GOLD IN FOCUS

SEP 2016

National Australia Bank

KEY POINTS:

- Gold prices have been relatively resilient in the past couple of months, fluctuating between $1300/oz and $1370/oz since late June, and have risen by around 30% between its most recent trough in mid-December and peak in early August this year.
- The relatively more hawkish communication by US Fed officials, including Janet Yellen at the Jackson Hole Symposium on 26 August, has raised market expectations of further Fed funds rate hike(s) this year, dampening the appeal of gold as an investment asset. **While weaker-than-expected US economic data over the past week, including the non-farm payrolls and ISM non-manufacturing reports, point to diminished market expected probability of a rate hike in September, buoying gold prices temporarily, we believe that the outlook for gold price movements is likely to be mildly bearish over the rest of 2016.** Central to our outlook are the assumptions that the US Fed will lift the Fed funds rate in December by 25bps and Hillary Clinton will win the upcoming US presidential election.
- After showing a staggering increase in the first half of this year to be the strongest H1 on record, net flows into Exchange Traded Funds (ETFs) slowed noticeably in July and August, although it has regained The Brexit vote appeared to have had only limited upside impact on investors' appetite in ETFs, after it was obvious that the functioning and confidence of financial markets was not fundamentally affected by it.
- In contrast, jewellery-related gold demand has been lacklustre in the year to-date, dragged down by significantly higher gold prices and highly uncertain geopolitical climate in a number of Middle Eastern countries. **However, jewellery demand is expected to pick up in H2 in conjunction with upcoming key Indian festivals, such as Dhanteras and Diwali, combined with Q4 holiday season in western India.**
- Overall, we have left our forecasts largely unchanged relative to those published in the Quarterly Minerals and Energy Outlook note published in July. **We continue to expect a gradual downward trend in gold prices over the next couple of years as the US Fed resumes monetary tightening, with prices slowing to a touch below US$1300/oz by end-16, before easing further to US$1117/oz by end-17 and US$1058/oz by mid-18.**

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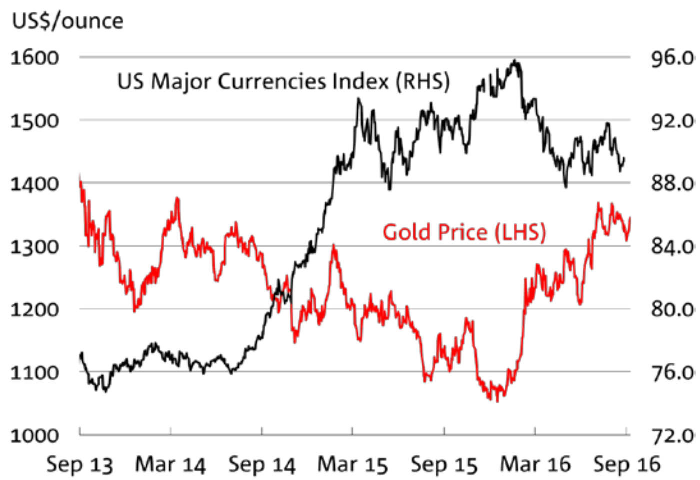
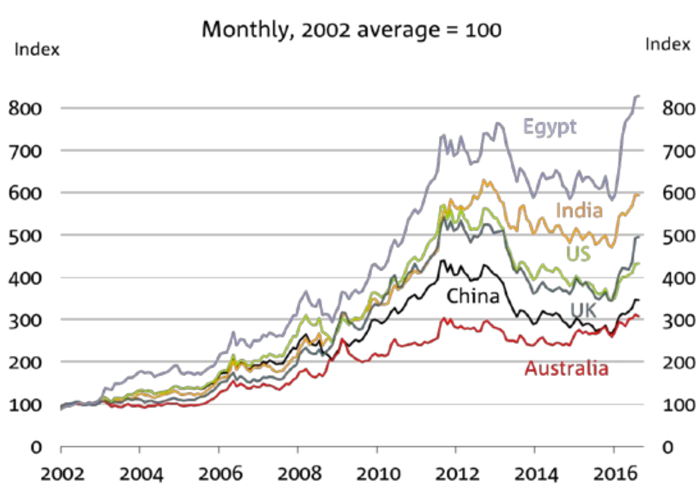
RECENT MARKET MOVEMENTS

DAILY GOLD PRICE AND THE USD INDEX



GOLD PRICES IN OTHER CURRENCIES



Sources: Datastream; NAB

- Gold prices have been relatively resilient in the past couple of months, fluctuating between $1300/oz and $1370/oz since late June, and have **risen by around 30% between its most recent trough in mid-December and peak in early August this year.**

- The inverse relationship between the USD and gold prices was an important factor during this period, as heightened global risks and a more gradualist approach by the US Fed in its tightening cycle resulted in a weaker US dollar index relative to its peak late last year. However, a more important driver in boosting gold prices had been the swift and concentrated surge in gold investment dominated by strong flows into exchange traded funds (ETFs). **According to the World Gold Council, the first six months of 2016 was a record H1 for gold investment, to be 16% higher relative to the previous record set in H1 2009.** That said, the USD has appreciated against a number of currencies this year, such as the British pound, Indian rupee and Egyptian pound, which resulted in an even stronger performance of gold prices denominated in these currencies.

- In August, gold prices rose marginally by 0.3% in monthly average terms, fuelled largely by the much weaker than expected US Q1 GDP data which was interpreted by the market as lowering the probability of a rate hike this year. However, gold prices gradually lost momentum over the month, as a number of US Fed officials, including Janet Yellen at the Jackson Hole Symposium on the 26th of August, suggested that further hikes in 2016 remain possible.

- **While weaker-than-expected US economic data over the past week, including the non-farm payrolls and ISM non-manufacturing reports, point to diminished market expected probability of a rate hike in September, buoying gold prices temporarily, we believe that the outlook for gold price movements is likely to be mildly bearish over the rest of 2016.** Central to our outlook are the assumptions that the US Fed will lift the Fed funds rate in December by 25bps and Hillary Clinton will win the US presidential election in November.

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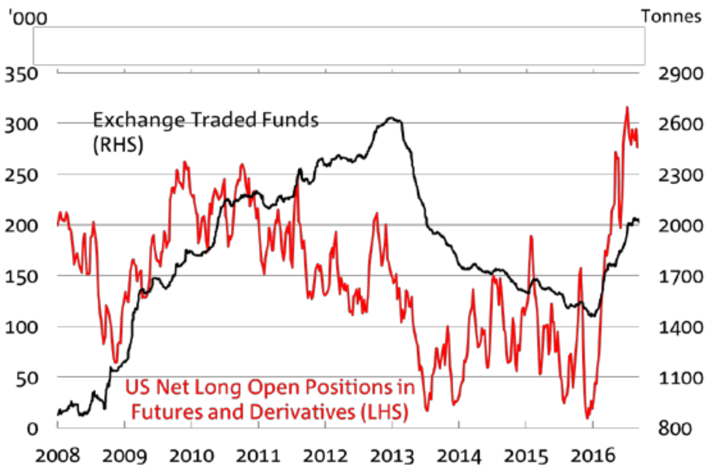
DEMAND CONDITIONS

GOLD NET LONG OPEN POSITIONS AND ETF FLOWS



Sources: Bloomberg; NAB

EQUITY MARKET INDICES AND INFLATION EXPECTATIONS

Source: Datastream, NAB

- After showing a staggering increase in the first half of this year to be the strongest H1 on record, net flows into gold ETFs slowed noticeably in July and August. **The Brexit vote appeared to have had only limited upside impact on investors' appetite in ETFs, after it was obvious that the functioning and confidence of financial markets was not fundamentally affected by it.**

- According to the World Gold Council, the swift upswing in investment this year was largely driven by the scale of pent-up demand that has built in western markets, with investors looking to initiate or rebuild strategic, long-term holdings.

- **Gold investors' positive sentiment was in turn underpinned by the negative interest rate policies adopted by Japan and Europe, as well as the expected slowdown in the US Fed monetary tightening cycle.**

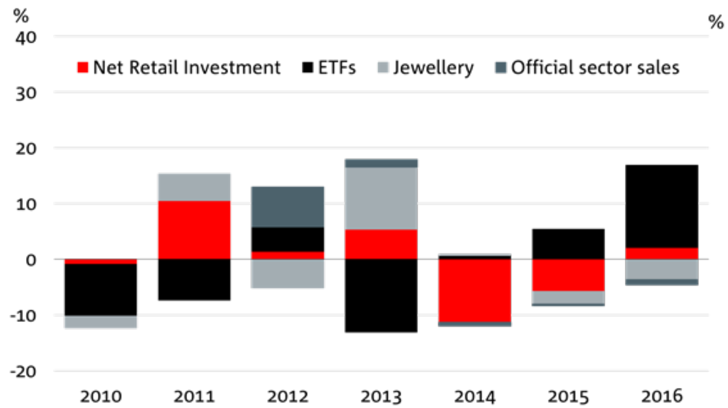
- **In recent weeks, however, the relatively more hawkish communication by US Fed officials, including Janet Yellen at the Jackson Hole Symposium on 26 August, has raised market expectations of further Fed funds rate hikes this year**, dampening the appeal of gold as an investment asset (given that gold does not offer any dividend or interest payments).

- That said, the tightening cycle by the US Fed is still expected to be gradual over the coming years. Hence the accumulation in the levels of ETFs could still have further to go, although is unlikely to proceed at the same rate witnessed earlier this year.

- The lack of inflationary pressures globally at present is also unlikely to provide much impetus for the demand for gold as an inflation hedge.

DEMAND CONDITIONS (CON'T)

CONTRIBUTION TO ANNUAL PERCENTAGE CHANGE IN GOLD DEMAND BY CATEGORY



* In the year to June quarter
Sources: World Gold Council; NAB

YEAR-ENDED PERCENTAGE CHANGE IN GOLD JEWELLERY DEMAND AND GOLD PRICES

Sources: World Gold Council; NAB

- Meanwhile, jewellery-related gold demand has been lacklustre in the year to-date, dragged down by significantly higher gold prices and the highly uncertain geopolitical climate in a number of Middle Eastern countries.
- **In India, weak income growth in rural regions from two consecutive years of deficient monsoon rainfall and new regulations have acted to dampen jewellery demand from the country in the first half of this year.** The introduction of an additional 1% excise duty and minimum purchase threshold of Rs200,000 beyond which a Permanent Account Number (PAN) is required are expected to have a long-lasting impact on Indian gold jewellery purchases overall.
- In China, weaker gold demand over the year-to-date relative to the same time last year was largely driven by poor consumer sentiment on the back of a slowing domestic economy.
- As a result, the US dollar value of global jewellery demand (USD 36.3bn) in H1 has been the lowest since 2010. Over the same period, demand in volume terms is 20% below its five-year average.
- **Jewellery demand is expected to pick up in H2 as we enter a seasonally strong period towards the end of the year, with upcoming key Indian festivals such as Dhanteras and Diwali, combined with Q4 holiday season in western India.** That said, some of the longer-term headwinds discussed above are likely to remain.

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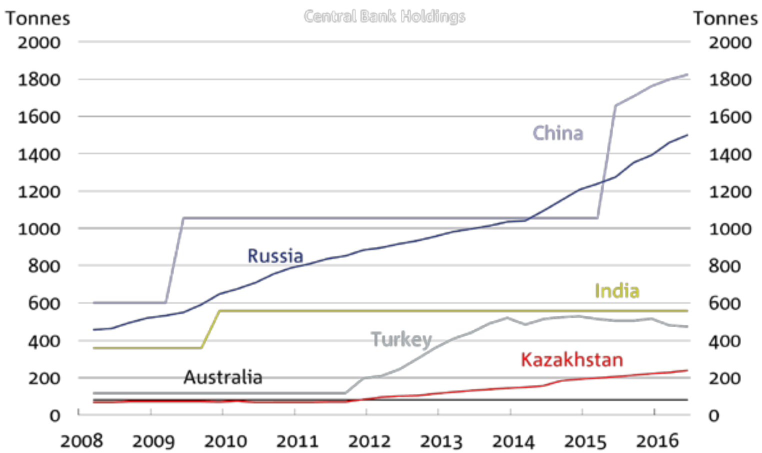
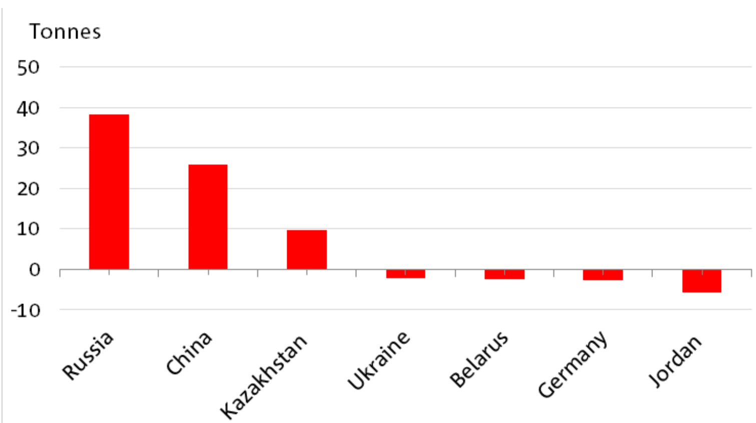
CENTRAL BANK HOLDINGS

REPORTED GOLD HOLDINGS BY CENTRAL BANKS



Source: World Gold Council

LARGEST GOLD HOLDINGS MOVERS IN Q2 2016



Source: World Gold Council, NAB Group Economics

- Against a backdrop of elevated global economic and geopolitical risks – such as a tentative divergence in monetary settings between the US and the rest of the world, continuing conflicts in the Middle East and the recent Brexit vote – many central banks continued to increase their gold holdings in H1 2016 as a way to diversify their reserve portfolio.

- However, the pace of accumulation over the year-to-date has been slower compared to the same period last year. Total net purchases by central banks in H1 were 185.1 tonnes, which was 23% lower than in H1 in 2015. This coincided with a staggering 25% rise in gold prices over the period. **Nonetheless, a period of continuous accumulation in central bank holdings saw the total volume of holdings reach 32,800 tonnes (to value at US$1.4 trillion) by the end of Q2, which is the highest level since 2013.**

- Meanwhile, slower global trade growth has also resulted in weaker overall balance of payment positions for large net exporting countries available to be converted into gold reserves.

- **Russia, China and Kazakhstan continued to lead other countries in their net gold purchases in Q2, motivated by the desires of these countries to stem capital outflows which had placed significant downward pressure on their domestic currencies.** The relative low percentages of gold as a share of total reserves in these countries also offered them the incentive to further diversify their reserve assets from foreign currencies.

- The imminent hikes in the US Fed funds rate are expected to result in more pressure for capital to leave large emerging economies such as China and Russia, which should see these countries continue to build their gold reserves over time.

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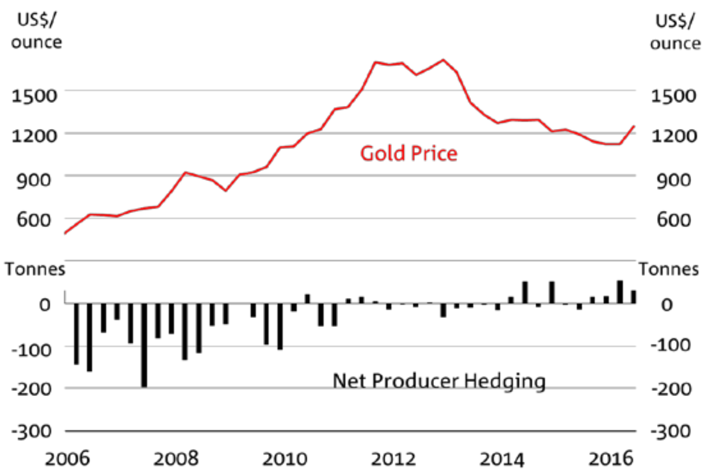
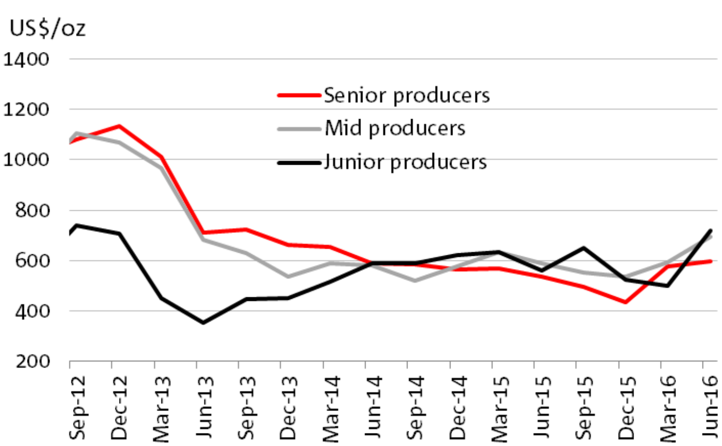
SUPPLY CONDITIONS

QUARTERLY GOLD PRICE AND NET PRODUCER HEDGING



Sources: World Gold Council; Thomson Datastream

AVERAGE CASH MARGINS BY PRODUCER SIZE



Source: Bloomberg, NAB Group Economics

- According to the World Gold Council, the world supply of gold fell by 1.5% (or 17.7 tonnes) to 1144.6 tonnes in Q2, after registering a sharp increase in Q1 of 57.8 tonnes.

- At current levels, the total supply of gold is 10% higher than at the same time last year, driven predominantly by gold recycling (up 23% year-on-year), which was in turn bolstered by the significant recovery in gold prices. Net producer hedging has also edged up noticeably in H1 (from a negative level in H1 2015), while mine production was flat year-on-year.

- Net producer hedging (selling forward of unmined gold) increased for the fourth consecutive quarter in Q2 2016, totalling 113.8 tonnes, as rising gold prices, especially in local producer currencies such as the Australian dollar and South African rand, prompted a number of producers to lock in the price they will receive for their output in advance. In Australia, producers which have extended/initiated their hedges included Newcrest (+6.2 tonnes), Oz Minerals (+5.3 tonnes) and Alkane Resources (+1.5 tonnes). **However, it is unlikely that this will be followed by a sustained period of large-scale hedging deals, given the offsetting effects of a rising USD on the gold price denominated in USD and prices denominated in local producer currencies as they depreciate against USD.**

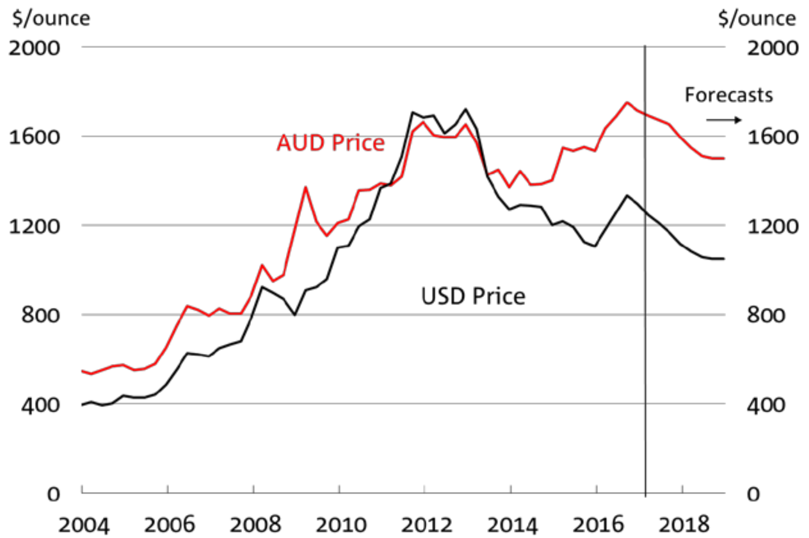
- Given the ongoing cost management efforts by gold producers since 2013, combined with strong rises in gold prices in H1, gold producers' average cash margins have improved. **Stronger producer margins and historically elevated gold price levels could see a pick-up in gold-related capital investment in the near term.**

FORECASTS

	Spot Price	Actual	Forecasts									
		Jun 16	Sep 16	Dec 16	Mar 17	Jun 17	Sep 17	Dec 17	Mar 18	Jun 18	Sep 18	Dec 18
Gold – US$	1345	1259	1333	1297	1247	1209	1167	1117	1083	1058	1050	1050
Gold – AU$	1752	1688	1750	1714	1692	1671	1651	1595	1548	1512	1500	1500

Note: Forecasts are in quarterly average terms.
Source: Datastream, NAB Economics

GOLD PRICE FORECAST (USD AND AUD)



Sources: Thomson Datastream; NAB

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