Gold Market Update

National Australia Bank

- **The price of gold fell by a notable 4.3% in July, but has stabilised more recently, recovering by a modest 2.8% over August to date. Spot gold is currently around $1,380 an ounce.**
- **The price of gold will certainly record its first annual decline since 2000. Compounding the recent weakness is the relative strength of other asset classes that have benefited significantly from extremely loose monetary policy settings.**
- **Latest data from the World Gold Council show that identifiable gold demand fell further in the June quarter, down 13.7%, consolidating a 17.0% decline in the March quarter. The decline largely reflected a sell off in investment. However, total quarterly supply of gold rose by 4.2%, to around 970 tonnes, driven by a seasonal pick up in mined production.**
- **The Indian rupee has plummeted over recent months, making the purchase of gold more expensive for Indian buyers. Despite this, gold imports appear to have held up well. In response, the Indian government introduced a suite of restrictions aimed at reducing gold demand and strengthening the rupee.**
- **The gold price remains vulnerable to future changes in policy settings. With the market now expecting the US Fed to begin tapering its asset purchase program in September, the US dollar has strengthened limiting demand for gold as an alternative investment.**
- **While the risks to gold appear skewed to the downside, it is quite possible that other asset classes that have benefited from loose monetary policy will fall in value as QE is unwound, underpinning investor demand for gold.**
- **Potential triggers of a rising gold price include a surge in inflation (either real or expected) or the re-emergence of fears about a global recession. We do not anticipate either of these events occurring.**

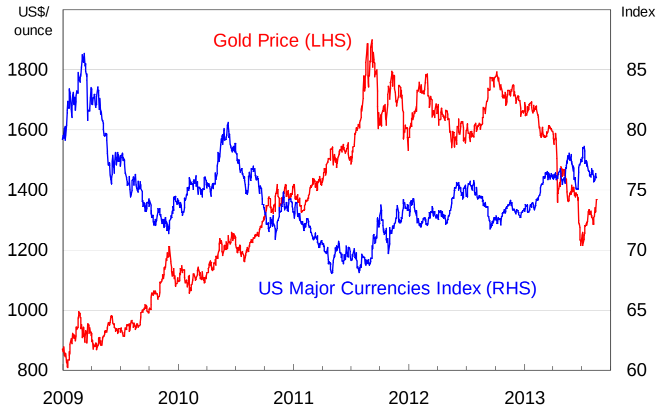
Recent Price Developments

The outlook for the global economy is looking brighter and inflation seems to be under control. As a result, gold is no longer flavour of the month with sentiment towards the shiny metal reaching fresh lows. While the gold price has recovered moderately since early July, it remains well down on levels earlier in the year. Will gold's upward momentum continue? Or will the end to the US Federal Reserve's asset purchasing program stifle any potential upside? While the answers to these questions remain uncertain, it is clear that we're in for a bumpy ride ahead.

Since peaking in late 2011, there has been a clear shift in expectations about the future path of the gold price. Prior to the most recent price slump, there was significant speculation that the price would push through $2,000 per ounce. Almost two years later, many are now forecasting gold to crash below $1,000 per ounce within the next year or two. Compounding the current weakness in the gold price is the relative strength of other asset classes that have benefited significantly from extremely loose monetary policy, including equities, real estate investment trusts, listed infrastructure and riskier forms of debt. While very accommodative monetary policy conditions have helped to support the perceived values of these alternative investments, just like gold, they too remain vulnerable to future changes in policy settings.

Expectations for the US Federal Reserve to begin tapering its $85 billion monthly debt buying program this year has sent ripples through the gold market. The price of gold is now certainly going to record its first annual decline since 2000. The latest FOMC minutes showed broad support for the tapering timeline outlined by Bernanke at his post June FOMC press conference. That is, for tapering to begin later this year (data dependent) and for the program to end in mid-2014. With the market now expecting tapering to begin soon (September seems likely), the US dollar has continued to strengthen, limiting demand for gold as an alternative investment. What is also becoming apparent is that the copious amounts of money printing by central banks around the globe are failing to materially lift inflation and inflation expectations, which gold is used as a hedge against.

Gold Price and the US Dollar (Daily)



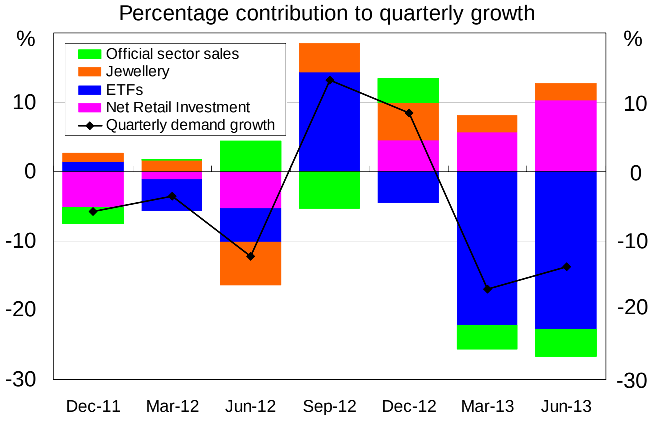
Source: Thomson Datastream

Gold's inverse relationship with the US dollar remains steadfast, with the recent rally in the US dollar coinciding with a deterioration in the price of gold. The US currency has gained strongly over recent weeks on the back of better data, which is making investors more confident about the outlook for the US economy. Market momentum is building with investors rushing to purchase US denominated assets, which is continuing to limit the desirability of safe haven assets, such as gold.

Gold Demand

While investor sentiment towards gold has faltered over recent months, there is still plenty of buying pressure from emerging markets. Data provided by the World Gold Council highlights continued demand from China and India, as buyers take advantage of lower prices. However, rapidly rising gold premiums in Asia and the Middle East, rising import and excise taxes in India and a devalued rupee appear to have restricted demand.

Identifiable World Gold Demand

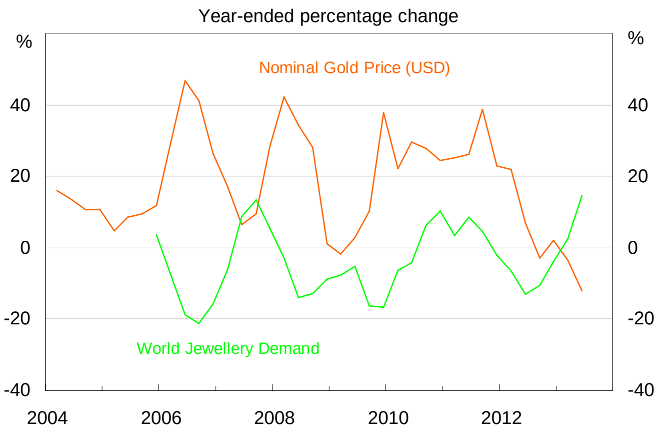


Sources: World Gold Council; NAB

Identifiable gold demand fell further in the June quarter, down 13.7%, consolidating a 17.0% decline in the March quarter. The contraction in gold demand almost entirely reflected a sell off in investment (in the form of exchange traded funds) and a softening in central bank purchases, which was partly offset by a contribution from jewellery purchases and retail investment. The volume of gold demand declined to 4,147.1 tonnes over the year to June 2013, down from 4,457.3 tonnes a year earlier.

While central banks continue to increase their holdings of traditional assets, including gold, purchases have lessened considerably over recent quarters. Central bank purchases amounted to around 71 tonnes in the June quarter, down from 110 tonnes in the March quarter, representing the smallest outcome in two years. Nonetheless, this outcome represented the tenth 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. However, while central bank purchases remain substantial, they slowed in the June quarter despite lower prices.

Gold Jewellery Demand and the Price of Gold

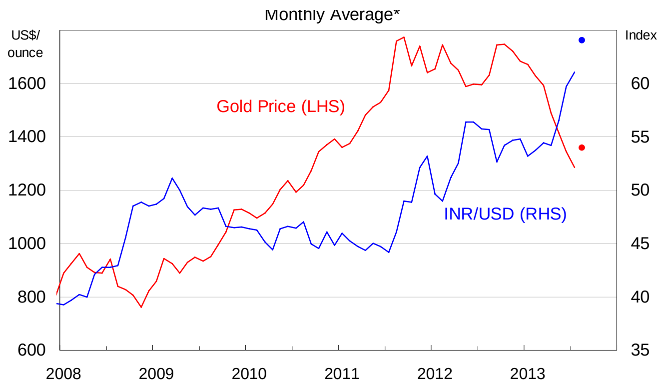


Sources: World Gold Council; NAB

The recent slump in the price of gold has spurred increased consumer demand from Indian and Chinese buyers. According to the world gold council, a 13% decline in the average gold price from Q1 2013 to Q2 2013 saw combined Indian and Chinese gold jewellery purchases increase by 116 tonnes (or 10%) to 1,238 tonnes in the June quarter. Together, these countries were responsible for almost 60% of world gold jewellery purchases in the quarter. The lure of lower prices seems to have supported gold jewellery purchases. Even in the face of falling prices, Indian and Chinese buyers continue to purchase gold because for these countries this is the traditional way to preserve wealth.

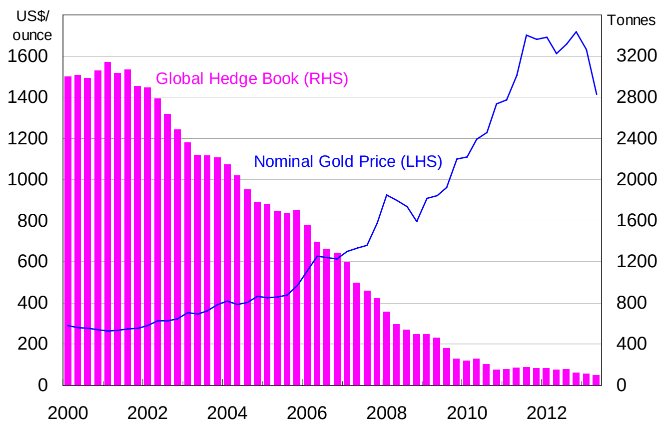
A slower growth outlook and a return of stability in the major advanced economies have seen investors shy away from currencies of the emerging market economies. India is the second largest consumer of gold, so the recent sharp depreciation of the Indian rupee is of particular importance for gold. Just last week, the value of the rupee crashed to a record low of over 64 per US dollar. For gold, a devalued rupee makes the purchase of the shiny metal relatively more expensive for Indian buyers, dampening Indian gold demand. But despite the declining value of the rupee, gold imports appear to have held up well, rising solidly in July. In a move to reduce Indian gold demand and to curb dollar spending, the Indian government has lifted the import duty on gold for a third time this year (from 8% to 10% on 13 August). It also wants to limit gold imports to no more than 850 tonnes per year by banning imports of coins and medallions, making purchasers pay in cash and enforcing that 20% of imports are used for exports. Theoretically, these restrictions should help to reduce Indian gold demand, thereby lessening Indian demand for US dollars and strengthening the rupee. However, Indian gold purchasing has remained reasonably solid to date, undermining such a recovery. In the longer term, higher duties could see Indian gold demand retreat, helping to reverse some of the recent depreciation of the rupee. However, wealth creation and rising incomes should help to underpin robust consumer demand.

Gold Price & the Indian Rupee



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

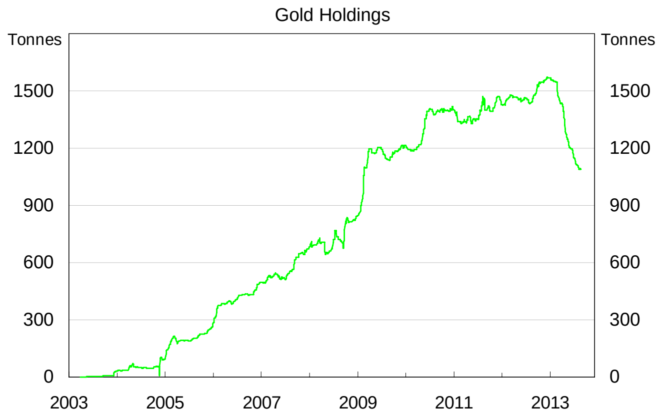
Producer De-hedging Activity



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

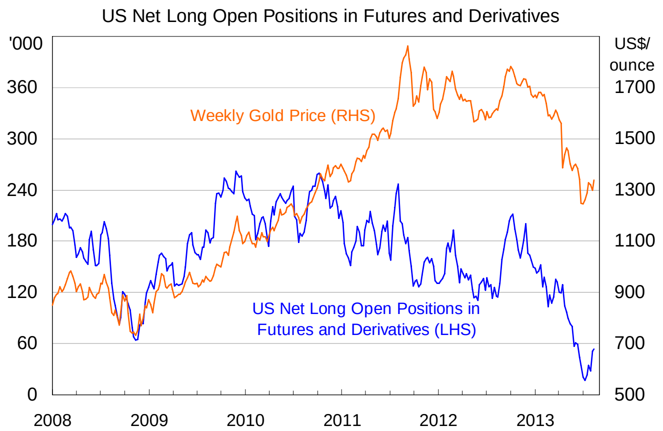
A diminishing source of gold demand is hedging activity among producers, which remains at historically low levels. Producers use hedges to insure against risk. With copious amounts of money printing by central banks around the globe failing to materially lift inflation and inflation expectations, the outlook for the gold price has fallen, causing a notable fall in de-hedging activity. In the June quarter 2013, the global hedge book is estimated to have declined by around 15 tonnes to around 97 tonnes of physical demand (see Graph). The reduction in the size of the global hedge 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.

Exchange Traded Funds*



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

Gold Investment



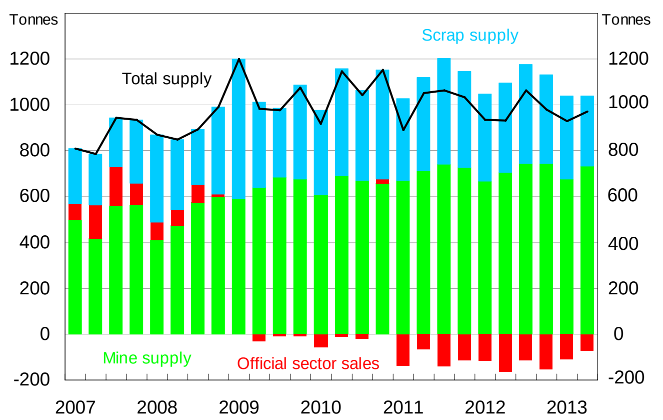
Sources: Bloomberg; NAB

The price of gold fell by a notable 4.3% in July, but has stabilised more recently, with the price recovering by a modest 2.8% over August to date. Furthermore, price volatility has narrowed, ranging from a (daily) low of $1,285 an ounce in the first week of this month, to a more recent high of around $1,380 an ounce. Data from a selection of US exchange traded gold funds (ETFs) highlight the sharp decline in holding of gold since the beginning of this year, 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 30% 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. While ETFs holdings of gold have continued to slide over the past month, money market managers in gold futures have increased their net-long positions (as reported by the US Commodity Futures Trading Commission), albeit from very low levels, implying a lessening of expectations of further price reductions following the recent mini-price rally.

Gold Supply

According to the World Gold Council, the supply of gold increased to 969.4 tonnes in the June quarter, which is around 40 tonnes above the volume of supply added in the previous quarter (see Graph). The pick up in gold supply in the June quarter is consistent with a seasonal increase in mined production, which remains the key driver of gold supply. With the price of gold falling by around 13% in the June quarter, there was again a notable fall in recycling flows. While central banks continued to purchase gold in the quarter, removing supply from the market, there has been a gradual reduction in the amount of gold purchases since the end of last year. Of note has been a pull back in Chinese central bank purchases, with 71.1 tonnes purchased in the June quarter – the lowest in two years.

World Gold Supply (Quarterly)



Source: World Gold Council

The falling price of gold is putting increased pressure on some gold producers, particularly those in South Africa where costs have surged rapidly over recent years due to rising wages and environmental pressures. However, even if the current soft price environment does put the brakes on future capacity plans, already committed mines will begin to yield production over the next year, which could see production rise from its current high level. Furthermore, gold used in electronics accounts for around 10% of gold demand, and given the short-life span of most gadgets, the flow of recycled gold should contribute more to supply in coming years.

Outlook

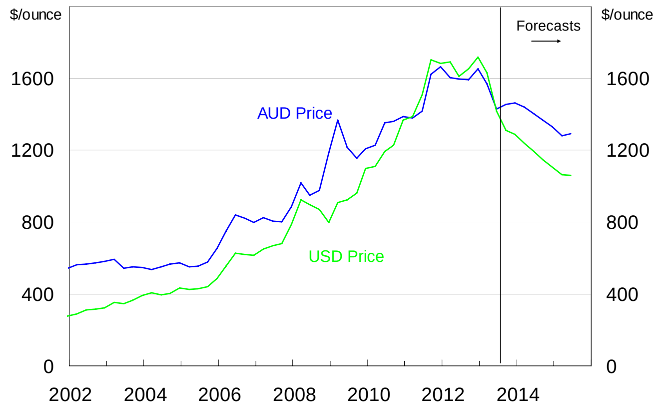
While gold is perceived as a safe-haven asset and an end to QE would imply the US economy is treading along a safer path to recovery, investors already seem much less concerned about the outlook for global growth. As such, much of gold's safe-haven appeal has already been tarnished. This implies that an end to QE may not necessarily see the gold price slump further. Indeed, it is quite possible that other asset classes that have benefited from loose monetary settings more recently will fall in value as QE is unwound, which may help to underpin investor demand for gold.

However, there is a real source of downside risk posed by the slowing Indian, and to a lesser extent, Chinese economies. India and China are both the largest consumers of gold, together accounting for around 55% of global demand. Thus, the outlook for these economies should provide some indication about the future path for gold. With the Indian rupee currently under a lot of strain, the risks to the Indian economy remain elevated, and government authorities remain intent on reducing gold demand. Things appear less uncertain in China, with authorities determined to keep a 7% floor under growth. While slowing economic activity could weaken underlying support for the shiny metal, Indian and Chinese buyers are likely to continue to purchase gold because for these countries, this is the traditional way to preserve wealth.

On the other hand, there are some potential triggers of a rising gold price, including a surge in inflation (either real or expected) or the re-emergence of fears about a global recession. Inflation is expected to eventually reappear in a number of countries as a result of current (loose) fiscal and monetary policy settings. However, it is expected to build slowly over the next few years. When combined with our expectation for global growth to gradually recover towards trend over the next year or so, neither of these triggers is likely to eventuate.

Taking all of these risks into account, as well as the outlook for rising global supply, it remains our expectation that prices will gradually soften over the forecast horizon. While external influences are likely to keep demand for gold varied over the remainder of 2013, we generally expect the price to moderate to around US$1,300 an ounce by the end of 2013, before gradually declining 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$	1417	1310	1290	1240	1190	1150	1100	1060	1060
Gold - AU$	1428	1460	1460	1440	1400	1370	1330	1280	1290

Sources: Thomson Datastream; NAB

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Important Notices