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Chart Blast

How to Watch for Signs that the Gold Correction is Ending

A Customizable Synthetic Gold Stock as a Source of New Liquidity

Market Analysis

Long-Term Bullish on Gold and Waiting for Corrective Action to End

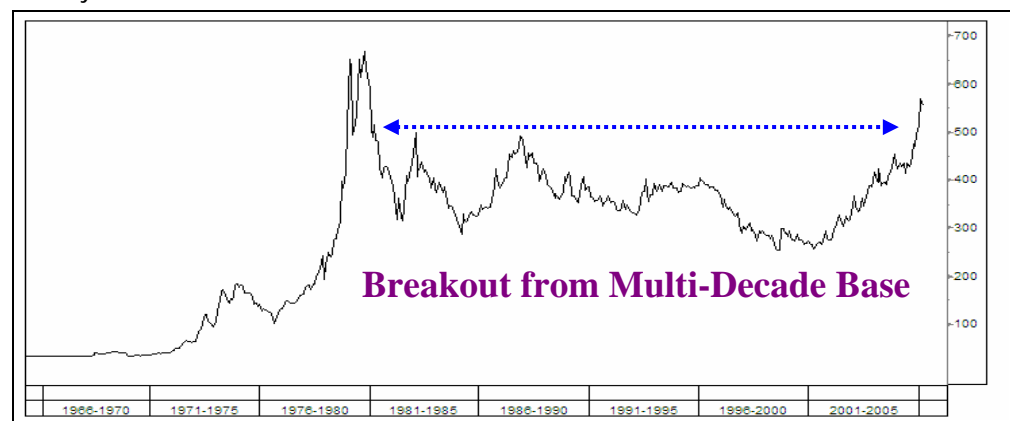
We remain long-term bullish on gold with a first target of \$600. We believe that we are in a secular bull phase for gold with a recent breakout of a multi-decade base at \$500.

In the short term the metal appears to be undergoing a correction. We suggest that long-term investors take advantage of this weakness to accumulate gold stocks at current levels. For traders, here are some signs that we would watch for that the correction may be ending:

- **Watch for gold stocks to begin performing better against bullion.** Gold stocks have been leading the gold price in the last three rallies and did not confirm the last gold rally up to the \$570 level. We would watch for better performance by gold shares as a sign that another upleg in gold and gold stocks may be starting (page 3).
- **Watch for signs of lower speculative enthusiasm.** Investors' bullish sentiment in gold peaked in late January and has been falling since, but we would wait for daily volumes in the Amex Gold Bug Index (HUI) to decline and for the PHLX Gold & Silver Index (XAU) to perform better against the CBOE Gold Index (GOX). In addition, keep an eye on whether Large Speculators are liquidating their net long positions in gold future. However, we would not rule out the possibility of a speculative blowoff in gold and gold stocks (pp. 4-5).

Investors may also wish to consider our approach to creating a customizable synthetic gold stock as an additional source of liquidity for exposure to this group (pp. 6-7).

Monthly Price Chart of London PM Gold Fix



Source: Merrill Lynch Market Analysis, Bloomberg

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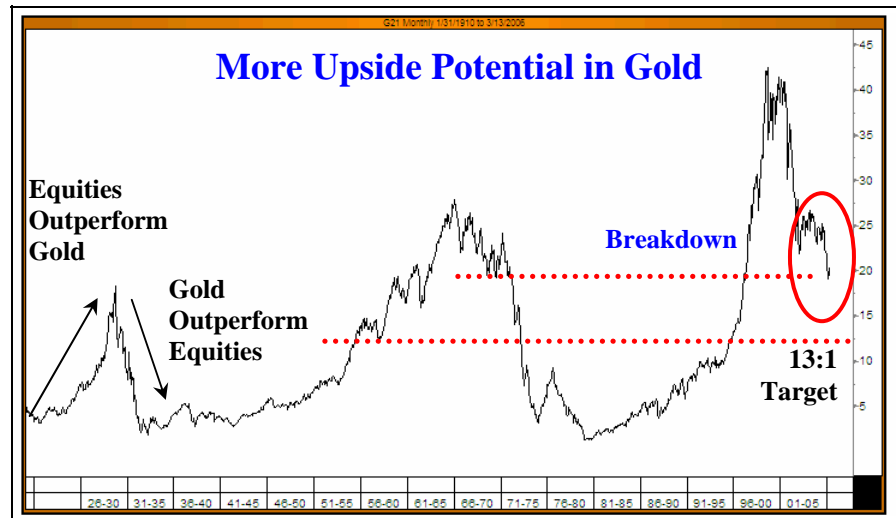
Investors should consider this report as only a single factor in making their investment decision.

Refer to important disclosures on page 9.

If the Past is Any Guide, Gold Can Still Outperform Equities

We went back to 1910 and analyzed the ratio of the Dow Jones Industrials Average against the price of gold. If the past is any guide, the relative ratio of the DJIA to Gold is likely to continue to decline, suggesting that gold should outperform equities over the next few years. However, returns are likely to be volatile. The long-term target for the relative ratio appears to be 13:1. Based on the current DJIA level of roughly 11,000, this would translate into a long-term gold price target of \$850, or the peak set in January 1980.

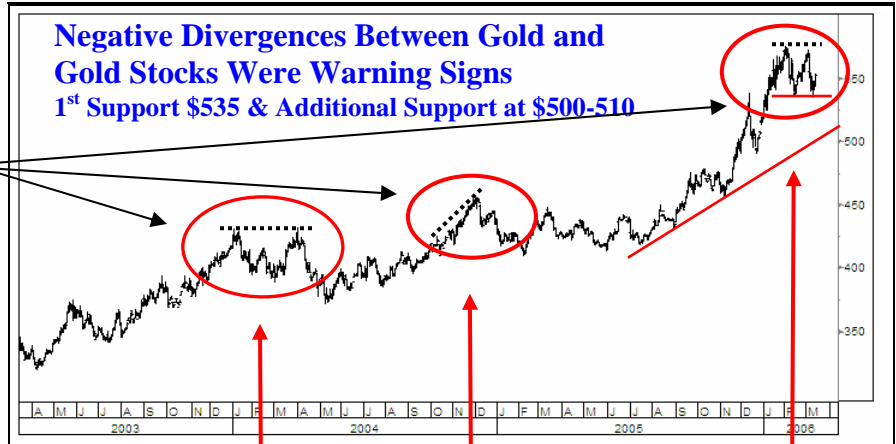
Monthly Relative Chart of Dow Jones Ind Avg vs. London PM Gold Fix (1910-Present)



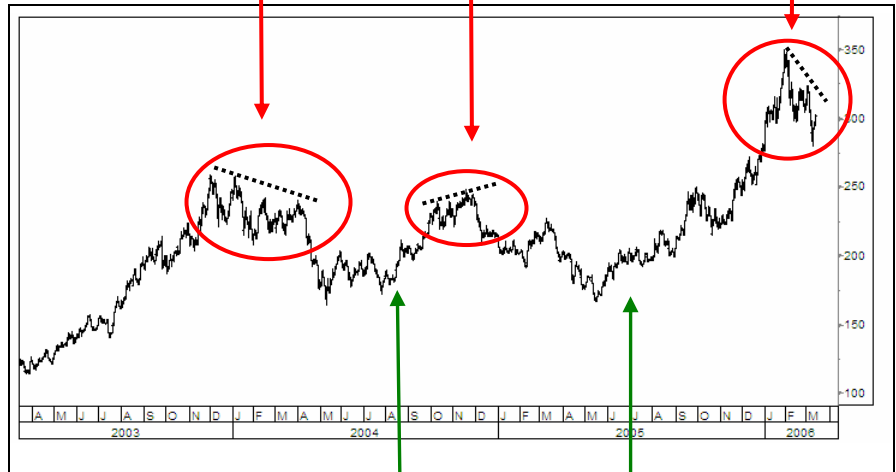
Source: Merrill Lynch Market Analysis, Bloomberg

Gold Stocks Lead Gold Prices - Watch For Signs of Better Gold Stock Relative Performance

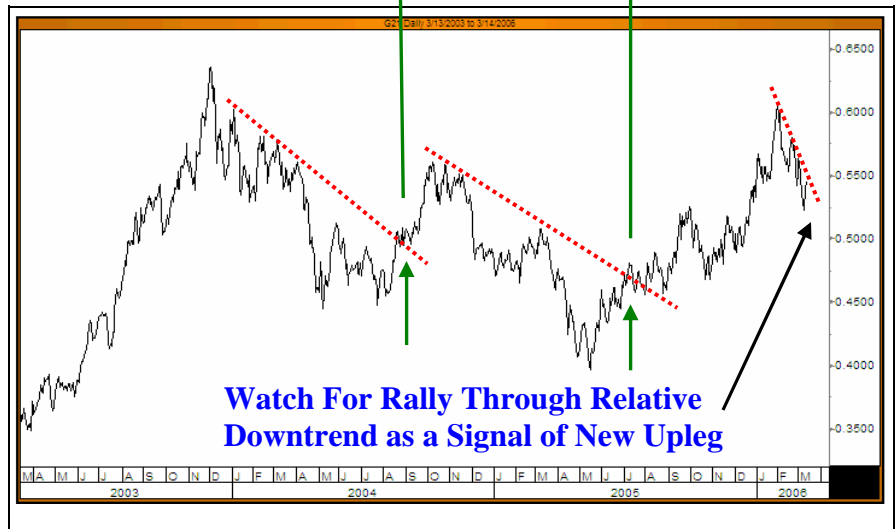
Daily Price Chart of Nearby Gold Futures Contract



Daily Price Chart of Amex Gold Bugs Index (HUI)



Daily Relative Price Chart of Amex Gold Bugs Index (HUI) vs. Nearby Gold Futures

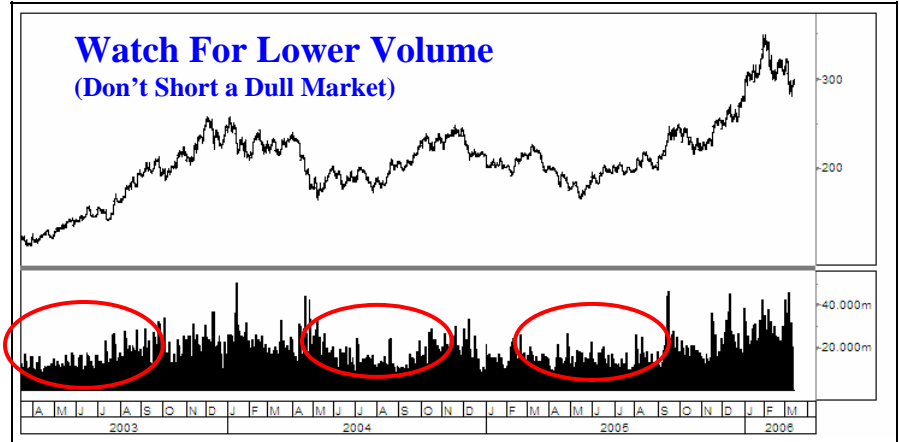


Source: Merrill Lynch Market Analysis, Bloomberg

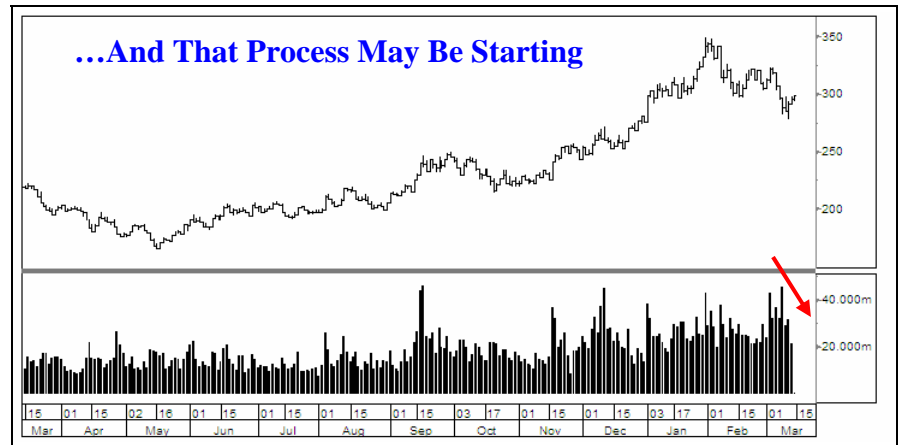
Buy Signals: Gold stocks begin to perform better than gold

Watch For Lower Volumes as A Sign of Waning Speculative Enthusiasm

3-Year Daily Price and Volume Chart of Amex Gold Bugs Index (HUI)



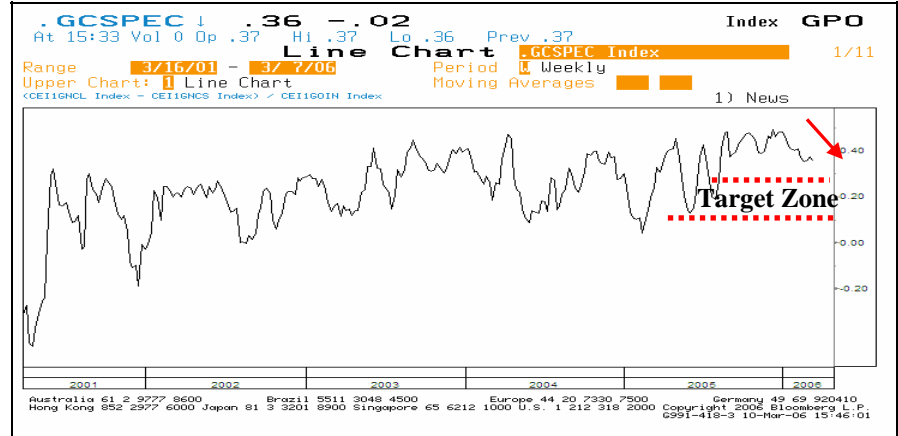
1-Year Daily Price and Volume Chart of Amex Gold Bugs Index (HUI)



Source: Merrill Lynch Market Analysis, Bloomberg

Watch For Large Speculators Net Long in Gold Futures to Fall Further as Further Confirmation of Fading Speculative Interest

Weekly Chart of Large Speculator Positions in Gold Futures to Total Open Interest



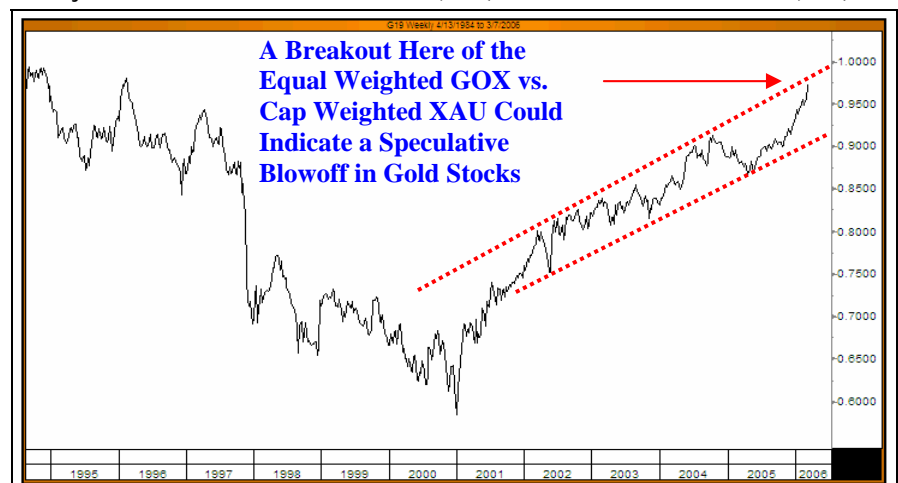
Source: Merrill Lynch Market Analysis, Bloomberg, CFTC

Equal Weighted GOX vs. Cap Weighted XAU Also Showing Excess Speculation but We Would Not Rule Out a Speculative Blowoff

A comparison of the CBOE Gold Index (GOX) against the XAU is another measure of the level of gold speculation. The GOX is an equal-weighted index of 10 gold producers that has higher weights in the smaller speculative gold producers. The XAU is a cap-weighted index and more representative of the returns of senior gold producers.

The GOX has been in an uptrend against the XAU since December 2000 and the relative line of the GOX vs. the XAU is at the top of the upchannel. We would prefer to see the relative line retreat to the middle or bottom of the channel before aggressively buying gold shares. However, should the GOX stage an upside breakout against the XAU through the uptrend, it could indicate that a speculative blowoff may be occurring in gold stocks.

Weekly Relative Price of CBOE Gold Index (GOX) vs. PHLX Gold & Silver Index (XAU)



Source: Merrill Lynch Market Analysis, Bloomberg

Introducing a Customizable Synthetic Gold Stock as an Additional Source of Liquidity

Conceptually a mine can be thought of as a series of call options on the underlying commodity, with the exercise price as the cost of production. If the commodity price falls below the cost of production, the mine operator has the option to either close or mothball the mine until prices improve. We created a synthetic gold stock by building a model based on these principles. Key features of the model are:

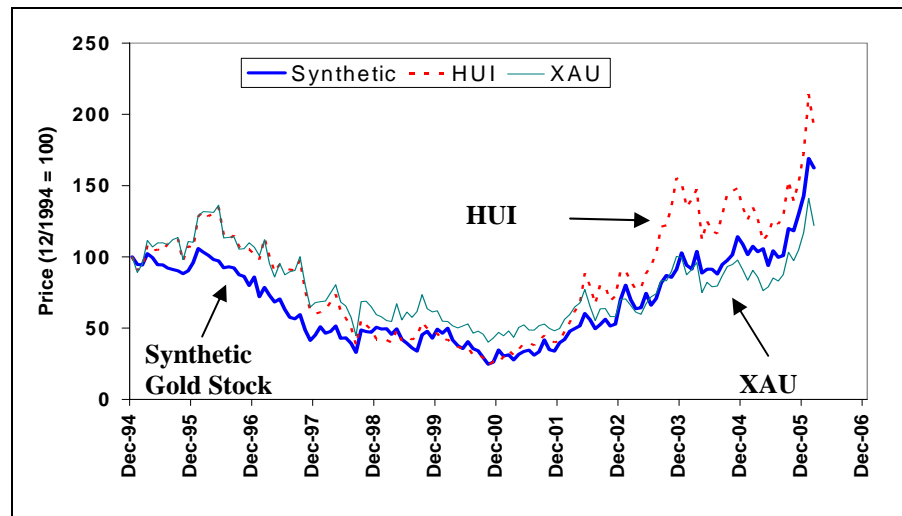
- A series of eight deep-in-the-money call options on the price of gold, with terms of 1, 2, 3 ... 8 years, which models a mine with an eight year life, a common estimate of long-lived gold mines;
- Exercise price equal to cash production cost of \$250, rising each year by the current inflation rate. \$250 appears to be a common estimate of cash costs for existing gold stocks. The ML Global Precious Metals team recently forecasted a cash cost of \$261 for North American producers in 2006 (refer to *This Week in Global Gold & Precious Metals Stocks* dated 9-Mar-2006);
- Equal amount of gold mined each year; and
- The position is rolled forward once a year at a cost of 1.5%.

Surprisingly this simple synthetic gold stock tracks the popular gold indices well. The monthly price correlations with the popular gold indices are high, with a correlation of 85% against the Amex Gold Bugs Index (HUI) and 72% with the PHLX Gold & Silver Index (XAU).

Using such an approach to gain exposure to gold mining return stream represents an additional source of liquidity. Of course, there are some important differences between the synthetic gold stock and the actual gold stocks themselves:

1. Gold miners have exploration upside and operational risk, which the synthetic gold stock does not
2. Gold mining companies may hedge the gold price with forward sales and other derivatives, which may account for the greater variance of the synthetic against the XAU, which have shares of companies that hedge, compared to the HUI, which is composed of unhedged producers. The synthetic does not.
3. Actual gold mines can somewhat manage the cost of production by high-grading when gold prices are low and mining a lower grade of ore when prices are high. The synthetic gold stock's assumed cost is inflexible.

Monthly Price Charts of Synthetic Gold Stock, HUI and XAU



Source: Merrill Lynch Market Analysis, Bloomberg

The Price Correlation of the Synthetic Gold Stock Is High Against the HUI and XAU

Monthly Price Correlations (12/1994 to 2/2006)			
	Synthetic Gold Stock	HUI	XAU
Synthetic Gold Stock	1.000		
Amex Gold Bugs Index (HUI)	0.850	1.000	
PHLX Gold & Silver Index (XAU)	0.723	0.955	1.000

Source: Merrill Lynch Market Analysis

Synthetic Stock Returns Are Comparable to Amex Gold Bugs Index (HUI)

Price Returns (12/1994 to 2/2006)

	1 Year	2 Years	3 Years	5 Years	Inception
Synthetic Gold Stock	51.2%	33.2%	32.4%	39.0%	4.4%
Amex Gold Bugs Index (HUI)	42.1%	16.6%	32.3%	40.9%	5.9%
PHLX Gold & Silver Index (XAU)	34.7%	15.6%	22.8%	20.5%	1.8%

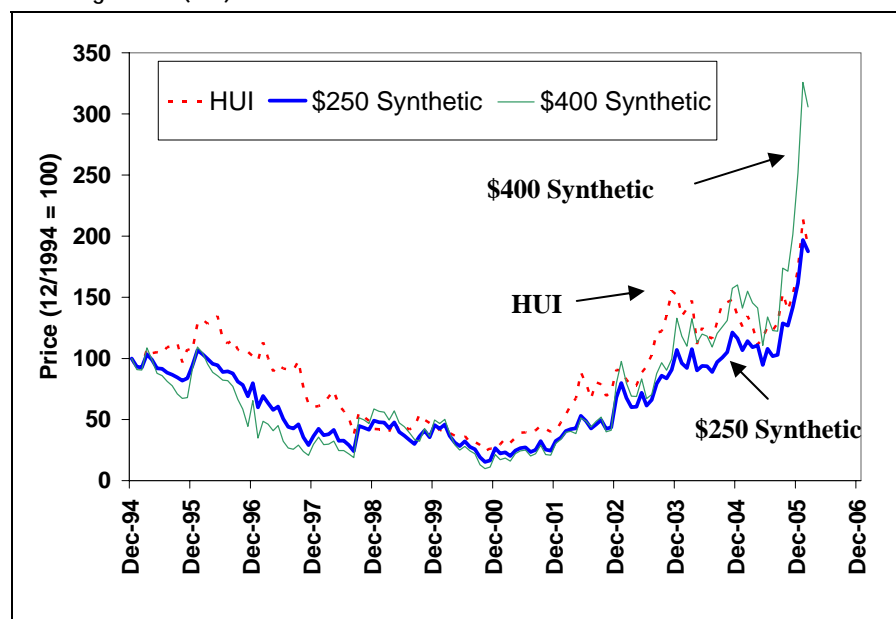
Source: Merrill Lynch Market Analysis

Past returns are no guarantee of future results. In calculating returns for the synthetic gold stock we have assumed annual transaction cost of 1.5% to maintain the position.

The Synthetic Gold Stock Can Be Customized to Investor Risk Preferences

For illustrative purposes we modeled a high cost gold mine with a \$400 cost of production and compared it to one with \$250 cost. The high cost producer is more volatile than the lower cost producer, but investors who prefer a higher leverage to the gold price can choose to create a synthetic high cost producer.

Monthly Price Charts of Synthetic Gold Stock with \$250 and \$400 Strike Prices and Amex Gold Bugs Index (HUI)



Source: Merrill Lynch Market Analysis

Analyst Certification

We, Mary Ann C. Bartels and Cam Hui, hereby certify that the views expressed in this research report about securities and issuers accurately reflect the research model applied in such analysis. We also certify that no part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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