

# Growth Stocks Weekly

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**Performance:** Year ended April 1996 116.9%; 1997 28.1%; 1998 36.4%; 1999 39.4%; 2000 180.9%; 2001 -50.5%; 2002 18.7%; 2003 28.8%; 2004 166.7%; 2005 28.2%; 2006 153.3%; 2007 8.8%

## Junior Gold and Natural Resource Sector Report May 27, 2007

### Sunset for the U.S. Dollar *(The Fall of Icarus)*

#### U.S. Dollar Index



Monthly chart, High 121.02, Low 80.22, Last Trade 82.28

#### America's Age of Empire

The devastation and financial ruin suffered by most of the economically advanced countries during World War II left one country particularly well-positioned as a safe repository for mobile wealth and intellect. With its intact cities and factories,

laissez-faire economic system, vast manpower and growing financial strength, the U.S. came out of the war a very powerful force. In fact, the U.S. dollar quickly became the de facto global reserve currency, the result of efforts to rebuild the international economic system as World War II was still raging. During the first three weeks of July 1944, 730 delegates from all 44 Allied nations gathered at the Mount Washington Hotel in Bretton Woods, New Hampshire, for the United Nations Monetary and Financial Conference. The delegates deliberated upon and signed the Bretton Woods Agreements.

After World War II, the Bretton Woods system was set up, which pegged the value of the United States dollar to 1/35th of a troy ounce (888.671 milligrams) of gold (the “gold standard”) and other currencies to the U.S. dollar. The U.S. promised to redeem dollars in gold to other central banks (but not to its own citizens). Trade imbalances were corrected by gold reserve exchanges or by loans from the International Monetary Fund.

Until the early 1970s, the system was effective in controlling conflict and in achieving the common goals of the leading states that had created it, especially the United States. The chief features of the system were an obligation for each country to adopt a monetary policy that maintained the exchange rate of its currency within a fixed value—plus or minus one percent—in terms of gold; and the ability of the IMF to bridge temporary imbalances of payments. For its part, while the U.S. guaranteed gold’s convertibility at \$35 “forever”, the political burden of backstopping the world’s economic system soon showed itself to be a misplaced trust.

In the face of rising U.S. inflation and bloated government spending for the war effort in Vietnam, this system effectively collapsed in 1971. President Nixon unilaterally cancelled convertibility in reaction to France’s Charles de Gaulle’s request for conversion of their foreign reserves of U.S. dollars for U.S.-held gold at the official \$35 conversion price. It was a request the U.S. could no longer stomach. It had already shipped out half of their gold, and saw the writing on the wall. The jig was up, and the world’s central bankers were worried about rising U.S. inflation and bloated government spending. The U.S. dollar thereby became a true fiat currency, maintaining legal tender status solely as a result of the government’s declaration that it is so, and by finding continued, albeit reluctant acceptance by foreign holders. The world had lost its anchor, but there was no viable alternative if you wanted to sell into the world’s largest marketplace.

### **Paper money**

The term “fiat” currency is used specifically to refer to a currency that is not pegged or fixed to a mass of precious metal. The inherent value of paper money is essentially zero, so it is measurable only against the value of consumables the bearer can exchange for each unit of currency held.

The first historical example of paper as fiat money was in China. Chinese governments would produce “notes of credit” which were valued as legal tender for limited periods of time, in order to prevent inflation. The Song Dynasty (960–1279), however, created unlimited legal tender paper money, good throughout their empire, as a way of centralizing financial control, and preventing external trade. This money, however, was only as stable as its enforcement, and only as safe as the rigidity and integrity of the people who created it. Since it was easy to counterfeit and communication was slow, the Song experiment with paper money collapsed, as individuals preferred doing business through bank drafts or cheques backed by gold or silver.

In the 19th century, there was increasing demand for international trade, which made monetary standards based on more than one kind of specie less and less stable. Individuals would take advantage of official exchange rates to buy silver where it was cheap, and then redeem it for gold where it was overvalued. This led to the gradual adoption of the gold standard among industrialized nations. Britain’s adoption of the gold sovereign in 1816 began their move to a gold standard, and 1844 is generally dated as the establishment of the practical gold standard in the United Kingdom.

Previously, silver had been the standard against which gold was measured, because Europe had an influx of silver from mines in Germany and silver looted from the Inca and Aztec empires. The word “dollar” comes from “Thaler”, a silver coin from the mines in Bohemia.

Governments would often produce notes, with the promise to allow holders to pay taxes in those notes, in effect, assuring at least one trading partner for the note in the future. Even this more restricted form of fiat money was prone to inflationary or deflationary cycles, as those entities which could tax in specie would do so, leaving the debt based money to be devalued.

The repeating cycle of deflationary hard money, followed by inflationary paper money continued through much of the 18th and 19th centuries. Often nations would have dual currencies, with paper trading at some discount to specie-backed money. Examples include the “Continental” issued by the U.S. Congress before the constitution; paper versus gold ducats in Napoleon-era Vienna, where paper often traded at 100:1 against gold; the South Sea Bubble, which produced bank notes not backed by sufficient reserves; and the Mississippi Scheme of John Law. The abuse of paper money led most industrialized nations to either outlaw private currency, or strictly regulate its printing, such as the United States National Banking Act of 1862.

Each cycle of inflation and panic would leave citizens vowing never to allow inflation again, until the next round of bone-crushing deflation caused business failure and squeezed borrowers who had to pay back in much harder money than they had borrowed. A good example of the latter was the abolition of the “Bank of the United States” by Andrew Jackson, where he declared paper money backed by the government “unconstitutional”. The temptations to create inflationary currencies repeatedly hobbled economic stability.

## **Hyperinflation**

It was World War I that again brought a collision between specie currency and fiat money. By this point most nations had a legalized government monopoly on bank notes and legal tender, and in theory governments promised to redeem notes in specie on demand. However, the costs of the war and the massive expansion afterward made governments suspend redemption in specie. Since there was no direct penalty for doing so, governments were therefore no longer responsible for the economic consequences of “running the printing presses”, and the 20th century found itself facing a new economic terror: hyperinflation.

The resulting economic crisis led to attempts to reassert currency stability by anchoring it to wholesale gold bullion rather than making it payable in specie. This money combined pure fiat currency, in that the currency was limited to central bank notes and token coins that were current only by government fiat, with a form of convertibility. Exchange via gold bullion, or via exchange into U.S. dollars which were convertible into gold bullion under the Bretton Woods system, provided the system some stability and credibility.

## **Credit-based monetary systems**

Global capitalism, where a currency is widely traded like a commodity, relies on credit money that reflects both commodity supplies and military protection to those supplies. It is not held stable by any one state but rather by tension between states, as investment migrates from currency to currency in the open “money market”.

The system relies on an unhindered international feedback mechanism, where states attempting to inflate their currency suffer a corresponding drop in international buying power as investors dump their holdings. It also requires an internal feedback mechanism, with the government liable for economic failures resulting from fiscal or monetary irresponsibility. With these in place the system avoids many of the characteristics of a fiat money system. Of course, mechanisms can not always be trusted, and money not directly based on specie redeemable on demand continues to be “fiat money”. This means that today all the currencies are fiat money, because no currency is based on specie (generally to gold) redeemable on demand.

This regime of asset-based money, or credit-based money — in which banks create currency as intermediaries and governments, in turn, back the banking system — produces a different series of problems. It is not immediately easy to differentiate sound currencies from unsound ones, and it is possible to convert credit-based money into fiat money by a legal act or regulation. The question of confidence dominates credit-based money, the confidence that a particular central bank or government will not act in a manner contrary to its national interest by allowing the money supply to rise or fall too much. Part of the system of confidence includes the holding of reserves to be able to support a currency if attacked, and the issuing of debt to regulate the supply of currency.

## **The Veil of Money**

In a market economy, individuals should ideally make decisions based on the tradeoff between having a good, service or license, and having the liquidity of money, essentially a tradeoff between desires. When the role of the government in maintaining or backing the money supply is in question, the issue of credibility enters decisions.

Economic actors begin making decisions they would not otherwise make for fear that the currency or money that they hold will radically change in value. This risk produces economic distortions: people convert money to other forms, increasing the demand for goods not for their inherent usefulness, but just to be hoarded as a hedge or temporary store of value. Economic actors will shelter income in other currencies, or charge higher interest rates to compensate. There may even be a depression as money leaves circulation, perceived to have more durable value when held for future use. Governments may be forced to stop striking metallic coins that are being hoarded by individuals.

Fiat money then calls into question the veil of money: Money ceases to be a commodity like others, and begins to have special and peculiar properties. Instead of focusing on production, investment and consumption, economic players begin to try to divine the actions of government. Players can have foreknowledge of government actions in ways they cannot have of markets. This in turn results in economic efforts to bribe, control or curry favor with entities holding fiat power.

## **The Pressures of War**

Fiat money is also closely tied to government borrowing for expenditures without a clear social return, or with negative consequences, such as wars of conquest. Governments will often pay for war in fiat money, rather than in hard currency or specie, in the belief that the returns of war will be sufficient to pay back the promised notes. Of course, in the absence of strong inflationary controls, this is seldom the case. Instead, the usual cycle is for the value of fiat notes to trade at a significant discount to portable and stable forms of exchange, specifically those that will retain tender value regardless of the winning side in the conflict.

Fiat money is also associated with attempts to control trade: if individuals possess notes which are not redeemable outside of the control of a government, the idea is that they will have to purchase preferentially within the boundaries of the nation, rather than importing. This merely leads to inflation, even if the money is backed by specie.

Occasionally a government seems oblivious to the root cause of hyperinflation as it excessively increases the money supply. Worse still, a government may be aware of the cause, but choose to ignore the problem as it is not one that will come to light in its current political term.

## **The Fall of Icarus**

Icarus was famous for his death by falling into the Sea when he flew too close to the sun, melting the wax holding his artificial wings together. Similarly, the U.S. is having a reality check, led by the melting value of the greenback and the country's housing stock, the inevitable result of consumer indebtedness, the wealth effect of over-inflated house prices, the trade imbalance and budgetary deficits financed through the massive creation of new money. The U.S. is now seen to be pushing the limits of its credibility vis a vis its reserve currency status, and clearly the stresses are starting to have effect.

Without moralizing on the right or wrong of it, the U.S. has been taking the least-difficult road by avoiding the pain of living beyond its means. After the "tech-wreck" in 2000, the Fed acted quickly to liquefy the system, deathly afraid of a deflationary depression scenario. This inevitably led to excessive money supply that wound up in a loosely regulated real-estate sector featuring zero-down purchasers, inflated appraisals, adjustable-rate (neutron) mortgages, and rampant speculation. Once again the Fed is left with little choice but to shore up a rapidly deteriorating situation, this time a real estate bear market, with a likely slash in interest rates and the creation of more greenbacks with no intrinsic value. The market is now catching on, and investors along with growing pools of private equity are scouring the world for hard assets, denominated in stronger currencies, as a place of refuge.

## **The Numbers Don't Lie**

Since 1970, the world's money supply has grown at a rate 20 times that of industrial production. Correspondingly and not surprisingly, gold and oil have risen 20 fold over those 27 years.

After Nixon's 1971 elimination of convertibility, there was no longer any constraint on the number of dollars that could be printed (other than a moral one). The U.S. economy is now so leveraged through the banking system and the use of derivatives that the ratio of debt to Gross Domestic Product is at its highest level ever, close to 350% compared to the previous record peak of 290% in 1929.

The U.S. trade deficit has resulted in an estimated \$6 trillion in the hands of foreigners, who now effectively control the value of the U.S. dollar. With the world's largest debtor hemorrhaging \$200 billion per year in interest payments, the return to foreigners holding a currency dropping faster than the interest earned is negative. Such a situation is not sustainable. As foreigners try to unload the U.S. dollar, the decline accelerates, and soon the U.S. administration decides something must be done. In just the last 5 months over 50 of the world's currencies have risen against the U.S. dollar. Since 2002 the U.S. dollar has dropped 30% against a basket of major currencies (see chart on page one - U.S. Dollar Index).

But what can the Fed do? The solution of raising interest rates would tip the U.S. economy into recession, or worse. And all that consumer and mortgage debt would become very expensive indeed, while job losses and bankruptcies accelerate.

## **Expectations**

The U.S. Federal Reserve is staring into an abyss. With debt levels at historic levels and the housing market looking for a bottom after an historic easy-money-driven bubble, the Fed will simply have no choice but to start lowering interest rates in an attempt to avoid something even worse – the "D" word. Deflation in the style that Japan suffered is to be avoided at all costs. Even today, after two decades of declining real estate prices and negative interest rates, Japan is still offering their money for free in an effort to grow their economy.

Unlike the Japanese who are the world's biggest savers and generally debt-adverse, American consumers have left themselves exposed to the danger of falling asset values through the use of increasing leverage. Their homes' market value is the only buffer the typical American has against negative net worth, and prices are falling fast. There is a huge supply of homes flooding the market and millions of U.S. jobs are tied to housing. At the same time, the U.S. government continues to pour billions into the war on terrorism while creating more and more drag on its economy and the free flow of goods, capital and people through layers of bureaucracy and restrictions.

Meanwhile, growth rates in Asia are running at 10% per annum, and Europe's continues to rise, with currencies strengthening and interest rates creeping higher. China is increasingly buying up companies and the world's resources by recycling their over \$1.2 trillion in U.S. foreign reserves. The fact of the matter is that the rest of the world is still growing strong while the U.S. stagnates. This is something we have not seen before! The U.S. has been the world's economic engine for more than a generation, and this has come to an end. Likewise, the U.S. dollar was seen as something of a safe haven during times of economic trouble, but this too is likely over.

Emerging nations like China and India, and also Japan and Europe, are taking a greater slice of the global economic pie, and therefore the U.S. is becoming a smaller relative player with less influence on international markets and economies. As the U.S. dollar reflects the relative risks and currency flows adjust to better opportunities for growth and security, the U.S. dollar will be pushed to new lows. If the dollar breaks technical support it will see accelerated selling as holders seek relief – a situation that will reverberate around the world.

## **Gold – the Canary in the Coalmine**

Meanwhile, European central banks continue to dump their gold. A recent report by Don Doyle and Neal Ryan of the Blanchard Economic Research Unit observes: "ECB banks have not sold this much gold in such a short time period in the life of the 2nd Central Bank Gold Agreement. In the last ten weeks, ECB banks have sold over 120 tonnes of gold into the market (EUR1.9 billion or \$2.55 billion in U.S. dollars). In the previous six months, ECB captive banks sold only 112 tonnes into the market." Their full report is found at: <http://news.goldseek.com/GoldSeek/1179846240.php>

As has been seen in the past, central banks will conspire to keep gold from climbing higher, and to keep it below critical technical levels. The futility of this seems eerily reminiscent of the blunder of British chancellor Gordon Brown, the apparent mastermind of a decision in 1999 to sell one-half of that country's gold reserves. That marked a key bottom of the gold price following a 19-year long bear market, and likely the last time that level will ever be seen again.

Central banks are busy fighting a tidal wave of money fleeing fiat currencies and seeking safety and security in gold. Gold is the only store of value not dependent on some government or a central bank's promise, and is recognized internationally as money – a portable and timeless unit of exchange. Central banks may control the buying power of their domestic currency through monetary policy, but they cannot determine the value of gold anymore than they can determine the value of any other tangible asset given liquidity and a free market. Central banks can and do influence the market process, and right now are dumping their reserves with an apparent unified purpose. They are trying to convince the market that gold's value is questionable. Only the market can determine the usefulness of a tangible asset, and therefore its sustainable value over time.

Gold performs best during a gradual, longer term decline in confidence for fiat based monetary systems. This growing mistrust became more pronounced in mid-2005 as gold began rising in terms of not only U.S. dollars, but every major currency. Growing global liquidity and burgeoning capital pools will continue to spill into gold. Highly populated third-world economies are developing into economic powers, and the greenback is no longer seen as a safe repository for their growing wealth.

A quick look at the gold charts clearly shows that the central banks aren't fooling the markets. Gold is in a secular bull market and it's not just rising in terms of U.S. dollars, it's rising against all of the world's major currencies, and some are already setting new all-time highs. Though gold has retreated somewhat recently as a result of heavy central bank selling, the charts show that the impact from this centralized effort has been minimal. As large as central bank intervention has been, gold prices have barely eased back. Technically the gold price remains within the pennant formations formed over the past year that are consolidating the tremendous gains gold achieved from August 2005 through to May 2006. This current round of central bank selling will eventually end. When it does, we'll likely look back at it as we now look back on the last consolidation area.

## 35-Year Gold Price History in the Major Currencies

Gold Price, \$ per ounce (London pm fix)



Gold Price, €\* per ounce (London pm fix)

\* Before 1999, Deutsche Mark converted to euro at the irrevocable euro conversion rate



**Gold Price, Yen per ounce (London pm fix)**



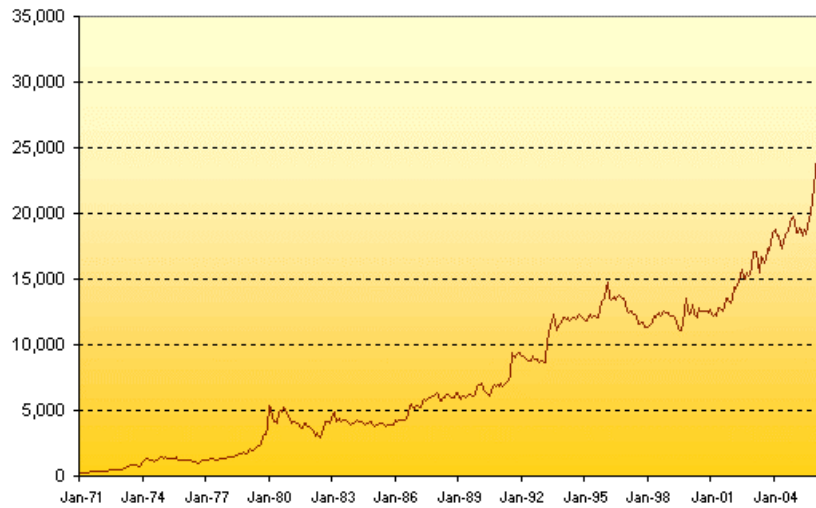
**Gold Price, AU\$ per ounce (London pm fix)**



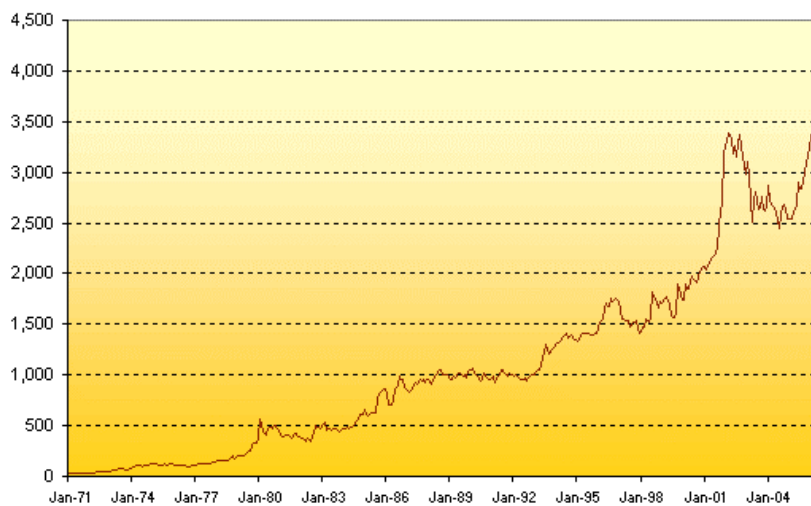
**Gold Price, CDN\$ per ounce (London pm fix)**



**Gold Price, Rupee per ounce (London pm fix)**



**Gold Price, Rand per ounce (London pm fix)**



**Conclusion**

Once again, U.S. political will is nowhere to be found when it comes to prudent money management, and so the printing presses run to keep up to never-ending spending commitments. Gold offers a time-tested anchor to which an international audience will be able to hitch their own ship of state, but supplies are obviously limited. The U.S. in particular has issues that are not resolvable without much pain, and it will take the path of least resistance, at least in a pre-election year. Their off-balance-sheet liabilities alone, for pensions and medical care to a rapidly aging baby-boom generation, are staggering. There will be no free lunch, and the day of reckoning cannot be avoided. The only real choice is between several bitter doses of medicine. Like their automobile industry, the U.S. government faces liabilities far in excess to their ability to pay.

The key safety valve available to adjust for these imbalances will be the U.S. dollars' exchange rate with the rest of the world's currencies, and the ultimate store of value – gold, as measured in those very same dollars. These factors are too big to control, even for the mighty U.S. levers of power. As a minimum, gold is the life-buoy on which to hang onto, but the opportunity does not stop there. Given the rest of the world's growing relative strength and the availability of technology, the resource sector will continue to see increasing demands on finite supplies and price pressure to the upside, and not just in terms of eroding U.S. dollars.

Back in 1980 gold reached an historic high of \$850 per ounce – \$2,200 per ounce in today's dollars adjusted for inflation. Typically these bull markets are in a 13- to 15-year cycle, and we are now only in the sixth year. And we are following a particularly long and painful bear market. These are still early days.

## APPENDIX

Canadian stocks have surged on massive foreign investments, mainly mergers and acquisitions in the mining and energy sectors. Canadian budget surpluses, strong fundamentals, and an internationally respected resource-heavy mining and investment sector is attracting investment capital seeking returns and safety. With a core inflation rate 0.2% higher than the U.S., and interest rates 1% higher, many are anticipating pressure for higher interest rates in Canada. The Canadian dollar is now hitting 30-year highs relative to the American greenback, and the trend looks set to continue. Calls are being heard for parity or even a premium as was the case back in 1974 when it cost Canadians only 0.96 dollars to buy one U.S. dollar. The more recent lows around the 1.10 area, essentially matching those set in 1991, has just been taken out – and a free-fall is likely before some interim support is found. Our short term target is the 1.065 area, which is around the \$0.94 U.S. dollar – not yet parity, but a breather may be necessary after such a steep and sudden break.

We suspect that the Canadian dollar will come to be seen by a growing percentage of Americans as a friendly, convenient and familiar means to protect against their own currency's continued erosion and loss of purchasing power. That the Canadian markets also offer access to the very resources the world is seeking, and that those markets are well developed, transparent and relatively liquid, makes operating in the Canadian resource-based currency an easy choice.

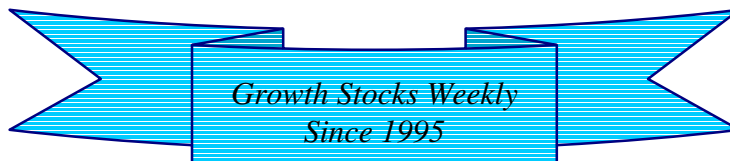
### The U.S. Dollar in Canadian Dollars



Weekly chart, High \$1.6165, Low \$1.0777, Last Trade \$1.0797

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