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Gold: review and outlook

The following is an edited transcript of a speech that Albert Friedberg delivered to institutional investors on April 25, 2006. His comments addressed the reasons behind the current bull market in gold and the outlook for the future.

Gold: It's always a fascinating subject, and it's becoming a little bit more interesting for the following reason: Markets tend to move in ways that capitalize on past history a great deal. There is a thing called the bandwagon effect, and we are very much aware of that; there's momentum in these markets. Gold had a self-reinforcing vicious circle over a period of 20 years, in which the price went down. And as the price went down, it made people more despondent about it, and so they decided not to invest in it. There came a point in the late '80s and the early '90s when some of the largest bankers – private bankers in Switzerland – began to tell clients, "You don't need to have any gold. There's no gold needed in your portfolio."

You could look back to 1990, '92, or '93, and say, "I held gold for those 13 years, and I have a minus absolute return of 40% or 35%. In real terms, I lost 80% of my money." It reinforced the feeling that gold was really not an asset.

At the same time, the process of demonetization took place on an official level. I think it's not unrelated to the fact that central bankers are also humans. They looked at the same thing as the private bankers and felt the same way. "What do we need this thing for?" The idea started off as an intellectual conflict. "In a floating-rate regime, we really don't need gold. It doesn't earn us any money. We could be earning money on T-bills." And so, more and more central banks joined the idea that they could demonetize gold.

Add to all these factors the most important factor of all: Mining companies – and this was a great discovery of Barrick Gold Corp. – came up with the idea that they could play this bear market in gold. They could earn the contango or they could earn the interest rate on the gold market. And they could assure themselves of a price. The strategy started off as a hedge. It ended up being almost like an investment position – a short position.

All these factors conspired to bring the price of gold down. I think it is a remarkable point that with all this bearishness, the price held between $260 to $300. This, for many years, was an indication of genuine demand. It had to be genuine demand, because the other side of it was the disinvestment. We had disinvestment for 15 years. So genuine demand was actually rising and picking up that gold.

What this market needed was a change in that sentiment. It's sort of strange to say, but the only way to change the sentiment is to have the market move up. A number of very significant things happened to change the sentiment.

First, the Washington Agreement. The Washington Agreement was absolutely key to this whole market. The Washington Agreement was between 9 main signatories at the time, and now it's expanded to 15. The central banks all decided that their selling of gold in an uncoordinated fashion, in a random fashion, in a secretive fashion, was actually hurting them. "What we need to do," they said, "if we want to get out of it, if we want to demonetize rationally, is tell the mar-

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ket in advance *how much* gold we are going to be selling." These countries initially agreed that they would sell only 400 tons a year. Over five years, 2,000 tons, that's the maximum they would sell – and they would agree among each other as to who could sell what of that 400 tons a year.

There was an electrifying reaction in the market. The market finally realized that there was going to be order and transparency. With that, the market had changed.

The selling took place and nobody noticed it. The market absorbed it without any problem. I mean the depth of the market is extraordinary. Large quantities were sold, and then a few weeks later, the Netherlands would say, "we just sold 39 tons," or some other country would say, "we just sold 40 tons or 50 tons." We knew which countries were selling, and we knew that the quantity could not go over a certain amount. Having said that, the markets found a little bit of a bottom. Then consumption continued to increase, and so the market began to crawl out of the bottom.

(Gold, by the way, is a play on emerging countries. China's and India's consumption has risen significantly.)

Hedging programs lost their "fashionability." When that happened, another of the supply considerations became clear and came out of the market. And as we crawled out of the bottom, something interesting happened. Year over year – for 2000 to 2001, or 2001 to 2002, I don't know precisely the years – you could look back and say, "as an asset class, this thing has gone up 6% or 7%." Well that's a lot better than Treasury bills – they were yielding 1.5%. And so gold came into the performance race. Now we can talk about gold like we can talk about anything else. You find anything in the world that moves and that has a little bit of a history, and today you can create an investment story. Gold had entered the positive side of the cycle. World investment demand became positive.

We know that new things happened after that. We created the ETFs. The ETFs are an excellent vehicle for institutions that cannot own the physical metal. That created more investment demand. The positive cycle says gold is going up because it went up. That's the momentum behind the market.

Investment demand is the key. We know that production has flattened for the last few years. We know that production is lower today than it was two years ago. We also know that gold mining companies are no longer selling forward, the short book is being reduced. We know that the Washington Agreement was renewed. Now, instead of 400 tons, it's 500 tons a year. Those things are taken care of. I think the supply side has been taken care of, totally.

The demand side is important. I don't think it's necessary to think about how much gold India or China buys. That is irrelevant. The relevant question is, What is investment demand for gold? How big will it be? How large will it get?

And ultimately, there is one more question, because as I stated before, central bankers are human beings, and they act very much like all of us. Will they change their minds? Will some of them ask, "Why do we need this Washington Agreement any more? We're not selling gold any more. Now we just want to hold what we have." And will that be contagious, and will the central banks in Asia, which own only a minuscule amount of gold, maybe 1% of their assets, join and say, "We want to own some gold too. We want to go up to the same sort of average level of gold that is owned by the European central banks – 30%, 40%."?

For the foreseeable, future we have not been able to find great discoveries. There are no great discoveries in gold. I think that there have been two major discoveries of gold in the last five years, and it takes years to bring them into production. The great gains in productivity are behind us, so from the production side, we don't have to even think about more gold coming on the market.

What we need is to be able to predict what is going to happen to the demand side of gold. As I sit here today, and as much as I think we know about the gold market, it's impossible for us to be able to make such a prediction. We don't know what percentage or allocation of gold major global portfolios, Swiss banks on behalf of sheiks, on behalf of wealthy individuals, will want to have in their portfolios. Three per cent? They didn't have any until now. Three, five, ten, fifteen? All we know is that we are on the positive side of the cycle. We know that the momentum will carry the market further. And we know that there are enough fundamentals to carry it further.

I want to show you a few numbers. Don't take this to mean a prediction. I wanted just to show you a couple of numbers that can give you some idea of what people will say to justify their positions.

If you look at Chart 1, this is the price of gold around the historic highs. The historic highs were made between 1979 and 1980, and at that time, if you remember, it got to $875 an ounce. It was a bubble. We had people lining up to buy gold. They were desperate. I remember trying to talk them out of buying it. This was the last four months of 1979. We could not talk them out of it. They were just plunking down money: "We want to buy, we want to buy, we want to buy."

What was the average price for that period? It went up, it blew off, it came down, and then it began to struggle in that $300 to $400 painful range for many years. What was the average during that period? It was $389 an ounce. And the

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lowest price reached in that period of time was $160. If you assume that the lowest price was not connected to the Iranian crisis of 1979, and if you take into account that the lowest price of $160 was not tainted so much by the enormous speculation against the dollar that took place later in '79, the $160 price to me sounded like a reasonable price.

I went back actually to some of the newsletters that we wrote, and we felt that $200-$250 was a very good price. We thought that it was a good idea at the time to buy at $225. So $160-$200 seems to be like a reasonable level.

So now we turn to Chart 2. We just have to look here at what is no more than a proxy of how much liquidity has increased in the past 25 years. This is looking at international reserves of central banks, that is, all the money that the central banks print, which ends up basically in reserves. It gives us an idea of what international liquidity did over that period. You can see that from 1978 to 2005, international liquidity ex gold went up eleven-fold. From 1980, 8.4 times. From 1982, 8.2 times. And if you want to see the annualized compounded rate, 9.29%, 8.9%, 9.6%.

Those, incidentally, are pretty close to the rates of return on equities for that period too. You don't have to be that smart to know that all you have to do is be in the right once at the right time. That over 20, 30, 40, 50 years, all assets follow about the same rate of increase – the growth of international liquidity over the period.

Now I told you that for the price of gold, the lowest in the range we saw from 1978 to 1982, was $160. If you were daring enough, bold enough to say, "well gold maybe should reach the level that is compatible with that increase in liquidity over that period," then just multiply that price times 11: 160 times 11 is $1,760.

So that would be reasonable. No, let me take that back. I'm not saying it's reasonable. I'm saying that would be a reasonable number for people *to project* for where the price of gold could go. Because as you'll remember, I said it's a question of demand, investment demand. And investment demand in a vacuum. What should it be? Well investment demand is based only on what the price would be tomorrow. So if you can get the price tomorrow, you would buy it today. It's a circle.

All I am going to say is that there are people who are going to make the argument that gold would be reasonably priced if it were trading about 11 times higher than that base price.

I refer now to Chart 3, which is gold divided by the Dow Jones, the Dow being an indicator of prosperity and an indicator of liquidity. You can see that the price of gold had a huge drop in relative terms from 1980 on. It bottomed out, I think, sometime in late 2000 after many, many years of going down, and though we have barely begun to scratch the surface, the market is turning. That is a beautiful chart. We are making a rounding bottom and coming out of a long-term downtrend. You can hardly find a better looking chart than this. What this chart tells you is that we have just begun going up, at least in terms of financial assets. Of course, if the Dow Jones drops 50% or 60%, gold may drop too, but the ratio between the two will still favor gold. This chart tells me that that will happen.

So, in summary, the fundamentals of gold look good. Production is declining now. It is probably going to stabilize over the next few years, but not until we find more gold and until we can extract more gold.

The major factors to consider in this market:

* ***Disinvestment because of poor performance.*** That doesn't exist. Now we have great performance. Go back four or five years. Gold has shown stupendous results – far better results than any financial asset. It feeds on itself. So investment demand should go up.

* ***Emerging markets will continue to buy gold*** – at decreasing rates, because the price is going up. But they will continue to buy gold.

* ***Mining companies would be crazy today to enter into any hedging operations***, because shareholders want the exposure to gold, so there is no selling from that side.

It's rosy looking. Is it going to go straight up? Probably not. We are going to have some substantial reactions along the way. Some of them will be very strong reactions, but one thing we have learned from the 30 years of being in this market – you never lose a position. When you think the fundamentals look good, you stay with the position. Don't lose the position. You ride it, and it will take you to unsuspected levels – I'm quite sure.

Chart 1 – Gold: January 1978-December 1982



Lowest price: $169.90; average price: $389.23

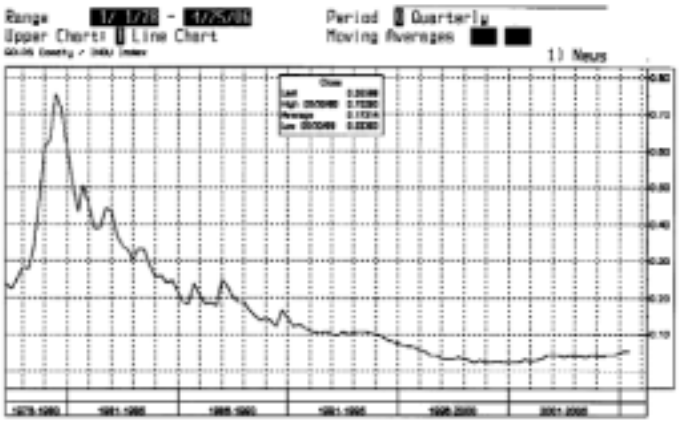
Courtesy Bloomberg

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Chart 2 – Growth in International Reserves (ex Gold)

Growth in International Reserves (ex Gold)		
		Compounded Annual Rate of Change
	2005	2005
1978	11.0x	9.29%
1980	8.4x	8.89%
1982	8.2x	9.60%

Chart 3 – Gold price (spot)/Dow Jones Industrial Average January 1978 - April 2006



Courtesy Bloomberg

CORN

Move over feed, here comes ethanol

The May USDA supply/demand situation report provided the first comprehensive overview of the 2006-07 marketing year for the corn market. The report showed a tightening market, and prices gapped up to challenge last summer's highs (Chart 4).

Using the March 31 planting intentions report – which estimated that US farmers would plant 3.8 million fewer acres than the previous year – and a trendline yield estimate of 149 bushels per acre, the USDA is forecasting a 2006-07 US crop of 268 million tonnes (10.55 billion bushels), 5% smaller than in 2005-06.

On the demand side, the item that attracted attention was the dramatic increase in the estimate for US ethanol usage to 54.57 million tonnes (2.15 billion bushels) for the new-crop marketing year from 40.61 million tonnes (1.6 billion bushels) in 2005-06.

Actually, neither of these statistics can be considered real news and should not have come as any great surprise. The early projection for the size of the crop, as mentioned, was based on data released on March 31, and employed historic planted-to-harvested ratios and trendline yields to achieve the output figure. The ethanol consumption estimate was exactly the same as the one the USDA issued at its outlook conference in February. Still, the average analysts' guesstimate for US 2006-07 ending stocks was sharply off the mark at 38.7 million tonnes (1.523 billion bushels), compared with the actual figure of 28.98 million tonnes (1.141 billion bushels).

While US output and bio-fuel data grabbed the headlines, developments on the US export front were glossed over and explain the wide discrepancy between analysts' guesstimates and the actual forecasts. In four of the past five weeks, export commitments have been very strong and sharply higher than expected by analysts, bringing total commitments up to 43.8 million tonnes. (This week's commitments were 500,000 tonnes above the high end of analysts' estimates.)

As a result of this robust activity, the USDA continued to raise its estimate for 2005-06 exports. The forecast for annual sales jumped to 51.44 million tonnes, up from 49.53 million tonnes in April and 48.26 million tonnes in March, which in turn shaved close to 2 million tonnes off stocks that will be carried forward to 2006-07. There are 17 weeks left to the marketing year, and the market can easily meet the USDA target.

Then, looking ahead to 2006-07, the USDA is forecasting US exports to reach 54.61 million tonnes. Although this may seem somewhat optimistic, we've seen these numbers before. US exports have stagnated over the past decade, but reached even higher levels in the late 1970s, the late 1980s, and the mid 1990s. China's domestic needs have grown faster than its crop size, and as a result, it will present less competition in the export market, shifting the business to the US.

Putting it all together, US ending stocks for 2006-07 are expected to fall to 9.8% of consumption, a steep slide from the 2005-06 carryover of 20.22% of consumption.

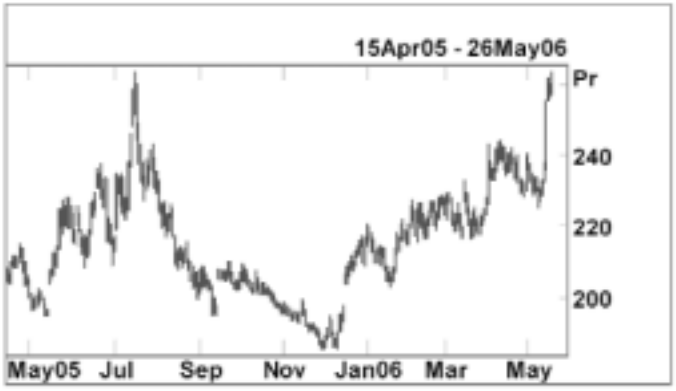
Global ending stocks will tumble to 92.26 million tonnes, or 12.9% of consumption, compared with last year's 18.78% of consumption. You'd have to go back all the way to the early 1970s to find such a low carryout.

There exists an abundance of skeptics who question the future commercial viability of ethanol usage that does not rely on government subsidies. But the current administration has expressed, in no uncertain terms, the necessity of developing

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alternative fuel sources to petroleum, and it is determined to launch and maintain initiatives that will meet that goal. The economics of producing and consuming ethanol are indeed not terribly efficient, but the USDA ethanol figures are based on hard data garnered from monthly production and consumption statistics. The global feed market will now be sharing US corn crops with the energy market, and as we witnessed in the sugar market over the past few years, prices will have to rise enough to encourage farmers to increase output to a level that will be sufficient to supply both segments of the market. Remain long. *[May 19, 2006]*

Chart 4 – Nearest contract corn



Courtesy: Reuters

WHEAT

A supply-side bull market

July CBOT wheat is trading just a shade shy of the late-2002 high of $4.34. Kansas City wheat (strictly hard red winter wheat) has sprinted to 10-year highs.

The global production/consumption surplus of 2004-05 turned out to be a single-season phenomenon. While the record crop we saw that year was followed by the second-largest global crop on record, usage grew far too quickly to keep up, and 2005-06 marked a return to the years of deficits.

The USDA May supply/demand situation report provided the first estimates for the 2006-07 season. The report confirmed the market's concerns.

For the US, crop estimates for all varieties were lower than expected. The estimate for the winter wheat crop was 1.323 billion bushels (36 million tonnes), compared with the average analysts' guesstimate of 1.373 billion bushels (37.41 million tonnes). Last year's winter wheat output was 1.499 billion bushels (40.85 million tonnes). Including the spring wheat crop, the estimate was 1.873 billion bushels (51 million tonnes), compared with a 1.949-billion-bushel (53.1-million-tonne) guesstimate and 2005-06 output of 2.105 billion bushels (57.3 million tonnes).

US farmers are expected to plant just about the same number of wheat acres as they did last year – 57.1 million, compared with 57.2 million last season – but the weather has proven to be a disaster for the winter wheat crop. Actually, according to the March 31 planting intentions report, winter wheat acreage was 1 million acres above last season.

Consider the weekly crop condition reports: Ever since the release of the USDA's first crop progress report of the season on April 3, which showed the good-to-excellent portion of the crop at 38%, the crop has deteriorated. As of the most recent progress report, the good-to-excellent portion has dropped to 30%. Last year at this time the top portion of the crop stood at 52%.

Argentinean output is expected to bounce back to normal production levels after a dismal 2005-06. But any gains in Argentina and other producing countries will be overwhelmed by the sharp drop in FSU crops, which were pounded by inclement weather and are expected to plunge by 16 million tonnes, or 17%, from last season.

Global demand is forecast to dip by 10 million tonnes, or 1.5%, in the new crop year, but reduced output will still leave the global balance sheet with a 16-million-tonne deficit. Ending stocks will fall to 128.13 million tonnes, or 20.8% of consumption, compared with last year's 23% of consumption. This will be the lowest carryout since records have been kept.

Back in the US, if current winter wheat conditions do not improve, the planted-to-harvested ratio will be 80.7%, compared with 83.7% in 2004-05 and 87.6% in 2005-06. We're not in nearly as bad shape as we were in the 2002-03 season when that ratio was 74%, but then again other countries picked up the slack back then. Global ending stocks at the end of that season were 27.7% of consumption. The way things look, there is not much chance of that happening in the current environment.

US export activity, the primary harbinger of global demand, has been steady, but we will not make the USDA estimate. The ending stock estimates published by the USDA will therefore have to be adjusted and would push the 2006-07 global carryout up to 21.1% of consumption, which doesn't

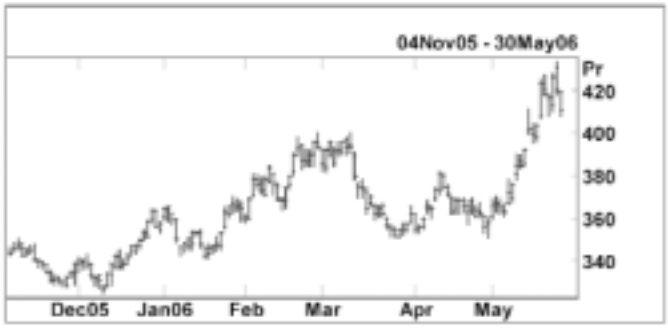
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change our bullish outlook very much.

Is the market overbought? Well, open interest has skyrocketed to absurd levels (520,000 contracts, up about 35% over the past six months), which means, of course, that commodity funds are buying wheat while the commercial community is taking the other side. The net-long position of 15,000 contracts, however, is not quite as extraordinary as the mammoth leap in the open interest would suggest.

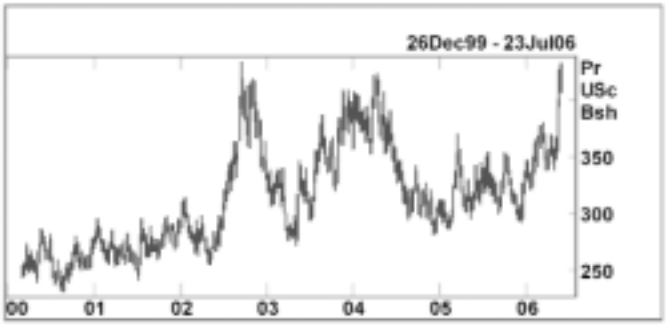
While the market is vulnerable to large setbacks, the development of bullish supply/demand fundamentals should keep this bull market alive. An increase in ho-hum demand would be the icing on the cake. Maintain long positions and look for the inevitable dip to establish new positions or to add to existing ones. *[May 25, 2006]*

Chart 5 – July CBOT wheat



Courtesy: Reuters

Chart 6 – Weekly CBOT wheat



Courtesy: Reuters

SOYBEANS

A bear in a field of bulls

Soybean prices have been moving in a sideways pattern for close to a year now (Chart 7), and with good reason. Were it not for the strength of the grains in the neighboring trading pits at the Chicago Board of Trade – not to mention the general strength in commodity markets – we'd venture a guess that soybean prices would long have broken support at the $5.65-per-bushel level. Supply/demand fundamentals have become increasingly bearish, and there isn't any other good explanation for beans to be trading close to $1 per bushel above the lows we saw early last year.

The May USDA supply/demand situation report confirmed a well-supplied market for the outgoing 2005-06 marketing year and painted an even more bearish picture for the coming 2006-07 season.

At 565 million bushels (15.37 million tonnes), or 20.3 % of consumption, US ending stocks for 2005-06 are at their most burdensome levels since the mid-1980s. Ending stocks averaged 7% of consumption in the 5-year period prior to the 2005-06 season.

The estimate for 2005-06 Brazilian output was trimmed by 500,000 tonnes, to 56.5 million tonnes, but it will still be a record crop. Argentina will produce 40.5 million tonnes, a record as well. Both harvests are complete now, so these estimates shouldn't change very much.

Global consumption grew by 4% in 2005-06, but production kept pace, leaving the market with a second consecutive year of surpluses. Ending stocks for 2005-06 stand at a modernday record of 55.94 million tonnes, or 26% of consumption. This compares with an average of just under 20% in the previous 5 years.

The USDA does not publish 2006-07 soybean estimates for foreign markets until June, but the May report does have an early outlook for the US.

Acreage lost to corn is expected to go to soybeans. Traders were as surprised by the jump in soybean acreage as they were by the drop in corn acreage (see *Focus on Futures*, May 19) in the March 31 planting-intentions report. US farmers are expected to plant 76.9 million acres of soybeans this spring, compared with only 72.1 million acres for the 2005-06 season. The estimate for output – 3.08 billion bushels (83.9 million tonnes) – is roughly the same as last year's. But the USDA is using a very conservative yield estimate of 40.7 bushels per acre, down substantially from last season's 43.3 bushels per acre. Genetic engineering has made it unprofitable to bet against yields of any of the major US crops in the past few years.

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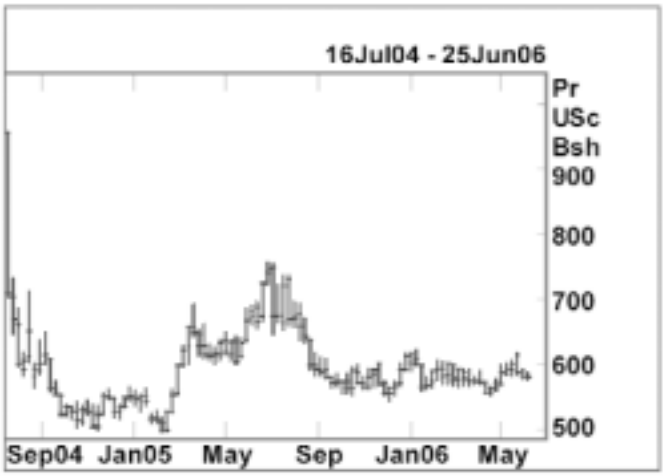
As it is, despite a forecast for record consumption, ending stocks will jump to 650 million bushels (17.65 million tonnes), or 22% of consumption. The optimistic usage estimate is based largely on an anticipated significant increase in exports to 1.09 billion bushels (29.7 million tonnes), from 900 million bushels (24.49 million tonnes) in the current marketing year.

A look at the pattern of foreign sales for 2005-06 makes one wonder whether the USDA is not jumping the gun. Shipments currently stand at 21.27 million tonnes, but with 15 weeks left to the season, the USDA estimate seems likely to be achieved. Even if the forecast is met, however, it will have been a dismal year for exports, with sales close to 12% behind the average of the previous 5 seasons. At this stage, it's unlikely that anything will derail the trend. In addition, we should take into account that South American exporters will also have record supplies on hand and could provide stiff competition to the US.

As we mentioned earlier, this market can be kept afloat to some degree and for some time by generally bullish grain and commodity sentiment. Ultimately, however, prices will represent economic realities.

Trade this market – cautiously – from the short side. Alternatively, remain long soybean oil, on a spread against short soybean meal as we recommended in the April 28 issue of *Focus on Futures*. This spread should continue to improve in favor of oil to reflect the growing bio-diesel market. *[June 1, 2006]*

Chart 7 – Weekly nearest contract soybeans



Courtesy: Reuters

COTTON

Underestimating the 2006-07 US crop?

The May USDA supply/demand situation report made several small changes to the demand side of the global balance sheet, which resulted in a drop in ending stocks to 44.7% of consumption from 45.25% in the April report. While this level of carryover stocks is still quite burdensome in historical terms, the market has been tightening steadily over the past few months.

The tightening trend seems to be continuing into the new season. The USDA's outlook for 2006-07 estimates that global output will increase just a bit, to 115 million bales, or 1.5% over 2005-06. Usage, on the other hand, is expected to climb to a record 122 million bales, or 4% over the previous year. This would leave a 7-million-bale production/consumption deficit, which would be the second consecutive year of inventory drawdowns and result in ending stocks of 47.4 million bales, or 38.9% of consumption. Unofficially, global ending stocks of below 40% of consumption could signal the end of a bear market for the cotton market.

The US is by far the largest exporter of cotton, accounting for about 40% of world trade in 2005-06. Domestic mill consumption continues to dwindle, as manufacturing moves to cheap-labor countries. Global demand, however, has been strong enough to compensate, and then some. Domestic usage has remained steady since 2003-04 at about 6 million bales, but annual US exports have grown by more than 3 million bales during the same period. With 10 weeks left to the marketing year, we are on track to meet the USDA estimate for a record 17 million bales.

China surprised the market by being an excellent customer for US cotton despite the fact that it grew a record crop in 2004-05 and a drought-reduced but still excellent crop in 2005-06. Domestic mill consumption in China increased from 32 million bales in 2003-04 to 46.5 million in 2005-06. The (albeit extremely early) estimate for 2006-07 is for Chinese consumption to grow further to 51 million bales.

The growth in demand is perfectly commensurate with worldwide economic growth, and there is no reason to believe that consumption patterns will not follow the path of other industrial commodities. With the market smack in the middle of a five-year price range and supply/demand fundamentals tipping to the bullish side, it would seem that there

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is a bullish case in the making.

We are skeptical. The USDA is using a very conservative forecast for US output. The March 31 planting intentions report estimated US cotton acreage at 14.63 million acres, 400,000 acres more than last year. Output, however, is estimated at only 20.7 million bales, down a rather drastic 3.2 million bales from last year.

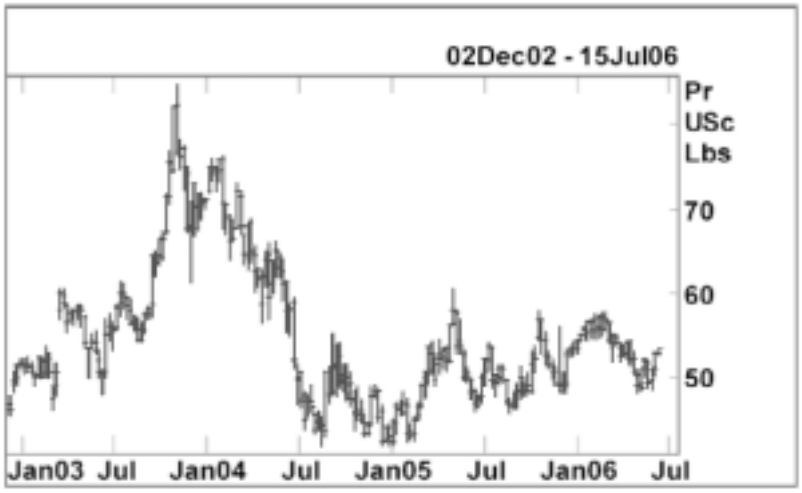
In notes accompanying the May report, the USDA explains that 2004-05 and 2005-06 experienced an exceptionally high ratio of harvested-to-planted acreage of 95.6% and 96.8% respectively. There was an unusually low rate of abandonment for these two crop years. The USDA based its 2006-07 estimate on a return to average harvested-to-planted ratio that we saw between 1996 and 2003. Yields were estimated at 770 pounds per acre, down from 855 in 2004-05 and 831 in 2005-06, which were based on the average of the past 4 years.

If yields were to improve again this coming season, it would be the fourth consecutive year of higher yields, and that has not happened since the early 1970s. But that does not mean that it cannot happen. During the 2005-06 season, the USDA was significantly off the mark with very similar reasoning. As late as August of last year, the USDA was still estimating US cotton output at 21.29 million bales. The final crop estimate was 23.89 million bales. As we pointed out in *Focus on Futures* regarding the other US agricultural markets earlier this month, betting against genetically engineered crops can be financially hazardous.

If US yields are similar to last year's, we're back to global ending stocks of 42% of consumption.

This market has not participated in the commodity bull market. Commodity funds were net-long earlier this year but have liquidated and are now net-short 26,000 contracts. The market is in the midst of a short-covering rally, but we believe that is all. Early season weather has not been great, but we recommend using the current weather rally to establish moderate short positions. *[June 5, 2006]*

Chart 8 – Weekly nearest contract cotton



Courtesy Reuters

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