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Nature's own bitcoin

They won't be overproducing bitcoin if the shadowy progenitor of the crypto-currency is as good as his word. Supply is fixed at 21 million units while 11.5 million units circulate. To conjure, or "mine," the remainder will take some fancy computing. In response to these known supply-demand constraints, the price of Silicon Valley's favorite monetary alternative has exhibited the following technical pattern: up and down and down and up and up and up and down.

Now begins a rumination on what might be considered the legacy form of bitcoin. Gold, too, is constrained in supply, though not by the pledge of a person unknown. Geology and profit margins, rather, inhibit its production. On the demand side of the equation, India and China are the geographical drivers, trust in credit and trust in fiat currencies are the conceptual drivers. This publication, perpetually bearish on the witchcraft of modern central banking, is perpetually (though not always profitably) bullish on the geologically finite alternative to government-issued currency. As wrong as we were on gold in 2013, we are just that bullish for 2014.

"The man in the street," writes John Hathaway, portfolio manager of the Tocqueville Gold Fund, in his new, must-read essay, "Let's Get Physical," "has apparently overlooked the similarities between gold and bitcoin. The future supply of newly minted gold would seem to be in jeopardy if current pricing holds. The same cannot be said for U.S. dollars. While mine output may continue for a year or two at the current pace, production post-2015 seems set to decline and perhaps sharply. Discovery of new gold-bearing ore bodies is down sharply. . . . At current prices, most gold-mining companies are barely breaking even on an 'all-in' cost accounting basis.

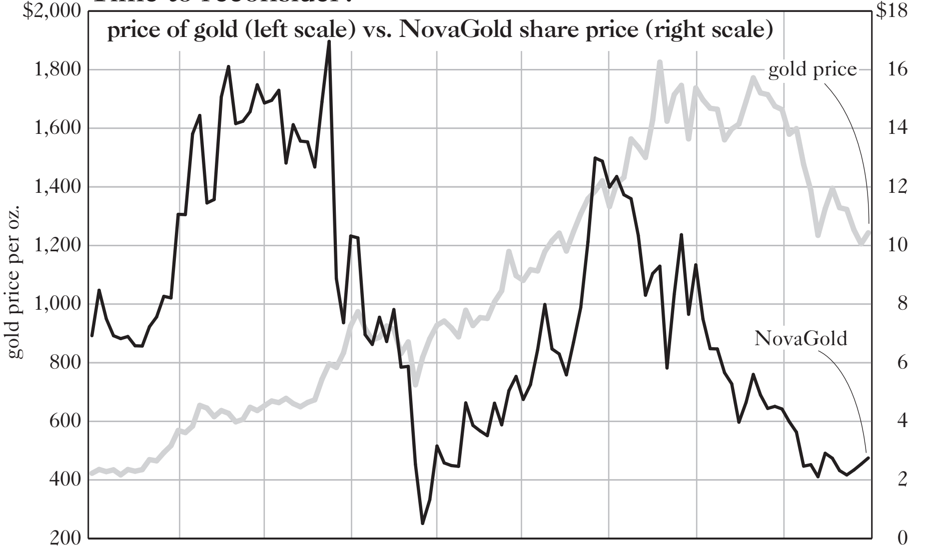
"The bitcoin-gold incongruity," Hathaway goes on, "is explained by the fact that financial engineers have not yet discovered a way to collateralize bitcoins for leveraged trades. There is (as yet) no bitcoin futures exchange, no bitcoin derivatives, no bitcoin hypothecation or re-hypothecation."

The gold market boasts each of these modern conveniences. Hathaway contends that the effect of the activity in derivatives, futures and the like is to exaggerate price movements—to drive the gold price higher and lower than it would otherwise go if trading were confined to the physical item itself. Trading is not so confined, as the Reserve Bank of India underscores in a 2013 report of a "Working Group to Study the Issues Related to Gold Imports."

"In the financial markets," says the report (which Hathaway quotes in his paper), "the traded amount of 'paper linked to gold' exceeds by far the actual supply of physical gold: the volume on the London Bullion Market Association (LBMA of which the RBI is a member) OTC market and the other major futures and options exchanges was over 92 times that of the underlying physical market." That was in 2010.

It's not self-evident to us that nefarious activity in the so-called paper market pushed gold to $1,230 per oz. from the neighborhood of $1,900 per oz. Maybe the price was manipulated to the downside; perhaps it had been manipu-

Time to reconsider?



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lated to the upside. For us, the central, commanding and irrefutable fact is that the Ph.D. standard is living on borrowed time. Something will succeed it. Perhaps that something will involve gold.

Hathaway is more inclined than we to blame the paper-gold industry for the 2013 gold market spill. Less important than that fine point, though, is his persuasive argument that a superstructure of leverage introduces deep complexities into the buying and selling of bullion. If things were as simple as they might be, maybe should be, Hathaway contends, Germany would not be having such a hard time bringing home its 300 metric tons of gold from the Federal Reserve vaults in lower Manhattan.

"A return of physical gold that could be easily accomplished in two transatlantic cargo flights must be stretched out over seven years, Germany was informed by the custodian of their gold, the New York Fed," Hathaway writes. "However, the Germans were cordially invited to view their gold bars in the meantime. The reasons for the stretched-out delivery schedule are not given by government officials, but we surmise that the difficulty relates to the unwinding of a web of leasing arrangements in which specific bars have been re-hypothecated, perhaps hundreds of times, over many decades. Who knows what counterparties were involved, not to mention their obligations or responsibilities?"

Hathaway's paper (log on to the Tocqueville Web site) deserves to be read front to back, all 10 pages. For the speculator in a hurry, the fact that the worst-performing stock in the S&P 500 last year was a gold stock—Newmont Mining gets the booby prize—may furnish a useful prod to action.

How to invest for the long run? The monetary case we make could be wrong; maybe it's Yellen who has the Midas touch. If our idea is right, we think it will be very right, as so few seem to believe it. In that case, orphaned gold-mining equities could vault to the head of the class from the financial reform school they have occupied the past couple of years.

A development-stage miner is a kind of long-dated, out-of-the-money gold option. It prospers in bull gold markets, perishes in bear markets. NovaGold Resources, 50% owner with Barrick Gold Corp., of the big, rich and remote Donlin deposit in Alaska, is an example of this kind of option (see *Grant's*, May 17). "Long-dated" really means long. To develop Donlin will take four years of permitting; this was year one. With those facts as background, Greg Lang, NovaGold's president and CEO, made some noteworthy remarks at an Oct. 16 investor conference.

"The industry is facing a production cliff," said Lang. "It's unavoidable. Major companies are closing or shutting down assets [or] selling them. There have been very few discoveries of over 20 million ounces, none in the last few years. Donlin has a 27-year mine life at a time when the big producers, four or five years from now, will have significantly depleted their existing reserves."

The dwindling price of gold, Lang went on, is actually a kind of boon for the farsighted and adequately financed developer: "Two or three years ago, the main thing you ever heard in the industry was where are we going to get the people or the mining equipment to build and operate these mines? It was hard to get an appointment at an engineering firm. Right now, they are all looking for work. Mining equipment—the lead times used to be measured in years; now it's practically you drive heavy equipment off the lot because of what has happened in the industry."

Colleague David Peligal, deputized to identify some investment-worthy junior mining equities, came up not exactly empty but certainly unenthusiastic; as businesses, he said, and as managements, the names he investigated left him cold. He turned to Pierre Lassonde, a man with a demonstrated Midas touch—he's a director of New Gold and chairman of Franco-Nevada—for suggestions.

"I'll give you two names I feel very comfortable with because I know the story inside out," Lassonde said. "One is Klondex Mines [KDX in Toronto]; it's a Nevada story. They just purchased the old Midas mill, which we built at Franco-Nevada. And they have a deposit that is very similar to Franco-Nevada—high grade, it's anything from a half ounce to one-ounce per ton of gold underground. And they're going to use the old Midas mill. I think Klondex will do 150,000 ounces a year—very high-grade, low cash cost. I think they should do really well.

"The other name I'll give you," Lassonde went on, "is a company called Teranga Gold [TGZ in Toronto]. The management team there consists of old Barrick guys. It's in West Africa. But if you look at the grade, it's like 1.5 grams to 2.0 grams per ton—open pit. Those two juniors stand out. I think Klondex's market cap is what they paid for the mill. You get the ore bodies for free, which is ridiculous. And Teranga is a bit of the same thing. . . . Klondex, I think, is one of the best high-grade deposits out there. And the CEO there, Paul Huet—when I was president of Newmont, he was my mine superintendent. He's the guy who ran the mine at Midas. He knows the deposit inside and out. I think he'll do a really good job."

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