Gold Market Update

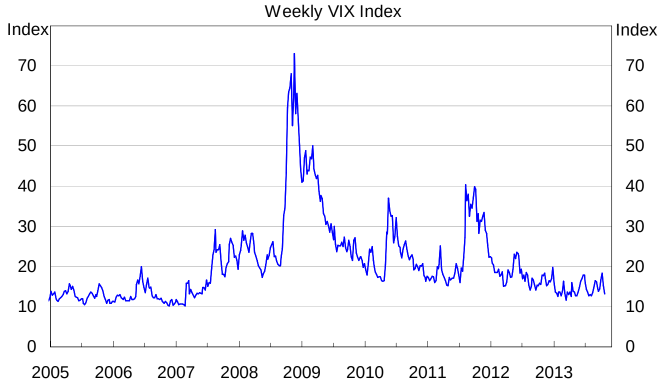
National Australia Bank

- **The average price of gold eased by around 2½% in October, though the daily spot price generally strengthened over the second half of the month and is currently trading at around $1,340 per ounce.**
- **Gold is set to record its first annual price decline since 2000, with demand for the shiny metal dwindling on reduced fears of a bad event and the outlook for still soft inflation.**
- **The price of gold has been supported by softer US data over recent weeks, which have lengthened the chances of later Fed stimulus withdrawal. This pattern is likely to continue until markets have more certainty around the timing of and the size of the withdrawals. Another source of uncertainty has been the recent US shutdown and the US debt ceiling debate, which has provided further support to safe-haven gold.**
- **Researchers at the CSIRO believe they have discovered a way to make gold exploration much quicker and cheaper, after finding veins of gold in the leaves of eucalyptus trees. It is believed that leaves with gold may indicate the presence of gold deposits up to 35 metres beneath the surface.**
- **While Indian demand is typically strong in the first week of November during the Indian Diwali festival – the biggest gold buying period of the year – the high price of Indian gold is likely to keep demand relatively soft this year.**

Recent Price Developments

Over most of October, financial markets were intently focused on political events in Washington. This was highlighted by the partial US government shutdown, although the focus increasingly turned towards the looming requirement to increase the Federal government's debt limit. Failure to do so would have extremely serious consequences. The partial shutdown of the Federal US government began on 1 October with the failure of Congress to agree on a bill to fund the government. While the shutdown was anticipated to have only a relatively small impact on GDP growth, the broader concern was how the requirement to increase the Federal government's debt limit would affect consumer and business confidence, which could damage other parts of the economy as occurred around the 2011 debt limit debate. The general uncertainty has seen a tick up in the VIX measure of financial market volatility but it has not reached a particularly high level. Nonetheless, gold was not unscathed, with the price of the shiny metal swaying between around US$1,250 and US$1,330 per ounce through the first half of October when the shutdown was in place. Data is yet to confirm the full impact of the government shutdown on the US economy during October but it is expected to be relatively small. In mid-October, a US Budget deal was reached, extending US borrowing authority through 7 February 2014 and restoring federal funding through to 15 January. While this is a positive step in the immediate term, it still threatens further problems early next year.

Index of Market Volatility



Source: Thomson Datastream

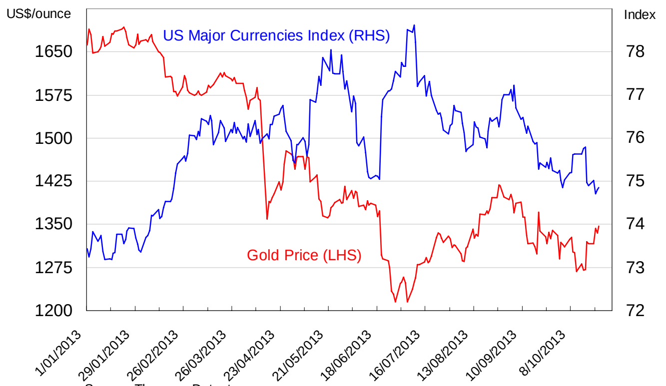
Another source of uncertainty has been the eventual timing of the withdrawal of US Fed stimulus. Rising expectations that the US Fed will postpone tapering its $85 billion monthly debt buying program and maintain current easy monetary conditions provided support to the price of gold in October. The reason for the expected delay largely reflects soft economic data in the US. Recent poor US jobs data provided evidence that the economy is not yet on a sustainable growth path, boosting confidence that tapering will be delayed until early next year. For gold, any sign of continued stimulus increases the risk of higher inflation in the longer term, and given gold's use as an inflation hedge, this drives up demand for the shiny metal.

Over October, the price of gold fluctuated widely largely on the back of US uncertainty. The average price rose by a modest 1% in October, to be trading at around US$1,340 per ounce currently. This followed no growth in September and a 5% rise in August. In year ended terms, the price of gold in October was around 25% below levels recorded in the same month of the previous year.

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.

Gold's inverse relationship with the US dollar has continued through October, with the recent softening in the US dollar coinciding with a rise in the price of gold. The US currency has fallen back over recent weeks reflecting changed views about the outlook for the commencement of Fed tapering following softer data outcomes and the partial US government shutdown. This has made investors less certain about the outlook for the US economy. The shift in market sentiment has seen investors limit their demand for US denominated assets and flock towards more desirable safe haven assets, such as gold.

Gold Price and the US Dollar (Daily)

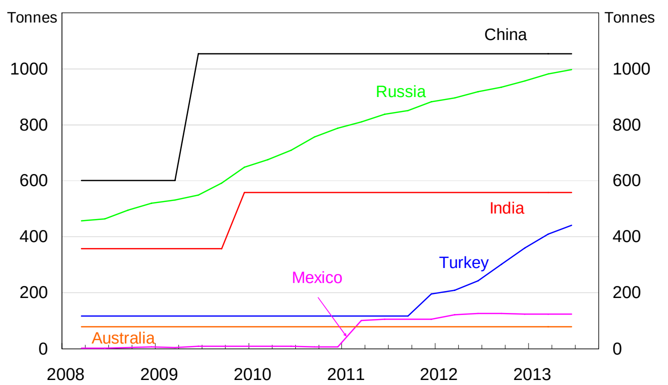


Source: Thomson Datastream

Gold Demand

The trend in gold demand has been highly influenced by events in the US, including the likely timing of Fed tapering and the outcome of the requirement to lift the debt ceiling. With the market currently anticipating no change to the Fed's asset buying program until early 2014, investors seem comfortable holding gold in their investment portfolios, Central banks also continue to purchase gold, but demand is dwindling on reduced fears of a bad event and the outlook for still soft inflation. However, demand from the world's largest gold consumer India is under threat as its government tries to rein in the economy's large current account deficit, with gold becoming the main casualty.

Central Bank Gold Holdings (Tonnes)

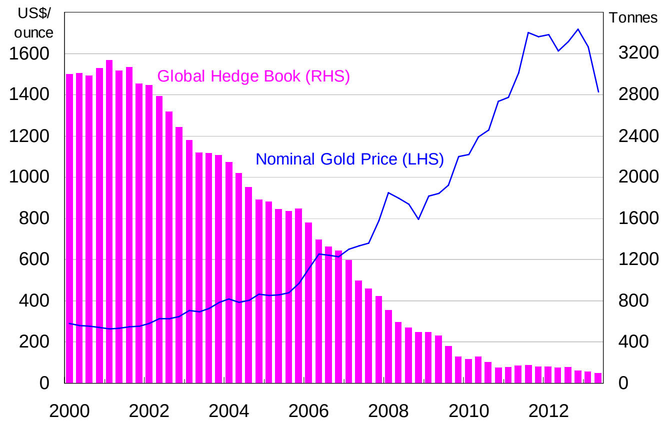


Source: World Gold Council

Central bank net gold buying has persisted into 2013, although the pace of purchases has 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. The pull back in the pace of purchases by central banks has been especially apparent in the emerging markets, which seems to reflect these banks having less cash to add gold to their reserves as a result of currency fluctuations and capital outflows this year. Nonetheless, there remain a number of economies that continue to increase their holdings of gold, notably Russia which has increased its gold reserves by almost 20% since the gold price peaked at above US$1,920 per ounce in September 2011. Surprisingly, however, the IMF reports that Russia sold 12,000 ounces of gold in September. Turkey has also continued to increase its holdings of gold at a very rapid pace since September 2011 (see Graph).

India has historically been the largest consumer of gold, but China may be set to take the number one spot this year due to the Indian government trying to curtail a huge current account deficit and a weak currency. This has prompted the government to lift the import duties on gold to a record 10%, with 20% of all imported gold to be re-exported as jewellery. As a result of the restrictive import conditions, gold supply in India has become increasingly tight and premiums have risen to above US$100 per ounce over London prices. It is expected that Indian gold demand will remain strong during the upcoming Diwali festival in November, India's biggest gold buying period of the year, providing additional support to the price of gold. However, the demand may be relatively softer than in previous years given the already high price of Indian gold.

Producer De-hedging Activity



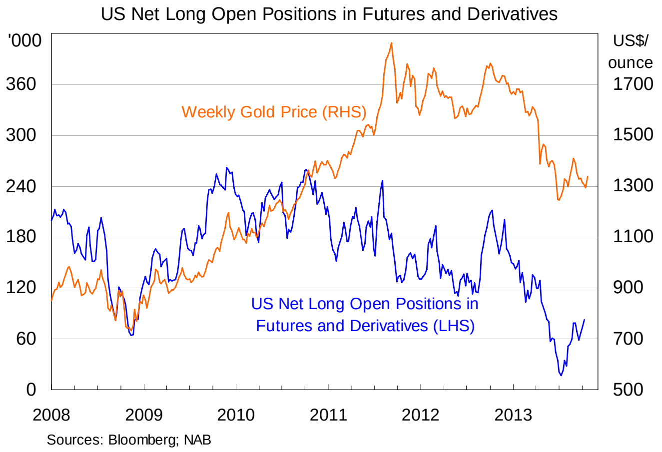
Sources: World Gold Council; Societe Generale; Thomson Reuters; NAB

A diminishing source of gold demand is hedging activity among producers, which is the practice of selling future production at fixed prices 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

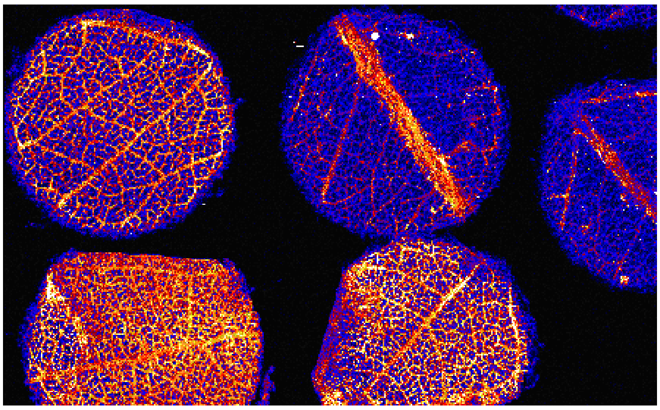


Data from a selection of US exchange traded gold funds (ETFs) have highlighted the sharp decline in gold holdings since the beginning of this year, with investors losing faith in gold as a store of value. More recent gold investment activity, while still soft relative to history, has picked up a little over recent weeks, as shown by a recent increase in US net long open positions in futures and derivatives. Much of the improvement in gold mining funds has been in response to recent soft US data, including consumer sentiment, manufacturing and jobs data, which together have helped to lessen the chance of any immediate tapering of Fed QE. This sentiment has been positive for gold as well as other asset classes, such as equities. Nonetheless, overall trading in the gold investment market has been relatively quiet of late.

Gold Supply

Research conducted by the CSIRO has the potential to make gold exploration much quicker and cheaper for mining firms. It is believed that eucalyptus trees sitting above gold deposits buried deep underground draw gold out of the ground in search for moisture during times of drought. Researchers have discovered veins of gold (around 1/5th the diameter of a human hair) in the leaves of eucalyptus trees. According to the research, the absorption of gold "promotes confidence in an emerging technique that may lead to future exploration success and maintain continuity of supply". For mining firms, this discovery could reduce gold exploration costs in a way that will also limit environmental damage from unnecessary drilling.

Gold veins discovered in the leaves of eucalyptus trees



The lower price of gold relative to recent history 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.

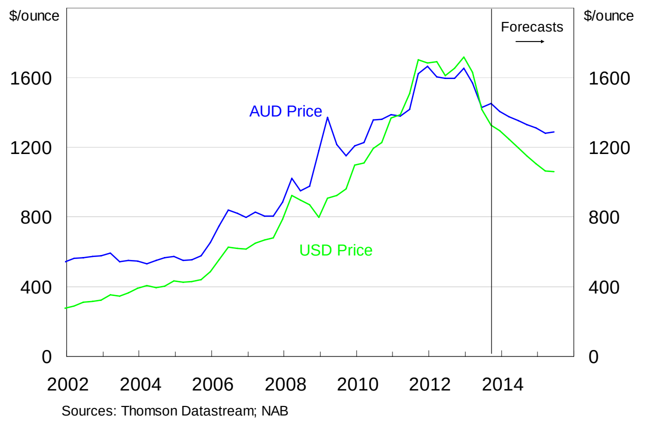
Outlook

Volatility is likely to remain a key theme in commodity and financial markets in the near term, with uncertainty over the timing of the withdrawal of central bank stimulus continuing to be an important driver of prices. While actual activity data have been important, data have not necessarily shifted gold in the traditional way. The price of gold is getting a boost from softer US data due to the expectation that weaker data lengthens the chances of later Fed stimulus withdrawal. This pattern is likely to continue until the timing of and the size of withdrawals becomes more certain. While the price of gold has lost around ¼ of its value over the past year, market jitters stemming from central bank stimulus uncertainty have reminded market participants of gold's safe-haven qualities and its role as a store of value.

The very high price of gold denominated in Indian Rupees is likely to limit Indian demand for gold in the near term. While Indian demand is typically strong in the first week of November during the Diwali festival – the biggest gold buying period of the year – the high price of Indian gold is likely to keep demand relatively soft this year. This is likely to limit potential growth in prices during November, especially when compared to increases over previous years; the average price of gold over the past decade (in US dollars) has risen by 3.0% in the month of November, compared to average monthly growth over the same period of 1.2%. In China, things also remain uncertain, with authorities determined to keep a 7% floor under economic 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.

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 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 softening to around US$1,110 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



Quarterly Price Profile

Gold Price Forecasts – Quarterly Average

	Actual	Forecasts							
	Sep 13	*Dec 13*	*Mar 14*	*Jun 14*	*Sep 14*	*Dec 14*	*Mar 15*	*Jun 15*	*Sep 15*
Gold - US$	1328	1300	1250	1200	1150	1110	1060	1060	1060
Gold - AU$	1450	1400	1370	1350	1330	1310	1280	1290	1300

Sources: Thomson Datastream; NAB

alexandra.knight@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

Ken Hanton
Senior Credit Analyst
+61 2 9237 1405

Equities

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

Jenny Khamphet
Senior Real Estate Equity Analyst
+61 2 9237 9538

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

Mike Jones
Currency Strategist
+64 4 924 7652

Kymberly Martin
Strategist
+64 4 924 7654

UK/Europe

Nick Parsons
Head of Research, UK/Europe,
and Global Co-Head of FX Strategy
+ 44 207 710 2993

Gavin Friend
Markets Strategist
+44 207 710 2155

Tom Vosa
Head of Market Economics
+44 207 710 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

Alexandra Knight
Economist – Australia
+(61 3) 9208 8035

Vyanne Lai
Economist – Agribusiness
+(61 3) 8634 0198

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

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

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

Gerard Burg
Economist – Industry Analysis
+(61 3) 8634 2778

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

James Glenn
Economist – Asia
+(61 3) 9208 8129

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

Important Notices