

INSTITUTIONAL ADVISORS

April 27, 2005

GOLD

CONTRA - CYCLICAL OPPORTUNITY ?

According to thorough technical analysis, the gold sector seems to have reached a significant low. This is complete with measurable signs of capitulation selling and rather bearish sentiment.

The latter shows up as extreme lethargy in exploration stocks generally, despite good programs and, until recently, some good gold rallies. This is opposite to the condition in March-April, 2004.

Quite likely, the condition offers much more than another trading opportunity out of an oversold market.

As outlined below, on the very long term the golds have set an important low in the Fall of the year that a great financial bubble climaxed and then enjoyed a cyclical bull market of 2 to 3 years as the big stock markets suffered the initial post-bubble bear market.

At times, gold shares were set back during the hard phases of the stock bear market, but generally the golds gained as gold outperformed commodities. The recovery out of the panic for stocks and low grade bonds in late 2002 became a boom by mid-2003, with gold underperforming commodities as well as silver.

Our gold/commodities index declined from 255 in mid-2002 to 192 in March of this year. This is not too far off the key cyclical low of 187 in the Fall of 2000. From 82 in June, 2003, the gold/silver ratio took a long decline to 56.6 on December 1. Last week's low of 58.4 seems to be testing both the December low and that of 57.2 on February 18.

The next step of this study is to review the exploration side of the gold market, which offers opportunity possibly beyond what one would expect from a normal cyclical recovery in gold's price relative to commodities and most asset classes.

Since the launch of the first cyclical bull market in gold stocks in 4Q 2000, there has been considerable activity by mining companies to expand gold producing assets through acquisition rather than fieldwork. Yes, there have been some discoveries but, in the meantime, it has been a top-down process

with the very big ones, such as Newmont merging with Franco Nevada, right down to takeovers of companies with only one mine.

Relative to this activity, there has been little spent on exploration.

A review of only one company as an example can explain the diminished exploration efforts and results. For decades until the early 1980s, Placer Dome (it was then known as "Placer"), enjoyed the reputation of having one of the great mine-finding teams and an outstanding startup team.

In the early 1970s, the company set up a forward planning committee that recommended an aggressive expansion in gold over the hitherto exposure to base metals. The timing and field results returned Placer to the ranks of important gold producers.

The play in gold into 1Q 1980 was remarkable, as was the subsequent plunge in both precious and base metal prices.

By that point, some of the old top management had retired and the new guys showed an alarming (at the time) dedication to short-term results as cash flows diminished. The bean counters laid off the exploration geologists.

That essentially ended the unique and ongoing culture it takes to find mines and start them up. Occasionally since then, strong rallies in gold's nominal price prompted Placer to suddenly acquire mine capacity, such as in South Africa, in order to be "in the play". The Cortez joint venture discovery has been the exception. (Placer's chart is now in a pattern from which a significant rally could follow.)

This one story generally reflects the policies of some of the major companies and the big opportunity pending is that the game of acquiring ounces has matured just as gold is set to start another post-bubble cyclical bull market.

On this one, it will become paramount to make many significant gold discoveries. Again, in turning to generalities, the exploration talent and ambition is not found solely in the big companies but in many small exploration companies.

Every era of financial bubbles is eventually followed by a severe credit contraction. Since the advent of modern financial markets by around 1700, there have been five examples prior to the blowout in 1Q2000.

Mother Nature needs to fill the post-bubble credit vacuum and, typically, gold's real price has increased significantly and this resulted in equivalently increased production and exploration success.

Also typically, the post-bubble rise in gold ran for 20+ years and, in a number of examples, a great gold rush occurred with gold's highest real price at the end of the secular credit contraction. The discoveries in the 1840s and late 1890s are the best known gold rushes – "California" and the

"Klondike". With varying degrees of intensity and success, the record is complete back to the 1690s' depression bottom, which recorded the "Oro Preto" mania in Brazil.

Over the past year, the severe decline in the U.S. dollar and associated rallies in gold haven't been as profitable as the goldbugs were counting on. However, as the more alert in the gold community are beginning to discover, a bunch of currencies suddenly jumping relative to the U.S. dollar doesn't translate to improving operating margins or soaring share prices in Australia or Canada, for example.

For a real, rather than faux, bull market, gold needs to be rising relative to alternative assets such as stocks, bonds, and commodities. It also has to be rising relative to most currencies.

When it comes to the decision between intuitive and thorough research, these pages have always trusted the latter. On the big sweep of time, financial history is quite straightforward. While it didn't start in 1700, it is an appropriate date to start this review. By the last quarter of the 17th Century, there were enough publicly traded shares to call it a stock market and the shaman of the financially superstitious – the central bank of perpetual accommodation – had opened its doors in 1694.

After building for some 20+ years, the "old" era of inflation blew out in 1711. This was followed by a "new" era of inflation in financial assets. Then, when this blew out in the ninth year (in 1720) after the mania in tangible assets, a secular contraction followed.

Typically, this lasted for some 20+ years as the bubbles in both tangible assets deflated. Of course, the usual 3 to 4 year business and credit cycle prevailed, so the process of credit contraction included some ups and downs.

Then from a secular low in interest rates and commodity prices, a secular recovery followed. The basic pattern recurs at the typical rate of twice per century.

Recently, there has been a successful attempt to popularize the notion that from the lows of late 2002 commodities have started a long bull market that could run for about 18 years.

It must take considerable intellectual audacity to promote intuitive research.

The above part of this brief review says it all. Yes, there are long bull markets for commodities and they typically run for more than 20 years.

They start from a depression bottom and end in the era of bubbles – never the other way around.

Throughout the period under review, the behaviour of gold's real price, or purchasing power, or mining profitability has been consistent. It has

recorded a significant low during the bubble era and then, once completed, gold's real price increased for some 20+ years.

Some confusion in the goldbug ranks can be reduced. Over the past 300 years, there have only been two bull markets for gold in senior currency terms and that was when sterling and the dollar were not convertible into gold at a fixed price. The first one ran for some nine years in the early 1800s and ended when the great financial mania that blew out in 1825 got underway.

The only other example ran for some nine years until 1980, from which collapse set up the era of bubbles, during which gold would be likely to set a significant low.

The following charts show two things. One is that our commodity index seems to be replicating the key top in the late 1980s.

The other – the gold/commodities index – details the end of the tech bubble in 2000, which was similar to gold's behaviour through the climax of the two previous stock bubbles. ***When the U.S. was not on a gold standard***, gold's real price declined until that stock bubble blew out in September, 1873. More specifically, it declined until November, 1873 when, with the reversal in the yield curve from flattening to steepening, gold began its first cyclical recovery and the economy suffered its first cyclical contraction within a secular post-bubble contraction.

On the next bubble, the U.S. was on a quasi-gold standard and it blew out in September, 1929. Then gold's real price reversed to a cyclical recovery in November along with the yield curve reversing from flattening to steepening.

Both the 1929 and the 1873 examples followed the pattern that was recorded with annual numbers at the bubble tops of 1825, 1772, and 1720. Gold's real price recorded a cyclical decline with the mania and then, with the initial business contraction, it enjoyed a cyclical recovery.

This recovery in stocks, business, and credit markets is showing some of the classic signs of topping at the same time as the gold side of the equation is indicating downside capitulation.

In which case, the second cyclical bull market whereby gold will outperform most commodities as well as most financial assets is about to get underway. The first one out of the collapse of the tech bubble launched a remarkable drive to acquire millions of ounces of gold.

This one will launch an even more remarkable drive to discover millions of ounces of gold. Exploration companies with outstanding field abilities and portfolios of identified properties will be outstanding performers. Think about the small-cap tech stocks in 1994.

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