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Precious Metals 2014 Forecast

Gold

November 2013

Executive Summary

The correction in Gold prices stepped up a gear this year with prices falling to a low of $1,180/oz, some 38.5% below the highs seen in September 2011. ETF redemptions have shifted the supply/demand dynamics, which in turn have pushed prices lower.

Concerns over the monetary system and debt have taken a backseat as far as institutional investors are concerned and talk of reining in quantitative easing suggested policymakers were getting less concerned about the road ahead.

While demand for exchange traded Gold has dropped, demand for physical Gold has picked-up and it is likely to be held in tight hands. If there is a need for further monetisation of Gold as confidence in fiat money deteriorates, Gold could well out perform again.

Introduction

Gold prices have been under pressure for most of the year, they set a low at $1,180/oz in June and have since been consolidating - albeit they still look vulnerable. Although the sell-off has felt endless, it is worth noting that prices are still well above the levels they were before the financial crisis. In addition, although bullish sentiment appears to have evaporated, it has not turned outright bearish. The most bearish aspect of the market has been the level of ETF redemptions that have fallen 29 percent, but that means 71 percent of the Gold that went into ETFs is still being held. Likewise, although the funds have become less bullish, they have avoided going net short and the selling from ETFs has been met by strong demand for physical Gold in the East. Given that prices are determined by the marginal difference between supply and demand, we feel prices have sold off as much as they have as this was the first major bout of profit-taking that the bull market has seen – the 2008 sell-off being more a necessity to raise cash as the credit crunch bit. Given no let-up in ETF redemptions and that imports into India have dropped significantly as a result of government intervention, it may be that prices still have further to fall. However, as the Gold leaving ETFs has made its way to the East in the form of small bars and jewellery, we feel that if institutional demand were to pick-up again, then investors will end up having to chase Gold prices higher as they scrabble to get physical metal. The question is whether it is likely that sentiment turns bullish again?

The Big Picture

There are a lot of cross currents affecting the global economy but generally the status quo has been kept and problems that have emerged in the financial/monetary system have been temporarily sorted out before they have turned into crises. Examples being: the US fiscal cliff, the Cypriot debt, Italian elections and the US debt ceiling. As a result of this, institutional investors have regained confidence in the broader financial markets, whether it be peripheral European bonds, the euro, the dollar, or equities – to name a few. While the issues have been tackled, solutions have still not been found and the measures taken have tended to buy time, as has happened all the way through the crisis.

One of the main developments in 2013 has been the focus on the ending of quantitative easing (QE). In the minutes from the December 2012 FOMC meeting that were made public in January, there were some comments about the reining in of QE later in 2013. Whether the prospect of an end of QE sparked concerns that liquidity would be drained from the system and there would be less investment money around, or that the financial crisis was coming to an end and therefore there was a call for optimism, is uncertain. That said, with equities outperforming expectations this year there has been a high degree of optimism and the talk of tapering QE has tended to depress commodity prices, especially the precious metals.

Indeed, as soon as the possible ending of QE was first mentioned it seems to have been seen as the 'writing on the wall' that prompted some investors to start reducing exposure to Gold. The fact that QE has continued each month since then seems to have been lost on the market. Hawkish Fed talk still tends to weigh on prices, while dovish talk only has limited ability to lift prices and rebounds have been short-lived. One interesting fact is that despite all the QE that has been done, whether in the US, UK, or in Japan, high inflation has not returned. So with QE now likely to be on the way out, concerns about inflation have died down. Ironically, if there is no threat of inflation, then it may well be that the Fed can delay the start of tapering, especially if fears of deflation started to rise again. While the prospects for rising inflation in developed markets might not be a worry, inflation in emerging markets is expected to remain an issue and in turn that is likely to fuel demand for bullion as a means to combat inflation.

So for now we view the global market as split between emerging markets and developed markets. In the latter, confidence is improving and with equities on the rise and periphery bonds looking less risky, the opportunity cost of holding Gold has risen to the extent that there is little fresh investment interest in the metal. However, the economic climate in emerging markets where individuals are concerned about inflation, governments about their exposure to fiat currencies and where there is a growing middle class with greater disposable income, Gold remains in demand. With hindsight it is not surprising that the marginal shift in supply and demand has resulted in a pullback in prices, but in turn lower prices have encouraged physical buying and that may well now rebalance the market and stabilise prices.

Going forward we still see the legacy of the build-up of massive amounts of debt as potentially bullish for Gold. Creditors of this debt, mainly in Asia and the Middle East, are likely to want to swap out of debt that is denominated in fiat currencies, especially after the recent fiasco over raising the US debt ceiling. The move by central banks to buy Gold in recent years, plus this year's pick-up in physical flows from West to East are all signs to us that Gold is being monetised and if this is the case and the notion of this catches on, then we feel there will be another broad-based scramble into Gold as a hedge against ongoing fiat currency debasement.

FACTORS DRIVING GOLD PRICES

The dollar

The dollar's long term down trend after the peak in July 2001 when the dollar index was at 121, reached a low of 70.70 in March 2008. Since then it has oscillated sideways either side of the 80 level. Interestingly, whereas the wide held view is that the Fed's programme of QE has weakened the dollar, in reality the dollar reached a low before QE started. This implies that all the money printing that the Fed has been doing since late 2008, which has seen its balance sheet rise from less than one trillion dollars to almost four trillion dollars, has not weakened the dollar. Perhaps because the Fed's action supported the US Treasury market, treasuries were seen as a safe-haven and foreign buying of US bonds underpinned the dollar as a result. Likewise, the banks that have been able to borrow cheaply from the Fed have over the years used that money to buy a broader range of assets. This explains why Gold prices, along with other commodities and equities, climbed once the Fed started QE. This has led to a situation where the dollar has generally been oscillating sideways, while Gold prices have been bullish – that is until early this year when sentiment started to turn bearish. In hindsight, it would appear that the first indication that the Fed would start to rein in QE, which was contained in the FOMC Meeting Minutes that were made public on 3rd January 2013, prompted some institutional investors to start reducing their exposure to Gold. Holdings in Gold ETFs peaked on 3rd January 2013 and have since been trending lower.

Looking forward, if QE has in a roundabout way supported the dollar as it has made US treasuries 'safe', then will an end of QE make treasuries less 'safe'. Given the fact that all the money printing and build-up of debt will have debased the value of the dollar, we feel there is a danger that although the ending of QE signals a halting of the printing presses, the market may start to reflect the scale of currency debasement that has been done. It is possible that if there is less need for safe-havens then foreign holders of treasuries may reduce their exposure to them before the dollar starts to reflect the debasement that has happened and before the biggest buyer of treasuries, i.e. the Fed, steps to the sideline. At some stage it seems inevitable that reality will catch up with the US and that the economy will suffer a delayed reaction to the currency debasement and all the debt that has built up and this may well show up in a weaker dollar. So for now Gold may be suffering as institutional investors reduce exposure, but another Gold rally may well get underway if confidence in the US financial set-up and the dollar, falter.

Gold strong on the crosses

Non-dollar Gold prices were falling in the first half of the year, in line with the dollar Gold price, but that changed once the Fed announced that it would look at tapering QE, which sent a shock wave through emerging markets. The prospect of an end to QE meant less foreign direct investment in these economies and indeed capital flight as investments that had been made in emerging markets, as investors chased higher yields, decided to withdraw their investments. The capital flight this caused also weakened their currencies. For example, in India Gold prices in rupees peaked at INR 98,375/oz in September 2012, dropped to 70,623/oz in June 2013, before being ramped higher to INR 98,842 in August. Similar patterns, albeit to varying degrees, were seen in Indonesia, South Africa, Brazil, Turkey and Argentina. In other countries that did not suffer significant currency weakness, Gold prices have followed dollar Gold price lower.

Inflation and Deflation

Across the globe there is a wide disparity between consumer prices (inflation) with India, Indonesia, South Africa, Brazil, Turkey and Russia all experiencing inflation of between 6 and 10 percent, while in China CPI is running around 3.2 percent, the US at around 1.6 percent and Europe is around 1.1 percent. In many emerging markets, where interest rates are below inflation rates, there are not the tools for savers to hedge against inflation and therefore Gold is used as a means to do so. Although in more mature economies where retail investors have other ways to protect their savings against inflation, Gold is not such a popular asset for this purpose. For now, Asia and other emerging markets are likely to have to continue to fight inflation, while in the developed world the onus is to stave off deflation. The use of stimulus, whether in the form of QE, or ultra-low interest rates, have meant Europe and the US have just about avoided falling into a deflation environment, although Europe is not out of danger yet, and how the US will react when QE ends remains to be seen. If it turns out that the US economy is still dependent on QE then deflation could become a concern again, while if stronger growth emerges and monetary policy is not tightened then inflation could start to be an issue. One country that has finally moved away from deflation is Japan, where massive stimulus has started to create some inflation. On balance, we feel 2014 will continue to see emerging markets fight inflation, which in China is likely to be driven by rising labour costs, food and house prices and in other emerging markets as currency weakness raises import prices. In developed markets the concern may continue to be more about avoiding deflation. In an inflationary environment we expect Gold demand to remain healthy, but how Gold will behave if countries slip into a deflationary environment is debateable. In theory, you would expect government treasuries to do well as even a small yield is good in such an environment, but we would argue Gold would also do well. If faced with deflation, we would expect the governments to do more QE and in turn that would likely debase currencies further, whereas although Gold would not pay a yield, it would stand a good chance of holding its value against currencies that are being debased.

De-hedging / hedging

At the start of the bull market for Gold in late 2001, which roughly coincided with the start of de-hedging, the total hedge book stood at 3,107 tonnes (99.9Moz). At the end Q2'13, the hedge book stood at 96 tonnes (3.1Moz), according to the Thomson Reuters GFMS. As the hedge book shrinks, the level of de-hedging has slowed: in 2009 the hedge book was cut by 249 tonnes, in 2010 it fell 96 tonnes, in 2011 it bucked the trend by climbing 6 tonnes, it dropped around 40 tonnes in 2012 and has continued to decline so far in 2013, dropping an estimated 26 tonnes in the first half. The end of the 'de-hedging era' removes one of the bullish drivers in the market as producers are no longer buying back large quantities of Gold on the open market to close out their hedges. What is somewhat surprising is the producers have not been faster at putting on hedges given the drop in prices this year. Admittedly, the attitude towards hedging turned very negative in the mid-2000s when new hedges were only put on when bankers/financiers demanded it for new projects and it may take time and some potential pain to change those attitudes. Going forward, we feel that if prices start to fall further towards producers' costs of production more hedging will be done, probably using options, but that will provide some headwinds for prices.

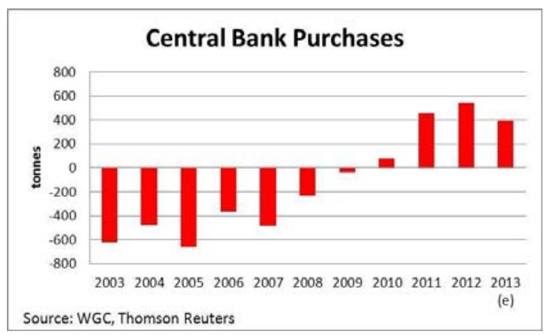
Central Bank Official Sales

For many years, central banks were net sellers of Gold, but that changed in 2010, when the sector became a net buyer. Since the start of the third Central Bank Gold Agreement (CBGA-III), on 27th September 2009, sales have totalled some 19 tonnes, excluding sales from the IMF. The agreement allows for sales of 400 tonnes of Gold per annum. Most of Gold that has been sold has been sold by the German Bundesbank to make commemorative coins. Now we are in the last year of CBGA-III and considering how little Gold has been sold, there is some debate as to whether another agreement will be made. Given that the signatories of the agreement still hold some 12,000 tonnes of Gold we think another agreement may well be deemed necessary, especially if sales have been put on hold due to the financial crisis in Europe. Needless to say the drop in sales from CBGA signatories helped counter the lack of buying from de-hedging. Outside of the CBGA there have been some small official sales, but most of these have revolved around keeping Gold reserves at a set percentage of countries' total official currency reserves.

The lack of uptake of the CBGA quota does leave room for European central banks to make further sales if they need to. Earlier on in the year there were suggestions from the European Commission that Cyprus could sell Gold to help with its debt and the thought of that spooked markets, as if Cyprus could do that then Italy, with some 2,400 tonnes, could end up selling some of its Gold. For now, distressed European countries have not utilised their Gold, as having Gold in their reserves has provided some solid substance to back their government bonds.

Central Bank buying

The financial crisis has turned the trend in official sector activity from being a net seller, to being a net buyer – see chart. Interestingly, the main buyers have been emerging markets, which suggests these countries have been swapping some of the proceeds of their trade surpluses out of dollars and euros and into Gold. The pace of buying, has slowed on a pro rata basis in the first three quarters of 2013 and that is thought to be the result of a combination of buyers holding back to see how far Gold prices fall and because capital flight/economic hardship have reduced their ability to buy. The countries that have bought the most this year have included Russia, Kazakhstan, Turkey, South Korea, Azerbaijan, Ukraine and Indonesia.



China builds up its Gold reserves

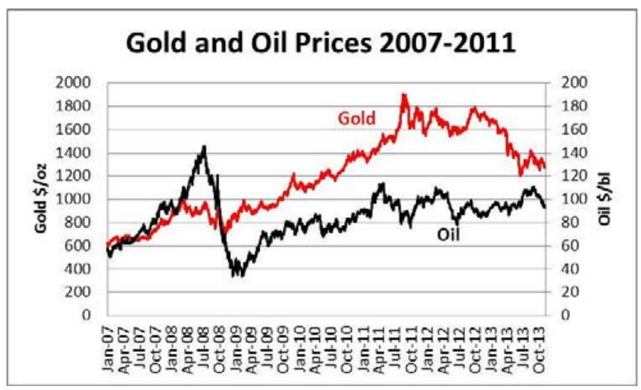
As fewer major currencies can now be called non-fiat, the attractiveness of Gold as a reserve asset has increased. In addition to the countries mentioned above, China is thought to be building up its Gold reserves. It has long been argued that even if China wanted to diversify its $3.4 trillion of reserves, it could not diversify into Gold without disrupting the Gold market. However by stealth, China seems to be doing just this. As well as being an important Gold consumer, China has become the world's largest producer of Gold and is likely to be the largest importer of Gold this year too. In the first eight months of the year, China imported some 861 tonnes of Gold via Hong Kong, compared with 361 tonnes in the same period in 2012. Although much of the Gold imports are believed to be feeding consumer and investment demand, it is thought likely that the country's reserves are also being added to. The last time China made public its reserves they had doubled to 1,054 tonnes, that was four and a half years ago in April 2009. If they make another update the market should be braced for a significant increase. In 2009, the market reacted bullishly to the news and we would expect a similar reaction if another update were to emerge – that is as long as it did not look as though China had built up enough reserves to slow down its accumulation. This seems unlikely as even if China doubled its holdings again it would still be below that of France, Italy, the IMF, Germany and the US – see table on right. China's official Gold holdings of 1,054 tonnes only account for some 1.3 percent of its reserves, whereas Gold held by the US, Germany, Italy and France accounts for around 68 percent of their reserves. We feel central banks' purchases of Gold will continue, driven by the prospect of further currency debasement as governments find ways to reduce their vast amounts of debt.

Gold Reserves	Tonnes	% of Reserves
US	8,133.50	71.7
Germany	3,390.60	68.8
IMF	2,814.00	
Italy	2,451.80	67.1
France	2,435.40	65.5
China	1,054.10	1.3
Switzerland	1,040.10	8.6
Russia	1,015.10	8.3
Japan	765.20	2.6
Netherlands	612.50	54.2
India	557.70	8.4
ECB	502.10	28.0
Source: IMF November 2013		

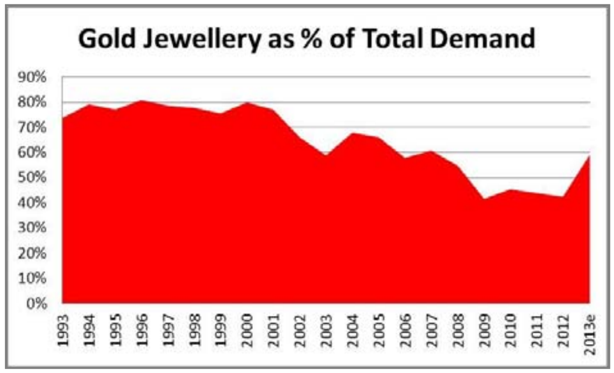
As well as seeking ways to diversify its reserves, China, may also be looking to build up its Gold reserves with the idea that before too long it will want to make the yuan a freely convertible currency.

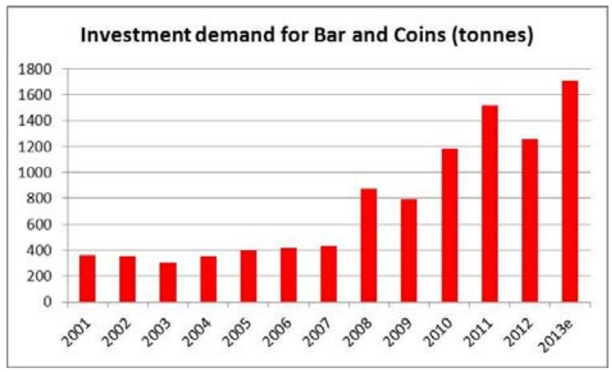
Oil and Gold

Oil and Gold prices have tended to be positively correlated for most of the recovery off the early 2009 lows. However, the correlation broke down in April 2011, which is around the time industrial commodities started to correct lower as concerns about economic growth materialised again. They remained uncorrelated during Gold's price correction from $1,800/oz and have only become more correlated again in recent months as the market anticipated the start of tapering. Whereas geopolitical tensions in Syria have at times underpinned oil prices, they have done little to support Gold prices. In addition, with tensions over Syria abating since it has agreed to its chemical weapons being destroyed and with improved US–Iran relations, geopolitical risks have eased, at least for now. That said, Israel is far from appeased by developments, so a strike against Iran by Israel is still possible and that would likely lift oil prices and be bullish for Gold, even if it only has a short-term impact. In previous Middle East conflicts that have threatened oil supplies, Gold prices have reacted positively as the disruptions have increased geopolitical risk and higher oil prices have had inflationary implications too.



Jewellery demand





In 2012, jewellery demand dropped around four percent compared with 2011, but weaker prices so far in 2013 have led to a significant rebound in demand. In the first three quarters, jewellery demand has climbed 20% with most regions seeing an increase, the notable exceptions being Europe and South Korea where economic hardship has dented demand. Jewellery demand in India started the year on a strong note, but the combination of a significantly weaker currency and government intervention in the form of excise duties and import restrictions, in an effort to deter imports of Gold, have led to significantly higher Gold prices. Local Gold prices are not only higher as a result of the weaker rupee, but also because import restrictions have increased local premiums. Basis third quarter data from the World Gold Council (WGC), jewellery demand in India was off 23%, compared with the same period last year. Year-to-date, however, demand is still showing a 13% increase, which highlights how earlier price weakness boosted demand. Looking forward, the likelihood of tapering in the US is expected to keep emerging market currencies weak and in turn that is likely to keep local Gold prices high. On the one hand this may deter Gold purchases, but equally a weaker currency is likely to import inflation and that is likely to drive investment demand for Gold.

A developing trend seen across most parts of Asia has been the buying of Gold jewellery as an investment. Although jewellery purchases in Asia have always had an investment element to them, this would appear to have increased as demand is now for higher carat jewellery. This is a turn round from recent years where jewellery fabricators, faced with high Gold prices, had to reduce the carat of their jewellery in order to keep sales flowing. The sell-off in prices has also prompted restocking within the jewellery industry.

Another trend that has had an impact on jewellery demand in recent years is rise in popularity of small investment Gold bars. With Gold prices moving much faster these days and becoming more volatile, investment bars have provided a more standard product to trade.

The sharp rise in jewellery demand in 2013 is unlikely to be repeated to the same extent next year as part of this year's rise was driven by pent-up demand following years of high prices. The combination of pent-up demand from consumers and restocking by jewellery manufacturers has therefore given demand a one-off boost. For 2014, we expect jewellery demand growth to be nearer five percent, compared to the 20 percent seen so far this year.

Investment demand

This year has seen some of the investment trends change course. Whereas in recent years investment buying has been extremely strong and has been a major upward driver of prices, the investment sector has now split with institutional investors reducing exposure to Gold exchange traded funds (ETFs), while retail investors' interest in coins and bars has gone from strength to strength, especially in Asia and Eastern countries.

Investors' holdings in ETFs peaked at 2,647 tonnes at the start of the year, but have now dropped some 29% to 1,884 tonnes. The reduction in holdings is still underway, there have been a few short-lived periods when holdings have climbed, but holdings are still falling day-to-day, even if the pace of decline has slowed. The trigger for this change in sentiment seems to date back to the minutes of the December 2012 FOMC meeting when the ending of QE was first mentioned. It would appear that some institutional investors saw that as the 'writing on the wall' that QE would end and they started to reduce their exposure. The ongoing decline in holdings does suggest that investor interest in Gold continues to fall. Whether this is actually the case still, is difficult to ascertain as it is believed that some institutional investors have opted to move out of ETFs in favour of buying physical Gold and arranging their own storage. If holdings in Gold ETFs were to start rising again then that would likely send a strong signal to the market that the worse may be over for the Gold price.

In recent years investors' interest has not just been confined to ETFs, there have been unprecedented levels of investment in Gold bars and coins, see chart. The buying dipped in 2009 and in 2012, as the economic recovery pushed money back into more traditional investments, but interest has rebounded with vigour this year. According to the WGC, the bulk of the growth in this sector has been seen in emerging markets and we would say that the buying has been spurred as investors seek to hedge against currency weakness and inflation. In the first three quarters of 2013, demand for bars and coins was running 36 percent above last year's level and such has been the demand that it has created tightness in Gold supply to the extent that backwardations have appeared as refiners have scrambled to get hold of large bars to produce the small bars that are in such high demand.

Given where the strong regional demand for bars and coins is coming from, we feel that demand will remain strong in 2014 on the back of the tapering of QE in the US, the capital flight this is causing and because inflation in these regions is likely to remain elevated.

The Futures market

The net long fund position (NLFP) peaked at around 247,000 contracts in September 2011, at the same time as the price set a record at $1,921/oz. Since then the overall trend in the NLFP has been to the downside, but there have been rebounds along the way. Interestingly the NLFP last peaked in October 2012 at around 208,000 contracts, it dropped to a low of around 16,500 contracts in July 2013, before rebounding to 100,000 contracts in late October, it has since fallen back to around 60,000 contracts. The chart showing both the long and short fund positions shows that the longs have been cutting exposure since October 2012 and the run-up in the NLFP since July was driven by short covering. As of mid-November, it looks as though the shorts are getting shorter again while the long position is holding steady. Unless Gold prices start to trend higher, it seems unlikely that funds will get bullish for Gold again, but if prices do start to trend higher then the relatively low level of gross longs means there is considerable room for funds to increase exposure. The gross long position at the time of writing was at 144,062 contracts, the average position size since 2010 has been 215,000 contracts.

SUPPLY

Gold supply is made up of mined output, scrap sales, official government sales, producer hedging and this year we would add redemptions from ETFs. In recent years, since 2008, mine supply has been climbing by an average of around four percent per annum, although last year supply was disrupted by strikes and operational issues. In 2012, mine production accounted for around 64 percent of total Gold supply, with scrap accounting for 36 percent. Official Gold sales dried up in 2010 and in recent years producers have not been in favour of hedging, so supply from these activities has been minimal.

Mine supply increased less than one percent to 2,861 tonnes in 2012 according to WGC, which was less than expected, but output was affected by industrial action in South Africa and Indonesia and due to operational difficulties elsewhere. Output in the first three quarters of 2013 increased 3.2 percent, compared with the same period in 2012. This increase has come about as a result of new production and as some of last year's operational difficulties have not been present this year. The increase so far this year has been 69 tonnes, considerably more than the 22 tonnes seen in 2012. This year, however, the market has also had to absorb Gold that has come from ETF redemptions. Indeed ETFs have swung from being a net buyer of around 94 tonnes in 2012, to a net supplier of 760 tonnes – a swing factor of around 850 tonnes – little wonder prices have weakened.

Mine output is expected to be little changed in 2014 as production is ramped up at new mines, but the swing factors in the market that are likely to determine mine production include the degree to which the market sees further disruptions and how producers decide to optimise output. With production costs rising and prices under pressure it may be that producers opt to cut operating costs, which in turn could see less metal produced. Conversely, if the outlook for prices deteriorates further then producers may start to look at hedging again and that could increase supply as more metal is borrowed from central banks and sold as part of a hedge.

In 2013, we expect mine output to increase around 2 percent to 2,918 tonnes, and remain around that level in 2014.

China's Gold production has taken off in recent years, with output rising to 403 tonnes in 2012, according to the China Gold Association (CGA). The country overtook South Africa as the world's largest producer in 2007 and has not looked back since. In the first eight months of 2013, output is reported by CGA to have climbed 8.2 percent to 270 tonnes. South Africa has now slipped to being the world's 6th largest producer, with Peru overtaking it last year, with Russia, the US and Australia now the fourth, third and second largest producers respectively.

Scrap

Gold supply from scrap is all important as it accounts for some 36% of supply. The importance of scrap has increased over the past decade as in the early 2000s, scrap accounted for around 22% of supply. However, as prices climbed more old jewellery has been cashed-in. Scrap supply peaked in 2009 at around 40% of total supply, but has since slipped as there is less old scrap around. This year as prices have been under pressure the amount of scrap supply has fallen. According to WGC in the first three quarters, scrap supply has dropped 13 percent compared with the same period in 2012. One country where scrap has increased is in India, where the combination of a weaker rupee and import restrictions that have lifted physical premiums, have led to a surge in rupee Gold prices, which in turn has led to a pick-up in scrap sales. WGC data suggests 61 tonnes were scrapped in the third quarter, compared with 34 tonnes in the third quarter last year.

With Gold prices generally well below the trading levels seen in recent years we expect the global supply of scrap to tail off and as such, we expect to see scrap supply as a percentage of total supply to drift lower in the years ahead.

Overall with mine output expected to be little changed and with scrap supply expected to fall, Gold supply is likely to drift lower. That could change should sentiment towards the outlook for Gold start to deteriorate further to the extent producers put on forward hedges. However, the biggest addition to supply this year has been the redemptions from ETFs – the pace of redemptions has slowed in recent months, but with 1,890 tonnes of metal held in ETFs the market has every right to remain nervous about the potential for oversupply.

Technical Outlook

After peaking at $1,921/oz in September 2011, Gold prices retreated before entering a long drawn out period of consolidation within what appears to be a descending triangle. Prices fell through the floor in April 2013, dropping to a low of $1,180/oz in June. They have since attempted a rebound that reached $1,434/oz, but are once again consolidating at lower numbers. Although the fall from the high has seemed a long way, prices are still well above the levels seen before the financial crisis, (see red box) and are above a long term trend line. The count from the top descending triangle is around $400/oz, and with the triangle broken at $1,537/oz that puts the target at $1,137/oz – the trend line marked on the chart is around $1,100/oz. Prices are also consolidating around the 38.2% Fibonacci retracement line of the whole of the bull market that started in 2001. Piecing all this together, suggests prices could still drop down to the trend line, which happens to be around where the 50% Fibonacci retracement line is – this would also reach the target set by the descending triangle. The stochastics remain bearish, so that suggests there could still be further weakness, but now that the stochastics are down in low ground, it would not take too much to turn them higher and that could then signal a pick-up in buying interest again in which case a new base may have been built.

Forecast & Conclusion

The extent of the correction in Gold prices this year has been surprising as many of the reasons that made us bullish for Gold are still present. The Western world's finances are still in a mess, indeed debts have got larger and policymakers are no closer to finding solutions to the debt and deficit problems. What they have been good at doing is kicking the proverbial 'can' further down the road and in doing so have bought time, but while they do that the underlying problems just get bigger.

The pull back in Gold prices, which from peak to trough have so far fallen 38.6 percent, do highlight that sentiment has changed, some profits have been taken and some short selling has been seen. Sentiment, however, has not become universally bearish - there are still large holders of Gold ETFs, investment buying of physical Gold in the form of bars and coins has been extremely strong and the funds position is still net long. What we have seen, however, is that as some investors turned bearish the extra supply they generated by selling Gold in ETFs has weighed on prices heavily. Seeing this, buyers have been able to buy dips and have not felt the need to chase prices higher. The only ones appearing to chase prices higher have been the shorts who have at times felt the need to cover.

Those who have cut their exposure to Gold may well have decided to do so not because they were bearish of Gold per se, but because the opportunity cost of holding Gold had risen as corporates were doing well and were paying dividends, which not only provided a yield, but also capital gains as equity prices rose. The one area where demand for Gold has not fallen is in the East where physical demand has been extremely strong. Part of the reason for that is organic growth as emerging markets develop and become more prosperous, this is especially so in China. Another reason is because Gold still offers protection against inflation and currency weakness in countries where there is not an established retail financial market. Western attitudes may feel Gold is an investment relic, but those who do not have access to financial markets are likely to see it very differently.

On balance we would say that institutional investors, especially in the West, have turned less bullish for Gold and some have turned outright bearish and given it is the marginal difference between supply and demand that sets the price, prices have suffered as former institutional demand has turned into supply as ETFs were sold. Having had a good run with Gold for many years, institutional investors may not return in a hurry, which could keep prices subdued and it also runs the risk of prompting more redemptions. That said, if demand for Gold ETFs did return, then buyers would no doubt have a real scramble on the hands to get hold of physical Gold again, a lot of which has been converted into small bars and jewellery that are likely to held in tight hands.

This begs the question what could spark up interest in Gold again and that is an easy one to answer - monetisation of Gold. If creditors of the developed world's debt start to monetise Gold as they fear the fiat money their debt is denominated in is being debased, then Gold prices are likely to rise and then institutional investors are likely to want to get involved again.

Overall we feel the issues facing the EU, China, Japan and the US are so big that policymakers will do whatever is necessary to avoid a meltdown. This has already been seen and it has provided investors with a degree of comfort on the lines of 'too big to fail' and as a result of that equity markets are hitting record highs. However, the leading developed countries' debt and deficits are now so large that it is difficult to see how they will be settled without some form of currency debasement where creditors' assets lose value and debt is reduced as the currency the debt is denominated in is devalued. Given the likelihood of this we expect Gold to become more monetised.

Given the weakness Gold prices have witnessed this year sentiment has been hit hard and there is little to suggest that sentiment could not fall further and with it prices. As such, we would not be surprised if prices tested support around $1,100/oz, possibly even down to $1,000/oz. That said, we see this weakness in Gold as a reaction to a bout of profit-taking. Given the funds are still net long, there are still many long term investors in ETFs and investment buying in the East is strong, highlights that the bulk of the market has not turned bearish. The next bullish chapter for Gold we think will involve greater monetisation of Gold as confidence in fiat money and government paper deteriorates and when that happens we think central banks and investors will end up chasing prices higher. How high prices end up going is difficult to say. In 2008, the market dropped 33 percent, before rallying 180 percent to the 2011 highs. It would require a 63 percent rally from the $1,180/oz lows to get back to the highs, which seems a tall order in the current climate, but it may not be out of the question at some stage in the years ahead. For 2014, a return to $1,435/oz would not be too surprising, but whether prices could then move up above $1,450/oz might be expecting too much. If they did, it would suggest sentiment is turning more bullish. Whether sentiment turns bullish next year, or further down the road is difficult to call, but at some stage given the debt situation we think it will.

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