Global Research - Commodities

Gold's fundamentals and its role as diversifier

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Global Research

Historical gold prices

Gold hit a record high of USD1,921/oz in September 2011, in nominal terms before falling sharply for the rest of the year

Prices recovered on the Federal Reserve's announcement of its third round of quantitative easing (QE3) but began to weaken after the US election

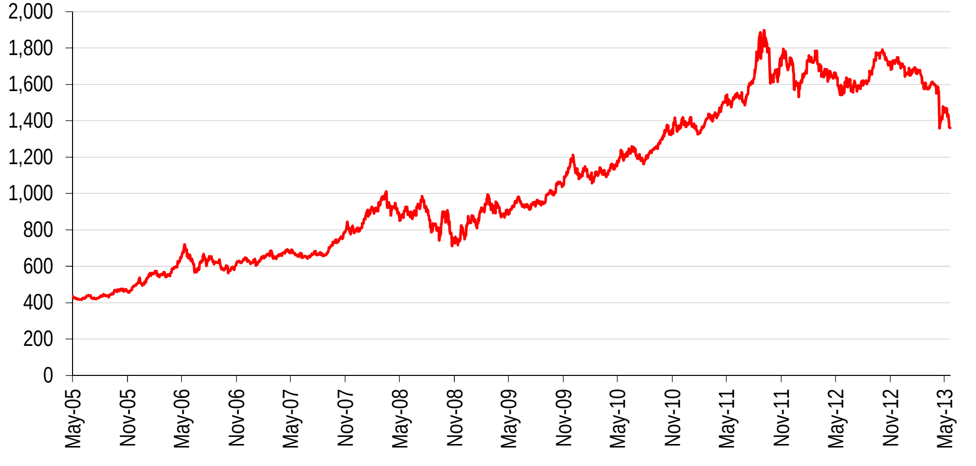
In April 2013 prices fell to USD1,320/oz on persistent financial market chatter that the Fed would end QE ahead of schedule and on a rotational shift out of commodities and into equities

The gold price's all-time inflation-adjusted high is cUSD2,350/oz, reached in January 1980

Gold prices (USD/oz)

Source: Reuters

Gold prices (USD/oz)



Source: Reuters

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Gold holds up in times of crisis

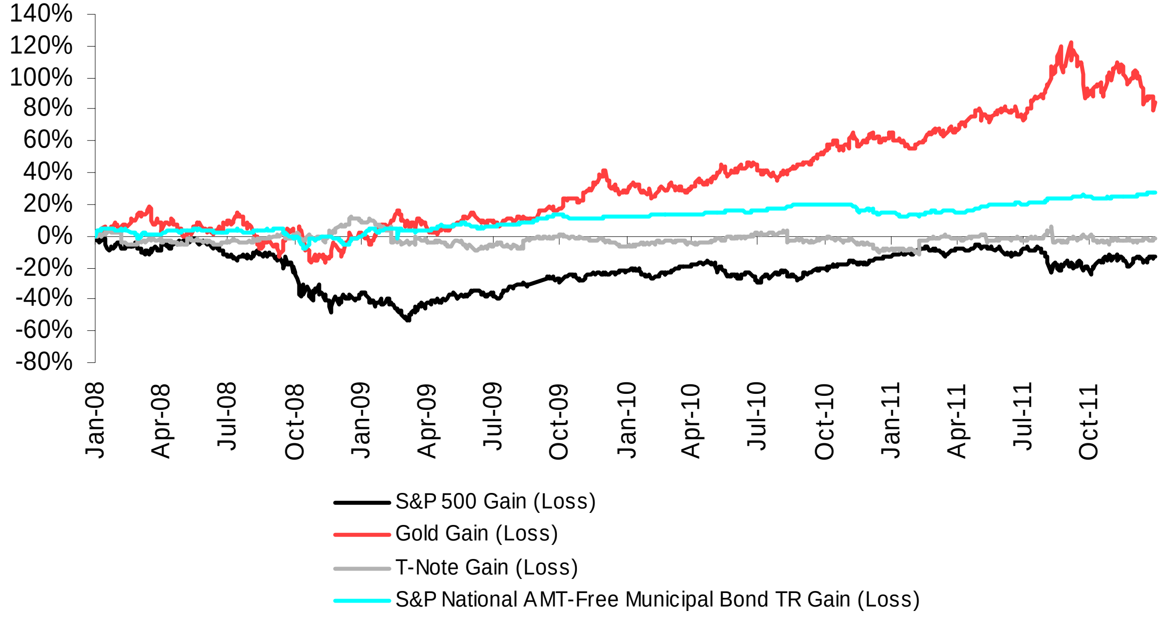
Since the global financial crisis in 2008, gold has appreciated significantly as the Federal Reserve initiated QE2 and "Operation Twist"

Gold notably outperformed other asset classes during this period, underscoring its traditional function as a safe haven

Gold has been supported by global accommodative easing, economic uncertainty, commodity price increases, and geopolitical risks

In the latter half of 2011, steep equity market declines, amidst deteriorating economic prospects and eurozone sovereign-debt concerns, boosted the USD and triggered a correction in gold prices

Returns for various asset classes, 2008-2011



Source: Reuters

Gold has not outperformed other asset classes so far to 2013

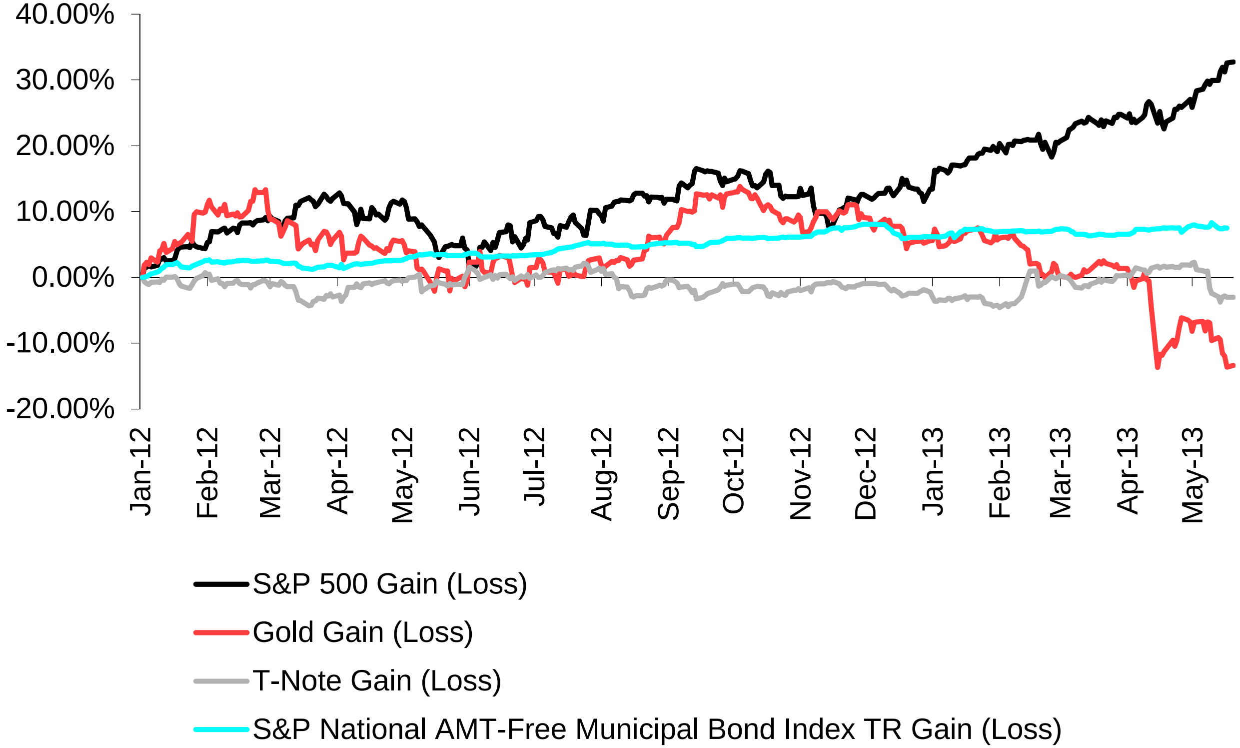
Gold outperformed most assets in early 2012 in anticipation of additional monetary easing, heightened geopolitical risk, and economic uncertainty

Following the February meeting of the Federal Open Market Committee, gold fell when Federal Reserve Chairman Ben Bernanke did not announce additional monetary policy easing

The FOMC QE3 announcement in September 2012 triggered a gold rally, which subsequently fizzled out

Since the end of 2012 the equity rally has noticeably outpaced gold resulting in a rotational shift out of bullion and into stocks

Returns for various asset classes, 2012 through mid-May



Source: Reuters

Gold timeline

Gold prices have been very sensitive to Fed statements

Prices dropped following statements by the FOMC and Fed Chairman Bernanke to Congress earlier in the year

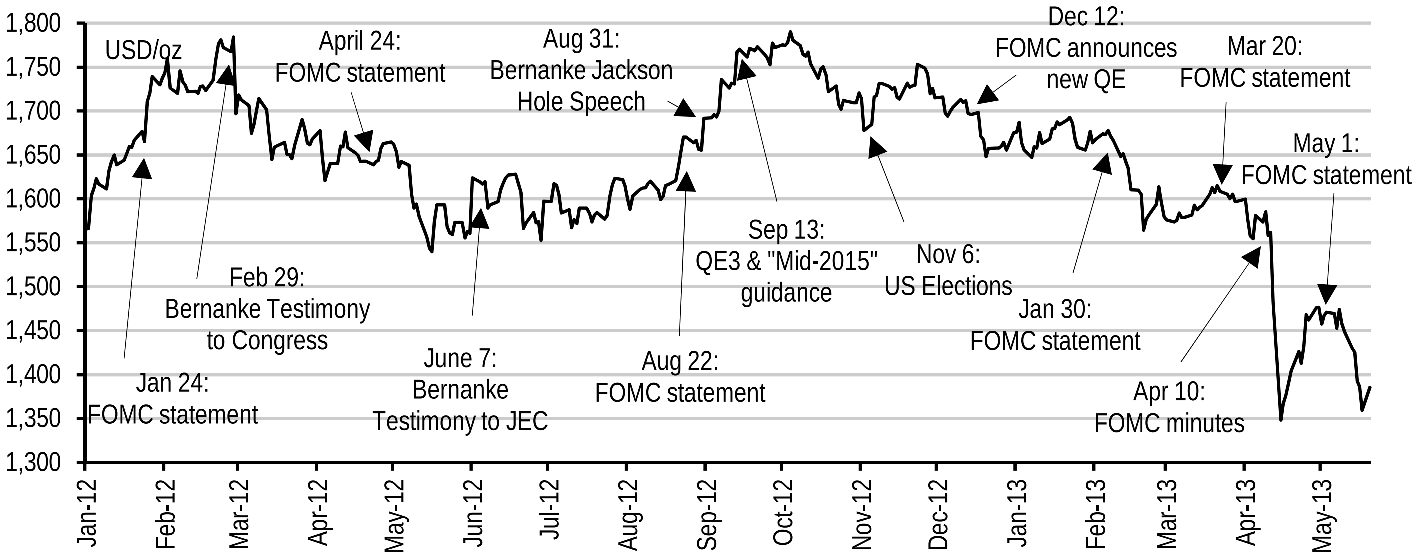
QE3 expectations followed by a FOMC announcement triggered a gold rally

Gold weakened significantly after the US election and after the December FOMC announcement of QE3

Gold mounted a short-lived near the 20 March FOMC, which confirmed accommodative policies

Prices crashed in April weighed down partly by the release of FOMC minutes which showed some Fed members calling for a tapering off of QE by year end

Fed statements and testimonies are highly influential on gold prices



Source: Bloomberg, HSBC

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Risk assets and gold

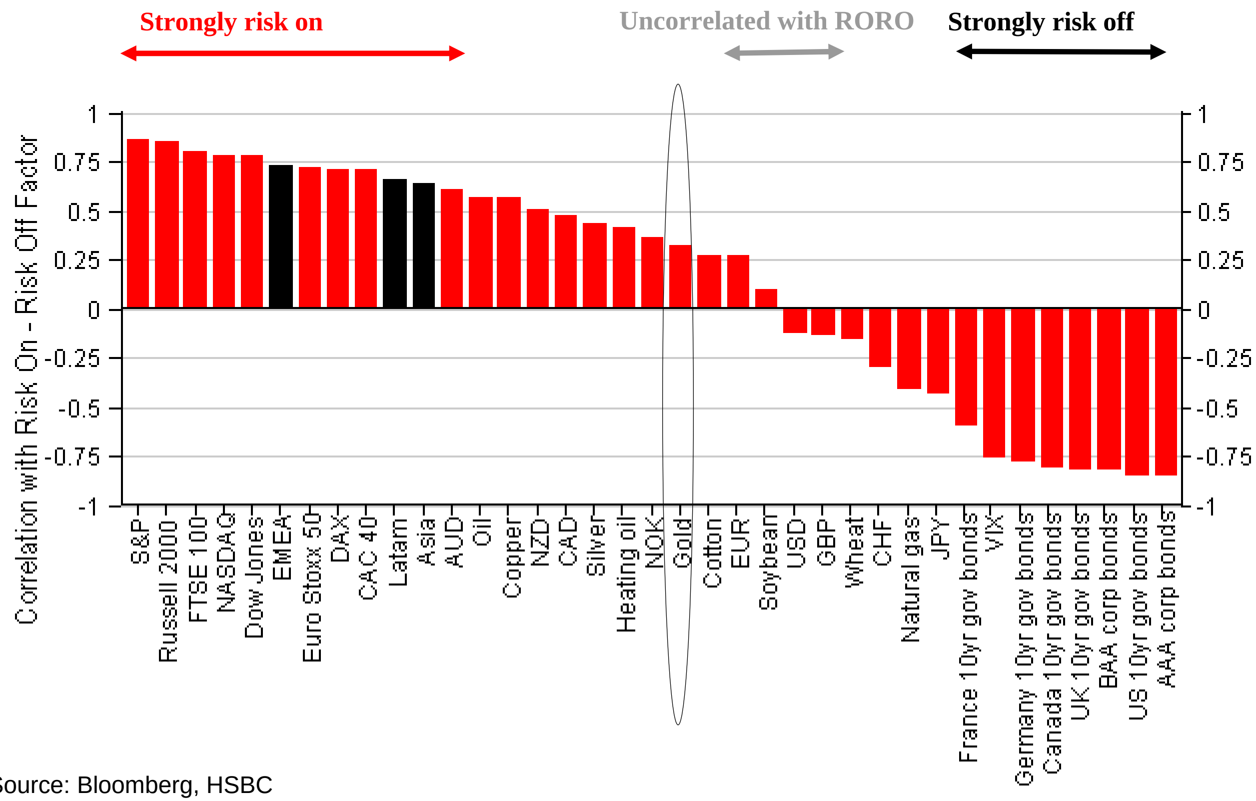
Traditionally, gold moves positively with risk

Since the beginning of the global economic and eurozone sovereign-debt risk crises, gold has tended to moved with risk

Gold shifted to occupy a neutral area between “risk-on/risk-off” assets for most of the past 24 months

More recently, gold has moved towards risk on assets but overall risk correlations have weakned

Asset correlations with the risk on – risk off factor

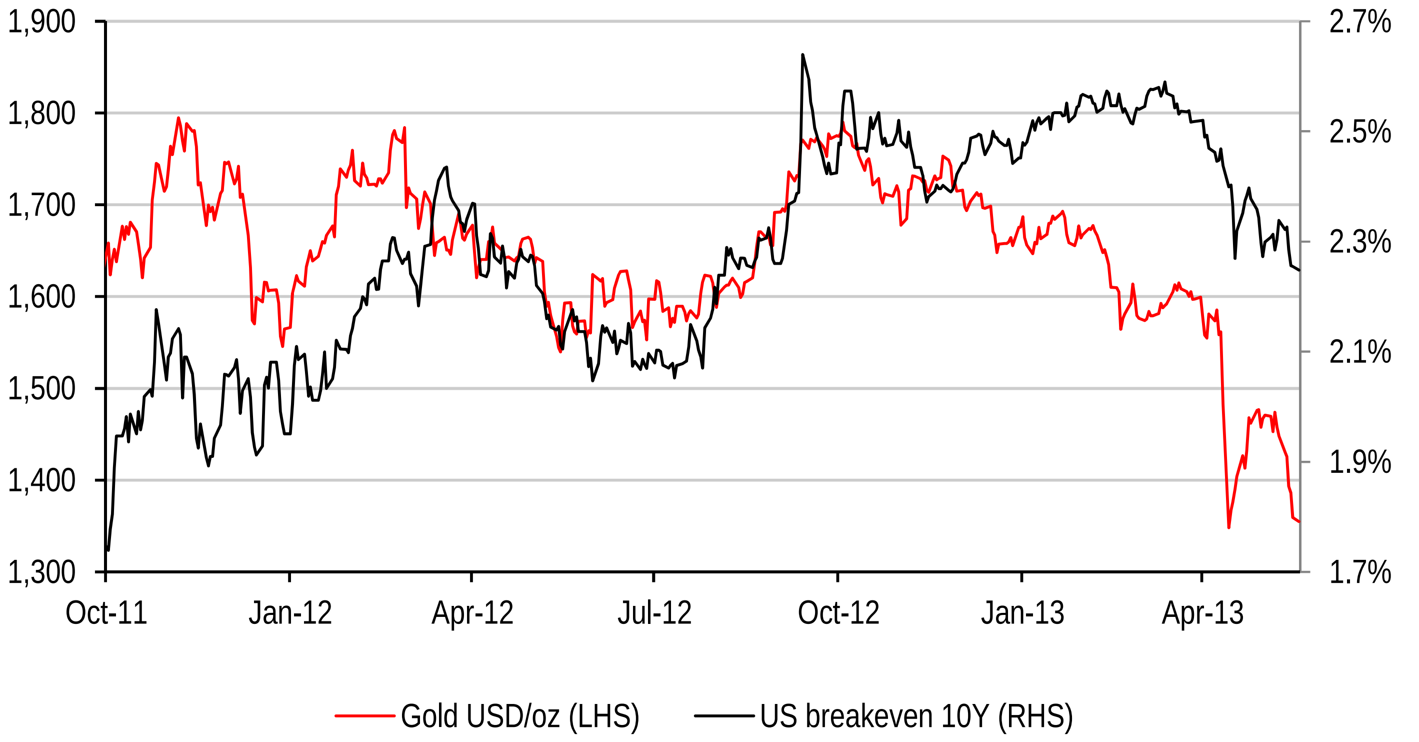


Source: Bloomberg, HSBC

Gold and inflation expectation

Gold has fallen in the absence of inflationary pressures

Gold and inflation expectation



Source: HSBC, Bloomberg

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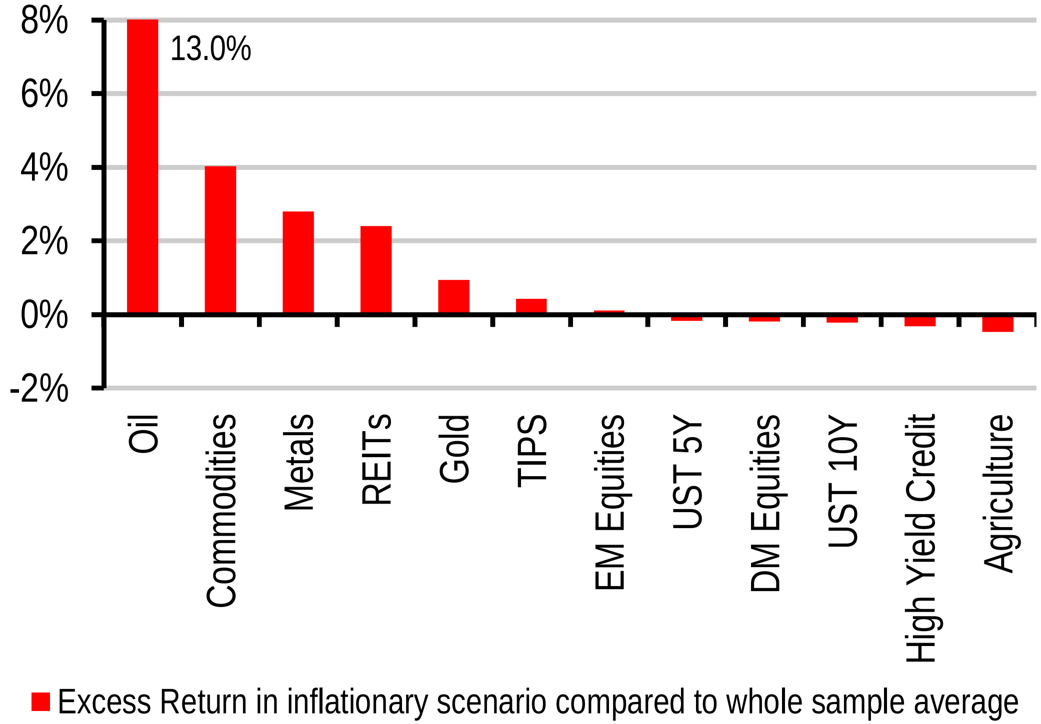
Gold and inflation expectations cont…

Gold is among the hard assets that generate excess returns compared with other assets in an inflationary scenario

Falling inflation expectations may undermine the need to own gold

Hard assets like gold are traditionally a hedge against inflation

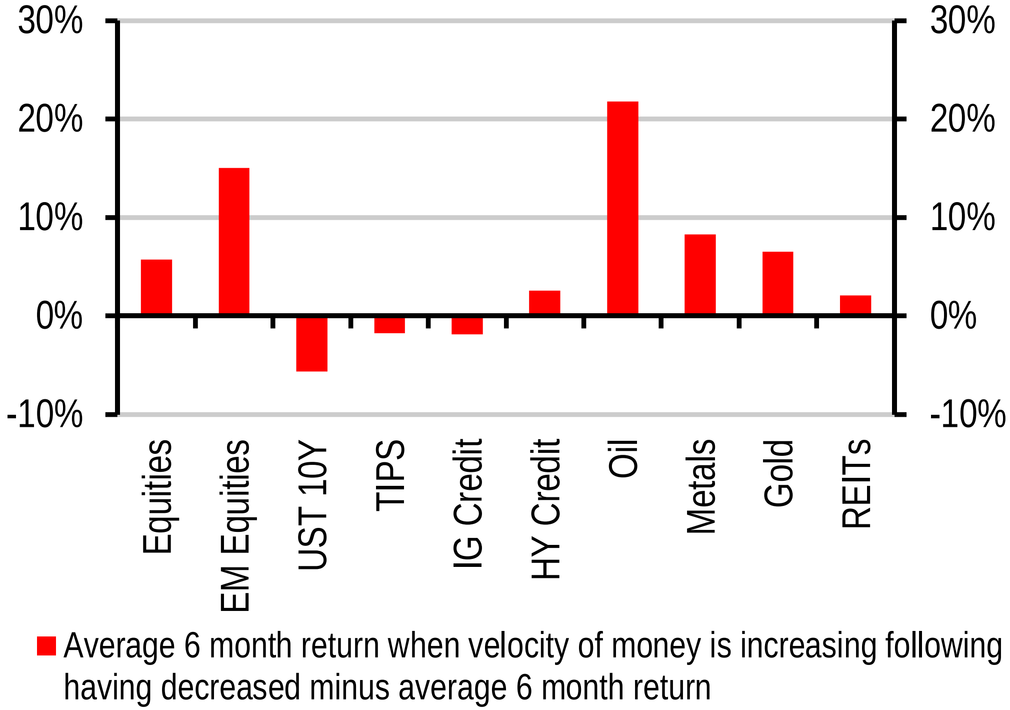


Source: HSBC, Thomson Reuters Datastream

Gold and inflation expectations cont…

During periods when the velocity of money is rising gold, along with other assets tends to rise

If inflation is driven by velocity of money, it is "risk-on" and good for gold

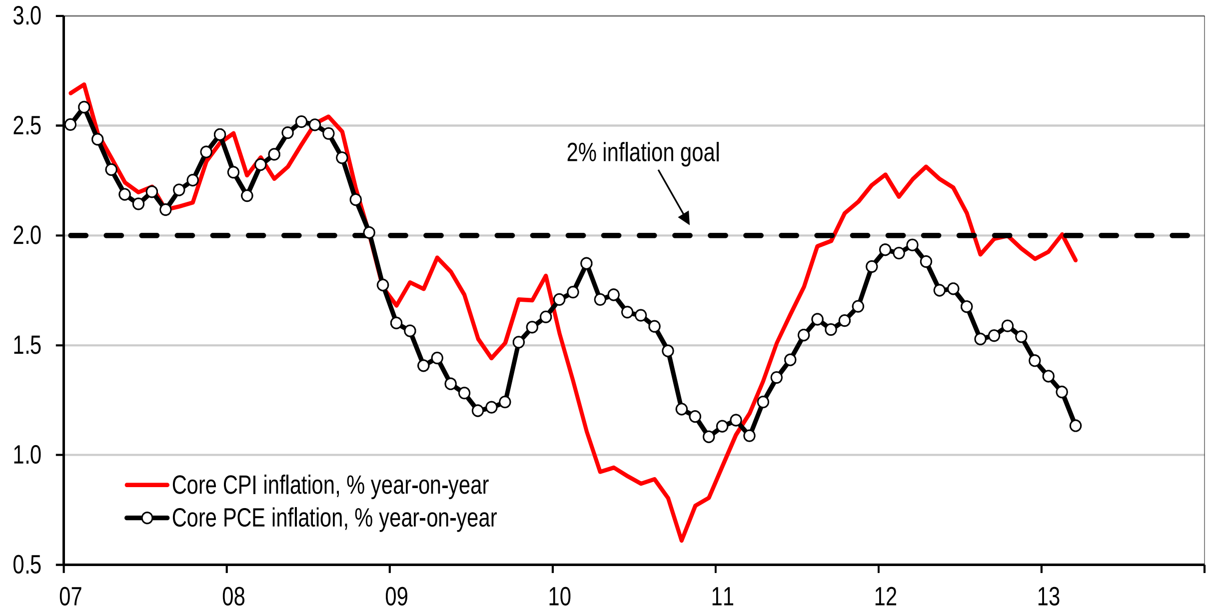


Source: HSBC, Thomson Reuters Datastream

Gold and inflation expectations cont…

Measured by Personal Consumption Expenditure (PCE) US inflation is only at half the Fed's 2% target. This exerts a negative impact on gold.

Core PCE have fallen from 2% but core PCI has not



Source: HSBC, Bureau of Labor Statistics, Bureau of Economic Analysis

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Dollar and gold trade inversely most of the time

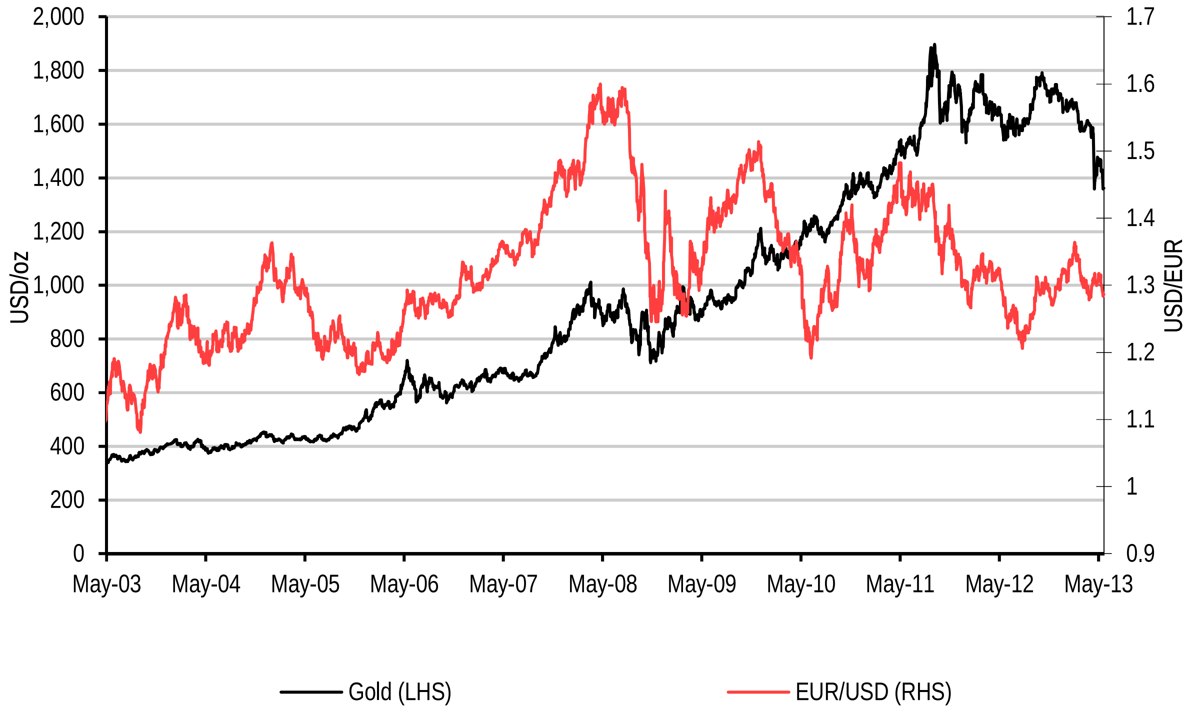
Gold and the USD's traditionally inverse relationship is based on:

- **Desirability of paper vs hard assets**
- **Mining economics**
- **Consumer demand outside the USD bloc**

USD weakness is viewed as fueling gold's long-run advance

The relationship has periodically broken down during the eurozone's sovereign-debt crisis but appears to have re-emerged

The EUR and gold



Source: Reuters

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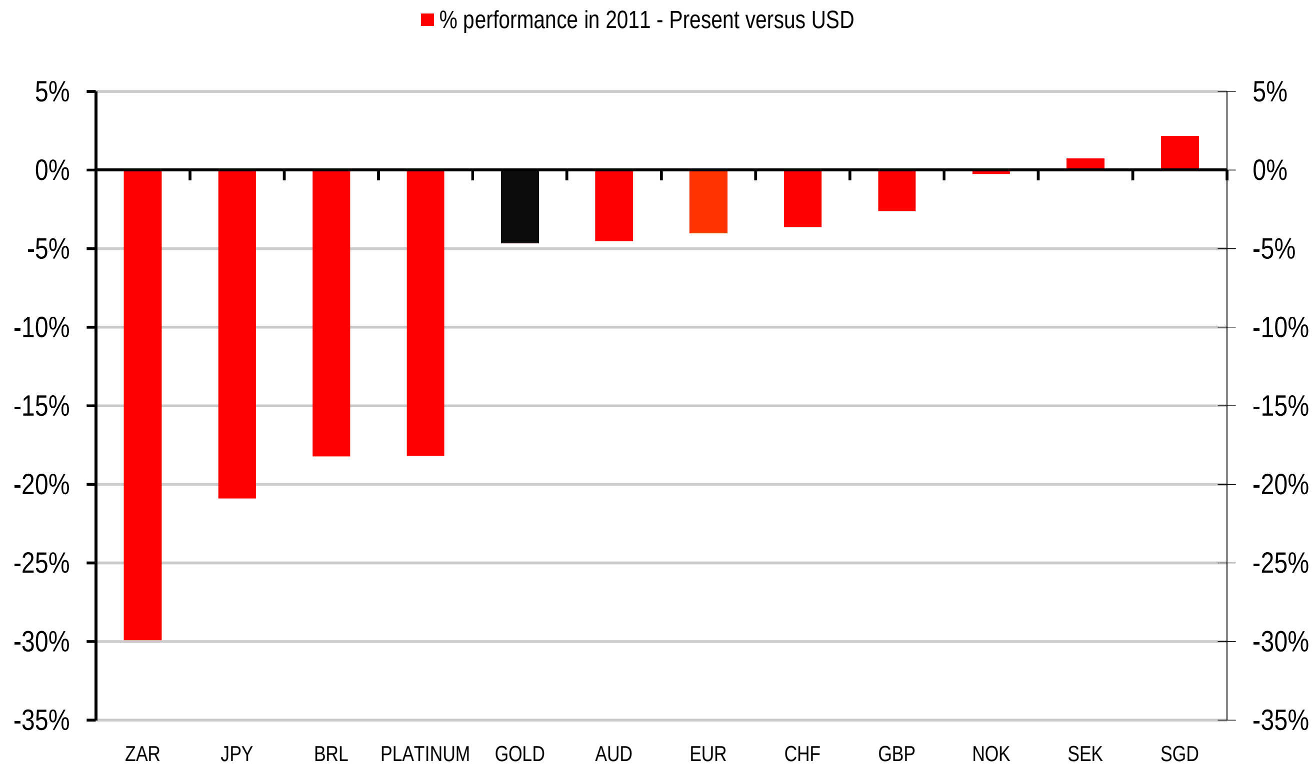
Gold is down in terms of all currencies

Throughout 2011 and 2012 gold gained against all major freely floating currencies, reaffirming its status as a surrogate currency

Recently losses have resulted in gold falling against the AUD, EUR, CHF, GBP, NOK SEK and SGD

Gold's returns compared to those of various currencies and platinum



Source: HSBC, Bloomberg

Funds' dollar positions generally mirror gold positions

The USD/gold relationship is demonstrated by the net spec positions on the Comex and IMM

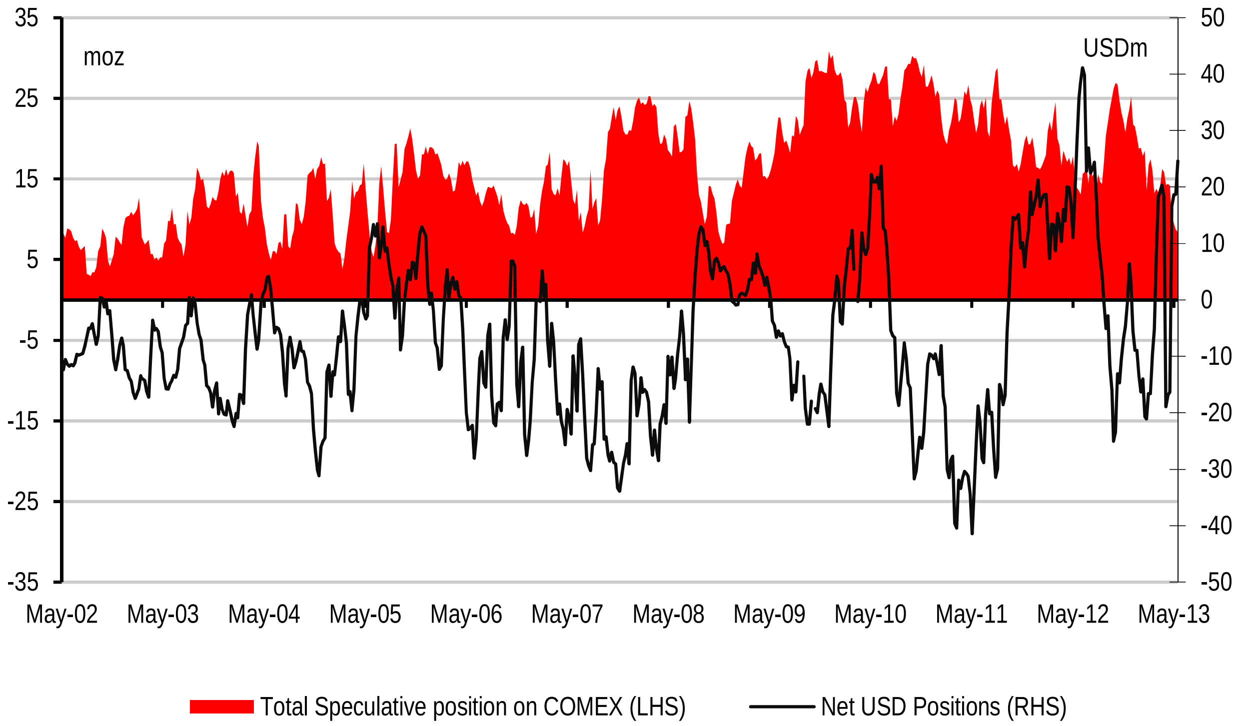
A widening of short USD positions typically coincides with a build in long gold positions

Historically, funds like to be long gold, but occasionally they go long the USD and reduce long gold positions

However, for a while, funds went long USD and increased long gold positions; this is generally a sign of elevated investor risk

Recently net gold longs have dropped as long USD positions jumped

Gold and USD net speculative positions



Source: CFTC

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Gold and scenario probabilities

The table is produced by HSBC's Asset Allocation team and shows a normalization in the global economy

The reduction in fat risk events has undermined the safe haven demand for gold and in our view helps explain some of the rationale behind bullion's decline

HSBC asset allocation team's scenario probabilities

	Q1-13	Sep-12	Dec-11	Jun-11	Oct-10
Inflationary growth	10%	5%	5%	5%	5%
Goldilocks	10%	5%	5%	15%	15%
Trend	15%	0%	0%	5%	15%
Stagnation	30%	40%	35%	40%	45%
Stagflation	20%	15%	10%	15%	5%
Recession	15%	35%	45%	20%	15%
Above trend growth	35%	10%	10%	25%	35%
Above trend inflation	30%	20%	15%	20%	10%

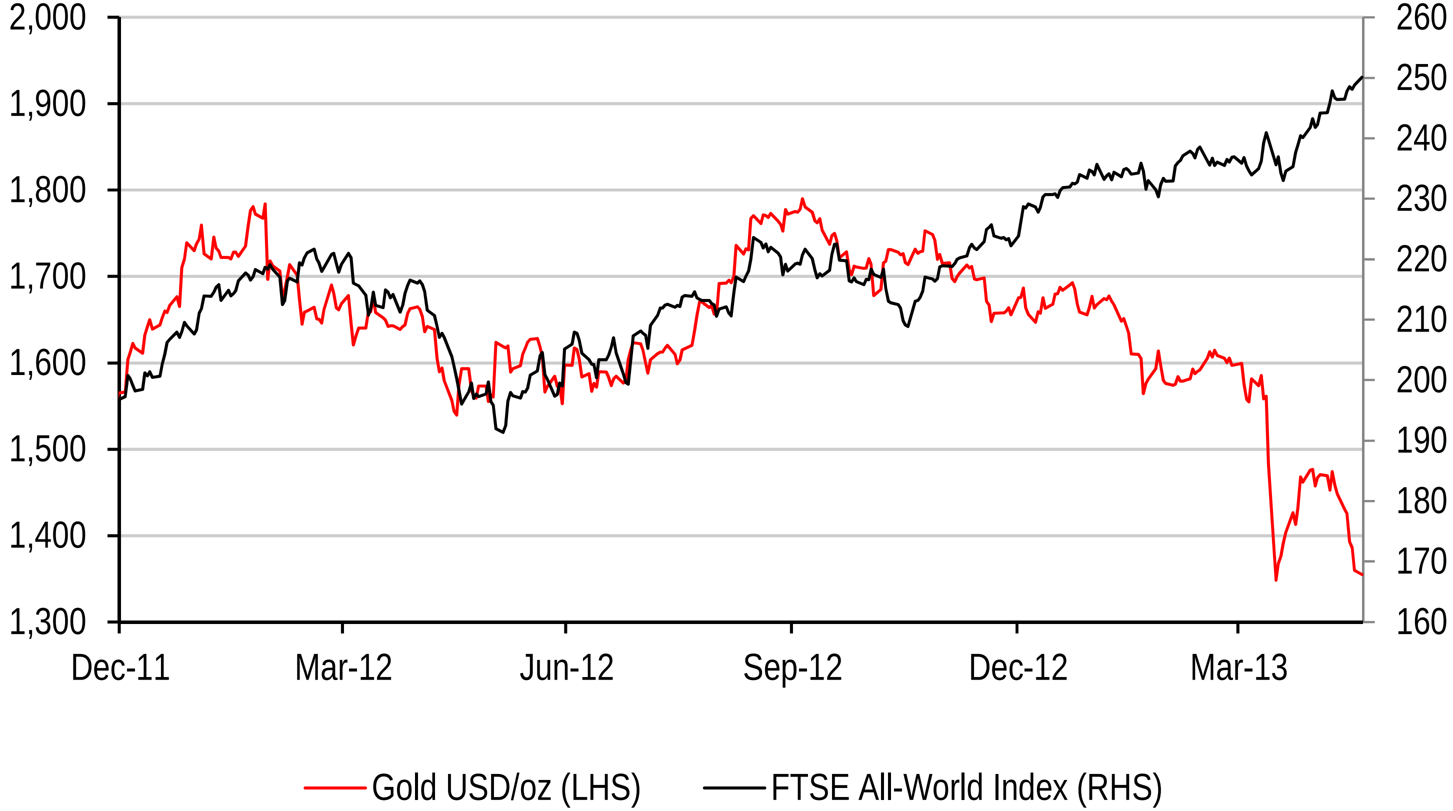
Source: HSBC

Gold and equities

Gold and equities decoupled in late 2012 and are trading divergently

The rotational shift out of commodities generally and into equities is an important reason behind gold's decline

Gold and equities



Source: HSBC, Bloomberg

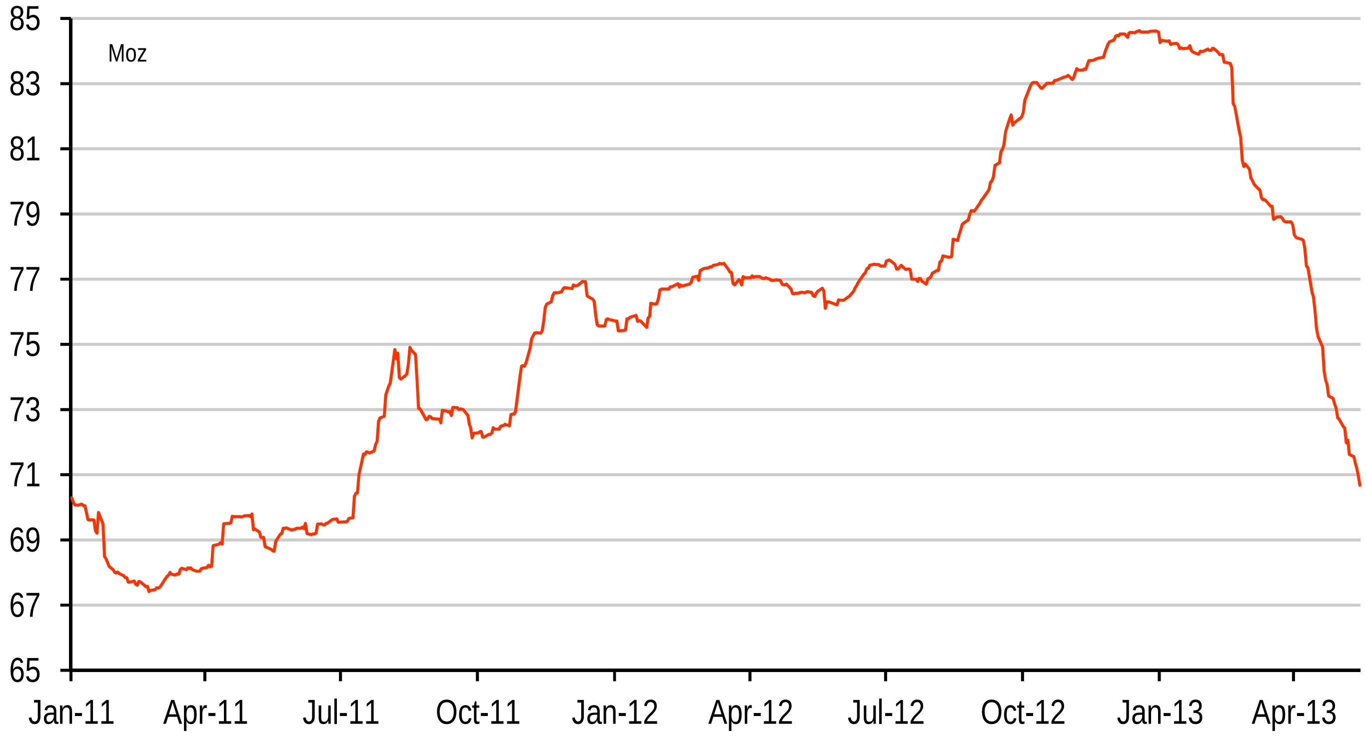
Gold in exchange-traded funds

After peaking in late 2012 at the equivalent of c90% of annual mine output, gold exchange traded fund holding have fallen

ETF holdings now stand at 70.4moz, down 14.3moz from the peak of 84.6moz

This liquidation helps explain gold's decline

Total gold holdings in exchange-traded funds

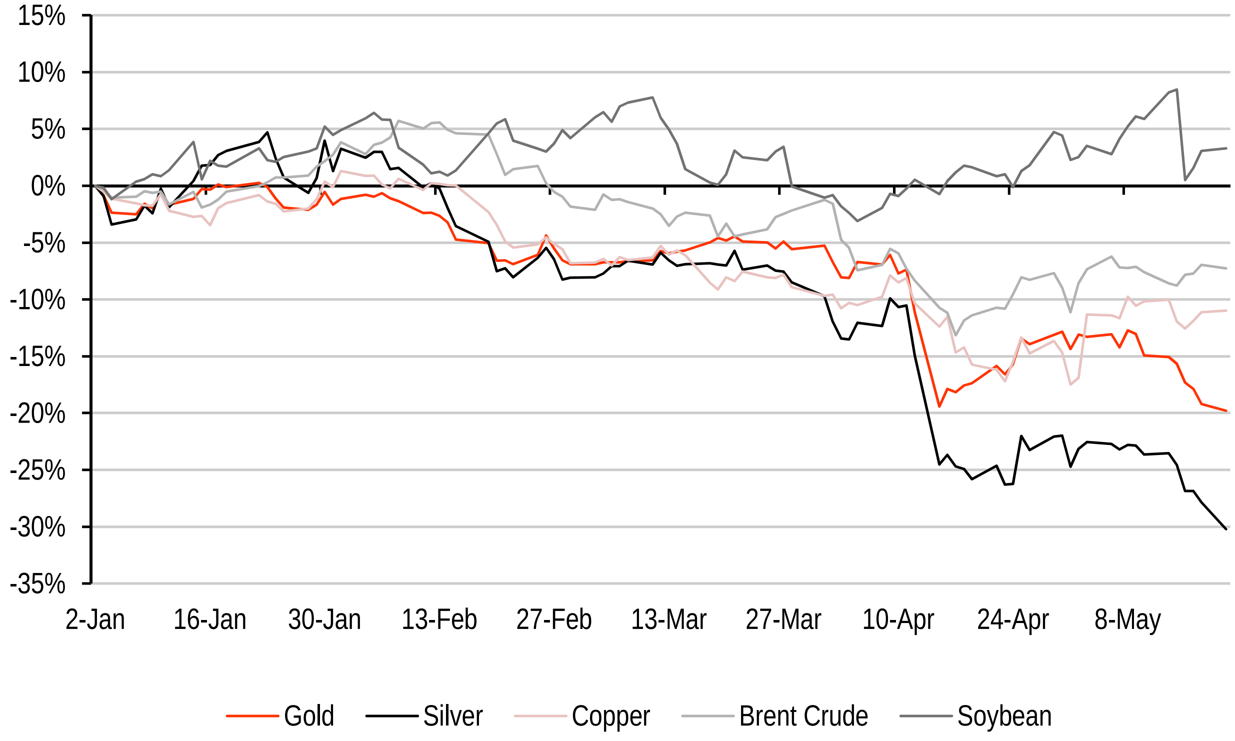


Source: HSBC, Bloomberg

Gold and commodities

Gold's decline was also part of an overall commodities rout.

Gold's returns compared to other commodities



Source: HSBC, Bloomberg

ETFs dominate investment demand

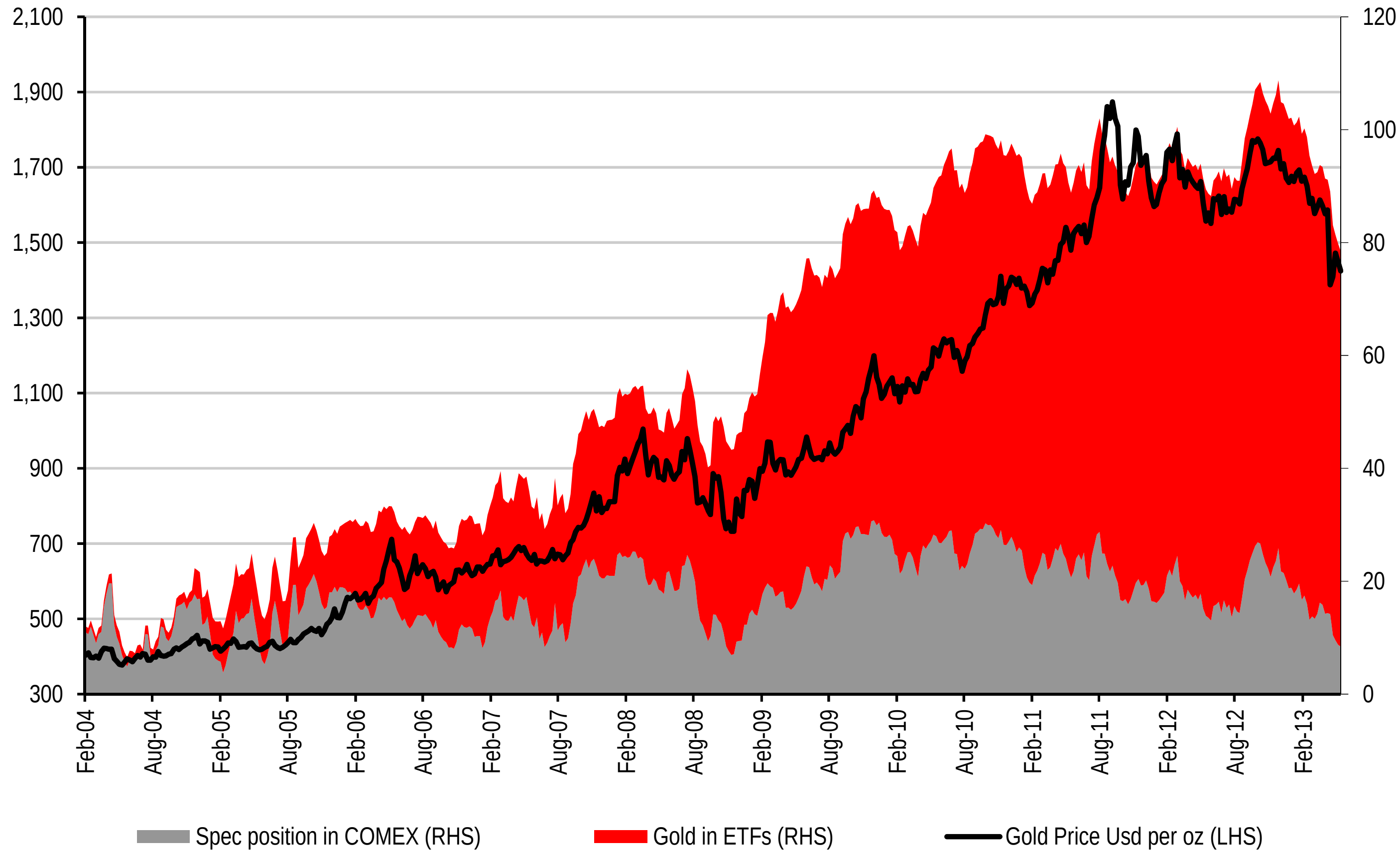
Note: Comex positions are considerably more volatile than those of exchange-traded funds

The greater ETF positions relative to the Comex show the shift in the gold market, from more-volatile Comex trading to more-stable ETF accumulation

Net long speculative positions were volatile in 2012 and currently stand at c22.7moz

ETF holdings are c70.4moz, down only slightly from a record 84.6moz and are still equivalent to three quarters of annual mine production

ETF and Comex positions (moz)



Source: HSBC, Gold Bullion, iShares, CFTC, ETF Securities

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Gold and US federal debt

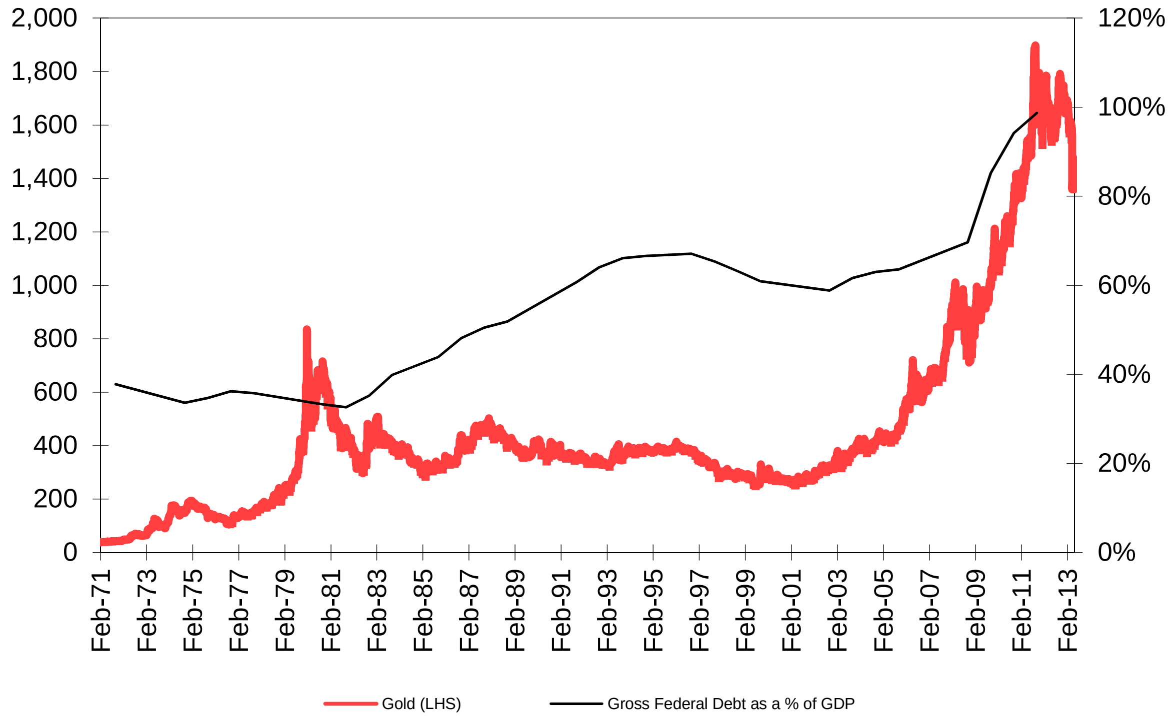
Declines in federal debt ratios coincided with a fall in the gold price in the 1990s

Rising debt levels since 2000, particularly since 2007, have coincided with a huge gold run

Historically, rising government debt has been positive for gold prices

The nonpartisan Congressional Budget Office noted an improvement in the budget deficit as a percentage of GDP but longer debt-to-GDP ratios are forecast to remain high

Gold and US public debt



Source: Congressional records, Reuters

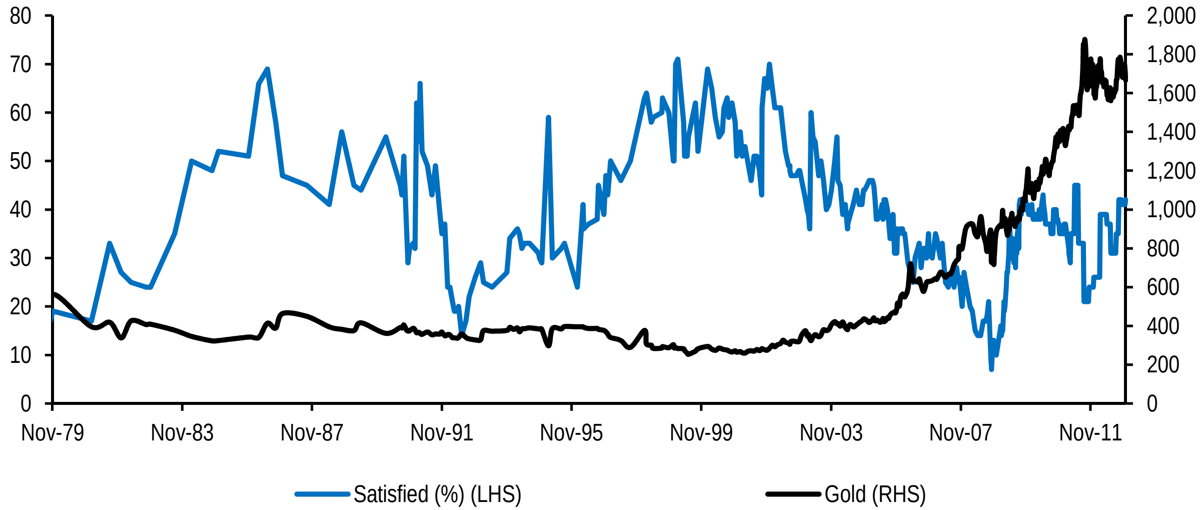
Gold and public satisfaction

Gallup asks a representative sample of more than 8,000 Americans every month, "Are you satisfied with the direction the country is headed?" followed by the question, "Are you dissatisfied with the way the country is headed?"

Gold prices tend to be high during periods when the polling finds that the public is dissatisfied with the direction in which the country is headed and low when the survey finds the public is satisfied

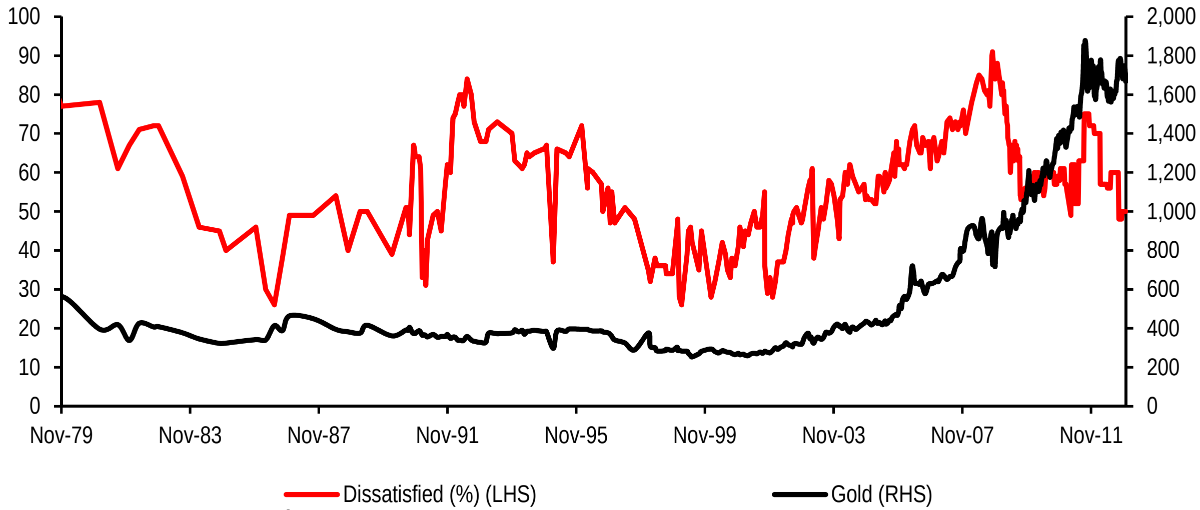
Low satisfaction ratings tend to support gold and a rise in confidence coincides with a decline in prices

Gold rallies as satisfaction falls



Source: Reuters, AP/Gfk, Gallup

Gold rallies as dissatisfaction remains high



Source: Reuters, AP/Gfk, Gallup

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Gold and economic policy uncertainty

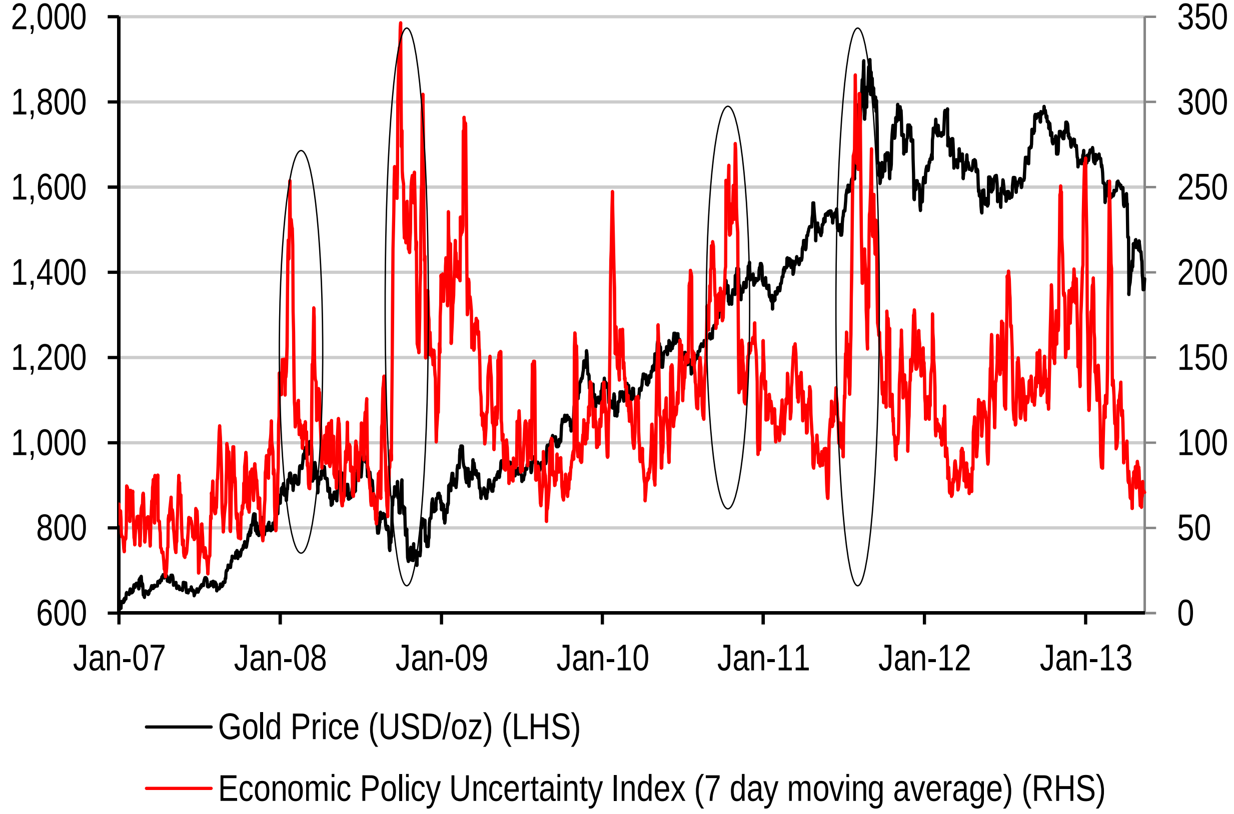
The Economic Policy Uncertainty Index is an index that measures the number of newspaper articles that mention the 3 sets of terms including the economy, uncertainty and congress

Gold prices tends to rally during heightened periods of economic uncertainty and falls during periods of low economic uncertainty

High economic policy uncertainty tend to support gold

Recently economic policy uncertainty has dropped, along with gold prices

Gold rallies on economic policy uncertainty



Source: Bloomberg, Economic Policy Uncertainty

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Gold and the US president's approval and disapproval ratings

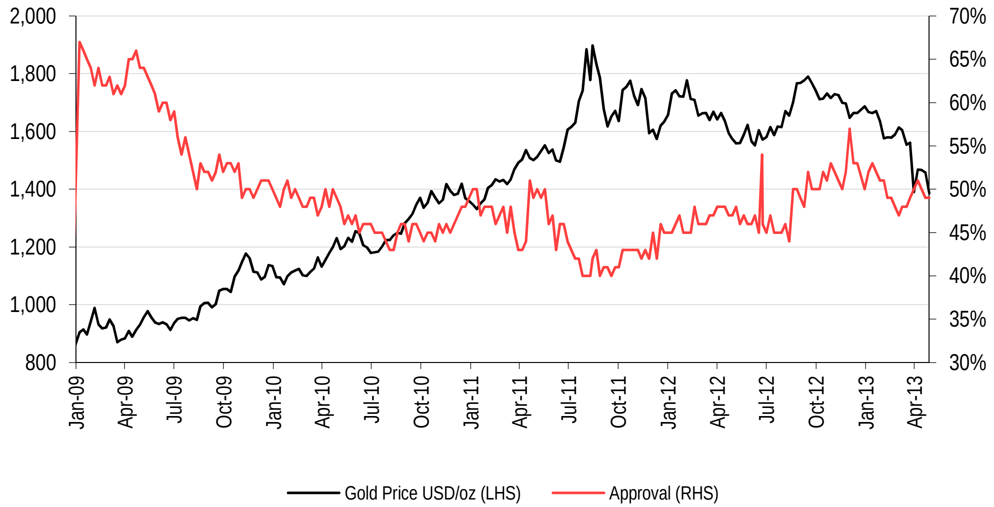
Gold has traded inversely to the US president's popularity

A look at gold prices during President Obama's time in office shows that gold's low coincides with his highest approval rating and his lowest disapproval rating, set during the week of his inauguration

Gold prices began to accelerate in April 2010 as the president's approval rating fell below 50%

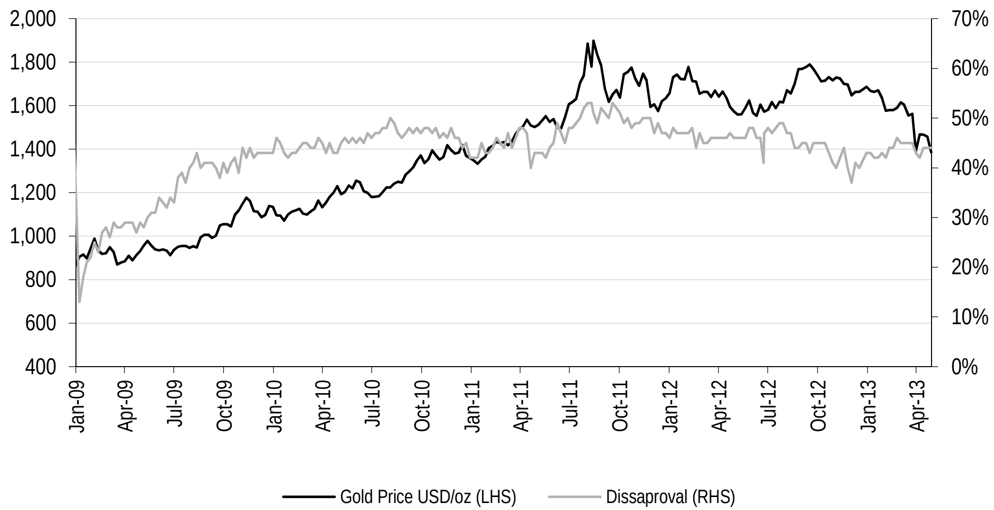
An uneven increase in approval ratings has been accompanied by a gold price decline

Approval ratings



Source: Gallup, Bloomberg

Disapproval ratings



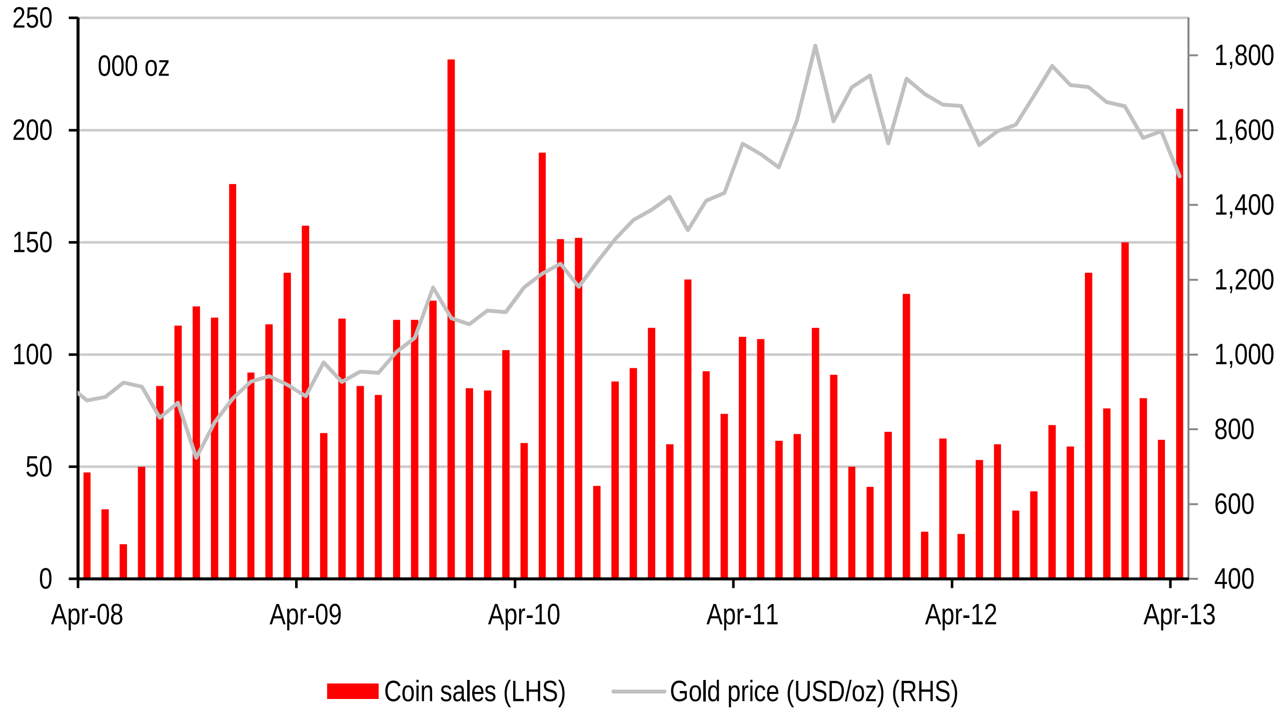
Source: Gallup, Bloomberg

Gold coins

The drop in price has led to a surge of physical demand

The US Mint is the largest bullion mint in the world and report a marked jump in demand, inside and outside the US

Gold coin sales by the US Mint



Source: HSBC, US Mint

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Gold as a percentage of currency reserves

Western central banks hold large percentages of their foreign exchange reserves in gold

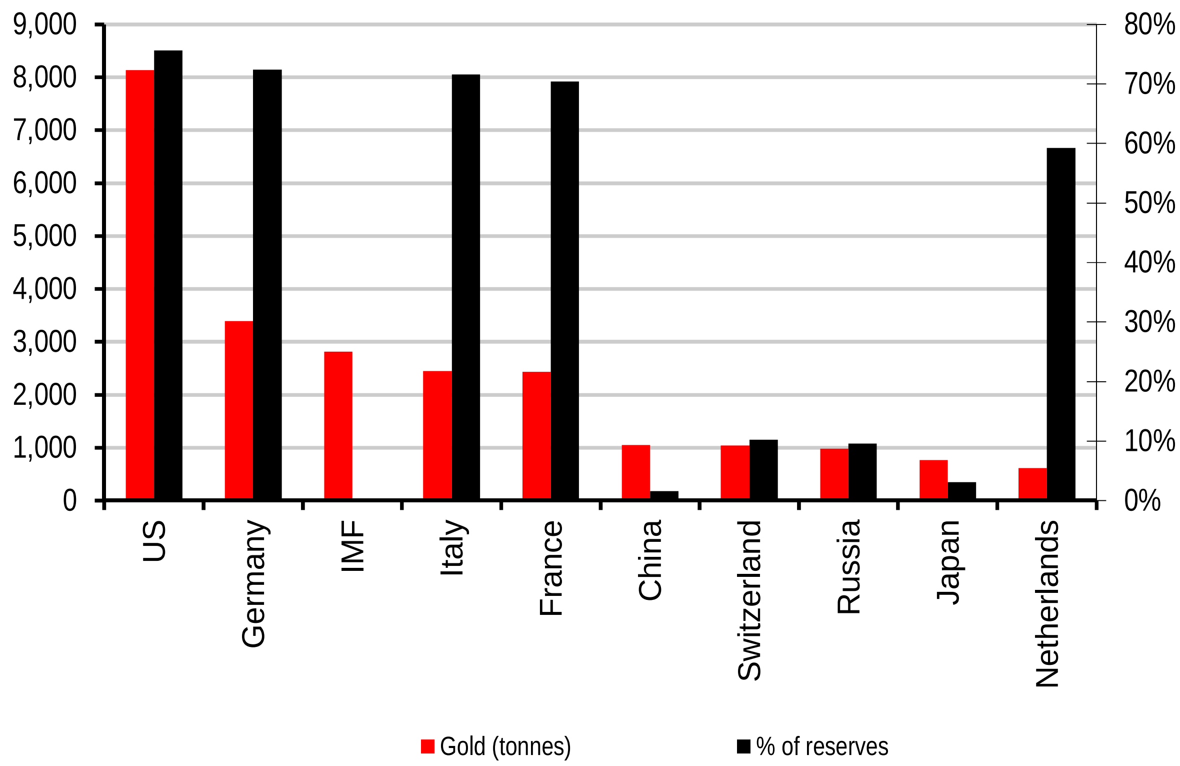
Most other countries have smaller allocations of gold in their foreign exchange reserves

Emerging-market central banks have shifted to being net buyers of bullion, while Western central banks have effectively stopped selling gold

In 2011, central banks bought c456t of gold and about the same for 2012

We believe that central banks will buy at least 400t of gold this year

Gold as a % of currency reserves



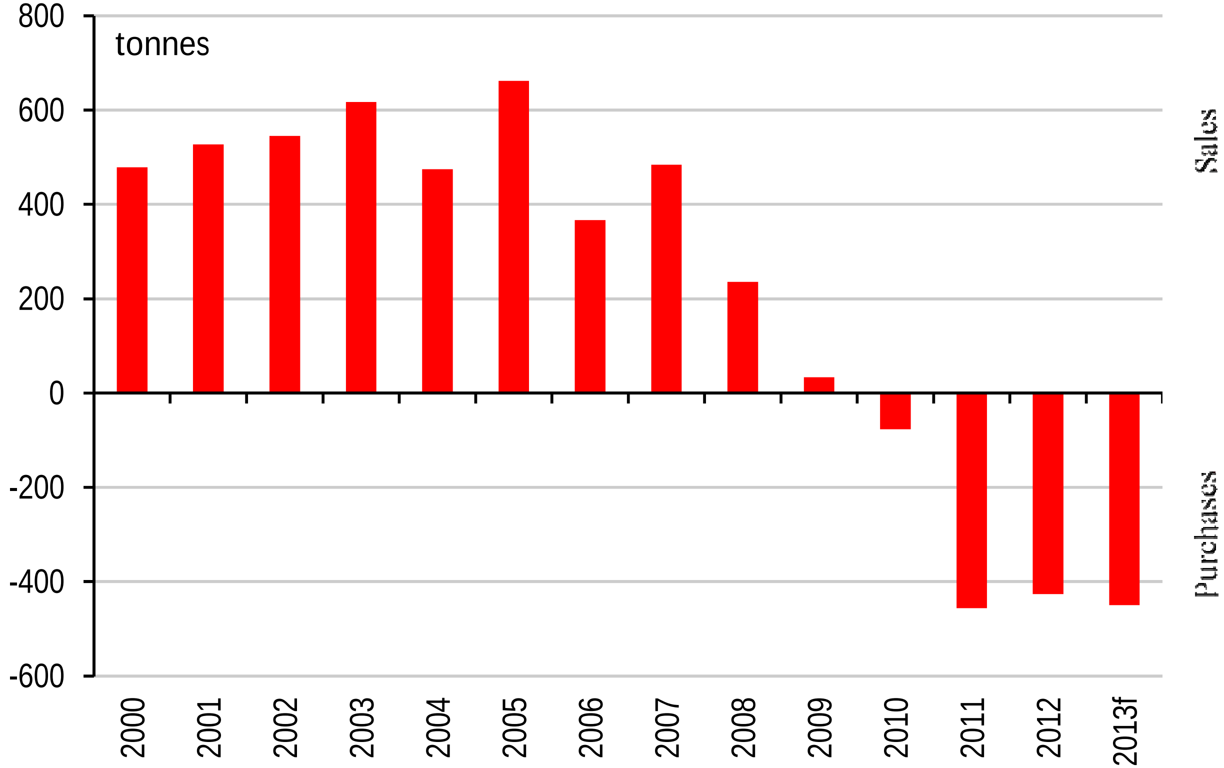
Source: WGC/IFS

Gold and central banks

Central banks have swung to being net buyers of bullion for some of the following reasons:

- **Gold is historically used 'war chest' or in times of crisis**
- **Can be utilized to settle underlying balance of payments deficits**
- **Can be useful in stemming a run on a currency**
- **Is a traditional proven diversifier in a US dollar-laden portfolio**
- **High gold reserves have significant prestige value**

Gold sales and (purchases) by the official sector



Source: Bloomberg, HSBC, World Gold Council

Gold and central banks since 2012

Official sector buyers are comprised entirely of Emerging Market and transitional nations

Sellers are few, with most bullion sold to support domestic coin minting programs

The slide in prices is likely to encourage central bank appetite for gold

Central bank gold purchases/sales, 2012 to present (tonnes)

Purchases	
Turkey	214
Russia	99
Korea	50
Kazakhstan	41
Brazil	34
Philippines	34
Iraq	24
Mexico	18
Paraguay	8
Ukraine	8
Belarus	6
Others	25
Sales	
Czech Republic	-1
Germany	-5
Sri Lanka	-12

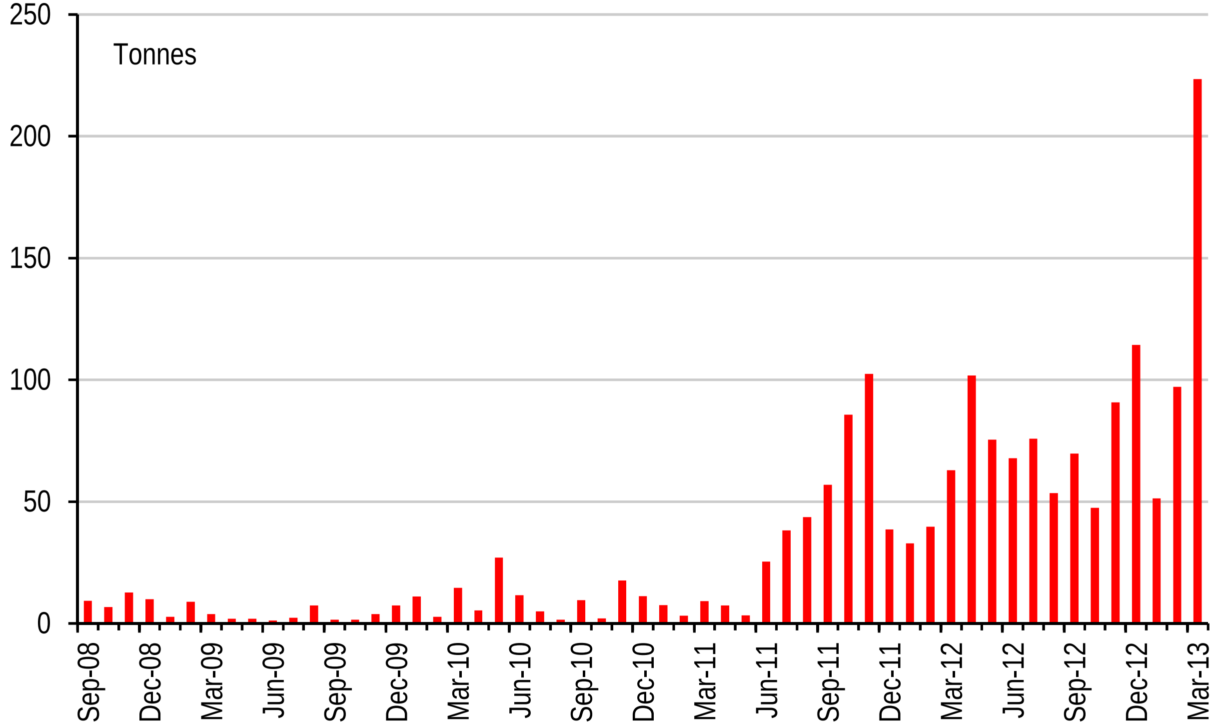
Source: HSBC, Thomson Reuters Datastream

Gold and China

The drop in prices has set off a wave of demand in price sensitive gold-consuming nations

This chart shows the strong increase in imports into China from Hong Kong in reaction to lower prices

China gold import from Hong Kong



Source: HSBC, Hong Kong Census and Trade Statistics

Gold mine production

High prices have stimulated production, and gold prices are still well above marginal costs of production

There is no Saudi Arabia of gold

Gold production is constrained by:

•Falling grades

•Inadequate infrastructure

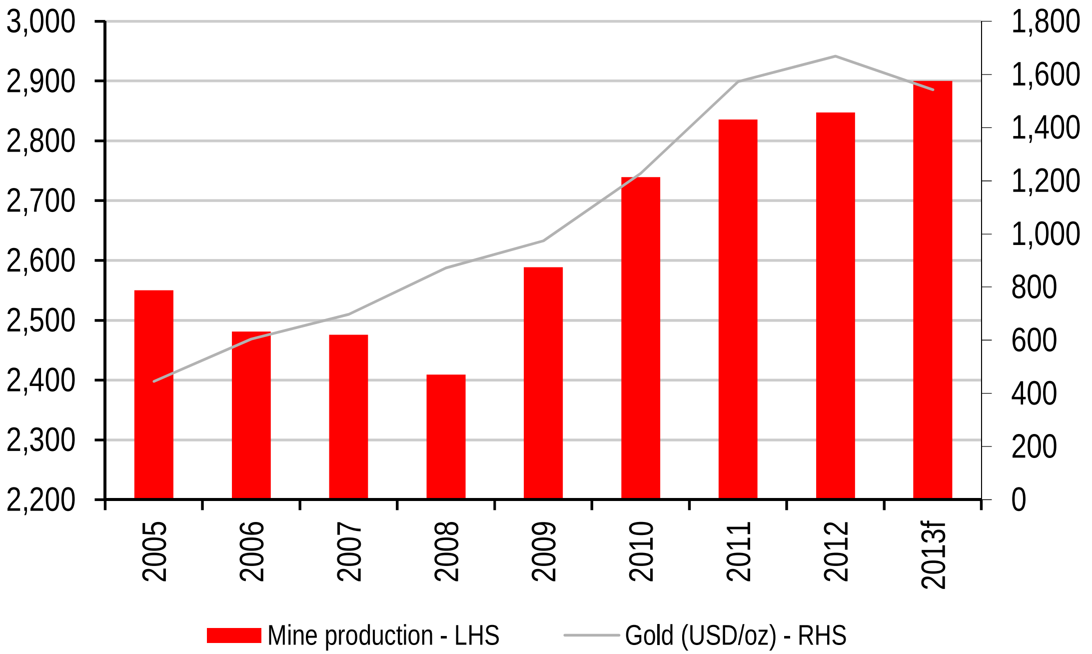
•Resource nationalism

•Power and fresh-water shortages

•Labor and skilled personnel shortages

•Long waiting times for mining equipment

Gold mine production (tonnes)



Source: HSBC, Thomson Reuters/GFMS, Bloomberg

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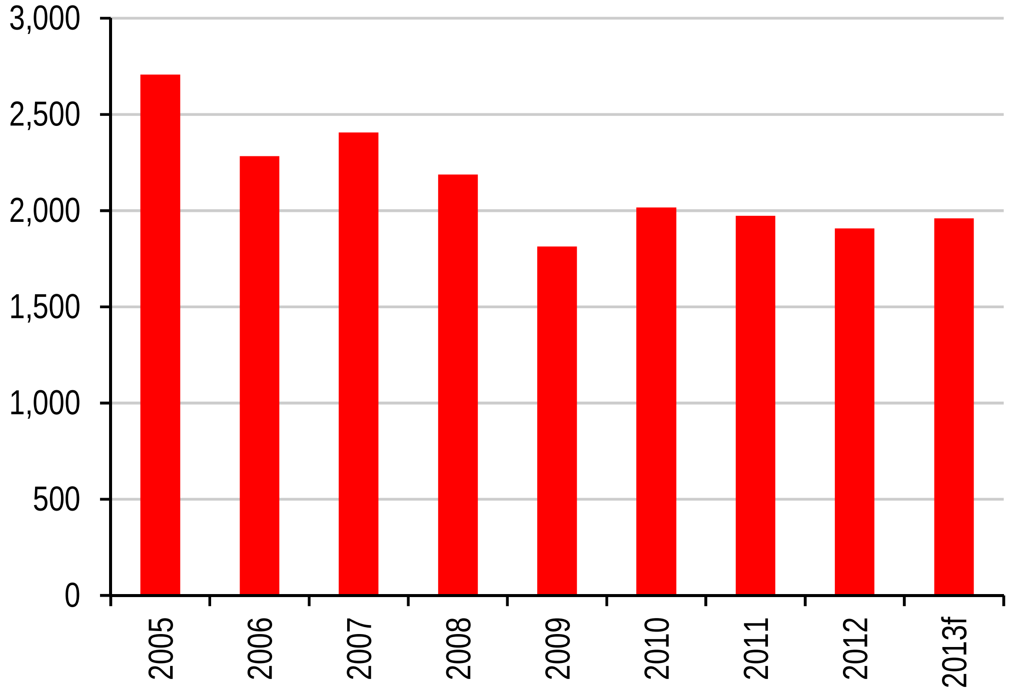
Gold jewelry demand

Jewelry is the biggest single source of physical demand, but it is losing market share to investment

Emerging-market gold demand is highly price-sensitive; this is helping to make gold prices more volatile

The recent price plunge should encourage greater physical demand

Gold jewelry demand (tonnes)



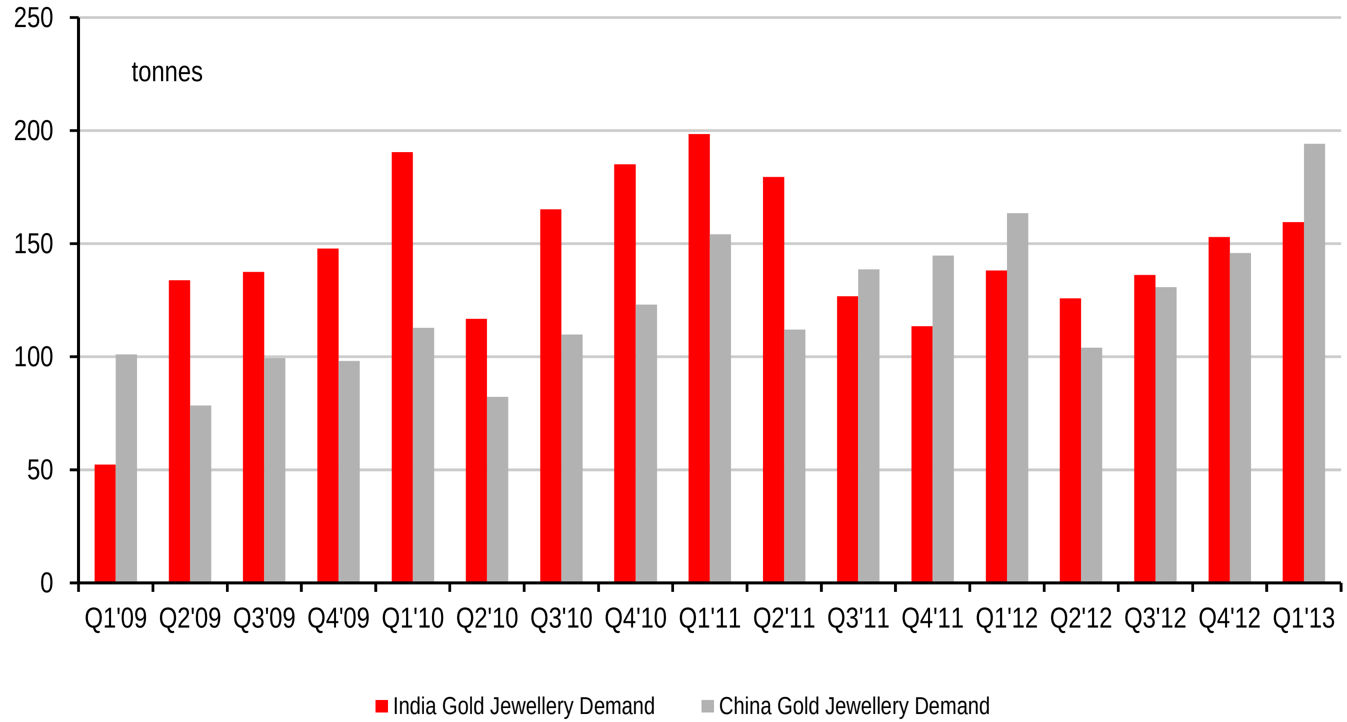
Source: HSBC, Bloomberg, World Gold Council

India and China: Gold jewelry demand

Both nation's demand for gold jewelry has increased, in reaction to lower prices

The two nations together account for more than half of gold jewelry demand worldwide

India and China: Gold jewelry demand



Source: Bloomberg, HSBC, World Gold Council

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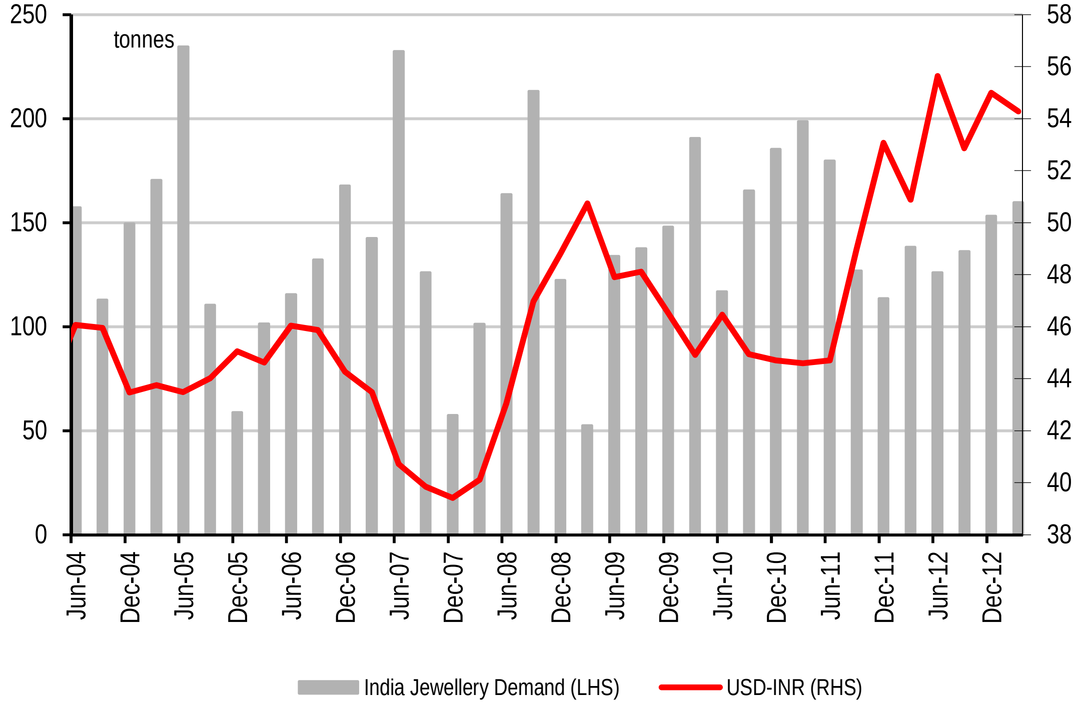
Indian gold jewelry demand and the INR

The weaker the INR, the lower local gold demand is, typically and the stronger the INR the greater demand

We expect to see a notable rise in Indian demand this year but this is more because of weaker gold prices in USD terms than because of a stronger INR

Indian gold jewelry demand and the INR



Source: Bloomberg, HSBC, World Gold Council

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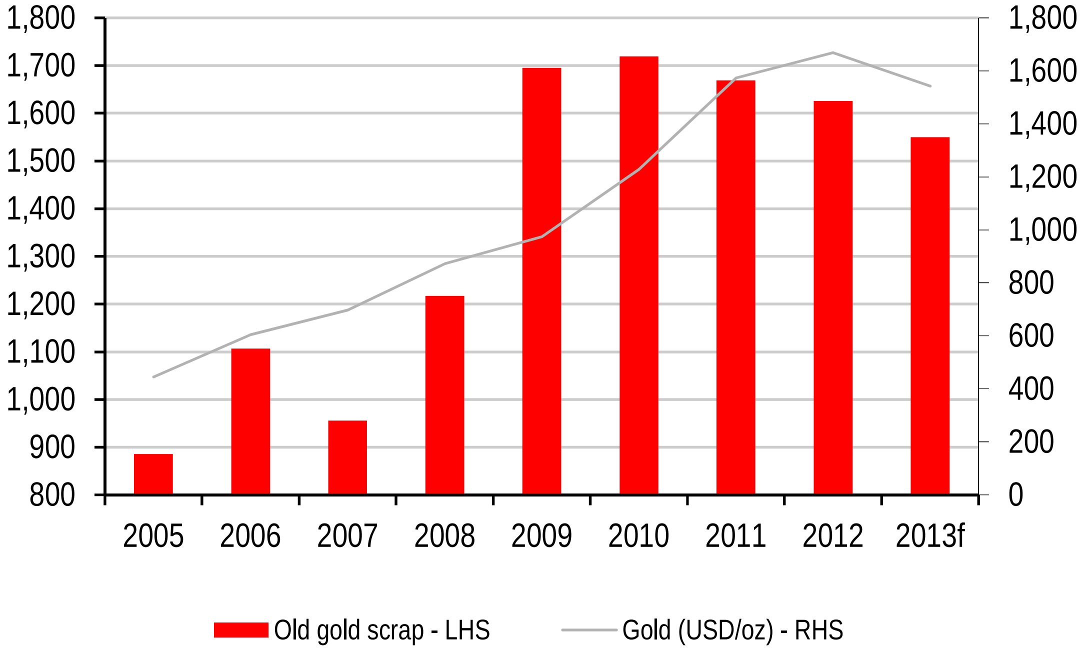
Gold scrap

Higher prices have helped trigger a surge in recycled gold

In addition to higher prices, economic hardship has buoyed scrap supplies until recently

The drop in prices will discourage price-sensitive scrap supplies

Old gold scrap (tonnes)



Source: HSBC, Bloomberg

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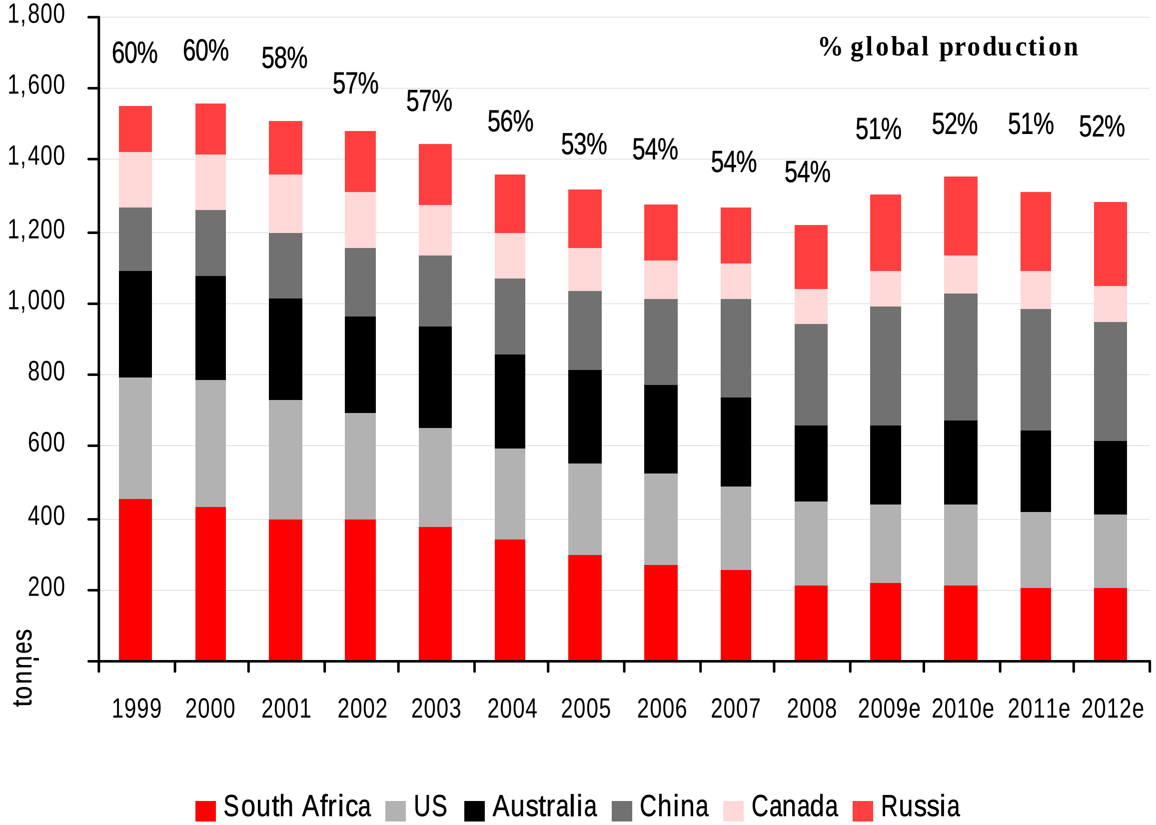
A question of reserves

Traditional producers are losing market share due to declining reserves

Gold reserves in major producing countries



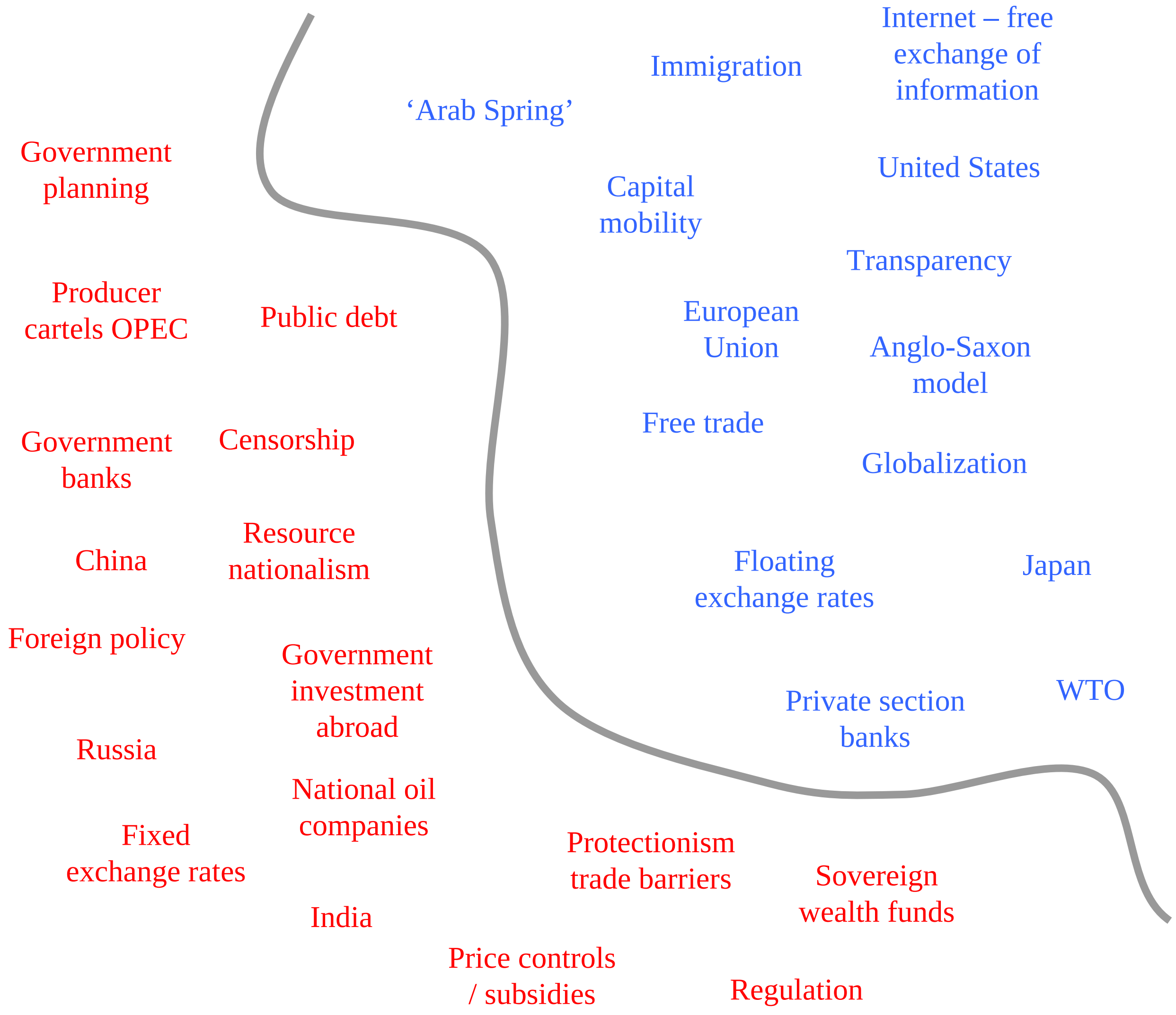
Source: USGS, GFMS, HSBC

Gold and free markets versus less-free markets

Gold prices tend to fall during periods when free markets are on the ascent

Gold tends to rise when governments intervene more in the economy

The global financial crisis has shifted power away from free markets and toward more government intervention



Left grouping = State intervention. Right grouping = Free market approach.
Source: HSBC

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