

STRAIGHT TALK ON MINING

No. 18

May 29, 2002.

Bull Riding Ain't Just for Texans

It never fails to amaze me; the material that passes for informed financial journalism these days. Most of it is complete fluff - the worst of it is actually hazardous to your financial well-being. The gold story continues to be dumbed-down into bite-sized, easily-digestible morsels by the mainstream media. This week the bull run is blamed on "terrorism fears" or "war jitters" in the majority of the mainstream press - as if the bull run is an ephemeral phenomenon; a fleet of fancy which will go away *if we just all calm down!* What utter and total nonsense! Even in a bull market such as we have, the defenders of gold have to man the ramparts against the journalistic Huns coming over the hill, who would drag us back to the Dark Age of the tech wreck for one more go around. It is indeed amazing. The gold market is not rocket science, nor is it intimidating - it is understandable by anyone. And by not giving you the full story most commentators are doing gross disservice to the general investing public.

Stalwart yeoman like Bill Murphy, Reg Howe and Adam Hamilton, if swallowed into the maw of media mediocrity would no doubt be muffled and emasculated - probably scribbling the obit page or writing commentary about the weather. Thank goodness for the internet - our only contrarian defence against the ho-hum. Those who have taken the advice of these gentlemen to heart over the last 18 months have not only preserved their wealth, but have added to it considerably.

For every three E-mails I get from people who have newly found gold, I get one from someone whose resolve is wavering, beguiled by the siren-song of Bubblevision to buy tech and large cap Dow stocks because "they are cheap" and worried that gold is topping. In *Straight Talk #4* back in October, 2001, I ridiculed an advertisement that was running on CNBC with Peter Lynch of Fidelity Investments exhorting us all to stay the course in the stock market...and yet the markets are down or sideways after its January-March post 9/11 rebounds. In *Kiplinger's Personal Finance*, June, 2002 issue, John Tumazos of Prudential Securities is quoted as saying that worldwide demand for gold jewellery has been shrinking over the past five years - "There has been a basic change in taste." Tumazos is the same chap I mentioned back in *Straight Talk #14* who February 11th moved his rating on Newmont Mining to "sell" from "hold" and stifled what in February was still a fragile nascent gold bull as his move was trumpeted far and wide. Let's see.....Newmont on February 8th closed at \$US25, and last Friday was \$US30.66, for a percentage gain since Mr. Tumazos' pronouncement of 22.64%. Good move! I'm sure your clients are most appreciative. Today arch-nemesis of gold, Goldman Sachs, downgraded AngloGold and Barrick citing "weakness in the demand for gold jewellery". Sounds like they scrambled around for some reason to knock gold, and in typically unoriginal fashion latched on to Tumazos' statement. (How lame. How transparent!)

Where do these guys get off downgrading gold stocks in a rampant bull market??! Why are they so intent on slaying the bull? Could it be they have a vested interest in choking off the rally?!

The media is only saved by the fact that it lives in the sound-bite era, sans memory - every market close expunges the sins of that day and all is bright, shiny and new on the morrow with the opening bell. Jay Hancock of the *Baltimore Sun* authored an article on May 5th when gold was \$312 [*nota bene*] "Gold bugs get sort of squashed in the long run" - an artfully-written piece which slammed gold with phrases as colourful as I exalt it, "I agree that gold looks better than a Treasury bond on a wrist or a bosom, but as a long-term investment it doesn't seem more attractive than it did a decade ago". *The Toronto Star*, May 26th edition contained an article, "The strange correlation between Nortel, Kinross", which ended with "Technology could be the empty space investors need to put their gold profits back to work in another asset class. It's called rotation. Do it or perish".

You get the picture. As I read on a gold forum this morning, "the big brokerages will talk it down all the way up". They exist in a parallel universe where all are perpetually balanced on the cusp of a broad market turnaround. Look up the recent performance of gold mutual funds, or view the 6 month graphs for Goldcorp, Durban Deep, Kinross, Harmony, Newmont and dozens of others. Now compare them to any Dow 30 component to cut through this BS.

B.Comm. and MBA students are force-fed the mantra, "diversify, diversify, diversify". It is all they know (knowledge however mysteriously abandoned during the tech Bubble). Most of the analysts and business journalists of the mainstream media know diddly about the gold sector, and so you will see whatever goes out on the wire services parroted by every hack from Fairbanks to Key West. Gold scares the hell out of 'em, especially as it becomes "the only game in town". Many of these folks are twenty-somethings who were in diapers when gold took its last great run. Recent low volume on the DOW and NASDAQ is explained away on Bubblevision as "early summer doldrums", "market malaise" or blamed on "uncertainty". But it can equally be explained by people exiting the markets altogether. Think about it. When someone sells Cisco and puts money in the bond market or physical gold they aren't moving that money into another stock market sector. Anecdotal evidence says much of the market exiting is being done by foreigners.

Enough of this purple prose! Below are THE TOP TEN REASONS to invest in gold. These cannot be easily rendered down to journalistic sound-bites, but I have done my best. They draw on many earlier posts. I haven't included reasons that could be construed as philosophical or moral (sound money arguments). These arguments are compelling in the face of currency meltdowns like we have witnessed in Argentina, but they won't move markets until America suffers a similar fate. I don't have an economics degree myself, but I've been following the gold market for over 20 years, and I remember the bull of '79 -'80. Today we have an incredible and unprecedented conjunction of macroeconomic and market forces moving gold.

In the background - the fundamentals underpinning higher gold prices:

1. Supply and demand

The supply of new gold from mining operations has not been able to satisfy the worldwide demand by fabricators for at least 16 years http://www.gold-eagle.com/analysis/supply_demand.html The only thing that has prevented a squeeze in supply has been the drawing on gold reserves cached away by Central Banks. The vast majority of western governments have considered gold a “non-producing asset” and so have off-loaded it into the market over the last decade, and not added to their reserves at all. Obviously, once the stockpile is gone, or governments decide it is imprudent to sell gold, the situation for supply gets desperate. Mine production is scheduled to decline over the next three years, even if the gold price skyrockets, because it takes time to find new underground reserves and develop them. During the last 5 lean years in the mining business there has been little investment in gold exploration. To replace draw downs on gold reserves from current mining, the industry must find at least fifteen, 5 million ounce gold deposits ANNUALLY. Do you know how many new mines of this size were found last year? None! The year before? None! None of this magnitude for 5 years! Mine supply is declining and there’s nothing anybody can do about it.

2. Inflation fears

Pundits talk about the strong housing market and consumer confidence, but it comes against a backdrop of substantially increased business risk, low or no interest loans, and massive expansion of personal debt. It is phoney growth without creation of profit. Some months ago we had a lot of public hand-wringing about whether or not we were in a recession. This has since evaporated as the consumer has ridden to the rescue, encouraged first by tax rebates and later by the lowest interest rates in 40 years. The housing bubble (which Greenspan explains away as “immigrant purchases”) when it pops could catapult America into depression.

How is America to get out of this mess? The only solution is continued and enhanced massive injections of liquidity and consequent inflation. Possibly the “war on terror” has ulterior motives - to put America on a quasi-continuous war footing in order to justify massive deficit spending. Governments can only get away with running debt-economies of the order we are approaching in times of war.

3. A fallacy: “All the gold ever mined is still out there waiting to be sold”

This is a line trotted out again and again by gold-knockers. I have heard it 3 times in the last three days. It is the short-syllable, unthinking, refuge behind which many gold-knockers hide. Because gold is near chemically inert and indestructible we hear time and again that it will go back into the equivalent of the recycling bin at the end of the driveway, should gold prices spike upwards. This is nonsense. During the Asian Crisis only a small fraction of private holdings were actually dishoarded, and in 1979-80 when gold and silver spiked up, yes, there were people selling their silverware and jewellery for scrap, but there were just as many buying gold and silver. Can anyone ever envision a scenario when all the peoples of the world dishoard all their gold at precisely the same moment? Of course not, and especially not in a rampant bull market.

With a tanking US dollar, it is increasingly unlikely that Germany will liquidate its large holdings, as was mooted back a few months ago. One clearly uninformed writer suggested that Russia would dishoard their gold in the near future. They have been recently adding to reserves and in any case are way down the list of gold holders. Eddie George in Britain is taking renewed flak for selling part of the Bank of England's stock. Who is going to sell?

Secondly, all the gold consumed in electronics and dental work is mostly out of play for good and is not recoverable. It's a known fact that the majority of diamonds in the jewellery market never ever see a pawn broker. Most are lost or handed down to relatives. In a similar way gold jewellery which is meant to be worn is mostly lost, worn away by use or tightly held as family keepsakes and heirlooms.

For the majority of this planet's population, who are rather cynical about banks and paper money, gold is the ultimate wealth refuge, to be liquidated only in times of extreme financial distress. As Pinank Mehta recently pointed out in a study of the Indian gold market, http://www.gold-eagle.com/editorials_02/mehta052402.html "the mentality is so possessive for gold that it will be sold as a last resort only, and before that most of the other assets will be liquidated". The peoples of the Subcontinent are the largest consumers of gold on the planet. Mr. Mehta tells me that the increased trouble in Kashmir will cause Indians to desert the domestic stock market for the protection of the yellow metal.

4. Safe haven buying:

After 9/11, gold spiked up in price and then came back down. The *Financial Times* and the *Wall St. Journal* then ran articles along the lines of "gold's safe haven status tarnished" etc. But with the ensuing Afghan war weeks later and trouble in Kashmir certainly the red line on the world thermometer of political tension didn't drop. President G.W. Bush's pronouncements about the "Axis of Evil" and renewed calls for military intervention didn't help reduce the global temperature either. Yet the gold price went down. But now the media has chosen to blame gold's riotous run on "safe haven buying", blaming Al Qaeda, Kashmir - heck some even throw in that tired old chestnut the Middle East - suggesting that in a similar way to September 2001, gold will spike up

and quickly move back down again. You can't have it both ways boys!

I don't wish to get on a political soapbox, but the constant barrage of warnings of impending terrorist attacks are starting to ring hollow in light of a conspicuous lack of arrests of conspirators and fifth-columnists, or discovery of caches of explosives and weapons, or actual terrorist attacks themselves. All that has happened lately has been a crazed American college student putting pipe bombs in rural mailboxes. America's allies against terror have given Bush's idea to pre-emptively attack Iraq a cool reception. There is probably no gold anywhere that is being bought for the safe haven reasons of a "terrorist threat" - none in the US, none in Europe, none in the Orient. There is much more being bought as a safe haven against the dollar. It is possible that foreigners are beginning to worry about the mounting costs of Bush's adventures in Asia and its effects on the dollar when it is eventually all tallied up.

Forces moving the market today:

5. The End of Central Bank Sales and the Gold Carry Trade:

When Alan Greenspan lowered interest rates in the US he made the Gold Carry Trade unprofitable. The Gold Carry Trade has weighed down gold prices all through the late 1990's. It worked like this: Central Banks would lease out their gold to bullion banks who would sell the gold into the market and invest the proceeds in vehicles that offered a greater return, like treasuries. It only worked well when there was considerable spread between the gold lease rate and the rate on bonds, which mitigated against any minor increases in the price of gold when the gold had to be eventually purchased on the spot market and repaid. Of course the situation could be disastrous to the borrower if gold started to move substantially upwards. This is what happened. Now Central Banks are increasingly reluctant to lend their gold and risk not getting it back. As well, the spreads have shrunk so much that the Gold Carry Trade is no longer profitable and is being abandoned *en masse*.

Governments are coming under increasing attack from their citizens for selling gold over the last two years at what are in hindsight, bargain-basement prices. Chancellor of the Exchequer, Gordon Brown in the UK used the cash from gold sales to buy Yen and Euros, both of which were also bad investments.

Hedging by gold producers is no longer *de rigueur*. The hedge was an invention by Barrick years ago to guarantee a stable revenue stream in an oscillating gold market, which would take the risk out of gold mining. It was embraced widely throughout the industry. Bankers loved it. Mining companies would sell their production forward at a negotiated price. In falling markets hedgers became big winners. However hedging acted as a mechanism which also capped the price. Investors had little expectation of higher gold prices when most of the industry's gold - even for years in the future - was already sold at a predetermined price. Hedgers are now almost all with a unified voice denouncing the practice and are busy attempting to unwind their positions, now that the

gold price is trending upwards. If it were to rise above the price in their hedge agreements the hedge would be “underwater”. A few years ago Ashanti and Cambior both nearly went bankrupt when their hedge books went underwater. They had provisions in their agreements to pay penalties in the unlikely event that the gold price spiked upwards. Both were caught off guard. It is hard to say how many miners are at similar risk. At some magical point miners will scramble to unwind their hedges by buying spot gold. Caught in a feedback loop, the spot market will spike up with renewed vigour, causing even more short covering in a cascade effect. The results could be disastrous. The keys to preventing a crisis are to choke off the gold rally, or at least draw it out over time. Time in this case is in short supply.

I won't say too much about gold derivatives, but we know the market is HUGE! A sharp, unforeseen and unanticipated run-up of the gold price could cause massive losses and short covering by those engaged in this tricky business.

6. Tanking dollar

For a couple of years now the balance of trade has been tipped towards foreign importers. In essence it has been cheaper for Americans to buy imported goods rather than domestically produced goods. Just look at all the “Made in China” goods in your local Wal-Mart. Sounds fine I suppose....until it starts to impact American workers and jobs are lost. The government has accused foreign governments of unfair dumping and attempted to redress the balance by imposing trade barriers and tariffs against foreign imported steel and softwood lumber, and has raised American farm subsidies. European trade partners and Canada have cried foul. Many of these same folks are allies in the war against terrorism. Running a trade deficit year after year is not a sustainable thing.

Foreigners have taken those dollars earned from exports and put them in American equity markets. As American companies report falling earnings and forecast poorer outlooks those foreigners are getting nervous and selling dollar denominated investments. What Greenspan can NOT do is protect the dollar by hiking up interest rates, because he would instantly plunge the US economy into depression, and so with poor and risky (more and more downgrades of bonds to junk status) returns on American investments the dollar will continue to be jettisoned for other options.

The dollar and gold price have been inextricably linked since gold was allowed to float in the Nixon era. Abandonment of the dollar - the economic *lingua franca* of the world - without a viable alternative safe haven currency in the Euro or the Yen, is precipitating a stampede into gold.

With a tanking US dollar it may be worthwhile to purchase your gold shares on foreign exchanges in non-US currency to get a double bonus.

7. Scandalous times

Who could have forecasted all the scandals, all the investigations and the sudden “retirement for personal reasons” of so many CEOs to tropical islands? We’ve had Enron, Andersen, Merrill, Worldcom, Adelphia.... all in a row. There is a general and widespread distrust of Wall Street and its pundits/bandits. How can a spin campaign against gold get anywhere?

The current gold bull run started out as conservative “wealth protection”, as investors saw an opportunity to rotate their money into a sector free from scandal and with considerably less downside risk than the broad market. Gold mining wasn’t susceptible to the knock-on effects of downsizing or bankruptcy by major purchasers of product - for instance, the arm-in-arm relationship between computer manufacturers and chip makers, or fibre optic cable manufacturers and telecom companies. The health of a given business is often inextricably intertwined and reliant on the health of suppliers and customers. At about the same time as the first scandals broke, the stories of Japanese lining up to buy gold were making the American evening news. Japanese investors piled into gold ahead of the curtailing of bank deposit insurance on large accounts.

The scandals keep coming. It is Bre-X writ large. However in the years since Bre-X numerous efforts have been made by regulatory agencies to clean up the mining industry and restore confidence. These regulations are already now in place. The mining business has taken its lumps. Vigilance is high, and the chances we will see another Bre-X to tank this market are nil.

Factors that will continue to move this market:

8. The gold market is small.

Barrick, the largest gold company by market capitalization is still smaller than Alcoa, the aluminium producer. According to fund-tracker Lipper Inc., gold represents just 1% of total industry assets. With all the money parked on the sidelines we could see tremendous moves in the gold sector. Old time miners used to use a method called “hydrauliking” to wash gold from hillsides with high pressure water. They didn’t have any pumps, so they used to take a small creek and funnel the water down into a large diameter pipe. Down the length of the pipe they would progressively neck the diameter down by using narrower pipes, finally to end in a brass nozzle on a fire hose. The pressure would be enough to cut a man in half, should he be unlucky enough to be in the way, and the hoses were typically mounted on a metal swivel support to harness them. In a similar way we could see a rather small shift of investment into the gold sector translating into huge gains, as large numbers of investors pile into a small market. In the past few weeks we have seen some junior stocks doubling and trebling. Also, the sector is shrinking all the time, as miners consolidate to attain the magical mystical large cap status that gets them on the radar of the larger funds. We’ll continue to see the number of listed companies shrink until the junior and IPO markets really roar

to life.

9. Is the gold market a “bubble”?

The gold-knockers are already making noises about the gold share market being a bubble, because of high and increasing P/E ratios. Many companies have made conscious decisions to forgo earnings and get leveraged to the price of gold by taking on currently uneconomic or inactive mine projects. It works like this: if an orebody costs \$300/oz to mine, every dollar increase in price means a substantial increase in operating profit. Leveraged miners are betting on a higher gold price. It's hard to say if the share market will continue to run ahead of the price of physical gold at so great a pace. As stocks become more expensive we may see the momentum slowing and a catch up of the gold price to the share activity. This would lower the P/E ratios for many miners. Tremendous efforts have been made over the past 15 years to improve recovery techniques and lower the costs of mining gold, but few mines are making money at \$330/oz gold. The majority of mining companies fail to factor in exploration, administration and other costs into their cost-per-ounce numbers. Most companies are in fact being carried by one or two super-profitable orebodies. We won't see a return to real profitability of the industry until we are upside of \$400/oz. In other words, we are still way below the point at which return on investment is meaningful, and at which ounces from depleted reserves can be replaced. So don't expect any sudden flood of newly-mined gold on to the markets. This bull market has a long way to run.

Talking about a gold “bubble” brings back uncomfortable memories of the tech wreck. The gold phenomenon is a different beast entirely. After all, we are not talking about a product for which we will have to artificially create demand! Gold mining has been around for 4,000 years. We don't have to dream up a new paradigm or declare a New Era. The fundamentals underpinning a higher gold price are there. They are reality! Some of the bizarre products the techies dreamt up were obsolete when they hit the drawing board - others were things no one really wanted.

and, perhaps most importantly:

10. Jumpin' on the bandwagon

Market psychology (some would say “mass hysteria”) was what fuelled the recently deceased Tech Bubble. What a windfall for the gold market! We have a greater percentage of people participating in stock market casino than ever before, the majority of which couldn't care less what sector it is in, “as long as it is going up”. The gold market offers them what they least expected....a potential chance to win back their tech losses! This could be the single most powerful and potent force for the gold bull market. Could we truly see the gold sector become the “only game in town”? Up until recently the gold bull has been cloaked in stealth mode. Bubblevision and the mainstream media wouldn't talk about it. Now the gold story is undeniable. I heard the gold price quoted today on the radio, along with the closing numbers for the Dow and Nasdaq.

That's the first time I've heard it for years!

With a lack of viable investment alternatives we have the potential for "feeding frenzy" type activity. My own simple gauge of market behaviour is the ever-increasing number of E-mails I get from investors leaping into gold for the first time. Few seem to be getting any meaningful guidance from their brokers. A common phrase is, "Is it too late to get in?" For a summary of what we could be in for, look at my *Straight Talk 11 - Predictions for 2002*. If feeding-frenzy behaviour should become reality, throw out the forecasts, throw out the historical comparisons, throw away the crystal balls, for we will be in uncharted territory.

May 29, 2002.

Keith M. Barron Ph.D.

keith@straighttalkonmining.com

© 2001, 2002

Straight Talk on Mining is provided for information purposes only. Nothing herein is to be construed as a recommendation to buy or to sell any particular security or financial instrument. Nothing herein is to be construed as a recommendation to engage in any particular investment strategy or trading strategy.

The investments discussed herein may be unsuitable for investors depending on their specific investment objectives, financial situation, and risk tolerance. Private investors should obtain the advice of a qualified financial advisor before entering into any transaction.

Straight Talk on Mining is based on information that is generally available to the public. The sources used are believed to be reliable, but because the information and data that they provide are beyond our control, no representation is made that it is complete or accurate. Staff of Straight Talk on Mining may or may not be invested in the equities mentioned.

References to other publications and direct links to external Internet sites are sometimes given. The inclusion of any publication, organization or Internet site herein does not imply any endorsement. Straight Talk on Mining has no control over the content of any Internet site that you may reach through links that are provided, nor can their truth, accuracy, or completeness be vouched for.

Straight Talk on Mining Ltd. is not a financial services company nor is it affiliated with any financial service company in any jurisdiction.

The author/publisher, Dr. Keith M. Barron, is not a qualified financial advisor and is not acting as such in this publication. The accuracy of any legal term or definitions used herein should be verified with your legal advisor or the appropriate government agency.

