‘Crappy’ Gold Mining

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The crappy gold mining business revisited

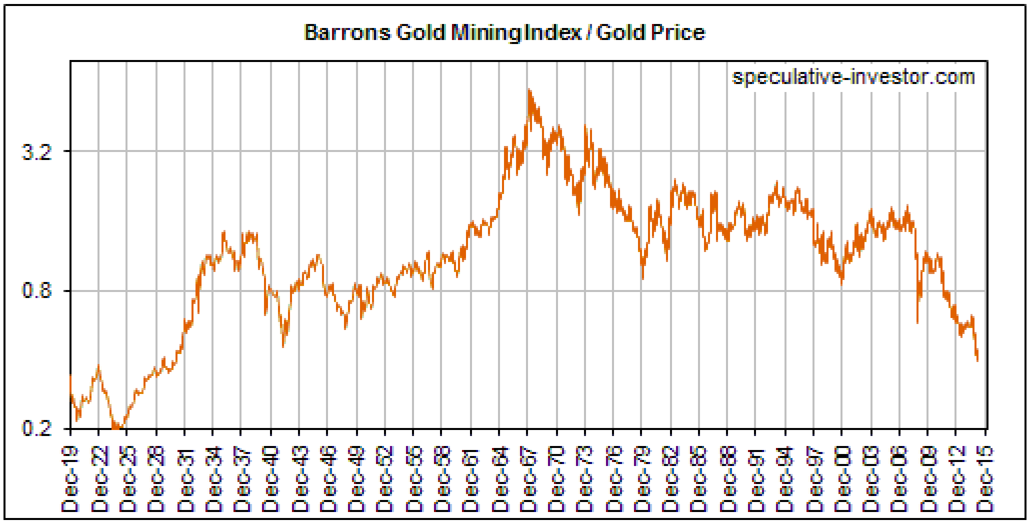
Last October I wrote a piece that explained why gold mining had been such a crappy business since around 1970 and why it was destined to remain so as long as the current monetary system was in place. The explanation revolved around a boom-bust cycle and the associated mal-investment linked to the monetary machinations of central banks.

The crux of the matter is that when the financial/banking system appears to be in trouble or it is widely feared that central banks are playing fast and loose with the official money, the stock and bond markets are perceived to be less attractive and gold-related investments are perceived to be more attractive. **However, gold to the stock and bond markets is like an ant to an elephant, so the aforementioned shift in investment demand results in far more money making its way towards the gold-mining industry than can be used efficiently. Geology exacerbates the difficulty of putting the money to work efficiently, in that gold mines typically aren’t as scalable as, for example, base-metal mines or oil-sands operations.**

In the same way that the mal-investment fostered by the Fed’s monetary inflation has caused the US economy to effectively stagnate over the past 15 years, the bad investment decisions fostered by the periodic floods of money towards gold mining have made the industry inefficient. That is, just as the busts that follow the central-bank-caused economic booms tend to wipe out all the gains made during the booms, the gold-mining industry experiences a boom-bust cycle of its own with even worse results. The difference is that the booms in gold mining roughly coincide with the busts in the broad economy.

In a nutshell, the relatively poor performance of the gold-mining industry over the past several decades is an illustration of what the Fed and other central banks have done, and are continuing to do, to entire economies.

Obviously, gold itself is not made less valuable by the monetary-inflation-caused inefficiencies and widespread wastage that periodically beset the gold-mining industry. That’s why gold bullion has been making higher highs and higher lows relative to the average gold-mining stock since the late-1960s, and why the following weekly chart shows that the BGMI/gold ratio (the Barrons Gold Mining Index relative to gold bullion) is now at its lowest level since the 1920s.



When the next bust gets underway in the broad economy, **the surging demand for gold will <u>temporarily</u> generate huge real gains for gold-stock investors.** At the same time it will lead to yet another round of massive mal-investment in the gold-mining industry that ensures the eventual elimination of these gains.