# Gold Market Update

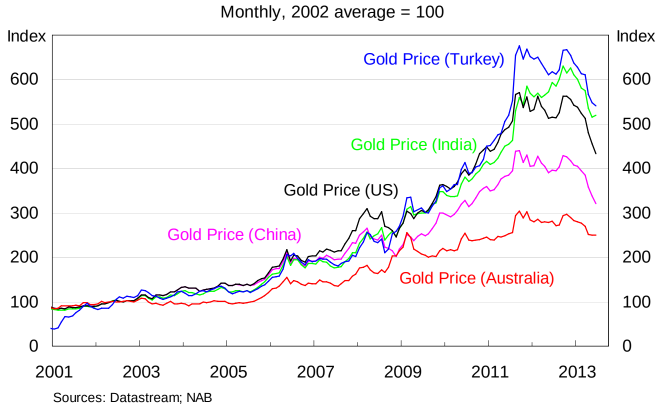
National Australia Bank

- **The price of gold fell by 5.0% over June, consolidating a 5.0% decline over May. The spot price is currently fetching around $1,240 an ounce.**
- **The price of gold is well on track for its first annual decline since 2000, with expectations for the US Federal Reserve to begin tapering its asset buying program this year, a rising US dollar and a slowing Chinese economy pushing prices lower.**
- **Investors are losing faith in gold as a store of value, with holdings of exchange traded products (ETPs) set to report their first annual decline since their introduction in 2003. But lower prices have been a catalyst for stronger consumer gold buying recently.**
- **Latest data from the World Gold Council show that the overall volume of gold demand in March quarter 2013 fell to 963 tonnes (US$50.5 billion), from 1,188 tonnes in the December quarter. However, total quarterly supply of gold eased to around 945 tonnes, reflecting a decline in mined production and recycled gold.**
- **Central banks continue to increase their holdings of gold reserves while reducing their purchases of US dollar and Euro denominated assets, providing underlying support for the shiny metal.**
- **Indian demand for gold may retreat over coming months following the end to the Indian wedding season and the recent raising of import duties on gold, while consumers may limit their purchases of gold in the current unstable price environment.**
- **The culmination of recent events has caused a drastic revision in the price of gold, bringing into question the ability of gold to maintain its mantle as a store of value. Over-exuberance during the post-GFC period seems to have lifted prices to unsustainably high levels over recent years, which are now being unwound. We have built in a moderate correction to our gold price forecasts this month and expect gold to end the year at around US$1,210 an ounce.**

## Recent Price Developments

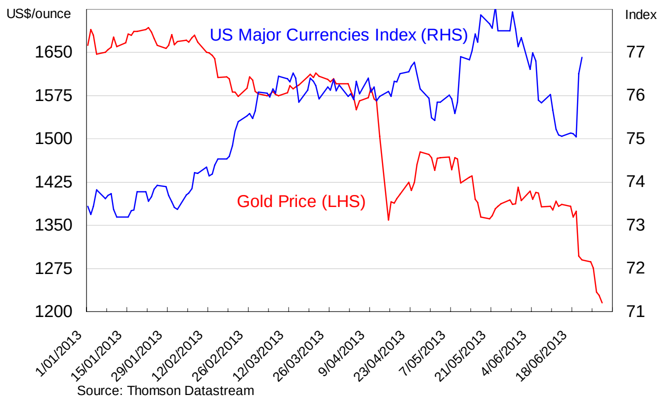
Expectations for the US Federal Reserve to begin tapering its $85 billion in monthly debt buying this year, a rising US dollar and a slowing Chinese economy have sent ripples through the gold market. The price of gold is now heading for its first annual decline since 2000. Investors appear to be losing faith in gold as a store of value, with falling investor demand sending prices from around $1,600 an ounce just three months ago, to a recent trough of below $1,200 an ounce. The Fed has indicated that if its expectations for the improved performance of the US economy hold, the tapering of QE will start later this year. All of this is helping to strengthen the US dollar, which has an inverse relationship with the price of gold. It is also becoming more evident that the copious amounts of money printing by central banks around the globe are failing to lift inflation and inflation expectations, which gold is used as a hedge against. Furthermore, weaker than expected activity data out of China over recent months are raising concerns about the outlook for the Chinese economy – the largest consumer of gold.

**International Gold Prices**




While the price of gold has taken a battering over recent months – in whatever currency you view it – not all recent news for the economy has had a dampening affect on prices. Demand for gold jewellery, bars and coins has remained relatively robust, with lower prices encouraging increased consumer demand, particularly in China and India. However, rapidly rising gold premiums in Asia and the Middle East have limited potential buying. While the end to the Indian wedding season, Akshaya Tritiya, and the decision by the Indian government to lift import duties on gold for the second time this year (from 6% to 8% on 5 June) could see Indian gold demand retreat over coming months, wealth creation and rising incomes should continue to underpin robust consumer demand.

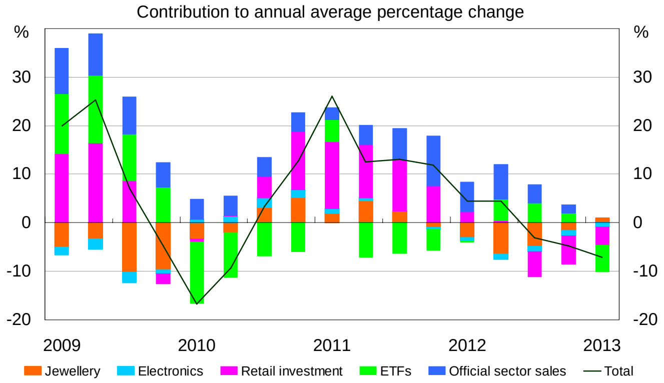
**Gold Price and the US Dollar (Daily)**




Gold's inverse relationship with the US dollar remains defiant, with the recent rally in the US dollar coinciding with a slump in the price of gold. Over much of June, an expectation has formed in markets for the US Fed to begin tapering its asset purchasing program before the end of the year on the back of improving economic activity. The lowering of US stimulus is a positive news story in the sense that activity is strengthening allowing room for the Fed to pare back stimulus. However, it also means that markets will probably raise their expectations for the Fed funds rate to be lift sooner. The US currency has gained strongly over recent weeks reflecting the changed view on the outlook for US monetary policy. Market momentum is building with investors rushing to purchase US denominated assets, which is limiting the desirability of safe haven assets, such as gold.

## Gold Demand

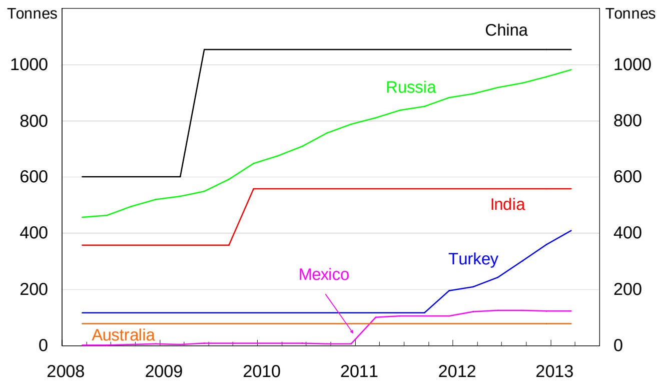
### Identifiable Gold Demand




Sources: World Gold Council; NAB

Identifiable gold demand softened over the year to March 2013, falling by 7.2%, consolidating a 4.8% decline over 2012. The contraction in gold demand largely reflected weakness in investment (in the form of exchange traded funds) and retail investment, which was only partly offset by a contribution from jewellery purchases. The volume of gold demand declined to 4217.3 tonnes over the year to March 2013, down from 4543.3 tonnes a year ago.

### Central Bank Gold Holdings (Tonnes)




Source: World Gold Council

Central banks continue to increase their holdings of traditional assets such as gold, with purchases amounting to around 109 tonnes in March quarter 2013, representing the ninth consecutive quarter of net purchases. With increased uncertainty in financial markets following the global financial crisis, gold has taken centre stage, particularly for the emerging world where central bank purchases have been pronounced. The likes of Russia, Turkey, Mexico and Korea have increased their holdings of gold reserves markedly over the past four years (see Graph). However, while central bank purchases remain substantial, they slowed in the March quarter despite lower prices.

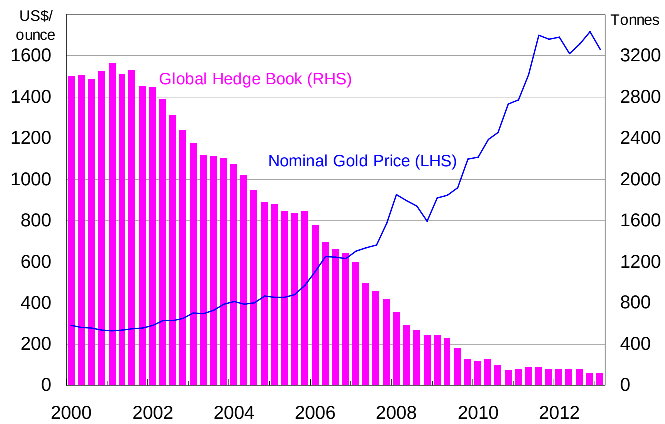
### Gold Jewellery Demand and the Price of Gold


Sources: World Gold Council; NAB

Demand for gold jewellery continued to strengthen into the March quarter, largely supported by falling prices and improved economic sentiment. According to the World Gold Council, jewellery demand increased from 522 tonnes in the December quarter to 551 tonnes in the March quarter. Much of the strength in jewellery demand can be attributed to a surge in Chinese demand, with consumer sentiment and a change of leadership in the December quarter helping to stimulate festive buying. Indian demand was also elevated, albeit slightly softer than the very high level of demand recorded in the previous quarter. US jewellery demand strengthened on signs that growth in the economy was improving.

More recently, sharper price declines look to have bolstered even stronger consumer demand for gold, which is expected to have contributed to solid jewellery buying. However, given the rapid rate of the decline in gold prices driven largely by the increase in uncertainty about the ultimate impact of monetary policy easing, consumers may not see any sense of urgency to purchase gold until prices begin to stabilise, or indeed pick up again. Rather, they may adopt a 'wait and see' approach in the near term, which could limit consumer purchases. Rising gold price premiums, the end to the Indian wedding season and higher Indian import duty on gold may also weigh on near-term demand.

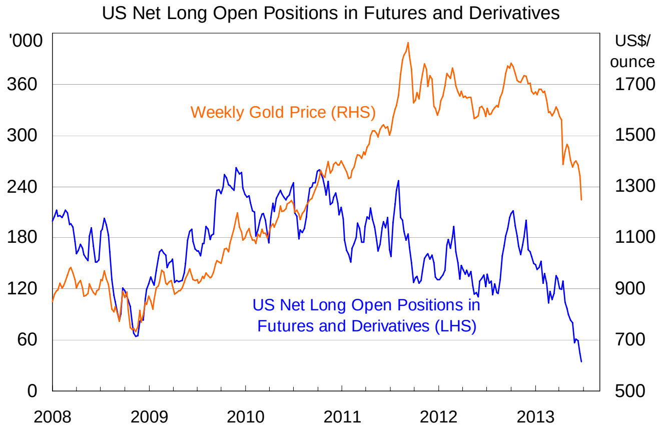
### Producer De-hedging Activity




Sources: World Gold Council; VM Group; NAB

A diminishing source of gold demand is hedging activity among producers, which remains at historically low levels. Producers use hedges to insure against risk. With inflation no longer a concern for many of the advanced economies, even in the face of heavy-handed money printing, the outlook for the gold price has fallen, causing a notable fall in de-hedging activity. In the March quarter 2013, the global hedge book is estimated to have declined by around 3 tonnes to around 116 tonnes of physical demand (see Graph). The reduction in the size of the global edge book appears to reflect scheduled deliveries or option expiries as hedge positions mature, though there does not appear to be a conscious decision by hedge producers to increase hedge cover in the softer price environment.

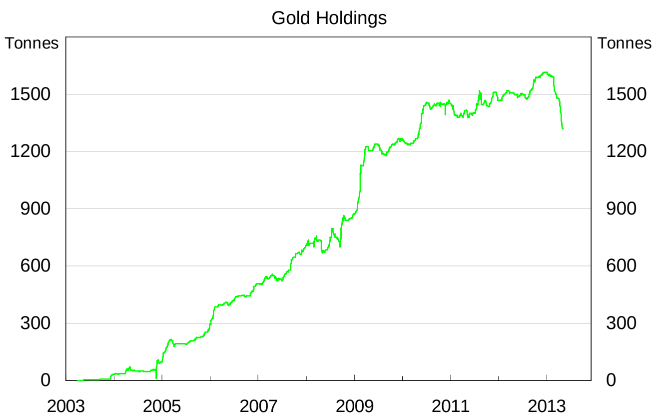
Gold Investment




Sources: Bloomberg; NAB

The price of gold traded over a fairly wide band in June – ranging from a high of above $1,400 an ounce at the beginning of the month, before falling to below $1,200 an ounce at the end of the month. Data from a selection of exchange traded gold funds (ETFs) highlight the sharp drop in holdings of gold over the past month, with investors losing faith in gold as a store of value. Investors have substantially reduced their exposure to the precious metal, with gold holdings down by around 20% already this year in response to falling prices; ETFs are set to record their first annual decline since these products were first introduced in 2003. Consistent with this, money market managers in gold futures have reduced their net-long positions (as reported by the US Commodity Futures Trading Commission), implying further expectations of reductions in the price of gold.

Exchange Traded Funds*

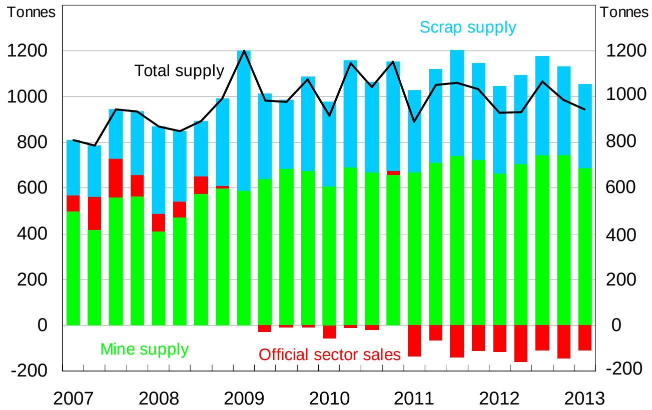



* A sample of funds from US and SA
Sources: ishares.com; exchangetradedgold.com; NAB

## Gold Supply

According to the World Gold Council, the supply of gold declined to 945.4 tonnes in the March quarter, which is around 40 tonnes below the volume of supply added in the previous quarter (see Graph). Consistent with the price of gold falling through the March quarter, a large proportion of the fall in supply reflected a drop off in recycled / scrap gold. Still strong central bank purchases also worked to remove supply from the market, while softer mined production also had an impact on supply. It is worth noting that mined production tends to be seasonally lower in the March quarter; more generally, mined production remains the key driver of gold supply, with previous investment yielding higher production rates over the past two years.

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. Official sector sales continue to lower available supply (see Graph).

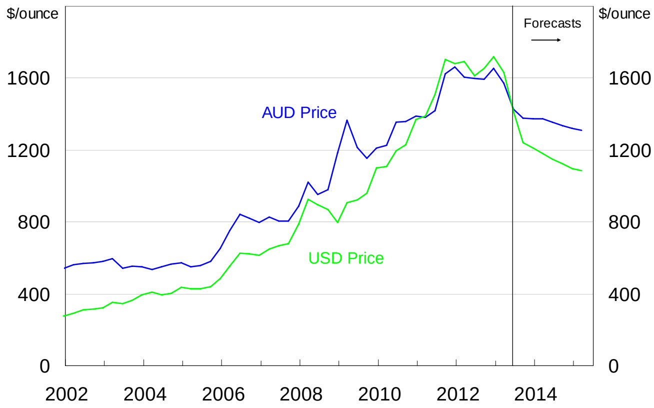
The falling price of gold is putting increased pressure on some producers, particularly those in South African where costs have surged rapidly over recent years due to rising wage costs in a labour intensiveness environment. South Africa is home to the world's deepest and costliest mines. Anecdotal reports suggest that the average cost of gold production at South African mines is around $1,200 to $1,400 an ounce; reports suggest that this is around 10% higher than the average gold production cost at Australian mines, suggesting South African producers are under immense pressure at current price levels.

## Outlook

Uncertainty about the eventual impact of aggressive monetary policy easing on economic growth appears to have intensified over June. Expectations for the timing of imminent tapering of the US Federal Reserve's asset buying program are tending to favour a commencement later this year. Bad news appears to be good news at present, with markets hoping that softer activity data will justify a delay. All of this talk about Fed tapering has come at a time when Chinese growth signals are becoming more concerning. The coincidence of these events has caused a drastic downwards revision to the price of gold and is bringing into question the ability of gold to maintain its mantle as a store of value. With prices falling rapidly over recent days, it appears that the urgency to purchase gold at lower prices has dissipated, with consumers perhaps looking to take a wait and see approach. This, combined with expectations for US stimulus to be unwound, is likely to keep the price of gold relatively low in the near term, though prices should remain volatile.

Over-exuberance during the post-GFC period seems to have lifted prices to unsustainably high levels over recent years, which are now being unwound. We have built in a moderate correction to our gold price forecasts this month and expect gold to end the year at around US$1,210 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$1,100 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 | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Jun 13 | *Sep 13* | *Dec 13* | *Mar 14* | *Jun 14* | *Sep 14* | *Dec 14* | *Mar 15* | *Jun 15* |
| Gold - US$ | 1415 | 1240 | 1210 | 1180 | 1150 | 1120 | 1100 | 1090 | 1060 |
| Gold - AU$ | 1425 | 1380 | 1370 | 1370 | 1350 | 1340 | 1320 | 1310 | 1300 |

Sources: Thomson Datastream; NAB

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## Important Notices