Gold Market Update – August 2014

NAB Group Economics

National Australia Bank

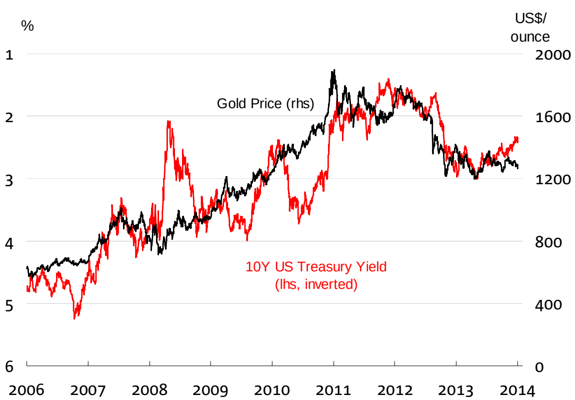
Key Points:

- Geopolitical tensions remain a key support for the gold market and with western countries ramping up their involvement, there is scope to further fuel gold's risk premium. Nevertheless, market volatilities have so far remained contained.
- Geopolitical factors tend to have only a temporary impact on gold prices. Rather, it is the outlook for the economy and monetary policy that will determine underlying and medium term trends in the market. The steady flow of generally positive economic data out of the US appears to be firming up expectations that the Fed will complete QE tapering in October, with interest rates likely rising from mid-2015. At the same time, inflationary pressures/expectations remain subdued, limiting demand for gold as an inflation hedge.
- These factors are driving USD strength and contributed to gold prices hitting a 3-month low in early September. The average gold price dropped around 1% in August, but dropped more sharply in early September (currently below US$1,260 per ounce).
- Despite an improving economy, US treasury yields have been declining, and other major central banks remain determined to keep interest rates low and liquidity high. This environment could increase gold's appeal to investors and drive up prices in Q4 (although we expect any gains to be modest and are forecasting yields to rise).
- Investor have been reluctant to run down their gold holdings as rapidly as they did in 2013, although ETF holdings did fall in August. 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 also fallen considerably, consistent with WGC reports of a decline in consumer gold demand over the year to Q2 2014.
- Aside from the geopolitical risks, further unwinding of India's gold import restrictions, as external imbalances improve, poses a significant upside risk to gold prices. New stimulus measures from major central banks are also significant, but our expectation for US interest rates to rise is underlying our forecast for further gold price declines in the medium term.

Recent Price Movements:

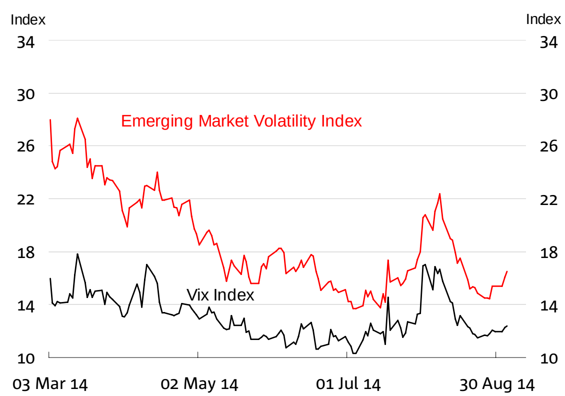
- The average price of gold fell by around 1.1% in August, reflecting declines mid and late in the month – more than offsetting a spike in the spot price early in the month. The average price has now fallen in four of the last five months, although declines have been much more modest than the market experienced over much of 2013 and were largely offset by a surge in June/July. Prices are currently trading below $1,260 per ounce, having dropped more than 3% since mid August.
- Gold prices rallied early in the year in response to economic growth concerns and geopolitical jitters – prices are yet to return to last years lows. For now, however, it appears as though low volatility in financial markets and the generally positive flow of economic data out of the US are helping to place moderate downward pressure on gold prices. Growing signs of weakness in the core European economies, some ongoing uncertainty over China's economy, and the ever present geopolitical tensions, all appear to be taking a back seat, although they are helping prevent much more substantial declines. Additional western involvement in the Middle East and the unpredictability of the Russia/Ukraine conflict, could bring about yet another shift in investor attitudes towards risk – the rally in the USD and treasuries could be consistent with such a shift.
- Gold's inverse relationship with the US dollar has been more apparent recently as the market tentatively turns its focus back towards US economic prospects and the path for interest rates. The USD major currencies index has risen over the past month and is close to its highest levels since 2010 – on a combination of USD strength and weakness in other major economies. USD strength has been weighing on the gold price of late, although falls in the gold price below US$1260-1270 per ounce still appears to trigger buyer interest.
- The gold price is yet to return to last years lows (although it is well on the way), but USD strength and a retreat in investor demand is still expected to set the tone for the gold market over the longer term. This will be the case even as the potential for higher consumer demand from Asia grows later this year (particularly if Indian import bans are relaxed further); although consumer demand will help provide a floor to the market.

Figure 1: Gold Price & US Treasury Yield



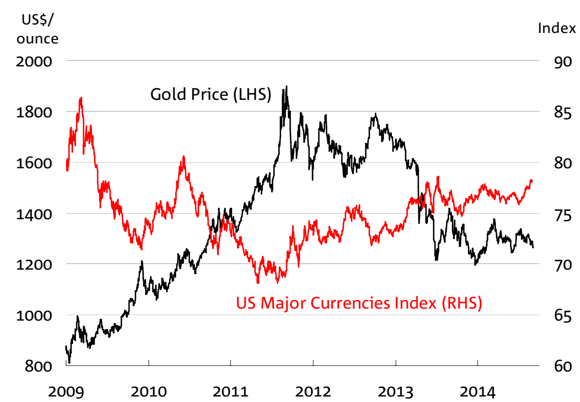
Source: Thomson Reuters; NAB

Figure 2: Implied market volatility (vix)



Source: CBOE, Thomson

Figure 3: Gold Price & USD

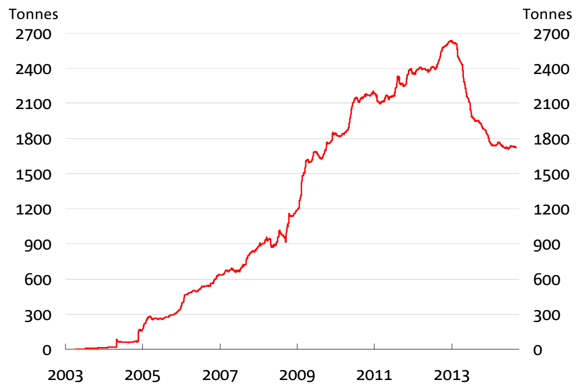


Source: Thomson Datastream

Gold Demand Conditions:

- According to data on US exchange traded gold funds (ETFs), investors reduced their gold holdings over August. However draw downs have been at a relatively subdued pace and holdings remain above their June lows. The persistence of geopolitical tensions and signs of economic weakness in major economies outside of the US may have discouraged a more significant reduction in investor gold holdings, but net long open positions in gold futures and derivatives have fallen noticeably.
- However, the drop in US treasury yields over recent months is indicative of market demand for safe assets in light of geopolitical uncertainties and efforts by many central banks around the world to keep interest rates low. At current levels, 10-year US treasury bond yields suggest some upside risk to gold prices
- Nevertheless, our expectation is that the improving US economy, benign inflation pressures, and (hopefully) an eventual resolution to geopolitical tensions, will weigh on investor gold demand in the medium-term. Our forecast for US interest rates to rise notably over the next 12-18 months is consistent with much lower gold prices ahead. However, the growing push for lower global interest rates will have implications for this outlook.
- Demand for gold as an inflation hedge is likely to be limited as inflation expectations have generally remained well anchored.

Figure 4: Exchange Traded Fund Holdings



Sources: Bloomberg; NAB

Figure 5: Comex Gold Inventories

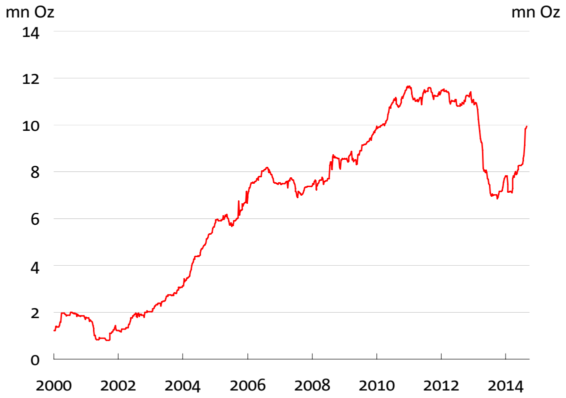


Figure 6: Other Gold Demand Factors

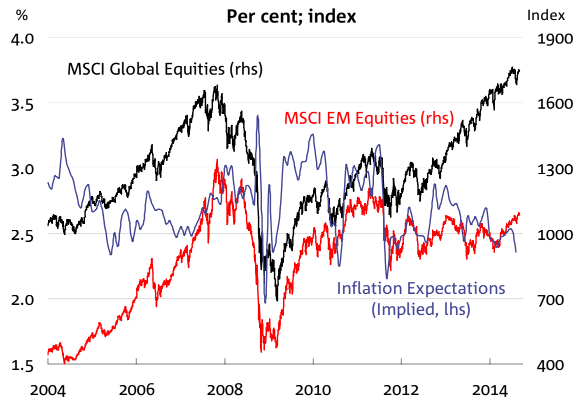
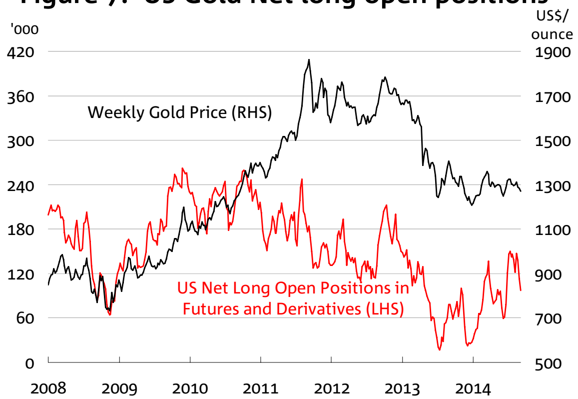


Figure 7: US Gold Net long open positions

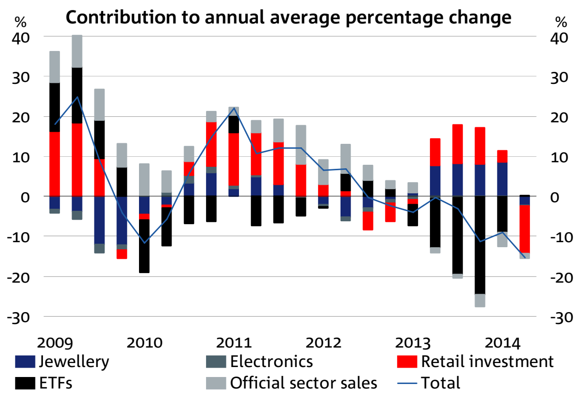


Sources: Bloomberg; NAB

Gold Demand Conditions (Cont.):

- According to the World Gold Council (WGC), identifiable gold demand dropped in the June quarter (to 964 tonnes), which is considerably below Q2 2013 (-16%). The fall in the quarter largely reflected fewer jewellery sales, although official sector purchases and investor demand also fell; retail investment hit its lowest level since early 2010.
- A surge in consumer demand (that largely stemmed from Asian markets), helped to partially offset a sharp fall in investor gold demand over 2013. But while investor demand has stabilised somewhat this year, consumer demand dropped considerably in Q2. This is partly a reflection of strong base effects, although this is just the third quarter to record demand sub 1,000 tonnes since 2010. Consumers demand has been more measured in the larger markets of China, India (following policy measures), Turkey, Russia and the Middle East, easing back to longer term average levels. Recent data shows net gold imports to China from Hong Kong have dropped considerably, pointing to softer demand.
- Central bank net gold buying eased in Q2 (from 124.3t to 117.8t), although this is consistent with long running buying trends by central banks. A new Central Bank Gold Agreement was announced in the quarter (effective end Sept) asserting that signatories do not have 'any plans to sell significant amounts of gold'.

Figure 8: Identifiable Gold Demand

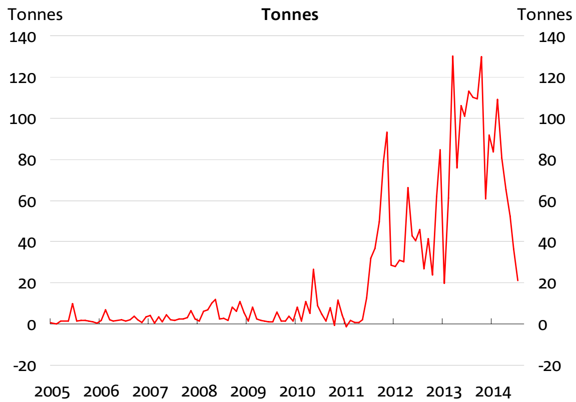


Sources: World Gold Council; NAB

Figure 9: Growth of Gold Jewellery Demand

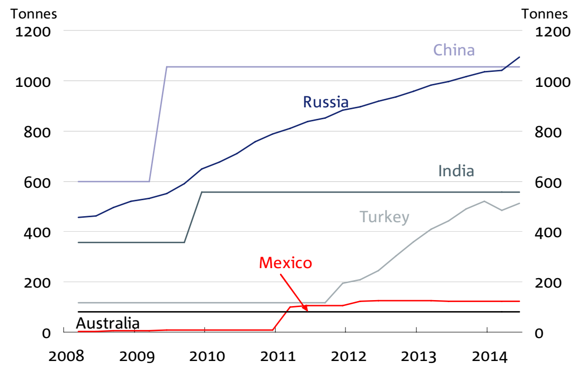
Sources: World Gold Council; NAB

Figure 10: Chinese net gold imports from HK



Source: CEIC; NAB

Figure 11: Central Bank Gold Holdings

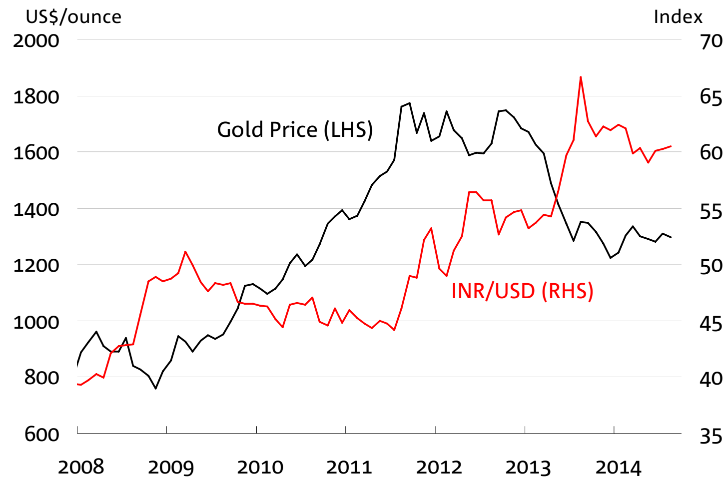


Source: World Gold Council

Recent Developments: India gold ban

- There were some major developments in relation to India's gold import ban over the past quarter or so. The general election in mid-May was particularly pertinent. Indian gold demand was restrained in the lead up to the election and immediately following as consumers waited to see whether the new government would ease import restrictions. Indeed, the RBI immediately introduced a measure allowing some banks and nominated agencies to import gold.
- Relaxation of import restrictions had its desired impact, releasing supply into the domestic market. In conjunction with the seasonally quieter gold buying period in Q2, domestic premiums have managed to fall considerably as a result – although the WGC have stated that unofficial gold flows into India continued in the quarter.
- While the Indian rupee has depreciated significantly in recent years, both the currency and gold price have been more stable this year, which has been a positive for consumer confidence in India. With rainfall improving late in the monsoon season, conditions are right for a bounce in demand during the coming festival season and following wedding season. Nonetheless, the lack of any further loosening of import controls since May (despite improvements in the countries current account deficit) could keep buyers cautious.

Figure 12: Gold Price & Indian Rupee



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

Figure 13: Indian Gold Imports & INR

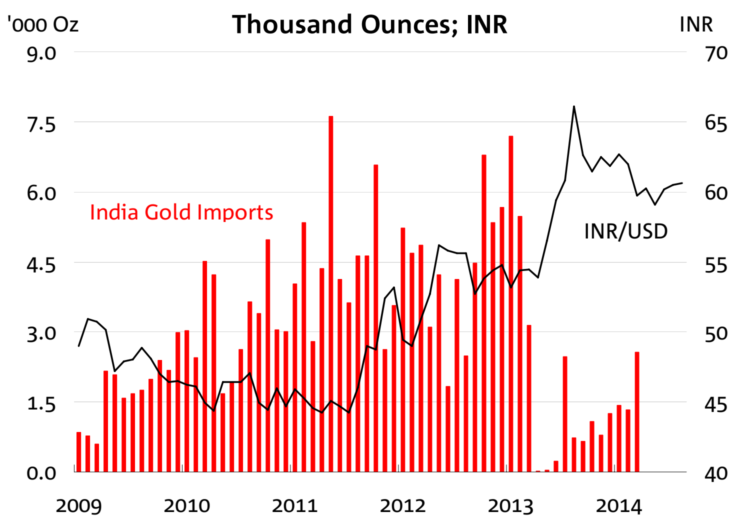
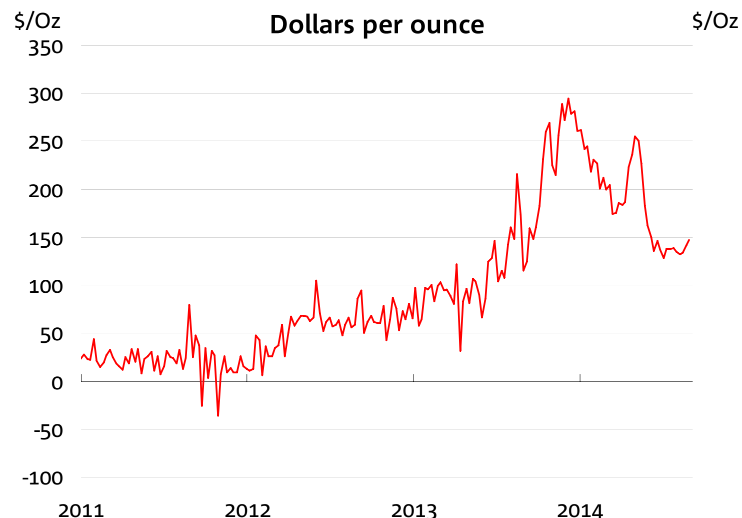


Figure 14: Indian Gold Spot Premium

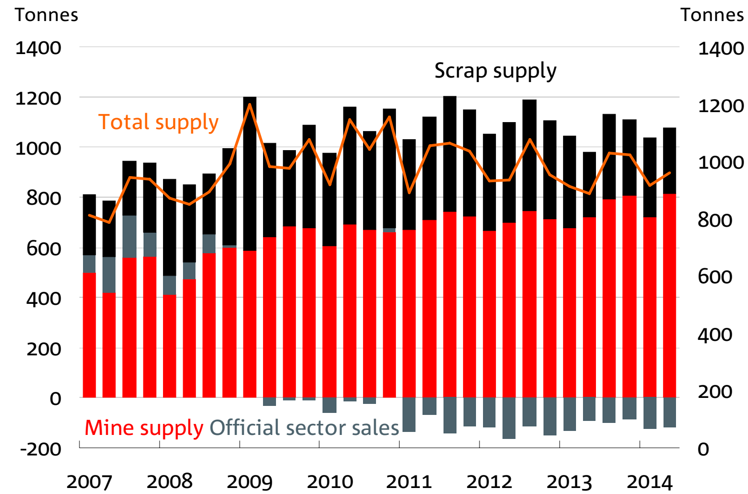


Sources: Bloomberg Industry; NAB Economics

Gold Supply Conditions

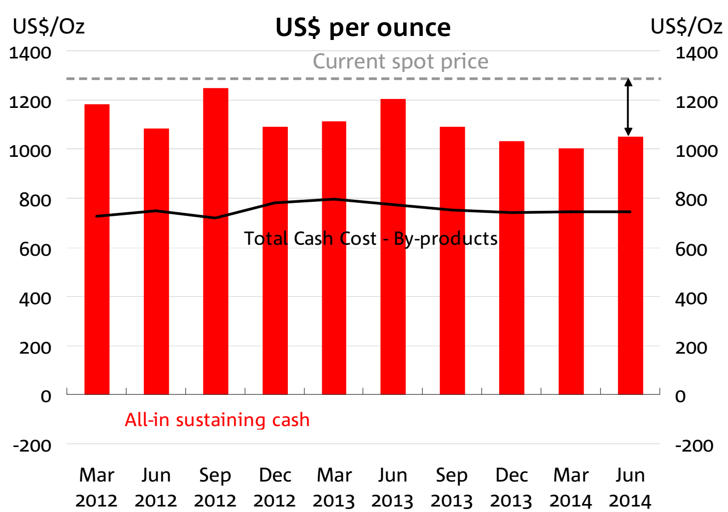
- According to the WGC, the supply of gold picked up over the year to Q2 2014, reaching 1078 tonnes, which is slightly more than 40 tonnes above the volume of supply in the previous quarter. The increase in supply over the year was driven primarily by a rise in mine output, which increased by 8% (including a jump in producer hedging), while the supply of scrap gold rose only modestly over the period (1%). Mined production also rose relative to Q1 2014, but the supply of scrap declined.
- The lower price of gold has placed pressure on gold producers, prompting them to aggressively cut costs and scale back expansion plans; declining gold grades have also necessitated cost rationalisation. 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. However, having gathered all the 'low hanging fruit' it seems unlikely that this trend will continue.
- Despite the pressure coming from lower prices (and increased cost pressures from previous years), mined supply is expected to continue growing in the medium term as a record number of new gold projects enter production – although some may postpone as prices decline.

Figure 15: World Gold Supply



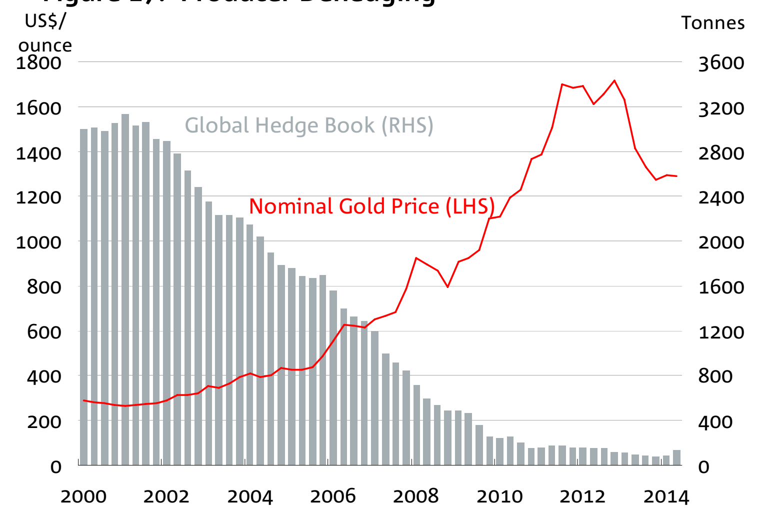
Source: World Gold Council

Figure 16: Gold Mine cash costs



Source: Bloomberg Industries; NAB

Figure 17: Producer Dehedging



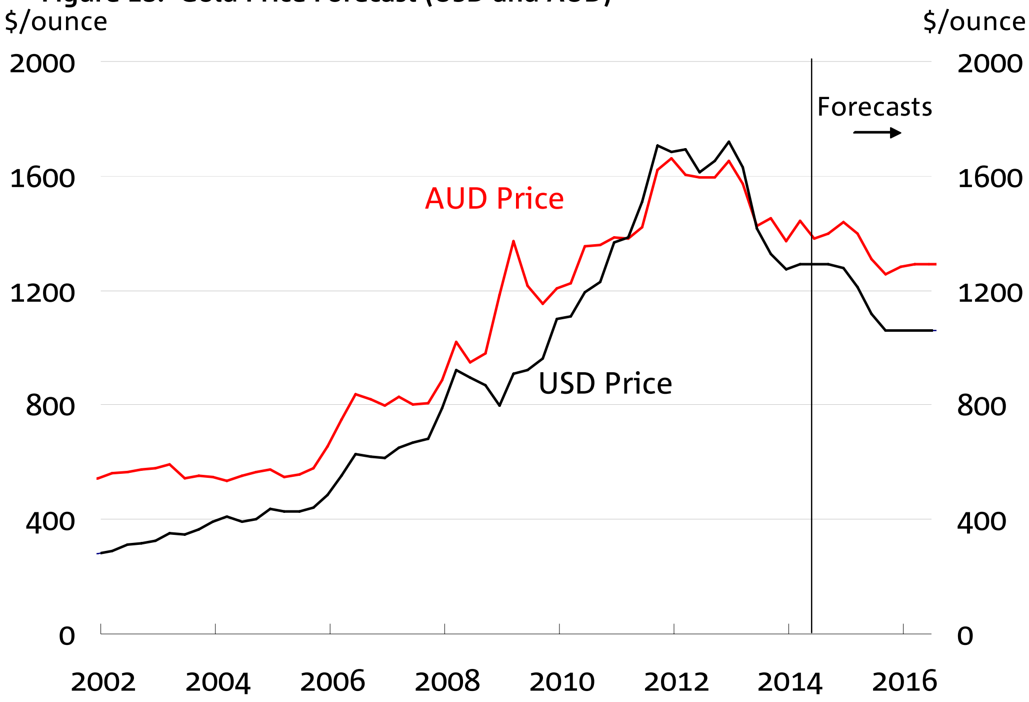
Sources: World Gold Council; Societe Generale; Thomson Reuters; NAB

Gold Price Forecasts (Quarterly Average)

	Spot	Actual	Forecasts							
	Price	Jun-14	*Sep 14*	*Dec 14*	*Mar 15*	*Jun 15*	*Sep 15*	*Dec 15*	*Mar 16*	*Jun 16*
Gold – US$	1268	1290	1290	1280	1210	1120	1060	1060	1060	1060
Gold – AU$	1365	1379	1400	1440	1400	1310	1260	1280	1290	1290

Source: Datastream, NAB Economics

Figure 18: Gold Price Forecast (USD and AUD)



Sources: Thomson Datastream; NAB

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