Gold Review

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Gold A Bullish Story

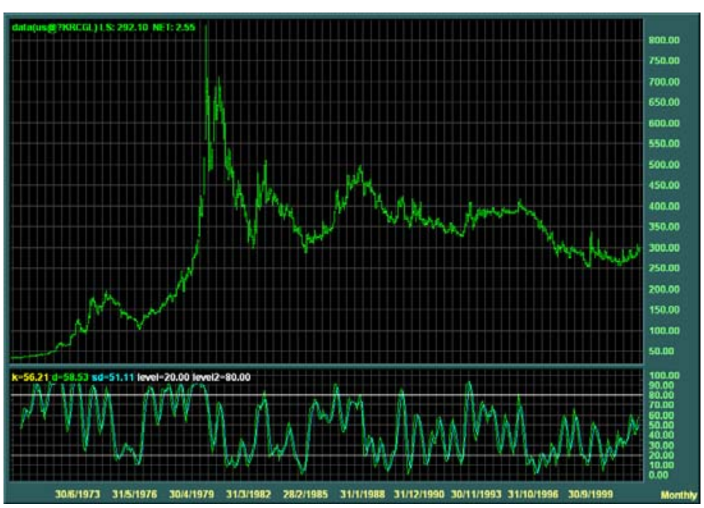
Dear All,

As you are all aware, I am friendly towards the price of Gold. Just recently I have had to put together an editorial on the reasons why I have this forecast. So pls find following the article for some light weekend reading.

“gold still represents the ultimate form of payment in the world … is always accepted and is the ultimate means of payment and is perceived to be an element of stability in the currency and the ultimate value of the currency…” said Dr Alan Greenspan when delivering evidence to Congress on the value of the metal in May 1999.

The importance of these words tend to sum up the perceived feeling of many a “gold bug” however realty has been hard to handle for these investors since it peaked on Jan 21, 1980 at USD850. The metal has consistently been sold on any rallies and technically has been entrenched in a bear market for over 22 years. The reasons for the down trend have been well documented and briefly include, the decline in the US inflation rate; the strength of the USD; Central Bank sales and lending of Gold and the great bull market in stocks and bonds. Is this bear market coming to a conclusion? Does the past provide evidence to the future prospects and do the current fundamentals and technicals provide early signs to the start of a new “Golden “era for the price of this historical metal.

Chart one- Price of Gold 1979 to 2002



Market sentiment towards the metal over the last six months has been changing; commentators are suggesting that the bear market is finally closing. We are starting to see a shift in attitude to the main components of this the bear trend. The reasons for this shift were well summarised by Pringle at the Nikkei Gold Conference in Tokyo with his main arguments including some old rhetoric however poignant to today’s economic climate. His main arguments for a change included the fact that Gold is an asset and not a liability; it is a good hedge against USD denominated assets; it is a hedge against inflation; and is a hedge against uncertainty. However it is also useful to look to history to find additional clues that provide valuable evidence to suggest that we should probably start looking more seriously at having an ounce or two of the metal in our portfolios.

The instigation of the Gold Standard can be attributed to Sir Isaac Newton in 1717, it was confirmed in 1816 in England and recognised Internationally between 1870-1914. The Gold standard provided a form of stability in the economic world. It had its faults however provided a period of general prosperity. Then, the Bretton Woods system with the USD-Peg set at US35.00 once a gain provide equal opportunity for economies and growth just as the Gold standard had. Nixon in August 1971 announced a parting of the Gold’s link to the USD from here on in the market evolved and rapid changes occurred.

During the late 1960s demand for non–monetary Gold had risen however the real price had restrained output due to low prices. This effectively caused a drop in new exploration and new supplies coming onto the market. During this period the price effectively started its move higher due to a shortage in supply caused by lags in production, which resulted a hefty demand scenario for the metal. Coupling this with the inflation of the 1970’s, weak monetary policy, a loss of confidence in currencies investment in Gold picked up and the price rallied to USD 200 to USD 300 level. This however was not the end of the rally. In the1980s we had the second oil shock, continued poor economic conditions, the Soviets invaded Afghanistan, the Iran hostage crisis exploded and a general lack of confidence in Governments helped contribute to an explosion in investment that ultimately spiked to USD850. Then the bear market commenced.

In retrospect, today, we question wether or not we looking at a carbon copy of this period however condensed into a shorter period of time? The price of the metal has been depressed for 22 years, resources for exploration have dried up and expectations of a lag in production look real. Interest rates currently at historic lows US 1.95%, Japan

0.2% etc are trying to stimulate demand however could represent an inflation threat, lack of confidence in the finance sector, an invasion of Afghanistan, a War on Terrorism, Middle Eastern conflicts continual flaring up and concerns over the values of “e-money” remain real. The only ingredients missing are inflation and a weak currency. Signs for deterioration in these areas are continually being monitored. The link between inflation, Gold and the USD is clearly evidenced as can be seen by the following charts. The key question that will help any rally in Gold will be: To what extent will the low cost of money in US and Japan have on inflation and USD as we head out of a recession?

Chart two –Gold verses the US Long Bond

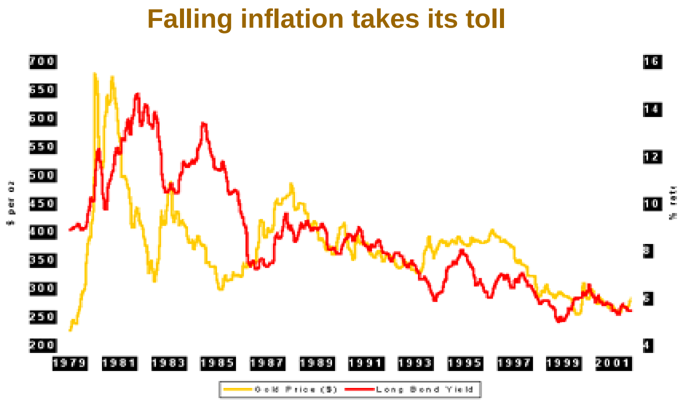
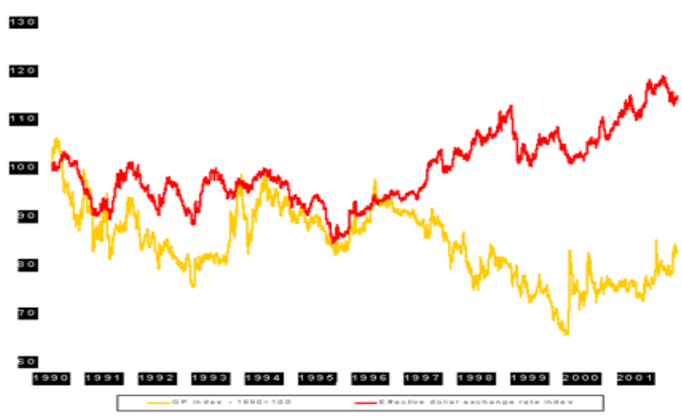


Chart three - Real gold price and inflation, 1960-2001



As these charts provide clear evidence to suggest that a decline in the inflation rate has had a disastrous effect on the price of Gold the correlation also provides clear evidence to suggest that any up tick in inflation will be beneficial to the price of Gold. Chart four – Inverse relationship between USD and Gold

Dollar and Gold Opposites

The above chart depicts the inverse relationship that exists between the two. It provides clear evidence to suggest that an appreciation of the USD will cause a deprecation of the price of Gold. Current economic thinking suggests that the USD is over valued. Therefore any depreciation of the currency will also culminate in a move higher for the price of Gold. On potential trends for inflation and a depreciation of the USD the jury is still out and trends are not yet confirmed. The potential for these trends do strongly exist however even with out taking this into account we can still present a positive outcome by analysing the supply / demand scenario for Gold over the coming years.

Supply of metal to the market looks limited as resources for exploration dry up and Central Banks limit their sale of Gold. Resources for exploration for new mines have dried up as current market prices question the viability of new projects. It costs on average US 234 to mine an ounce of Gold, low and lagged returns on funding projects and new infrastructure are too costly at current levels. Sounds like the 1960s. Concerning Central Bank sales, in Sept 1999, 15 of the largest central banks all signed in an agreement in Washington that would limit the sales of reserves to 400 tonnes a year, until 2004. Central Bank sales of the metal due to the agreement have capped an easy and important supply. The most recent BoE England Auction, the last for a while, was again over subscribed and like many of the Auctions suggest that the supply was absorbed into the market. So if we have an increase in demand we have to question where the metal will come from or the price will have to rise in order to induce sellers into the market.

The demand story for Gold also presents a bullish picture. Traditional thinkers see a resurgence in demand based on some tried and tested ideas namely, Gold is an asset and not a liability, it is a good hedge against USD denominated assets, it is a hedge against inflation, and is a hedge against uncertainty. This rhetoric all sounds familiar as most of the economics for this demand can be evidenced during the period from 1960s through to1980s mentioned in previous paragraphs. One interesting aspect to the demand story comes from that fact that close to 80% of current demand for Gold is tied up in “investment jewellery” notably from Asia and the Middle East and expectations remain positive for this demand to continue, after all the population growth is not going to go way. In addition, the freeing up of the regulations concerning the trading of Gold in Mongolia and China can potentially open up a whole new market of would be purchases. So fundamentally, we can source a solid argument for the appreciation of the metal; do the technicals reveal the same?

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Technically, Gold has been in a major down trend since its exhaustive peak at USD850. Over the last four years it has managed to have some impulsive moves off the 250 level. In fact we can technically suggest that we have a "double bottom" at this level. Currently, we are going through a consolidation period off the 250 level a break below 280 will however sees a retest of this level. If it holds then we can look for a test of resistance at 310 the 340. 300 is an important level for Gold as it is from this level that we fund support after we had a 550 USD drop in the early 80's and then subsequently in the mid 80's found support there again. Once this area is clearly broken then 340 represents the next major level of resistance, which represents the lows from the early 1990's. Between 300 and 340 we expect the price of Gold to do allot of work and the period of consolidation could extend into a protracted range. It would be a rare event that Gold breaks the 250 level again however could based off some fundamentals such a change in production frontiers for the metal however this would have severe fundamental repercussions for economies of most mining companies and Governments. If it did then technically US190 would be the next level. However simple charting methods reveal a strong case for a low of some magnitude at current levels.

In conclusion, we have presented a completely biased expectation for the price of Gold, however feel that we have based our expectations on solid evidence. It is important to put these conclusions into perspective, as the fundamentals of change do not happen over night. Movements of any magnitude take time, just look at the bear market, with the most important ally to any move being a solid fundamental base from which to work off backed up with sound technicals. Most of which we hope we have outlined above.

How do investors trade in the Gold market?

Spot deferred market is one way, this involves the leveraged buying and selling of Gold with open positions being subject to 3% deposits and the position managed through the use of variation margins. Traders tend to use this market as a quick entry into the Gold market when needed 24 hours a day. (Those that have an understanding as to the nature of leveraged investments use the spot deferred market). The other way is to buy call or put options. This method is mainly used be risk adverse investors who like to know what they are risking. All you can lose is the premium paid for the option.

Please do not hesitate to call concerning any of the above. I can be reached on direct call 1300 660 734.

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