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The third sentence of The U.S. Minority Report of the U.S. Gold Commission of 1982, which is required reading for anyone who wants to understand the history and current structure of U.S. banking system, reads: "All great inflations end with the acceptance of real money—gold—and the rejection of political money—paper."

Those words came to mind after reading a quote from German Chancellor Angela Merkel, who recently said: "In some ways, it's a battle of the politicians against the markets. I'm determined to win. The speculators are our adversaries." A few days later she banned short selling, which caused the euro to drop over 1.5% in an hour, and the German market 3% the next day. One could be forgiven for mistaking Merkel for the ghost of Richard Nixon who, in this clip, blamed dreaded "international speculators" for forcing the U.S. to close the gold window, and insisted the dollar would be worth just as much after as before:

http://www.youtube.com/watch?v=iRzr1QU6K1o

Nixon didn't beat the speculators, and neither will Merkel. For that matter, neither did the Emperor Diocletian whose price-fixing edict of the third century read, in part:

> And to the avarice of those who are always eager to turn to their own profit even . . . in an unproductive year to haggle about the sowing of the seed and the business of retail dealers; who . . . seek private gain and are bent upon ruinous percentages of profit – to their avarice, ye men of our provinces, regard for common humanity impels us to set a limit.

All three leaders had the same problem. Diocletian replaced the gold and silver coins, which had already been massively debased, with copper ones and mandated that prices stay the same. They didn't. Nixon ended the convertibility of dollars into gold – the same thing as debasement – and likewise ordered prices not to rise. They rose. Now we have Merkel, who just sold out the Germans by allowing the French to print $750 billion new euros to give to the Greeks. This story has only one ending.

As an aside, the U.S. Treasury recently announced that due to the increasing costs of producing coins (most coins contain materially more metal value than nominal value), it is entertaining the idea of switching to porcelain tokens with identification chips. Of course, the metal isn't getting more valuable, it's the currency that is declining in value.

And yet, there are very sophisticated deflationists who argue that the next crisis, like the panic of 2008, will be liquidity driven causing the dollar to sore in value. They may well be correct – in the short term – in regards to falling asset prices, but over the long term debasement will cause the price of goods – the price of living – to increase dramatically. And that's what makes people poor fast: lower asset prices and higher goods prices.

In this battle between political wealth and real wealth, the state will not give up easily. Not only did the euro plunge after Merkel's assault on the market, but as reported by Ambrose Evans-Pritchard €9.5 billion flowed into the Swiss franc in a matter of hours, forcing the SNB and ECB to intervene in the currency markets to teach "speculators" a lesson. One wonders for how long such interventions are sustainable.

Italy, for its part, has been photographing cars traveling to Switzerland in order to audit the owners. Clamping down even further, last week Italy banned cash transactions of over €5000 in an effort to better track its citizens and their wealth. Meanwhile, Greece has been using satellite images to find their citizen's assets, and the UK has been searching through safety deposit boxes Soviet style.

Perhaps the scariest invasion of privacy, though, is occurring right here in the U.S. Under the Senate financial regulatory bill, the government will be able to collect, and make public, data on any individual utilizing the consumer financial services market (i.e., anyone), including checking accounts, ATM transactions, etc. Senator Shelby summed up the bill by saying: "behind the veil of anti-Wall Street rhetoric is an unrelenting desire to manage every facet of commerce under the guise of consumer protection."

But capital will not sit idly by and await its own destruction. In the past month, GLD added another 11% (4 million ounces) to its hoard, 1 million of which was added yesterday – that's 30 tonnes in one day. The Sprott Physical Gold Trust, so named because it claims to have actual possession of the gold it owns (unlike GLD), announced it is acquiring another 6 tonnes. In terms of physical holdings, the U.S. Mint reports it had sold over 200,000 one ounce coins in the first three weeks of May, or one third of the total so far this year. Despite price volatility in dollars, gold is serving its traditional role as a refuge for capital.

On May 19, CNBC ran a clip that began: "You know gold has peaked when … you can bring your gold jewelry into department stores and cash it in," demonstrating once again the ignorance of mainstream commentators about gold. When someone sells gold, they receive cash in return. In other words, there're really buying fresh new dollars. Perhaps CNBC thinks that Kmart shoppers are the smart money – one shopper they interviewed admitted he sold his wife's jewelry at $800/oz.

In fact, the preceding two paragraphs reveal in microcosm how the classical gold standard operated: a country's imports were balanced by exports of either goods or gold. Thus, on balance, gold always moved from consumers to producers, from spenders to savers. Currently gold is moving from Kmart shoppers to those with capital to preserve: from jewelry to coins.

For an idea of where it's going, this clip may prove a guide:

http://www.youtube.com/watch?v=SbUvvfJakfI

Whatever politicians decide about exchange rates and quantitative bond purchases, the market is now moving gold directly from consumers to producers.

In credit news, the U.S. has passed a new milestone with over $13 trillion in net debt as of yesterday. Part of the cause for the jump was April's record $83 billion deficit (compared to $20.9 billion a year ago). April, one might recall, is the month the government receives its taxes, and therefore is often in surplus. But with individual income tax receipts down 21% in April and total spending up 14%, it takes Ben Bernanke to keep the books in balance.

The more interesting credit news occurred in Spain, where last week the government seized CajaSur. In response, four smaller cajas united to form a larger, more stable bank. This same banking shuffle occurred in the 1930s, and if the banks were illiquid it might work. But if, as is likely, the banks are instead insolvent, then merging them just makes things worse. Today the Wall Street Journal reported that Spain's second-largest bank, Banco Bilbao Vizcaya Argentaria SA, was unable to renew $1 billion of short-term funding. The Fed only has so many fingers, and there are apparently an unlimited number of dykes.

Unsurprisingly, the gold/commodity ratio continues to move sharply higher as the credit woes from Europe continue to intensify.

As anticipated, even though gold and the gold/commodity ratio is rising, gold stocks have been falling in sympathy with the broader markets, with the small cap GDXJ falling nearly 10% in the week ending yesterday. The micro-cap names fared even worse, but it does present buying opportunities, and there is light at the end of the tunnel.

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The chart below left shows an ETF of large gold mining companies still well below the nominal peak reached before the crash of 2008. And the same graph divided by the price of gold, below right, shows that in terms of gold these stocks are still down nearly a third from the peak. It appears from the charts that the gold stocks must soon decide whether to break out or break down.

Given the large increase in volume it's a good bet that the stocks break to the upside, though we may bounce off the upper trend line a few times first.

This update closes with a quote from the Third Quarter of 2007 Broyhill Letter, as relevant today by replacing $700 with $1200:

> Charles Kindleberger set out three preconditions for a mania where prices overshoot the bounds of rational valuation, in his classic, "Manias, Panics, and Crashes: A History of Financial Crises." First there must be plenty of liquidity to fuel the asset price rise. This is as true as ever today, given the global tendency toward low real interest rates and strong money growth. Second, there must be a "displacement," which is defined as a fundamental shift that makes the focus of the mania attractive. In the case of gold, this involves the incentive for competitive devaluations of paper currencies, as well as persistent geopolitical uncertainty. Finally, there must be uncertainty about how the asset in question is properly valued, which allows for "new era thinking" to take hold. Especially true for gold. Valuation and gauging extremes is an art rather than a science as the metal is heavily influenced by hard-to-measure factors such as central bank intentions, political risk, policy irresponsibility, etc. It is easy to argue that proper fair value is substantially higher than today's levels when one considers the jump from $600 to $700 has not yet spurred much enthusiasm.

Watching the clip on the previous page gives some indication of the forces gathering steam. In the 1930s, Europe was on its back and the rest of the world was abjectly poor. That gold bull was U.S. driven. In the 1970s Europe was a player, but the third world still had no wealth. That gold bull encompassed the developed world. The gold bull of the 2010s will include all of Asia, India, and even parts of Africa. No brokerage account is required to participate, just a link from a gold chain that a peasant decides not to part with. In the end, real money—gold—will displace political money on a global scale. This is why Soros recently predicted that gold will be the ultimate bubble. And the best way to play it is in micro-cap gold mining stocks.

Yours,

Dan

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