon them and move on.

Mines have always had these problems, but lately there are additional issues as well. Recovering gold particles from the surrounding ore has always been a challenge for miners, and the industry was revolutionized when cyanide heap leaching was introduced on a large scale in the 1970s. In this process, the ore is crushed and formed into large heaps, then sprayed with a solution of sodium cyanide. The gold dissolves in the cyanide, runs off, and is collected for further processing and extraction. The remaining rock is discarded.

This process works well, but it's *very* toxic to the surrounding area. More and more localities are resisting this practice. As they do, it gets more difficult to extract gold from ore, and more difficult to produce gold from the mines in that region.

Lastly, mining production has fallen because of the savage bear market in gold from 1997 to 2001. Gold's price fell so far that many mines were shut down. More to the point, exploration for new deposits fell sharply.

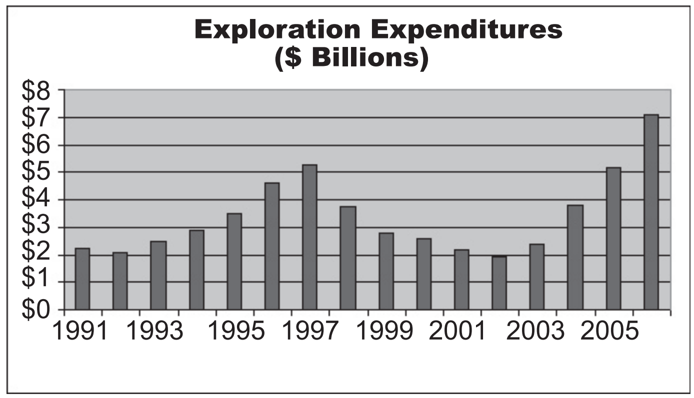

Figure 2.5: Global expenditures for gold exploration only recently recovered from the bear market of the late 1990s

Expenditures on exploration fell by 60 percent from 1997 to 2002. Since it takes 5-10 years to go from discovery to production, the world's gold supply will not recover fully from this lack of exploration until 2011-2012.

Secondary Supply is Declining

Gold can often be recovered and recycled after its use. After melting and refining, the gold comes back onto the market for use again. This is known as secondary supply.

There are multiple sources for this recovered gold. The two primary sources are industrial scrap and old jewelry.

Traditionally, nations in the Middle East and Asia were the largest sources of old jewelry. A common practice when buying new jewelry was to sell the old at the same time. However, this is changing. More and more, new jewelry buyers are keeping their old necklaces, bracelets, rings, and so on.

Thus, the secondary supply of gold has been declining. It peaked in 2003, but has fallen ever since.

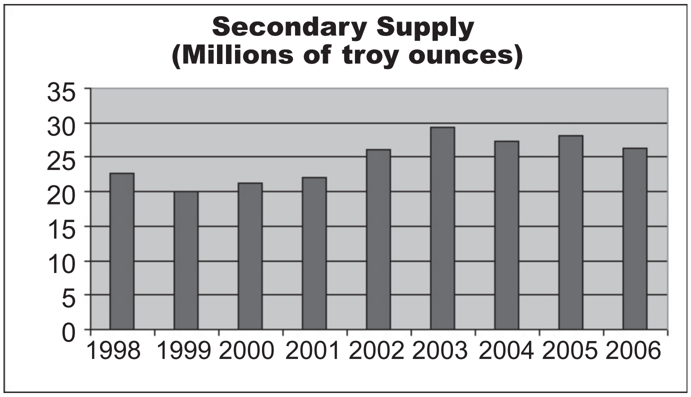

Figure 2.6: Secondary supply of gold peaked at 29.4 million ounces in 2003, and has fallen by almost 10 percent since then.

Will secondary supply increase again as gold pushes up to $2,500? Probably. Nevertheless, I don't expect this to suppress gold's price.

As we saw earlier, secondary supply is less than one-fourth of gold's overall supply. Thus, it won't exert as much influence on the price as the more important components of supply and demand.

Supply from Official Transactions Has Declined

In the past, sales from central banks have exerted a substantial effect on gold's price.

In fact, these tend to affect the gold market far out of proportion to their actual amounts. Governments have used official sell-offs to deliberately suppress the market. Whenever gold's price got too lively,

Will Gold's Supply Plunge Even as Gold Approaches $2,500?

In all 6,000 years of recorded human history, we've extracted about 142,600 tonnes (metric tons) of gold from the Earth. Of course, as a physical asset, gold has a limited supply.

As the remaining amount of gold in the Earth declines, gold's price will rise even more strongly than we've seen so far. For centuries, prospectors and explorers have scoured the world for gold. By now, the most obvious deposits have all been found.

No doubt, there are many bonanzas still waiting to be discovered. But prospecting gets more difficult every year. New deposits are increasingly more expensive to find.

Plus, much of the world's remaining gold is in places you wouldn't want to visit. Repressive governments and unforgiving terrain can intimidate even the most ambitious gold miners. There are excellent reasons why the US, Canada, and Australia have all been thoroughly explored, and many other places have not. The remaining deposits are concentrated in places where costs are much higher, for political and/or geographic reasons.

Add it all up, and the cost of finding new gold is climbing. This is bullish for the price. But there's another factor that's even more important…

How much gold is still undiscovered in the world?

Obviously, this question can't be answered precisely. However, it's possible to get a rough estimate. And this calculation produces a *very* interesting number.

Thanks to work done by the US Geological Survey, we've mapped out the geological formations for almost the entire Earth's surface. We also know from experience which types of geological formations are likely to contain gold.

Therefore, we can estimate how much gold is left to be found.

We can calculate the total gold left in the world to be about 137,700 tonnes. Notice this number is a little less than all the gold ever mined in human history. Put another way, we've already extracted more than 50 percent of all the gold in the Earth.

And remember, mining has accelerated tremendously in the last few decades. About half of all the gold ever produced was mined since 1960, in less than 50 years. And the rate of mining has accelerated tremendously—it's more than doubled in just the last 30 years. Every year, it accelerates even further.

So that last 50 percent or so of gold in the Earth won't last long.

Yes, it will take a number of years before we exhaust the Earth's treasure. But meanwhile, the gold that's left is getting harder to find, and more expensive to dig out.

Even as the gold bull rages on—even as gold approaches $2,500 and beyond—we might see the annual supply of gold start to *shrink* instead of grow. Truly, this will be an explosive bull market!

another round of sales would be announced.

However, those days appear to be over. Official reserves have fallen sharply from these sales. Governments have sold some 170 million ounces of gold just since 1989, when the Maastricht Accord was signed in Europe.

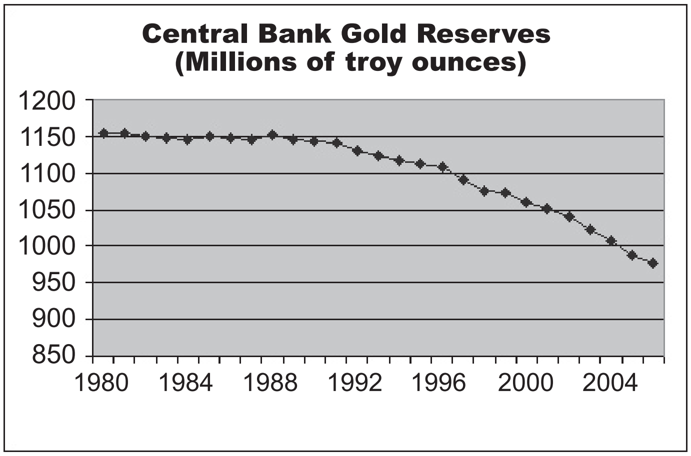

Figure 2.7: Central bank reserves have declined

Bankers and government officials rarely mention gold sales anymore. It appears they have sold all that they are willing to sell.

Not only that, private investors (who historically tend to be bullish) are now a more powerful force in the markets than central bankers. For the first time in almost a century, investors now own more gold than governments do.

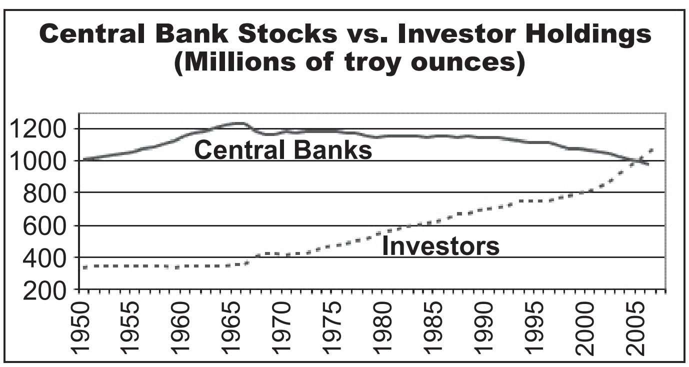

Figure 2.8: Investors are now a stronger force than central banks

In the past, political considerations have played a large role in determining gold's price. This influence was almost always negative; government officials usually resent gold's ability to expose their financial misbehavior. That's why governments (including the US) have acted so often to try and suppress the price of gold.

But those days are over. Now we can assume that market forces will be the primary forces driving gold's price. Since the metal's fundamentals are all positive, we can expect gold's price to rise unhindered from here.

Fabrication and Jewelry Demand Has Declined—But That's Not Necessarily Bad News

Fabrication demand represents the demand for gold as a raw material. In the last decade, this has declined by about 25 million ounces, although current projections show it bouncing back a bit.

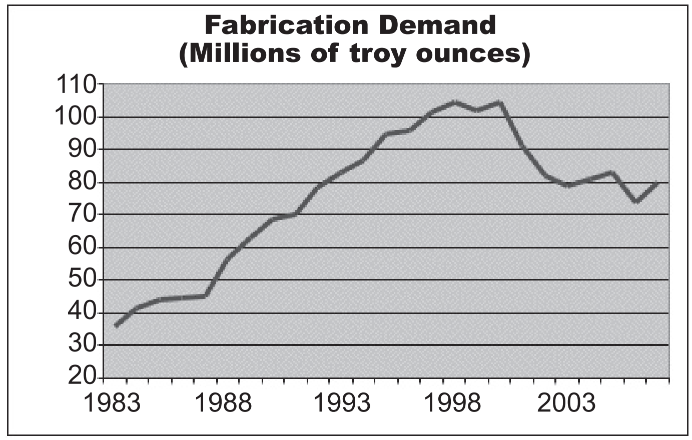

Figure 2.9: Global fabrication demand

Is this bad news for gold? Not particularly.

Much—perhaps most—of this demand has merely been redirected. Buying patterns in the Middle East and Asia (especially India) are changing.

Traditionally, many Asians bought gold jewelry to store their wealth. Gold is portable and convenient—even a small amount represents a large amount of value. Also, in some Hindu and Muslim sects, women are only allowed to own the things they wear. (Everything else belongs to the husband, and reverts to his family upon his death.) Women in these cultures need to wear their wealth—and gold jewelry is perfect for this.

However, as I said, this pattern is changing. It's still prevalent in rural communities, but urban dwellers have been buying less jewelry. Increasingly, they're viewing gold as more of a financial asset. Instead of necklaces and rings, they're buying gold bullion, coins, and even gold ETFs (exchange traded funds).

Thus, the decline in fabrication demand isn't necessarily bad news for gold. Asians are still eager to buy gold. They're just buying it in different forms.

In fact, as we saw earlier, this is actually a positive influence on gold from the supply side. The declining purchases of jewelry are part of the reason why secondary supply has been falling. There's less jewelry to be recycled.

Even as fabrication demand has gone down, investor demand has gone up. And this is an exciting category of gold's fundamentals …

Investor Demand is Surging

Investor demand is a large, complex force in the gold market. Indeed, the next nine chapters of this book will explore various reasons why investor demand will increase over the next few years.

For now, we'll look at investor demand overall. In general, investors are a reliable source of demand for gold. As I mentioned earlier, investors have only sold gold on a net basis once in the last 30 years.

Even when gold is unpopular among one group of investors, there's usually another group somewhere else that is eager for it. One or more large economies are usually experiencing high inflation or a currency crisis of some sort. (Recent examples include Italy, Argentina, and Turkey.) Therefore, investor purchases in those places tend to counteract sales in other countries.

Another important factor is the diversity of reasons that investors buy gold. We can easily identify at least six of these: gold serves as a commodity, a currency hedge, an inflation hedge, a safe haven, a form of savings, and an alternative asset.

This variety of reasons provides a strong foundation for investor demand. Let's look briefly at each.

Gold as a Commodity. As a physical asset, gold can rise in price as its underlying fundamentals change. Investors who follow the physical gold market closely can make handsome profits.

Gold as a Currency Hedge. We mentioned this a moment ago. There are always a few currencies in the world being threatened by the stupidity of their own governments. Gold allows investors to protect themselves as their currencies periodically plunge into crisis after crisis.

Gold as an Inflation Hedge. Even if the viability of a currency isn't being threatened, its long-term value is never sustainable. Governments continuously inflate their currencies, destroying their values over time.

As we saw in the previous chapter, gold is an excellent way for investors to profit as their currencies depreciate.

Gold as a Safe Haven. We previously discussed gold's immunity to most troubles that can befall a market. The recent credit contagion that blasted through the US markets is a great example of this. A remarkable breadth of investments tanked as this contagion swept through the economy.

Since gold is immune to counterparty defaults and other such problems, investors stampede into the metal when troubles loom.

Gold as Savings. Many investors prefer to have at least some of their savings in gold.

This isn't limited to people in India or the Middle East who store their wealth in gold jewelry. For example, many American investors sleep better, knowing part of their wealth is safely stored as gold—immune from banking failures, problems in the money markets, or whatever.

Gold as an Alternative Asset. Finally, many investors love gold because unlike other assets, it's both tangible and beautiful. If you've ever held a one-ounce gold coin in your palm, you know what I mean.

There's a quiet satisfaction you get from gold. It's something you just can't get from numbers on a bank statement.

So there are multiple reasons why investors buy gold. In the following chapters, we'll see why these reasons will become even more powerful in the next few years.

In this chapter, we've covered gold's attractiveness as a commodity. We'll summarize it by saying…

Declining Supply and Increasing Demand Mean a Strong Bull Market

Despite record prices, all three sources of gold's supply are falling.

Meanwhile, overall demand is surging. Not only that, there are excellent reasons to expect demand to soar even further in the years ahead.

In the next chapter, we'll start to look at these in depth. We'll begin with a new source of demand, which is causing a massive shift in the markets—the gold exchange-traded funds.