

# Gold Showing Signs of Life

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## SUMMARY

- The gold shares have strengthened, in tandem with the recent \$12 move higher in the price of gold.
- Gold lease rates have surged, a sign that supplies are tightening. Given that gold's recent upward move has been accompanied by short covering -- which implies reduced demand for borrowed gold -- we believe the metal rally may go further in the near term.
- We remain constructive toward gold and gold shares. Our Buy recommendations include Freeport-McMoRan Copper & Gold, Newmont Mining and Agnico-Eagle Mines. We maintain Outperform ratings on Barrick Gold, Homestake Mining and Placer Dome.

## OPINION

The price of gold rallied by almost \$5 per ounce Monday and by \$12 in the latest week -- **and is likely to attract further attention as the underlying macro environment becomes increasingly supportive.** The metal's increase is being underpinned by strength in one-month gold lease rates, which have surged from 0.5% in mid-January to the 3%-4% range currently (and briefly above 5% in recent trading). **In our view, the dynamics of the gold lending market are key to gold's price path.**

Our positive stance toward the metal has long been predicated on positive commodity fundamentals. Through the last decade, central bank gold sales and gold loans have been essential in filling gap between supply (mine production plus scrap) and demand (jewelry plus investment). **Gold lending provides the liquidity** for producers to hedge and for speculators to sell short -- two factors that have kept the price under pressure.

**As developments unfold in the coming weeks, we urge investors to stay focused on the following questions:**

**Is the rise in gold lease rates due to curtailment of supply (gold lending by central banks and other holders) or an increase in demand (from producers adding to hedge positions, or speculators adding to short positions)?** When the price of gold recently tumbled below \$260 per ounce, we were worried that some producers, in panic mode reminiscent of the summer of 1999, would increase their hedge positions. That does not appear to have happened. Gold speculators clearly have increased their short positions -- with the latest CFTC report showing the largest speculator short position on Comex since September 1999. However, the increase

in lease rates gained momentum only in the last several days, and the resulting firmness in gold price likely would have induced speculators to cover their shorts (in other words, reducing the speculators' demand for borrowed gold). The fact that lease rates continued to climb even as short positions are being reduced **suggests that the supply of gold being lent to the market is, in fact, tightening.**

**Is there evidence that central banks are reducing the supply of gold available for lending in the market?** The short answer is, yes. Excerpts from a letter that the World Gold Council sent last week to its producer members have been circulating on a number of Internet sites. **We confirmed that the letter was written, and that the excerpts are quoted accurately.** It appears that the Bank of England (an outright seller of gold through its semi-monthly gold auctions) has not been lending gold in recent days, a move that the WGC characterized as "unprecedented, as its short-term lending is considered a vital tool in the smooth running of the London market." In the wake of the late-1999 unruly gold market, when both lease rates and gold prices spiked, some client central banks apparently injected necessary liquidity by lending gold for longer periods than normal -- a year or more, rather than three-month or six-month periods. As the gold loans have matured this year, in an environment of depressed gold prices and sub-1% lease rates, **some of these central banks chose not to renew the loans, thus drying up liquidity.**

**What will the central banks do next?** We would guess that if lease rates were to spike to levels last seen in the wake of the September 1999 Washington Agreement on Gold -- perhaps with gold even moving into backwardation -- some central banks will move quickly to restore order by lending gold again, and quickly. Nonetheless, the apparent willingness of central banks to step back from lending if lease rates appear insufficient, suggests that some in the official sector may have established "lease rate targets" that provide an adequate risk-adjusted return on their gold loans. If this proves to be the case, we would expect gold prices -- and gold lease rates -- to settle into higher ranges commensurate with the targets, but not to spike inordinately higher.

**Are the European central banks -- which in September 1999 announced a watershed agreement to cap gold sales and lending -- ready to announce a new, more restrictive lending agreement?** We are skeptical. Trade stories have suggested that another announcement may be in the offing; we suspect that confusion arises from the current unwinding of lending activity following the late-1999 gold price surge and the desire, at that time, of central banks to ensure adequate liquidity. **The current five-year Washington Agreement on Gold is due to expire in 2004, and we understand that the central banks and some in the industry are continuing discussions as to the form any subsequent agreement might take.** The difficulty in assessing this issue arises from the central banks' unwillingness to disclose outstanding lending positions -- and the subsequent inability of the market to determine whether the European central banks are, in fact, sticking to the 1999 agreement.

We maintain a positive stance toward gold's commodity fundamentals, as shown in our accompanying supply/demand estimates. Mine production likely will edge lower in 2001,

as weak prices take their toll, and we assume only a modest 1.5% increase in jewelry demand this year. We estimate that in 2001, the gap between commodity supply and demand will approach 850 metric tons (mt). While outright sales by central banks could measure 500 mt, additional central bank lending will be required to fill in the remainder of the gap. We concede that for now, our \$290 gold price estimate for 2001 -- and \$325 for 2002 -- appear aggressive. Nonetheless, **recent developments in the lending market support our long-held contention that the equilibrium gold price is well above \$300 per ounce. We continue to believe that the longer gold prices stay mired near 20-year lows, the more explosive the eventual upturn may be.**

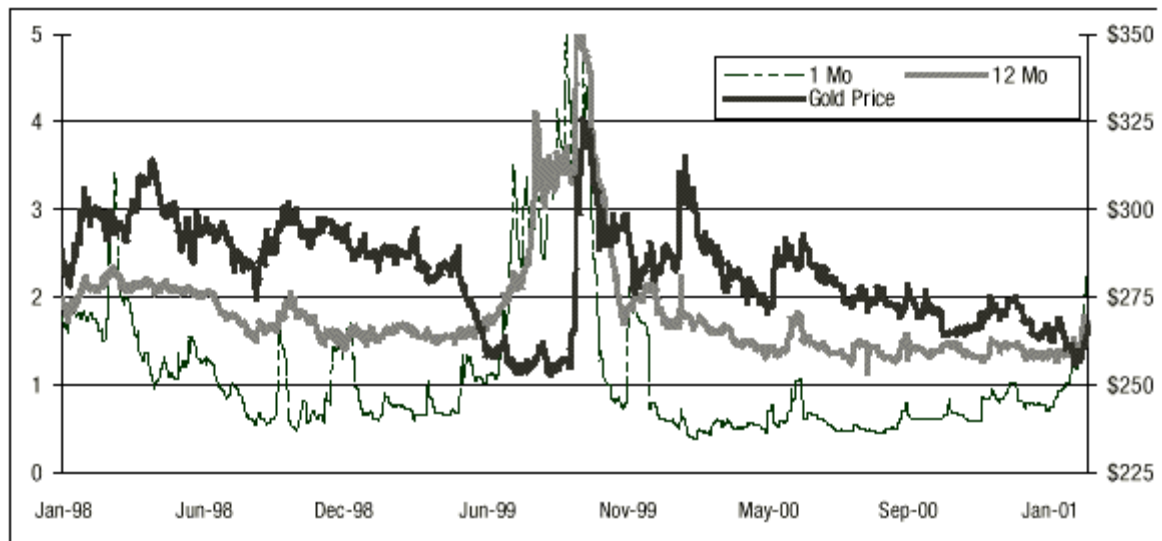
### WORLD GOLD SUPPLY/DEMAND (Metric Tons)

1995 1996 1997 1998 1999 2000E 2001E 2002E

| Supply                                      |              |              |              |              |              |              |              |              |
|---|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Mine Production                             | 2,274        | 2,358        | 2,481        | 2,541        | 2,570        | 2,568        | 2,550        | 2500         |
| Old Gold Scrap                              | 625          | 641          | 629          | 1,098        | 616          | 602          | 610          | 610          |
| <b>Production and Old Gold Scrap</b>        | <b>2,899</b> | <b>2,999</b> | <b>3,110</b> | <b>3,639</b> | <b>3,186</b> | <b>3,170</b> | <b>3,160</b> | <b>3,110</b> |
| Fabrication Demand                          |              |              |              |              |              |              |              |              |
| Jewelry                                     | 2,792        | 2,851        | 3,345        | 3,151        | 3,155        | 3,191        | 3,239        | 3,336        |
| Electronics/Dental/Other                    | 416          | 423          | 464          | 441          | 455          | 504          | 500          | 500          |
| <b>Total Fabrication Demand</b>             | <b>3,208</b> | <b>3,274</b> | <b>3,809</b> | <b>3,592</b> | <b>3,610</b> | <b>3,695</b> | <b>3,739</b> | <b>3,836</b> |
| <b>Fabricated Demand/Supply Balance</b>     | <b>309</b>   | <b>275</b>   | <b>699</b>   | <b>(47)</b>  | <b>424</b>   | <b>525</b>   | <b>579</b>   | <b>726</b>   |
| Investment Demand                           |              |              |              |              |              |              |              |              |
| Official Coins                              | 87           | 63           | 98           | 127          | 136          | 48           | 75           | 75           |
| Bar Hoarding                                | 306          | 182          | 324          | 157          | 252          | 187          | 180          | 180          |
| Implied Western Investment (Disinvestment)  | (54)         | (102)        | (241)        | 229          | 115          | (282)        | 0            |              |
| <b>Total Investment Demand</b>              | <b>339</b>   | <b>143</b>   | <b>181</b>   | <b>513</b>   | <b>503</b>   | <b>(47)</b>  | <b>255</b>   | <b>255</b>   |
| <b>Total Demand</b>                         | <b>3,547</b> | <b>3,416</b> | <b>3,990</b> | <b>4,105</b> | <b>4,113</b> | <b>3,648</b> | <b>3,994</b> | <b>4,091</b> |
| <b>Total Demand/Supply Balance</b>          | <b>648</b>   | <b>417</b>   | <b>880</b>   | <b>466</b>   | <b>927</b>   | <b>478</b>   | <b>834</b>   | <b>981</b>   |
| Filling The Gap                             |              |              |              |              |              |              |              |              |
| Net Forward Sales/Gold Loans/Option Hedging | 475          | 142          | 504          | 97           | 506          | (14)         | ?            | ?            |
| Net Official Sector Sales (Purchases)       | 173          | 275          | 376          | 370          | 420          | 491          | 500          | 500          |

Sources: Gold Fields Minerals Services Ltd and Salomon Smith Barney

#### GOLD LEASE RATES, 1998-PRESENT



Source: Salomon Smith Barney

In the meantime, we view recent developments in the lending market as bullish -- and given the size of the recent short positions, current price strength may be exacerbated by short covering. Rising lease rates, especially when combined with a weakening U.S. dollar, should discourage price hedging by non-U.S. producers and reduce the propensity of speculators to build short positions. We remain constructive toward the gold shares, with Buy recommendations on Freeport-McMoRan Copper & Gold, Newmont Mining and Agnico-Eagle Mines and Outperform ratings on Barrick Gold, Homestake Mining and Placer Dome.