



# Gold Market Monthly – 7 December 2009

Minerals & Energy: Ben Westmore

## Key Points

- Gold prices have rallied strongly over the past month, currently trading at around US\$1150 per ounce.
- Since November 3 the gold price has risen by over 10 per cent, with markets surprised by the extent of central bank gold demand.
- After decreasing gold holdings since the mid-1980's, some central banks appear keen to rebuild their gold reserves amid uncertainty around the value of the US dollar.
- Investor interest continues to support gold demand, while jewellery consumption remains very weak.
- With producers anticipating further rises in the price of gold, dehedging activity increased in the September quarter.
- Gold prices are expected to remain well supported before trending higher with a rebound in jewellery consumption over 2010.
- In the short-term, there is the possibility for speculative investment flows to push prices well in excess of US\$1200 per fine ounce. However, in the absence of further news, we expect that such a rally would eventually be unwound.

## Strong central bank demand fuels gold price rally

The steady gold price appreciation since December 2008 has been a function of US dollar weakness, investor 'safe haven' buying and heightened inflation expectations. These are all symptoms of the financial crisis and the extraordinary measures by governments and central banks to stimulate activity. In October, we considered the impact of these factors on demand to have been more or less priced into the gold market. With prices moving above US\$1000 per ounce, we foreshadowed the possibility of some near-term weakness as investors grew more confident and unwound some safe haven purchases. Unforeseen, however, were the strong signals by central banks in recent months that they were aiming to increase gold holdings as a proportion of reserve assets. The strong central bank response to IMF gold sales surprised the market, causing prices to rally to around US\$1200 per ounce (see Graph 1). Central bank gold net accumulation is a new and unexpected

source of gold demand and, as such, it is appropriate to make some upward revision to our expectations for gold prices. In quarterly average terms, we now expect the gold price to move above US\$1200 around mid 2010.

## IMF gold sales

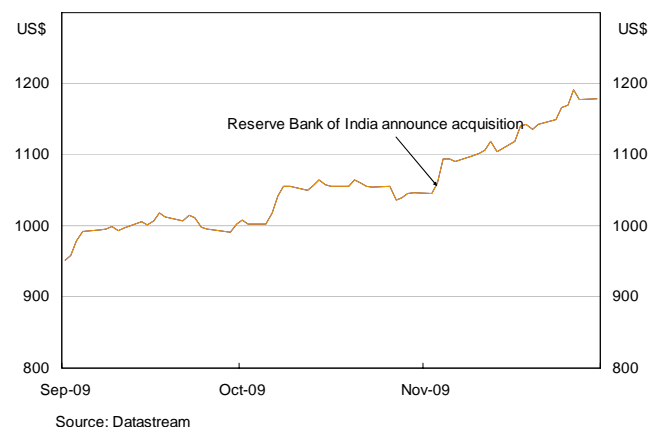
In September, the IMF executive board approved the sale of 403.3 metric tonnes of gold for the purposes of financing future lending. While the IMF planned to sell most of the bullion directly to central banks, some was anticipated to be sold on the open market in a phased manner. However, recent activity suggests that the IMF could have underestimated the extent of central bank interest.

## RBI purchase follows a period of central banks decreasing gold holdings

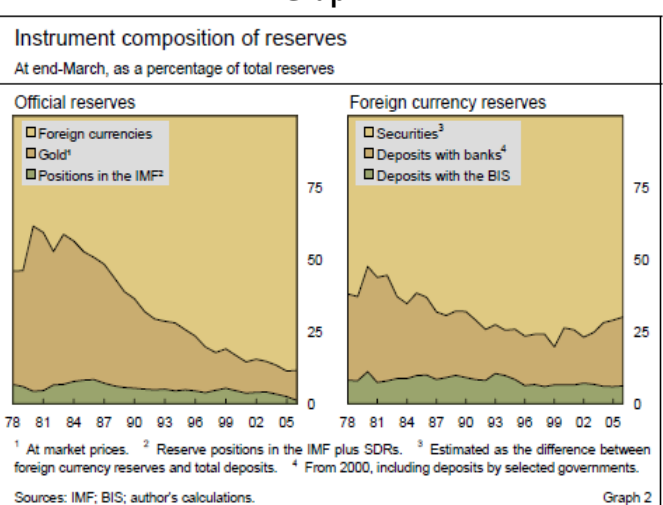
Following the purchase of 200 metric tonnes of gold by the Reserve Bank of India (RBI), increases in holdings (albeit by a much smaller magnitude) were announced by the central banks of Sri Lanka and Mauritius. For India, the acquisition concludes a period, since the liberalisation of the gold policy in 1991, characterised by effectively no central bank gold transactions.

Graph 1

Nominal Gold Price



Graph 2



This was indicative of the trend from the early 1980s of central banks selling down gold holdings, as the price depreciation failed to endear it as a vehicle for investment. Instead, central banks increased their holdings of foreign currency, with the US dollar the global reserve currency. This is best shown in the left panel of Graph 2, published by the Bank of International Settlements in 2006.

**Questions around the value of the US dollar causing central banks to rebalance reserve portfolios**

Recent uncertainty around the value of the US dollar and its very high share in most countries reserve portfolios is prompting some central banks to take steps to diversify away from US dollar reserve holdings. For emerging economies there is evidence that this rebalancing process has been underway since 2000, although US dollar holdings by advanced economies remained relatively high up until 2008 (see Graph 3).

With concerns at the moment around the possibility of further financial instability as well as some expectations for future inflation (induced by expansionary monetary policy) gold has become an attractive alternative investment to US dollars. This is largely due to gold’s properties as a safe haven asset and a medium with which to hedge against inflation.

**Investors underestimated central bank gold demand**

To give a sense of the relative size of the RBI purchase, 200 metric tonnes of gold is equivalent to 5 per cent of total global gold demand in 2008. Before the RBI acquisition, market participants underestimated the extent to which central banks were looking to increase gold holdings. While most were expecting the People’s Bank of China to purchase from the IMF, due to a very low share of gold relative to total reserve assets (around 1 per cent at the beginning of 2008), the size of the purchase by India at a price considered very high by historical standards surprised the market. Since the announcement of the RBI purchase on 3 November, the gold price has risen by over 10 per cent. Moreover, in recent weeks there have been reports that India is conducting talks with the IMF to acquire a further large quantity (up to 200 tonnes) of gold.

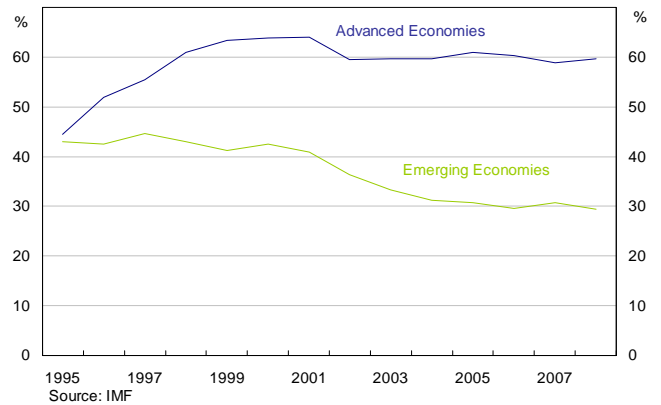
**Weak jewellery consumption has partially offset investment demand**

World Gold Council statistics continue to show that global demand is being supported by investment. In the September Quarter 2009, net retail investment and exchange traded funds (ETFs) contributed 7 and 9 percentage points respectively to annual average demand growth (see Graph 4). Since then, monthly data continue to show ETFs remaining active, steadily increasing gold holdings in October and November (see Graph 5). Nevertheless, through the year, investor interest has been largely offset by a 12 percentage point subtraction from jewellery demand with trend growth in this category declining for the past seven consecutive quarters.

**Graph 3**

**US Dollar Reserves**

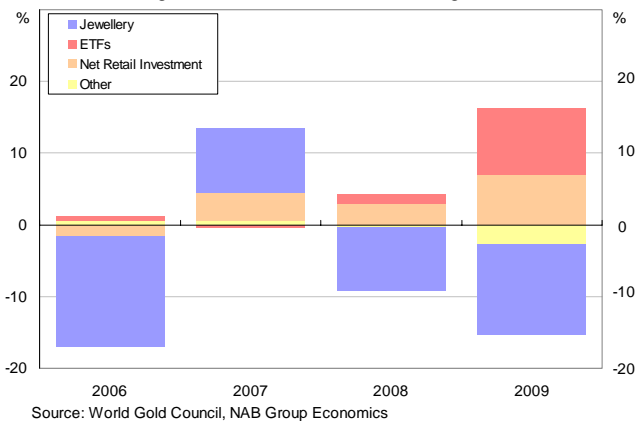
Proportion of Total Foreign Exchange Holdings



**Graph 4**

**World Gold Demand**

Percentage Contribution to Annual Average Growth



**Graph 5**

**Exchange Traded Funds**

Gold Holdings



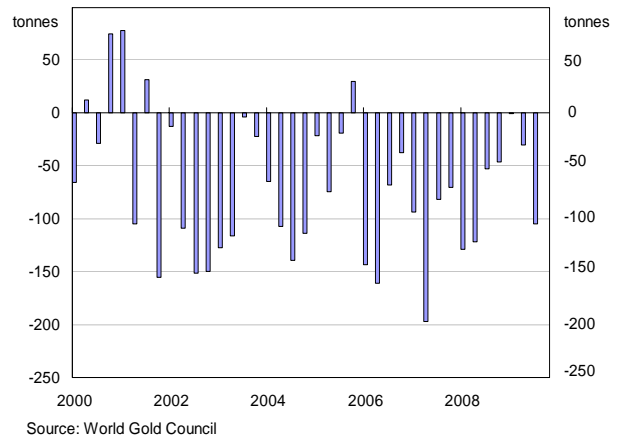
Based on data for the past five years, growth in world jewellery demand moves inversely with US dollar denominated gold prices. This implies that consumers delay their purchases until a moderation in the gold price raises the perceived value of an

acquisition. Such intertemporal deferral will be dependant on both the current price and consumer's price expectations over the foreseeable future. As a result, the recent steep increase in the gold price is likely to have further deterred jewellery purchases, with this source of demand unlikely to resurface until either prices decline or consumers revise their price expectations higher.

**Gold supply likely to remain limited with net producer dehedging and flat mine output**

As mentioned in previous *Gold Market Monthly's*, we are expecting gold supply from mines to be broadly flat as the effect of declining ore grades in Indonesia and South Africa broadly offsets an increase in mine reserves in China, Australia and Russia. This is coupled with the fact that net dehedging by producers rose in the September quarter to indicate tight gold supply (see Graph 6). The increase in dehedging activity reflects producers expectations of further rises in the gold price, reducing supply as producers effectively buy back gold. In the quarter, net producer dehedging increased to 105 tonnes after relatively muted activity in the first half of 2009. A large proportion of this is attributable to Barrick Gold, the world's largest gold producer, who in early December announced that all gold hedges had been eliminated by dehedging 85 tonnes of gold between 7 September 2009 and 1 December 2009.

**Graph 6**  
**Dehedging Activity**  
Net Producer Hedging



**Prices to hold their current highs before consumption recovers over 2010**

With output from gold mines expected to be relatively flat and producer dehedging to continue, growth in gold supply is set to remain muted over the coming year. This emphasises the high price inelasticity of gold supply and is an important contributor to the rise in its value. Nevertheless, there have been recent reports suggesting that recycled gold supply is picking up as households respond to higher prices by selling jewellery and other gold products. The possibility of a rapid increase in recycled gold in the market is not factored into our forecasts as yet, but represents a downside risk to expectations for the gold price.

The prediction of tighter supply is coupled with an expectation for continuing solid gold demand from investors and central banks. This is based on a belief that market participants now hold a greater preference for less opaque assets. The future strength of central bank gold demand undoubtedly depends on prospects for the US dollar. Over the medium term, NAB Currency Strategists are predicting a structural depreciation in the US dollar brought about by very low official interest rates and the country's swelling fiscal deficit. At the very least, uncertainty around the value of the US dollar is expected to continue, causing central banks to further rebalance reserve holdings away from US dollars. This, along with the appetite for gold recently displayed by central banks, signals further support for gold demand.

In the second half of 2010, we expect jewellery consumption to recover as household incomes rise in line with stronger economic growth. In addition, an extended period with the gold price in excess of US\$1000 per fine ounce will likely cause consumers to revise price expectations upwards instead of waiting for gold to become more affordable. The increase in jewellery demand is likely to be greatest not only in those countries with traditionally strong consumption, such as India and Turkey, but also in rapidly developing areas that have a less clear preference for gold (i.e. China).

In the short-term, there is the possibility for speculative investment flows to push prices well in excess of US\$1200 per fine ounce. However, in the absence of further news being released to the market, we expect that such a rally would eventually be unwound as prices settle around our quarterly average forecast levels (see Graph 7).

**Graph 7**  
**Nominal Gold Price**



**Quarterly price profile**

	Actual	<i>Forecasts</i>						
	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10	Dec 10	Mar 11	Jun 11
Gold - US\$	961	1100	1149	1174	1204	1234	1260	1290
Gold - AU\$	1153	1180	1163	1162	1173	1242	1260	1290

Source: Datastream, NAB Group Economics

**Group Economics – Some Useful Contacts by Specialisation**

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