COMMERZBANK

Commodity Spotlight Precious Metals

15 July 2013

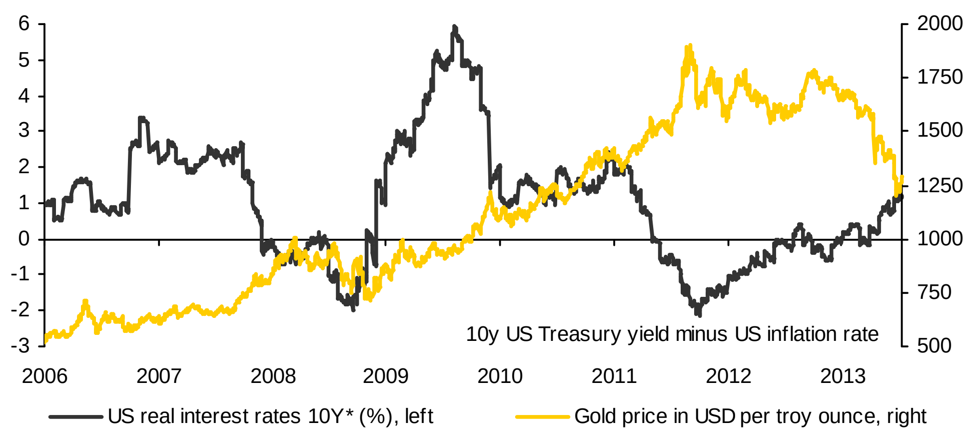
Headwind for gold should ease in the autumn

The gold price has suffered its largest quarterly loss for more than 40 years triggered by record ETF outflows, a forthcoming reversal of US monetary policy and rising US real interest rates. The price should increase again as soon as the scaling back of Fed bond purchases is factored in and most of the ETF investors willing to sell have withdrawn. We expect this to happen in the autumn. Silver, which has lost even more of its lustre than gold, should also recover. Platinum and palladium have remained largely unscathed by the weakness affecting gold. Supply risks and robust demand are also continuing to support prices.

In the second quarter, the gold price registered its largest quarterly percentage decline since the system of fixed exchange rates ended and the associated floating of the gold price started in the early 1970s. After the historic steep decline of mid-April and a 2-month stabilisation phase, the yellow precious metal came under renewed pressure in the second half of June, sinking to a 3-year low of USD 1,180 per troy ounce by the end of the month. What are the reasons for the ongoing price weakness and what are the future prospects?

The recent price drop was triggered by a sharp rise in real interest rates due to speculation about an imminent reversal of US monetary policy. Fed Chairman Bernanke announced at a press conference after the Fed's last meeting on 19 June that, provided certain conditions are met, the US central bank will scale back its third bond purchasing programme - "QE3" - which has been ongoing for almost one year, turning the taps off completely by mid-2014. The yield on 10-year US Treasuries subsequently increased by more than 40 basis points within a week, reaching 2.75% at the beginning of July - its highest level for almost two years. At the beginning of May the yield was still a good 100 basis points lower. At the same time, inflationary pressure is very subdued. The inflation rate in the USA is currently only about 1.4% compared to almost 4% in the summer of 2011. The combination of rising nominal interest rates and falling inflation has led to a spike in US real interest rates. Whereas these were still negative up to the end of 2012, they are now at above 1% (chart 1). Rising real interest rates are negative for the gold price, since they increase the opportunity costs of holding gold, which does not generate any interest. However, the level of real interest rates remains very low. In the past, real interest rates had to rise to more than 2% over a prolonged period to have a sustained negative impact on the gold price (chart 11, page 8). We do not expect this to happen. After the current phase of adjustment in the wake of the announced scaling back of the Fed's bond purchases, the headwind affecting the gold price should therefore ease from this side.

CHART 1: **Increasing real interest rates weigh on gold price**



Source: Bloomberg, Commerzbank Corporates & Markets

Commerzbank Forecasts 2013/14

	Q3	Q4	Q1
Precious metals			
Gold	1200	1300	1400
Silver	19	21	23
Platinum	1350	1425	1500
Palladium	675	700	725

USD per troy ounce

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Gold price rose during the last Fed rate hike cycle

A gradual scaling back of ultra-loose US monetary policy need not necessarily be negative for gold. This is evident if we look at the last cycle of interest rate rises by the Fed between June 2004 and June 2006. In the six months before the first increase in key rates at the end of June 2004, the gold price fell by 5% because the Fed had flagged up the forthcoming reversal of monetary policy in advance and the market priced this in accordingly. The first rate hike did not therefore exert any additional pressure on the gold price. When it became clear from the subsequent interest rate hikes in mid-August and at the end of September that, as the Fed had announced, rates would be increased gradually, the price of gold began to creep up (chart 2). At the end of 2004 it was already trading at 11% higher than at mid-year. In 2005 the gold price increased by another 18% despite steady interest rate rises. When it became evident in spring 2006 that the cycle of interest rate hikes was approaching an end, the price even climbed sharply, reaching a 26-year high of USD 700 per ounce in May 2006. Similar to the situation nine years ago, the gold price is likely to start increasing again once the Fed has begun to scale back its bond purchases. The reversal in ultra-loose monetary policy is also likely to proceed gradual this time around given the low inflation rate. Hence, a comparison with the cycle of interest rate hikes at that time seems justified.

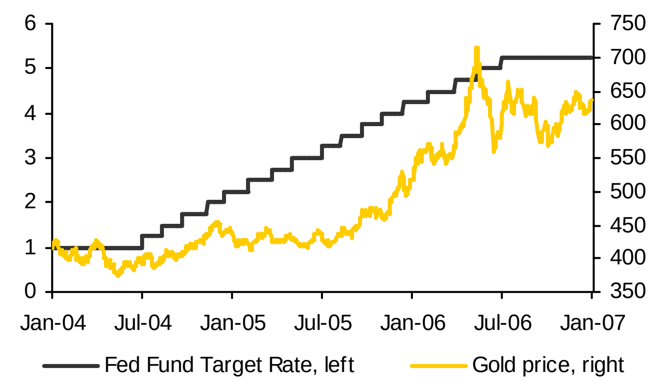
Massive ETF outflows depress demand for gold in second quarter

Another major negative factor for the gold price is the record level of, and until recently ongoing outflows from gold ETFs. These amounted to more than 400 tons in the second quarter alone, exceeding the volume of coins and bars purchased per quarter in preceding quarters. It is therefore possible that investment demand made a negative contribution to total gold demand for the first time in the second quarter. In any case, the massive ETF outflows will have had a very negative impact once again on demand for gold in the second quarter. In the first quarter, ETF outflows of 180 tons had already contributed to a 19% q-o-q decline in gold demand to a 3-year low (chart 16, page 8). In order to at least regain this level, demand for coins and bars, jewellery, for industrial purposes and from central banks would have had to have already increased to approx. 1,370 tons in the second quarter, thus clearly topping the previous record set in the first quarter of 2011. This is very unlikely despite strong physical demand in the weeks after the price slump in April.

ETF outflows accelerated after strong price declines

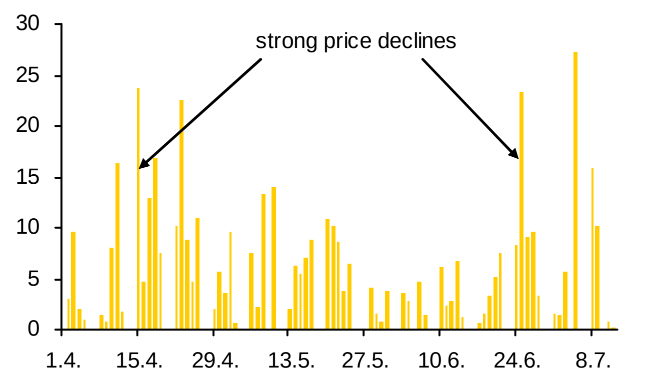
Since the beginning of the year 650 tons of gold have been withdrawn from ETFs and are therefore available as additional supply. Outflows were particularly marked between mid-April and mid-May with daily averages of 8.5 tons, and since the end of June averaging 10 tons daily (chart 3). In both cases the outflows were triggered by a sharp decline in the gold price. Some ETF investors were obviously using gold to benefit from upward price movement. This group therefore withdraws when prices fall. In order to be able to estimate future outflows, it is therefore worth taking a look at the prices at which ETF holdings have been built up. Chart 4 on page 3 shows the "break-even curve" for gold ETFs. This indicates what volume of ETF holdings has been purchased at a certain price level or respectively at higher prices in the period from the launch of the ETFs in autumn 2003 up to the end of 2012, when ETF holdings peaked at around 2,630 tons.

CHART 2: **Trend in gold price during the Fed's last rate hike cycle** Gold price in USD per troy ounce



Source: Bloomberg, Commerzbank Corporates & Markets

CHART 3: **Outflows from gold ETFs picked up after price declines** daily ETF outflows in tons



Source: Bloomberg, Commerzbank Corporates & Markets

Decline in gold price could trigger further ETF selling

The ETF outflows so far since the beginning of the year correspond to a price level of approx. USD 1,210 per troy ounce. If the gold price falls below this level, selling pressure will intensify. Another 120 tons of ETF gold would be "submerged" at the June low of USD 1,180 per troy ounce. With a price decline to USD 1,100 per ounce, 220 tons would be affected, and at USD 1,000 per ounce, 340 tons. ETF outflows are unlikely to be much more substantial than this. Most of the remaining ETF holdings of almost 2,000 tons are likely to be held for other reasons than short-term profit maximisation, i.e. mainly to hedge against long-term financial market risks and a loss of purchasing power due to inflation and currency devaluation. These motives continue to apply given the unresolved debt crises, high sovereign debt in the industrialised countries and therefore the continuation of ultra-loose monetary policies by the major central banks.

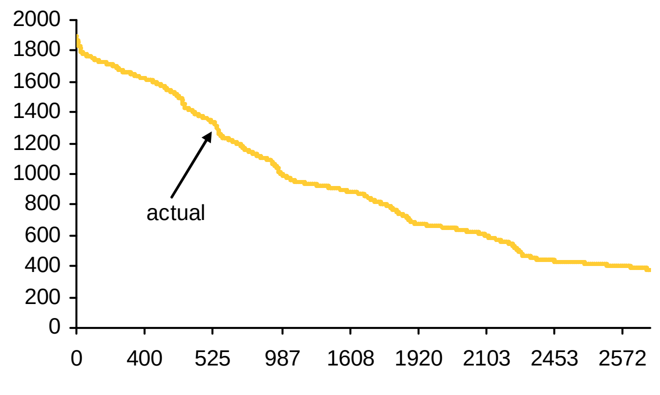
Demand for gold expected to weaken in India and China as well

Temporarily weaker demand for gold in India and China could also depress the price. These two countries still account jointly for half of global gold demand. In India, the government and the central bank implemented a number of measures at the beginning of June to curb gold imports. These included raising tax on gold imports from 6% to 8%, tightening the financing of gold imports and restrictions on the use of gold as collateral for loans. Jewellers and gold dealers are also obliged to stop selling gold coins to private individuals for investment purposes. The measures have also recently been extended to rural areas, which account for the lion's share of demand for gold in India. Indian households are therefore likely to buy significantly less gold in the months ahead than in previous months. In May, gold imports had risen to a record level of 162 tons. In China too, demand for gold is likely to ease considerably in the second half, having reached about 800 tons in the first half, according to the largest gold producer in the country. This is almost the amount from the entire year 2012 and is reflected in strongly rising Chinese gold imports via Hong Kong (chart 14, page 8). Many planned gold purchases are likely to have been brought forward after the price decline in the spring. Incomes are also being negatively affected by weaker economic growth and problems in the Chinese banking system. Over the full year, China National Gold only therefore expects demand to exceed 1,000 tonnes.

Sustained price recovery unlikely in the near future

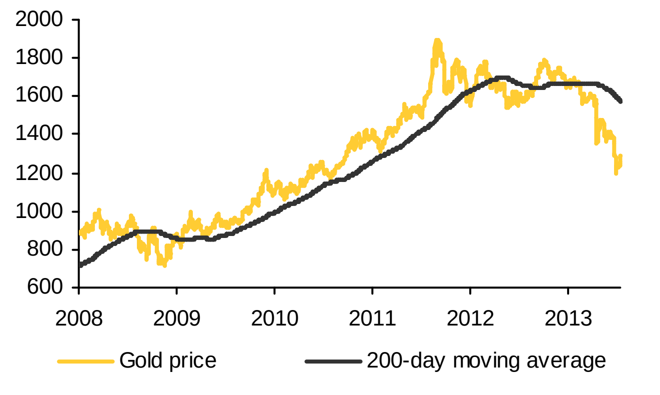
However, the gold price is likely to have virtually bottomed out despite the headwinds mentioned above. Market sentiment is already very bad for gold, as evident from the fact that speculative net long positions have fallen to their lowest level for seven years (chart 12, page 8), extremely negative public reporting and the marked divergence in the gold price from the 200-day moving average. The divergence was more than 20% at times and thus even greater than when prices fell sharply in autumn 2008 (chart 5). A countermovement may therefore set in at any time, driving the gold price up by USD 100-200 within a short period. A sustained price recovery is unlikely as long as the outflows from ETFs continue and real interest rates continue to rise. After a bottoming out phase the gold price should resume its interrupted upward trend again in the winter half of 2013/14. The tightening of monetary policy in the USA should then be priced in and no longer have an adverse impact on the price, provided the scaling back of bond purchases takes place gradually as we expect.

CHART 4: **"Break-even curve" for Gold ETFs**
X-axis: Gold ETF holdings in tons, Y-axis: minimum purchase price in USD per ounce



Source: Bloomberg, Commerzbank Corporates & Markets

CHART 5: **Extremely negative market sentiment supports bottoming out** Gold price in USD per ounce



Source: Bloomberg, Commerzbank Corporates & Markets

Gold failed to benefit from "QE3"

In any case it can scarcely be claimed that the gold price has benefited from the current bond purchasing programme.True, the gold price increased to USD 1,800 per ounce briefly after the announcement in September 2012. However, the price-driving effect of "QE3" lasted for only a short time. While the Fed's balance sheet has grown by almost USD 600bn since the beginning of the year, the gold price has fallen by 26% in the same period. The gold price has now even fallen back to the level before the announcement of the second bond purchasing programme "QE2" in late summer 2010 (chart 6).

Gold price likely to increase to USD 1,600 per ounce by end of 2014

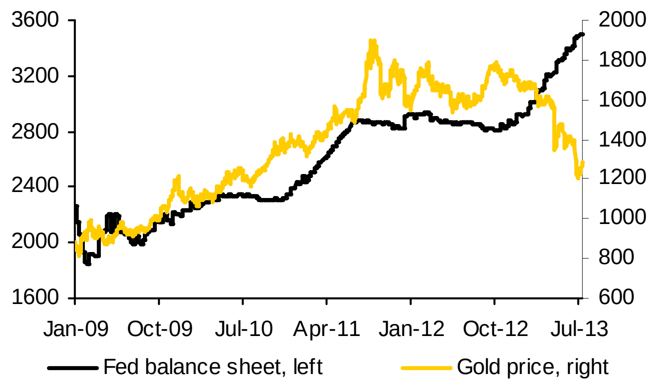
ETF investors, who have bought gold solely with the aim of short-term profit maximisation, should have largely left the market by year-end. In contrast, long-term investors are likely to use the lower price level to accumulate gold, particularly since real interest rates will remain low on a historical comparison. The two largest gold-buying countries China and India should also move on from the weak demand of the second half of 2013 and create stronger demand for gold again next year. In addition to this are the long-term effects of the decline in the gold price on supply. Given the lower price level, some planned mining projects have been put on hold, as was already the case with the "Pascua Lama" project of the largest gold producer Barrick Gold. The supply of gold scrap is likely to contract visibly as a result of the decline in the price level. In contrast, the central banks of the emerging countries will continue to top up their still very low gold reserves, thus taking supply out of the market. All in all, we expect the gold price to increase to USD 1,600 per ounce by the end of 2014 (chart 7).

Silver

Silver has shown the sharpest decline of all commodities this year

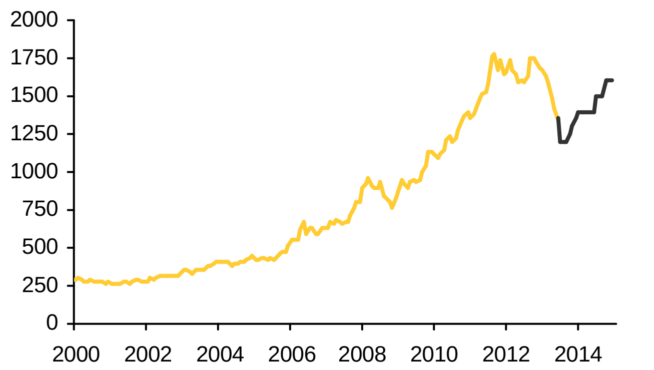
Silver shows a close correlation with gold and follows price movements in the yellow precious metal in both directions to a disproportionate extent. The silver price has come under correspondingly severe pressure in recent months. Since the beginning of the year silver has declined in value by 34% on a USD basis, and therefore shows the worst price performance of all the commodities. At just over USD 18 per ounce, silver was cheaper at the end of June than at any time since August 2010. The closely watched gold/silver ratio has increased to above the level of 66 for the first time since August 2010 (chart 17, page 8), emphasising additionally silver's relative price weakness. Silver has faced headwinds from several sides simultaneously. Whereas, unlike gold ETFs, silver ETFs were still reporting inflows of 760 tons in the first quarter, the picture altered at the beginning of the second quarter. At the end of the quarter, outflows of more thann 900 tons have also been reported here (chart 8, page 5). Speculative financial investors had also withdrawn significantly and even bet on falling silver prices on balance at times (chart 18, page 9). This was not balanced out by robust US coin sales, which increased to 25m ounces in the first half, thus reaching a new record level.

CHART 6: **Gold price has fallen to "pre-QE2" level**
Fed balance sheet in USD bn, gold price in USD per troy ounce



Source: Bloomberg, Commerzbank Corporates & Markets

CHART 7: **Gold price to resume upward trend in 2014**
Gold price in USD per ounce, forecast from mid-2013



Source: Bloomberg, Commerzbank Corporates & Markets

Global economic recovery indicates upturn in industrial demand

Industrial demand for silver has also been fairly subdued, as evident from the weaker silver import figures for China. At 991 tonnes, based on data from the Chinese customs authorities the level was down by almost 12% year-on-year in the first five months of the year (chart 15, page 8). This reflects the slowing of the Chinese economy. After the USA, China is the second largest silver consumer in the world. Should the gold price recover on a sustained basis, we would also expect silver to pick up again significantly. The expected revival of the global economy, which should result in an increase in industrial demand, should also provide impetus for the price of silver. Industrial demand accounts for almost half of total demand for silver. Because of its excellent conductivity, silver is mainly used in the electrical engineering and electronics industries. Investment demand should benefit from the fact that silver is now priced very favourably relative to gold. VAT on silver coins in Germany will also be raised from 7% to 19% on 1 January 2014, which is likely to boost sales of coins towards year-end before this happens. We anticipate an average silver price of USD 21 per ounce in the fourth quarter. Next year the price should increase to an average of USD 25.5 per ounce thanks to the expected recovery in the gold price. This is based on the assumption that industrial demand will pick up as the global economy recovers.

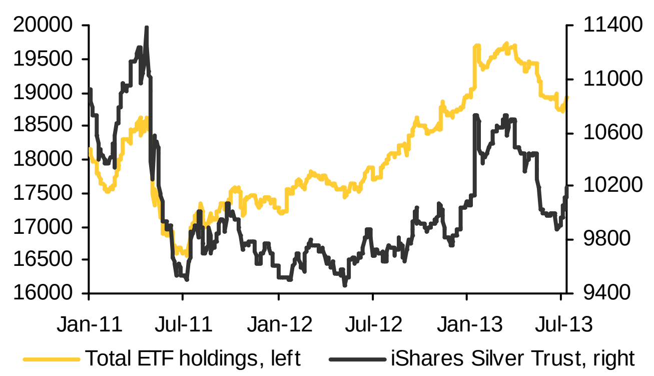
VAT increase on silver coins in Germany will spur coin demand

Platin/Palladium

Tense situation in South Africa

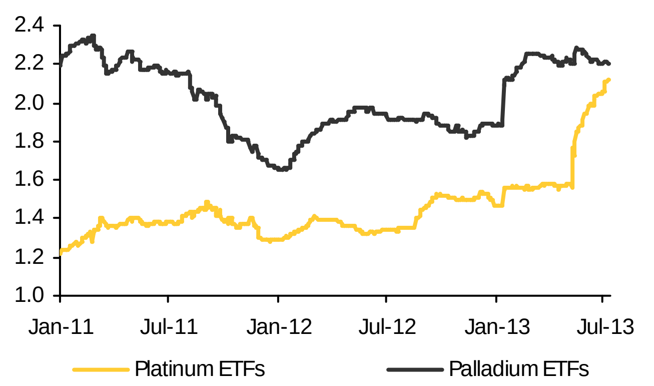
Platinum and palladium have not remained completely unscathed by the weakness affecting gold, but are more affected by factors specific to them. The platinum price has thus fallen by only 8% since the beginning of the year, and the price of palladium is even up 3%. Consequently, for the first time in two years platinum is more than USD 100 per ounce more expensive than gold (chart 24, page 9). On the supply side, the focus remains clearly on South Africa. While it appeared, for a while, that conditions in the country might stabilise - with government mediation it seemed that both the mine operators and also the unions were intent on achieving a lasting agreement - conflicting tendencies have been evident again recently. For the radical union AMCU has refused so far to sign up to the stability pact brokered by the government and is insisting that certain conditions be met. The forthcoming wage negotiations could also cause disruption. The AMCU had already called for the largest global platinum producer Anglo American Platinum to at least double mineworkers' wages. However, the mining companies cannot meet this unrealistic demand, since production is already barely covering costs. However, the weakness of the South African currency is providing some relief for the mining companies on the cost side. The rand has depreciated by about 15% so far this year against the US dollar. However, in our view, market players are likely to focus less on the currency, and more on the potential supply risks as a result of production shortfalls. This factor should provide solid support for platinum and its sister metal palladium.

CHART 8: **Silver ETFs also posted outflows in Q2**
Silver ETF holdings in tons



Source: Bloomberg, Commerzbank Corporates & Markets

CHART 9: **Strong inflows to platinum ETFs in particular**
ETF holdings in million ounces



Source: Bloomberg, Commerzbank Corporates & Markets

Robust vehicle sales in the USA and China…

On the demand side, the trend in vehicle sales has to be considered. While sales remain very robust in the USA and China, the European automobile market is still weak. This should tend to support palladium, which is used in the production of autocatalysts for gasoline-driven engines, since the US and Chinese markets are mainly gasoline-based. Demand for platinum jewellery could be negatively affected by the relative increase in the price of platinum compared to gold. On the other hand, investment demand will play a greater role this year for platinum and, according to the largest platinum processor in the world - Johnson Matthey - will be the deciding factor in determining the level of the supply deficit in the global platinum market this year. Measured by ETFs, investment demand has aready absorbed large volumes of supply since the beginning of the year. The platinum ETFs recorded by Bloomberg have already shown inflows of more than 650,000 ounces so far this year (Chart 9, page 6). This already exceeds total investment demand last year. For palladium too, ETF inflows amount to almost 320,000 ounces since the beginning of the year, which corresponds to roughly 70% of total investment demand last year. Both markets could therefore be tighter than previously assumed, which should support prices. In the fourth quarter we expect an average platinum price of USD 1,425 per ounce; palladium should be trading at around USD 700 per ounce in this period. The tighter market conditions are also unlikely to change much next year. Platinum should therefore increase to an average of USD 1,575 per ounce, and palladium to an average of USD 770 per ounce.

… and strong ETF inflows suggest tighter market situation for platinum and palladium

At a glance

TABLE 1: **Our forecasts**

	Quarterly average									Yearly average		
	12/07/13	**Q1 13**	**Q2 13**	**Q3 13**	**Q4 13**	**Q1 14**	**Q2 14**	**Q3 14**	**Q4 14**	**2012**	**2013**	**2014**
Gold	1286	1632	1417	1200	1300	1400	1400	1500	1600	1669	1375	1475
Silver	19.9	30.1	23.2	19.0	21.0	23.0	24.0	26.0	28.0	31.2	23.5	25.5
Platinum	1408	1632	1467	1350	1425	1500	1525	1600	1700	1553	1475	1575
Palladium	722	742	714	675	700	725	750	775	825	645	710	770

Quarterly averages, based on spot prices; Source: Bloomberg, Commerzbank Corporates & Markets

TABLE 2: **ETF holdings (weekly data)**

			Total net change			% change	52 weeks	
	Date	Holdings	1 week	1 month	1 year	1 year	High	Low
Gold ETFs (in '000 ounces)	12.07.13	63858.1	-752.9	-4199.8	-13575.7	-17.5	84615.7	63858.1
Silver ETFs (in '000 ounces)	12.07.13	608236.2	6100.5	8.3	37708.5	6.6	633631.7	570527.7
Platinum ETFs (in '000 ounces)	12.07.13	2118.8	9.6	128.6	773.9	57.5	2118.8	1334.5
Palladium ETFs (in '000 ounces)	12.07.13	2202.0	-9.7	-16.7	285.7	14.9	2280.9	1816.6

Source: Bloomberg, Commerzbank Corporates & Markets

TABLE 3: **Net long positions of money managers (weekly data)**

			Total net change			% change	52 weeks	
	Date	Level	1 week	1 month	1 year	1 year	High	Low
Gold (in '000 contracts)	09.07.13	23.882	2.498	-31.436	-56.405	-70.3	167.473	21.384
Silver (in '000 contracts)	09.07.13	3.935	0.985	4.592	-1.408	-26.4	36.485	-2.497
Platinum (in '000 contracts)	09.07.13	18.006	-0.287	-5.224	6.741	59.8	40.846	7.032
Palladium (in '000 contracts)	09.07.13	18.850	0.609	-3.773	15.510	464.4	25.676	2.797

Source: Bloomberg, Commerzbank Corporates & Markets

TABLE 4: **History**

	Current	% change				History							
	USD per troy ounce	1 week	1 month	y-t-d	y-o-y	Q111	Q211	Q311	Q411	Q112	Q212	Q312	Q412
Gold	1286	3.7	-7.7	-23.4	-19.3	1388	1509	1706	1683	1691	1612	1653	1718
Silver	19.9	3.8	-10.2	-34.6	-27.4	32.0	38.5	38.9	31.8	32.7	29.5	29.9	32.6
Platinum	1408	3.7	-2.4	-8.4	-1.5	1793	1785	1771	1531	1609	1501	1500	1598
Palladium	722	4.2	-0.8	3.0	24.1	791	760	752	630	683	629	613	654

Source: CFTC, Bloomberg, Commerzbank Corporates & Markets

TABLE 5: **World Official Gold Holdings (monthly data)**

Country	tonnes	Country	tonnes
USA	8,133.5	Switzerland	1,040.1
Germany	3,391.3	Russia	996.1 (+14.5)
IMF	2,814.0	Japan	765.2
Italy	2,451.8	Netherlands	612.5
France	2,435.4	India	557.7
China	1,054.1	ECB	502.1

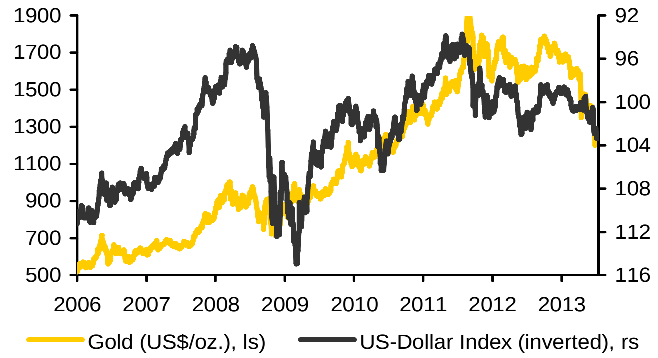
Source: World Gold Council, Commerzbank Corporates & Markets

TABLE 6: **Upcoming Events**

16 July	EUR	EU new car registrations, June
17/18 July	USA	Semi-annual testimony of Fed Chairman Bernanke to the Congress
19/20 July	INT	Meeting of G20 Finance Ministers and Central Bank Governors
31 July	USA	FOMC meeting
1 August	EUR	ECB meeting and press conference
1 August	USA	Vehicle sales, July
21 August	USA	Minutes of 31 July FOMC meeting

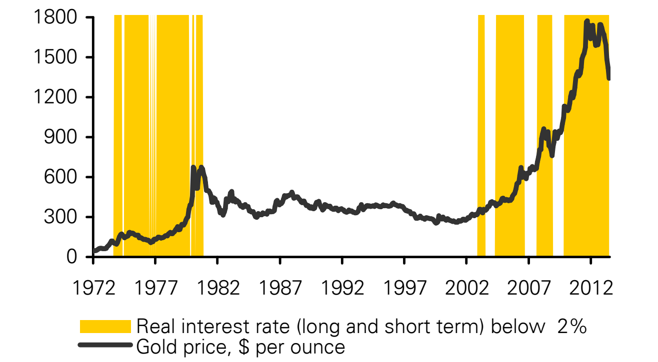
Source: Commerzbank Corporates & Markets

CHART 10: **Gold versus US dollar**



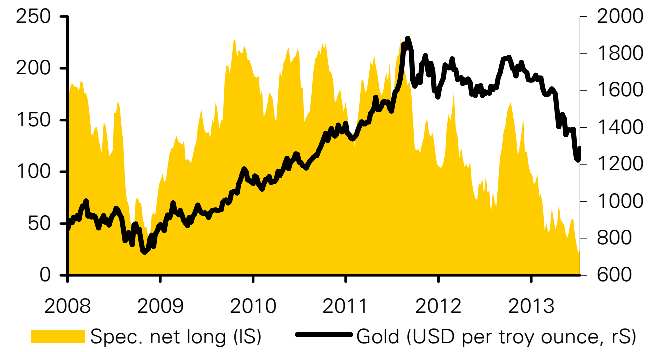
Source: Bloomberg, Commerzbank Corporates & Markets

CHART 11: **Gold price and real interest rates**



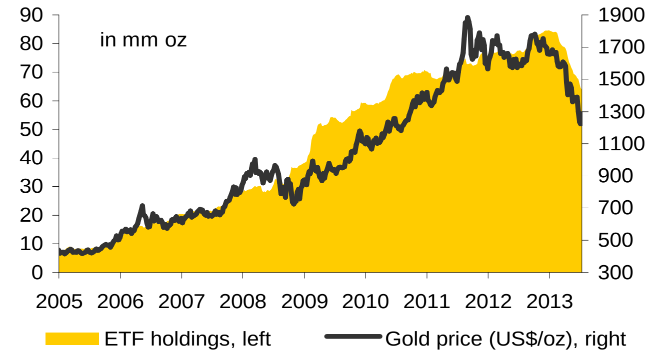
Source: Bloomberg, Commerzbank Corporates & Markets

CHART 12: **Net long positions of money managers (Gold)**



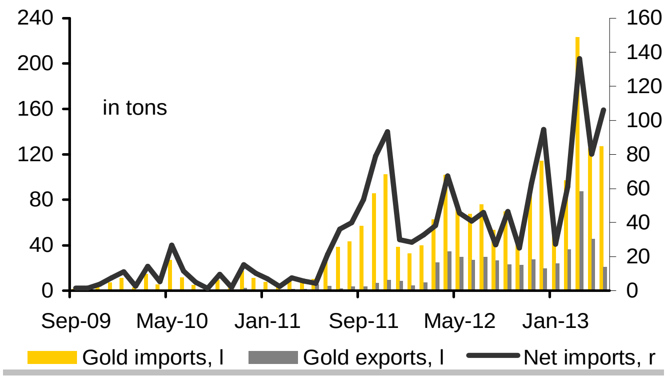
Source: CFTC, Bloomberg, Commerzbank Corporates & Markets

CHART 13: **Gold: ETF holdings**



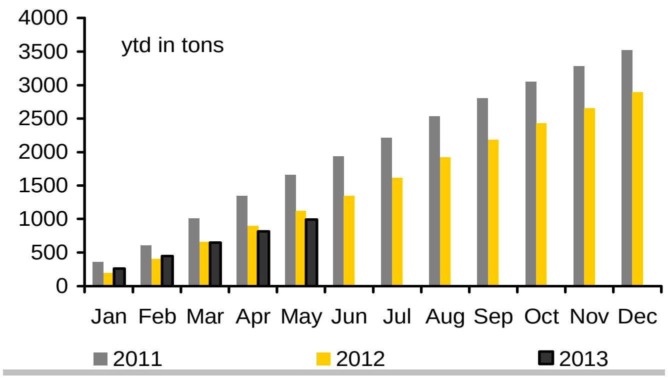
Source: Bloomberg, Commerzbank Corporates & Markets

CHART 14: **Chinese gold trade via Hong Kong**



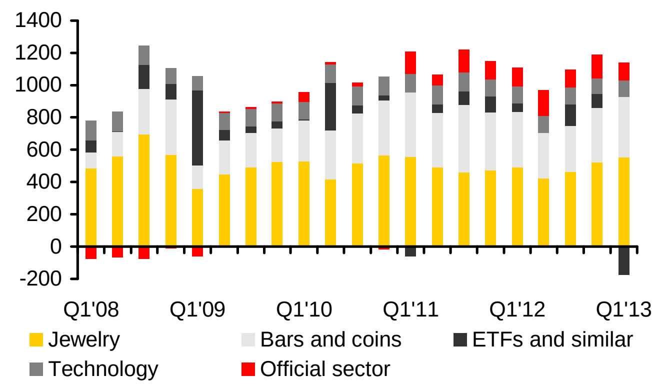
Source: Statistics Department of HK, Reuters, Commerzb. Corp. & Markets

CHART 15: **Chinese silver imports**



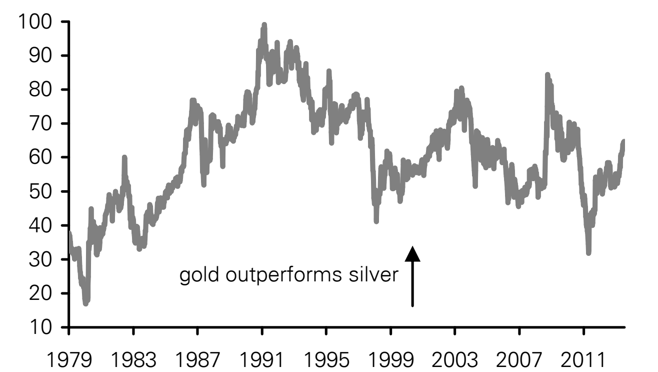
Source: Chinese Customs Authority, Commerzbank Corporates & Markets

CHART 16: **Gold demand per quarter in tons**



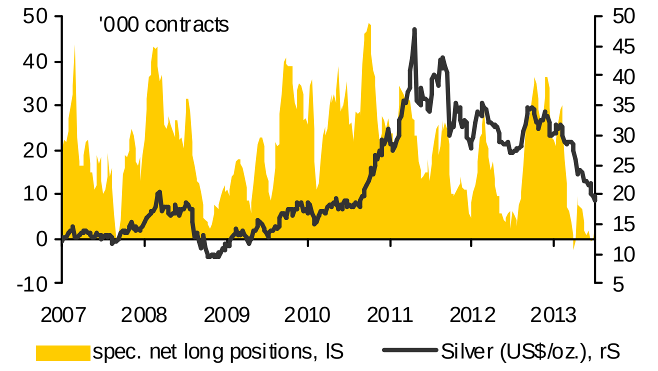
Source: WGC, Commerzbank Corporates & Markets

CHART 17: **Gold/Silver ratio**



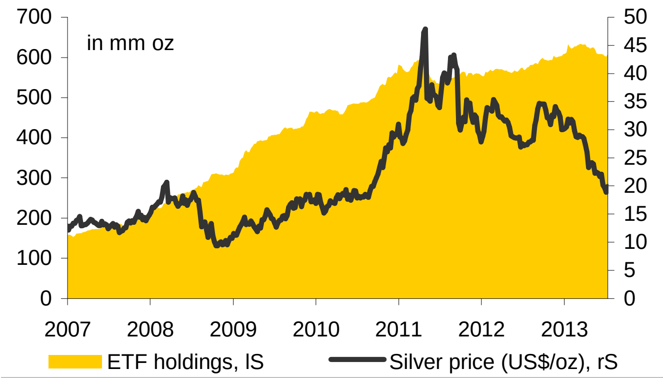
Source: Bloomberg, Commerzbank Corporates & Markets

Chart 18: **Net long positions of money managers (Silver)**



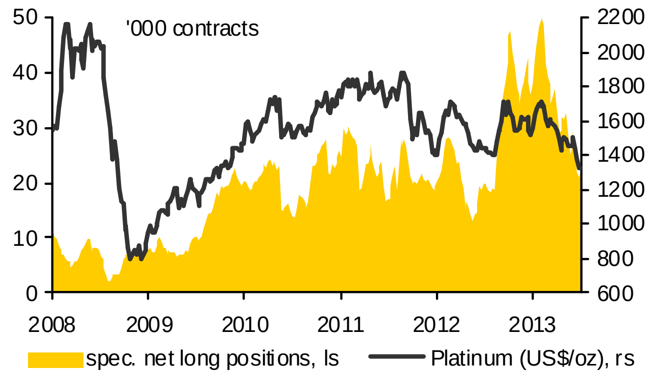
Source: CFTC, Bloomberg, Commerzbank Corporates & Markets

Chart 19: **Silver: ETF holdings**



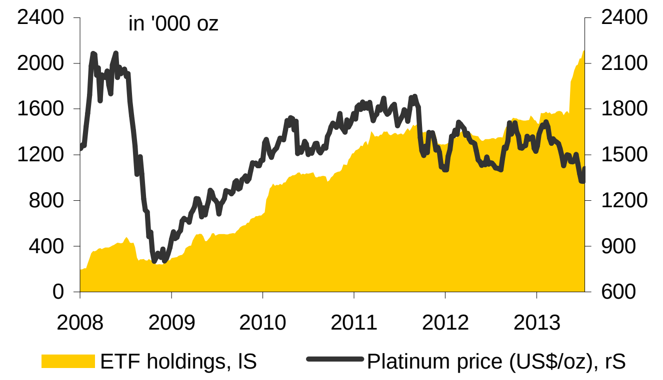
Source: Bloomberg, Commerzbank Corporates & Markets

Chart 20: **Net long posit. of non-commercials (Platinum)**



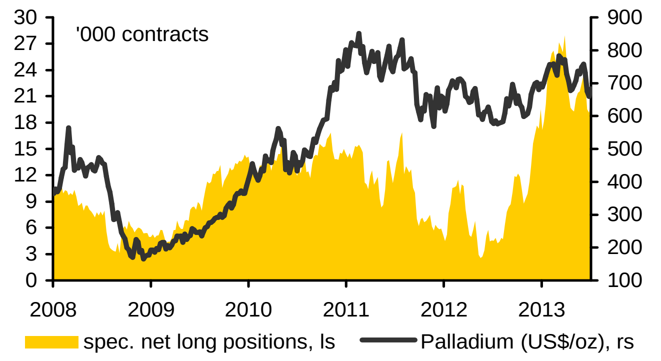
Source: CFTC, Bloomberg, Commerzbank Corporates & Markets

Chart 21: **Platinum: ETF holdings**



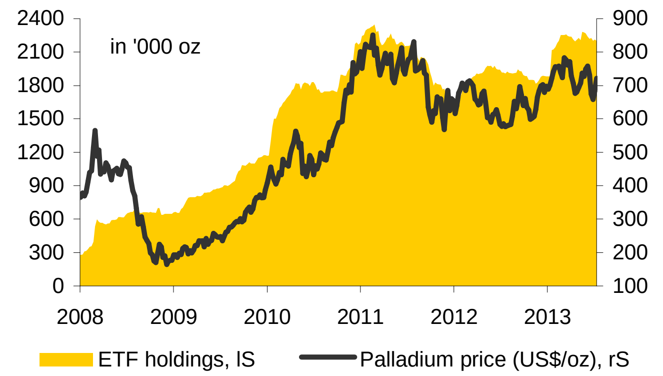
Source: Bloomberg, Commerzbank Corporates & Markets

Chart 22: **Net long posit. of non-commercials (Palladium)**



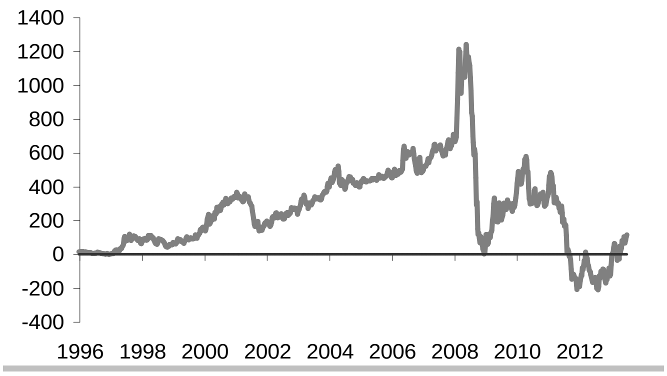
Source: CFTC, Bloomberg, Commerzbank Corporates & Markets

Chart 23: **Palladium: ETF holdings**



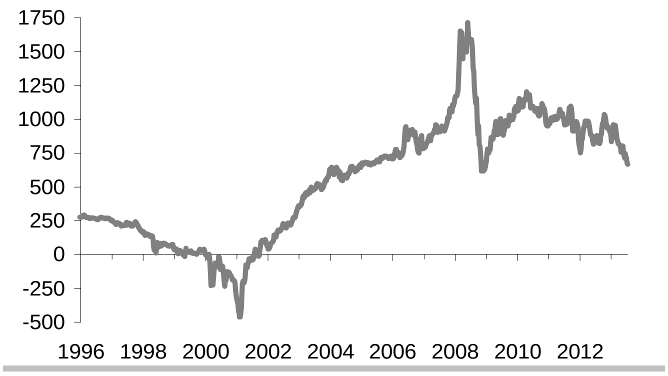
Source: Bloomberg, Commerzbank Corporates & Markets

Chart 24: **Price difference platinum vs gold (US$/oz)**



Source: Bloomberg, Commerzbank Corporates & Markets

Chart 25: **Price difference platinum vs palladium (US$/oz)**



Source: Bloomberg, Commerzbank Corporates & Markets

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