Gold Market Update

National Australia Bank

- **The gold price fell by 6.6% over April. Recent gold demand appears to have fallen sharply on news of soft US inflation, slowing Chinese growth as well as fears that highly indebted European countries like Cyprus may resort to selling gold reserves.**
- **Prices partially recovered over the second half of April as a result of renewed interest in physical gold buying as consumers and central banks took advantage of relatively low prices. Purchases of gold coins and bars at mints across the globe surged following a 14% price tumble in two days in mid-April.**
- **Latest data from the World Gold Council show that the overall volume of gold demand over 2012 reached 4405.5 tonnes, which on a values basis was an all-time record of US$236.4 billion. However, the supply of gold eased to around 988.2 tonnes in December quarter 2012, reflecting a drop off in recycled gold and increased central bank purchases.**
- **Central banks continue to purchase gold by way of strengthening and diversifying their asset holdings. Russia, Turkey, Mexico and Korea are just a handful of countries that have significantly increased their holdings of gold reserves over recent years.**
- **It is likely that gold market participants have overreacted to recent news of a slowing Chinese economy, soft US inflation and expectations for US stimulus to wind up. However, we believe the upside risks to the gold price will dissipate (further) as the global economy improves and equities become more attractive. As such, it is our view that gold will end this year below US$1,500 per ounce.**

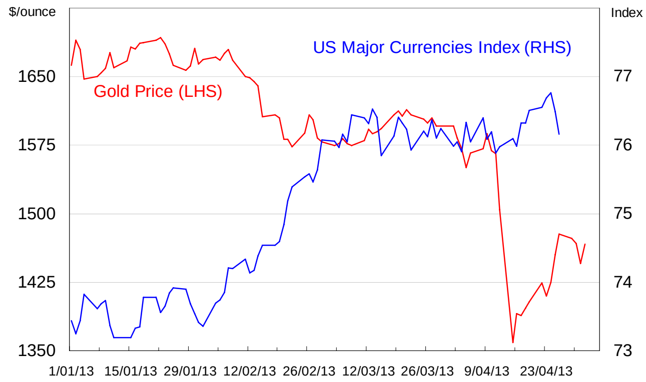
Recent Price Developments

At the time of our last detailed gold update in November 2012, the price of gold was hovering above US$1,700 per ounce – much higher than the current price of around $1,470 per ounce. At the time of our last update, the price of gold was supported by announcements of further stimulus by major central banks (in US, Europe and Japan). It appeared that inflation expectations had lifted permanently as a result of policy announcements, making gold more attractive to investors given its historic role as a hedge against inflation. The end of last year also pre-dated the avoidance of the US fiscal cliff, and was a time when equity prices remained relatively low compared to current levels; gold as a consequence upheld its appeal for investors in the face of elevated uncertainty and market risk.

A lot of water has gushed under the bridge since late 2012. Expectations for central bank stimulus were scaled back sooner than previously anticipated in the US and a surge in equity prices, which saw investors flock towards riskier assets, sent the spot price to a low of $1,336 an ounce at one point in the middle of April, which is more than 20% below the average price in November. In fact, the price of gold tumbled by 14% in just two days in mid-April, representing the largest two day decline since 1983. Part of the decline was driven by news of soft inflation in the US, slowing Chinese growth as well as fears that highly indebted European countries like Cyprus may resort to (rapidly) selling its gold reserves – valued at around 550 million Euros in February 2013 – in order to secure bailout funding. During the sell off, institutional investors indicated their expectation for prices to remain low relative to recent levels, with sales of exchange traded products rising rapidly, spurring further price declines.

Gold Demand

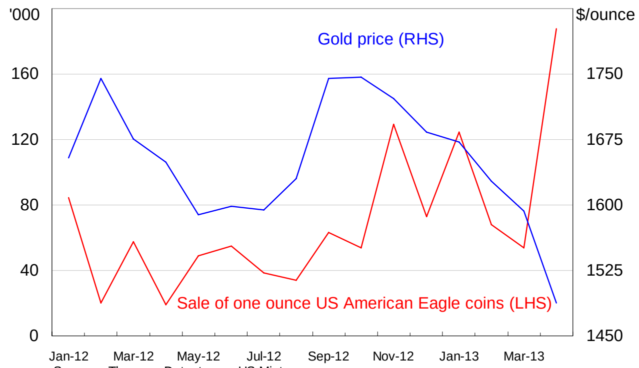
Gold Price and the US Dollar (Daily)



Source: Thomson Datastream

The price of gold has recovered somewhat over the past two weeks, largely reflecting renewed interest in physical purchases as consumers take advantage of relatively low prices. Sales of the US Mint's smallest American Eagle gold coin, weighing one 10th of an ounce, were suspended after demand more than doubled. The price for American Eagle gold coins is benchmarked against the London 'fixing' price used by some mining companies to sell output, and can vary from week to week. Physical gold purchases have also strengthened in other parts of the globe, with sales by the Perth Mint in Australia doubling and retail purchases across China tripling. A surge in jewellery and coin demand in India ahead of the Indian wedding season prompted jewellers to offer premiums on imports of gold of up to US$10 per ounce to allow supplies to keep up with demand.

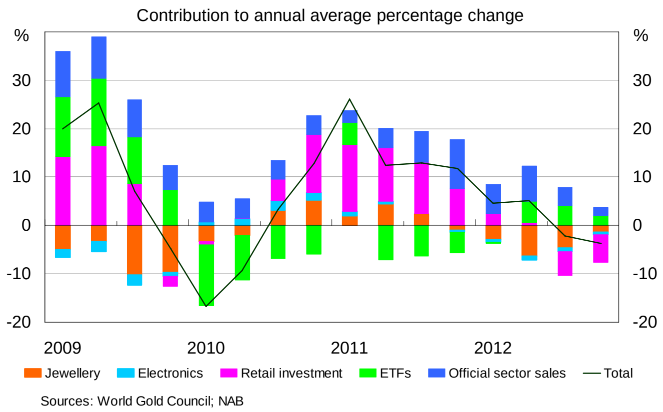
Sale of gold coins at US Mint & the gold price (monthly)



Sources: Thomson Datastream; US Mint

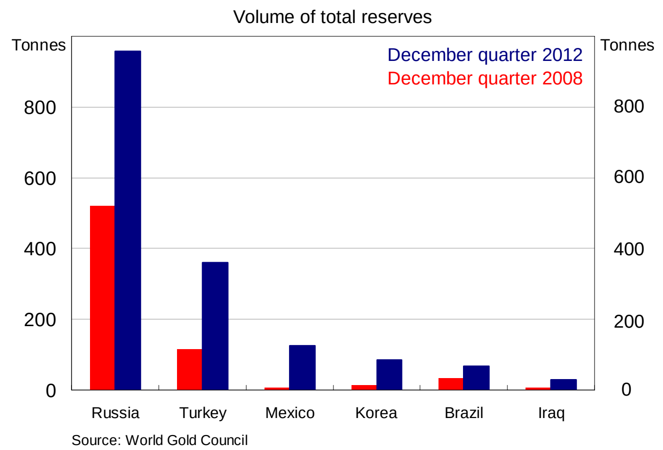
Gold's inverse relationship with the US dollar appears to have broken down through most of April, or perhaps more accurately, gold's lustre appears to have been tarnished by events that have provided little support to the US dollar (see Graph above). Chiefly, fear of a sell off of European central bank gold reserves in Cyprus caused prices to fall due to the anticipated increase to supply. However, the overall magnitude of the Cyprus crisis is fairly small (given Cyprus makes up just 0.2% of euro-zone GDP) and therefore had little impact on US confidence and the US dollar.

Identifiable Gold Demand



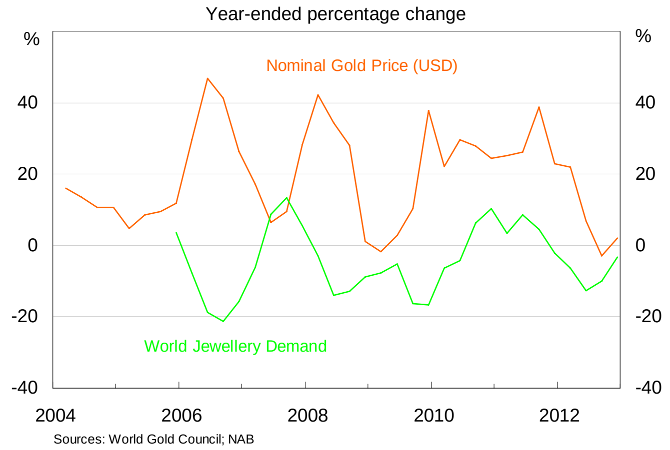
Identifiable gold demand softened over 2012, down 3.8%, consolidating a 2.1% decline over the year to September quarter 2012. The subtraction in gold demand was largely driven by weakness in retail investment, while jewellery purchases and demand for gold for use in electrical goods also subtracted from annual demand growth. Partly offsetting these were contributions from official sector purchases as well as investment (in the form of exchange traded funds). Despite growth in volume easing over the year to 4405.5 tonnes, the overall value of demand over 2012 reached an all-time record of US$236.4 billion (according to the World Gold Council).

Central Bank Gold Holdings (Tonnes)



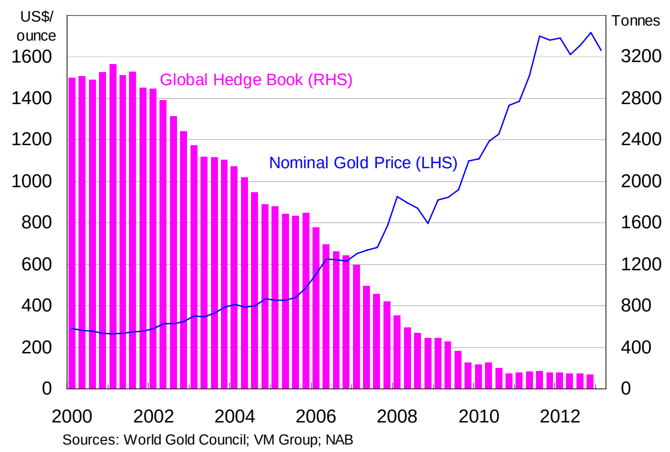
Central banks continue to purchase gold by way of strengthening and diversifying their asset holdings. This is particularly true for the emerging world, which has provided a significant boost to underlying gold demand since around the time the global financial crisis hit. The likes of Russia, Turkey, Mexico and Korea have increased their holdings of gold reserves markedly over the past four years (see Graph). However, central bank purchases have slowed over recent quarters, reflecting the relatively high price of gold as well as a gradual reduction in perceived global risk since the middle of last year. Nonetheless, overall central bank purchases continue to provide a significant amount of support to gold demand and it is likely that the recent gold price slump will provide an additional buying opportunity for central banks.

Gold Jewellery Demand and the Price of Gold



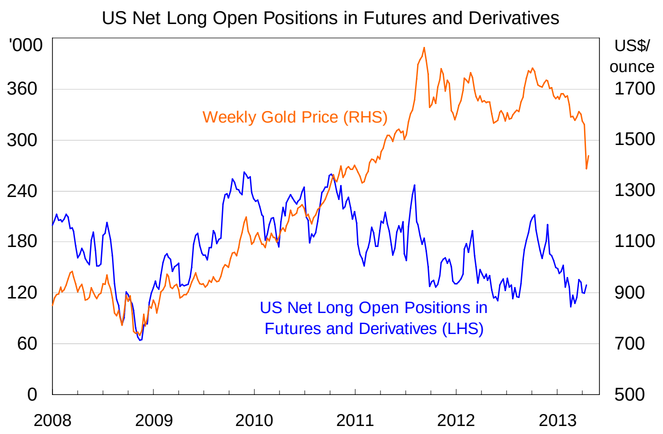
Demand for gold jewellery picked up solidly in December quarter 2012, though demand growth continued to fall in annual terms, albeit at a softer pace than in recent quarters (see Graph). According to the World Gold Council, gold jewellery demand rose from 464 tonnes in September quarter to 525 tonnes in December quarter. With the average price of gold lifting in the December quarter, the improvement in jewellery demand is unlikely to have been an artefact of price. Rather, Indian demand for gold jewellery – the world's largest gold destination – appears to have contributed significantly to the overall rise in jewellery demand. Jewellers and bullion dealers anticipated the Indian government lifting the import duty on gold in early 2013 (which subsequently eventuated), encouraging stock-building in the December quarter. More generally, it is possible that the positive wealth affects associated with a strengthening in riskier asset prices – such as equities – may have also encouraged increased demand for the shiny metal.

Producer De-hedging Activity



A diminishing source of gold demand is hedging activity among producers, which remains at historically low levels. Producers use hedges to insure against risk of the likes of inflation, deflation, devaluation and financial collapse. While deflation remains a real concern for many advanced economies at present, the risks to the price of gold appear to have lessened over recent years, causing a notable fall in de-hedging activity. In the December quarter 2012, the global hedge book is estimated to have declined by around 10 tonnes, to around 137 tonnes of physical demand (see Graph). The reduction in the size of the global hedge book appears to partly reflect scheduled deliveries or option expiries as hedge positions mature, rather than a conscious decision by hedge producers to remove hedge cover.

Gold Investment

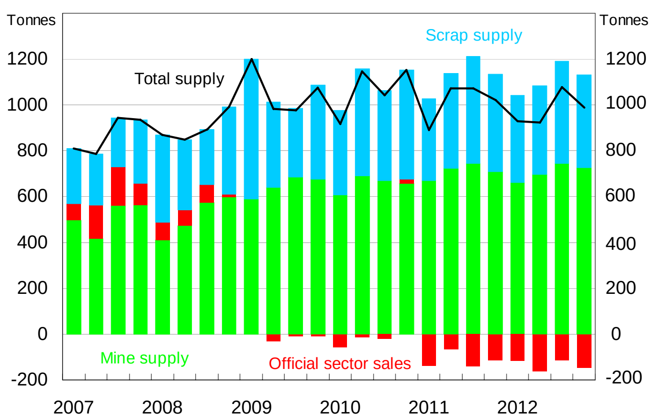


Sources: Bloomberg; NAB

Gold Supply

According to the World Gold Council, the supply of gold eased to around 988.2 tonnes in the December quarter 2012, which is around 90 tonnes below the volume of supply added in the previous quarter (see Graph). Consistent with the price of gold falling through the December quarter, a significant proportion of the fall in supply reflected a drop off in recycled / scrap gold. Increased central bank purchases helped to remove supply from the market, while weaker mined production in the quarter also helped. Nonetheless, mined production in the December quarter remained robust relative to the quarterly average level of production over the past year. More generally, it is clear that mined production remains the key driver of gold supply, with investment conditions for gold having increased materially over the past two years, providing more support for gold projects than for many other commodities.

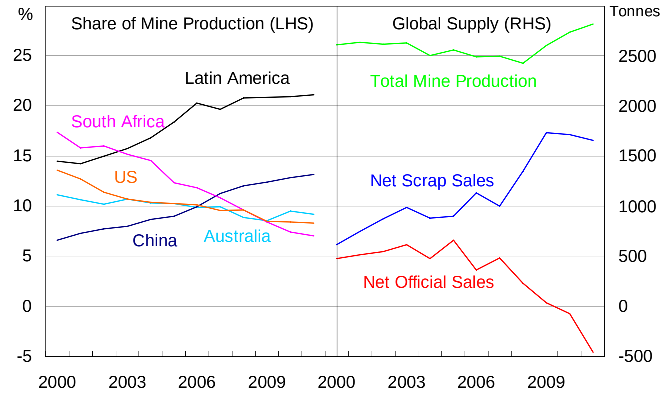
World Gold Supply (Quarterly)



Source: World Gold Council

Similarly, annual data show that mine production remains the biggest source of gold supply, while the contribution of scrap sales to the supply of gold has increased significantly over recent years, although it has turned down more recently (see Graph).

World Gold Supply (Annual)

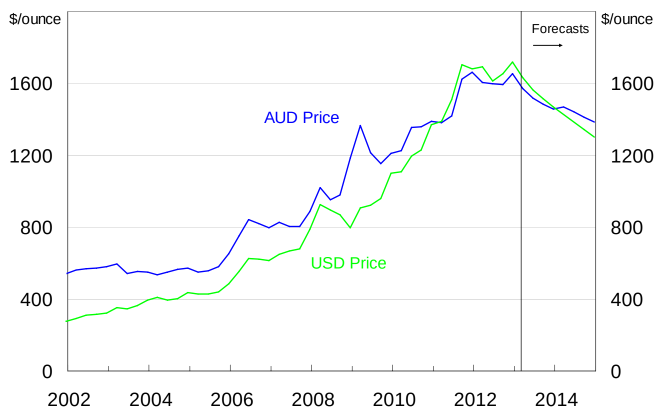


Sources: Bureau of Resources and Energy Economics; NAB

Outlook

It is likely that gold market participants have overreacted to recent news of a slowing Chinese economy, soft US inflation and expectations for US stimulus to wind up more quickly than previously anticipated. A continuation of the US Federal Reserve's bond buying program as well as strong central bank gold buying should provide support to the price of gold over much of this year. Physical demand is also likely to remain firm until the price recovers sufficiently to limit further purchases to more normal levels. However, offsetting risks remain prevalent, with soft inflation in the advanced economies and a shift in demand towards better performing equities likely to weigh on prices. While central bank buying is expected to keep a floor under further price declines, the supply side impact of this will be partly offset by continued gradual expansion in mined production. We expect gold's final resting place at the end of 2013 to be around US$1,470 an ounce, which is below levels recorded at the end of last year (gold averaged US$1,684 an ounce in December 2012). Looking further ahead, we generally expect the price to moderate to around US$1,300 an ounce by the end of 2014, as growth in the major advanced economies regains momentum and investors increase their demand for riskier assets.

Nominal Gold Price



Sources: Thomson Datastream; NAB

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Quarterly Price Profile

Gold Price Forecasts – Quarterly Average

	Actual	Forecasts							
	Mar 13	*Jun 13*	*Sep 13*	*Dec 13*	*Mar 14*	*Jun 14*	*Sep 14*	*Dec 14*	*Mar 15*
Gold - US$	1632	1560	1510	1470	1430	1380	1340	1300	1290
Gold - AU$	1571	1520	1480	1450	1470	1440	1410	1380	1400

Sources: Thomson Datastream; NAB

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Important Notices