Gold Market Update

National Australia Bank

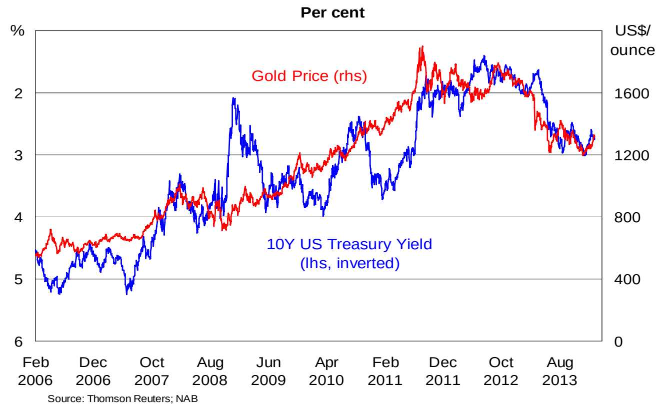
- **The average price of gold rose by around 1½% in January and has lifted a further 4½% in February to date, the first consecutive rise since late 2012. Prices have been volatile of late, but are currently trading at around $1,330 per ounce.**
- **Last year, gold recorded its first annual price decline since 2000, despite strong physical demand for the shiny metal, as speculative investors ran down their holdings in response to Fed QE tapering and an outlook for still soft inflation.**
- **Since the start of the year, the price of gold has lifted again, supported by a run of softer than expected US economic data, relevant to expectations over the timing and size of additional QE tapering (which the Fed emphasis is 'data dependant').**
- **Emerging market jitters and geopolitical risks have been another source of support for gold recently and have contributed to the volatility in markets.**
- **These patterns are likely to continue in the near-term, but the US economy is expected to be the primary driver of gold price trends in 2014 and 2015. Our view is that the US recovery will get back on track this year once the impact from bad weather passes, allowing the Fed to continue with its tapering program (to be completed by years end). A higher USD and rising interest rates will weigh on gold prices.**
- **Physical demand for gold has been quite strong, particularly in Asia as consumers respond to lower prices – even as Indian official import demand is dampened by government import restrictions and currency pressures. This is likely to continue to be a relative bright spot for the gold market, although the possibility of further negative shocks to emerging market currencies could be a risk. The Indian import restrictions are expected to be lifted late this year, or possibly in 2015.**

Recent Price Developments

Last year brought about the long anticipated bear market for gold as an improving US economy allowed the Fed to commence tapering their asset purchase program – monthly asset purchases were scaled back from US$85 billion a month last year to US$65 billion more recently. Rising interest rates, a higher USD and a rally in equity markets all weighed on the attractiveness of the shiny metal to investors, driving down prices by almost a third over the course of the year.

More recently however, market concerns over the US economic recovery, along with anxieties over emerging markets, have contributed to some volatility in financial markets. Since the start of the year, the run of softer than expected (and probably weather affected) economic data out of the US – namely soft labour market reports and weaker industrial activity – have generated some unease over the outlook for the US economy, pushing interest rates back down from their multi-year highs – rejuvenating investor interest in holding gold. In the scheme of things, however, these data followed quite strong outcomes in previous months, while the weather impacts are likely to be temporary. Consequently, our International Economics team think that the recovery remains on track, granting the Fed sufficient impetus to maintain the current track of Fed tapering (to be completed by end-year).

US 10-Year Treasury Yield

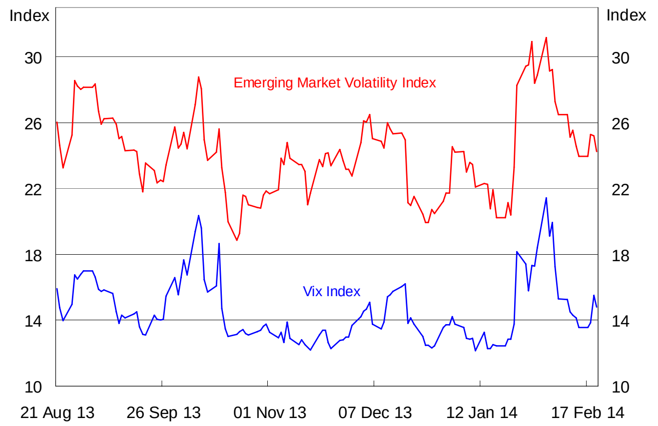


Outside of the US, concerns resurfaced again earlier in the year over the stability of the emerging economies. China, the largest emerging economy, continued to show signs of slowing growth momentum. Real GDP growth eased to 7.7 per cent in Q4, down from 7.8 percent the previous quarter, while more timely indicators do not suggest much improvement. Given the timing of the Lunar New Year, Chinese economic data have been limited, meaning that alternative indicators like the manufacturing PMI have had even greater significance to financial and commodity markets. In January and February the PMIs tended to suggest that the Chinese manufacturing sector continued to slow. The HSBC PMI (representative of SMEs) has been particularly soft, below 50 in January (suggesting a contraction in activity), while the February flash estimate deteriorated further.

Concerns over the Chinese (and global) growth outlook tends to be much more significant to industrial metals than to gold – although with China becoming the largest gold importer last year, the significance certainly is not negligible. Nevertheless, the slowing down of the Chinese economy has particular significance to emerging economies (especially in Asia), which have already come under scrutiny over how they will manage the looming end to (and eventual unwinding of) quantitative easing by the major advanced economies. Countries with poor external balances stand out as targets for capital flight, which has already created volatility in exchange rates and seemingly contributed to a boost in demand for safe haven assets (including gold) in late January/early February. Fortunately, markets were quick to price in these concerns and the swift response of some emerging economies to stabilise their currencies helped to alleviate some of the market fears. Solid credit and exports reported in China may have also helped in this regard, although some have questioned the quality of the exports data, while stronger credit growth may actually fuel negative sentiment in terms of the potential policy response.

There has also been a marked increase in safe haven demand for gold corresponding to escalating tensions in the Ukraine. The main concerns stem from both a call for financial aid (to the tune of $35 billion over 2 years), potentially reigniting the European austerity debate, while the possibility of energy disruptions enhance the allure of gold as an inflation hedge. However, the magnitude and longevity of its impact is near on impossible to predict. Nevertheless, new elections are expected to be held shortly that may help to clarify the situation, at least for the time being – this (upside) tail risk will continue to be watched closely.

Index of Market Volatility (Vix)



Source: CBOE, Thomson Reuters

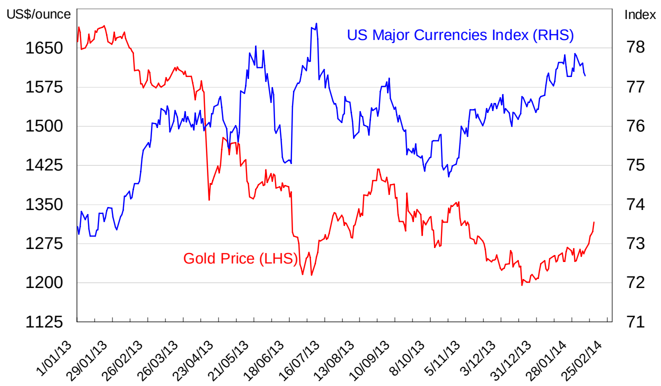
The general uncertainty saw a temporary tick up in the VIX measure of financial market volatility in late January, although it did not reached a particularly high level. Similarly, the emerging market volatility index recorded a sharp spike in late January, but also remained within manageable levels and settled back down towards levels consistent with the average seen over the past 18 months. Nonetheless, the gold price has responded, lifting to a 4 month high in late February (slightly over US$1,340/ounce), although prices have remained volatile. But while the US economic recovery and emerging markets are currently under the microscope, one source of volatility that was prevalent late last year appears to have subsided. The premium placed on gold prices due to US political uncertainty (and last years government shutdown) appears to have washed out of the market following a deal struck to lift the Treasury's borrowing authority until March 2015. This is certainly a positive development, removing some tail risks.

Since the end of December, the price of gold has ebbed steadily higher. The average price of gold rose by around 1½% in January and by a further 4½% during February – currently trading at close to US$1,330 per ounce. This is the first back-to-back increase in month average prices since October 2012. Nevertheless, in year ended terms, the price of gold in February was more than 20% below levels recorded in the same month of the previous year.

Gold's inverse relationship with the US dollar appeared to break-down at the start of the year, with the US dollar appreciating against major currencies as the gold price turned up. However, this could have reflected a temporary boost to physical demand from Asia in the lead up to Lunar New Year, negating the negative impact from a higher USD. More recently, the traditional inverse relationship has strengthened somewhat. The USD is generally lower compared to major trading partner currencies over February, while the gold price remained on an upward trend.

However, if geopolitical tensions start to escalate, it is possible that safe haven demand could push both the USD and gold price higher.

Gold Price and the US Dollar (Daily)

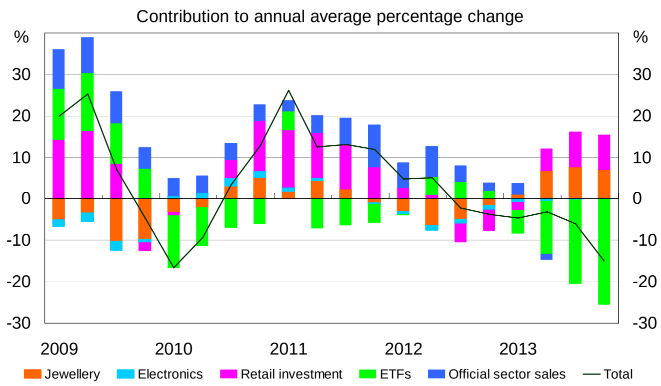


Source: Thomson Datastream

There has been a clear shift in market expectations for gold prices over the past year, but views on the future path for prices appear to have diverged notably. At one extreme, some analysts are expecting that a solid pick up in Asian demand (including a reversal of India gold import restrictions), and/or possibly a faltering US recovery, will see the gold price continue to push higher. At the other end of the spectrum, forecasters who are anticipating additional strength in the USD, US interest rates and equity markets expect the gold price to resume pushing lower, until supply side constraints are hit. We tend to fall more into the latter camp. Although weather related disruptions caused activity in the US to slow more than anticipated in the near-term, we continue to believe that the economic recovery in advanced economies will get back on track in coming months. Consequently, we expect US interest rates to rise from the current levels, placing additional pressure on gold prices. The magnitude of the declines will eventually be limited by supply side constraints, although additions to supply capacity will allow prices to dip lower in the longer term. Nevertheless, an earlier than expected lifting of the Indian import restrictions, along with geopolitical and emerging market concerns present some significant upside risks to our forecast.

Gold Demand

Identifiable Gold Demand

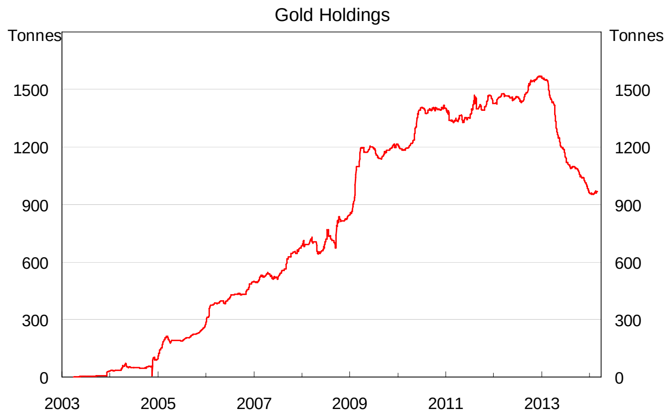


Sources: World Gold Council; NAB

Identifiable gold demand softened noticeably over the year to December 2013, falling by 15%, consolidating a 3.7% decline over 2012, and the largest decline since early 2010. The contraction in gold demand was driven completely by weakness in investment (in the form of exchange traded funds). In contrast, physical demand (particularly jewellery demand) was solid, supported by lower prices over the year; jewellery demand hit a 16-year high. Lower prices helped to trigger stronger physical demand in Asian and the Middle Eastern markets in particular, but the sentiment also spread to western markets late in the year. In contrast to ETF trends, investor demand for coins and bars surged to an all time high. The volume of gold demand declined to 3756.1 tonnes over the year to December 2013, down from 4415.8 tonnes a year ago.

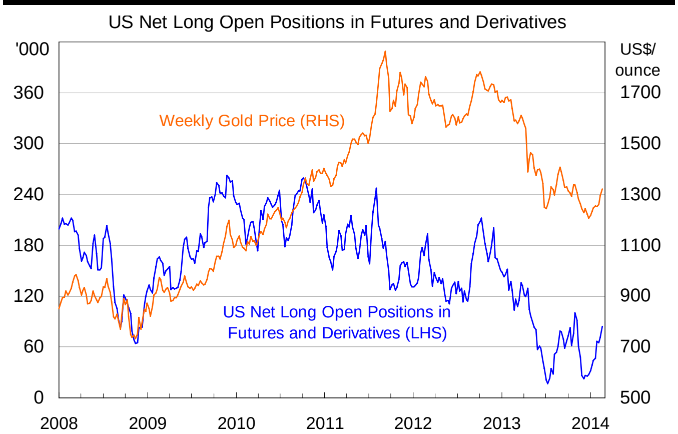
Consistent with expectations for a rising USD and interest rates, investors became less comfortable with holding gold in their investment portfolios during the course of 2013. However, softer than expected economic data out of the US and China, along with emerging market jitters have contributed to fears of a bad event that is helping 'safe haven' demand for gold. Indeed, the Fed has continued to emphasise the fact that tapering will be 'data dependent', although Fed members have emphasised that the barrier to delay tapering is high. Nevertheless, data from a selection of US exchange traded gold funds (ETFs) have highlighted the sharp decline in gold holdings since the beginning of 2013, with investors losing faith in gold as a store of value. This has similarly been reflected in a reduction of net long open positions in futures and derivatives, which dipped to their lowest post-GFC levels last year. However, gold investment activity, while still soft relative to history, has picked up a little over recent weeks – US net long open positions have lifted from recent lows, and ETF gold sales appear to have stalled in response to the factors already mentioned above.

Exchange Traded Funds*



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

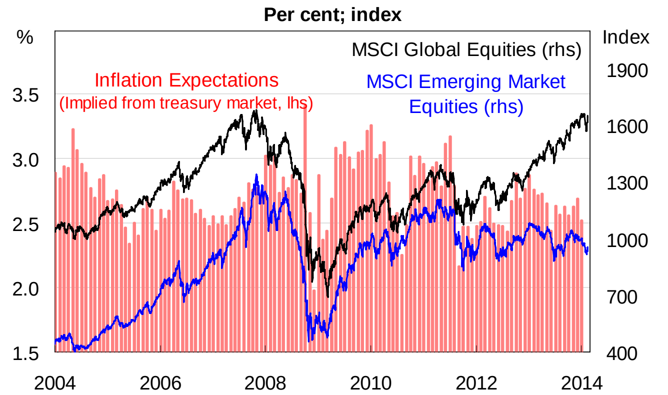
Gold Investment



Sources: Bloomberg; NAB

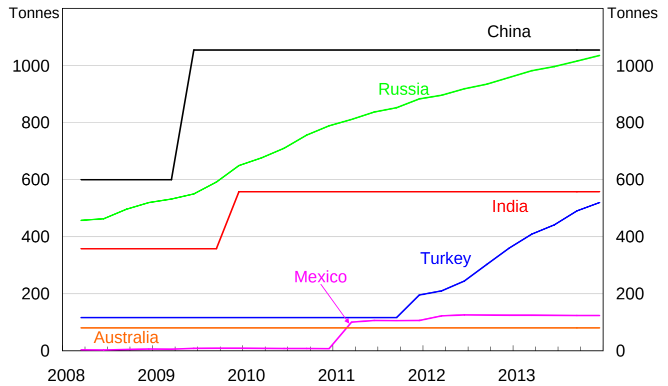
We suspect the recent improvement in attitudes towards gold is likely to be temporary – setting aside the unpredictable nature of the geopolitical tail risks. In particular, equity markets continue to perform relatively well, at least outside of emerging markets, while demand for gold as an inflation hedge is likely to be limited as inflation expectations have remained anchored. But most importantly, our current forecasts for the US continue to have US interest rates rising from current levels over the coming quarters.

Inflation expectations & global equity prices



Central bank net gold buying has persisted over 2013, although the pace of purchases lessened towards the end of the year in response to higher volatility in gold and slower foreign reserve accumulation. Central bank purchases amounted to around 61 tonnes in the December quarter, down from 96 tonnes in the September quarter, representing the smallest outcome in three years. The pull back in the pace of purchases by central banks largely reflects a broader slowing in accumulation, rather than a rise in the number of central banks reducing their holdings. Many of the large emerging economies have kept their reserves broadly unchanged for a number of years now, although Russia and Turkey have been notable exceptions, as well as some middle-eastern countries. Korea also added to their official reserves.

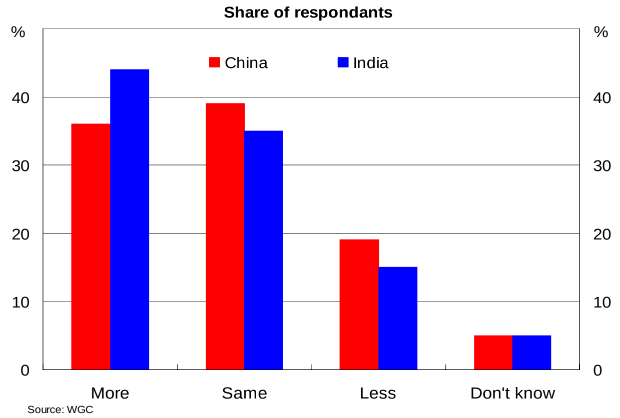
Central Bank Gold Holdings (Tonnes)



Source: World Gold Council

A major upside risk to our demand outlook for gold is the potential for stronger than expected physical demand from Asia, which has remained strong despite the Indian import restrictions imposed last year and significant depreciation of some EM currencies, as consumers responded to lower prices. The World Gold Council's most recent report of gold demand trends showed that China's gold demand lifted 32% over the year to the December quarter (to 1,066t in 2013), meaning that it has surpassed India as the world's largest consumer of gold. Nevertheless, India's gold demand still managed to lift 13% over the year, despite a drop in official imports and a rise in domestic gold premiums. Unofficial gold import channels have been used to satisfy India's healthy gold demand, with the WGC estimating unofficial volumes at between 150-200t (although they suggest that imports in 2013 were probably closer to the top end of this range). The timing of any removal or reduction in India's import restrictions is uncertain, although our expectation is for late in the year, at the earliest (WGC suggest any time after Q1 2014). Any surprise removal (or relaxation) of the import restrictions is another upside risk to the outlook, particularly given the robust gold purchase intentions evident in the WGC survey (chart).

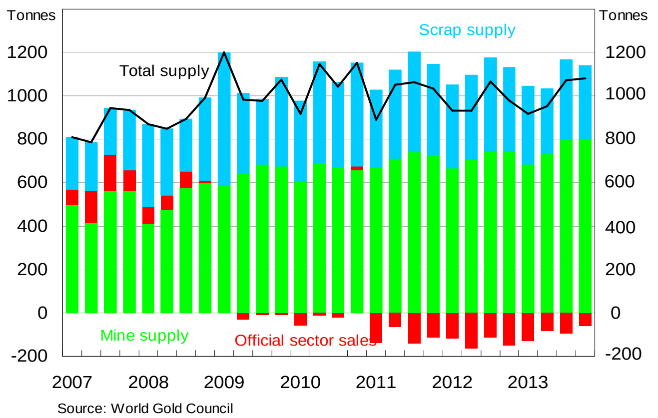
India and China consumer gold spend intentions



Gold Supply

According to the World Gold Council, the supply of gold picked up over the course of 2013, reaching 1080.1 tonnes in the December quarter, which is slightly less than 10 tonnes above the volume of supply added in the previous quarter (see Graph). The increase in supply during the quarter was driven by a rise in mine output, which reached a record high of 802.7t, while there was much less of a drag on supply from the official sector as central banks slowed down their reserve accumulation. In contrast, scrap/recycled supply softened in the quarter consistent with declines in the gold price. Similarly, looking at the whole of 2013 the data show that mine production and less demand from the official sector were the biggest source of gold supply, while the contribution of scrap sales to the supply of gold has declined significantly.

World Gold Supply (Quarterly)



The lower price of gold has been putting increased pressure on some gold producers, and reports suggest that this has persisted despite the recent price rally. While production capacity has been rising in recent years, production costs have also surged due to rising wages and environmental regulation pressures. However, even if higher costs in combination with the current soft price environment does put the brakes on future capacity plans, already committed mines will still begin to yield production over 2014 and beyond, including projects like Goldcorp's Eleonore and Newmont's Akyem. This is expected to see production rise from its current high level. However, the decline in scrap supply (currently accounting for around a third of supply) is expected to continue as previous high prices brought forward significant supply.

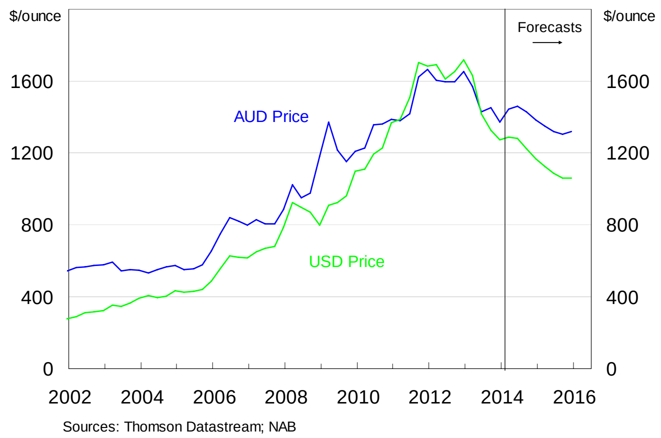
Outlook

Emerging market concerns are likely to mean that commodity and financial markets will remain relatively volatile for the time being. Similarly, given that Fed tapering is to remain 'data dependant', we are likely to see markets fluctuate with the ebb and flow of economic data out of the US. The current price of gold is being supported by the recent run of softer US economic data, but given that the impacts from weather related disruptions are likely to be temporary, we expect the economic recovery to get back on track this year. This will see the USD and US interest rates lift over the course of the year (10-year treasury yields are forecast to touch 3% this year, before moving much higher in 2014), which we consider to be distinctly bearish for gold prices.

The renewed interest in gold as a safe haven asset, stemming from emerging market volatilities and the Ukraine's geopolitical risk, is difficult to predict going forward and is likely to contribute to volatility in the market. Nevertheless, in contrast to previous years, gold has become an expensive way for investors to insure against these types of tail risks. In particular, despite its high price, gold has no intrinsic value and does not generate an income flow like other assets do. Consequently, safe haven demand generated by these factors is likely to be marginal and temporary.

The main bright spot for gold is likely to be ongoing demand from Asia, particularly if India's import restrictions are removed sooner than expected. Consumers in Asia are highly sensitive to prices and we have seen consumer demand respond to price declines to date. However, the prospect for further currency declines in emerging markets could be a potential road block – although Indian demand has managed to weather these headwinds relatively well to date. On the other hand, concerns about looming inflation pressures and/or economic instability, could prompt additional safe haven demand in the region to preserve wealth.

Nominal Gold Price



Taking all of these factors into account, as well as the outlook for rising global gold supply, it is our expectation that prices will hold up in the near term, before gradually softening over the forecast horizon as uncertainty dissipates. While external influences are likely to keep demand for gold varied in H1 2014, we generally expect the price to moderate to around US$1,170 an ounce by the end of 2014, before gradually softening to around US$1,060 an ounce by the end of 2015, as growth in the major advanced economies regains momentum and investors increase their demand for riskier assets. Potential risks to the outlook include a further faltering of the US recovery, worse than expected emerging market volatility, an escalation in geopolitical tensions or stronger than expected demand for gold from Asia. All of these risks point to a higher gold price than currently forecast.

Quarterly Price Profile

Gold Price Forecasts – Quarterly Average

Gold Price Forecast - Quarterly Average

	Spot	Actual	Forecasts							
	Current	Dec 13	*Mar 14*	*Jun 14*	*Sep 14*	*Dec 14*	*Mar 15*	*Jun 15*	*Sep 15*	*Dec 15*
Gold - US$	1341	1273	1290	1280	1220	1170	1120	1090	1060	1060
Gold - AU$	1484	1371	1440	1460	1430	1380	1350	1320	1300	1320

Sources: Thomson Datastream; NAB

james.glenn@nab.com.au
rob.brooker@nab.com.au

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia

Economics

Rob Henderson
Chief Economist, Markets
+61 2 9237 1836

Spiros Papadopoulos
Senior Economist
+61 3 8641 0978

David de Garis
Senior Economist
+61 3 8641 3045

FX Strategy

Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Emma Lawson
Senior Currency Strategist
+61 2 9237 8154

Interest Rate Strategy

Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Rodrigo Catril
Interest Rate Strategist
+61 2 9293 7109

Credit Research

Michael Bush
Head of Credit Research
+61 3 8641 0575

Equities

Peter Cashmore
Senior Real Estate Equity Analyst
+61 2 9237 8156

New Zealand

Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Markets Economist
+64 4 474 6923

Kymberly Martin
Strategist
+64 4 924 7654

UK/Europe

Nick Parsons
Head of Research, UK/Europe,
and Global Co-Head of FX Strategy
+ 44207710 2993

Gavin Friend
Markets Strategist
+44 207 710 2155

Tom Vosa
Head of Market Economics
+44 207710 1573

Simon Ballard
Senior Credit Strategist
+44 207 710 2917

Derek Allassani
Research Production Manager
+44 207 710 1532

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Tom Taylor
Head of Economics, International
+61 3 8634 1883

Rob Brooker
Head of Australian Economics
+61 3 8634 1663

James Glenn
Senior Economist – Australia
+(61 3) 9208 8129

Vyanne Lai
Economist – Agribusiness
+(61 3) 8634 3470

Karla Bulauan
Economist – Australia
+(61 3) 8641 4028

Dean Pearson
Head of Industry Analysis
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Industry Analysis
+(61 3) 8634 4611

Brien McDonald
Economist – Industry Analysis
+(61 3) 8634 3837

Amy Li
Economist – Industry Analysis
+(61 3) 8634 3837

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049