Gold Market Update – May 2014

National Australia Bank

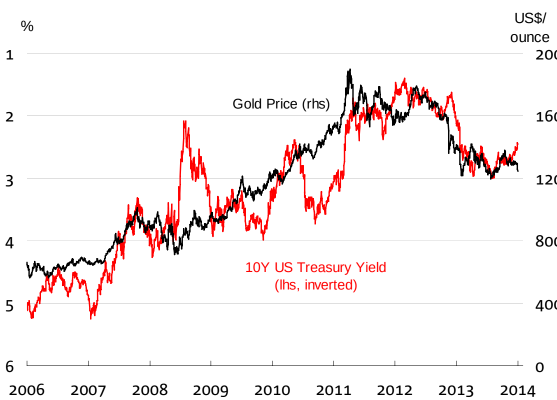
Key Points:

- ***Tensions between the Ukraine and Russia have been less disruptive than a month ago, reducing market volatility and bringing down gold's risk premium – allowing gold markets to refocus attention on macroeconomic drivers.***
- ***Reasonably positive economic data out of the US, and some recent good company results, have helped US and global equity prices rally. Similarly, the US Fed's QE tapering is largely unfolding as expected, putting aside recent falls in bond yields, while relatively benign inflation pressures are limiting demand for gold as an inflation hedge.***
- ***This has all weighed heavily on investor demand for the shiny metal. Exchange traded fund (ETF) holdings of gold have again started to decline, having experienced a period of stabilisation since around the start of the year. Net-long positions in gold are also down from recent peaks.***
- ***Physical demand indicators are also a little softer, contributing to a rise in Comex gold inventories. Chinese net imports of gold from Hong Kong have fallen 40% from their most recent peak in February, and are 50% below last year's all time high.***
- ***Consequently, after remaining relatively trade bound for much of the past month, gold prices dropped almost 4% since the end of May to around US$1,245 per ounce.***
- ***Aside from the geopolitical risks, a potential unwinding of India's gold import restrictions, post the recent election, poses a significant upside risk to gold prices. Some measures have already been relaxed and should help to ease elevated gold premiums in India, although the impact on exchange prices has so far been limited.***

Recent Price Movements:

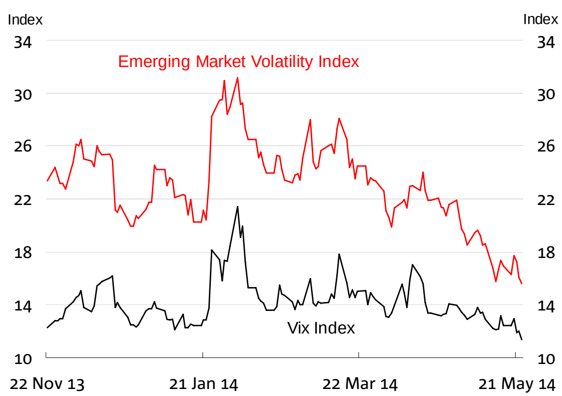
- The average price of gold fell by around ¾% in May, reflecting a sharp drop in prices late in the month – following a period of relative stability. This is the second consecutive fall in prices, but has only partly unwound the rally recorded earlier in the year that came on the back of heightened geopolitical uncertainties and economic growth concerns. Prices are currently trading at around $1,245 per ounce, having dropped almost 4% in the last week of May.
- 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. This adjustment temporarily stalled earlier this year, coinciding with a reduction in risk appetite, but a retreat in investor demand is expected to continue setting the tone for the gold market over the longer term. This will be the case even as consumer demand from Asia becomes more significant later in the year (particularly if Indian import bans are relaxed); although consumer demand will help provide a floor to the market.
- Emerging market jitters and geopolitical risks will need to be monitored closely and are intrinsically difficult to predict. Nevertheless, confidence that these risks are subsiding has contributed to lower volatility in markets (Figure 2) and a reduction in gold's risk premium.
- Gold's inverse relationship with the US dollar has been less apparent in recent months, with the USD generally easing against major currencies while the gold price has fallen. This is likely a reflection of improvements in risk appetite that is pushing investors out of USD and gold and into equities and other higher yielding assets. However, this is somewhat inconsistent with the recent rally in US treasuries, which has pushed yields back to their lowest levels since early 2013.
- Given the unpredictability of emerging market and geopolitical risk, it is possible the USD and gold price will exhibit periods of positive correlation. However, our longer-term view is for the USD to strengthen on the back of an improving macroeconomic environment (prompting a further withdrawal of monetary stimulus), while a rise in risk appetite pushes gold prices lower.

Figure 1: Gold Price & US Treasury Yield



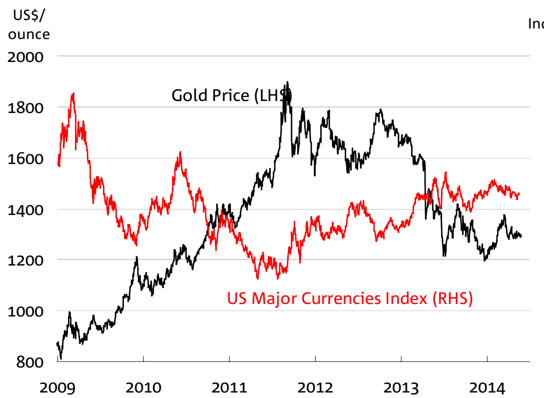
Source: Thomson Reuters; NAB

Figure 2: Implied market volatility (vix)



Source: CBOE, Thomson

Figure 3: Gold Price & USD

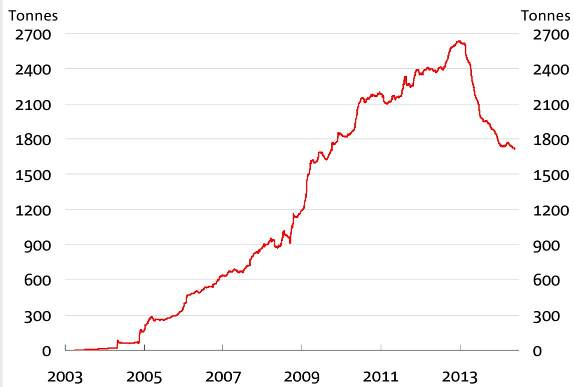


Source: Thomson Datastream

Gold Demand Conditions:

- The recent shift in risk appetite has once again seen investors became less comfortable with holding gold in their investment portfolios. Data on US exchange traded gold funds (ETFs) indicate that investors have resumed drawing down their gold holdings, suggesting they have lost faith in gold as a store of value. This is similarly reflected in a reduction from recent peaks of net long open positions in futures and derivatives.
- However, a drop in US treasury yields and mixed indications on Chinese growth means that the longevity of this trend is unclear. Nevertheless, confidence in the Chinese economy appears to be returning on stimulus hopes, but we remain cautious given the lack of transparency on the size and timing of any new stimulus spending.
- Our expectation is that improving advanced economies, benign inflation pressures, and easing geopolitical tensions will weigh on investor gold demand in the medium-term. Our forecast for US interest rates to rise over coming months from current levels is consistent with much lower gold prices. However, any potential ECB quantitative easing (although not expected by us), could stem investor withdrawals.
- Demand for gold as an inflation hedge is likely to be limited as inflation expectations have remained anchored.

Figure 4: Exchange Traded Fund Holdings



Sources: Bloomberg; NAB

Figure 5: Comex Gold Inventories

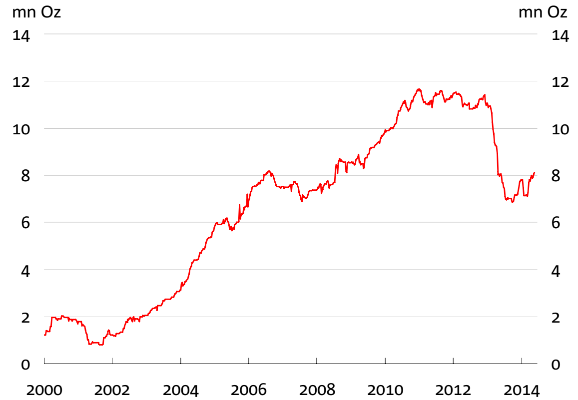


Figure 6: Other Gold Demand Factors

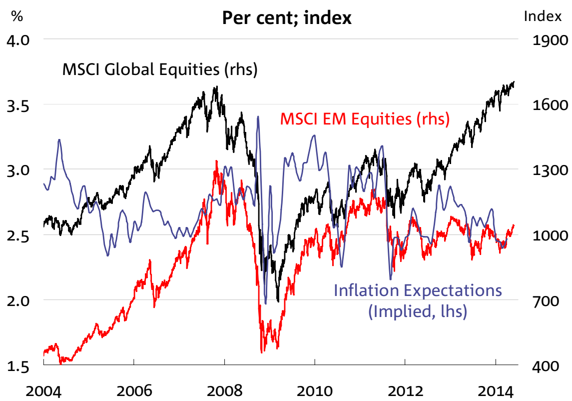
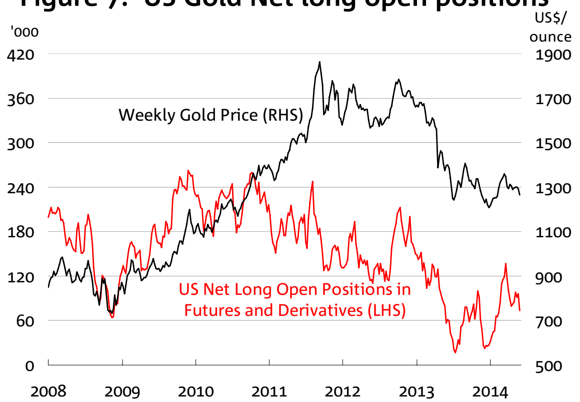


Figure 7: US Gold Net long open positions

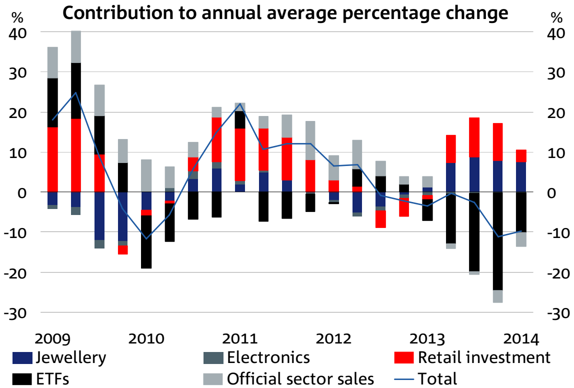


Sources: Bloomberg; NAB

Gold Demand Conditions (Cont.):

- According to the World Gold Council (WGC), identifiable gold demand rose in the March quarter (to 1074.5 tonnes), but was down slightly over the year (-¼%). The rise in the quarter largely reflected fewer reductions in ETF gold holdings, with private physical demand actually easing slightly; retail investment also hit its lowest level since 2010.
- Over the year however, physical demand recorded a notable improvement driven by lower gold prices and improved consumer confidence. A rise in jewellery demand was relatively broad based, although growth in China has been particularly strong (overtaking India last year as the worlds largest consumer). More recently, however, net gold imports to China from Hong Kong have eased notably, pointing to softer demand. Certainly, prices have lifted somewhat from last years lows, and currencies in some markets have depreciated heavily, which should limit consumption for now.
- Central bank net gold buying lifted in Q1 (from 85t to 122.4t), but is still within the comfortable levels seen in recent years. Most signatories of the Central Bank Gold Agreement remain inactive (reluctant to sell), although Germany was an exception, reducing holdings slightly for the purposes of their coin-minting program.

Figure 8: Identifiable Gold Demand

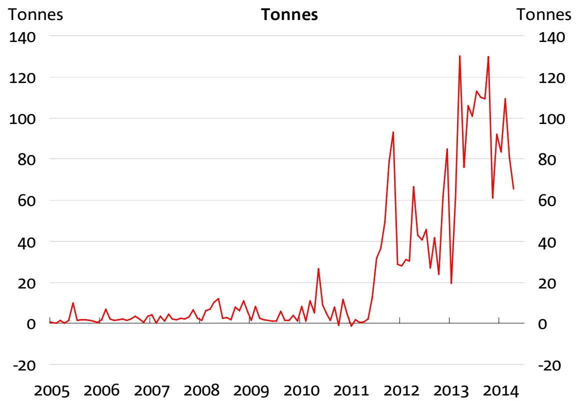


Sources: World Gold Council; NAB

Figure 9: Growth of Gold Jewellery Demand

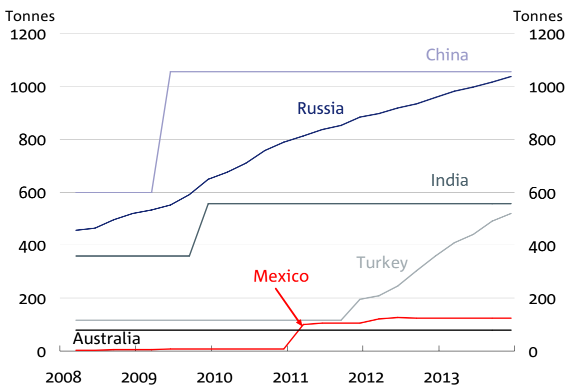
Sources: World Gold Council; NAB

Figure 10: Chinese net gold imports from HK



Source: CEIC; NAB

Figure 11: Central Bank Gold Holdings

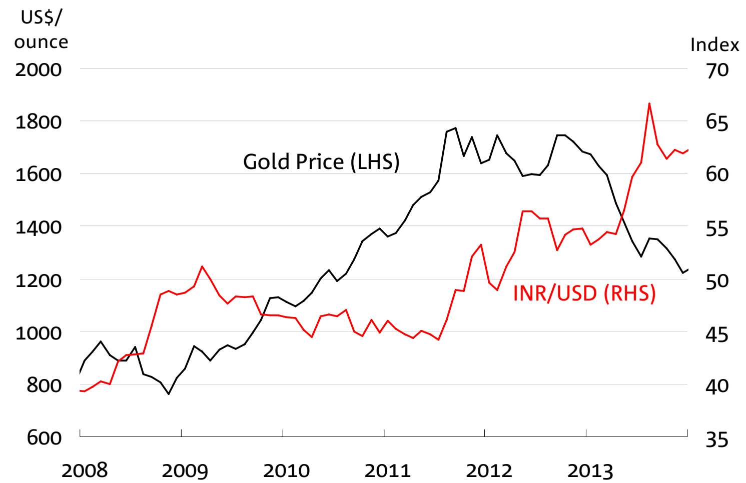


Source: World Gold Council

Recent Developments: India gold ban

- An upside risk to our demand outlook for gold is the potential for stronger than expected physical demand from Asia as consumers responded to lower prices. More specifically, India's ban on gold imports could have significant ramifications if fully reversed by the new government.
- The ban has already been modified. The RBI recently announced that has liberalised gold import norms under the 80:20 rule. Expectations indicate that the change in rules could see monthly average gold imports almost double from 25-30 tonnes per month currently. However, this is likely to be largely offset by reductions in illegally imported metal, while there is still potential to re-tighten the ban if India's current account begins to deteriorate again.
- The WGC reported that unofficial gold entering the Indian market has been a large source of supply but has seemingly lost some momentum after the initial surge of last year.
- Adjustments to the ban this year have helped to ease domestic premiums from previous highs and are generally expected to see premiums ease further.

Figure 12: Gold Price & Indian Rupee



*Dots represent current spot values
Source: Bloomberg; Thomson Datastream; NAB

Figure 13: Indian Gold Imports & INR

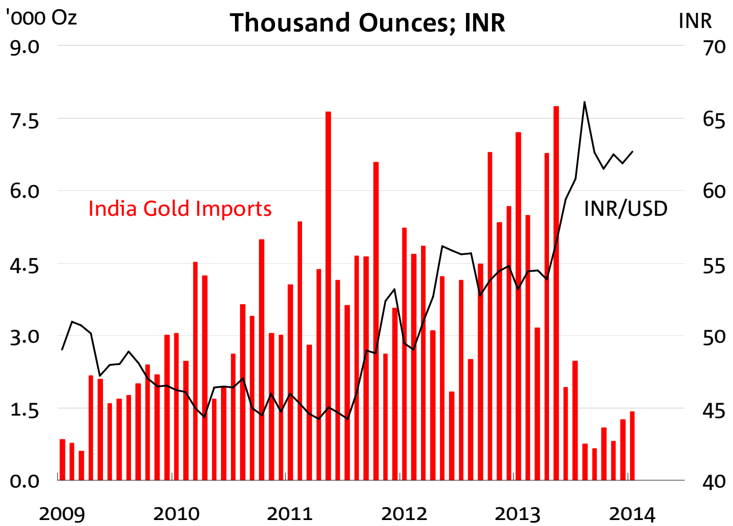
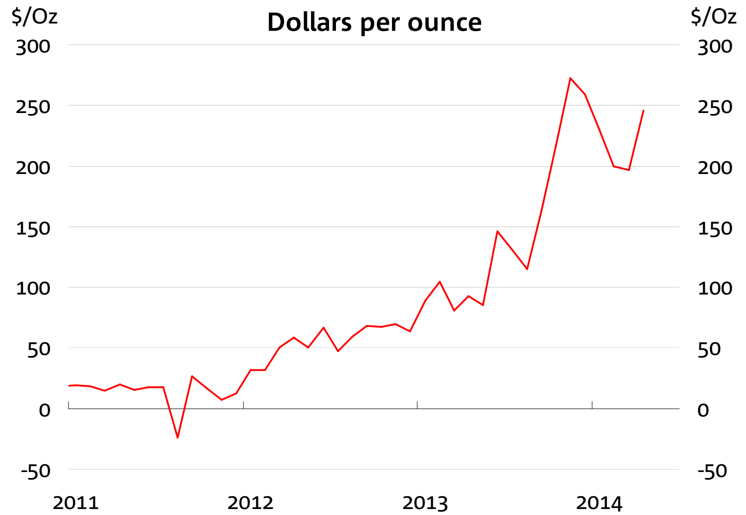


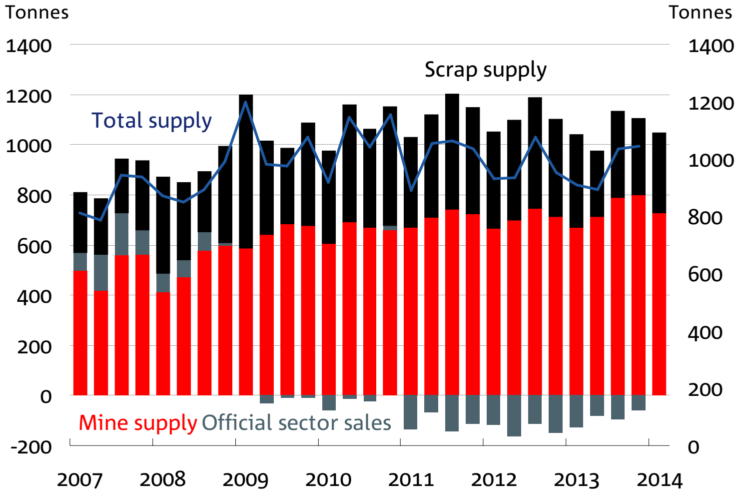
Figure 14: Indian Gold Spot Premium



Gold Supply Conditions

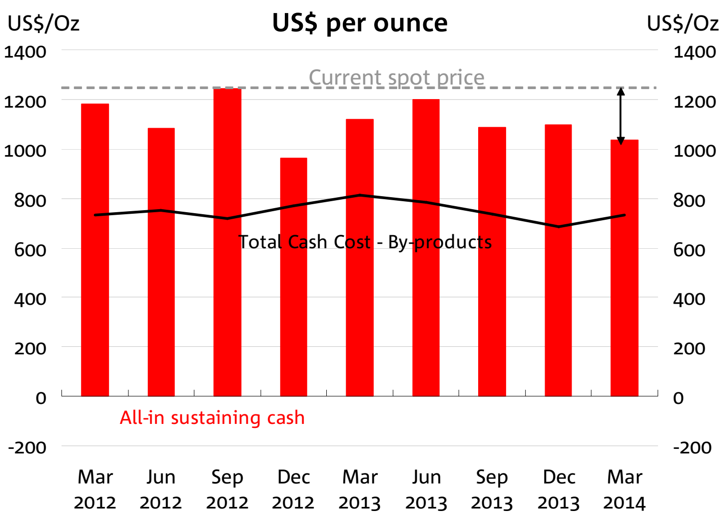
- According to the WGC, the supply of gold picked up modestly over the year to Q1 2014, reaching 1049 tonnes for the quarter, which is slightly less than 60 tonnes below the volume of supply added in the previous quarter. The increase in supply over the year was driven by a rise in mine output, which increased more than 8%, while the supply of scrap gold fell over the period. Compared to Q4 2014 however, the trend is reversed, with mined supply dropping 9%, while scrap rose modestly.
- The lower price of gold has put increased pressure on some producers, and conditions remained tough into Q1 despite the price rally. Despite the pressure coming from lower prices (and increased cost pressures from previous years), already committed mines will still begin to yield production over 2014 and beyond; even if conditions put the brakes on new capacity announcements. This is expected to see production rise from its current high level as producers seek economies of scale. Regarding scrap supply (currently accounting for around a third of supply), declines are expected to continue as previous high prices brought forward significant supply.
- On a positive note, data reported by Bloomberg Industries suggests that all-in gold cash costs have eased in recent quarters, which will be providing some 'breathing room' for producers if prices continue to ease.

Figure 15: World Gold Supply



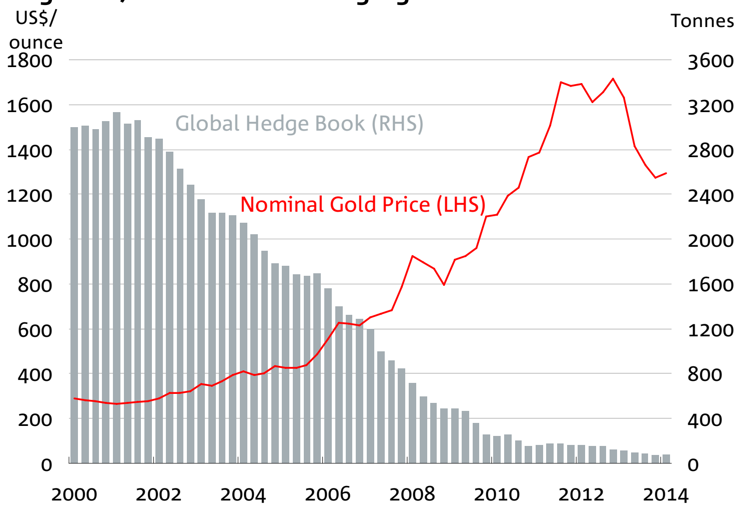
Source: World Gold Council

Figure 16: Gold Mine cash costs



Source: Bloomberg Industries; NAB

Figure 17: Producer Dehedging



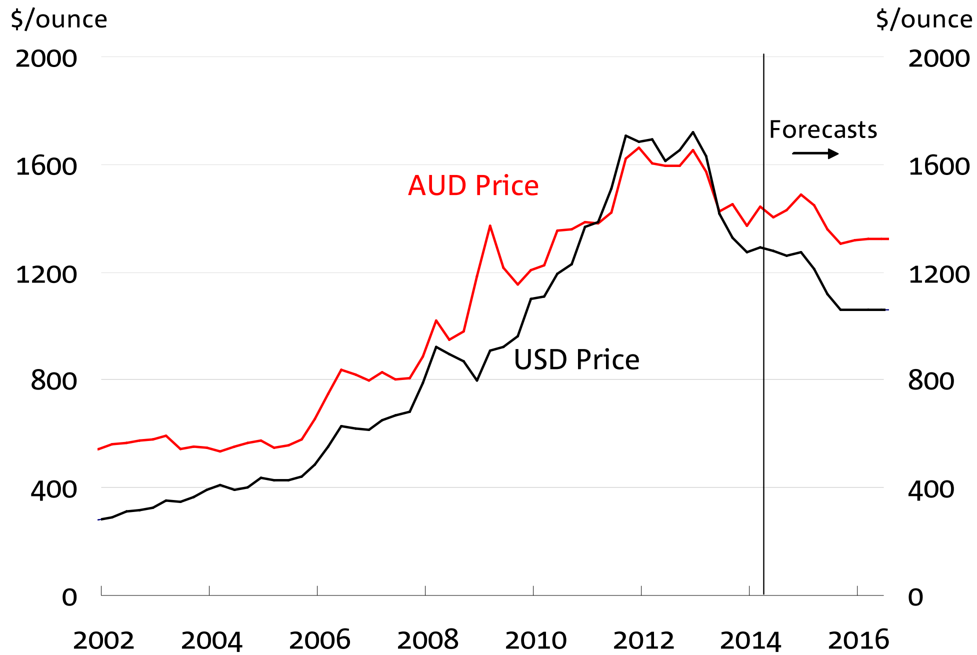
Sources: World Gold Council; Societe Generale; Thomson Reuters; NAB

Gold Price Forecasts (Quarterly Average)

	Spot Price	Actual Mar-14	*Jun 14*	*Sep 14*	*Dec 14*	*Mar 15*	*Jun 15*	*Sep 15*	*Dec 15*	*Mar 16*
			Forecasts							
Gold – US$	1245	1292	1280	1260	1270	1210	1120	1060	1060	1060
Gold – AU$	1336	1443	1400	1430	1490	1450	1360	1300	1320	1330

Source: Datastream, NAB Economics

Figure 18: Gold Price Forecast (USD and AUD)



Sources: Thomson Datastream; NAB

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