ANALYSIS

Ugly gold corrections just part of the game

By John Embry

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The month of May lived up to its reputation as historically being a very difficult month financially. Most markets were stressed, and gold and silver were by no means exempt. Following their meteoric rises since August of last year, both metals came under severe pressure.

Some of the weakness could be legitimately attributed to profit taking but the heavy hand of the anti-gold crowd was at work as well. The simple fact of the matter is that the whole fiat paper money system is looking increasingly shaky as the result of the astonishing financial profligacy of the United States.

Therefore, sharp rises in the gold price (and, by association, silver) must be resisted with force periodically, lest the investing public get the wrong message and shy away from paper assets.

When gold traded comfortably above US$700 an ounce, up some 65 per cent since the end of August, it triggered a response from officialdom and a US$150 downdraft quickly ensued.

For those readers who doubt that intervention occurs in the gold market, consider the words of William R. White, economic advisor and head of the Monetary and Economic Department at the Bank for International Settlements, in a fascinating speech he gave at the B.I.S.'s fourth annual conference in Basle, Switzerland, in June of 2005 (the contents of which were only released recently).

Mr. White, while discussing central bank co-operation in general, stated that there will be "the provision of international credits and joint efforts to influence asset prices (especially gold and foreign exchange) in circumstances where this might be thought useful."

That's pretty blunt talk from a gentleman speaking under the aegis of the B.I.S., which is essentially the central banker to the rest of the world's central banks.

Ominous words

The present time would have certainly qualified as a propitious one for intervention when one considers the Organization for Economic Co-operation and Development's recent warning that the rebalancing of the U.S. current account gap "looks increasingly unavoidable" and that depreciation in the U.S. dollar may be "of the order of one-third to one-half."

Furthermore, it observed that the adjustment in the U.S. deficit would "need to endure a sharp slowdown in U.S. domestic demand and that would have adverse spill-over effects on other economies through the trade and asset revaluation channels."

These are ominous words from one of the world's primary international bodies and would no doubt spur the central bankers into action on the gold front.

However, as I have reiterated in the past, this is the nature of the gold market, and ugly corrections are part of the process. All you have to remember when you are going through one of these periodic episodes is that gold demand is running far ahead of mine supply, which is falling, and the central banks are rapidly depleting their reserves, which have been essential to fill the supply-demand gap while also being available to drive the market down at appropriate times.

The central banks' predicament of falling reserves was essentially confirmed in an International Monetary Fund report in the second week of May. The report revealed that the central banks are not accounting for their gold loans and swaps properly and, in fact, are double counting their reserves.

This has been a major contention of the Gold Anti-Trust Action Committee for years and was emphasized in a treatise entitled, "Not Free, Not Fair: The Long-Term Manipulation of the Gold Price" that my colleague Andrew Hepburn and I penned two years ago. Then, it was denied by the IMF, which had concocted the bogus accounting rules in the first place, but now the truth is emerging at the very time when the central banks have a growing need for their missing reserves.

In addition, there are large existing short positions, which must be covered before the gold price explodes and I believe these violent corrections are being orchestrated to facilitate this process.

At the same time, the Russians' avid appetite for gold appears to be intensifying. President Vladimir Putin, who has no great love for the Americans or for the pre-eminence of the U.S. dollar as the world's reserve currency, has ordered the Russian central bank to raise its gold share of foreign reserves from five per cent to 10 per cent.

This is not chump change as Russia's reserves have surged to US$247 billion and, with a current account surplus close to 10 per cent of GDP, the country must purchase a big chunk of global gold production just to maintain the bullion share of its reserves.

When this current correction runs its course, gold will set sail for its all-time high of US$850 per ounce, achieved over 26 years ago.

A noteworthy development recently was the replacement of the bumbling John Snow as U.S. Treasury Secretary with Henry Paulson, the CEO of Goldman Sachs.

Why this is relevant to the gold market relates to Goldman's long involvement in the suppression of the gold price, which became evident for all to see when they joined Tocom, the Japanese future exchange, last year. Goldman Sachs was featured in a cover article in The Economist a couple of months ago and its considerable risk profile was detailed.

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Perhaps the most interesting statistic in the article was, that in the last fiscal year, the average compensation for Goldman's 24,000 worldwide employees was $U.S.520,000 per head.

I'd say that was pretty handsome recompense for a firm whose participation in the suppression of the gold price has helped to impoverish AIDS-wracked African gold-producing nations while devastating northern mining communities in Canada.

The short-term negative for gold is that if Mr. Paulson headed a firm involved in holding the gold price back, what will he do now that he is head honcho at the U.S. Treasury?

Turning to gold stocks, I think the correction that we have been experiencing is close to running its course and the second half of the year could be a very good one for those who are invested in gold and gold equities.

A company that has struggled and is now turning the corner is **Glencairn Gold** (GGG-TSX $0.63, 416-860-0919, *wwwglencairngold .com*). It possesses two producing mines, the Bellavista in Costa Rica and the Limon in Nicaragua, which have had their trials and tribulations.

However, in the new higher gold-price environment, they are now both generating cash, and in the case of Limon, considerable exploration potential exists. This package alone more than justifies the current price, but the company has just purchased two more properties from Yamana Gold: the producing La Libertad mine in Nicaragua and the Cerro Quema project in Panama, which can be brought into production at an estimated capital cost of less than US$15 million.

Both these assets formerly belonged to RNC Gold, which was acquired by Yamana earlier this year. La Libertad had been seriously mismanaged and Glencairn management thinks that it can unlock the potential in the operation. In any case, the company will be in a position to produce well over 200,000 ounces per annum by 2009 without a lot of capital outlay. Sporting a market cap of less $150 million, this represents an excellent opportunity in a rising gold price environment.

I mentioned in a column a couple of months ago how gratified I was by the success of **Aurelian Resources Inc.** (ARU-TSX/VEN $19.34, 416-868-9100, *www.aurelian.ca*), which I had previously recommended, and the company has continued to achieve amazing results.

Lesson on diversifying

However, this is not a one-way street and another company I had recommended, **Beaufield Resources Inc.** (BFD-TSX/VEN, $0.47, 613-721-2919, *www.beaufield.com*), hit a bit of an air pocket recently, falling over 40 per cent in one day after reporting some dull drilling results on two of its properties. The reality is, the geological interpretation wasn't particularly negative, and there is gold in both systems, but the market was disappointed and reacted accordingly.

I think the stock is back in buying range again, but this is a good lesson, illustrating the fact that they don't all work, and anyone speculating in junior golds would be well served by holding a diversified group of stocks. A rifle-shot approach can be very injurious to your net worth.

John Embry is chief investment strategist at Sprott Asset Management. The "Sprott Funds" hold or may hold any of the above mentioned securities. For further information on Sprott Fund holdings , please visit www.sprott.com.

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