Gold: Plenty of room to move higher - and higher

While a settlement of the U.S. debt impasse may see a sharp correction in the gold price this will only be brief with $1700 gold easily in sight this year and rock solid fundamentals suggest much higher prices in the future.

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Despite gold's recent run up to new historic highs, I believe the yellow metal's price has far to go - both in future percentage appreciation and duration before the great gold bull market comes to its ultimate cyclical end.

Right now, there is no evidence of a buying frenzy to suggest we are anywhere near a long-term top . . . but there are plenty of rock-solid fundamentals that suggest the market is healthy with plenty of room to move higher. Moreover, the world economic and geopolitical environment remains very supportive - and seems likely to remain pro-gold for years to come.

My forecast, published on NicholsOnGold and in other speeches and reports, of $1700 gold by year-end 2011, now seems within easy reach.

And this is just the beginning of gold's next great leap upward, a leap that will carry the metal to $2000 an ounce in 2012 - with prices heading still-higher, quite possibly to $3000, $4000 and maybe even $5000 an ounce by the mid-to-late years of the decade.

From a long-term perspective, gold prices near $1500, should we ever return to that level, $1600, or even $1700 an ounce will prove to be bargains.

As I have cautioned in the past, expect high two-way price volatility and periodic sharp corrections, corrections that some will mistake as the end of the bull market - but consider these opportunities for "scale-down" buying, opportunities to acquire additional metal at bargain-basement prices.

A PAUSE THAT REFRESHES

Rising some $300 an ounce from its January 2011 low point and more than $120 in just the past few weeks, gold has scored a series of successive all-time highs. Now, however, there is certainly some risk of a sharp short-term correction, particularly if the political-economic news on either side of the Atlantic looks less threatening to financial market stability.

A political compromise to raise the U.S. Treasury debt ceiling and agreement to narrow the Federal deficit in future years that avoids any downgrading of Treasury debt by the rating agencies would remove or reduce an important source of anxiety that has contributed to gold's recent strength. News of positive movement toward or actual completion of an agreement could trigger a swift - but temporary - gold-price retreat.

Speculative long positions held by institutional traders on world derivative markets have increased sharply in recent days. Should the market lose upward momentum, speculative pressures could quickly turn negative. Moreover, if the short-term news turn bearish for gold, liquidation of these long positions and/or institution of new speculative short positions could leave the market especially vulnerable to a swift correction .

Adding to my short-term caution has been a price-related relaxation of physical demand and the appearance of increased quantities of gold scrap returning to the market, especially from India and other price-sensitive national markets in recent weeks as prices rose above $1550 and approached $1600 an ounce.

I expect Indian and Chinese scrap reflows will diminish significantly over time, even at high price levels. In the meanwhile, should gold approach or fall below the $1550 level, scrap supplies will quickly abate and price-sensitive demand, smelling a bargain, will re-appear.

HOT SUMMER, HOTTER AUTUMN

Contrary to the view expressed by most serious gold analysts, we said in past reports that gold would not pause for its typical summer vacation - and it hasn't! Nor would we see this summer a seasonal relaxation in price volatility. Indeed, it has been a very hot summer as gold moved up smartly to achieve new all-time highs with plenty of fireworks and price volatility both up and down.

However, come September, positive seasonal factors will kick in - and, other things being equal, give gold still more firepower. There are three distinct sources of seasonal demand, all of which will likely contribute to demand and higher prices as we move into the later few months of 2011: First, jewelry manufacturers step up fabrication demand ahead of Christmas gift-giving late in the year; second, Indian dealers begin stocking up ahead of the autumn festivals and wedding season, and in expectation of good harvests and healthy household incomes in the gold-friendly agrarian sector; and, third, later in the year and in early 2012, we should expect a sharp rise in gold investment and jewelry demand associated with the approaching Chinese lunar new year.

For sure, irrespective of the season, price-sensitive Asian demand - principally from China and India - for physical metal will continue to underpin these markets and limit downside risks.

So too will bargain hunting by a number of central banks eager to raise their official gold holdings without disrupting the world gold market by increasing upward price volatility.

CENTRAL BANKS REDISCOVER GOLD

Official statistics published monthly by the IMF show that central banks, as a group, have been busy buying gold. Russia, India, China, Saudi Arabia, Mexico, and Brazil have been among the big buyers in recent years and a number of other countries have added smaller amounts of gold to their official reserves. One big surprise was Mexico's purchase of some 100 tons earlier this year as a hedge against the possible decline in the value of their U.S. dollar reserve holdings.

Moreover, a recent survey of 80 central bank reserve managers predicted that the most significant change in their official reserve holdings in the next 10 years will be their intentional build up in gold reserves. They also predicted that gold will be their best performing asset class over the next year and sovereign debt defaults will be their principal risk.

SOVEREIGN DEBT CRISIS PROMPTS SAFE-HAVEN DEMAND

European Central Bank president Jean-Claude Trichet a few weeks ago raised the alarm level on Europe's debt crisis to "red," warning that the crisis is nowhere close to being resolved . . . and he also warned of the "potential contagion effects across the [European] Union and beyond."

Meanwhile, Europe's sovereign debt problems are worsening and the likelihood of sovereign default by one or another of the more vulnerable periphery economies is increasing, despite the past week's patchwork aid package that avoided (or more likely postponed) a sovereign default by Greece.

Despite all the talk among finance ministers and the European central bank, it looks like the future fate of "periphery' country debt is increasingly in the hands of the credit rating agencies who view any delay in full repayment as partial default.

Several factors suggest that the European debt crisis will continue to worsen:

Longer term, the more restrictive fiscal policies the periphery nations (Portugal, Ireland, Italy, Greece, and Spain - the so-called PIIGS) have been asked to accept will push their economies deeper into recession - and increase, rather than decrease, government deficits and borrowing needs for years to come.

More immediately, the downgrading of sovereign debt by the rating agencies raises interest rates and borrowing costs - and pushes these countries closer to the brink (a lesson that the United States needs to learn before it also finds itself with higher Treasury borrowing costs should we suffer a cut in our own debt ratings on U.S. Treasury securities).

As credit ratings decline for the peripheral countries, the rising cost of refinancing maturing debt make it all that much more difficult to keep their heads above water. Reflecting the recent deterioration in credit ratings, Greek two-year bond yields last week were over 35%, Spanish 10-year bonds hit a record 6.3%, and Italian 10-year bonds were also yielding around 6%. Higher borrowing costs will increase government deficits and make repayment of past debt all the more difficult.

An important aspect of the crisis is that default on European sovereign debt, debt that is held by many European banks, will require the banks to write-down these questionable assets, leaving them with insufficient capital and effectively bankrupt.

The broader effect of bank failures on the European economy, capital markets, and banking system could be far more devastating than the Bear Sterns and Lehman Brothers debacle in the United States - and would likely result in the European Central Bank along with the U.S. Federal Reserve flooding financial markets with newly created money, depreciating paper currencies, inflating prices, and boosting gold.

I continue to believe that ultimately the euro, Europe's single currency, will be replaced by a multi-currency system - with the core countries possibly retaining the euro while the periphery nations will revert each to their own monetary unit or a deeply devalued renamed euro of their own.

With no solution in sight, Europeans will continue to abandon the euro for "safe havens" including gold and, ironically, the U.S. dollar. At the same time, the problems of the euro will discourage its acceptance as a reserve currency by some central banks - and make gold an even more attractive alternative.

MEANWHILE, BACK AT THE FED

The U.S. economy is still mired in recession, or worse. Nearly everyone knows it, even if the official statistics show some positive growth in real GDP. Unemployment remains stuck at over 9 percent. The huge inventory of foreclosed homes held by banks continues to weigh heavily on home prices. Various economic indicators released in the past few days and weeks are pointing to the second dip in what may be called a double-dip recession.

So far, most Washington politicos and Wall Street bankers are in denial, refusing to see the worsening signs of renewed recession. Instead, they are arguing for restrictive economic policies that, if enacted, would exacerbate the developing downturn . . . and which future history books will liken to the policy mistakes of the 1930.

The Fed also fails to see, at least publically, the writing on the wall. Having ended its program of quantitative easing at the end of June as scheduled, it will - in my view - soon be forced by rising unemployment and sluggish business activity to resume monetary stimulus in one form or another. Contrary to popular belief, the Fed can stimulate the economy and liquefy the financial system through open-market purchases of securities and even real assets, not just Treasury securities but stocks, corporate bonds, commercial paper, mortgages, credit-card debt, student loans and even real estate.

The resumption of quantitative easing (QE3) or some other program of monetary stimulus will be reflected in a swift and significant jump in gold prices.

As I have said in past reports and speeches, the only viable and politically acceptable means for America to dig itself out of its unbearable burden of excess debt - federal, state and local,

housing, and other private-sector debt - is to pursue a pragmatic policy of higher inflation that will deflate the ratio of outstanding debt to nominal gross domestic product (GDP) to historically acceptable and manageable levels. This is what we did in the 1970s, a decade of stagflation, and we're already doing it again. Indeed, under Chairman Bernanke's lead, the Fed is quietly pursuing this policy of targeting somewhat higher U.S. price inflation.

Pursuit of a mildly inflationary monetary policy will not however excuse the Congress and Administration from developing a responsible believable program of long-term spending restraint and deficit reduction. However, now is not yet the time to impose these restrictions on an ailing economy - though articulation of a realistic bi-partisan plan for long-run deficit and debt reduction would help calm world financial and currency markets.

Whatever happens in the U.S. and European economies, it is hard to imagine a realistic scenario that won't push gold prices significantly higher in the months and years ahead.

OTHER PRO-GOLD TRENDS CONTINUE

Meanwhile, other important pro-gold trends continue unabated. These bullish trends include:

- The growth in Chinese, Indian, and other Asian gold demand accompanying their expanding economies, growing wealth, rising inflation, and historic affinity to gold in jewelry and as a saving and investment medium.
- The expansion of the gold investment infrastructure around the world - such as the development of gold exchange-traded funds and other forms of physical gold . . . or the implementation of gold distribution systems through banks and other retail outlets in China, India, and elsewhere).
- The recognition of gold as a worthy asset class for inclusion in investment programs and portfolios of individuals; pensions, endowments and other institutions; sovereign wealth funds; and central banks.
- The relative stagnation of new gold-mine production (certainly in comparison to the growth in gold demand) and the rising costs of discovery, development, and operation of new mines.