WORLD GOLD COUNCIL

Investment commentary: first quarter 2013



About the World Gold Council

The World Gold Council is the market development organisation for the gold industry. Working within the investment, jewellery and technology sectors, as well as engaging with governments and central banks, our purpose is to provide industry leadership, whilst stimulating and sustaining demand for gold.

We develop gold-backed solutions, services and markets based on true market insight. As a result we create structural shifts in demand for gold across key market sectors.

We provide insights into international gold markets, helping people to better understand the wealth preservation qualities of gold and its role in meeting the social and environmental needs of society.

Based in the UK, with operations in India, the Far East, Europe and the US, the World Gold Council is an association whose members comprise the world's leading gold mining companies.

For more information

Please contact Investment Research:

Juan Carlos Artigas
juancarlos.artigas@gold.org
+1 212 317 3826

Johan Palmberg
johan.palmberg@gold.org
+44 20 7826 4773

Boris Senderovich
boris.senderovich@gold.org
+1 212 317 3882

Marcus Grubb
Managing Director and Strategist, Investment
marcus.grubb@gold.org
+44 20 7826 4724

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- Gold in the *Great Rotation*
- Gold holdings: ample room for growth in a broad and liquid market

Investment commentary: first quarter 2013

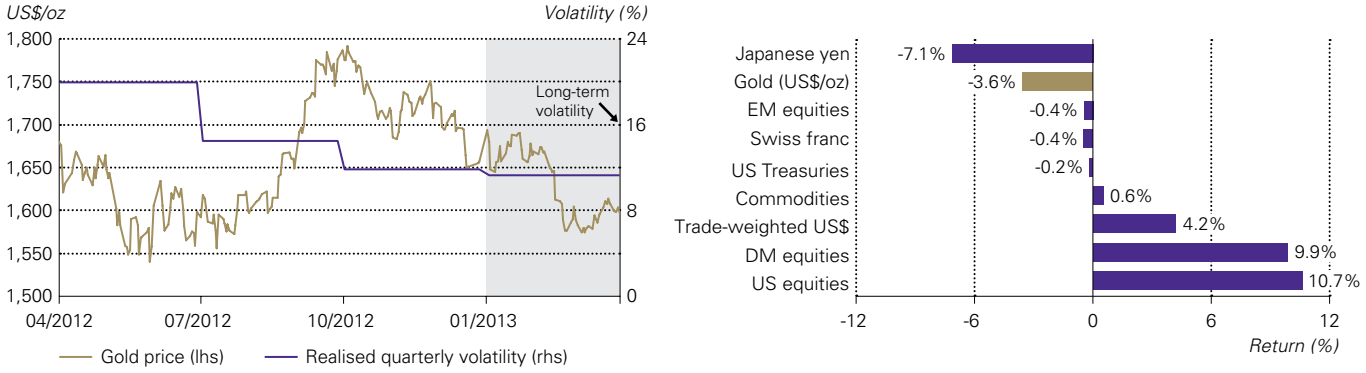
Gold's recent price weakness and the sizeable outflows from gold-backed ETFs have rekindled speculation about the end of gold's bull run and generated comparisons to its 1980s decline. We discuss the limitations of the most common arguments and contextualise gold's price pullbacks. We examine structural shifts that the gold market has experienced over the last decade resulting in a robust set of demand factors, very different from that seen during the 1970s.

First quarter performance

Gold prices fell 3.6% in Q1 amid gains in developed market equities.

Gold prices fell by 3.6% during the quarter (**Chart 1a**) alongside traditionally 'safe' assets such as US Treasuries, the Swiss franc and Japanese yen amid sizable gains in developed world equity markets – with US equities alone gaining 11% (**Chart 1b**). The US dollar appreciated by more than 4% in the period creating some headwinds for the gold market. Following the quarter's end, during an erratic two-day move in mid April, gold prices had dropped a further 10%.

Chart 1: (a) Gold prices continued to fall, while (b) developed market equities soared during the quarter



Reference notes are listed at the end of this article.

Source: Bloomberg, World Gold Council

Sentiment in the US may have improved, but problems in Europe linger.

During Q1, positive economic developments in the US prompted investors to rotate funds out of cash into equities, a phenomenon we discuss in *Gold in the 'Great Rotation'*. There was also a slight improvement to European economic confidence early in the quarter, but it did not last long. News of a proposal to tax bank deposits in Cyprus eroded investor confidence and temporarily boosted gold prices. While Cyprus was a case of limited contagion, their deposit tax solution set a precedent and sent shivers throughout Europe. Subsequently, the European Central Bank signaled that Cyprus could employ central bank gold reserves to cover losses from emergency loans to commercial banks, putting downward pressure on prices and exacerbating bearish views in the gold market. While Cyprus's decision to sell gold has not been confirmed, the announcement raised concerns about central bank independence and the prospect of sales by other European nations. However, both the Central Bank Gold Agreement (CBGA)[1] and strong emerging market demand, which accounted for the bulk of 2012 central bank purchases (535 tonnes), should allay fears.

In Japan, aggressive inflationary policies will benefit gold in the long term.

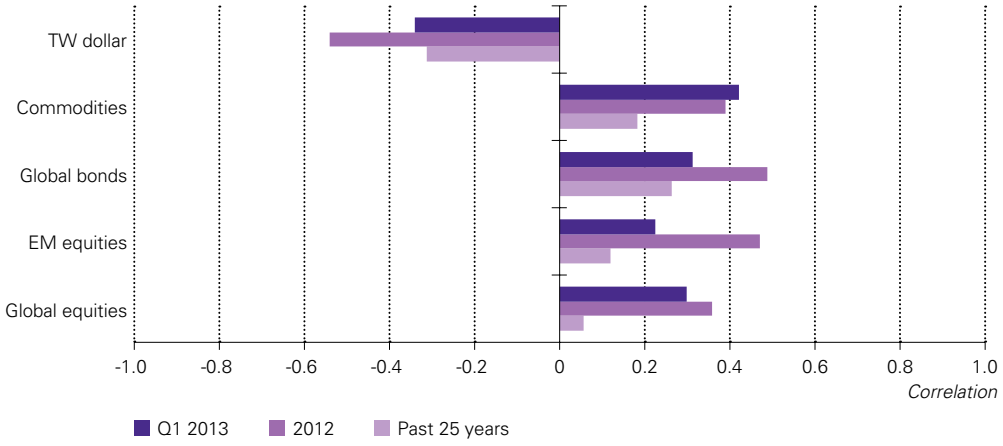
Elsewhere, the Bank of Japan (BoJ) enacted unprecedented expansionary monetary policies in early April weakening the yen to almost ¥100 per US dollar – a level not seen since 2009. Expansionary measures should generally be positive for gold. However, after more than a decade of deflation, Japanese investors have seen this as an opportunity to increase flows into equities. Additionally, one unintended consequence of a ballooning monetary base in Japan is the flow of capital into foreign assets, primarily US-dollar denominated assets, which in the short term can be negative for gold. Over the longer term, concerns about higher inflation and the sustainability of BoJ polices are likely to become more apparent and make gold's role more relevant.

Gold's volatility marginally fell during Q1 and so did correlations.

Gold's volatility marginally dropped to 11.1% during Q1 2013 – its third lowest quarter in the past decade. Gold volatility typically decreases in a falling price environment in contrast to what is typically observed in most risk assets. However, a sudden 9% price drop on April 15 has pushed gold's volatility higher; despite this gold's three-month rolling volatility (approximately 20% by the time of writing) is still within levels seen as recently as Q2 2012. At the same time, gold's correlation to other assets fell during Q1 2013 relative to 2012 as macroeconomic drivers that pushed many risk assets higher, did not have the same effect on gold. Nonetheless, correlation remains high compared to historical levels (**Chart 2**).

But what does the current period tell us about gold's bull run?

Chart 2: Gold's correlation to global assets fell during Q1, but are still high relative to history



Reference notes are listed at the end of this article.

Source: Bloomberg, J.P. Morgan, World Gold Council

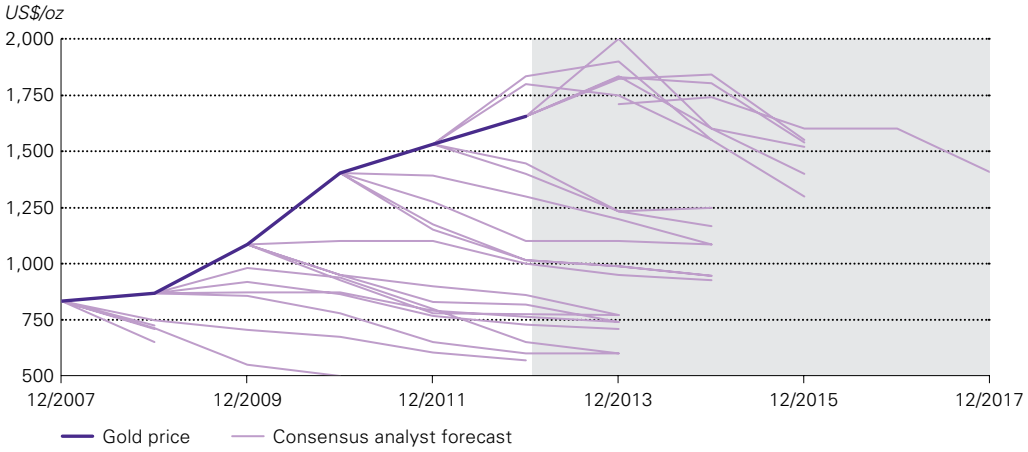
1 CBGA prevents signatories from collectively selling more than 400 tonnes of gold in a year and includes all European Union members.

A perspective on gold's recent pullback

With gold prices dropping by 16% in Q1 from their high, analyst have called the end of the bull run, but not for the first time.

The gold price has appreciated for the past 12 years, with average and year-end prices consistently rising since 2001. However, gold prices have fallen from their nominal high of US$1,895/oz (based on the London PM fix) set on 6 September 2011. By the end of Q1 2013, gold traded near US$1,600/oz – a 16% pullback from its record high. In the first weeks of April, exceptional conditions pushed the gold prices down further (as much as 27% below the US$1,900/oz level). As gold prices fell, market participants questioned whether this drop represented the end of the bull market and many gold analysts revised down their long-term price forecasts. In the past, analysts' short-term price predictions have not been without merit despite the difficult task of forecasting gold. However, gold's longer-term outlook has consistently been underestimated and the top of the market called on multiple occasions (**Chart 3**).[2]

Chart 3: Consensus analyst forecast has consistently been bearish on gold prices



Reference notes are listed at the end of this article.

Source: Bloomberg, World Gold Council

Often, price predictions exclude the effect of non-US factors.

It appears that, as a consensus, gold analysts have failed to appreciate the structural changes that have taken place in the gold market, firmly supporting price increases over more than a decade. Additionally, most of the analysis tends to focus on US-driven factors neglecting other important global variables. This leads to a particularly relevant question: is the recent pullback a true sign of changing dynamics or is it consistent with gold's 12-year trend?

In 2011, gold prices rapidly rose to a record high, not giving time for organic demand to adjust.

First, we need to understand the economic environment that pushed gold prices to US$1,900/oz. During 2011, concerns over the economic health of the US and Europe and the aggressive monetary policies that followed (Western demand) coupled with strong emerging market growth (Asian demand) boosted gold prices. Gold prices accelerated from US$1,500/oz in June to US$1,900/oz in less than two months – an uncharacteristic acceleration. Such sharp increase proved difficult for long-term demand drivers, such as Asian and central bank demand, to support. The issue was not the price level itself, but how rapidly prices rose. In this sense, using an US$1,900/oz as a benchmark for comparison overstates the correction and obscures the long term trend.

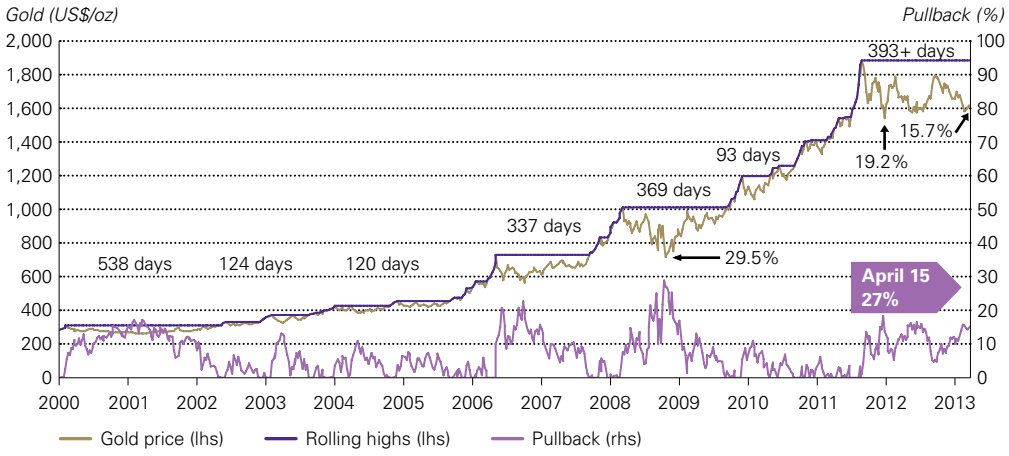
2 This systematic bias is by no means confined to the gold market. Interest rate strategists have consistently had an upward bias to their forecasts of benchmark interest rates in the US, predicting higher rates even as the 2008-09 financial crisis unfolded.

However, this pullback has not been the first. Prices have fallen by more than 10% seven times and three times by more than 20% since 2001.

Even so, it is not the first time the gold market has experienced a pullback of this magnitude and will likely not be the last. Asset price pullbacks occur naturally across financial markets and gold is no exception. Instead, it is important to understand the sustainability of long-term drivers once the effect of short-term drivers wears off. For gold, price pullbacks have often been linked to investor profit taking, higher opportunity costs, and less uncertain economic environments, among others. However, given that only 35% of annual demand is currently driven by investment, many others factors influence gold's performance. These factors such as emerging market demand or central bank activity have little to do with economic conditions in developed markets. Over the course of its 12-year bull run, gold prices have fallen by more than 10% (peak-to-trough) on seven occasions and by more than 20% on three (**Chart 4**).[3] The largest correction took place between March and October 2008, when gold prices fell by 30%. After each of those occasions, gold prices made new highs supported by healthy demand. In fact, anecdotal evidence suggests that Chinese and Indian consumers as well as emerging central banks have used price pullbacks as buying opportunities.[4] Such purchases have made the news following gold's exceptional mid April sell off, as purchases have been brought forward in response to lower prices.[5]

So, what has made the gold market been so resilient for such an extended period of time?

Chart 4: The gold price has previously fallen by more than 10% seven times since 2001



Reference notes are listed at the end of this article.

Source: Bloomberg, World Gold Council

A decade shaped by structural changes

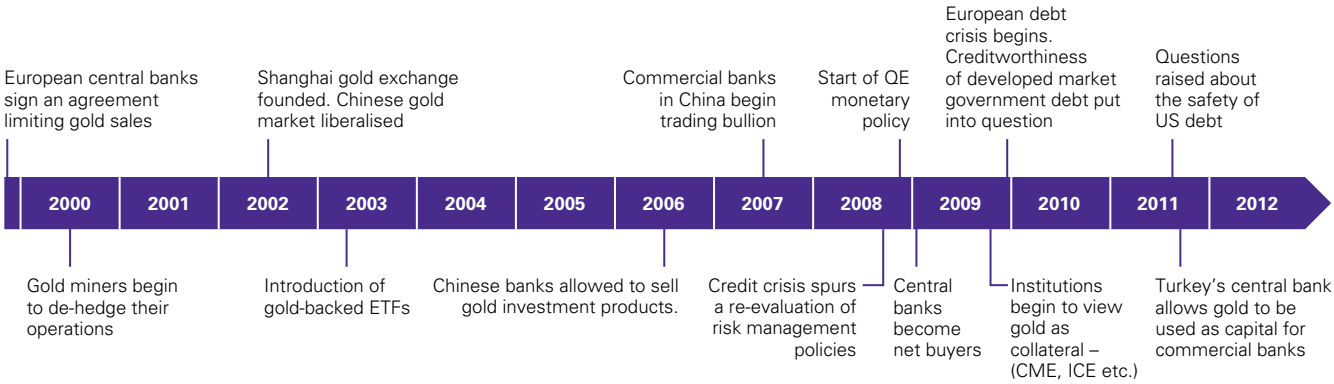
The gold market has seen multiple structural shifts since the turn of the century...

The gold market has seen a number of positive structural changes since 1999 (see timeline opposite). These include the launch of gold-backed ETFs, the liberalization of the Chinese gold market, the Central Bank Gold Agreement, developments in the use of gold as collateral, an increase in emerging markets disposable income, and the resurgence of investment demand as a by-product of the 2008-09 financial crisis and its aftermath. The effect of these events was not felt immediately, but its combined and long-term effects have had significant implications for gold.

3 We define a separate pullback as one that occurs for a unique period of a new high. In other words, multiple oscillations around the 10% pullback level for the same period were not counted.

4 *Precious metals daily,* UBS, 5 April 2013 and *Precious metals daily,* HSBC, 25 March 2013.

5 Bloomberg, *Gold tumble stokes demand from Indian bazaars to Chinese malls,* 18 April 2013.



Reference notes are listed at the end of this article.

…such as the advent of gold-backed ETFs…

The introduction of gold-backed ETFs has made gold investment accessible to a wider audience through a transparent, regulated and liquid instrument that is backed by physical gold (and thus is not a derivative contract). While gold-backed ETFs represent only 10% of average annual demand (and less than one-third of investment demand). As of the end of Q1, there were 2,600 tonnes of gold held in the form of ETFs, corresponding to just 8% of above-ground stock held by private investors. The amount held in ETFs is roughly equivalent to one full year of mine production.

…strong demand from India, China, and other emerging markets…

The establishment of the Shanghai gold exchange and the legalization of gold investment purchases were tectonic shifts for the Chinese gold market. In turn, consumer demand has increased from 200 tonnes per year in 2002 to over 750 tonnes per year in 2011 and 2012. Chinese demand growth was not only fuelled by accessibility but by higher economic output. In fact, growth in India, South East Asia and many other emerging economies has been particularly relevant to the gold price development. As GDP and incomes in these countries increased, so did demand for gold.

…a reassessment of risk management practices by investors in developed markets…

The financial crisis of 2008-09 represented a paradigm shift, structurally changing investors' risk management practices. The fallout has led developed market central banks to heavily intervene in financial markets by implementing aggressive monetary policies. A persistent increase in central bank balance sheets has motivated many western participants to purchase gold as a hedge against future inflation and currency debasement. While assets such as US Treasuries, German bunds, UK gilts, and Japanese Government Bonds are still widely considered 'safe', the financial crisis and its aftermath has exposed some of their weakness, lowered their ratings, and prompted questions not only on the underlying creditworthiness of government bonds but their excessive correlation. Even as the economic environment improves, most structural problems in developed markets have not been properly addressed leading to an increasing frequency of tail risk events as summarised in *Gold holdings: ample room for growth in a broad and liquid market*.

…and central banks have turned to net buyers.

Additionally, central banks have become net buyers after two decades of selling. The impact of central bank activity is driven by two trends. European central banks, that had been the primary source of central bank sales since the collapse of Bretton Woods and the gold standard, slowed down their sales. At the same time emerging market central banks started to increase their gold purchases as they looked to diversify their foreign reserves. As a result, what was close to 500 tonnes of annual supply less than 10 years ago had become over 500 tonnes of demand by 2012.

Two very different bull runs

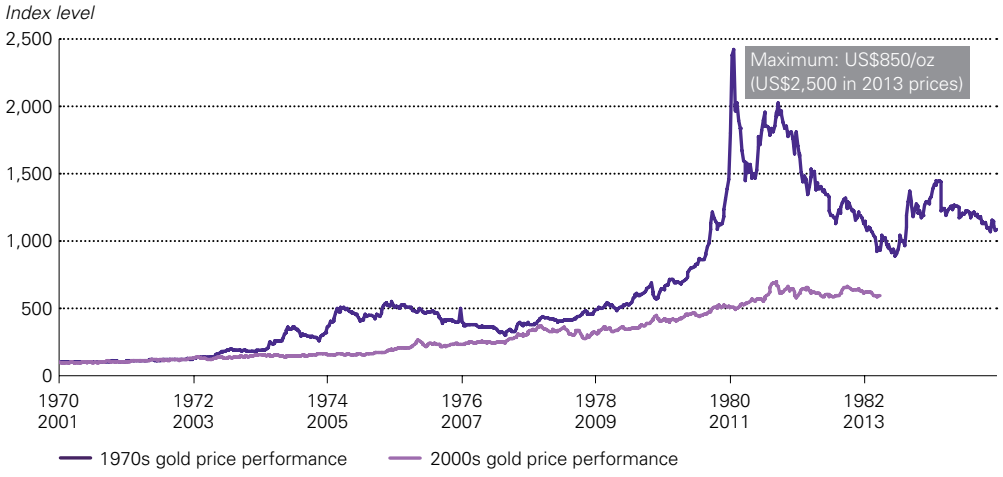
In contrast, gold demand during the 1970s was fuelled by cyclical factors.

The recurring comparison between the current gold price trend and the seemingly equivalent inflation-adjusted price appreciation gold experienced period between 1971 and 1980 is, in fact, a simplistic and flawed parallel. These two periods have been characterized by different price performance and remarkably dissimilar fundamental drivers. During the 1970s, the advent of fiat currencies made gold a free-floating market while private gold ownership was once again permitted in the US. During that decade, oil prices spiked and tensions in the Middle East rose, leading to hyperinflation and instability. Gold prices shot up on the back of these tailwinds. However, speculative flows led the way, not giving enough time for demand to grow organically.

Prices quickly rose amid violent pullbacks and ownership levels were high.

During the 1970s, gold prices rose by an average of 30% per year, with similar levels of volatility. At their peak, inflation-adjusted prices rose 12-fold to more than US$2,500/oz amid violent pullbacks of over 40% (**Chart 5**). A combination of fewer financial assets available, strong gold investment demand, and a meteoric price increase, substantially increased gold ownership levels to a 14% share of all financial assets. In comparison, gold represents just 1% of assets today as discussed in *Gold holdings: ample room for growth in a broad and liquid market*. At the same time, the gold market was significantly less diverse. During the 1970s, demand was largely driven by purchases in the US, UK and Europe which accounted for approximately 60% of demand leading up to gold's peak (**Chart 6**). On the supply side, South Africa greatly dominated mine production and a flurry of discoveries increased supply in the early 80s, putting further downward pressure on the gold price.

Chart 5: Gold's current bull run has been measured and steady, in stark contrast to the 1970s price action

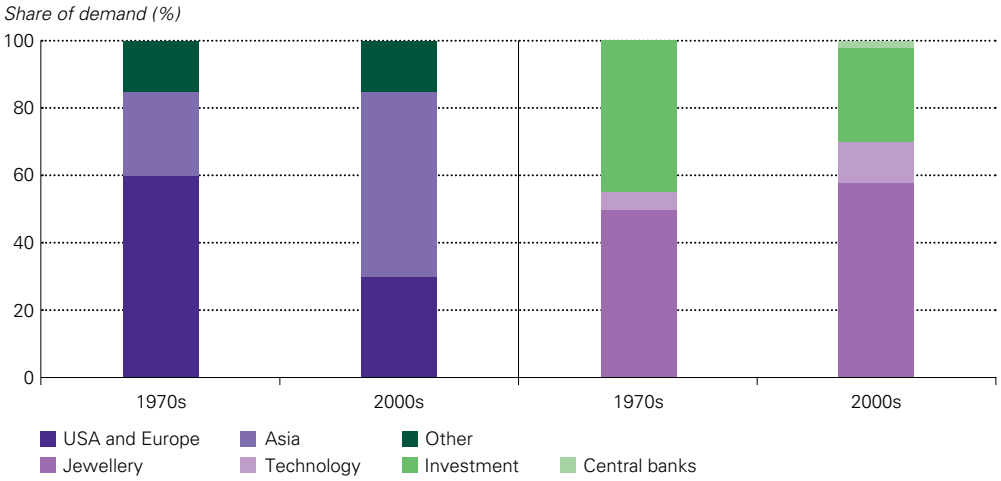


Price performance	1971 – 1983	2001 – present
CPI inflation	9%	2%
Annual return	30%	16%
Volatility	29%	19%
Maximum price increase	1,065%	465%
Maximum pullback	46%	29%
Number of 20%+ pullbacks	4	2

Reference notes are listed at the end of this article.

Source: Bloomberg, LMBA, IMF, Thomson Reuters GFMS, World Gold Council

Chart 6: Geographic composition and source of demand is more diverse today than it was during the 1970s



Source: Thomson Reuters GFMS, World Gold Council

For the past decade, gold has been supported by a robust combination of factors.

In contrast, the bull market in the 2000s, influenced by the structural factors previously discussed, has been driven by growth in Asian emerging markets and economic problems in developed markets. Demand and supply are more balanced and geographically diverse resulting in a measured and less volatile trajectory.

What does the future hold?

Short term factors can put pressure on gold, but long term dynamics remain healthy.

Short term factors including market momentum and the concentrated sell-off following analysts' downward gold price forecast revisions along with Cyprus' gold sales contagion could put pressure on gold prices in the near future. However, we consider that many of the fundamental drivers that have supported gold's 12-year trajectory are still well in place. Data suggests that some investors in developed markets are betting on a swift economic recovery, and while economic data may seem encouraging in the US, many of the underlying issues that financial markets face are still relevant: countries face high level of debt while monetary policies have yet to unwind. At the same time, gold's fate does not rely only on uncertainty and malaise in developed markets. Gold's performance is also linked to their long-term economic expansion. There is consensus that emerging market economies will continue growing. Most economists agree that emerging markets will continue to grow and surpass developed market economies by 2020 in term of GDP.[6] Finally, the US dollar will likely remain a crucial component of the monetary system, but may have to make room for others. As central banks diversify their foreign reserves, gold will continue to be one of the most relevant assets.

6 Economist, *Power Shift*, 4 August 2011.

References

Chart 1: (a) Gold prices continued to fall, while (b) developed market equities soared during the quarter

(a) Realised volatility is computed using daily returns for each quarter. The wide arrow on the right represents the long-term volatility computed using return data from December 1987 to December 2012.

Chart 2: Gold's correlation to global assets fell during Q1, but are still high relative to history

Correlations are computed using daily data over the period referenced in the legend. 'TW dollar' is a trade weighted currency basket for the US. Barclays Global Aggregate, MSCI Emerging Markets and MSCI World are used for global bonds, emerging market and global equities, respectively.

Chart 3: Consensus analyst forecast has consistently been bearish on gold prices

Analyst forecast is a median of analyst estimate of future gold prices as indicated by the Bloomberg composite. Gray lines correspond to these forecasts.

Chart 4: The gold price has previously fallen by more than 10% seven times since 2001

The red line labelled rolling high is a rolling maximum price moves up when new a high is reached. The days shown in the chart represent trading days, not calendar days. Pullback is calculated by taking the percentage difference between the gold price and the relevant rolling highs.

The table below shows the relevant dates of highs at each stage, the date of the 10% pullback and the date of the maximum pullback followed by the maximum gold price for each period, the price at the maximum pullback price and percentage as well as the length of the pullback period.

Count	Date of high	First date prices fall more than 10%	Date of maximum pullback	Gold price high (US$/oz)	Gold price (US$/oz) at maximum pullback	Maximum pullback	Trading days to new high
1	07/02/00	28/03/00	02/04/01	312.70	255.95	-18.1%	538
2	05/02/03	13/03/03	07/04/03	382.10	319.90	-16.3%	124
3	01/04/04	07/05/04	10/05/04	427.25	375.00	-12.2%	120
4	12/05/06	19/05/06	06/10/06	725.00	560.75	-22.7%	337
5	17/03/08	01/04/08	24/10/08	1,011.25	712.50	-29.5%	369
6	02/12/09	22/12/09	05/02/10	1,212.50	1,058.00	-12.7%	93
7	05/09/11	23/09/11	29/12/11	1,895.00	1,531.00	-19.2%	-

Source: LBMA, World Gold Council

Gold market timeline of events since 1999

The events shown in the timeline have a structural influence on the gold price and were not necessarily price moving events at their announcements.

Chart 5: Gold's current bull run has been measured and steady, in stark contrast to the 1970s price action

The two price series were normalised (=100) at the beginning of each period: 1970 – 1983 and 2001 – 2013.

Return performance based on daily data. Fundamental drivers computations based on average annual figures.

Chart 6: Geographic composition and source of demand is more diverse today than it was during the 1970s

The 1970s period is computed using the annual demand date from 1973 to 1979. The 2000s period is computing using annual demand data from 2004 to 2012. Negative values of demand was considered part of supply and not included in the calculations. Many of these figures have been subsequently revised as a result of changes in methodology.

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World Gold Council
10 Old Bailey, London EC4M 7NG
United Kingdom

T +44 20 7826 4700
F +44 20 7826 4799
W www.gold.org

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