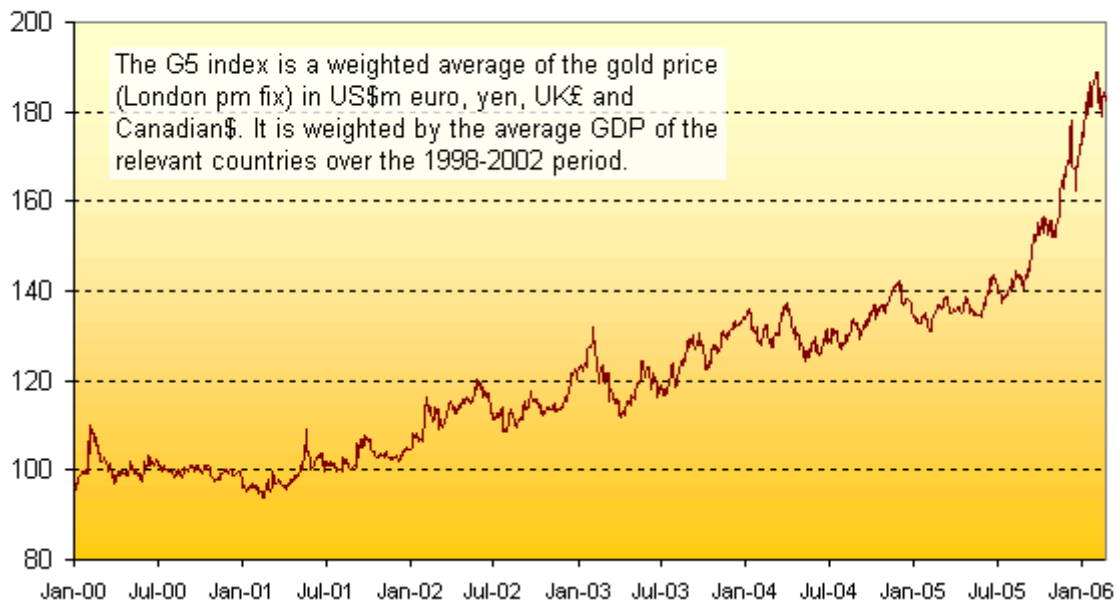


Real Demand

A recurring theme in all metals markets is determining a measure of “real” demand. It’s usually brought up by those of the bearish persuasion. The crux of the bearish view is that any large increases in metals demand are transitory and therefore suspect. It’s an argument we’ve always had trouble with since we have always been of the view that all investments are (or should be) considered “tradable”. A profit is not a real profit until it’s locked in and the whole issue of “transitory” demand seems meaningless. That’s not to say we are day traders or think you should cycle through everything in your account every month. On the contrary, there are companies that have been on the HRA list for years and are up hundreds of percent, but we still consider them core holdings. We feel that way because we know how early we are in a very long cycle. That said, we still keep an eye on everything and we’re not above suggesting its time to take profits even on core holdings, even if we do it with the foreknowledge that we might suggest adding back at a lower price. The task of core holdings is to act as a hedge to other holdings and to your portfolio as a whole. They help stabilize and hopefully increase your returns.

The reason for this little digression is that we consider gold and gold stocks one of those necessary core holdings, especially if your other holdings are valued in US Dollars, even though we think gold, like everything else, should be considered tradable. As the chart below which shows gold prices long term in against a G5 basket of currencies (from gold.org, the World Gold Council site) makes clear however gold is and increasingly important portfolio hedge for everyone.

Gold price, G5 index, Jan 5 1998=100



So where does the “transitory” part come in? A big part of the bear camp’s arguments in the past year for all metals has relied on hedge funds. Every time there is a strong move in a metal’s price, including gold, market strategists are quick to credit “hedge fund activity”. Hedge funds have become the modern day bogeymen used to scare longer term buyers in commodities into believing there will be a mountain of metal descending

on them any moment. Is this true? Well, we're sure hedge funds own some, though probably not anywhere near as much as many think. Given the overall lackluster results for the hedge sector we think it's safe to assume they haven't been that smart as a group. As we've alluded to in earlier columns, a lot of buying has been by new entrants, institutional and retail, who have been picking up both physical metal and ETF's.

As we predicted, the impact of gold ETF's has been huge, it's only going to get bigger and this is just one aspect of "real" demand. 2005 statistics just published by the World Gold Council give ample evidence of "real" demand. Total demand increased by seven percent, even in the face of prices that were nine percent higher (in Dollar terms) than 2004. The biggest sector increases came from "retail investment" (a 15% increase) and ETFs (a 53% increase). Even areas like India and the Middle East where buyers traditionally get skittish at higher prices saw increases.

On the supply side, again as predicted, longer lead times and regulatory difficulties (plus more basic difficulties in finding superior deposits) continues to constrain the mining sector's ability to deliver more gold. Actual new production at mine sites increased by only one percent in 2005 and while companies may do better in 2006 we definitely don't expect miracles. Official sector sales are slated to be larger this year but we also expect other central banks to increase their accumulation which should balance this sector out.

The bottom line is that the demand increases for gold are very real, widely spread and probably far less subject to short term whims than many people think. There will always be traders and there will be times where they will move the market a lot, in both directions. Beneath the daily noise however is a growing contingent of people and institutions taking long term positions to anchor portfolios. This trend should continue to accelerate continue to drive prices higher. With the physical demand side increasingly having the upper hand going forward the number of traders brave enough to go short and stay short will keep dropping.