GOLD IN FOCUS

JULY 2017

National Australia Bank

KEY POINTS:

- Gold began 2017 strongly, up 8% in the first half - despite falling 2% in June. This weakness has continued into early July, with the strong US payrolls data exerting further weakness on gold. However, gold received some support following Fed Chair Janet Yellen's semi-annual testimony, which the markets interpreted as somewhat dovish.
- Gold tends to move inversely with the US dollar, as a lower dollar ensures a lower price for non-US buyers, thereby raising their demand. Conversely, gold tends to be positively correlated with the Japanese Yen, as both are viewed as safe haven assets. Of late, the JPY has been weakening due to the widening interest rate differential between Japan and the rest of the developed world due to the Bank of Japan's operations.
- A sharp rise in gold imports from India and China during the first half of this year has provided support for gold, although the World Gold Council predicts some easing in Indian demand due to the launch of the GST in July, 2017. China continues to provide innovative gold offerings, including the launch of Microgold, which allows users to electronically send gold through WeChat.
- Demand for gold from Central Banks has been generally subdued, with the exception of the Central Bank of Russia, which has steadily been raising its purchases of gold.
- Gold supply is expected to modestly ease in 2017, with Reuters expecting a reduced quantity of mined gold production.
- **The cross-currents impacting gold tend to generate divergent outcomes. Overall, we are mildly optimistic about gold – despite some near-term weakness.** While an expectation for higher interest rates generates headwinds, gold's safe haven status, low correlation with other assets such as equities and the possibility of a re-emergence of financial market volatility will help underpin demand. **We are forecasting the price of gold to be around USD1,235/oz. by end 2017, rising to USD1,300/oz. by end 2018.**
- **For gold' price to descend to around USD1,100/oz and below, we would need a period of heightened geopolitical/financial calm. Conversely, a major geopolitical or financial shock could see gold's price surging above USD1,400/oz. This is not our central forecast, though.**

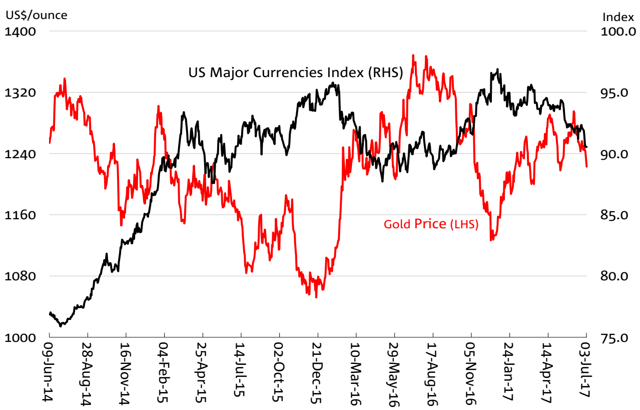
Contents

Contact

John Sharma, Economist
John_sharma@national.com.au
James Glenn – Senior Economist
James_Glenn@nab.com.au

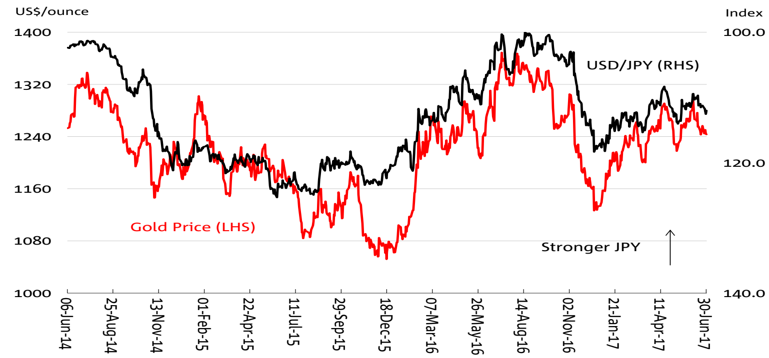
RECENT MARKET MOVEMENTS

DAILY GOLD PRICE AND THE USD INDEX



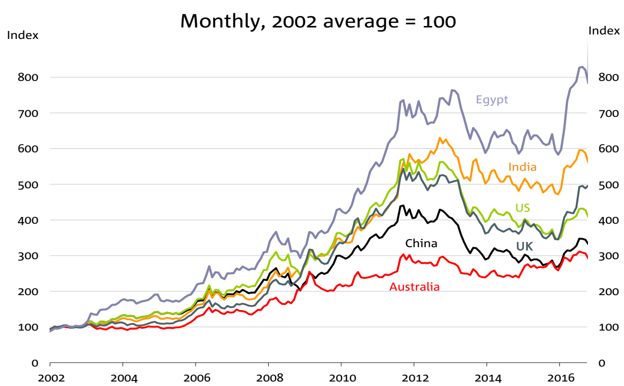
Source: Thomson Datastream, NAB

DAILY GOLD PRICE AND THE JPY



Source: Bloomberg, NAB

GOLD PRICES IN OTHER CURRENCIES



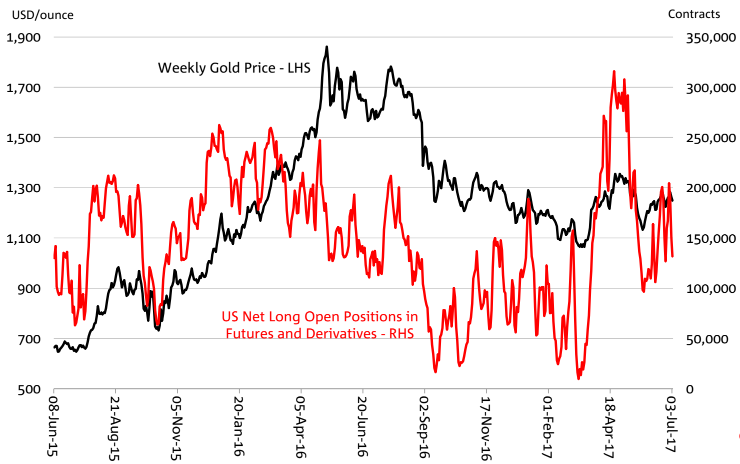
Sources: Datastream; NAB

- Gold fell nearly 2% in June, 2017, its first monthly fall in 2017. This was driven by hawkish comments from the BOE, Bank of Canada, as well as market expectations that the ECB is expected to announce some tapering to its asset purchase program. This weakness has continued into July, following the strong US payrolls data. However, it has received somewhat of a reprieve following comments from Fed Chair, Janet Yellen, markets interpreted as dovish.
- That said, the price of gold is up almost 8% during the first half of the year, as markets lowered their expectations of the Trump administration delivering on its policy agenda.
- In general, gold tends to move inversely to the US dollar, as it is cheaper for overseas investors to purchase gold. Conversely, gold tends to move more in line with the Japanese Yen – although they are not perfectly correlated - as both are seen as safe haven assets during times of geopolitical/financial stress.
- Overall, we are mildly optimistic about gold – despite some near-term weakness. While an expectation for higher (Central bank driven) interest rates generates headwinds, gold's safe haven status, and low correlation with other assets such as equities will help underpin demand. We are forecasting the price of gold to be around USD1,235/oz. by end 2017, rising to USD1,300/oz. by end 2018.
- For gold's price to descend to around USD1,100/oz and below, we would need a period of extreme geopolitical/financial calm. Conversely, a major geopolitical/financial shock could see gold's price surging above USD1,400/oz.

National Australia Bank

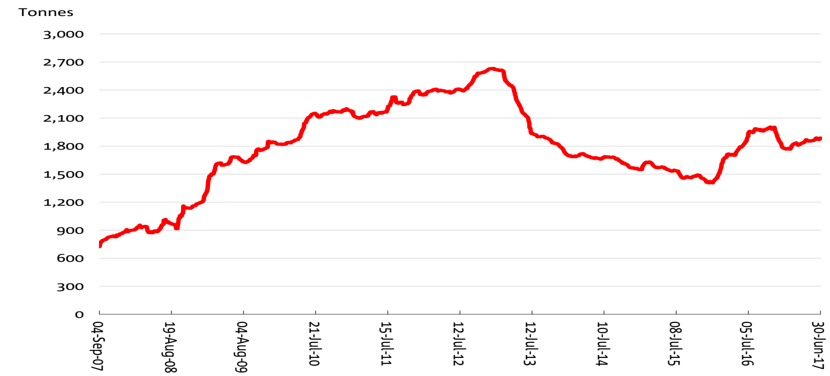
DEMAND CONDITIONS

NET LONG POSITION AND GOLD PRICES



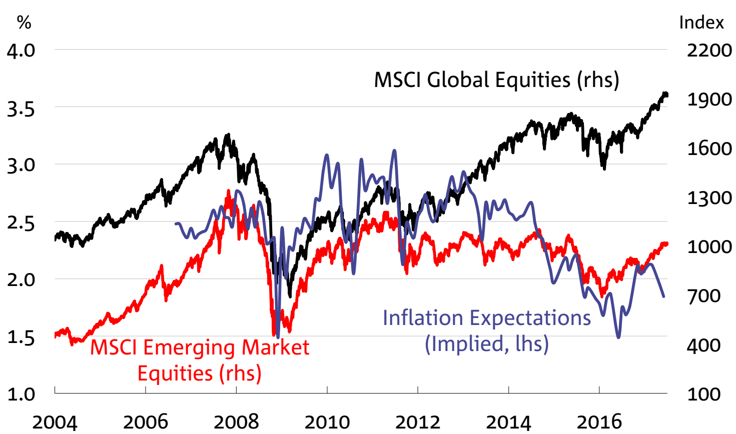
Sources: Bloomberg; NAB

GOLD ETF HOLDINGS



Source: Bloomberg, NAB Group Economics

EQUITY MARKET INDICES AND INFLATION EXPECTATIONS

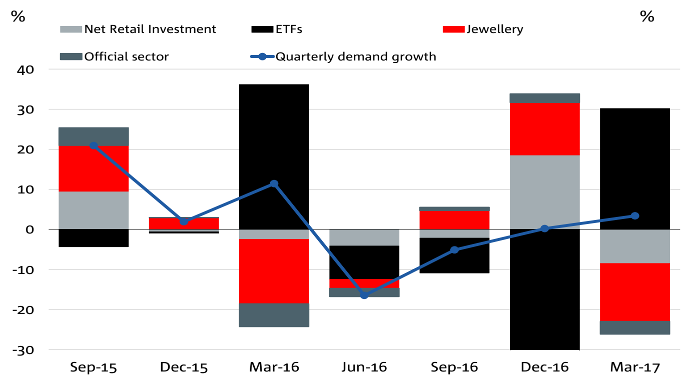


Source: Datastream, NAB

- ETF gold holdings fell during the end of 2016, but picked up in 2017 as doubts surfaced about the Trump administration's economic agenda, as well as new bouts of geopolitical tension, such as in North Korea.
- A similar pattern is observed in the net long positions in futures and derivatives by non-commercial players. There was a spike in net long positions during April, reflecting an upsurge in tensions between the United States and North Korea. The number of open positions –a proxy for gold sentiment among traders – has since abated, but remains well above levels since the beginning of the year.
- Equity markets remain close to record highs, a point raised by Fed officials, including San Francisco Fed President who was 'somewhat concerned about the complacency in the market'. With equities at such high levels, any concerns about a possible market correction should be supportive of gold.
- Inflation expectations (based on 5 year break even inflation rates) have eased a touch of late, although they are well off their lows. NAB Economics is forecasting one rate hike in 2017,and three in 2018.
- The recent Fed minutes indicates that the Committee was split as to how inflation would affect the rates outlook, an important factor for gold. A more hawkish outlook, for example, would lead to a faster pace of rate hikes, which is negative for gold.

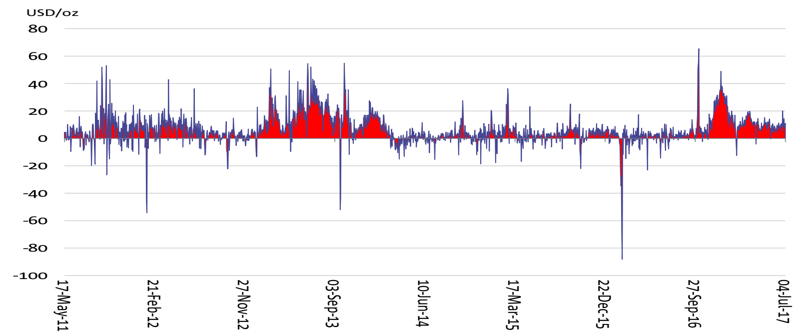
DEMAND CONDITIONS (CON'T)

CONTRIBUTION TO QUARTERLY PERCENTAGE CHANGE IN GOLD DEMAND BY CATEGORY



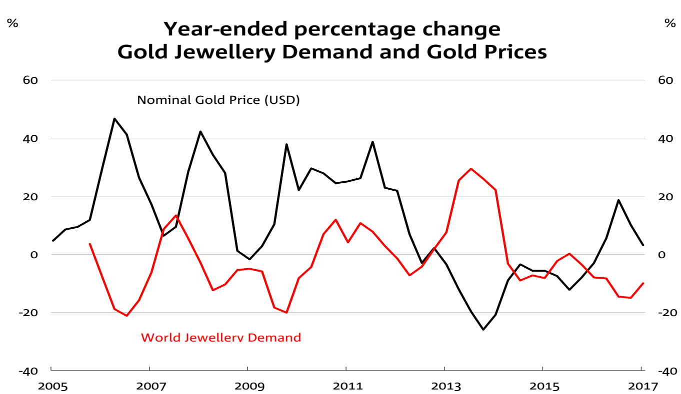
Sources: World Gold Council; NAB

CHINA GOLD PREMIUM



Source: Bloomberg, NAB

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

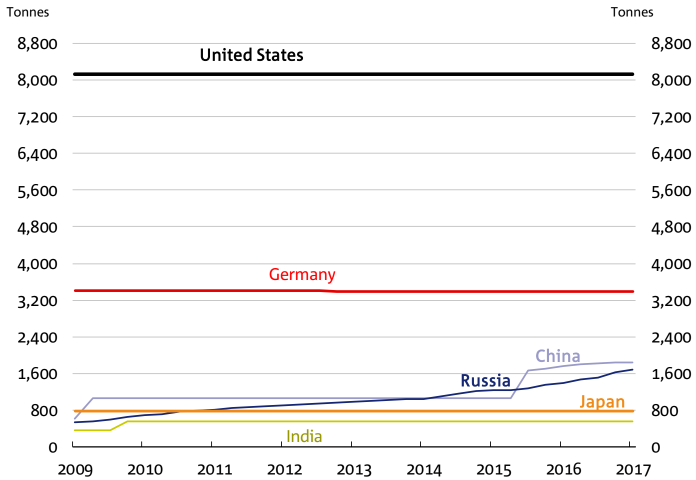


Sources: World Gold Council; NAB

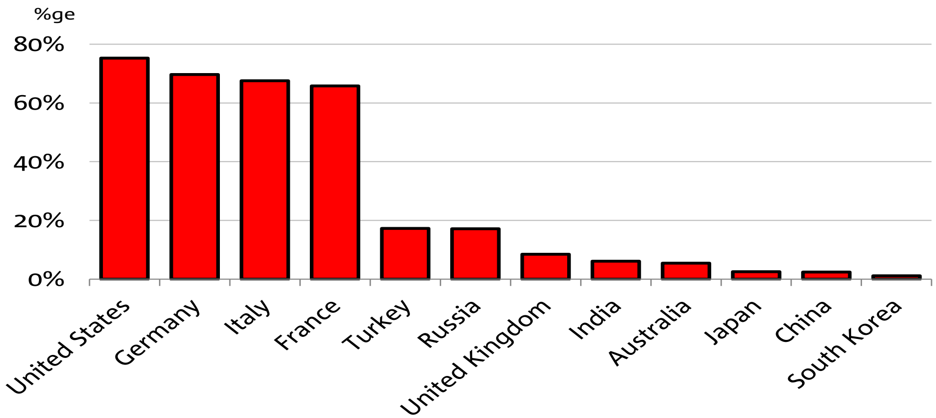
- There was a slight (3.1%) **quarterly** increase in gold demand in March quarter 2017, driven primarily by growth in demand for investments in exchange traded funds, primarily by European investors. Elsewhere, there was a slowing in the pace of jewellery purchases, bar and coin demand, and Central bank purchases of gold and bar and coin demand.
- On a **yoy** basis, however, there has been something of a reversal of these trends. Demand for ETFs fell sharply (-68%); bar and coin demand rose (9%), driven by solid demand in India and China; and jewellery (1%) increased slightly. Weak Central band demand was the common factor in both the quarterly and annual data.
- Jewellery demand tends to be price sensitive. Indian demand, overall, has remained strong, assisted by factors such as pent up demand due to demonetisation, the *Akshaya Tritiya* festival land advance purchase to beat the GST impost, which is set at 3% for gold. According to Reuters, Indian gold imports rose by a staggering 153% yoy in the first 5 months of 2017.
- Chinese gold imports too increased, with Reuters reporting a 14.2% rise over the 4 months to April, with Hong Kong and Switzerland the key international hubs. Gold and coin demand has remain very strong in China. In fact, ICBC & Tencent have developed a product called Microgold, which allows users to electronically send gold to friends via WeChat. The strong underlying demand for gold in China can be seen through the premium that gold attracts in China, around USD10/oz.

CENTRAL BANK HOLDINGS

REPORTED GOLD HOLDINGS BY CENTRAL BANKS

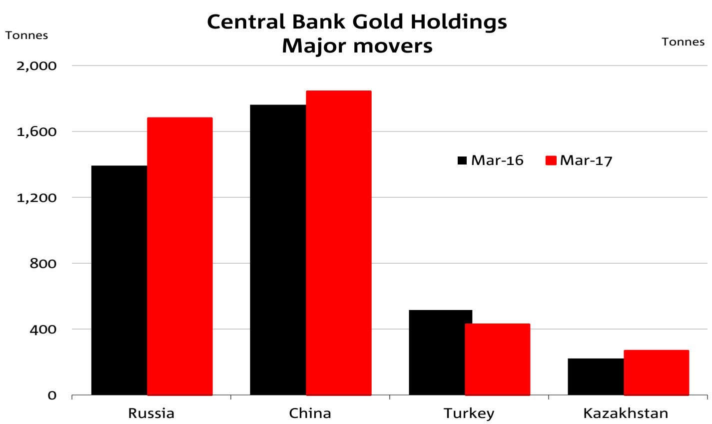


GOLD'S SHARE IN INTERNATIONAL RESERVES



Sources: IMF; World Gold Council; NAB

LARGEST GOLD HOLDINGS MOVERS IN Q2 2016



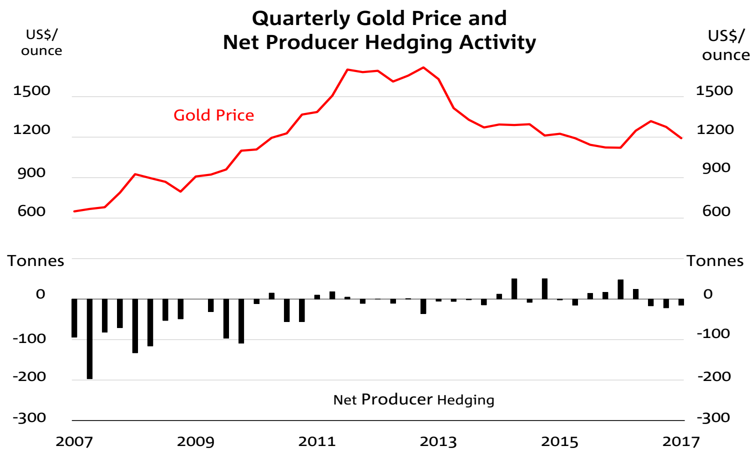
Source: World Gold Council

- **The US Federal Reserve and the German Bundesbank have the largest volume of gold holdings among the major Central Banks. Moreover, the US dollar, and the Euro are among the most actively traded currencies in the world.**
- The pace of gold purchases has been generally modest. An estimated 76 tonnes was purchased by Central banks over the March quarter, 2017; for the year to March an estimated 349 tonnes were purchased. This represents a 38% decline over year ago levels.
- Russia (+287.2 tonnes) was the largest net purchaser of gold during the period, followed by China (+80.2 tonnes) and Kazakhstan (+45.8 tonnes). Turkey (-87.7 tonnes) shed some of its gold holdings during the period.
- Russia continues to augment its gold holdings, with the Central Bank or Russia data indicating that the value of Russia's gold holdings rose by USD1.73bn to USD69.3bn between March and May 2017.
- With a number of Central Banks such as Russia, China, India, Japan and South Korea holding high levels of FX reserves – all exceeding USD350bn – but a relatively low proportion of gold, there is scope for them to raise their gold holdings in the event of a rise in risk sentiment.

National Australia Bank

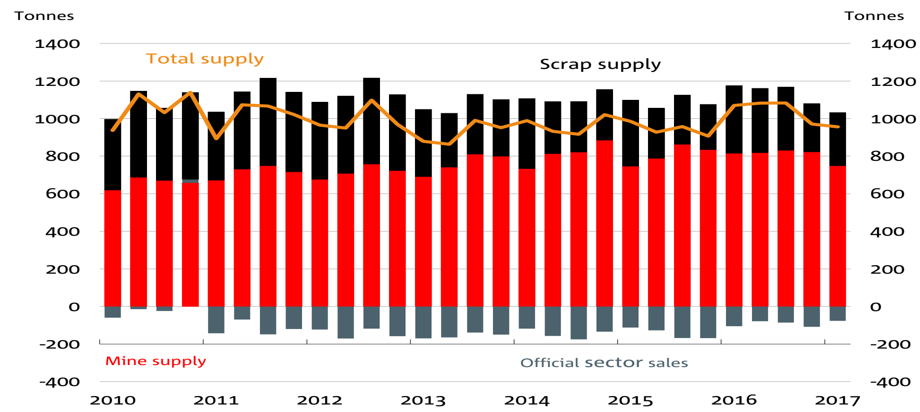
SUPPLY CONDITIONS

QUARTERLY GOLD PRICE AND NET PRODUCER HEDGING



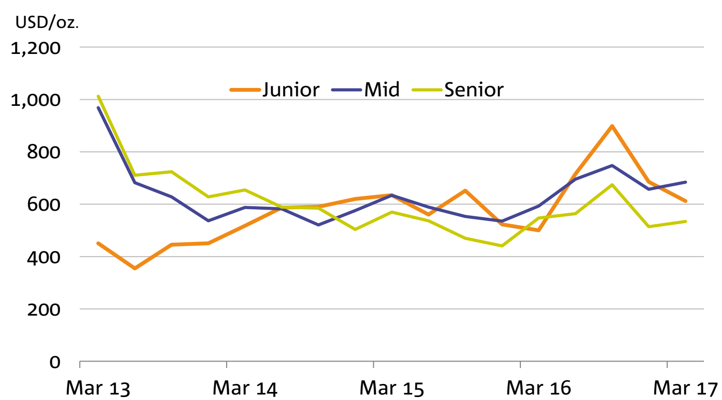
Sources: World Gold Council; Thomson Datastream

QUARTERLY GOLD SUPPLY



Source: World Gold Council

AVERAGE CASH MARGINS BY PRODUCER SIZE



Source: Bloomberg, NAB

- According to data from the World Gold Council, overall gold supply (excluding official sector sales) increased by 200 tonnes to 4,584 tonnes. This was driven largely by an increase in recycled gold, with notable increases in Egypt and Spain.
- In the March quarter, 2017 total supply was 1,032 tonnes, a 12% yoy decline. Mining supply was at a similar level as March quarter, 2017. However, there was a fall in the supply recycled gold, as well as a decline due to net producer dehedging.
- Net producer hedging (selling forward unmined gold) releases gold into the market; net producer dehedging, on the other hand, withdraws gold from the market. Australian miners Newcrest and Evolution mining were among the miners engaged in dehedging.
- Average cash margins of miners fell during the second half of 2016, but recovered somewhat in early 2017. The current weakness in price would likely pressure mining margins, suggesting limited upside in supply.
- According to projections from Reuters, supply volumes are expected to decline in 2017, driven by lower mining production. North America could be an exception, with production from the Oceana Gold's Haile mine in South Carolina and TMAC Resources' Hope Bay mine in Northern Canada having commenced operations in 2017.

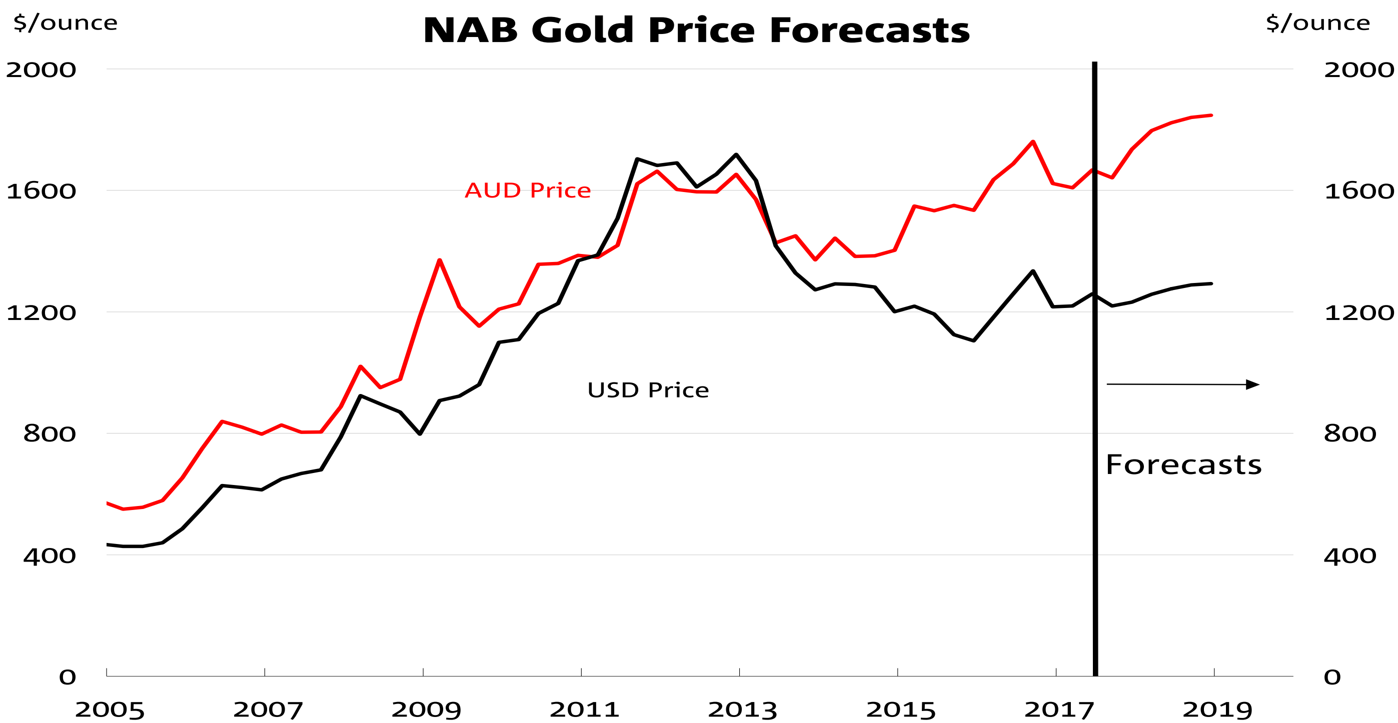
FORECASTS

Gold Price Forecast - Quarterly Average

	Actual	Forecasts									
	Jun 17	*Sep 17*	*Dec 17*	*Mar 18*	*Jun 18*	*Sep 18*	*Dec 18*	*Mar 19*	*Jun 19*	*Sep 19*	*Dec 19*
Gold - US$	1259	1220	1232	1258	1276	1288	1293	1300	1315	1332	1347
Gold - AU$	1667	1642	1735	1797	1823	1841	1847	1857	1861	1858	1854

Sources: Thomson Datastream; NAB

GOLD PRICE FORECAST (USD AND AUD)



Sources: Thomson Datastream; NAB

Group Economics
Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities
Riki Polygenis
Head of Australian Economics and Commodities
+(61 3) 8697 9534

James Glenn
Senior Economist – Australia
+(61 4)55 052 519

Amy Li
Economist – Australia
+(61 3) 8634 1563

Phin Ziebell
Economist – Agribusiness
+(61 4) 75 940 662

Behavioural & Industry Economics
Dean Pearson
Head of Behavioural & Industry Economics
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 3837

Steven Wu
Economist – Behavioural & Industry Economics
+(613) 9208 2929

International Economics
Tom Taylor
Head of Economics, International
+61 3 8634 1883

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

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

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

Global Markets Research
Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia
Economics
Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

David de Garis
Senior Economist
+61 3 8641 3045

Tapas Strickland
Economist
+61 2 9237 1980

FX Strategy
Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Rodrigo Catril
Currency Strategist
+61 2 9293 7109

Interest Rate Strategy
Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Alex Stanley
Senior Interest Rate Strategist
+61 2 9237 8154

Credit Research
Michael Bush
Head of Credit Research
+61 3 8641 0575

Andrew Jones
Credit Analyst
+61 3 8641 0978

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

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

Kymberly Martin
Senior Market Strategist
+64 4 924 7654

Jason Wong
Currency Strategist
+64 4 924 7652

Yvonne Liew
Publications & Web Administrator
+64 4 474 9771

Asia
Christy Tan
Head of Markets Strategy/Research, Asia,
+ 852 2822 5350

Julian Wee
Senior Markets Strategist, Asia
+65 6632 8055

UK/Europe
Nick Parsons
Head of Research, UK/Europe, and Global Co-Head of FX Strategy
+ 44207710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 2155