# A New Millennium Gold Rush:
## Bull Market is Just Beginning

## Executive Summary


### European central banks say, "Enough, already."

The European central banks announced on September 26 that they will limit annual gold sales to 400 metric tons (mt) over the next five years, and that they will not increase their gold lending or futures and options beyond current levels. We believe that the positive implications of the announcement are not yet fully appreciated by the market--and perhaps not even by the central banks themselves.

### The gold market has grown utterly dependent on central banks to provide liquidity for short sales and to keep commodity supply and demand in equilibrium.

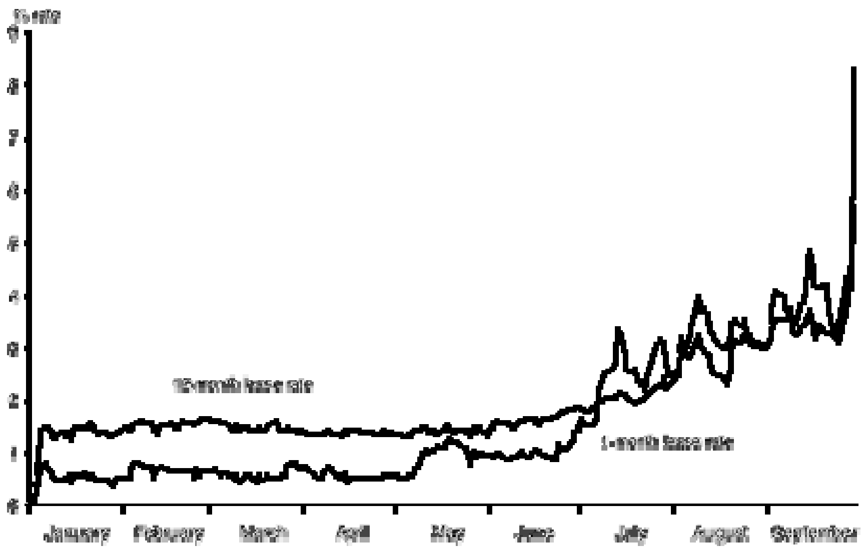
Our bullish thesis on gold has been predicated on the massive imbalance between mine production/scrap supplies and fabricated gold demand. The gap has been filled through the 1990s by steady central bank sales and increased lending--which has provided the liquidity for producers to sell forward and for speculators to go short. We have argued for some time that the market's complacency could be shattered by any action that would cause central banks to curtail liquidity. The magnitude of the new bull market in gold will be determined, in the short term, by the extent of outstanding central bank gold lending--a subject of great dispute within the industry--and the timing of the producer and speculator short-covering that is required to unwind unprofitable positions. Ultimately, much-higher prices are needed for the gold market to achieve physical equilibrium.

### Guilt by association--hedging debacles hurt all gold producers.

Two highly visible gold hedging debacles-- those of Ghana-based Ashanti Goldfields Ltd. and Canadian producer Cambior Inc.--have made investors understandably wary about the hedging minefields that could lie ahead for other gold producers. As gold prices appreciate further, these concerns likely will be accentuated. We are bullish on gold from current levels...

## Central Banks Issue a Wake-Up Call

- Rising lease rates in the summer signaled growing supply tightness. [See following graph...included here by USAGOLD but not part of the original SSB study]
- The successful second U.K. auction put the spotlight on short positions, and the central banks touched off a scramble to cover.
- Gold carry trades and other short strategies generated huge losses.



**1999 Gold Lease Rates** (from WGC *GOLD in the Official Sector*/October 1999, NUMBER 9)

### THE SUMMER OF GOLD'S DISCONTENT...

It will be months--probably even years--before the gold market will be able to unravel all of the causes and implications of the recent, dramatic turnaround in the yellow metal's fortunes. Suffice it to say that in retrospect, the Bank of England's May 7 disclosure of its intent to sell 415 mt of its 715 mt in gold holdings-- complete with timetable of five bimonthly 25 mt auctions commencing in July 1999--marked the beginning of gold's final capitulation to the bears. Until then, the metal had been showing signs of pushing up toward the elusive $300 per ounce level. Instead, after the U.K. announcement, gold prices tumbled by 13% before finding a bottom in late August. A poorly bid first auction on July 6 spurred a final bout of panic producer hedging.

## ...MAKES THE AUTUMN RALLY THAT MUCH SWEETER

*"The market response to the 15 central banks' agreement has been unequivocally positive."*

In a surprise announcement on September 26 following the G-10 meeting, key European central banks committed to limits on gold sales and lending. Specifically, 15 central banks including Eurosystem members plus the U.K., Sweden, and Switzerland announced they would cap gold sales at 400 mt (12.8 million ounces) per year for five years and freeze gold lending and futures/options activity at current levels. This provided short-covering and speculative impetus to the fledgling rally that began after the U.K. auction-- and, in one fell swoop, swept aside the bearish preoccupation with official-sector supplies. As liquidity dried up in the short-covering scramble, gold prices, lease rates, and option volatilities spiked--with disastrous consequences for hedge funds, traders, speculators, and producers caught short. From the summer lows, gold prices surged to highs near $330 per ounce. Lease rates spiked so much that gold shifted into backwardation--in which the spot price traded at a premium to forward prices--and option volatilities expanded to as much as 45%-55%.

While the motives behind the G-10 initiative will be debated exhaustively--whether to support reserve values, signal departure from dollar hegemony, or capitulate to producing country pressure--we believe the effect on gold bullion and equities is unequivocal--it's positive.

## CENTRAL BANK AGREEMENT MARKS WATERSHED

*"Roughly 90% of central bank gold holdings are subject to lending curbs."*

We believe the central bank agreement fundamentally alters the landscape for gold. The 15 signatories account for roughly 50% of official sector stocks; adding other non sellers and non lenders, such as the United States, the IMF, and the Bank of Japan, lifts the total to nearly 90%. While the 400 mt in annual sales is toward the high end of the actual sales range for the 1990s, it does include the ongoing U.K sales (365 mt remaining) and possible Swiss sales (1,300 mt).

We view the commitment to freeze gold lending as even more significant--although scrutiny suggests lending may have been approaching its natural limits. Additions to the central bank lending pool have been required for years to bring commodity supply and demand into equilibrium. In turn, the gold lending provides the liquidity for producer hedging and for speculator short selling, both of which appeared to be a "win/win" situation in recent years as lease rates were low and prices were falling. The speed with which the market has begun to adjust to the new realities of central bank lending has been remarkable, even for those of us who had argued the potential for an explosive move in the price at some point. Even more astounding, the sharp price rebound has occurred *in anticipation of* the lending freeze, not in response to it.

### HIGHER PRICE REQUIRED TO BALANCE MARKET

Prior to the recent rally, we believed that there was a structural deficit in the gold market--physical demand in excess of mine supply plus scrap of some 1,050 mt. Depending on the view of the true level of central bank lending, deficit estimates as high as 2,000 mt are credible. These deficit estimates amount to 25%-40% of total demand. With the official sector retreating from center stage, we believe the key to gold's price path is how, on what terms, and over what period of time the market will return to equilibrium. It is clear that a massive readjustment process has just begun.

Looking ahead, we expect rising gold prices to crimp jewelry consumption while boosting investment demand. Typically, bull markets for gold are characterized by increasing investment demand--which accounted for 50%-60% of total demand in the 1979-80 rally, for example, and roughly one-third of total demand in the 1986-87 period--at the expense of jewelry demand.

*"High prices will not soon reverse the downward mine production trend."*

## The Gold Hedging Debacle

*"Hedging risks made losers of companies that should be winners in the new gold bull market."*

The sudden rally in gold prices has punished heavily hedged mining companies, as well as traders, dealers, and speculators caught short. Volatile price behavior and tightness in the markets for borrowed gold--manifested in record-high lease rates and intermittent backwardation-

- have exacerbated the situation. Reports of staggering losses on speculative short-gold positions and carry trades are rife, and we believe there is more to come. Common hedging techniques--touted as offering virtually risk-free downside protection as well as upside exposure for producers sophisticated enough to grasp the new orthodoxy--already have proven disastrous for several companies. Others simply are being pummeled by equity investors who demand leverage to gold and are not inclined to accept management assurances or to parse vaguely composed position statements to discern top-line revenue. Just as low, stagnant gold prices imposed cost discipline on producers, the long-term benefits of the carnage in the gold derivatives arena likely will be renewed emphasis on transparency and critical assessment of financial risk.

We have long argued that derivatives positions in gold were lopsidedly short and disproportionately large for the underlying market. At its core, our positive view on gold in 1999 has been based on a belief that gold market liquidity was less than participants blithely assumed--and that when speculator and producer shorts were inevitably forced to cover, the results could be spectacular....

The carnage in the gold derivatives market resulting from a 25% jump in prices is astounding to us, especially against a backdrop of double- and triple-digit percentage gains in oil, copper, aluminum, and nickel; resurgent inflation signals; dollar weakening; and looming Y2K concerns. "Stress testing" of portfolios and "Value at Risk" (VAR) measurements captured only normal market and trading variability and failed to provide a meaningful assessment of comprehensive risk in the event of an "exogenous" shock--such as the European central banks' announcement. Particularly nettlesome were complex structured derivatives--forward contracts with embedded contingent options--and leveraged option strategies that could not be unwound quickly. The practice of selling out-of-the-money call options to finance put purchases backfired as well. Even basic spot deferred contracts were tarnished as gold breached reference prices and climbing lease rates eroded forward premiums. We question whether managements understood their exposures and conclude that any positions put on this summer in a $250-per-ounce gold price environment were misguided at best, and disastrous at worst.

## SFAS 133 -- NEXT YEAR'S ACCOUNTING NIGHTMARE

FASB has written a new accounting standard governing the treatment of derivative instruments and hedging activities in financial statements. Implementation was recently postponed one year to June 15, 2000--and debate continues as to the impacts of this complex, technical standard on company income statements, balance sheets, and actual hedging behavior. SFAS 133 will require different accounting treatment for derivatives considered "hedges" and "non-hedges"--with most related activities by mining companies qualifying as "cash flow hedges." However, many derivatives strategies will fail to qualify for hedge accounting--and thus to the extent that these are used to offset an economic risk (the gold price), mark-to-market impacts to net income will not be matched by recognized period-to-period changes in the underlying exposure (the value of reserves). This will result in greater net income volatility.

Important departures from current practice will be marking-to-market of the time value of options through the income statement-rather than straight-line amortization of the premium paid or received. Forward contracts will be treated more favorably--with mark-to-market fluctuation flowing through equity on the balance sheet. However, this will introduce equity volatility and has the real potential to throw off credit ratios--complicating the lives of analysts, bankers, and shareholders. Under SFAS 133, the recent gold rally and plunge in mark-to-market value of mining companies' hedge books would result in huge hits to net income from call options sold and to equity from sub-market forward contracts. Current rules allow these effects to be disclosed as a simple footnote to the financial statements, but if the gold price stays in the $320 per ounce range--or trades higher as we expect--the SFAS 133 derivatives-related damage to company income statements and balance sheets will be staggering.

## HEDGE BOOK MARK-TO-MARKET VALUES PLUMMETED

Rising gold prices, lease rates, and volatilities have also served to crush the mark-to-market value of company hedge positions--most of which have swung deep into the red since the second quarter reporting cycle. The symmetry is intriguing--that much-touted premiums to spot in previous periods are often completely offset by negative mark-to-market values now, revealing that many programs amounted to simply selling financial risk. The damage is compounded by the fact that price premiums were earned when gold prices were low, group equities were out of favor, and share-price multiples contracting-- while the upside is surrendered now that investor interest is high and multiples expanding for gold-leveraged names...

As spectacular as some of the negative mark-to-market numbers are, it is important to recognize that under current U.S. GAAP, the value of derivatives is shown as a footnote to the financial statements and does not flow through the balance sheet or income statement. With the implementation of SFAS 133 next year, this will all change. In severe cases, counterparties can demand that mining companies post cash margin to cover the paper loss--exactly what happened to Ashanti Goldfields, whose hedge book plummeted from positive $300 million in value during our July site visit to an astounding negative $570 million at $325 gold.