

Special Report Gold

In Gold we trust – July 2009

Outstanding risk/return ratio for gold investments

Wall Street discovers gold

Austrian School of Economics: massive expansion of money supply as basis for a gold bull market?

Gold is still in the early stages of a bull market - rise with the biggest momentum is yet to come

A strong case for gold mining shares

CoT Report indicates massive short concentration

First target price 1,300; longterm target: inflation-adjusted all-timehigh of USD 2,300

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Introduction

Shining development in 2008 and 2009

Since our initial recommendation in 2007 at USD 650, gold outperformed almost every other asset class. The gold bull market has been running with an **annual performance of 16% since 2001**. **Gold closed the year 2008 with the eighth annual increase in a row. And in the year to date, the performance has been outstanding as well: the gold price has recorded an increase of 7% (in USD) and 8% (in EUR)¹, respectively.** The average price in 2008 was USD 872/ounce, i.e. 25% higher than in 2007 (USD 695).

Reversal or “little breather” ahead of upswing??

But are we after the gold rush already? It is a legitimate question to ask whether we are facing an imminent trend reversal or if the recent correction was nothing but a “little breather” ahead of the next massive upward swing. What could be a potential catalyst to the continuation of the gold rush? What are the risks? In the third edition of our annual special report on gold we would like to discuss why we believe that the gold sector still offers a “shiny outlook” for existing and potential investors.

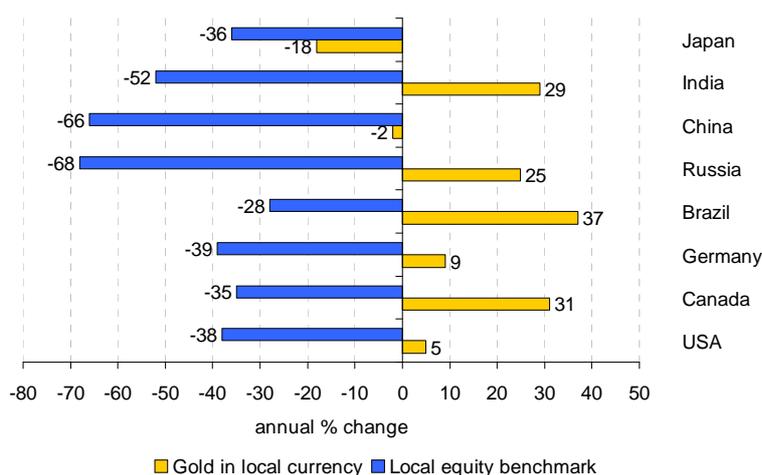
Central banks are laying perfect foundation

The strongly expansive policy followed by the central banks and the resulting money creation at historic levels as well as the massive expansion of government debt around the globe might make inflation literally *the* problem of the coming years. In conjunction with the almost worldwide zero-interest policy and the rising criticism regarding the US dollar as global reserve currency, in our opinion this situation offers a perfect basis for further increases in the gold price.

Disappointing performance 2008? Neither in relative nor in absolute terms...

Many a market participant expected an exploding gold price due to the panic-stricken and turbulent events last year, and ended up disappointed by the performance. But even the collapsing oil price or the rallying US dollar failed to put a lid on the gold price. Gold outperformed most other investments both in absolute and in particular in relative terms. On top of that, gold set new all-time-highs in the euro, the British pound, the Canadian dollar, the South-African rand, the Russian rouble, the Indian rupee, and many other currencies. The comparison with equity indices in local currencies is particularly interesting:

Gold in local currency vs. equity indices 2008



Source: Datastream

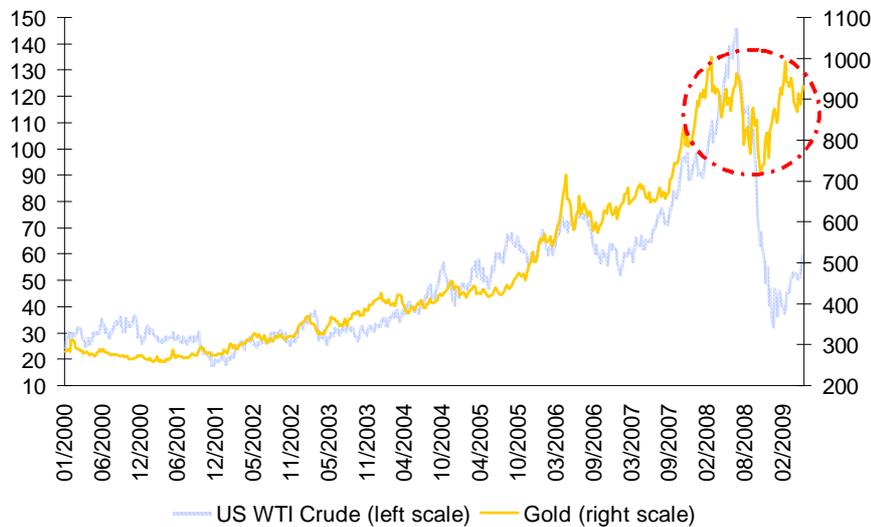
One reason for the devastating impact of the financial crisis is the high positive correlation among many asset classes. Portfolio diversification through alternative investments, equities, and commodities clearly failed in 2008. The S&P 500 index for example lost almost 40% in 2008, as did the GSCI commodity index. Gold on the other hand went against the grain – although numerous leveraged positions had to be liquidated in the third and fourth quarter.

¹ As of 28 June at USD 940/ounce

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Gold therefore set itself clearly apart from the rest with an annual performance of 6% in USD and almost 10% in EUR.

Gold is emancipating itself from oil and other commodities



Sources: Datastream, Erste Group Research

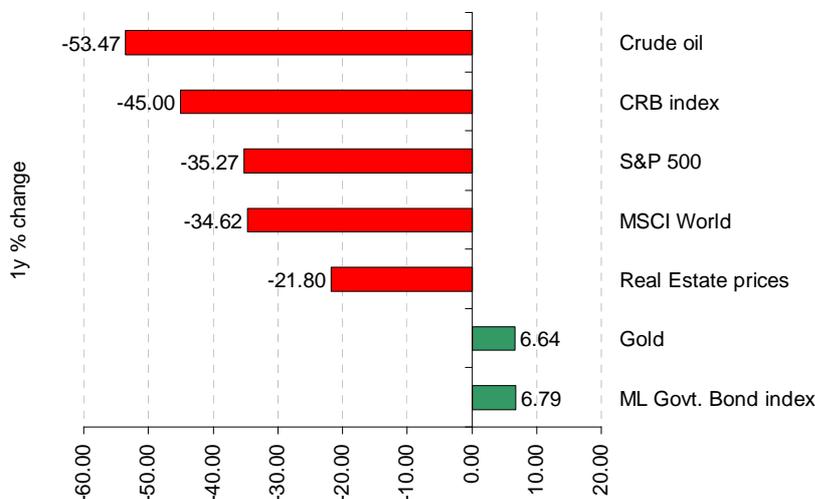
Soft metal, hard currency: the rediscovery of the monetary aspects of gold

Gold has long been a way of insuring the portfolio against inflation, but recently investors have started to credit gold also with the monetary role again that it used to play for thousands of years. Gold is a globally accepted means of exchange that locks in the purchase power and thus the value over long periods of time, and due to its natural scarceness, it contains all the essential elements of a currency. As a result of the financial crisis, central banks have grown fonder again of the yellow metal. The mere existence of a gold reserve creates trust, and we should have overcome Keynes' notion of gold as "barbaric relic" at this stage.

Supply and demand: night and day in the first quarter 2009

According to the World Gold Council, gold demand increased by 38% in the first quarter as compared to the referential period of 2008. Total demand was 1,015.5 tonnes. Investment demand exploded by 248% to 595.5 tonnes. The inflows into exchange-traded funds (ETFs) as well as the physical demand for coins (+154%) and bullions were robust. In only the first two months of 2009 more funds were funnelled into ETFs than in the entire year 2008. Jewellery demand on the other hand slumped by 24% to 339.4 tonnes, and the electronics sector required far less gold as well (-36% to 51.3 tonnes). That said, the high gold price also led to an increase in the recycling of gold: the volume of recycled gold increased by 55% to 558 tonnes.

Gold vs. other asset classes since our most recent Gold Report (June 2008)

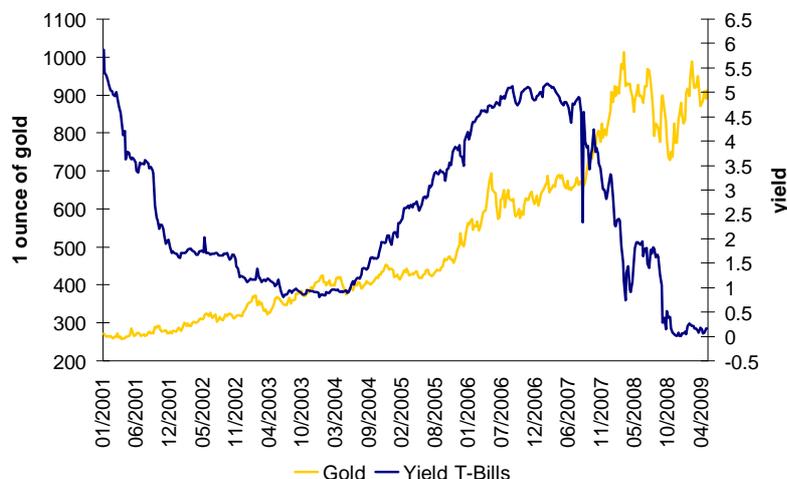


Source: Datastream

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Opportunity costs also continue to fall. The yield of the 3M US bills was even negative for a short while in December 2008, which puts an interesting spin on the term “smart money”.

Yield 0-3M T-bills vs. gold

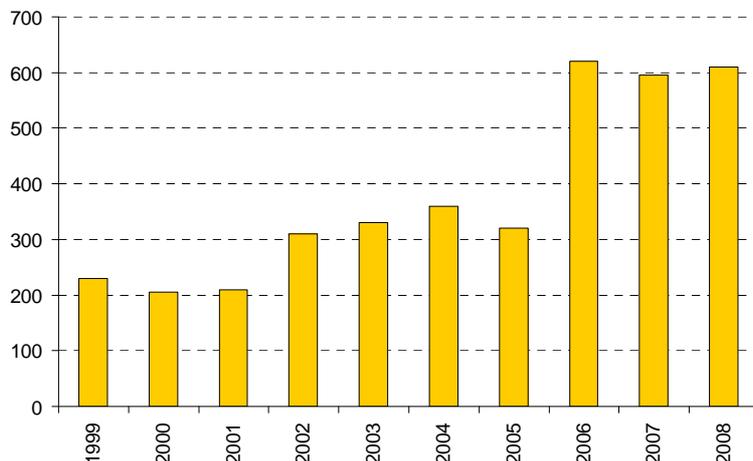


Source: Datastream, Erste Group Research

Discrepancy between physical gold and paper gold

2008 was also characterised by an extreme discrepancy between the markets for physical gold and for paper gold. The price of bullions or coins was at times 20% to 30% above its price on the forward markets (mainly COMEX). In the USA coin sales increased by 123%, in Austria by more than 200%. The US, South African, and Australian mints even had to decline certain new orders and had to work extra shifts in order to be able to satisfy the enormous demand. Premiums of close to 5% are customary. In the case of silver, some of the premiums on coins amounted to 100% on top of the spot price. At the moment less than 3% of all COMEX positions are covered by real physical gold, and the nominal value of all open derivative positions was a worrying USD 600bn at the end of 2008.

Nominal value of all OTC gold derivatives in USD bn



Sources: BIS, Erste Group Research

Central banks around the globe are trying desperately to avoid deflation, although in our opinion inflation is the real danger – as this quote from **Ben Bernanke** would confirm:

“The conclusion that deflation is always reversible under a fiat money system follows from basic economic reasoning. A little parable may prove useful: Today an ounce of gold sells for \$300, more or less. Now suppose that a modern alchemist solves his subject’s oldest problem by finding a way to produce unlimited amounts of new gold at essentially no cost. Moreover, his invention is widely publicized and scientifically verified, and he announces his intention to begin massive production of gold within days. What would happen to the price of gold? Presumably,

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the potentially unlimited supply of cheap gold would cause the market price of gold to plummet. Indeed, if the market for gold is to any degree efficient, the price of gold would collapse immediately after the announcement of the invention, before the alchemist had produced and marketed a single ounce of yellow metal.

*What has this got to do with monetary policy? **Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent) that allows it to produce as many U.S. dollars as it wishes at essentially no cost.** By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, **under a paper-money system, a determined government can always generate higher spending and hence positive inflation.***²

² Ben Bernanke, 21 November 2002, "Deflation: Making Sure "IT" doesn't happen here."
<http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021121/default.htm>

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The most common arguments, myths, and points of criticism about gold

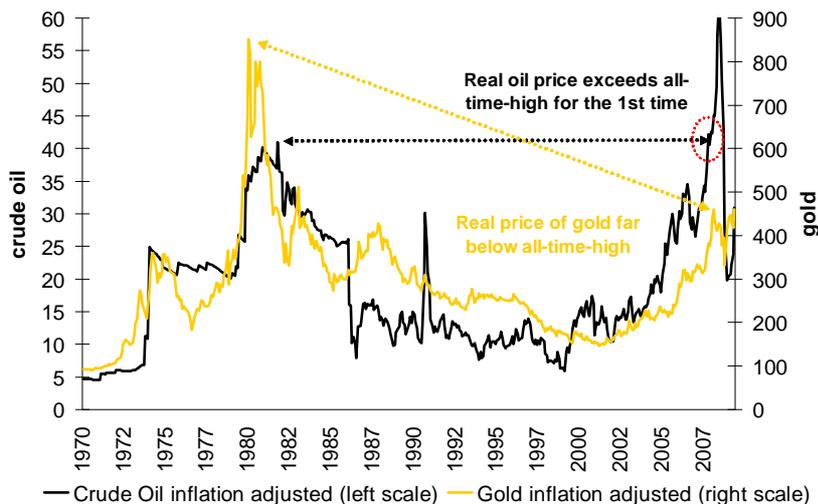
There are numerous associations, points of criticism, and arguments in relation to gold, some of which are just plain wrong. On the following pages we want to address seven of the most commonly raised issues.

Myth # 1: Gold is (too) expensive

Does the price of gold rise or the value of fiat money fall?

One might as well say that it is not the price of gold that rises, but the value of the respective paper currency that falls. Gold preserves the purchase power and in fact even increases it gradually. Comparing how many real assets one ounce of gold would buy in a historical context, can substantiate this statement. In 1980 the American currency had a significantly higher purchase power than today. According to the official inflation calculator of the Federal Reserve, the inflation-adjusted all-time-high of one ounce of gold is currently USD 2,300. In other words, the gold price would have to rise to USD 2,300/ounce in order to reflect the real equivalent value of 1980. Oil, the black gold, has recently passed its real highs of the 1980s for the first time – we expect a similar scenario for gold sooner or later.

Oil vs. gold inflation-adjusted:



Source: Datastream, Erste Group Research

Inflation-adjusted price of gold still extremely attractive

The inflation-adjusted gold chart puts the most recent price increases into perspective. While the gold price was at USD 850/ounce at the end of the 1970s/beginning of the 1980s, the average American household income amounted to about USD 17,000 per year. Nowadays an annual income of USD 17,000 would put a family of four below the poverty line. The level of debt has increased dramatically as well over the past decades. Whereas private households were USD 10bn in debt in 1987, this amount has meanwhile increased to USD 28bn, i.e. 350% of GDP. This means that a nominal comparison of the gold price over decades is of limited significance. Therefore the following graph shows the gold price on an inflation-adjusted basis:

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Gold price, inflation-adjusted



Source: Datastream, Bloomberg

Gold could only start to be considered expensive from USD 2,300

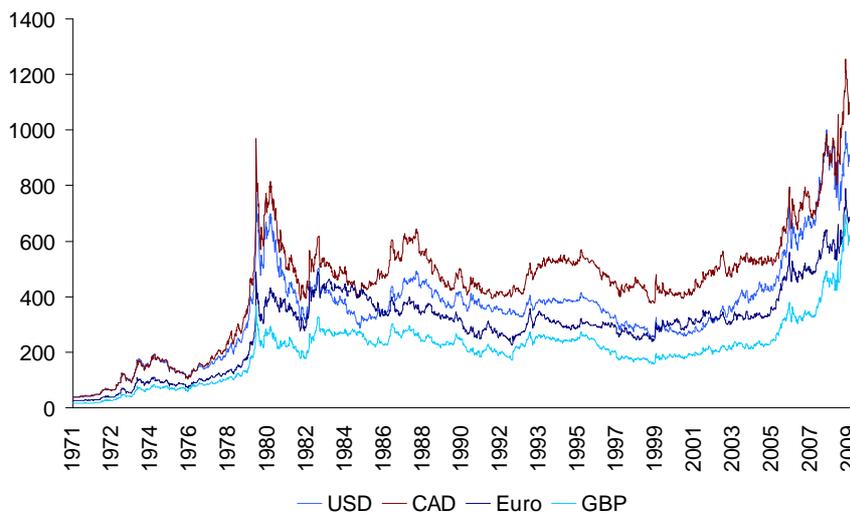
In a long-term perspective the gold price is therefore not overheated at all – in fact, quite the opposite is the case: the chart above highlights the fact that the price has seen a trend reversal. On an inflation adjusted-basis, the gold price is still almost 260% away from its highs at the beginning of the 1980s. In order to reach its all-time-high in real terms, the yellow metal would have to rise to USD 2,300 – only then could one claim that gold is actually expensive.

Myth # 2: Gold is of no interest to euro investors

A myth easily thwarted by numbers and the following graph. The average performance per year since 1971 has been:

- in USD: 10.8 %
- in EUR: 9.5 %
- in GBP: 6.5 %

Gold in USD, CAD, EUR, and GBP since 1971



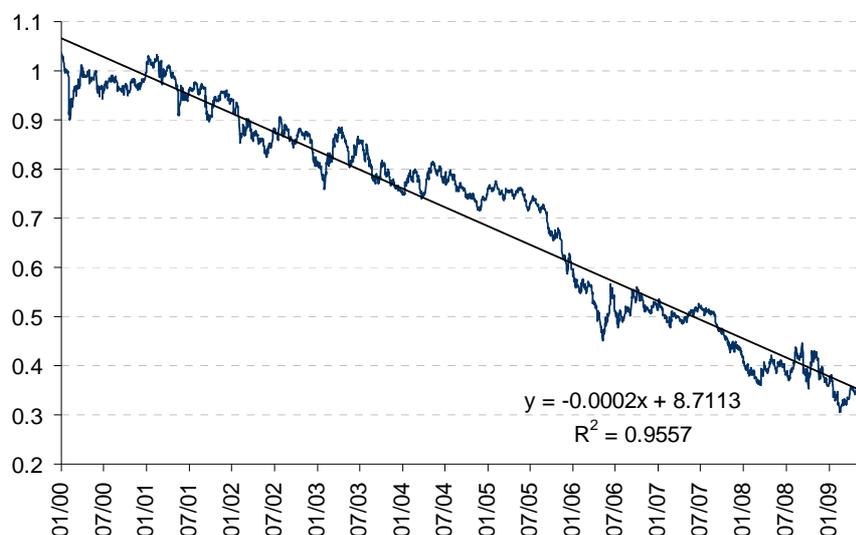
Source: Datastream

The short-term charts also underline the positive development of the gold price in the most important currencies. The development of a currency basket with equal weightings of US dollar,

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euro, Australian dollar, yuan, Swiss franc, Indian rupee, and British pound in comparison with gold is shown in the following.

Currency basket vs. gold



Source: Datastream

There is little reason to believe that the downward trend will weaken in the foreseeable future, to this extent we of course stick to our positive evaluation of the gold price.

Price gains in various currencies since 2001

	USD	AUD	CNY	EUR	INR	CHF	GBP	Average:
2001	2.50	11.30	2.50	8.10	5.80	5.00	5.40	5.80
2002	24.70	13.50	24.80	5.90	24.00	3.90	12.70	15.64
2003	19.60	-10.50	19.50	-0.50	13.50	7.00	7.90	8.07
2004	5.20	1.40	5.20	-2.10	0.00	-3.00	-2.00	0.67
2005	18.20	25.60	15.20	35.10	22.80	36.20	31.80	26.41
2006	22.80	14.40	18.80	10.20	20.50	13.90	7.80	15.49
2007	31.40	18.60	23.00	17.90	17.50	21.50	29.20	22.73
2008	5.80	32.50	-1.10	11.90	30.40	0.20	44.30	17.71
Average	16.28	13.35	13.49	10.81	16.81	10.59	17.14	14.07
Median	18.90	13.95	17.00	9.15	19.00	6.00	10.30	15.56

Sources: Erste Group Research, Datastream

Myth # 3: Gold does not pay interest

Gold preserves value and purchasing power

True – but it overcompensates the lack of interest payments by preserving the value and purchase power of the asset as well as through price increases. The US dollar has lost more than 95% of its purchase power since the creation of the Federal Reserve in 1913, whereas gold has increased by a factor of 50 during the same period. The decline in purchase power has been particularly pronounced since the abolishment of the gold standard: the US dollar has lost 80% of its purchase power since 1971. In order to buy the same basket of goods that one ounce of gold would buy in 1980 (for USD 850), one would have to spend USD 2,300 today. This is impressive testimony to the purchase power preservation capabilities of the yellow metal. On top of that, it does not produce any taxable income.

It also makes sense to compare that myth with growth shares that do not pay dividends, yet many times still outperform value shares. The counter-argument compared to bonds could

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therefore be, that only issuers with low ratings have to pay high coupons - or in other words, that gold is an issuer of the highest reputation and rating.

Myth # 4: The gold price is volatile and speculative

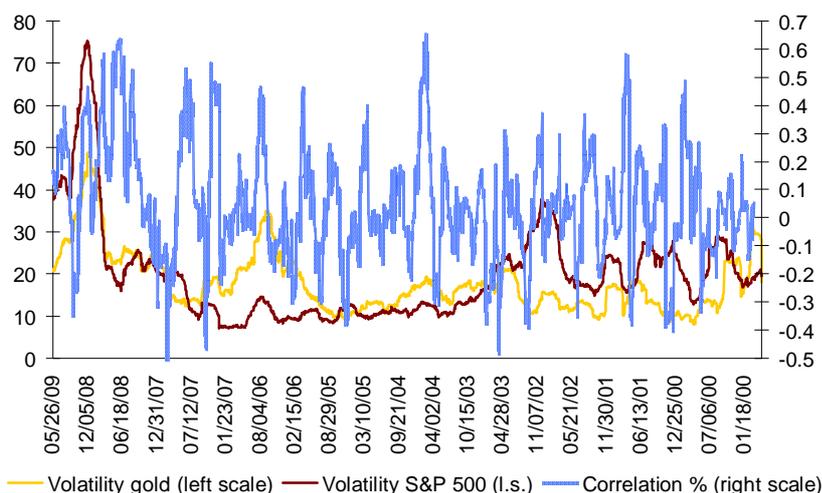
Lower volatility than equities and other commodities

Both the past few months and a long-term look into historic time series show that gold is substantially less volatile than equities (e.g. MSCI World). Only the shares of junior explorers with low market capitalisation deserve the label “highly speculative”. In the past ten years, the volatility of the Dow Jones index has been 16%, whereas that of gold has been 12%. The correlation of gold and the S&P 500 index has been -0.15 since 1990, as confirmed by a study of the World Gold Council³. The volatility of gold has been substantially lower than that of oil, other precious metals, the GSCI commodities index, and most equity indices in the past 20 years.

Low correlation to other asset classes

According to a study by Lawrence und Colin⁴, gold has zero, or an even negative, correlation to all other asset classes. Over the past ten years this correlation has amounted to a mere 0.049%. Average (60-days) volatility has been at 17 since 1999, whereas equities (S&P 500) have shown an average volatility of 19.4. Also, there is no statistically significant correlation with macroeconomic data such as industrial production or GDP.

Volatility and correlation gold vs. S&P500



Sources: Erste Group Research, Bloomberg

This is probably due to the fact that gold is not exposed to any liquidity risk or credit risk and has only low levels of market risk associated with it. In contrast to shares or bonds, gold is not contingent on any debt or promises and can thus only fall to its inner value, which is about equal to its aggregate production costs.

Myth # 5: In periods of deflation, gold is a bad investment

Gold outperforms in deflationary periods

The fact that gold is an excellent hedge against inflation should have established itself more or less as common knowledge. Investors use it to protect themselves against the erosion of their purchase power. However, the development of gold in a deeply deflationary environment has not been subjected to much analysis. The only relevant period that would lend itself to comparison is the Great Depression of the 1930s. However, those were the times of the gold standard, i.e. the gold price was fixed.

³ “Is gold a volatile asset?”, Rozanna Wozniak, World Gold Council

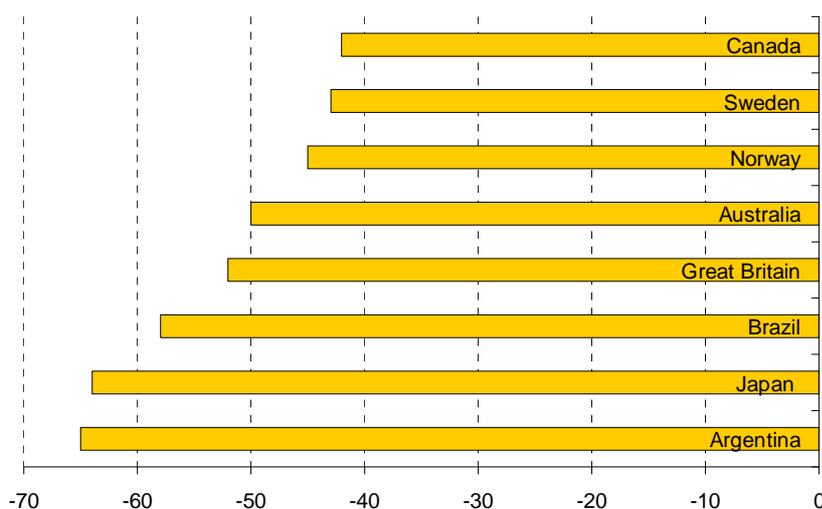
⁴ “Why is Gold Different from Other Assets? An Empirical Investigation, London, World Gold Council, 2003.

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By 1934 the industrial production had fallen by 50%, and the unemployment rate was up at 30%. Governments around the world had to step up their spending drastically and stop the price slump. The Western currencies were gradually depreciating. However, the economic situation the USA was in in the 1930s could not be compared to the current scenario. Whereas the country used to be the big creditor nation, it has now turned into the single biggest debtor.

We can try to establish how the gold price would have developed by analysing the subsequent depreciation of the currencies after abandoning the gold standard. Great Britain depreciated the pound in September 1931 by 52%, and the USA followed by appreciating gold by about 60% in 1933 (from USD 20.67 to USD 35/ounce).

% Depreciation of selected currencies vs. gold – end of March 1934 as compared to gold parities 1929



Sources: Datastream, ETF Securities, Erste Group Research

This means that enormous buying pressure had been building up during the period of the gold standard. When in 1933 the gold reserves had fallen to the minimum requirements, President Roosevelt instructed that all private gold holdings be confiscated. All gold exports were discontinued, and the dollar depreciated massively against gold.

Gold shares, on the other hand, were going from strength to strength. The development of the most important gold producer, Homestake Mining, can serve as reasonably approximate series for comparison. From 1929 to end-1935, the share price increased from USD 75 to above USD 500, and dividends totalled USD 130. However, **the strongest increase only happened after the period of deflation (1929-1932) and as the sudden onset of inflation (1932-1935). We would envisage a similar scenario for the future.** The stability of the gold shares during the general crash on the equity markets was probably due to the fact that the gold price was fixed and the revenues of the producers were therefore stable, whereas all other commodity prices collapsed.

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Homestake Mining vs. Dow Jones 1929-1937



Source: www.sharelynx.com

Other gold mining shares outperformed the market at impressive degrees as well. Dome increased from 1929 to 1936 by almost 1,100%, and Battlemountain shares soared by 1,200%. That said, the performance came also on the back of substantially increased resources, higher production, and improved margins.

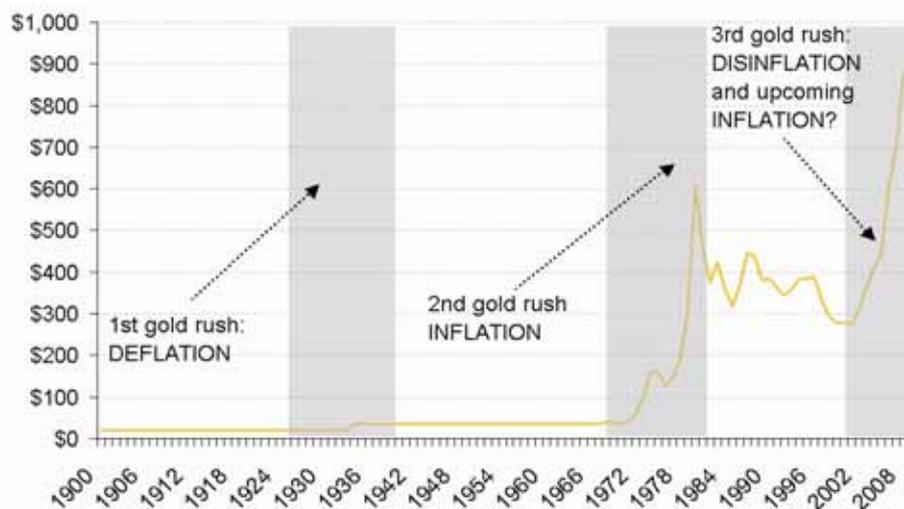
Silver as a good proxy for gold

Gold AND silver have always been the only two metals of monetary importance and also have a highly positive correlation. Therefore it should be possible to resort to the price of silver – which was not fixed – as well for comparison's sake. In 1931 and 1932 shares fell by 42% and 51%, respectively, whereas silver fell by 8% in 1931 and by 16% in 1932. Gold should have outperformed silver in this environment, given that silver is much more integral to industrial production and gold is influenced by demand that is contingent on the economic cycle to a much lower degree.

Seeing that in periods of deflation, cash outperforms all other asset classes, this should also apply to gold. Especially in an environment of expansive central bank policy, gold is surely a currency of highest quality and should therefore outperform the market. **This means that gold seems to be an excellent investment also in times of deflation.**

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Average gold price since 1900



Sources: Erste Group Research, Sharelynx.com

Myth # 6: Gold does not have the relevance that it used to in today's modern society

If this were the case, the central banks would have already sold their holdings. But the truth is that central banks – outside the Central Bank Gold Agreement – are now net buyers of gold, because it is the only reserve currency that is not contingent upon a promise of an obligation to another institution or nation.

On top of that, gold is becoming more and more essential to industrial use, e.g. satellite parts, wind and solar power, the computer industry, or laser technology, due to its unique characteristics. Even if the quantities are only marginal, they multiply to sizeable magnitudes.

Gold has a number of characteristics that make it a unique commodity:

- **owning gold is not contingent on the promise of any government, institution, or person**
- portable and easily transportable
- almost indestructible
- easily identifiable
- easily divisible
- high value density (= high value/weight and value/volume ratio)
- worldwide accepted universal currency

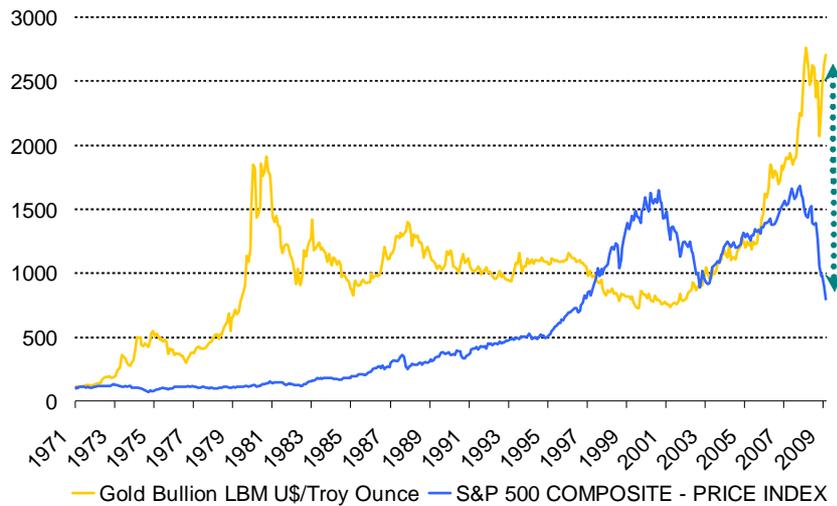
Myth # 7: Gold is only a crisis investment

“Hope for the best, prepare for the worst”

This would have been true for anyone who bought gold in the cyclical high of 1980; however, the most rapid increase lasted only three months (end of 1979 to beginning of 1980). A comparison of gold with equities puts this statement into perspective. It took the Dow Jones index until 1954 to pass the previous highs of 1929 again. The Nikkei is still a solid 75% away from its all-time-high in 1989. The Dow Jones has achieved a cumulated performance of 1,400% since 1971. In the same period, gold – not fixed anymore after 1971 – has increased by a factor of 27.

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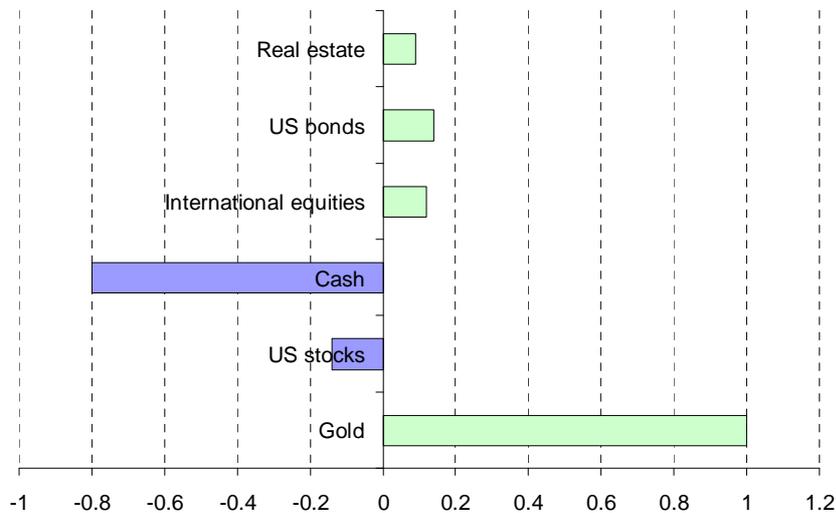
Gold vs. S&P 500 since 1971 (start value standardised at 100, both in USD)



Sources: Erste Group Research, Datastream

In addition, many studies have shown gold as part of the portfolio to reduce overall risk and improve performance. Gold dampens the fluctuations especially in highly volatile periods, and there is no statistically significant correlation of gold and economic data. Therefore gold is highly recommendable for diversification purposes.

10Y correlation



Sources: Bloomberg, Erste Group Research US equities (S&P 500), Cash (Citigroup 3M-T-bill index), international equities (MSCI World), US bonds (Lehman Brothers Aggregate Bond index), property (Dow Jones REIT index)

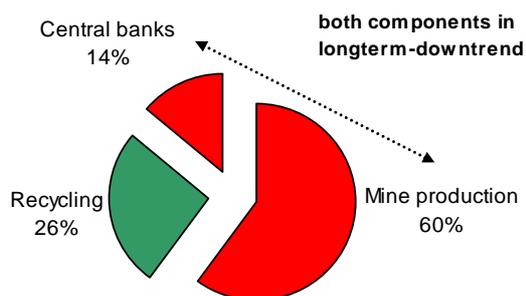
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Supply

Annual production: a cube with an edge length of 4.2 metres

Gold has exhibited a structural primary deficit for many years, i.e. annual demand exceeds supply by 40%. This deficit can only be covered by central bank sales and recycled gold. The annual gold production amounts to about 2,500 tonnes. To illustrate this figure: this corresponds to a cube with an edge length of only 4.2 metres.

Supply (5-year average)



Sources: Bloomberg, World Gold Council, Erste Group Research

The components mine production and central bank sales have been receding for years in spite of the gold price hitting record levels. Only the recycling supply managed to close the supply gap in recent periods. Whereas the gold price has increased by more than 250% since the year 2000, the annual mining output has fallen from 2,620 to 2,416 tonnes.

The central bank sales have embarked on a continuous downward trend; the maximum of 500 tonnes within the CBGA agreement was not fully used anymore. Overall supply is therefore almost 200 tonnes below that of the year 2000. This phenomenon intensified last year; in total 2008, mine output decreased by 3%, central bank sales plummeted by 50% to 246 tonnes, whereas recycled gold supply soared by 22% to 1,218 tonnes.

Supply	2000	2008
Mine production	2,620	2,416
Recycling/scrap	629	1,218
Central bank sales	479	246
De-hedging	(15)	(358)
Total	3,713	3,522
Average gold price in USD	284	869

Sources: World Gold Council, Datastream, Bloomberg

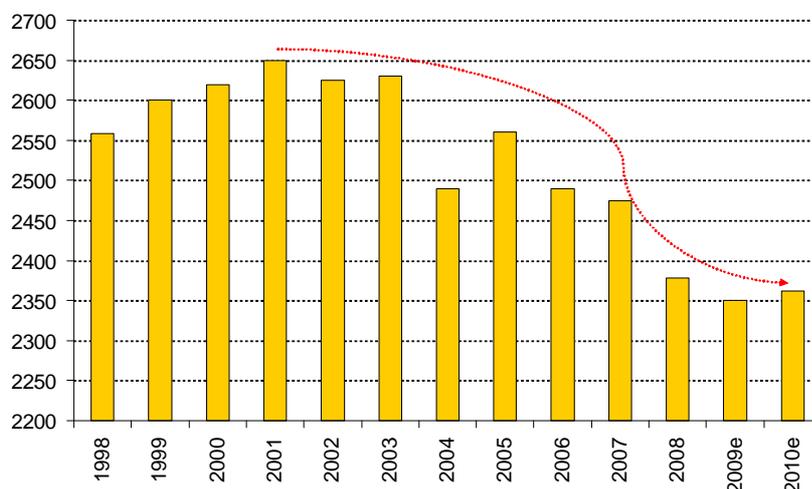
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Mine production

Production still clearly sliding

Primary supply fell in 2008 for the ninth time in a row, this time by 3% to 2,416 tonnes. This was the lowest level of production since 1996. Many signs would indicate that the 2,600 tonnes that were produced in 2001 were the all-time-high of gold production.

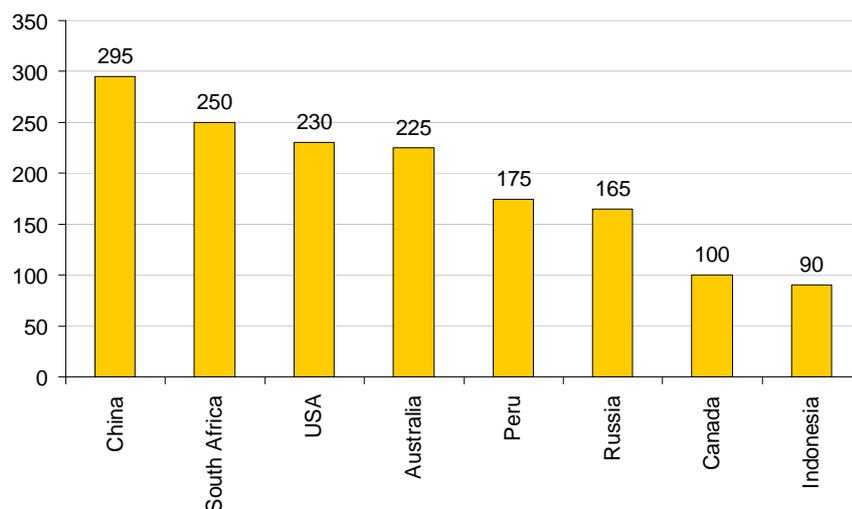
Mine production 1998 – 2010e



Sources: World Gold Council, Erste Group Research

Production is gradually shifting to the emerging markets. While China, Peru, Russia, and Indonesia accounted for 19% of world production ten years ago, their share in global output has in the meantime risen to 34%. The massive decline in production of the largest mining nations was offset mainly by smaller, sometimes politically unstable countries with bad infrastructure. There are more than 90 countries with at least one producing gold mine. Given that China and Russia are net importers, in other words given that the largest (China) and the sixth-largest producer hoard their own gold production domestically, they do not contribute a single ounce of gold to the global gold markets.

Mine production 2008 in tonnes



Sources: US Geological Service, World Gold Council

The cash costs increased by about 20% to USD 470/ounce in 2008. The majority was incurred in the first half, when energy, personnel, and base materials were on the rise. The financial crisis and the dramatic slump in lending caused numerous production outages, the suspension of exploration projects, and a moratorium on planned projects in the gold sector. This will be

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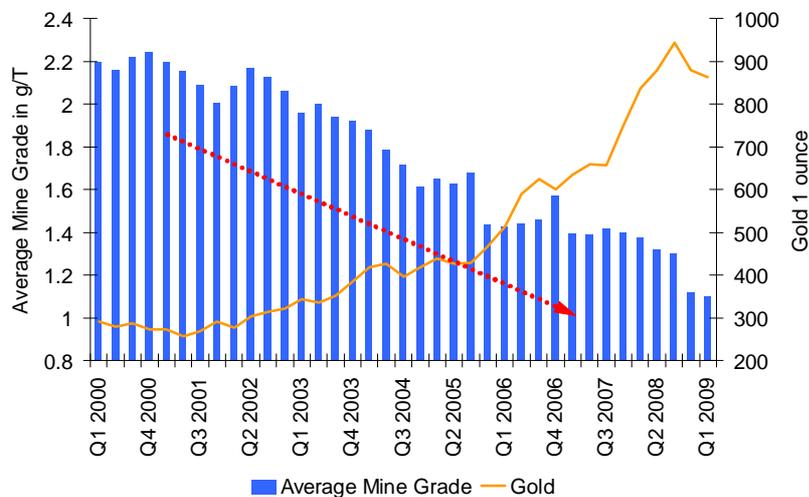
reflected by lower inventory levels, future shortages, and eventually higher prices – a classic example of the pork cycle.

From 1992 to 2007, a total of 90 deposits with 2.5mn ounces of gold each were discovered. However, the number of discoveries is caught in a sharp downward trend: after the turn of the millennium, only three larger deposits have been discovered per year. Graham Birch, manager of the BGF World Gold, said that he expected a decrease in production of 10-15% over the coming five years. At the moment, 80mn ounces are produced, but only 15mn ounces are discovered every year⁵.

Major discoveries are largely a thing of the past

On top of that, the gold content has been gradually sliding. Whereas the average gold content in the year 2000 was still 2 grams per tonne of rock, this ratio had declined to 1.2 grams in 2008. This is on the one hand due to the drastic price increase (which has turned the exploration of low-grade deposits profitable), on the other hand to the dwindling high-grade deposits.

Average mine grade vs. gold



Sources: Company Reports, US Geological Service, Erste Group Research

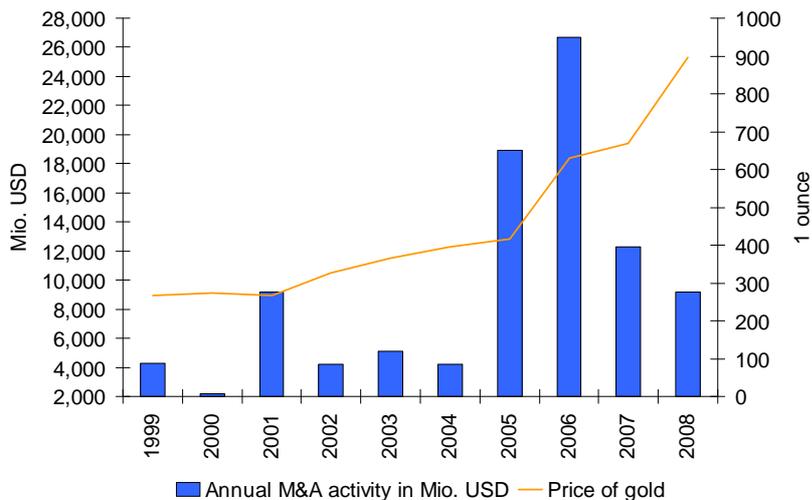
Structural problems of the industry

The largest gold producers in the past have mainly grown through acquisitions. The majority of takeovers were financed by capital increases, which diluted the gold reserves per share considerably. We expect this tendency to last; explorers with proven reserves should be of particular interest to the big gold producers.

⁵ www.rohstoff-welt.de/news/artikel.php?sid=7362

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M&A in the gold sector

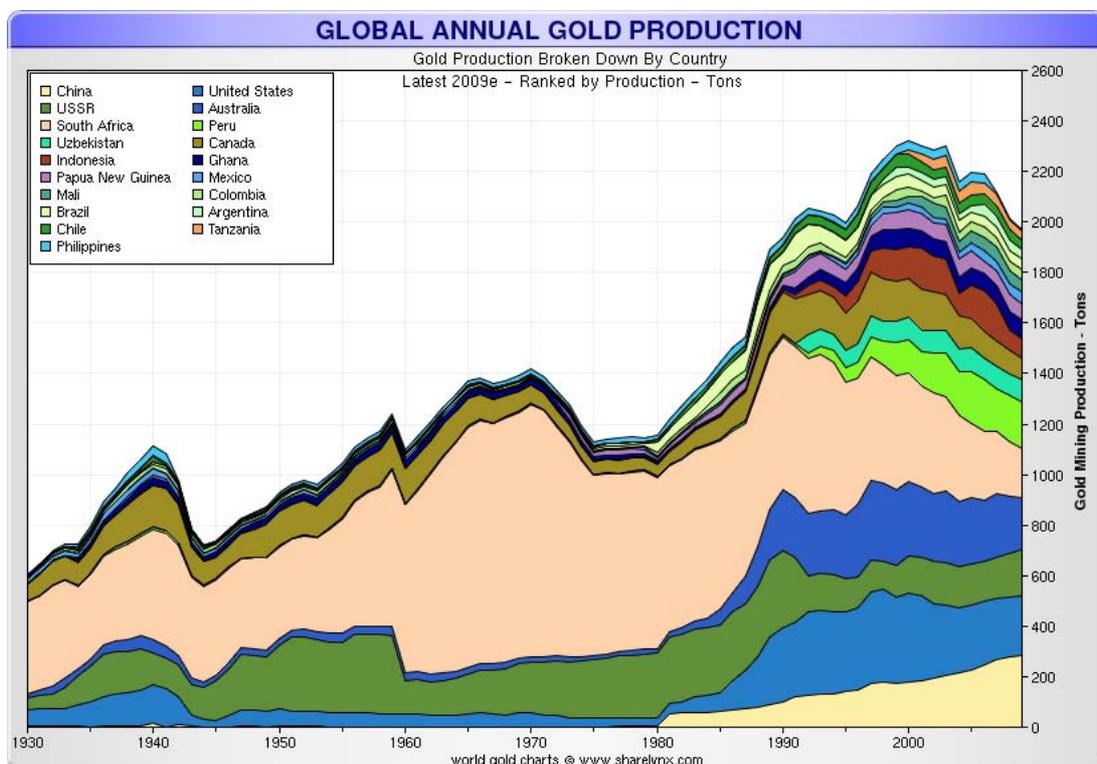


Sources: VanDyk, Erste Group Research, Metals Economics Group

Future of the industry: smaller, low-grade deposits in remote regions

New discoveries will be gradually smaller, of lower grade, and in more exotic and remote regions. The majors are globally diversified. Because of their broad diversification as well as their high-clout lobbying activities, they are relatively impervious to problems such as rebellions, coups d'état, union strikes, and sudden, apparently random changes to the legal framework; in many countries these kind of problems occur almost on a daily basis. In addition, the credit markets are still out of bounds for many junior explorers.

Annual production since 1930



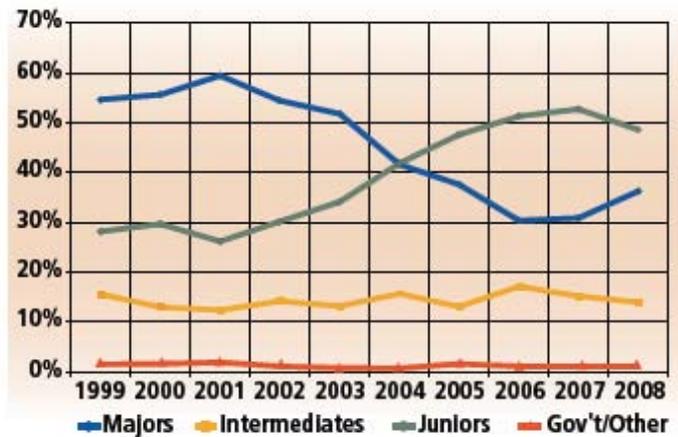
Source: www.sharelynx.com

In the period of 2002 to mid-2008, cash costs increased by almost 300%. According to the US Geological Survey, establishing an underground mine would have set you back by an average USD 100mn ten years ago. Today, this amount has probably increased to at least USD 1bn. This kind of capital requirement can mainly be met by already producing companies – as

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supported by the fact that in the year 2000 about 20% of gold production was mined by the 20 largest producers, and 43% in 2008.

Budgets by company type, 1999-2008



Source: Metals Economics Group, 2009

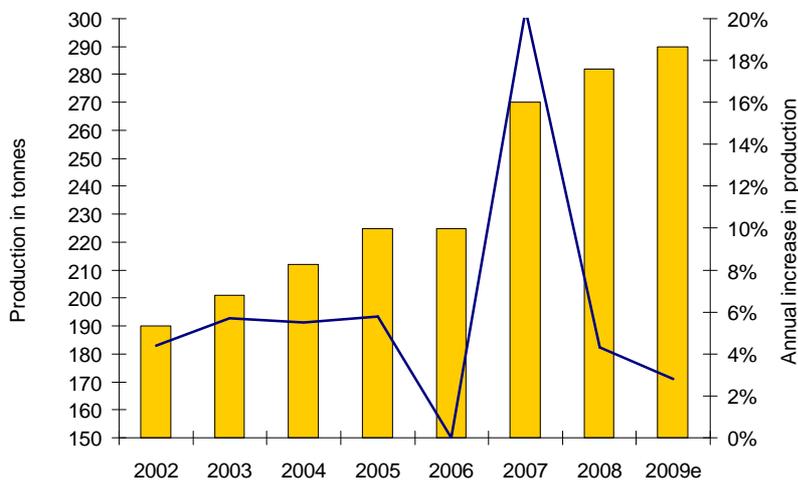
Cash Costs + 18% in 2008

In 2008, the cash costs increased to an average USD 476/ounce produced, i.e. by 18% on 2007. In the first half of 2008, they even amounted to USD 570/ounce. According to the National Bank of Canada, the break-even costs in North America are USD 710/ounce.

China remains no.1

China has stepped up its production since 2001 by more than 59% to 260 tonnes in 2008. This means that China is the only large gold-producing country that managed to increase its output. Almost 15,000 small and sometimes diminutive mines take care of the country's production. Their profitability is very often based on extremely low staff costs and dubious environmental standards.

Chinese gold production vs. gold price



Sources: CEIC, Chinese gold producers, Erste Group Research

Gold production is shifting from the Big 5 to many small producing countries

In 2008 a total of 22 countries accounted for more than 90% of gold production. Among those were numerous unstable nations such as Uzbekistan, Venezuela, Colombia and Congo. This means that production has been shifting from the traditional to emerging markets. Over the past decade the share of these countries in terms of total production has increased from 18% to 31%. In 2007 China overtook South Africa as no.1 producer – in 1970, South Africa had still accounted for 70% of total global production. In 1997 the Big 5 (Australia, Canada, Russia, South Africa, USA) made up more than 90% of total production, whereas today this share has fallen to 41%. This means that the security of supply has obviously diminished given that resource nationalism is clearly on the rise.

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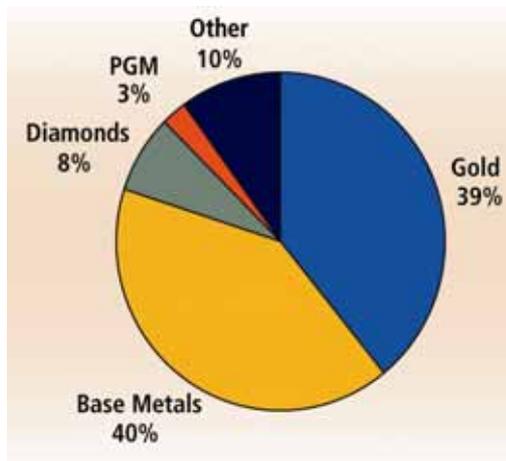
Increasing resource nationalism

Gregory Wilkins, Vice President of Barrick Gold, said that the list of countries that Barrick avoids was getting longer and longer. The instability of many Latin American countries – influenced by Hugo Chavez – is too great a risk for Barrick. According to Metals Economics Group⁶, exploration programs are encountering increased risks from political and regulatory instability in many developing nations. Many of those countries tend to have inferior infrastructure and inexistend political stability, which leads to slower mine development at higher costs. The current production pipeline of 1.7 billion ounces, 19% is in lower-risk jurisdictions, 57 % in medium-risk areas, and 24 % in high-risk jurisdictions.

Many mines have entered the winter of their useful lives

Currently the majority of production is derived from mines the have been operating for more than 15 or 20 years. The output can be maximised through state-of-the-art methodologies, and lower grades can be exhausted as well, but many large mine are still approaching their expiry date fast. In spite of a fivefold increase in exploration expenses, production has been receding for years, and no adequate replacement has been found for the dwindling reserves. This means that production has exceeded the discovery of new deposits for years.

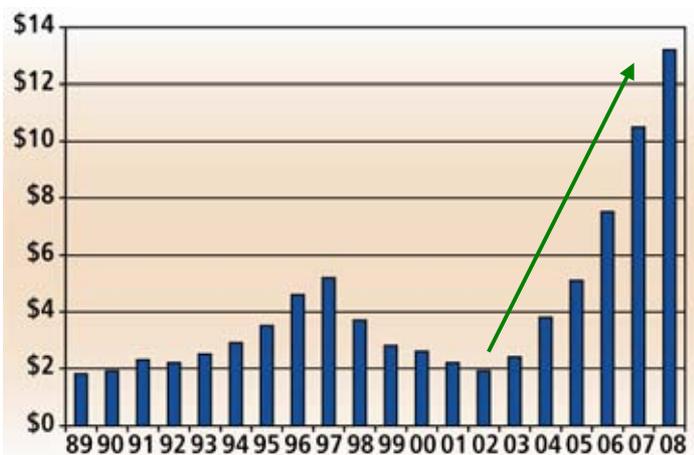
Global exploration budget 2008 by segments



Source: Metals Economics Group

Although exploration expenditure has been rising significantly since 2002, hardly any bigger deposits have been discovered.

Global exploration budgets in USD bn



Source: Metals Economics Group

⁶ http://www.metalseconomics.com/pdf/Strategies_for_Gold_Reserves_Replacement_2009.pdf

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Historic gold production in South Africa – a prime example of "peak gold" for the entire industry?

South Africa down to 3rd rank

35 years ago South Africa accounted for almost 90% of world gold production at nearly 1,000 tonnes, whereas today this share is down to 13%. In 2008, the country recorded the biggest decline in decades. Production fell by 14% to the lowest level in ten years. The situation was caused by the ever more difficult and dangerous exploitation of existing reserves as well as by problems of the public energy company Eskom. The closures of mine shafts imposed by the government after a number of fatal accidents resulted in lower production. In the meantime, South Africa has fallen back to third rank behind China and the USA. The situation in Australia is not really much brighter. Australian gold production fell to the lowest level since 1989. Therefore we definitely may say that Australian and US-gold production have already peaked.

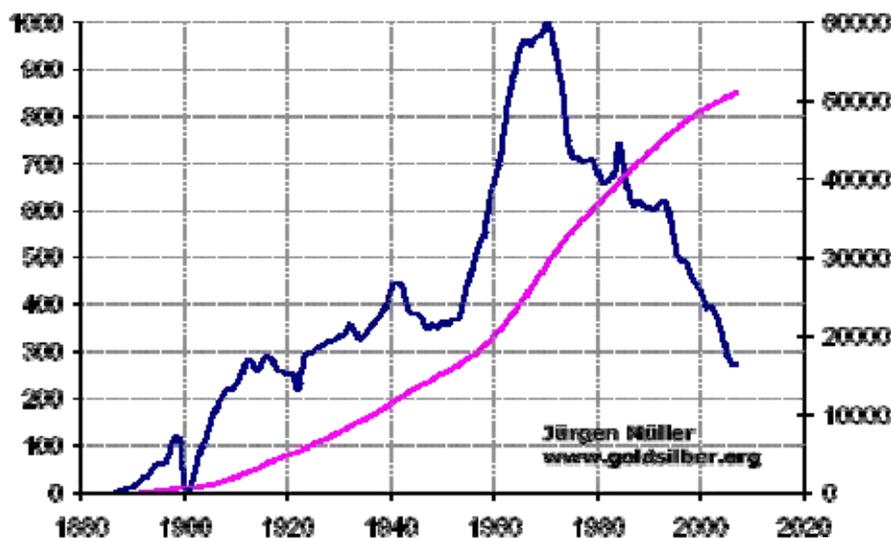
The often quoted and vividly disputed term "peak gold" describes a situation where global gold production has reached its maximum. Reaching and passing this point would entail significant price increases and supply crises. Peak gold does not mean that the existing reserves are about to be depleted. It just means that beyond this point production declines at an ever growing momentum. This can be partially offset or mitigated by price increases.

The US geologist M. King Hubbert came up with this theory back in the 1950s and described how the production rate of a finite commodity followed an almost symmetrical bell-shaped curve. While the increase tends to be slow at the beginning, it ends with almost exponential growth rates shortly before reaching the peak. Hubbert predicted the American peak oil for 1971 back in 1956. Later the model was used for other regions and commodities as well.

Witwatersrand dead ringer of Ghawar oil fields

There are numerous clues suggesting an imminent peak, for example the situation in South Africa, formerly the world's largest gold-producing nation for more than 100 years. A total of more than 50,000 tonnes have been produced here (magenta line), which equals about a third of the overall gold production so far. The deposits in the Witwatersrand region are a dead ringer of the Ghawar oil fields in the Middle East.

South African gold production– prime example of peak gold



Source: www.goldsilber.org

The worlds of gold and oil converge

Similar to the situation of oil, gold is getting more difficult to find by the day. Production takes place in ever greater depths while encountering lower and lower concentrations, and the extraction process is getting more costly and demanding. Experts claim that more than 70% of economically exploitable reserves have already been exhausted. Despite massive investment in exploration, production still fails to increase. For many years, production exceeds the volume of new discoveries. This is where the worlds of oil and gold converge. Mark Cutifani, CEO of

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Industry insiders take a realistic and pessimistic view

AngloGold Ashanti, expects production to decrease by at least 5% per year over the next five years. Apparently in South Africa the output has decreased by even 20-30% over the past five years. The cost pressure is particularly high for those mines that are located kilometres below ground. For example, the Savuka mine of AngloGold takes production to depths of almost four kilometres. And the content has fallen significantly as well: at the moment, one tonne of rock would typically yield less than 6.5 grams of gold.

Barrick Gold CFO Sokalsky expects a long-term downward trend as well. The ever more challenging funding of new projects will result in effects on the industry that nobody can imagine today. Peter Munk, legendary founder of Barrick, called the supply situation "tragic"; he pointed out that the large deposits were approaching a state of depletion, whereas the establishment of new production sites was becoming ever more difficult and expensive.

For example, according to estimates by Professor Saager from ETH in Zürich⁷, another 45,000 tonnes of gold can be produced profitably with today's technologies. He also estimates that the entire amount of gold that can be mined amounts to about 100,000 tonnes. This means that we will not run out of gold, but the price will decide on what is deemed a minable reserve.

According to US Geological Survey the residual life of gold reserves is currently 17 years, while that of silver reserves is 14 years, statistically speaking. The residual life would shift upward along rising prices, but numerous models expect a significant increase in the residual life only from a gold price of USD 5,000.

Recycling

The supply of recycled gold has drastically increased recently. The recycling volume rose by almost 30% in 2008 to a total of 1,218 tonnes. And as much as 500 tonnes were already sold in only the first quarter of 2009. However, we expect this trend to weaken. Normally sharp increases in the volume of recycled gold are mainly seen in Asia, but in the meantime, and as a result of the crisis, they have made it to Western Europe. For example in 1998, as a result of the Asian crisis, the volume of recycled gold soared to 1,100 tonnes. In the event of a crisis, the rainy day funds are dug out, and the traditional dowry ends up in the smelting furnace. This is particularly critical since the Indian subcontinent, the Middle East, and the Far East account for almost 70% of total jewellery demand. 2008 saw a similarly high level, with the price playing a crucial role as well. This means that we certainly see the potential for a selling wave, along the lines of the one we witnessed in 1998 during the Asian crisis, where 1,100 tonnes of gold were recycled.

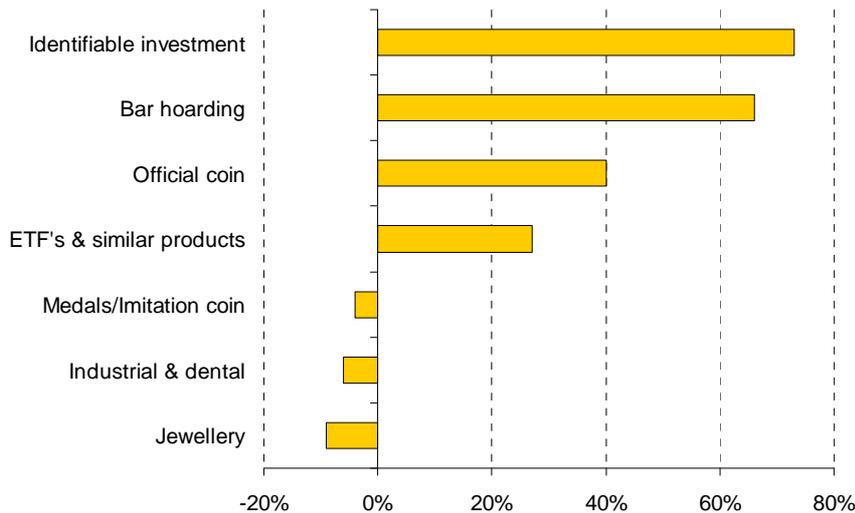
⁷ Source: Lucien F Trueb „Gold, Bergbau, Verhüttung, Raffination und Verwendung“

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Demand

The demand for gold increased in 2008 by 7%. Due to the massive turbulences, the various demand components exhibited a mixed development.

Demand 2008 (vs. 2007 in %)



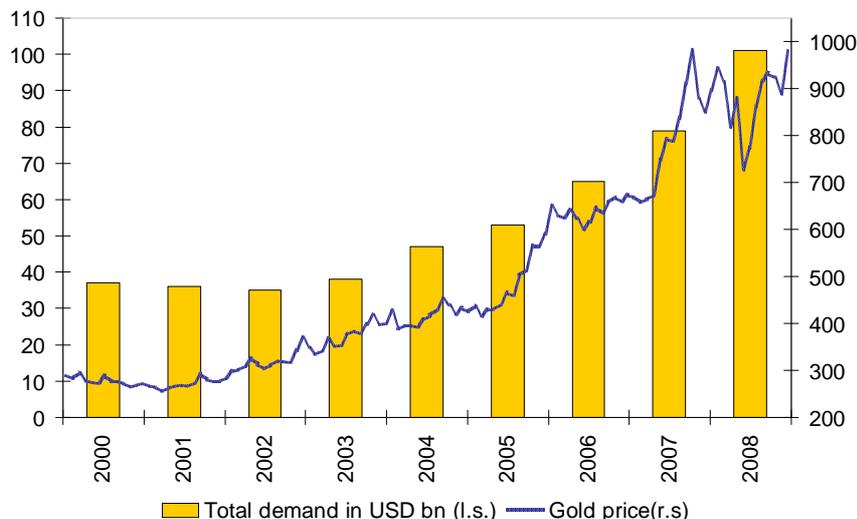
Source: World Gold Council

Investment demand exploded in the second half of 2008, with the demand for retail investments (coins, bullions) soaring by 396%.

China is now biggest producer AND biggest consumer

The Chinese population appreciates the stable value of gold more than ever, in fact last year China became the largest gold consumer. Interestingly, it was mainly gold of highest quality, i.e. 24 karats, that found buyers. This would indicate that it was bought as crisis currency and not for jewellery purposes. 432 tonnes of jewellery, coins, and bullions were bought in 2008, which equalled an increase of 17% on the previous year.

Aggregate demand still on the rise



Sources: World Gold Council, Erste Group Research

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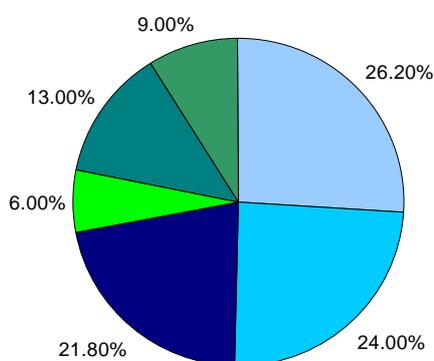
Comparison 2000 vs. 2008

Demand	2000	2008
Jewellery	3,204	2,159
Industry	799	1,075
Investments	(300)	288
Total	3,703	3,522
Average gold price	284	869

Sources: World Gold Council, Bloomberg, own research

Jewellery demand decreased by 10% to 2,159 tonnes in 2008, whereas investment demand soared by 77% to 1,159 tonnes. ETFs accounted for 312 tonnes (+27%), whereas industrial demand fell by 5% to 436 tonnes.

Global gold demand 2008



Legend: East Asia (light blue), Indian Subcontinent (cyan), Middle East (dark blue), North America (green), Europe (teal), Other (dark green)

Source: World Gold Council

In the first quarter of 2009 total demand was robust. Germany and Switzerland saw their demand soar by a factor of five in comparison with the first quarter of 2008. In the USA the purchases of physical gold increased by 216% to 27.4 tonnes. The demand for so-called paper gold, i.e. ETFs, increased massively too.

Industrial demand

The industrial demand declined last year by 7% to 290 tonnes. This was mainly the result of the economic decline and the consequential decrease in demand for electronic goods, computer chips etc.

De-Hedging⁸

In the whole of 2008 the total de-hedging volume amounted to slightly less than 360 tonnes. We expect the decline to continue in 2009, and substantially so, given that the global hedge book holds a mere 500 tonnes. AngloGold still commands the largest hedge positions, followed by Barrick Gold and Newcrest.

⁸ Since mine operators are subject to substantial capital expenditure for exploration and production, they sell parts of their future gold output forward. The cancellation of these forward positions is called "de-hedging", i.e. additional gold is taken off the market.

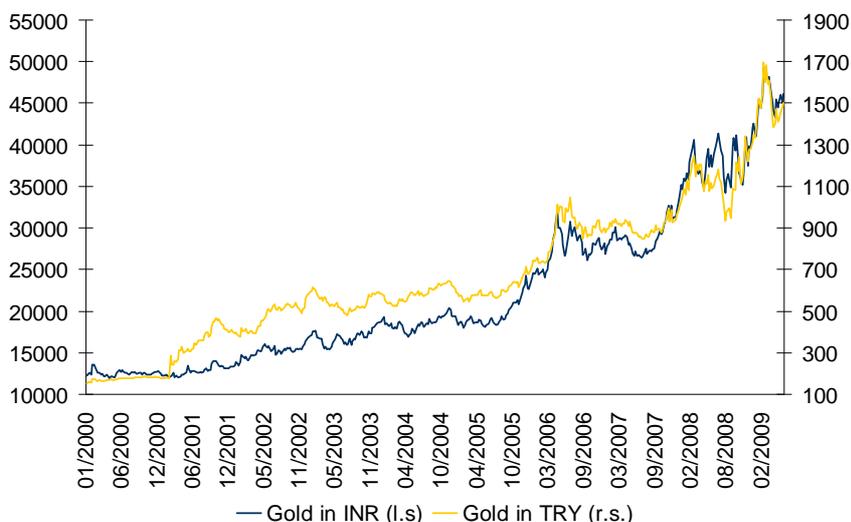
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Jewellery demand

Buyers in Turkey and India on strike

The rapid growth in the emerging markets was responsible for the continuous upward trend in jewellery demand. Due to the slump in GDP growth, but also the generally weaker local currencies, we continue to expect a more subdued jewellery demand in 2009. However, this weakness should be more than offset by investment demand. The particularly important jewellery demand from India was practically non-existent in the second half of 2008. Normally the period of October to December, i.e. the wedding season, is known as a key price driver – but not last year, it was not. Indian demand slumped by 84% in the fourth quarter. In 2008 alone, the gold price increased by 30% in Indian rupee and by 33% in Turkish lira. So far in 2009 sales have remained lacklustre, but have gradually recovered following the appreciation of the Indian rupee.

Gold in Indian rupee and Turkish lira



Source: Datastream

Central banks

Last year central banks only sold 358 tonnes of gold, or as little as in 1999, when the first central bank gold agreement was signed. In the last year of the agreement, which will expire in September 2009, only 85 tonnes have been sold so far. The large sales by European central banks are probably history, as a press statement by the German Bundesbank suggested as well:

*"Gold represents an essential component of the currency reserves of Bundesbank which meets the bank's requirements in terms of safety and diversification of the portfolio. The gold reserves create trust in, and support the stability of, the currency."*⁹

Central banks revising their opinion (in the eleventh hour)

Central banks are publicly considering gold purchases

Ecuador recorded large-scale purchases. The central bank more than doubled its reserves and now holds 54.7 tonnes of gold. Venezuela continues to buy as well, its reserves have increased to 363 tonnes, i.e. 36% of its total reserves. Russia has recently bought 90 tonnes, and the past 26 months have seen reports of gradually increasing gold reserves. Prime Minister Putin has confirmed that he wishes to step up gold to 10% in terms of total reserves. And there are similar

⁹ http://www.bundesbank.de/presse/presse_aktuell_goldreserven.php

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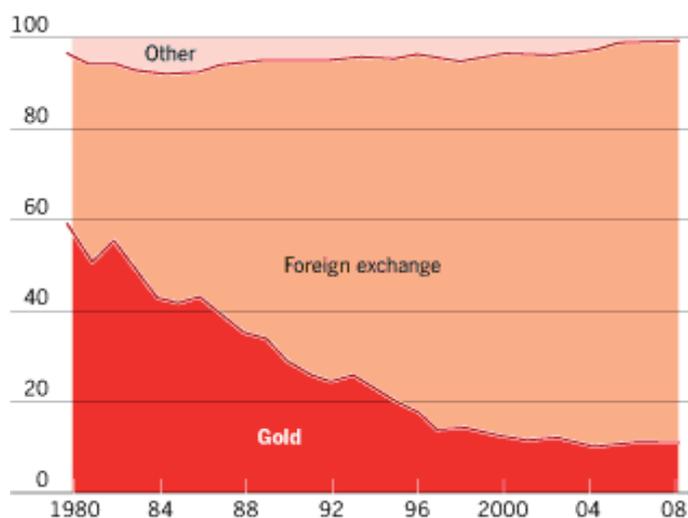
tendencies in Brazil, India, the Gulf States, and especially China. Singapore, Saudi Arabia, and Norway are also publicly considering purchases.

The fact that the US has in the past made a consistent point of encouraging other central banks into selling their gold, but never touched its own reserves kind of fits the picture.

Share of gold in terms of total reserves at an all-time-low

Whereas gold accounted for almost 70% of central bank reserves worldwide in the 1940s and 1950s, this share has in the meantime fallen to 10%. This is primarily due to the expansion of foreign exchange reserves. Nowadays the distribution is heavily segmented. Ten central banks hold almost 80% of all gold reserves. According to the IMF, 51 nations have no gold reserves at all, and 36 nations have only 0.01-5% allocated in gold. Among those are nations with gigantic foreign exchange positions such as for example China, Korea, Japan, Brazil, and Singapore.

Breakdown of global central bank reserves in %



Source: www.ft.com

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Golden China

China increasingly critical of the US currency hegemony

On 12 March 2009 Prime Minister Wen Jiabao announced that he was worried about the state the US dollar was in. Ten days later, central bank governor Xiachuan said that the US dollar should urgently be replaced as world reserve currency. We regard these statements as extremely important, especially in the light of the directness of the wording in comparison with earlier statements. They underline the massive concerns of China with regard to the fiscal and monetary policy of the USA. And at the G20 summit, there was a broad understanding that the enormous dependency on the US dollar had to be curtailed.

China admits "secret" gold purchases

According to a report of the state-run news agency Xinhua China holds gold reserves to the tune of 1,054 tonnes. Xinhua relies on numbers given by the Director of the State Administration of Foreign Exchange (SAFE), Hu Xiaolian. This means that China has increased its holdings by 454 tonnes in the past six years that were mainly bought on the domestic market and from domestic gold producers, as Hu pointed out. The purchases in the past six years were not made public. The Gold Anti-Trust Action Committee (GATA) reported as early as in September 2003 that the Chinese central bank was going to make massive purchases, but was not taken seriously.

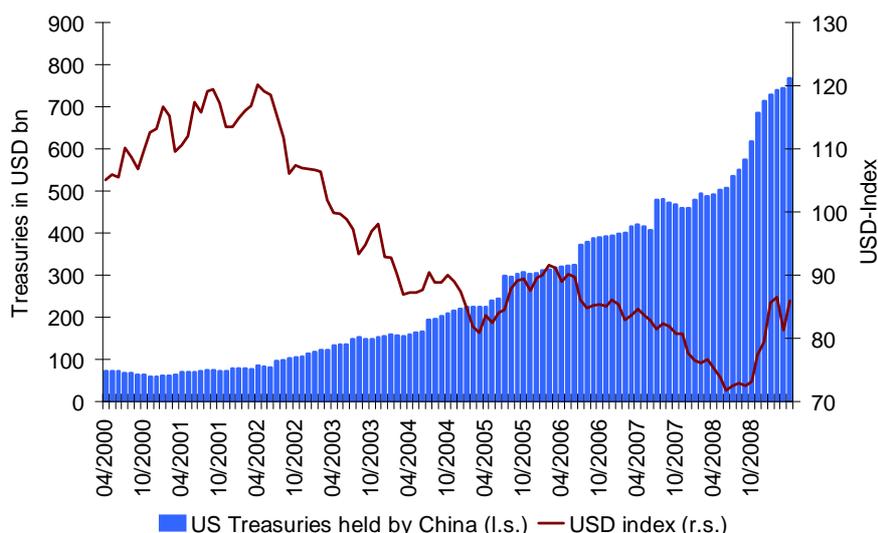
China regards gold as essential monetary component

This means that since 2003 China has increased its reserves by 76% (from 600 to 1,054 tonnes). China now owns more gold than Switzerland. The press release said that gold would be given a more important role as crucial monetary element of the currency reserves. As largest producer, China buys the entire domestic production, and Chinese gold probably never leaves the country.

India and China want IMF gold

China and India also recommended to the IMF that it should sell all of its holdings of gold reserves, i.e. currently 3,217 tonnes, in order to support the poorest developing countries. China is likely to buy 403 tonnes of gold from the IMF directly in a first step – perhaps within the framework of a newly to-be-arranged selling programme. We do not believe that altruism has spawned this proposal, but rather the intention of Chinese and Indian leaders to buy the IMF gold themselves.

Chinese holdings of US Treasuries vs. US dollar index



Sources: Datastream, Erste Group Research

China does not trust the value preservation of the USD

We expect China to continue buying in order on the one hand to diversify out of the US dollar, and on the other hand to increase its gold coverage so as to bolster the trust in a fully convertible renminbi. Whereas at its peak (March 2007) China had accounted for 27% of all investments in US Treasuries, the share had fallen to 11% at the beginning of 2009. China and

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Japan currently hold 23% of the USD 6.3 trillion of external debt of the USA. According to statements made by Hou Huimin from the China Gold Association, plans were to build reserves totalling 5,000 tonnes. China thus clearly implies that it does not trust the value preservation of the US dollar anymore.

**Only 1.6 %
gold coverage
– China will
continue to
accumulate
gold**

1,000 tonnes are, however, not a lot when compared to the foreign exchange reserves of USD 1.95 trillion. Currently they account for about 1.6% of total reserves and are valued at USD 30bn (at a gold price of approximately USD 900/ounce). Although China has stepped up the number of tonnes, the share of gold in terms of total reserves has still declined. This means that the nation with the biggest foreign exchange reserves has also the lowest gold coverage ratio. The international average is 10%. We believe that this is a clear indicator that China will continue to increase its holdings. If China were to buy the 3,217 tonnes of the IMF, they would be looking at about USD 100bn (at USD 1,000 /ounce), which would still only account for 5.2% of total reserves (about USD 2 trillion).

Gold purchases necessary to achieve a 10% gold coverage ratio

Country	Reserves (tonnes)	Reserves @ 10 % coverage	Purchases to achieve 10 % coverage
Japan	765,2	4.027	3.262
China	1054	6.667	5.613
Russia	495,9	2.254	1.758
Taiwan	422,4	1.173	751
India	357,7	1.192	834
Singapore	127,4	708	581
			12.799

Sources: IMF; internet pages of the respective central banks

We also believe that many nations will follow the Chinese example, which is based on a long-term strategic rationale.

**Russia critical
of currency
regime as well**

The Russian chief economist, Dvorkevich, has also repeatedly declared himself in favour of a new "Super Currency", which should contain a healthy weighting of gold as well as include the Chinese yuan and the rouble. He also pointed out that Russia was going to step up the share of gold reserves in terms of total reserves gradually to at least 10%.

Asia with low share of gold in terms of total reserves

	reserves in billion USD	Gold as a % of total reserves
China	1953.7	1.6
Japan	989.7	2.2
Russia	383.8	4
Taiwan	300	4.2
India	241.9	4.2
Hong Kong	186.2	0
Singapore	166.1	2.2

Sources: World Gold Council, central banks

Central Bank Gold Agreements

**Will the IMF
sales be
processed
within
CBGA3?**

The International Monetary Fund currently holds more than 3,200 tonnes of gold. The Fund has repeatedly pointed out that it wishes to sell 403 tonnes (i.e. 13 million ounces) and fill its empty coffers with the proceeds. But due to the global economic crisis the IMF has gained importance again – it granted almost USD 50bn worth of emergency loans to Iceland, the Ukraine, Pakistan, and Romania. The interest income would make the announced gold sales obsolete.

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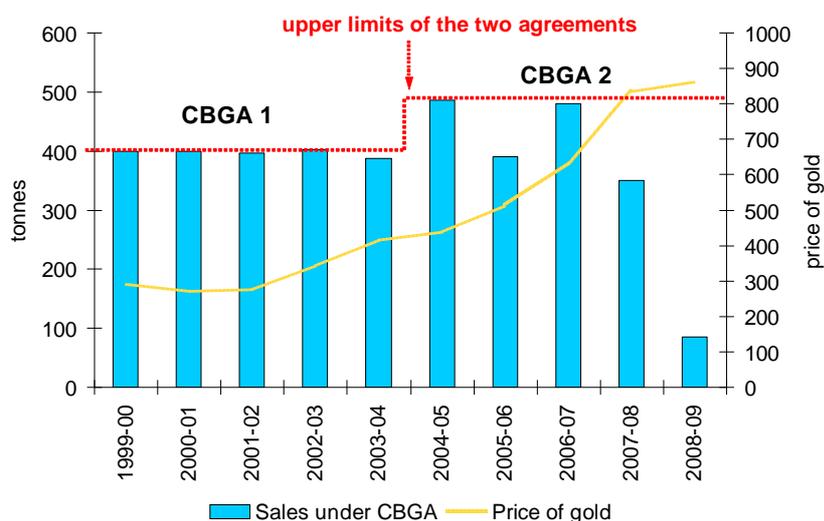
But at least 85% of the votes have to be in favour of such a proposal and given that the USA holds 17% of voting rights, it effectively has veto power. However, the effects of the – very likely – IMF sales should be of limited nature. After all, the sales would be conducted within the framework of, the CBGA and in agreement with the member states. Also, the sales would be stretched out over a longer period of time in order not to flood the market. Besides, the sales have most likely already been priced in.

Selling programmes have mostly come to an end

In 2008 the central banks sold as little gold as they had previously done only in 1999. Nations outside the CBGA have long turned into net buyers of gold. The two earlier agreements clearly stabilised the gold sector after prior to them, uncoordinated selling had been causing high volatility, confusion, and uncertainty. For example, the British government (under then Chancellor of the Exchequer and now Prime Minister Gordon Brown; a transaction that set him up with the nickname "Golden Brown") sold almost 400 tonnes of gold between the years 1999 and 2002, which battered the gold price down to a low of USD 250.

In the fourth year of the agreement only 358 tonnes were sold, and in the fifth year only 91 tonnes have been sold to date. This means that the large selling programmes of the central banks have come to an end. This makes it likely for the IMF sales to be processed under the third CBGA.

Sales and upper limits of the two gold agreements



Sources: Gold.org; Datastream

A total of 3,800 tonnes of gold has been sold over the past decade, although the timing of the sales transactions was rather bad: the European central banks alone destroyed more than USD 40bn of value because of bad timing. Many nations (e.g. Spain, France, Portugal, the Netherlands) followed the British example and sold large parts of their gold reserves at prices of between USD 280 and 300/ounce.

Investment demand

Speculative demand exceeded jewellery demand in 2008 for the first time since 2004, posting an increase of 300% to a total of almost 600 tonnes, whereas jewellery demand fell by 24% to 339 tonnes. Jewellery demand in India decreased to the lowest level in 20 years in 2008, whereas demand from China increased dramatically.

Wall Street discovers gold

Northwestern Mutual, the third-largest life insurer in the United States, reported at the beginning of June that it had bought gold for the first time in its 152-year history. The company invested a total of more than USD 400mn in gold. **Hedge fund manager John Paulson** also announced that he had invested massively in gold. Paulson, who was one of the first to see the subprime disaster on the horizon and took up positions accordingly as early as 2005, regards

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gold as the next big opportunity. His fund invested USD 2.8bn in Spider ETF and USD 638mn in Market Vectors Gold Miners ETF. On top of that Paulson bought 2.6% of Gold Fields, 4.4% of Kinross, and 11.3% of AngloGold Ashanti.

Exchange Traded Funds (ETFs)

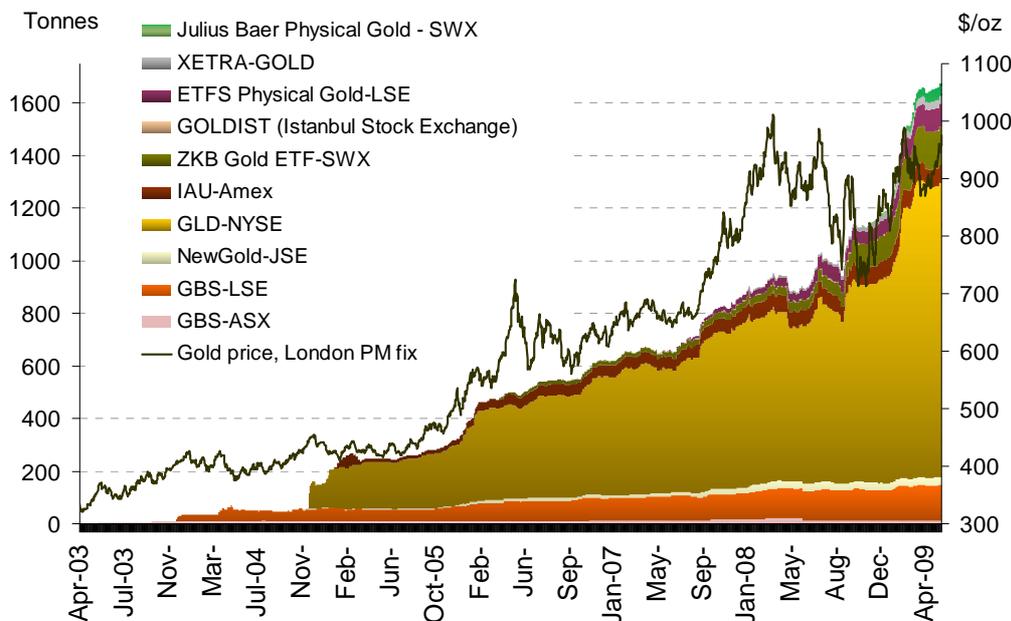
Enormous demand for gold ETFs

Due to the market turbulence the inflow into gold ETFs covered by physical gold was enormous in 2008, amounting to a total of 318 tonnes. At the end of 2008, gold ETFs were holding 1,190 tonnes (+37%). During the historically volatile and turbulent trading days around the collapse of Lehman Brothers (11 September to 16 October), ETFs bought 188 tonnes of gold. This trend seems to have accelerated in 2009.

"Buying the dip" approach of ETFs smoothes the demand side

Spider Gold Trust now holds more than 1,100 tonnes of gold, which is more than the holdings of the Swiss central bank. The first quarter 2009 alone saw a level of purchases that was 15 times higher than that of the referential period of 2008. The positive aspect is the fact that ETF transactions are not subject to any seasonality (as opposed to jewellery demand). The rationale seems to be "buying the dip", which has a smoothing effect on the strong seasonality caused by Indian jewellery demand.

Gold ETF: holdings in tonnes



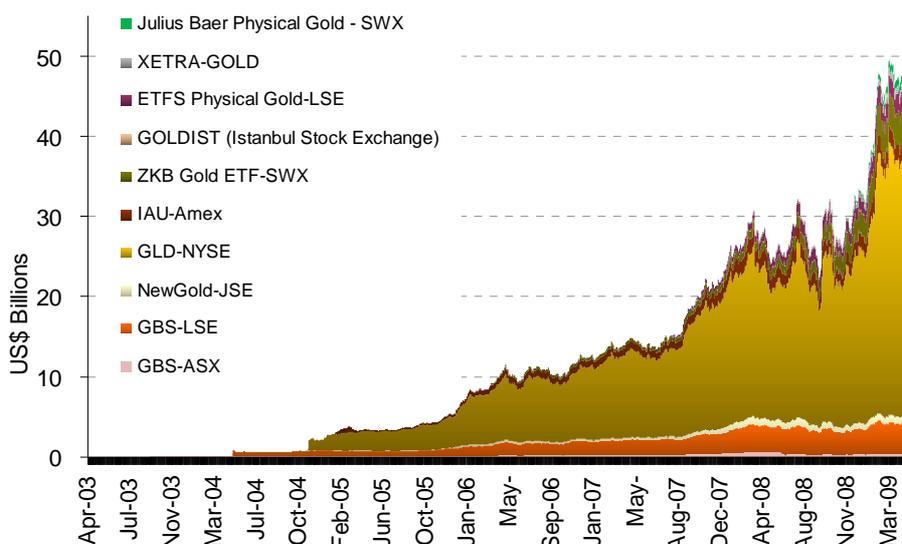
Sources: www.ishares.com; www.exchangetradedgold.com; www.etfsecurities.com; Zurich Kantonalbank; www.Deutsche-Boerse.com; www.juliusbaer.com; Global Insight
 Chart: World Gold Council, www.gold.org
 World Gold Council, www.gold.org

The aggregate volume of all ETFs totals USD 50bn at the moment. In relative terms, this seems rather small. USD 50bn equals about a quarter of the market capitalisation of companies such as Wal Mart or Microsoft, or exactly the one of Research in Motion¹⁰. This means that this is by no means a "gold bubble".

¹⁰ Prices as of 10 June 2009

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Gold ETF holdings: value in USD bn



Sources: www.ishares.com; www.exchangetradedgold.com; www.ETFsecurities.com; Zurich Kantonalbank; *Finans Portföy*; www.Deutsche-Boerse.com; www.juliusbaer.com; *Global Insight*
Chart: World Gold Council, www.gold.org
World Gold Council, www.gold.org

We regard the massive demand for ETFs mainly positive since it helps the gold price stabilise, given that ETFs are mainly bought as part of a buy-and-hold strategy. So far the downward phases of the gold price have never seen anything like an ETF sell-off.

Coins

The sales of US Mint increased by 78% in 2008. Silver investors went on a buying spree as well, they bought a total of 19.9mn ounces (+98%). This is even more remarkable since many products were sold out or rationed during the year and the premiums as well as prices increased to record highs. Sales posted a particularly strong rise in the fourth quarter. The Australian mint Perth Mint reported an increase of 194% in comparison with the referential period of 2008. In Austria 22.7 tonnes were sold in the first quarter of 2009 as compared to 1.9 tonnes in the first quarter of 2008.

Gold lease / Backwardation

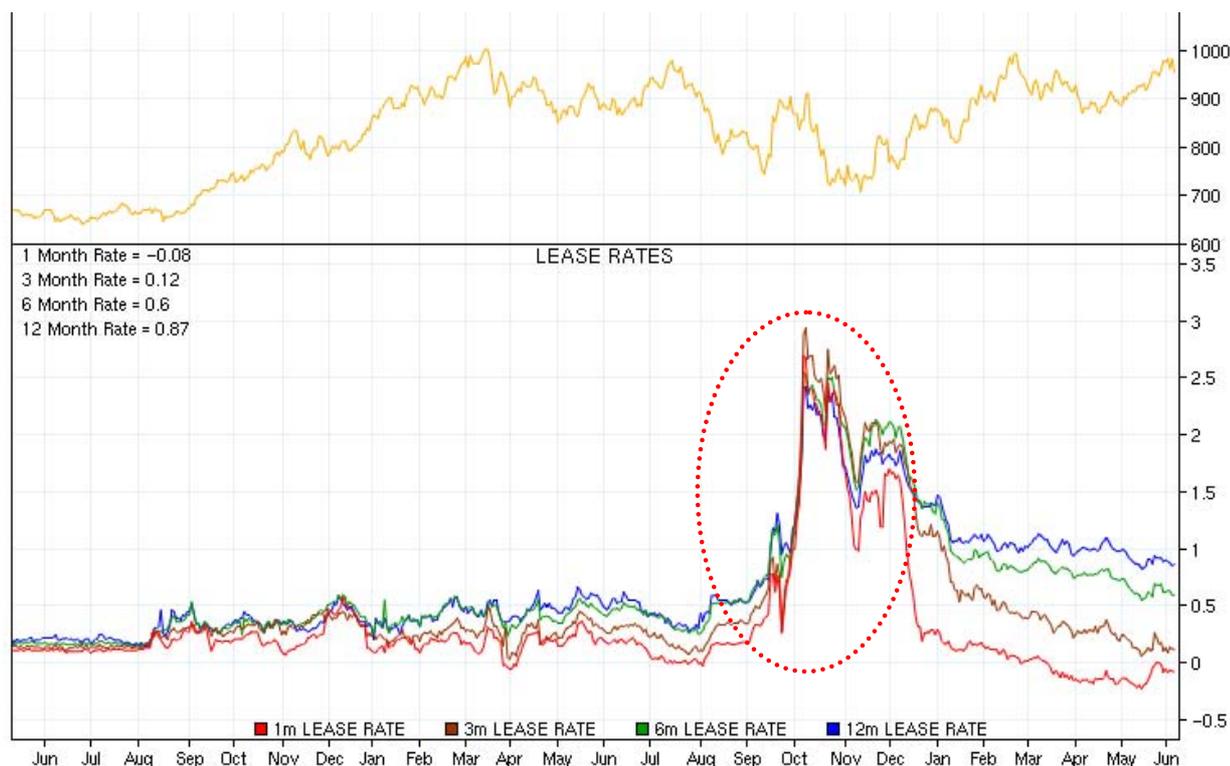
Naked short selling by the central banks?

In September/October 2008 the leasing rates for gold increased to 3%. This rise was due to the central banks' unwillingness to enter into short-term lease contracts. According to GATA, the volume of leased central bank gold amounts to anything between 12,000 and 15,000 tonnes. This is equal to half of the total holdings or six times the annual production.

Central banks lend the gold to banks that in turn lease it out to hedge funds or mining companies and put the proceeds in investments with better yields. To this extent, the term "naked short selling" may be more applicable to these business practices. In the event of a sharp rise in prices, short covering may occur and lead to exploding price increases.

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Lease rates



Backwardation signals strained supply situation

Besides, the forward markets were focusing on short-term backwardation. This means that the current contracts are traded at a premium to contracts with later dates of delivery. The market therefore sends a signal according to which demand experiences a sudden increase and it makes no economic sense to bet on a later delivery date, seeing that the costs of storage, financing, and insurance would be higher at a later stage. This scenario occurred for the first time on 2 December, when gold was traded at a 2% spot premium on the nearest future with a delivery date of 31 December. Backwardation is a clear indicator of supply problems, but it is not uncommon on the commodity markets. The copper market was in backwardation 10 out of the past 20 years. Given that gold is stored and not consumed, it is usually traded in contango.

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Gold mining shares

Gold shares on historically low valuation levels

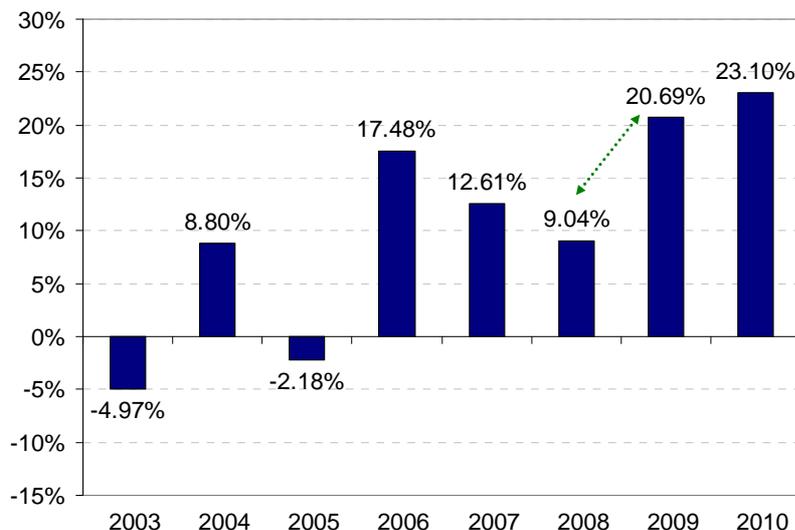
The gold sector will be one of the few industries to be reporting earnings growth and higher margins in 2009. The ratio of the price of gold to gold mining shares is currently two standard deviations outside the trend, which means that we can expect gold shares to outperform gold, not the least supported by the general tendency towards the mean value. Gold mining shares have recently displayed relative strength in relation to the gold price, but also to many other sectors. We consider this a reliable leading indicator. In comparison with their historic valuations, gold shares currently price in a gold price of USD 825/ounce, which means that they are still on extremely attractive valuation levels.

At the end of the 1970s, beginning of the 1980s, the market capitalisation of the entire gold mining sector accounted for about 25% of the overall market. But at the moment, the market capitalisation of the Amex Gold Bugs index is a mere USD 168bn, which is roughly equal to the market capitalisation of Google.¹¹

Significant fall in production costs make a case for gold mining shares

The turbulences on the commodity markets and the strength of the US dollar have triggered a significant fall in cash costs. Energy, chemicals (primarily caustics such as sulphuric acid) and steel are the largest cost factors, together with staff costs. Diesel prices have slumped by almost 60% since their high in July 2008, and the costs of equipment such as mills or excavators have fallen by 25%. Therefore input costs for gold producers have decreased to the level of 2006. Costs have come down from their high in mid-2008 by 20-25%. Cash costs should fall by almost 20% in 2009, with open-pit projects coming out as main beneficiaries.

Amex Gold Bugs Index: net margins 2003-2010e



Sources: JCF Factset, Erste Group Research

¹¹ Market capitalisation as of 10 June 2009; share price: USD 439

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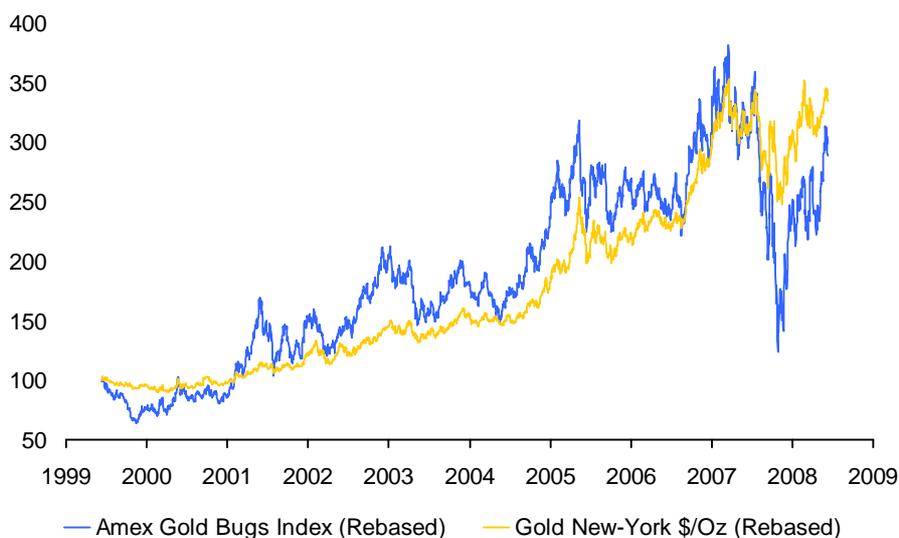
Based on these facts, Erste Group has modeled a basket-certificate of goldmining shares (ISIN: AT0000A0DY51)¹² containing stocks that should be main beneficiaries of that development:

Gold Basket	
ISIN-Code	Company
CA0084741085	AGNICO EAGLE
CA0115271086	ALAMOS GOLD
CA1520061021	CENTERRA GOLD
CA2506691088	DETOUR GOLD CORP
CA2849021035	ELDORADO GOLD
CA3809564097	GOLDCORP
CA36467T1066	GAMMON GOLD
CA3901241057	GREAT BASIN GLD
CA6882781009	OSISKO MINING
CA7562971076	RED BACK MINING
CA98462Y1007	YAMANA GOLD INC

Gold mining shares vs. gold since 2000

The disappointing performance of shares vis-à-vis gold results from the sharp increase in input costs during the same period. Companies only managed to boost earnings and cash flows marginally in spite of the gold price going from strength to strength. Also, shares suffer from enormous competition from ETFs, because the investor is not exposed to any operational risk in the case of these funds.

Amex Gold Bugs vs. gold since 2000



Source: Factset

Conclusion

We envisage substantially lower operating costs and therefore rising margins for the gold mining companies in 2009, and we expect them to clearly outperform the gold price. The best performance should be coming from those companies that have presented positive feasibility studies with prices based on peak costs of around mid-2008. M&A activities have recently picked up again. Due to the massive capital increases of the senior and mid-tier producers we expect the sector consolidation to be prolonged.

¹² Website for notices: www.products.erstegroup.com

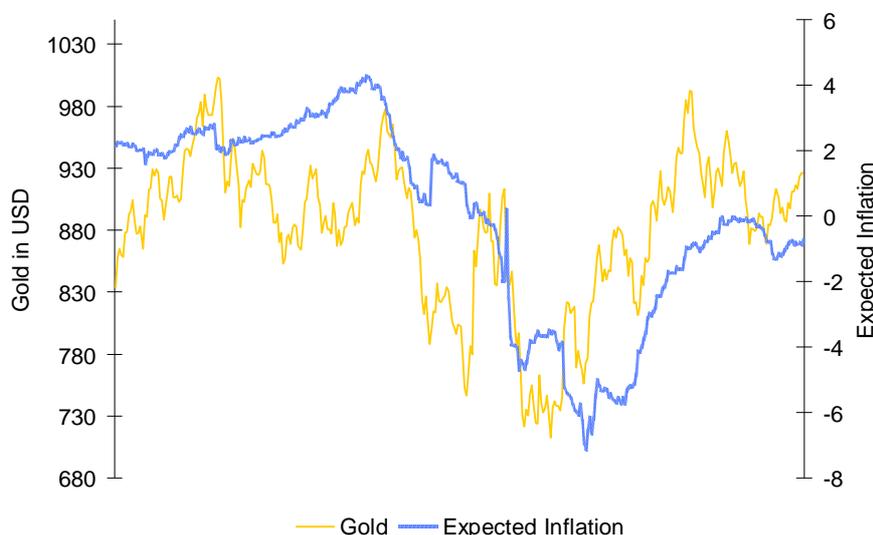
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Is gold pricing in the coming inflation?

Falling rates of inflation as result of the base effect

Although the inflation rate has been on a clear decline, a substantial part of this movement is due to the statistical base effect (as a consequence of the drastically fallen oil price). The development of the gold price is strongly correlated with inflation as soon as inflation hits extreme levels. The monthly correlation coefficient of gold and the rate of inflation has been 0.48 from 1971 to 2009. In the period of high inflation from 1978 to 1982, it was 0.76. When the rate of inflation was climbing to new highs in the USA and Europe at the end of the 1970s, so did the gold price. A similar phenomenon occurred during WWI and WWII and in the Weimar Republic. From 1914 to 1918, the German money supply soared from 8.5bn to 55bn Reichsmark, which paved the way for hyperinflation of historic dimensions. The gold standard is proven to offer the best protection against inflation: annual inflation from 1879 to 1914 was 0.2% at a volatility of only 2.2%. Since 1971, volatility has been 2.8%, with average inflation at 4.6%.

Gold vs. expected inflation



Source: Datastream

Hyper-inflationary discussion of hyperinflation

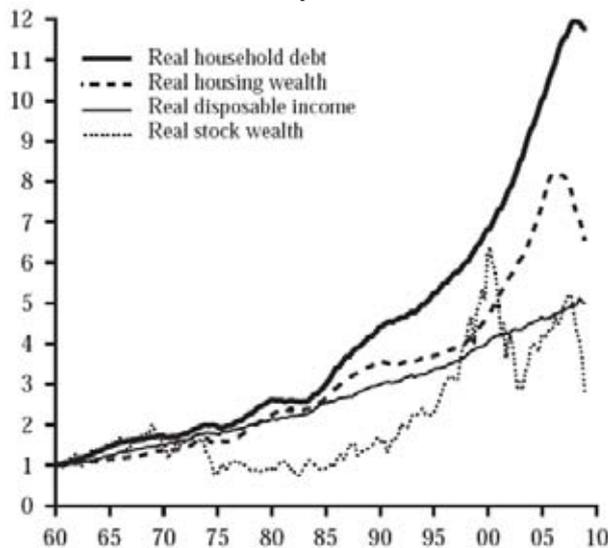
Risk of inflation is created as soon as the economy recovers, while monetary policy remains too loose and capacity utilisation rises. The media indulge in discussions of the often quoted fear of hyperinflation, but we consider this a negligible counter indicator – as a comparison with the 1950s would support: at the end of WWII, US debt had increased to 120% in terms of GDP, but it was reduced to 30% within 30 years without having to resort to hyperinflation. We expect that the actions taken by the central banks, which were of historic dimensions, will ultimately lead to inflation; gold should be one of the main beneficiaries of this scenario.

Excessive debt wherever you go

In comparison with 1980, the US budget deficit has increased almost tenfold from USD 1.3 trillion to USD 13.8 trillion (+946.6%). At the same time, public debt soared from USD 667bn to USD 6.36 trillion, i.e. 852%, or almost 30% per year. The problem of excessive debt seems to permeate all levels and areas. In the mid-80s, the ratio of household debt to disposable income was at 65%. By 2007 this ratio had increased to 133%. The dramatic rise in debt was accompanied by a sharp decline in the savings ratio. This combination led to a situation where consumer spending increased much more significantly than disposable income, which in turn fuelled US consumption. According to cardweb.com the average American holds nine different credit cards. Current aggregate credit card debt amounts to USD 850bn – sharply up from USD 200bn in 1990. Average debt per household is currently almost USD 9,000. Obviously this area is still in need of significant de-leveraging – a painful process that will probably take years.

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Excessive debt also in private households

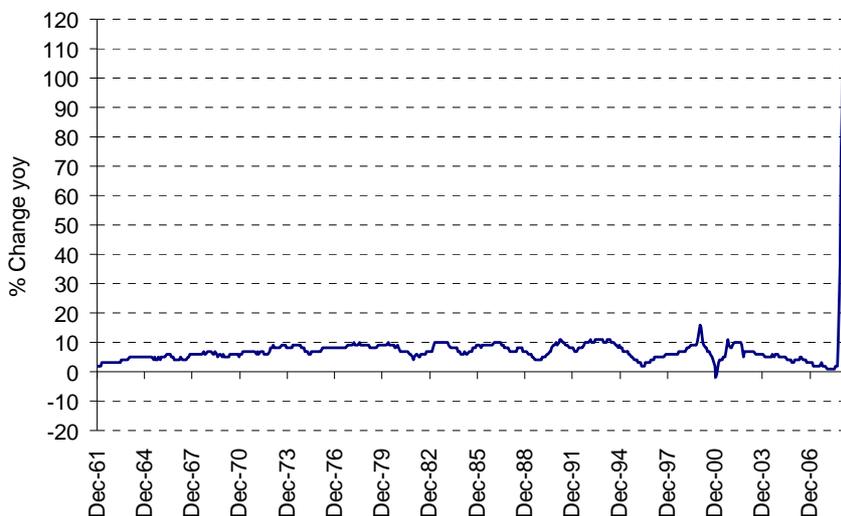


Source: www.frbsf.org

Estimates put the US budget deficit 2009 to USD 1.84 trillion, or 12.9% of GDP. The 2010 budget allows for a deficit of USD 1.26bn; however, one of the premises of this figure is a massive economic recovery.

It is not like the money supply has only recently embarked on a growth path; in fact it has been growing for years by more than GDP growth would have justified. Since 2000, the money supply has more than doubled in terms of GDP. If 25% of the US money supply M2 were to be covered by gold, this would lead to a fictitious gold price of USD 7,000/ounce.

US MONETARY BASE



Source: Federal Reserve St. Louis

The perfect storm?

The perfect setting for the gold price would be a continued weak economy in connection with desperate stimulus measures by the central banks and governments, where the measures all of a sudden worked out and the economy picked up momentum rapidly before central bank could withdraw the excess liquidity. Actually the central banks should try to reduce the money supply in good time and quickly as soon as the first signs of an imminent end of the recession are coming through. While this may not be a technical problem, it could meet with massive political resistance, given that unemployment would still be high at that stage.

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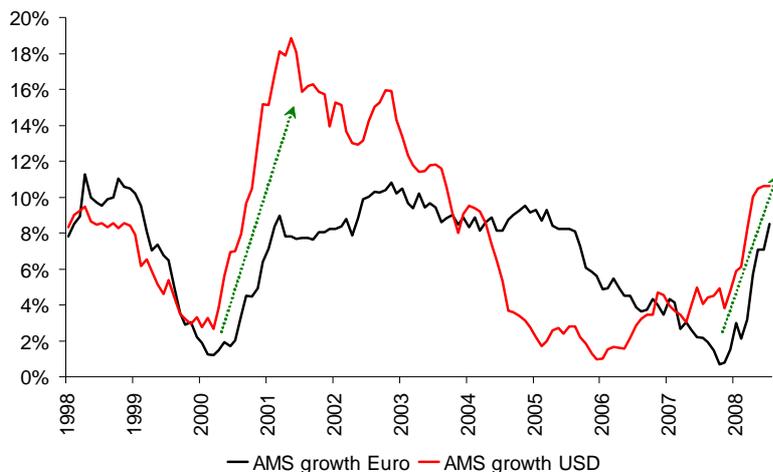
Excursus

Money supply development according to the Austrian School of Economics

Massive expansion of money supply as basis for the gold bull run?

Based on the definition of money supply according to the Austrian School of Economics (hereinafter referred to as AMS for Austrian Money Supply), the money supply has recorded a considerable increase both in US dollar and in euro since autumn 2008. The AMS has a very narrow definition and contains only cash and cash-like instruments such as demand deposits and savings deposits.

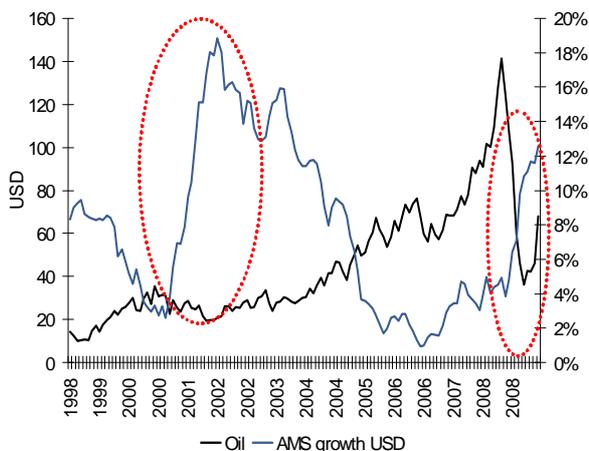
AMS growth US dollar vs. euro 10/1998 – 04/2009



Sources: Erste Group calculations, Fed. St. Louis, ECB

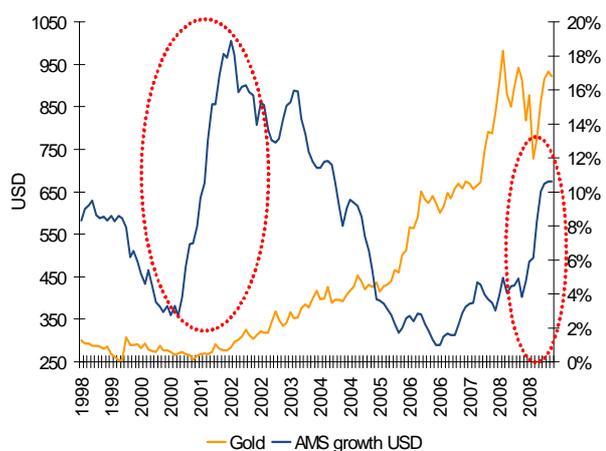
The comparison of US dollar and the Eurozone shows that AMS denominated in US dollar was substantially outgrowing the one in euro in the period of 2000 to 2005. The growth rates in the Eurozone, on the other hand, were less substantial but remained constant above 10% over a longer period of time. In view of the continued expansive monetary policy of the US Fed and the ECB we do not expect AMS growth to slow down in the foreseeable future.

Gold price vs. USD AMS growth



Sources: Erste Group calculations, Fed. St. Louis

Oil price vs. USD AMS growth

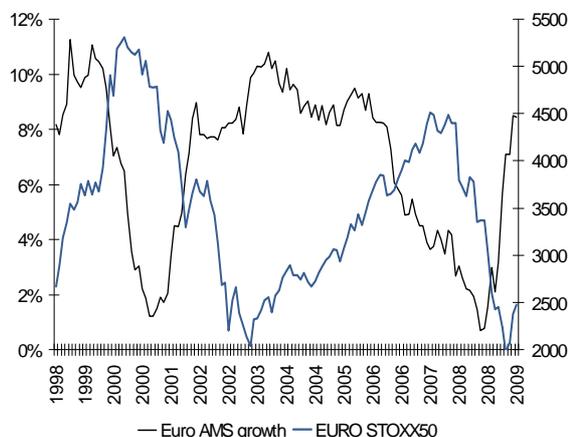


Similar to the bursting of the dotcom bubble in March 2000, AMS growth has been picking up substantially since autumn 2008. Among the beneficiaries of the relatively strong growth of AMS that tends to come in waves have been the oil price as well as the gold price. It is worth

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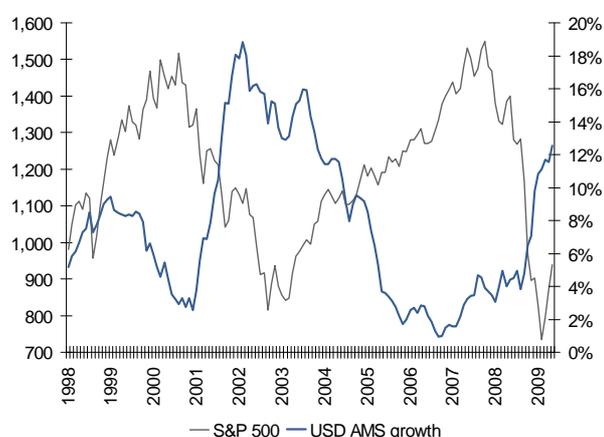
taking note of the fact that gold, in contrast to oil, did not react negatively to the subdued growth rates of money supply from 2005 to autumn 2008. AMS growth has also shown a significant correlation to equities (as reflected by the most important equity indices) over the past ten years.

EUROSTOXX 50 vs. euro AMS growth



Sources: Erste Group calculations, ECB, Reuters

S&P 500 vs. USD AMS growth



Sources: Erste Group calculations, Fed. St. Louis, Reuters

The charts underline the fact that gold has been the only asset class to preserve the growth of money supply in the past ten years. Whereas the most important equity indices and the oil price reacted to the slower growth of money supply with losses at some stage, the gold price would remain stable.

Excursus: the Austrian School of Economics. The Austrian School of Economic was founded in the 19th century by Carl Menger. Man, with all his strengths and weaknesses, is the focus of the analysis of the Austrian School of Economics (“subjectivist analysis”). The Austrian School categorically rejects simplifications that are not supported by empirical evidence in terms of real actions of human beings. Also, this branch of economics is not fond of mathematical models and rather stresses the dynamic aspect of economic processes. Ludwig von Mises, very much ahead of his time 70 years ago, called the concept of homo oeconomicus a fiction and pointed out that any sort of models that were based on this concept would necessarily yield wrong results. Eugen Böhm-Bawerk amended the basic ideas of Carl Menger by a comprehensive theory on capital. Ludwig von Mises und Friedrich Hayek eventually expanded the basis of the Austrian School and acquainted the Anglo-Saxon world with its teachings. Friedrich von Hayek was one of the most pointed critics of J.M. Keynes and addressed crucial errors and unacceptable simplifications in Keynes’ works as early as in the 1930s. Probably due to a lack of lobbying and its rejection of any form of centralised control of economic issues by governmental institutions, the Austrian School of Economics ended up falling into oblivion. Which is of course a shame, because the theories of the Austrian School could cast an interesting light on the current global economic crisis.

Gerald Walek, CFA

End of Excursus

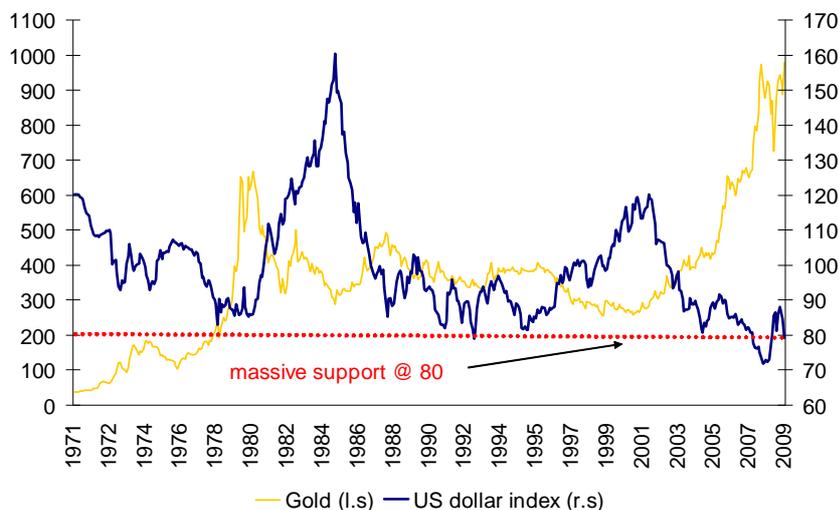
Gold will continue to benefit from dollar diversification

Oil-producing nations are in constant and massive need of hedging their revenues against a falling US dollar. Saudi Arabia even expects a budget deficit in 2009, which it intends to cut by selling off assets denominated in US dollar. Russia has already disposed of 20% of its dollar reserves, which total USD 600bn. State funds are also increasingly eager to diversify out of the US dollar. The state fund of Abu Dhabi announced it would reduce its exposure of dollar-denominated investments from 80% to 60%. And SAFE (China State Administration of Foreign

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Exchange) is increasingly on the look-out for investment targets in Europe and Africa. The Qatar Investment Authority has made statements along the same lines.

USD index vs. gold



Sources: Bloomberg, Erste Group Research

A new gold standard?

One idea that was completely unthinkable a few years ago has been raising its profile recently. A new gold standard has been demanded by many so as to thwart the consequences of the excessive growth in money supply. If the balance sheet total of the Federal Reserve (M0) of almost USD 1.7 trillion were to be covered by the official gold reserves of 8,134 tonnes, one ounce of gold would be valued at USD 6,500. Including Japan and China – i.e. the world's second and third-largest economies – would push the price to almost USD 10,000/ounce.

The first gold coins in history were minted under King Croesus 600 B.C., and they were made official legal tender. Gold has all the essential characteristics that a currency should have: it is divisible at the holder's discretion, is the only financial asset that is not contingent on the promise of another party, is easily transportable, has a high inner value per unit, is standardised, globally accepted and negotiable, scarce, difficult to destroy, and it is accumulated and not consumed.

Gold = cash

Currencies covered by gold also seem to contribute significantly to economic, political, and social stability. Many eras in history (the Roman Empire, the Republic of Venice) maintained stable prices over centuries, and it was only when the content of precious metal in the coins was reduced that the respective societies started to falter. For example, the standard of the Roman denarius coin fell from almost 97% to about 2% within 300 years.¹³

Gold = stability

However, we do not expect a new gold standard to find the necessary political backing, given that that system would only allow minor levels of new debt. On the other hand, over the past few months we have seen a lot of things happen that many would have considered utopian and completely inconceivable. Therefore we cannot fully exclude the introduction of a new gold standard.

"In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value. If there were, the government would have to make its holding illegal, as was done in the case of gold." Alan Greenspan, "Gold and Economic Freedom", 1966.

¹³ Geld und Inflation – Die Sicht der Wiener Schule, Mag. Gregor Hochreiter

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Is the gold price subject to manipulation?

The intraday movements have been showing an unusual pattern for many years now. In the early hours of Asian trading, the gold price tends to go up. Conversely, the afternoon fixing in London tends to trigger a downhill ride, which finds itself offset only partially in the New York session. The extreme concentration of futures positions seems particular as well: currently¹⁴ three US banks are positioned net-short to the tune of 12.3mn ounces. This is equal to more than 15% of global production.

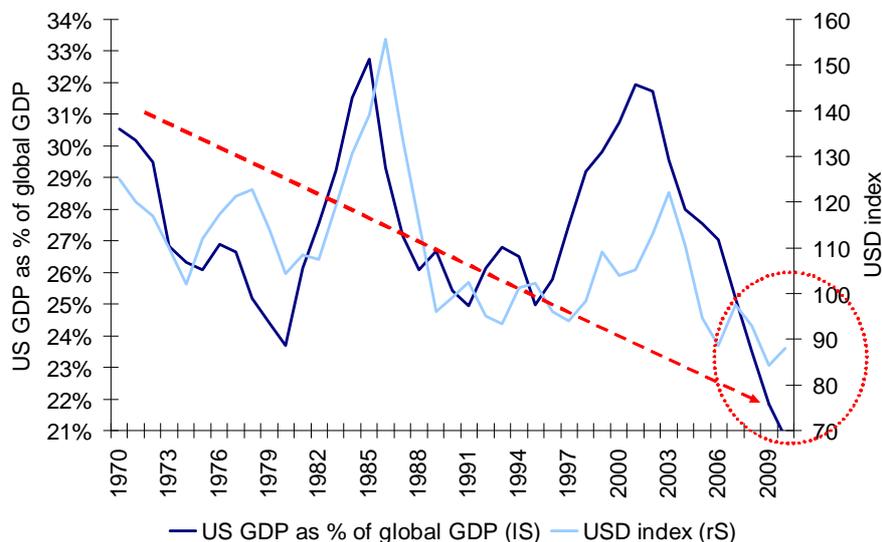
In a speech in July 1998 **Alan Greenspan** addressed this context, saying that “central banks stand ready to lease gold in increasing quantities should the price rise.”¹⁵ The article “Gibson’s Paradox and the Gold Standard” by **Lawrence Summers**, currently chairman of the economic advisory board of President Obama, is another example. In this article, Summers explains the connection between low key lending rates and the gold price. **Paul Volcker**, former chairman of the Federal Reserve (1979 to 1983) and currently member of the economic advisory staff of President Barack Obama, pointed out, “Joint intervention in gold sales to prevent a steep rise in the price of gold, however was not undertaken. That was a mistake”¹⁶. And **James Mofett**, CEO of Freeport-McMoRan said, “The central banks are the OPEC of gold. They will control the price of gold by selling until they change their minds”.

Gold in the context of a new world currency?

US dollar is losing its influence slowly but steadily

Even if there have been periods in the past when both gold and the US dollar were rising (e.g. in 2003 or 2005), this scenario remains the exception to the rule. This is why we believe that the negative correlation should arise again this year again. The USA is of course well aware of the dwindling importance of its currency. In the 1970s, some 90% of global trade was invoiced in USD, whereas today this share has fallen to 55%. The following graph underlines the high correlation of global economic output with the development of the US dollar:

USD index vs. US share in total global economic output:



Sources: IMF, Datastream, Bloomberg

“The dollar is our currency but your problem”

As a result of the strongly expansive central bank policy and the massive public debt, worldwide foreign exchange reserves have increased 14-fold in the years 1980 to 2008. They soared from USD 350bn to more than USD 5,200bn. Nowadays, 75% of all dollar reserves are

14 Bank Participation Report, May 2009

15 <http://www.federalreserve.gov/boarddocs/testimony/1998/19980724.htm>

16 Wall Street Memoir, Paul A. Volcker and Henry Kaufman

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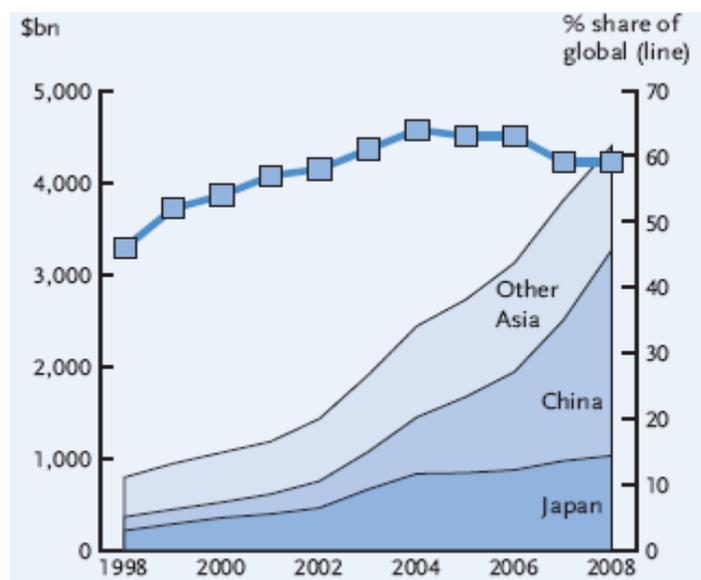
held outside of the USA. "The dollar is our currency but your problem", as Richard Connally, Secretary of the Treasury under President Richard Nixon, put it very fittingly.

Increasing internationalisation of the yuan heralding a new global currency?

On Christmas Eve Chinese officials announced that China intended to further internationalise the yuan. This will make it possible to settle international trade transactions in yuan for the first time. In the event, Brazil and China announced they were going to settle their transactions only in renminbi and real, respectively. This goes beyond even the bilateral currency swaps with Argentina. Swap agreements totalling USD 130bn have been signed in the past five months; among the partners to these agreements were countries such as Argentina, Brazil, Indonesia, Malaysia, Byelorussia, and South Korea. China wants to invoice 50% of all transactions with Hong Kong in yuan by the year 2010. On top of that, China entered into barter agreements with Russia. Russians will guarantee China energy supplies for the next 20 years in return for a loan of USD 25bn. China also announced it would introduce rouble-yuan currency swaps, highlighting its efforts of gradually establishing the yuan as global currency.

China therefore tries to swap soft dollars for hard commodities step by step. In his speech "Reform the international monetary system" of March 2009¹⁷, Zhou Xiaochuan, governor of the Chinese central bank, also expressed his appreciation for the so-called "bancor". This is a global currency proposed by John Maynard Keynes that is linked to gold and to a broadly diversified basket of commodities. Keynes had declared himself against a pure gold standard, the rationale being that a broadly diversified commodity basket could balance out a disequilibrium more easily. Seeing that Keynesian economic policies are becoming more important again, maybe this idea should be taken seriously as well.

Asian currency reserves



Source: IFSL

China is quite obviously trying to step up its strategic commodity reserves by a massive degree in order to reduce its dependence on the US dollar. This would also come with numerous positive side effects. It would defuse the appreciation pressure of the yuan without any accusation of currency manipulation coming up. Supply shortages would be alleviated, which would fit the long-term strategic plan of the communist government.

Gulf states are planning a currency union

The Gulf region is slowly but surely trying to shift out of the dollar. The four Gulf states, Saudi Arabia, Kuwait, Qatar, and Bahrain have finalised an agreement on setting up a currency union modelled on the Eurozone. The United Arab Emirates and Oman abandoned the project,

¹⁷ <http://www.pbc.gov.cn/english/detail.asp?col=6500&id=178>

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unhappy as they were after the decision had been taken that the common central bank would be based in Riyadh. The introduction of common banknotes and coins is already scheduled for 2010.

A new Bretton Woods?

The world leaders demanded surprisingly radical steps at the Global Economic Summit and at the World Economic Forum in Davos. Gordon Brown for example mentioned a new global financial order that would involve a new Bretton Woods. The French Prime Minister Sarkozy was addressing the complete re-evaluation of the global financial system and said it was time to change the rules of the game, very much like in the days of Bretton Woods. Prime Minister Putin pointed out that the massive dependence on the US dollar was associated with extreme risks.

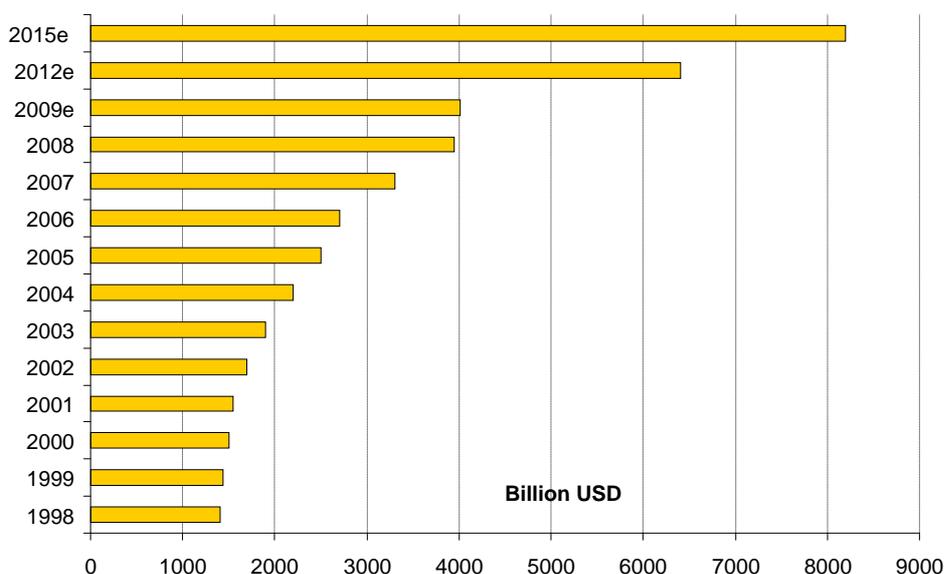
Gold re-(e)valuation imminent?

At a conference in St. Petersburg the discussion about substituting the dollar was substantiated further. The IMF was optimistic it would be able to establish special drawing rights as new world currency¹⁸. According to the IMF 70% of all currency reserves are denominated in US dollar. And the Russian President Medvedev has also increasingly questioned the role of the US dollar as global reserve currency. He said he expected a re-evaluation of gold within the context of the currency system; he did, however, exclude a new gold standard.

The situation reminds us of a similar dilemma of the French in the 1920s. France found itself in the "sterling trap", as they tried to get rid of their massive currency reserves, without causing a massive collapse of the sterling and a huge loss on their holdings.

Nevertheless, the US dollar will not be deserted over night; but the above-cited statements would indicate that the days of the greenback are numbered.

State funds: volume in USD bn



Sources: websites of the respective state funds, Erste Group Research

18 <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aUYeJEwZaQrw>

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Country	Name	Assets in bln USD
United Arab Emirates	Abu Dhabi Investment	875
Saudi Arabia	SAMA	433
Singapore	Government of Singapore Investment	330
China	Sage Investment	312
Norway	Government Pension Fund of Norway	301
Kuwait	Kuwait Investment Authority	265
Russia	National Welfare Fund	225
China	China Investment Corp.	200
Hong Kong	Hong Kong Monetary Investment	173
Singapore	Temasek	134

Sources: Bloomberg, SWF Institute, home pages, data as of end-2008

Recessions are no positive environment for gold

Contrary to the general opinion on the market, recessions are no optimal environment for rising gold prices. During the past eleven recessions in the USA the average performance of gold was +4.8%, whereas the Dow Jones index gained 6.87% in the same period of time¹⁹. In periods of growth the average performance was +51.95% (since 1945) against 75% of the Dow Jones Industrial index. This would prompt the conclusion that the measures taken during the downturn, especially those of monetary and fiscal nature, lay a positive foundation for the gold price, but that the price only rises once the economic situation has improved.

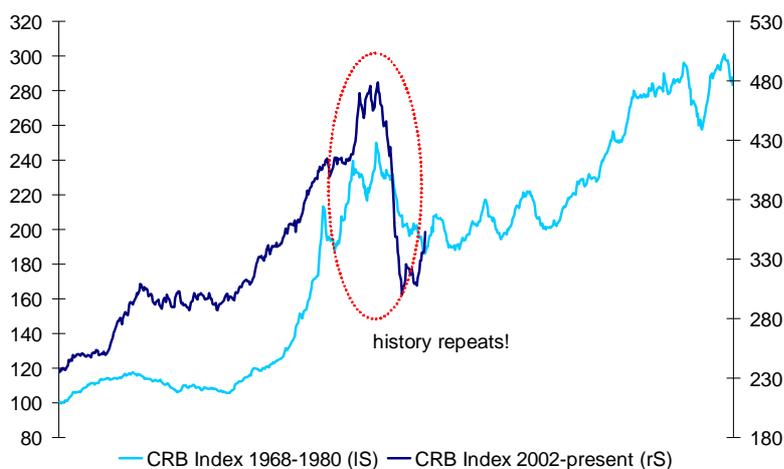
History repeats itself: 2009 = 1974?

"Nothing new ever happens. It is always the same old stories experienced by new people."
William Faulkner

Gold is still in the early stages of a bull market

Numerous aspects and features of the current situation remind us of the 1970s. The development of the CRB commodity index recorded a massive correction midway through the bull market in 1974, which was the starting point of the most dynamic part of the movement. We can see clear similarities to the current market scenario.

Comparison CRB index 1968 to 1980 and 2002 to date



Sources: Erste Group Research, Datastream

¹⁹ Robert Prechter on Gold & Silver, Elliott Wave International

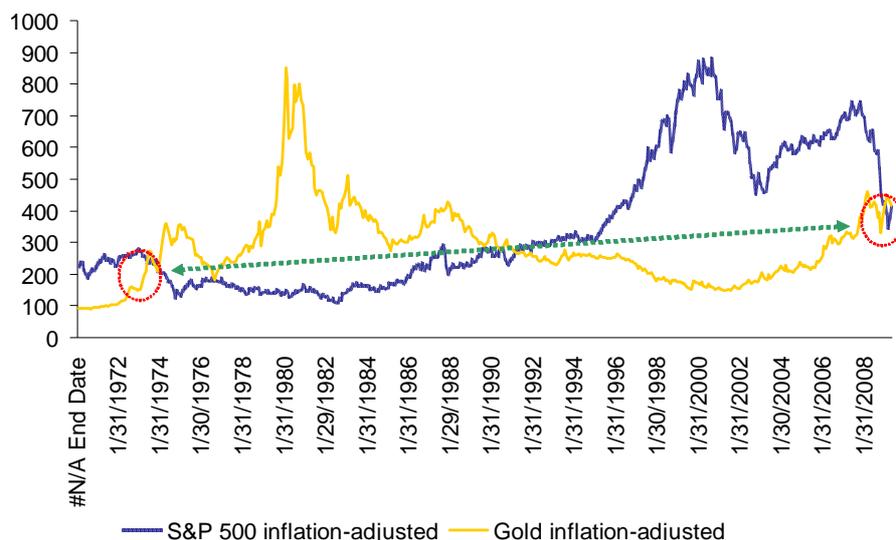
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An era of rising oil prices and the generous policy of the Federal Reserve were creating a positive environment for commodities until in February 1974 a massive correction hit the markets. But in July 1975, an intense fear of inflation, a weaker US dollar, and a looser central bank policy fuelled the second phase of the commodity bull market. Back then, the world was also characterised by a lack of trust in paper money, and the rapidly rising money supply triggered a broad diversification to the commodity sector. Precious metals, energy, but also agricultural commodities were the most attractive asset class; there was a massive inflow into commodities both from institutional and retail investors. The current situation would appear to be similar, with the time for taking positions near-perfect after the correction. For the US the situation was still much brighter in the 70ies. The US was a prosperous country with a positive balance of payments and a savings rate was about 12 % of disposable income. In 2009 the US is by far the biggest debtor, posts record-high trade deficits and the private sector is overindebted.

Paradigm shift similar to 1974?

In autumn 2008 the price of one ounce of gold, in its upward movement, broke through the S&P 500 index for the first time since 1974. Back then the breakthrough was followed by a dynamic seven-year bull market, with the gold price increasing by almost 600%.

Gold vs. S&P 500 – both inflation-adjusted since 1970



Sources: Datastream, Erste Group Research

In the past, every reflation cycle has led to another asset bubble; in the 1970s it was a commodity bubble. Many an indicator would suggest that we are facing a similar situation as in 1974. Substantial supply shortages, growing risk aversion, a lack of trust in paper currencies, dramatically rising money supplies, and – sooner or later – a recovery of the global economic growth might lead to a similarly explosive development. This would mean that the rise with the biggest momentum were yet to come.

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Technical analysis

Ratio analysis

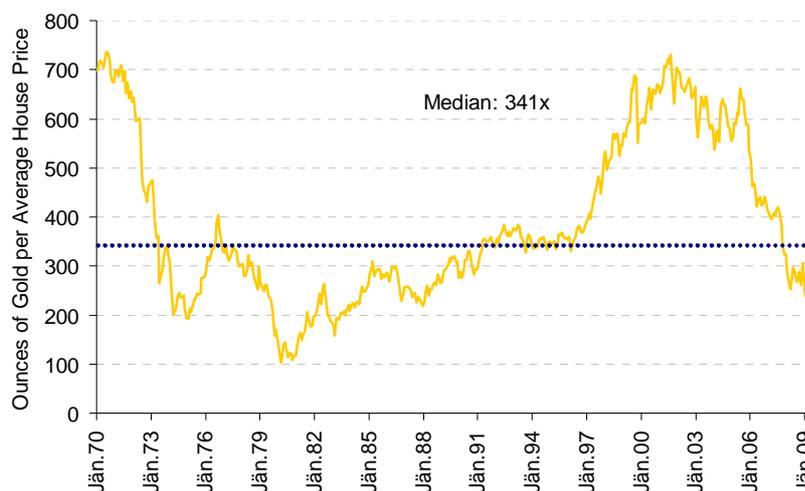
The analysis of long-term relationships between gold and other assets is supposed to help the investor see the current market situation from a new angle with a long-term horizon. The calculations are based on simple division.

1. Property/gold ratio

230 ounces of gold for a single-family home

The relation of an average single-family home and gold confirms the purchase power preservation impressively. Currently 230 ounces of gold would buy a single-family home; the 40-year median is 341 ounces. This means that property is currently cheap in relation to gold. At the end of the last gold rush, that number was down to 100. We regard such a development as realistic.

Property / gold ratio



Sources: Datastream, Erste Group Research

2. Gold/oil ratio

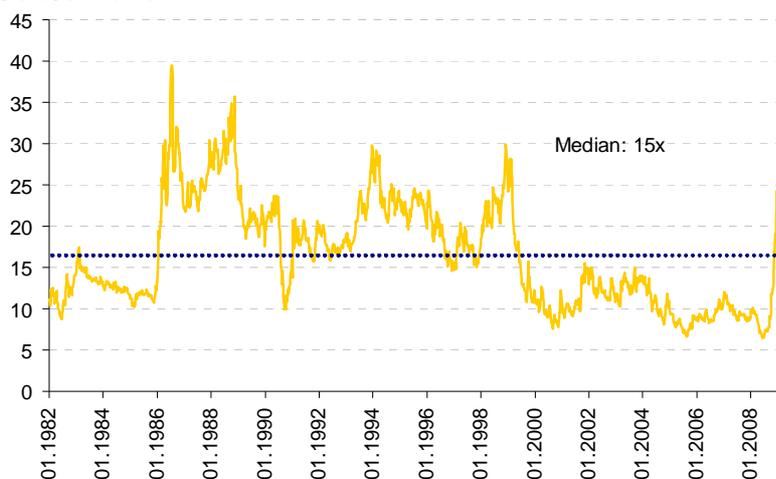
An increasing gold/oil ratio tends to go hand in hand with recessions and economic turbulences, whereas a falling ratio tends to indicate economic prosperity and stability. Oil and gold have a strong positive correlation, which is often explained by the need to protect one's assets from inflation. In addition, both commodities are traded in US dollar and tend to rise when the dollar depreciates against the most important currencies. Also, the peak oil argument, i.e. the fact that the point of maximum oil production has been reached or will soon be reached, is also applicable to gold (in analogy).

The ratio is currently 16 and thus only slightly above its historical median of 15. The ratio saw its low in summer 2008 at slightly below 6, and its high of almost 40 in 1987. This means that gold is currently fairly valued in relation to oil.

The stable purchase power of gold is also reflected in this ratio: one ounce of gold currently buys about the same amount of oil as it did in 1945, 1982, and 2000.

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Gold/oil ratio



Sources: Datastream, Erste Group Research

3. Gold/silver

The ratio is currently slightly below 70 and thus more than two standard deviations away from the historical average. As soon as first signs of an economic floor become visible, the ratio should improve in favour of silver, given that silver is mainly regarded as industrial metal, and less so as monetary asset.

Gold/silver ratio



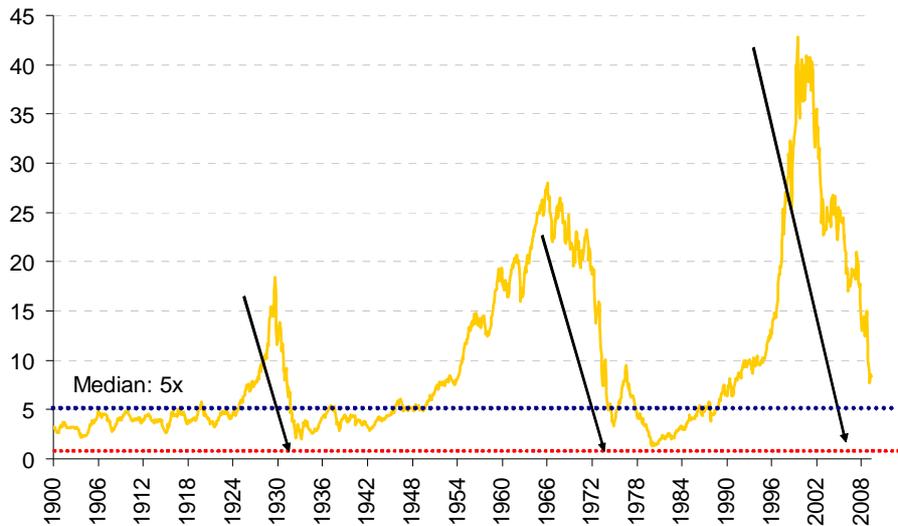
Sources: Datastream, Erste Group Research

4. Dow/gold ratio

The Dow Jones index was created in 1896 and, since it does not contain dividends, represents a good benchmark for gold, which does not pay interest or dividends either. In 1896 the ratio was 2. In other words, it took two ounces of gold to buy the entire Dow Jones index. In the following years the ratio was fluctuating in a narrow range before experiencing an intermediate high of 18 as a result of the stock exchange bull market. On the back of the Great Depression, the ratio quickly fell to 1, and it was only in 1965 that it reached a new high at 27. In the event, the oil crisis and the end of Bretton Woods triggered a new decrease to 1.5. In 2000, the ratio reached its all-time-high of 43.

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Dow/gold ratio



Sources: Datastream, Erste Group Research

Currently the ratio is at 8.3, the historical median is 5. This means that gold is still attractively valued in comparison with US shares, albeit not quite as attractively as in 2000. The Dow/gold ratio hit its lows in 1932 and 1979 at 1. Following this ratio, and assuming a stable Dow Jones index, gold would therefore have to increase to almost USD 8,300.

Technical Outlook

Gold should have found its support around USD 927 an ounce, which marks the 50 % retracement of its most recent rally (from 865 to 990). On the further downside, the 880 area, where the 40 and 80 week moving average converge, might be a major support. The next support should be at 850, which is the old all-time high of 1980. If the downstream support area of USD 833 - 845 (which is further supported by a Fibonacci level) were broken, the correction target would be USD 770. Lower support lines are situated at USD 730 and 710. Below that there is a massive support around USD 695 - 700. Even this kind of correction would not endanger the primary upward trend in place since 2001. Only a sustained fall below these supports would constitute a clear signal for a trend reversal and indicate the end of the current gold bull market.

Gold since 2007

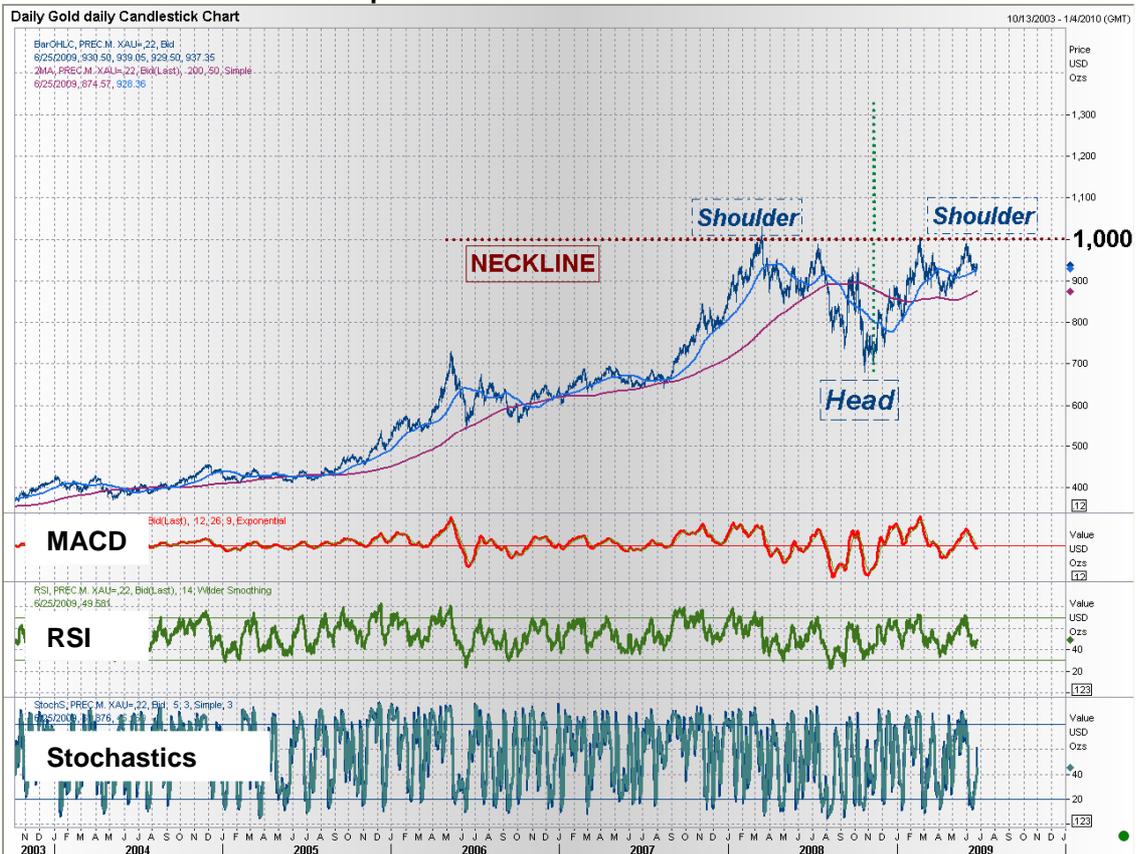


Sources: Datastream, Erste Group Research

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In the medium-term picture, the gold price is still hovering around the ominous value of USD 1,000. After the record high of March 2008 at USD 1,031 the yellow metal embarked on a consolidation phase while the base trend (in place since April 2001) was successfully tested at 770. A rise above USD 1,031 would correspond to a break of the neckline of the inverse shoulder-head-shoulder formation. This would trigger a sharp move higher, in which case the target price would be USD 1,300.

Inverse Head and Shoulders pattern



Source: Reuters, Erste Group Research

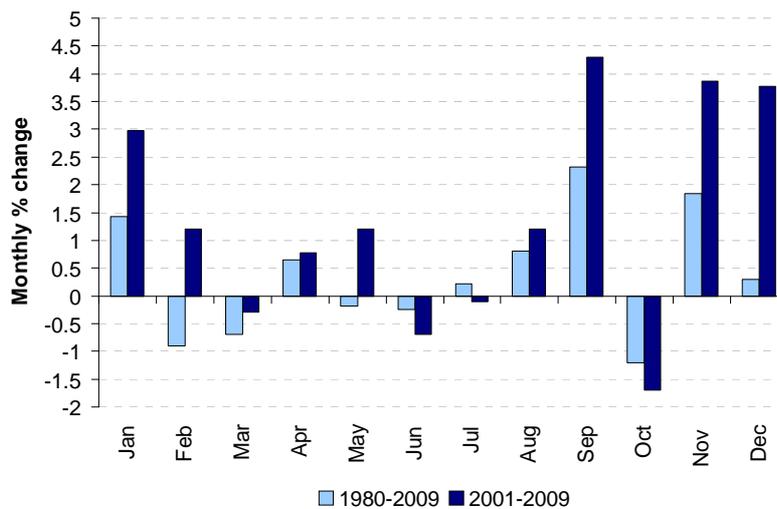
Seasonality

One reason for the most recent correction of the gold price is the pronounced seasonality of the price. Said seasonality is not the least due to the so-called wedding season as well as the Diwali Festival in India. Since people in India get married mainly in spring and autumn, the jewellery industry stocks up on material in the third and fourth quarter. The climax and end of the wedding season is May 7th, the day of the Akshaya Tritiya Festival. In addition, jewellers tend to stock up on gold for Christmas in the third and fourth quarter.

This is why the fourth and the first quarter show the best performance of the year. In the second quarter the price tends to correct significantly, and in the third quarter it would usually move sideways. This seasonality has been true for 75 to 80% of the cases.

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Average monthly % change 1980-2009 and 2001-2009



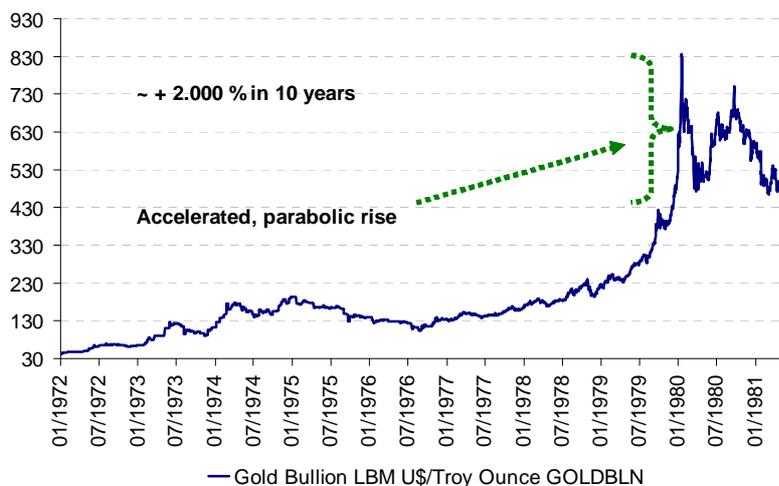
Sources: Datastream, Erste Group Research

The current vs. the last great bull market

At the beginning of 1980 the gold price experienced a rapid increase of more than 100% to its then all-time-high at USD 850/ounce. Shortly after, the price slumped as rapidly as it had increased by 30% and went into hibernation for 20 years. Will we get to see Highway 80 revisited?

In contrast to 1980, we have seen an increase in continuous steps since the turn of the millennium, which would suggest a lasting paradigm shift. In 1980, the increase was fuelled mainly by speculation, but today it is nurtured by a completely different set of motives and is essentially based on a structural supply/demand deficit. In addition, we have not experienced the “blow-off top” yet, i.e. a typical formation in the commodity segment resulting from a parabolic increase within a short period of time (similar to 1980).

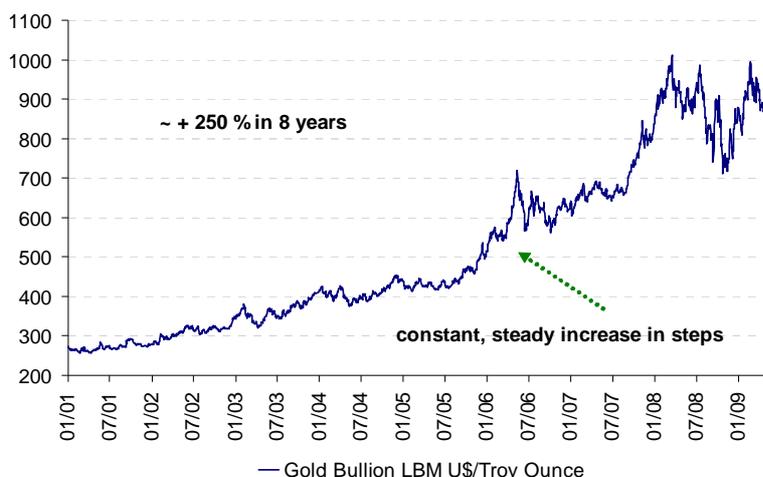
Gold 1972 – 1981



Sources: Datastream, Erste Group Research

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Gold 2001-2009



Sources: Datatream, Erste Group Research

Commitment of Traders (COT) indicates massive short concentration

The Commodity Futures Trading Commission (CFTC) publishes weekly information regarding long and short positions. The so-called Commitment of Traders (CoT) Report categorises market participants into three groups:

1) Commercial hedgers:

- Large traders using futures for hedging purposes (e.g. gold producers, jewellery manufacturers)
- Often called smart money because of their intricate knowledge of the fundamentals and opportunities
- Anti-cyclical trading
- Tend to identify turning points correctly

1) Large speculators:

- Mainly institutional investors (banks clearing houses, hedge funds)
- Take positions because of speculative interest
- Tend to be trend followers
- Often too late in the identification of turning points

2) Small speculators:

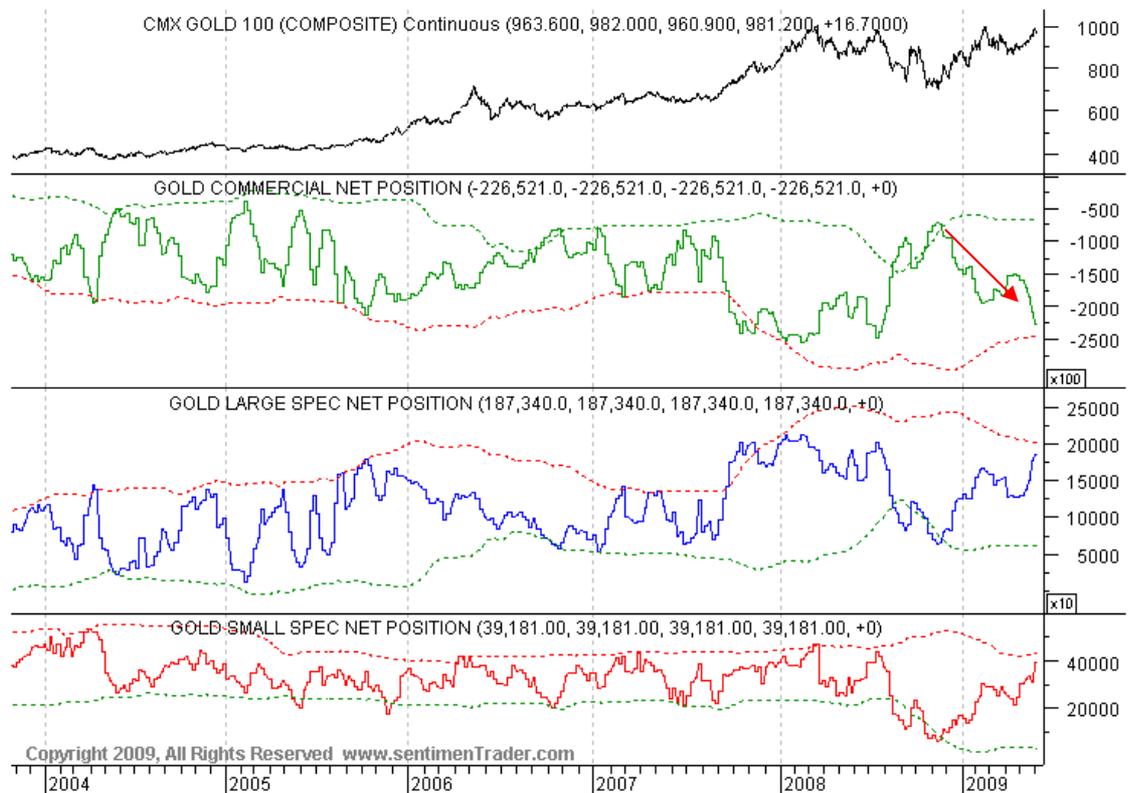
- Small traders
- Often referred to as dumb money
- Trend followers
- Good counter indicator in the case of extreme values

Traders like to observe the CoT data in their decision-making process, but they should not be the only criterion. Not the least as the CoT report contains only US futures markets and does not take into account other countries or OTC options. Nevertheless, the CoT is usually helpful for spotting low risk buying opportunities and high risk points.

The report of 2 June indicated a massive increase in long positions from speculators and short positions from commercials. And it was the concentration of the positions that was particularly worrisome. Both CoT and Bank Participation Report show that the short positions are held by

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only two US banks, and they amount to 123,000 contracts (i.e. 12.3mn ounces). The largest commercials currently hold 57.8% of the entire open interest net short. This is the most substantial short position in about a year. The silver situation is similarly extreme.



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Conclusion

How long can the gold cycle last?

More than ever, we consider the gold price in a secular upward trend, and we believe that we have only seen about half of the full swing so far – the most impulsive phase is yet to come. Commodity and precious metal cycles tend to take particularly long, at least 15 to 20 years. Given that the most recent bull market started only in 2001, we have only come through half of the cycle yet. **This would make our price target of USD 2,300 at the end of the cycle appear more realistic than ever.**

“Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria”, Sir John Templeton

We believe that we are currently still at the optimism stage, it is certainly too early to be talking about euphoria.

Negative factors:

- Clearly falling jewellery demand
- Recessions are basically no good environment for the gold price (the gold price gets stimulated at a later stage by the measures taken during the recession)
- Gold tends to be held as assets and cash of the last resort, which means it is liquidated in extreme financial situations. Given that more than 70% of jewellery are bought on the Indian subcontinent, the supply of recycled gold might continue to rise
- De-hedging is coming to an end
- The futures positions (CoT) would suggest a short-term correction

Positive aspects:

- The worldwide reflationary policy will continue for a while
- Global USD reserves are excessive, and the need to diversify is enormous
- De-facto zero interest policy in USA, Japan, and Europe
- Central banks have changed their attitude towards gold
- Supply still in long-term downward trend
- Investment demand will remain high, Wall Street has discovered gold
- Commodity cycle has a long way to go
- Geopolitical environment remains fragile
- China will increase its gold reserves

The ultimate currency?

In an environment that is dominated by the search for the “one-eyed king among the blind” gold should be able to retain its shining prospects. One could say that it is not gold that appreciates, but paper money that depreciates, i.e. more and more units of paper money will be required to buy an ounce of gold.

Gold is a soft metal, but a hard currency

The market is gradually rediscovering the monetary aspect of gold that has established and manifested itself over the past centuries. Gold and silver are the only accepted currencies that can neither be created nor controlled by central banks. Gold has been a symbol of value preservation, independence, and stability for centuries. This has shown yet again amid the current turbulences, and we expect this trend to hold over the coming years. The question of whether gold is becoming more expensive or the purchase power of paper currencies is becoming cheaper, is in the eye of the beholder. At any rate, gold can only fall to its inner value, which equals the production costs. Numerous examples prove its stable purchase power. One barrel of oil costs about 2 grams of gold today – as it did 50 years ago.

The perfect setting for the gold price would be a continued weak economy in connection with desperate stimulus measures by the central banks and governments, where the measures all of a sudden worked out and the economy picked up momentum rapidly before central bank could withdraw the excess liquidity. Actually the central banks should try to reduce the money supply

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in good time and quickly as soon as the first signs of an imminent end of the recession are coming through. While this may not be a technical problem, it could meet with massive political resistance, given that unemployment would still be high at that stage. Even if the race between inflation and deflation is not run yet, we believe that gold represents an optimal investment in both scenarios (please refer to “Myth # 5”).

Gold: stress test passed with flying colours

The US budget deficit at a record high, the smouldering inflation risk, and the stepped-up liquidity on the market will form a solid base for the gold price and further increases. Governments around the globe are faced with the agony of choice between tax increases, drastic cuts in spending, or pushing the “on”-switch of the printing press again. We believe that they will opt for the latter solution.

Flight to real assets imminent?

Once the monetary floodgates open and the velocity of money picks up again, we might see a flight into real assets amid the inflationary environment. Commodities would generally benefit from such a scenario, and oil and gold in particular. This is why we continue to recommend gold as panic-proof component of your asset allocation and as long-term advisable way of protecting your purchase power.

The façade is done up, but the basement remains shaky...

We remain critical about the long-term consequences of the unprecedented actions taken by the central banks. We expect the US dollar to turn into one of the most important catalysts for the gold price, and we also envisage it to return to its usual negative correlation with the gold price. Gold will clearly benefit from that situation. Due to the de-facto zero interest rate policy in the USA, Japan, and Europe, the opportunity costs of gold are next to nothing, which means that the environment remains excellent. As long as the real interest rates stay as low as they are now, we do not foresee any end to the bull market.

Gold is still in the early stages of a bull market

Even though gold has almost quadrupled from its low at USD 250, the market has still not embraced the sustainability of the increase. This is surely due to the more than 20 years of bull markets for equities, bonds, and property, and the opposite development of the gold price. On top of that, there are only a few market participants left that actively experienced the high of the gold price in 1980. Due to the positive performance in the train wreck of a year of 2008, investors should put increasing trust in the yellow metal again. In the 1970s it was an unwritten law to invest at least a fifth of one's assets in gold. In 1980, gold and gold mining shares accounted for 26% of global financial assets, whereas nowadays they make up a mere 0.6% of global assets. Even at a price of USD 5,000/ounce only 3% would therefore be allocated to gold.

We continue to see an **outstanding risk/return profile for gold investments**. We regard the current consolidation as good buying opportunity and envisage higher gold prices in the medium to long term. The infamous USD 1,000 per ounce threshold should be clearly passed again in 2009, and positive seasonals should lend further support to the price from the third and fourth quarter. Passing **USD 1,300 is our first target, in the long run the price may well pass the inflation-adjusted all-time-high of USD 2,300.**

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