Bank Financial Group

Observation

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TD Economics
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HIGHLIGHTS

- **Gold prices have come off their recent highs, but there remains some upside potential for the yellow metal over the next 3-6 months.**
- **By-mid 2010, a stabilization in the U.S. dollar and the notion of a tightening in monetary policy will lead to a pullback in prices toward the US$800-900 range.**
- **Further out, prices are likely to lose further ground as the metal typically delivers poor longer-term returns compared to other asset classes such as equities which, unlike gold, provide an income stream.**

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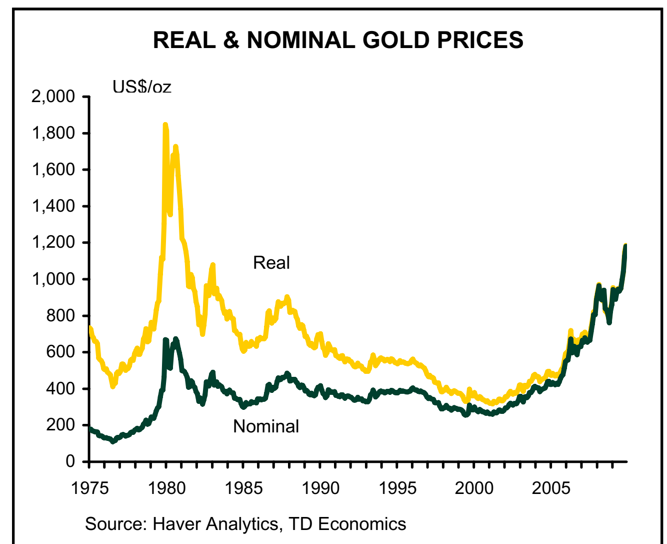
GOLD PRICES: HAS THE RALLY RUN OUT OF STEAM?

After outperforming all major asset classes with a massive 20% advance in the past two months, gold prices have given back about one-quarter of that gain over the past week. Stronger-than-expected U.S. employment data for November and disappointing economic news in Japan and other parts of the world have led to the recent selling pressure. We believe that the current setback will prove only temporary, with the price of the yellow metal embarking on a new leg up in the near term. Looking out to 2010, however, the story will be different, as some of the favourable fundamentals underpinning gold prices will fade to some extent, taking the price of gold down to a new plateau. To the extent that prices rebound from their current level of about US$1125 per ounce, the more severe the medium-term adjustment is likely to be.

Looking back over time, the gold market has been characterized by multi-year up- and down-cycles, with periods of significant buying (selling) followed by sudden and sharp reversals along the way. The current up-cycle began in 2001, making it a 9-year bull run. But this is not unprecedented by any stretch. Indeed, the downtrend in the 1980s-90s lasted for about 15 years. There has been only one episode that could be characterized as a “bubble” in gold markets since central banks moved off the gold standard. In January 1980, gold prices hit a record high of US$2,300 in inflation-adjusted terms, up from about US$900 just five months earlier. Prices plunged 40% to US$1,320 by May, and after another (smaller) rally later that year, prices crashed to below US$700 by mid-1982.



Source: Haver Analytics, TD Economics

In contrast, the current rally for the most part has been gradual and orderly. However, the acceleration in the uptrend over the past two months raised red flags that prices had gotten ahead of themselves. The inevitable correction has been taking place.

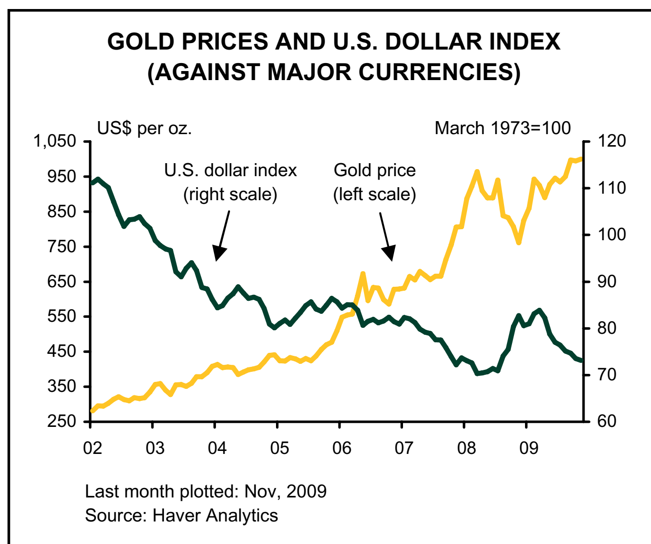
The bigger risk over the next few months, in our view, is that the market becomes increasingly gripped by irrational exuberance. As the table on the following page shows, gold prices are less influenced by direct central bank purchases/sales, supply and demand in the fabrication market and producer hedging/de-hedging than by investor purchases through exchange traded funds or other vehicles. Certainly, developments in these other areas have a significant influence on market

GOLD SUPPLY AND DEMAND (tonnes)	2008				2009			% chg*
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	YTD
Supply								
Mine supply	545	589	633	648	584	632	670	7%
Net producer hedging	-129	-122	-53	-47	-1	-31	-105	
Total mine supply	415	467	580	601	583	601	565	20%
Official sector sales	77	69	77	13	62	-5	-15	-81%
Old gold scrap	360	275	216	358	569	314	283	37%
Total supply	852	811	874	972	1215	910	833	17%
Demand								
Jewelry	475	532	695	484	352	407	475	-27%
Industrial and dental	116	118	112	90	80	94	100	-21%
Total fabrication	591	650	807	574	432	501	575	-26%
Bar, coin and retail investment	98	148	270	346	144	168	186	-3%
ETF's and similar	73	4	149	95	465	57	41	149%
Total demand	762	802	1227	1014	1041	726	802	-8%
Inferred investment demand	91	9	-353	-43	174	184	31	642

*Inferred Investment demand - change in tonnes
Source: GFMS and World Gold Council

sentiment. For example, India's recent announcement that it would be purchasing 200 tonnes of the metal from the IMF – at market prices – in order to diversify its holdings set the stage for an investor stampede into gold. Still, investor appetite looms large, particularly with the emergence of many investment vehicles in the current cycle.

In the near term, investors are likely to buy on the recent dip. As indicated by the strong inverse relationship shown in the accompanying chart, a key driver of gold prices is the direction of the U.S. dollar given bullion's status as an alternative store of value. Worries about massive fiscal deficits, extremely accommodative U.S. monetary policy and rumblings about other central banks' diversification away from the U.S. dollar are all likely to conspire further against the greenback in the months ahead. Despite some waves of positive U.S. economic data, figures on the whole are likely to point to an economy recovering only slowly, similar to other trading partners. At the same time, however, worries that inflation will emerge in the medium-term are unlikely to be quashed. And with an abundance of global liquidity chasing returns in a low interest-rate environment, the ingredients may be in place for additional froth to form in the gold marketplace.



Headwinds to grow in 2010

Guessing when gold prices will ultimately peak and at what price is a mug's game. For what it's worth, the current price level in real terms is sitting at about one-half of its record level set in 1980, although market conditions and drivers of that rally were starkly different. Back then, hyper-inflation was the primary focus compared to the U.S. dollar today.

What we do know, is that regardless of the near-term trading pattern, gold prices will face increasing headwinds as 2010 unfolds and we move into 2011. And just as the U.S. dollar has been the major source of the rally since 2001, it is likely to mark the most significant impediment over the medium term.

With the economy still quite fragile and in need of this stimulus to get back on its feet, we suspect that the Federal Reserve will leave interest rates unchanged until early 2011. However, as early as the second quarter of 2010, foreign exchange investors are likely to increasingly take note of the outperformance of the U.S. recovery vis-à-vis most other major industrialized economies and to start pricing in a reversal in some of the extreme stimulus measures that have been put in place to support the economic recovery – which in turn should provide some support for the greenback. This will deal a double blow to gold, since rising short-term interest rates in the U.S. (and elsewhere) will also rein in some of the abundant liquidity and raise returns on alternative fixed-income investments.

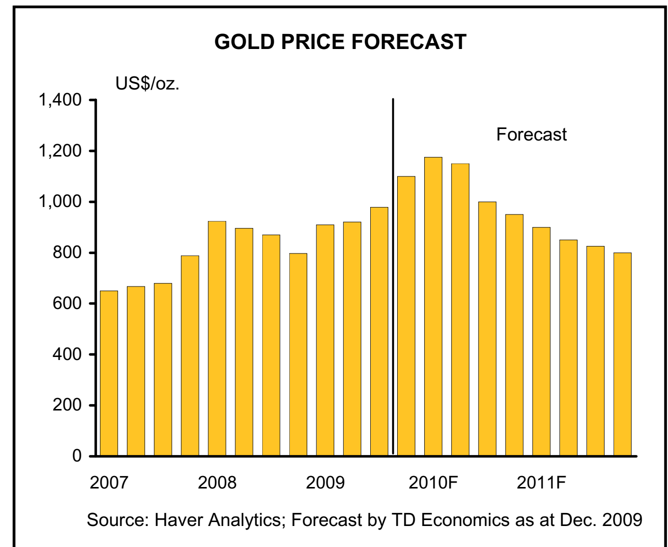
Inflation worries are also likely to subside to some extent in 2010. In the coming months, the vast amount of economic slack could lead to an intensification of disinflationary forces in the U.S. economy and around the world. While upward price pressures could take root if the Fed keeps its monetary policy too stimulative for too long, we believe it is highly unlikely that U.S. government would intentionally attempt to inflate its debt away. Nor would the Fed stand idly by and allow inflation to accelerate – too much hard earned credibility would be lost. Fed Chairman Bernanke has recently underscored this last point in recent speeches. This is also the view in the bond market, where inflation expectations, as measured by the differential in yields on treasury inflation protected securities (TIPS) and conventional bonds, are pointing to more of an upward drift in prices rather than a spike.

What's in store for gold prices?

These dynamics will contribute to a less fertile ground for gold prices. By the end of 2011, the price of bullion is likely to be trading close to US$800. Keep in mind that this price is still high compared to the average real price recorded between 1983 and 2008 of about US$580. Looking out longer-term, the picture gets increasingly cloudy. Gradual diversification away from the greenback and the use of gold as a hedge against both U.S. dollar softness and global financial uncertainty could keep the longer-term upcycle intact. But while many forecasters believe the U.S. dollar remains significantly over-valued, implying scope for further declines post-2011, much of this over-valuation is against currencies that aren't freely floating, such as China's – and projecting China's longer-term currency policy is no easy feat.

Even further out, there are reasons to be less bullish about the price of gold. Looking at historical trends, gold has generated little or no return in real terms over extended periods of time, with only a few sharp (but fairly short-lived) bursts occurring in the last 35 years. While the volatility in gold prices can generate large profits if timed right – which is very difficult to do – a large drawback of the metal for long-term investors is that it does not pay an income stream, unlike equities which are typically able to generate strong gains over the long run through re-investing dividends. Indeed, over the past three decades, gold has underperformed several other asset classes. As the accompanying table shows, the benefit of holding gold since 1980 has been far less than holding stocks or bonds. This was at the time when gold prices last peaked. But even if you strip out the "bubble" years and take the average price in 1983, the return from holding the yellow metal between then and now, at 180%, still pales in comparison to the earnings generated from each of the other asset classes. As such, once financial conditions are more stable, demand for gold is likely to fade in favour of assets that have the potential to generate higher returns, driving gold prices back down toward their long-term, inflation-adjusted average of US$500-600.

GOLD PRICE FORECAST



Source: Haver Analytics; Forecast by TD Economics as at Dec. 2009

RETURNS BY ASSET CLASS

	1980-2009
Gold (peak in 1980 to peak in 2009)	43%
Gold - post bubble (1983 avg to peak in 2009)	180%
S&P 500*	2,182%
U.S. Treasuries	1,089%

*dividends reinvested on a gross basis

Source: Bloomberg News, Haver Analytics

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