OBSERVATION
TD Economics

May 24, 2013

GOLD PRICES: HAVE THE BULLS RUN OUT OF STEAM?

Highlights

- Gold prices have been in the spotlight lately after a sharp selloff in mid-April sent the precious metal into a bear market. The weakness in the gold market seen this year has stemmed largely from a souring in investor sentiment.
- Going forward, the upside for gold is likely limited. While fabrication demand is expected to remain strong, the investment environment – which has had a dominating effect on prices in recent years – will continue to be a headwind.
- Overall, we expect gold prices on an annual average basis to decline over the next 2-3 years, bringing an end to the streak of gains that began early in the last decade.

Gold prices have been making headlines in recent weeks, after a sharp mid-April selloff sent the yellow metal into a bear market. Since then, sentiment towards the precious metal has soured, with some investors even questioning its safe-haven status.

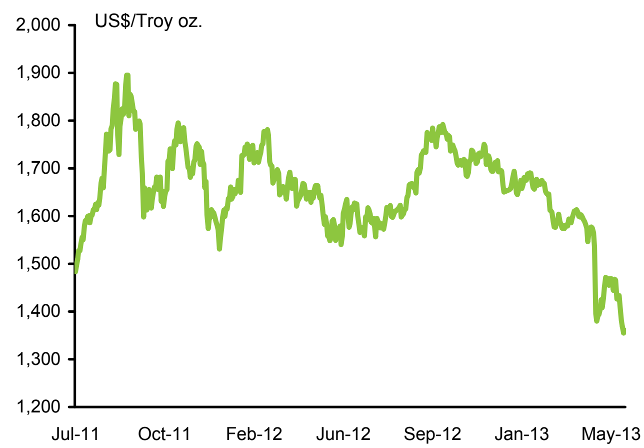
To recall, gold prices hit a peak of US$1895 in September 2011 as a deterioration in Europe's fiscal situation and concerns of a global economic slowdown spooked financial markets. After remaining fairly rangebound between US$1600 and US$1800 through 2012, prices have since fallen sharply, and now sit 28% below their peak. Indeed, after steadily declining through the first quarter of the year, prices experienced an 11% drop in just two days in mid-April, marking the largest 2-day slide seen in over 30 years. After bouncing back somewhat in the following three weeks, prices have since reversed course, and are now back below the US$1400 mark.

Investment demand is the key culprit

As shown in the table on the following page, investment demand has been a driving force behind the weakness seen in the gold market this year, far outweighing the slight increases seen in jewellery and technology demand, which together account for over half of total consumption. Net central bank purchases remained in positive territory during the first quarter of the year, albeit they were lower than those seen in the previous quarter.

Within the investment spectrum, an uptick in physical bar and coin demand has been more than offset by a decline in net purchases of exchange-traded funds (ETFs). In fact, ETFs have recorded net outflows over the past four months, and are down 16% so far this year. This is in contrast to the steady growth seen in ETF holdings since they were created in 2003. Similarly, non-

GOLD PRICES



Source: Haver Analytics

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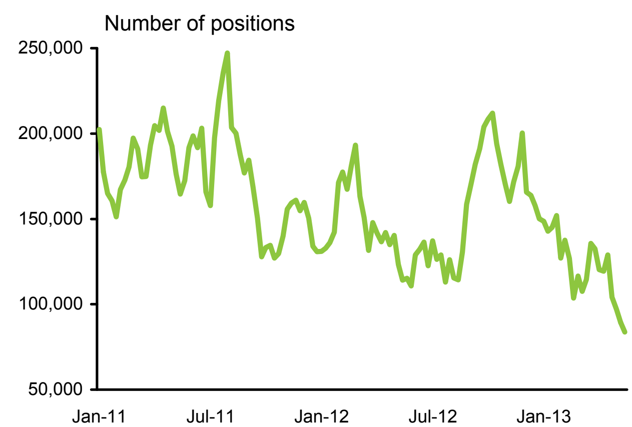
GOLD DEMAND (tonnes)							
	2012				2013	2013 Q1	
	Q1	Q2	Q3	Q4	Q1	Q/Q % chg	Y/Y % chg
Jewellery	490.8	420.8	462.1	521.7	551.0	6%	12%
Technology	105.8	103.3	102.1	96.2	102.0	6%	-4%
Central Bank Net Purchases	115.2	161.4	110.2	146.4	109.2	-25%	-5%
Investment	395.8	284.1	422.0	423.9	200.8	-53%	-49%
Bar and Coin	342.5	284.1	284.2	335.8	377.7	12%	10%
ETF's and Similar Products	53.2	0.0	137.8	88.1	-176.9	-301%	-433%
Total Gold Demand	**1107.5**	**969.7**	**1096.4**	**1188.2**	**963.0**	**-19%**	**-13%**

Source: Thomson Reuters GFMS and World Gold Council

commercial net long positions on the COMEX have fallen by 40% since the start of the year, to the lowest level seen since the end of 2008. All this suggests that gold has lost a great deal of luster within the investment community.

There are several reasons for the recent outflows. The U.S. dollar has appreciated against most major currencies this year, thanks to the massive quantitative easing (QE) program announced by the Bank of Japan and expectations that the Federal Reserve will begin unwinding QE3 by the end of this year. As well, there were signals that Cyprus was planning to sell some of its gold reserves, which triggered fears of other European countries – with much larger holdings – doing the same. Furthermore, investors may be shifting their holdings from gold into equity markets, which in the U.S., have rallied to record highs this year, generating healthy capital gains. Also, the mid-April selloff may have left some investors less confident in the yellow metal as a safe haven asset – especially at a time when inflation worries are far from the radar.

NON-COMMERCIAL NET LONG POSITIONS ON THE COMEX



Source: Haver Analytics; Last plotted: May 2013

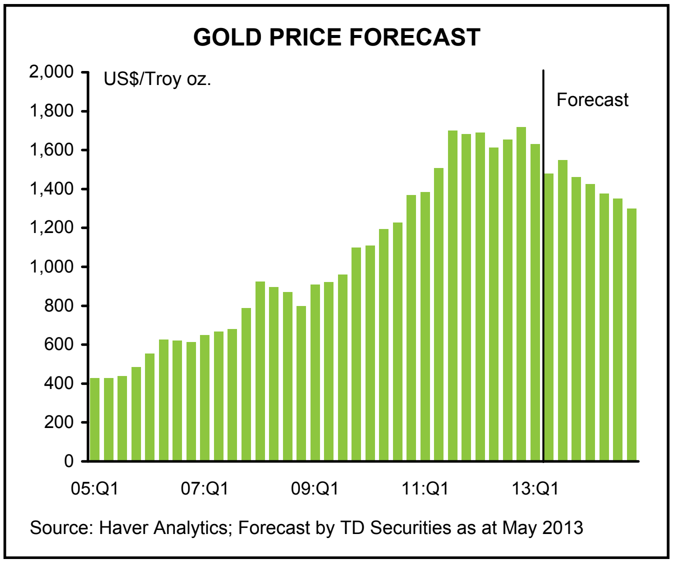
Where to from here?

The sharp pullback seen in recent weeks has left many wondering whether the recent leg down is set to continue or if gold prices will reverse course and extend their 12-year bull run. Some key market drivers should continue to be relatively supportive for prices, with jewellery demand expected to stay healthy, and central banks likely to remain net purchasers of the yellow metal – particularly in emerging markets. However, as we have seen over the last few years, it is the investment environment that seems to have a dominant effect on prices. And on that front, there will be several headwinds to contend with.

The tapering of asset purchases under QE3 in the U.S. is expected to begin by the end of this year. Combined with a pick up in economic growth during the second half of the year, these factors should continue to lift the greenback, and weigh on gold prices. Moreover, as economic growth around the globe improves heading into next year, the desire for safe haven assets such as gold is likely to diminish further – particularly as excess slack keeps inflation at bay in the advanced world. As well, given that equities have been particularly strong, and expected to remain healthy given the economic outlook, the rotation into riskier assets that generate a higher return is likely to continue.

Further out, once short-term interest rates begin to rise in the U.S. (and elsewhere) and liquidity is reined in, returns on fixed income investments will also increase. This will increase the opportunity cost of holding gold, which doesn't pay an income stream.

As such, while gold may stage a mini-rally in the near term, as some choose to buy on the dip, the upside for gold over the next 2-3 years is limited. In fact, after staging a modest rebound from current levels to around US$1500 in the third quarter of this year, we expect prices to embark on



a steady downtrend, falling below US$1300 by the end of next year. Our forecast implies that the annual average price of gold will decline this year and next, ending the streak of yearly increases that began early in the last decade. Longer term, the value of gold could see some further downside, although cost pressures should keep a floor under prices. Hence, a return to pre-recession levels of US$400-600 is doubtful.

Of course there are risks to this forecast. The sovereign debt crisis that has hampered the European economy over the past few years is far from resolved. While economic growth in the region is expected to improve in the coming quarters, any bump along the recovery path has the potential to spark concerns throughout the investment community. Such a development would lead to a rise in demand for traditional safe haven assets such as gold. Similarly, the impact of the recent tax hikes and sequestration in the U.S. has yet to be fully felt, and could hit the economy harder than is currently expected. This would likely result in a more prolonged period of quantitative easing, a weaker U.S. dollar, and consequently net inflows into gold.

Despite being far from the radar at the moment, if central banks keep monetary policy too accommodative for too long, inflation concerns could begin to surface. While certainly a risk, the Fed is unlikely sit on the sidelines as inflation accelerates. The central bank has earned a great deal of credibility in keeping price pressures stable, and should continue to keep inflation expectations well-anchored. Indeed, inflation expectations, as measured by the differential in 5-year yields between nominal bonds and Treasury inflation-indexed securities (TIPS) are currently sitting in the 2-3% range – right in line with where they were prior to the recession.

Bottom Line

The drop in gold prices seen in recent months was driven largely by a souring in investor sentiment towards the precious metal. While some may see the current weakness as a good buying opportunity, any rebound in prices is likely to be fairly short-lived. An improvement in economic growth in the U.S. (and around the world), combined with a gradual unwinding of stimulus measures by the Fed later this year and into next, will likely give the U.S. dollar a boost, weighing on gold prices. Further out, inflation expectations are likely to remain largely contained. As such, the need to hedge against inflation will be outweighed by the desire to hold riskier assets or those that pay an income stream given an environment characterized by stronger economic growth and rising interest rates.

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