Gold Market Update

National Australia Bank

- **The gold price rose by a spectacular 7 per cent over September. Some of the strength has subsequently been unwound, with the gold price easing to around US$1,710 per ounce in early November.**
- **Stimulus announcements by the ECB, US Fed and Bank of Japan during September, which have increased the outlook for inflation, caused a sharp pick up in the gold price because of the metal's perceived ability to hedge against inflation.**
- **While the price of gold remains elevated following these announcements, the price did unwind over October, suggesting that initial expectations for higher inflation may have been a little exuberant.**
- **The near-term gold price is likely to be influenced by further details of policy stimulus in major economies, whereby more stimulus will equate to higher prices. However, just how permanent these announcement effects will be remains to be seen. Our sense is that markets are likely to overreact to changes in policy, and prices will take some time to revert back to more 'normal' levels.**
- **We have lifted our forecasts a little this month in response to having confirmation that policy stimulus will occur. We expect the gold price to average around US$1,750 per ounce over the December quarter 2012. Thereafter, upside risks to the gold price are expected to dissipate as the global economy strengthens and risk aversion dissipates.**

Recent Price Developments

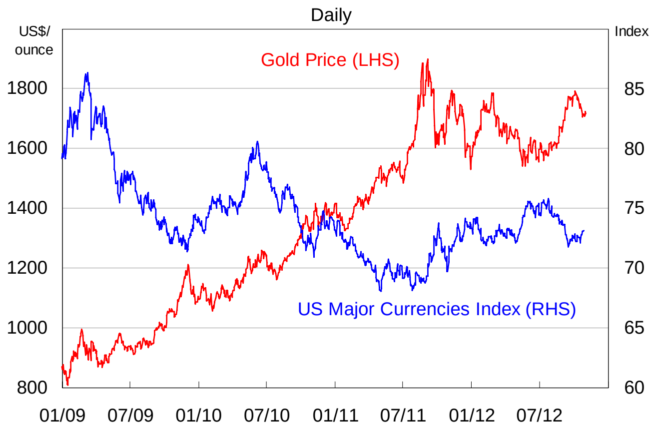
Recent central bank stimulus announcements (particularly from the US, Europe and Japan) have caused a rise in inflation expectations and as a consequence have driven up the price of gold. The impact of ECB, US Fed and Bank of Japan stimulus saw an immediate spike up in the price of gold (see Graph). While turning down over recent weeks, the price of gold has held onto some of these announcement gains due to the overall increase in expectations for inflation, with investors looking to hold more of the shiny metal as a hedge against any increased future price pressures.

The price of gold rose by a spectacular 7 per cent over September, but some unwinding saw its price gradually soften over October. Nonetheless, the average price of gold over October was around ¼ per cent higher than the average price over September, implying that these announcement effects have had a material impact on price.

Stimulus Announcement Impacts - Daily Gold Price ($US)

Part of the recent downturn in prices over the past month appears to have reflected movements in currency markets; a recent appreciation of the US dollar has in effect increased the attractiveness of holding US currency and treasury bonds rather than gold (see Graph). Spot gold is currently trading at close to US$1,710 per ounce.

Gold Price and the US Dollar



Source: Thomson Datastream

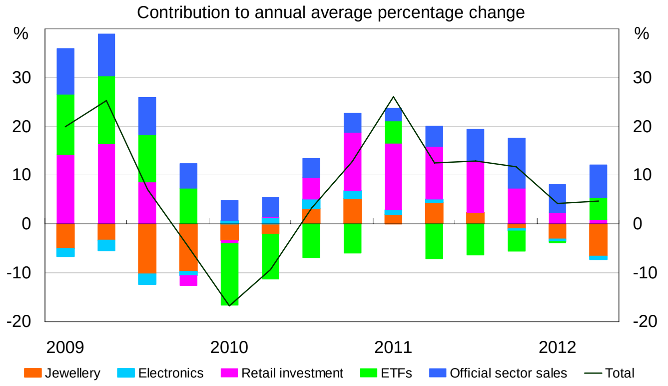
More broadly, underlying demand for gold is being held up by the general level of uncertainty in the global economy. Central banks continue to purchase gold as a way of strengthening and diversifying their asset holdings in a period of heightened uncertainty around the outlook for the world's major reserve currencies. These purchases are providing a significant amount of underlying support to gold demand.

It is likely that uncertainty clouding the global economy will remain a persistent theme for some time, keeping the gold price elevated – at least in the near term. However, day to day price movements are more likely to hinge on future central bank policy announcements, if and when they occur. We expect solid central bank buying to continue in the near to medium term, providing some resistance to further price falls. However, soft physical demand remains a key downside risk to gold prices, and if current trends continue, it is likely to provide little additional support to prices. Looking further ahead, we generally expect the price to moderate as general economic uncertainty dissipates, the recovery in the US economy regains momentum – and the US dollar subsequent appreciates – and mined production increases.

Gold Demand

Gold demand remained soft in June quarter 2012, rising by an annual rate of around 5 per cent, compared to growth of 26 per cent only 18 months earlier. While official sector gold purchases and investment (ETFs) provided a solid contribution to annual gold demand in the quarter, this was offset but a significant subtraction from jewellery demand. In total, global gold demand eased from around 1,100 tonnes in the March quarter, to 990 tonnes in the June quarter, which was around 7 per cent lower than levels a year earlier.

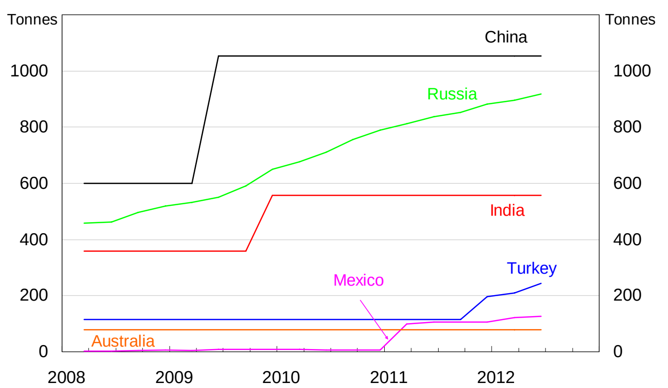
Identifiable Gold Demand



Sources: World Gold Council; NAB

It appears that investor fear and uncertainty is providing a sizeable support to gold demand, with gold buying by central banks rising to a record high of 158 tonnes in the June quarter, according to the World Gold Council (historical data series begins in 2007). The strength in net purchasing of gold by the official sector largely reflects central banks looking to strengthen and diversify their asset holdings during a period of heightened uncertainty around the outlook for the world's major reserve currencies, in particular, from the US dollar and euro-denominated reserves. World official central bank gold reserves are currently around 31,400 tonnes, up from around 30,000 tonnes four years ago. Given that the nominal price of gold has almost doubled over this same period, this represents a significant increase in the value of central bank gold reserves.

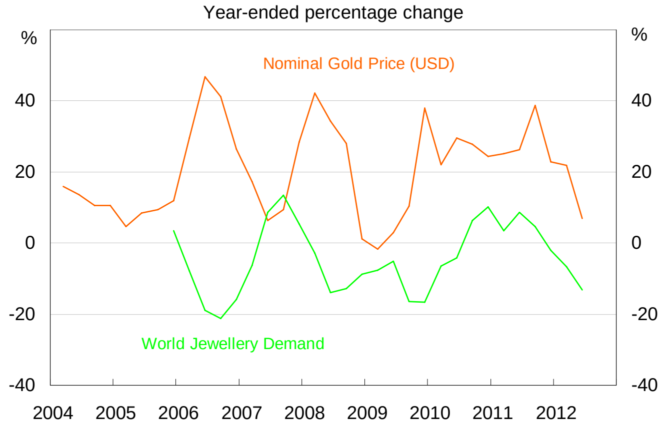
Central Bank Gold Holdings (Tonnes)



Source: World Gold Council

Demand for gold jewellery has softened considerable over the past year or so, with relatively high prices seemingly driving away demand for physical gold. According to the World Gold Council, gold jewellery demand fell from 488 tonnes in the March quarter to 418 tonnes in the June quarter – the lowest level in two years. Interestingly, while gold jewellery demand and the price of gold have historically exhibited an inverse relationship, this relationship appears to have broken down over recent quarters, with overall gold jewellery demand falling despite softer in the price of gold.

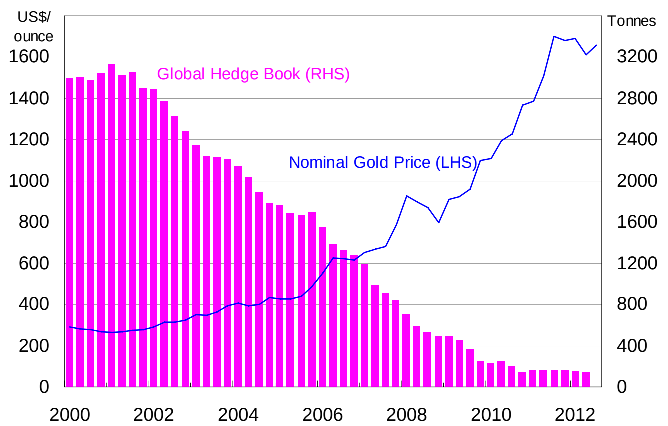
Gold Jewellery Demand and the Price of Gold



Sources: World Gold Council; NAB

A diminishing source of gold demand is producer de-hedging activity. Producers have steadily bought back their gold hedges over the past decade, with the global hedge book declining to around 142 tonnes of physical product in June quarter 2012 (see Graph). Strength in Chinese and central bank buying – particularly by the developing countries – is helping to replace the diminishing demand from the producer hedge book closure over the past decade and ETF buying, which has more or less stalled over the past year. However, given a recent slowing in Indian demand for gold jewellery – partly reflecting the introduction of taxes earlier this year – it is unlikely that these sources of increased demand for gold will be sufficient to fully replace the artificial demand created by producer hedge book buying. Overall, the global hedge book remains relatively small at present.

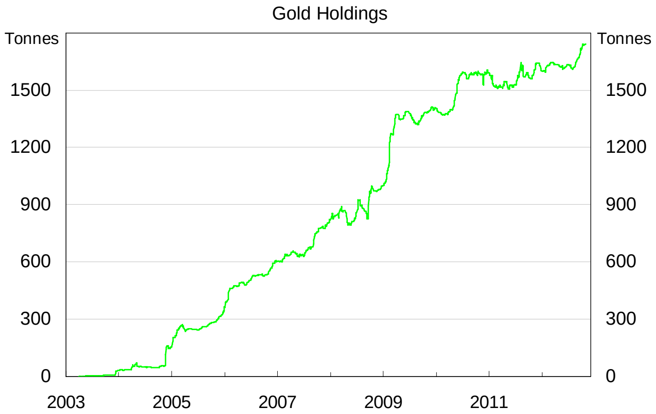
Producer De-hedging Activity



Sources: World Gold Council; VM Group; NAB

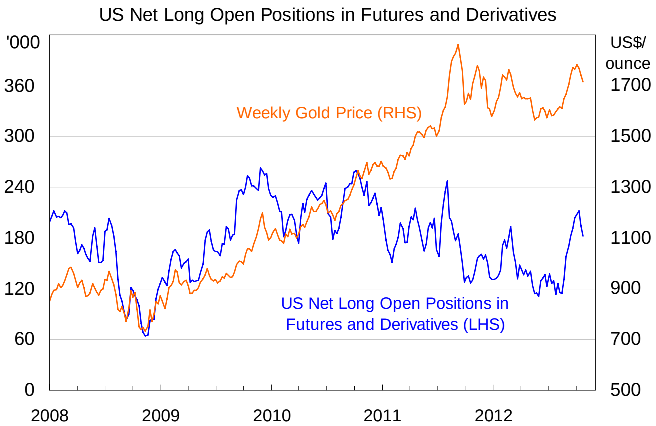
The price of gold has been particularly responsive to central bank stimulus announcements over the past two months, with prices nudging US$1,800 per ounce in early October. Data from a selection of exchange traded gold funds (ETFs) indicate that there has been a gradual increase in the accumulation of gold since mid-August (see Graph). The current amount of gold investment holdings is at record high levels, with investors still looking to gain exposure to the precious metal. Money managers in gold futures reduced their net-long positions over most of October (as reported by the US Commodity Futures Trading Commission), implying a lowering of expectations for further price rises.

Exchange Traded Funds*



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

Gold Investment

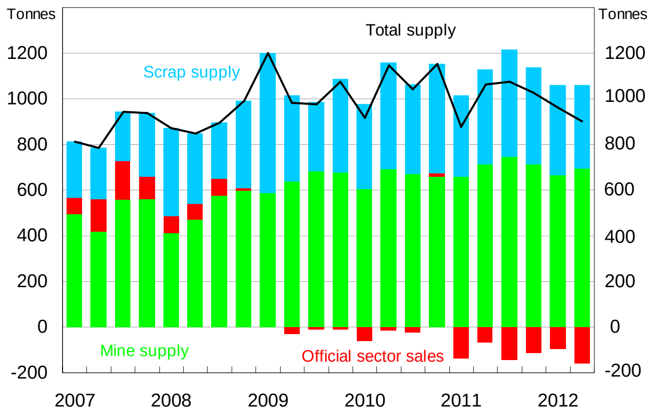


Sources: Bloomberg; NAB

Gold Supply

According to the World Gold Council, the supply of gold eased to around 900 tonnes in the June quarter, down from around 960 tonnes in the previous quarter and 1,060 tonnes one year earlier (see Graph). Gold is typically available from three sources – mined production, central bank sales and recycled or scrap gold. Looking at these components separately, mined production remains the key driver of increased gold supply, with production remaining reasonably firm in the quarter. Recycled gold is also a significant source of additional supply, though less scrap gold was made available in the June quarter than in the previous quarter. It is possible that the supply of scrap gold is being diminished, as elevated prices over the past year may have drawn a lot of this supply into the market already. In contrast, central banks continued to take supply out of the system in the June quarter, providing resistance to overall supply growth.

World Gold Supply



Source: World Gold Council

Outlook

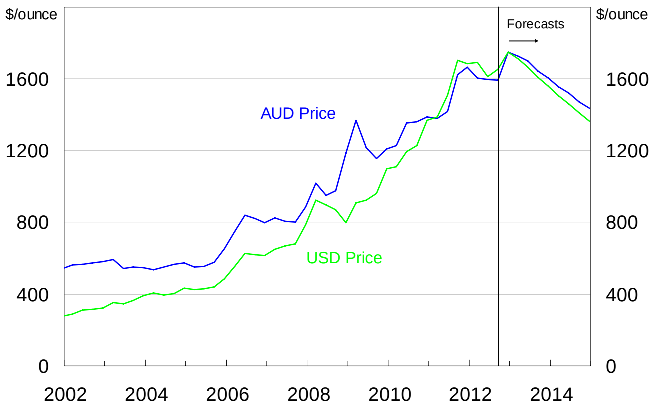
Movements in the gold price have hinged significantly on central bank stimulus announcements, which have taken place since early September – when commodity markets were in disarray. Confirmation that major advanced economies would press ahead with unconventional forms of policy stimulus caused an upward shift in inflation expectations and therefore the price of gold, given that the metal is perceived as a store of value.

Commodity (and financial) markets appear to have been a little too optimistic about the implications of stimulus announcements on economic activity, with prices generally unwinding recent gains over the past month. Fundamentally, systemic problems in the heavily indebted European and US economies still exist, and throwing money at these problems should only be viewed as a temporary solution. Nonetheless, what recent policy announcements have shown is that central banks are willing and able to provide additional support when called upon. Overall, while the gold price has softened over the past month, the average price over October was higher than the average price over September, suggesting that stimulus has materially strengthened the outlook for the shiny metal. As a result, we have lifted our near-term forecasts for the price of gold.

Looking further ahead, we continue to expect the gold price to ease as global fundamentals return. Chinese demand for gold should remain strong, supported by rising incomes, and while Indian demand may soften on the back of relatively high prices and a weak rupee, it will remain supportive overall. In the medium to longer term, we expect more certainty surrounding the European sovereign debt situation to emerge, while a relatively stronger US dollar and a return to fundamentals should also help to reduce prices.

Future gold mine production is expected to rise as producers look to take advantage of elevated prices. Mined supply should also benefit from new projects coming online in Latin America and the continued expansion in Chinese gold production. In addition, as copper production intensifies over coming years, more gold should be produced as a by product. Continued official sector sales should also provide a boost to gold supply. Partly offsetting this, mined supply may be limited by the continued maturity of gold mines in South Africa and Indonesia, and continued industrial disputes abroad, while rising production costs may also limit the extent of price falls.

Nominal Gold Price



Sources: Thomson Datastream; NAB

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Quarterly Price Profile

Gold Price Forecasts – Quarterly Average

	Actual	Forecasts							
	Sep 12	*Dec 12*	*Mar 13*	*Jun 13*	*Sep 13*	*Dec 13*	*Mar 14*	*Jun 14*	*Sep 14*
Gold - US$	1653	1750	1710	1660	1610	1560	1510	1460	1410
Gold - AU$	1592	1750	1730	1700	1640	1610	1550	1520	1470

Source: Thomson Datastream, NAB

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