



GOLD COULD GET LIFT AT YEAR END

J.P. Morgan urges investors to buy gold for the holidays

J.P. Morgan analysts John Bridges and Steve Shepard recently advised, "We'd be buying some gold for our Christmas stocking and Hanukkah gifts."

Author: Dorothy Kosich

Posted: Monday, 01 Dec 2008

RENO, NV -

J.P. Morgan metals analysts John Bridges in the U.S. and Steve Shepard in South Africa said that while they realize the difficulties gold miners face, "we feel they have probably underperformed enough for now, and we'd be buying the gold space for the run into the holidays."

In a recently published commentary on gold, Bridges and Shepard advised that "the tighter gold supplies and counterparty risk could give gold (and thus directly the equities) a lift through year end."

Investment Thesis

J.P. Morgan's analysis suggests that "gold has shown two faces to the market: gold equities have underperformed the S&P 500 since the beginning of this financial crisis, but gold bullion has outperformed the general markets handily. We continue to feel this results from the operational challenges the gold miners face as a group but points to upside potential for gold prices as mine supply continues to fall and now central bank sales diminish."

While Bridges and Shepard noted that "our favorite technician feels the dollar could strengthen further," gold should not "be simplified to being the dollar not." They asserted that gold does diverge from its relationship with the dollar "when the supply demand fundamentals for gold overcome the prevailing (price) relationship with the dollar."

"We see mine supply continuing to fall and now, with central banks depleting planned sales quotas, we expect official sector sales to fall quickly," the analysts forecast. "Given the very large above-ground gold stocks, falling supply does not guarantee stronger pricing, but it does, in our opinion, create the right environment for stronger prices."

"We'd be buying some gold for our Christmas stocking and Hanukkah gifts," they advised. "We like the pure play on gold itself and also our Overweight stocks Agnico-Eagle (AEM), Compania de Minas Buenaventura (BVN), Kinross (KGC), Goldcorp (GG) and Newmont (NEM)."

Gold equities disappoint

Nevertheless, Bridges and Shepard expressed misgivings on the recent performance of gold equities, noting, "Far from outperforming in a period of economic weakness, the gold equities have disappointed against gold and the S&P."

"We continue to believe that gold equities trade as a type of gold option," they suggested. "The size of the option is the amount of gold that underpins each share, and the exercise price of the option is the ongoing cost of production, which includes cash costs, maintenance capex and essential G&A. ...Option pricing models show that the exercise price is a key part of the value."

"Option price = Stock price*Probability - (Exercise price times Probability)."

The analysts said that it is reasonable to assume that the option value that gold companies represent will deteriorate "via a rising exercise price (cash costs) and/or falling ounces produced. We have one takeaway from industry's problems, and that is that the gold price must increase."

Central bank sales to collapse

"We believe the price of gold was artificially low starting in the mid-1990s as physical oversupply from the mines, central banks and forward selling pressed down on prices. The lack of new discoveries suggests to us that higher prices are needed to bring on new supplies," they advised.

J.P. Morgan's analysis concurs with that of GFMS, which expects central bank gold sales to collapse. "The banks are now close to ending a second agreement that limits total gold sales to 500 tonnes pa and with Germany, Italy and France unwilling to sell, we expect gold supplies from this source to fall," Bridges and Shepard suggested. "Now, with supplies falling (and a weaker dollar), the bank sales are slowing.

Physical gold, gold leases

The analysts also suggest that "the gold coin and small bar market has seized."

With the interest in gold growing, demand for gold coins and small gold bars has grown. "Tight coin supplies could have added to the panic of some buyers. Yet the gold price has been stable, and larger bars are still readily available," they noted.

J.P. Morgan's research revealed that gold lease rates "have picked up recently in an echo of the tightness in the coin market. ...We also understand investors are switching holdings from unallocated gold (a general liability of bullion banks) to allocated gold (a more secure custodial holding).