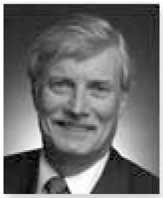
John Embry: "When the gold's all gone, the market will go nuts"
Source *The Gold Report* 09/12/2008


John Embry, Chief Investment Strategist for Sprott Asset Management and renowned industry expert, has researched the sector for 30 years. He expresses disbelief as he explains today's irrational pricing in this exclusive interview with The Gold Report. He attributes gold's alarming distress to "violent intervention by the paper players." But he's convinced they can only hold prices down for so long and forecasts four-digit gold by January 2009. Juniors present the best opportunity to leverage the coming gold price explosion and he shares his favorite names.

The Gold Report: In our last interview you said gold would unquestionably detach from the dollar. Ten months later, gold is still tethered.

John Embry: The downturn in both gold and silver was literally preposterous in magnitude relative to the rise in the dollar. This was a violent intervention by the paper players. Three U.S. banks on COMEX shorted something like 8,000 contracts in a very short time. That's more ounces than all the world's miners produce in a month.

TGR: Can they keep doing that forever?

JE: No, they can't. This is similar to what happens when you compress a spring. You hold it down but when it comes up, it springs back hard. We'll see a violent reaction in the gold price soon.

TGR: Will we have to wait six months or six weeks?

JE: If gold hasn't moved up by the end of this year, I would be very surprised. People don't realize how distressed the gold mining industry is. Even at $1,000, miners weren't doing very well. At $800, the entire industry is in crisis. Costs have risen so much, nobody's making any real money. In fact, some mines are starting to close.

TGR: Could mines reopen when gold reaches $850 or $900?

JE: Gold would have to be at least $1200 before mines reopen.

TGR: Is now the time for the majors to start acquiring?

JE: I don't understand why the majors aren't acquiring because I've never seen anything like the discrepancy in value between the big cap stocks and the small stuff. Many interesting smaller companies are trading for a song; whereas, Agnico-Eagle and Goldcorp and Kinross are aggressively valued.

TGR: Some of the juniors have lost 80%.

JE: If you had told me we'd see this kind of carnage in the juniors while the gold was still north of $800, I would have said impossible. One of the reasons is that investors are giving up and gold funds, ours included, are under redemption pressure. This creates forced selling with insufficient buying and that leads to the most depressed prices since this cycle began in 2000.

TGR: How long can this go on?

JE: I don’t know but I’ve got some that actually are selling below the cash on their balance sheets.

TGR: Do you want to give us some names?

JE: Orvana Minerals Corp. (TSX:ORV) has an extremely efficient mine and has generated a lot of cash from it—considerably more cash than the stock’s trading for. There is $75 million in the bank with a $60 million market cap. Orvana has a very profitable mine plus another ore body that would be easily developed and they are both in the good part of Bolivia.

TGR: You said they couldn't even afford to mine with gold around $800?

JE: You can’t get into production because it’s hard to attract capital and the capital costs have risen so much, but an existing mine with a good orebody is fine. This credit problem will significantly impact gold production over the next three or four years. There’s a bunch of mines coming off the table as they get depleted and the high-grade ores run out. Without new mines, production is going to fall regardless of the gold price. The supply-demand gap, which is already yawning, is growing wider and wider. Central banks will do what they can to fill the gap but if they can’t, the price is going to explode.

TGR: You said Orvana has an efficient mine, and money in the bank that exceeds the market cap. Can they bring gold out of the ground profitably?

JE: They’re making an extraordinary profit.

TGR: So they have cash flow.

JE: The problem is that it’s a short-life mine with only a couple of years left. They do have other assets, although they're being valued at less than nothing.

TGR: Should investors wait for gold to go above $1,000 before investing in the juniors?

JE: Things have gone much farther down than I could have imagined in my worst nightmare. If you are confident that the gold price is going higher, this is an ideal time to be picking away and buying a diversified list of very good quality, cheap juniors. I’ve made the most money in my life buying things that are out of favor because there’s no downside risk, certainly from a fundamental standpoint. When the worm turns, these things could double very quickly. When that happens it’ll be hard to buy. Start picking away now, as long as you share my opinion that the gold will see a hefty price rise over the next 12 months.

TGR: How does an investor determine which juniors merit a closer look?

JE: It all revolves around the people and the asset. I look for companies with strong financial support, a legitimate project with a 43-101 resource and sound management. Using those criteria, you can make a reasonable evaluation of what the net asset value is. You can put in your own gold prices while knowing that they're not going to be cash-starved.

TGR: Do we have to work through this panicked selling before stocks will change?

JE: As long as people are abandoning the sector and taking money out of these funds, then there's a lot of irrational selling. The fund manager has no choice but to sell. This is creating a phenomenon where prices don't make much sense. The larger cap stocks are the ones being bid up; they trade because generalists buy them. There's a far bigger pool of capital prepared to buy them. That's why you've got this remarkable discrepancy in valuation between the little guys and the big guys.

TGR: Other people we've interviewed are concerned about a real crash in the overall markets.

JE: We've already had the crash in the junior gold shares. That brings up the naked short selling of these stocks. I think there are grounds for a suit. A lawyer has been phoning me on this subject. Someone is trying to bring a suit against the perpetrators. There has clearly been nefarious activity in these stocks because they get driven down to a level where they can't put their head up without getting pounded back down again.

TGR: If the market crashes, it'll pressure the gold funds.

JE: That assumes that the gold price doesn't explode. If the market crashes, the authorities are going to pour so much money into the system to try to avert economic disaster. Money has to go somewhere. Some of it will go to gold. If the gold price heads higher, you've got the cheapest gold stocks in history. Maybe they won't get dragged down in the crash. Maybe the big caps are going to crash.

TGR: Big caps gold stocks?

JE: Big caps period. Investors have already abandoned the illiquid stocks and huddled in the big caps.

TGR: A lot of people are saying that they see a slowdown in deflation. Do you agree?

JE: I think the problem is potential deflation because I am a great believer in Austrian economics and we've had the greatest credit abuses in history. There's an awful lot of debt and you're stuck creating more of it to keep the momentum going. The real issue here is, can you do it? There is a good argument for a deflationary spiral like the Great Depression. On the other hand, this time paper money isn't anchored. Everything's fiat and the government can create it with the stroke of a pen or the touch of a computer key. If you really want to pin me down, I'd say we're going to have a hyper inflationary depression. The value of money will be destroyed and economic activity will grind to a halt. It'll be the worst of all possible worlds— a South American meltdown. If that happens, the one thing I want to own is gold. I have been investing more in bullion recently than in stocks. I already own some stocks. But I do believe that if bullion performs as I expect it to, the stocks will do well. If you go back to the 1930s, the best performing things on earth were the gold stocks.

TGR: They went down in the beginning.

JE: They did, but these have already gone down. That would make the case that we had the bear market in gold. I guess they could go down 90% from the peak prices, but still the risk/reward heavily favors the reward side. That is not true for large cap stocks, particularly those that make up the indices.

TGR: But if the price of gold doesn't turn around, don't a lot of juniors risk bankruptcy?

JE: If they're not in production and are fairly careful, they can gear back. The ones in production and losing money are at the greatest risk of bankruptcy. If gold doesn't turn soon, they won't be able to finance their operations. A lot of these guys lose money and just kept going out and raising more. They just keep losing money, so they close the mines. That's also very bullish for gold. We're going to have less and less gold in production.

TGR: What about the juniors that aren't in production?

JE: I'm not worried about the ones that have real ore bodies and have gotten pounded down to where they're trading at $10, $15, or $20 an ounce in the ground.

TGR: Because they'll be taken out?

JE: They'll be taken out or they've hit bottom and, as long as they have enough capital to move forward, they can gear down. Small, quality gold shares are proxies for a higher gold price. The problem is that the gold price is so severely suppressed vis a vis other commodities that the whole business has become uneconomical.

TGR: What percentage should an investor have in bullion and in what form?

JE: Central Fund of Canada Limited (CEF.AMEX; CEF.A. TSX) and Central GoldTrust (TSX: GTU.UN; GTU.U:AMEX:GTU) are really excellent vehicles in which to hold gold. I'm very leery of funds that have no allocated gold. Whereas, in Central Gold Trust, which I'm involved with, it's a sort of sister company of the Central Fund— so I know the Spicers that run it very well. I know for a fact that you can go look at gold in the vault. So they are perfect vehicles in this environment. If the worst happens and everything goes to hell in a handcart, you want bullion. So the core of your portfolio has to be bullion. Depending on how much money you've got, you can decide what percentage you want to wager on the upside. If the gold price goes where I think it's going soon—to $2,000— then some of these gold stocks will look pretty good. They're depressed enough that they will move faster than gold. They could go up three to five times when gold goes doubles.

TGR: So you recommend a core holding of bullion. Do you believe people should have coins?

JE: Absolutely. I'm a big believer in coins and actually have them in addition to physical gold as part of my position.

TGR: Would the balance be in producers and exploration companies?

JE: I can't pound the table for any of the large cap producers because they don't represent terrific relative value. However, when the gold price goes up, they're going to go up in price. My view is that some of the smaller ones will go up a lot more. It depends on what your goal is. If you only want to protect yourself, own nothing but bullion. But if you want some leverage and to make some money, then you should probably get some intermediate and smaller gold stocks that have been really taken to the wood shed and pounded.

TGR: Do you want to talk about a few of those?

JE: One that I've been a great fan of for quite a while is Wesdome (WDO.TSX). It has performed horribly. It has two operating mines, one in Quebec and another in Ontario. The high Canadian dollar beat them up quite a bit and they were in the red, but now both mines are cash flowing positively. This stock trades around $.85, so it has a market cap of $85 million. If the gold price goes to $2,000, these two mines will spin money and I suspect the stock will go up fivefold. A stock like that at these prices is a gift. It's in production, so you don't have to spend any more money. Quebec is probably the best place on the planet to mine.

Lake Shore Gold (TSX:LSG) is another one that I like. It's not in production yet, but it has wonderful sponsorship, which will take it into production. The stock trades around $1.20 and has a market cap somewhat higher than Wesdome, but it's probably got a couple million ounces of very economic grade. Even more importantly, Hochschild, the big Peruvian silver player, has taken 35 to 40% of the company at twice the current price. They will put it into production. I know the ore body intimately and it's a good one. This stock, which has been pounded down to $1.20, is excellent value.

TGR: Where are their mines located?

JE: This one is located in Timmins in Ontario.

JE: Going a little further afield, there's AXMIN Inc. (AXM.TSX.V). It just got annihilated. They have four million ounces in the Central African Republic. It was at $1.40 and is now down to $.15. You're buying the people because they discovered the Geita Mine, now in production in Tanzania, which is one of the more successful mines in Africa. This is the best exploration team in Africa. They've got this project in the Central African Republic with a proven reserve and, then another one in Ghana and a third in the Sierra Leone, which they're moving forward. The stock has been blasted, but they've got Audax Petroleum, one of the big Swiss oil companies, which owns 50% of this company, to back stop to any extent required. There's no financing risk; they have assets; and the best mine-finding team in Africa. You get all this for $30 million.

TGR: And it just got clobbered.

JE: I don't understand why. I talked to the company and we went over everything. It's simple. There are more sellers than buyers.

TGR: People are panicking. They're selling anything and everything.

JE: You can come up with a zillion reasons why a stock is going to go lower, but at some point you've got to put the pin in and say, this is really a great value. I believe the gold price is going up a lot. If I buy something and with 10% or 15% on the downside worst case, and I can make five times on the upside, that represents a good investment.

TGR: That brings the buyers out. Everybody's hoping investors return from their summer vacations and start focusing on the values of some of these companies.

JE: It's going to take a fairly significant advance in the gold price. If there's a major stock market debacle and gold moves in the opposite direction that will shine more light on the gold shares and the money will go there.

TGR: You talked during our last interview about Gold Fields Limited (NYSE & JSE: GFI), Minera Andes Inc. (TSX :MAI;OTCBB:MNEAF), Aquiline Resources Inc. (AQI.TSX.V) and African Gold Group, Inc. (AGG.V). Do you have any comments on them?

JE: Gold Fields, for example, just reported 80 million ounces in reserve and another 246 million ounces in resources. Sure, South Africa is an issue but half of their production is outside of South Africa. I think Gold Fields, for a big cap stock, is literally a gift at these prices. The other ones like African Gold have gotten pounded, I'm not quite sure why – it's just a thin stock and when you get forced selling, it gets driven down. It's got legitimate projects in Ghana and Mali.

TGR: How much lower can they go?

JE: That's the big question. You do the metrics. Calculate how many ounces of resource. What're you paying for it? These stocks are so low I've seldom seen anything cheaper in my career. It's odd that the gold picture is so remarkably bullish, even with this price hit, which I don't think was necessarily a natural hit. I think it was assisted. If the bottom's not near, then my whole thesis on gold is wrong and I don't think it is.

TGR: Could the powers that be continue to drive gold down?

JE: They have a financial crisis of epic proportions and the last thing they want is for gold to become the go-to asset, so they've been throwing everything at it but the kitchen sink. That strategy has resulted in unprecedented shortages of physical gold. Half the bullion dealers and coin dealers in America can't get it.

The U.S. Mint suspended production of Gold Eagles. They claimed it was due to a shortage of blanks. I don't believe that. I think it's a physical shortage. COMEX has created an irrationally low price and people are coming out of the woodwork buying it.

TGR: And they can't replace it.

JE: The fact is that all this stuff at central banks has been leased and swapped and sold into the market. It's gone; it's not coming back. So we're running out. The question is when will it be completely gone—that's when the market will go nuts.

TGR: Are you forecasting that for January of 2009?

JE: That's when we'll have four-digit gold—maybe higher four digits. As this credit crisis unfolds, the gold market can come into its own again. Attempts to discourage people by pounding the gold will end. When everyone realizes what's going on, I think it'll have a salutary effect on the gold price.

TGR: What would be in the top ten holdings?

JE: Aurelian Resources Inc. (ARU:TSX) is an interesting one—arguably the best find in the new century. It has a minimum of 10 to 13 million ounces. Because it's in Ecuador they're having all the problems with Correa's government. Kinross has put in a bid to take them out. The bid has given the stock a lift, but it's a remarkable asset and I hope this deal doesn't go through.

TGR: Another company we've been hearing a lot about recently, too, is Minera Andes Inc.

JE: Rob McEwen put a lot of money into Minera and they have a solid asset in South America. It remains a solid company.

TGR: John, as usual, we appreciate your time.

JE: It's always best to talk when things are at their worst because I think that's when the opportunity is the greatest. When we have another conversation six months from now, I think it'll be a much happier one.

John Embry is chief investment strategist at Sprott Asset Management. Embry, an industry expert in precious metals, has researched the gold sector for over 30 years and has accumulated industry experience as a portfolio management specialist since 1963. He joined SAM as Chief Investment Strategist in March 2003 with focus on the Sprott Gold and Precious Minerals Fund and the Sprott Strategic Offshore Gold Fund, Ltd. Prior to joining Sprott, Embry was Vice-President, Equities and Portfolio Manager at RBC Global Investment Management, a $33 billion organization where he oversaw $5 billion in assets, including the flagship $2.9 billion Royal Canadian Equity Fund and the $250 million Royal Precious Metals Fund.