

OBSERVATION

TD Economics



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THE BULL MARKET FOR GOLD IS FIRMLY IN THE REAR VIEW MIRROR

Highlights

- The collapse of the price of gold seen in 2013 was the metal's worst showing in the last three decades, with a decline of 29% in the year to about US\$1,200/troy oz. Not surprisingly, gold was one of the worst-performing assets in 2013, bringing its decade-long, bull market rally to an end.
- Gold's demise in 2013 can be chalked up to several factors including: growing expectations of a scaling back of U.S. central bank asset purchases, stellar stock market performances which give investors plenty of alternatives to secure a return elsewhere, import restrictions for gold in India, and a strengthening greenback relative to other major currencies.
- While demand softened for electronically-traded gold, the same cannot be said for the consumer demand of bars and coins. A case in point, as gold prices dropped throughout 2013, demand for jewellery surged across key consuming markets like China and India.
- Over the near-term, gold is not poised to take another severe beating. Instead, we foresee prices stabilizing. We expect the yellow metal to hover around US\$1,175 in 2014, before rebounding slightly to US\$1,280 in 2015.

Over the past decade, gold has been one of the best performing asset classes. Gold's momentum crashed into a wall in 2013, with a loud bang. The price of gold plummeted by 29% last year – its worst showing of the last three decades. Bullion is now trading in the US\$1,245 range, well off from the record high of US\$1,895 posted in early September 2011. It was not one fatal blow that brought down the yellow metal in 2013, but instead, a rapid fire of negative forces, with each successive bullet doing more damage than the previous one. In this report, we take a look at the reasons behind gold's tumble and then turn our attention to where prices are headed.

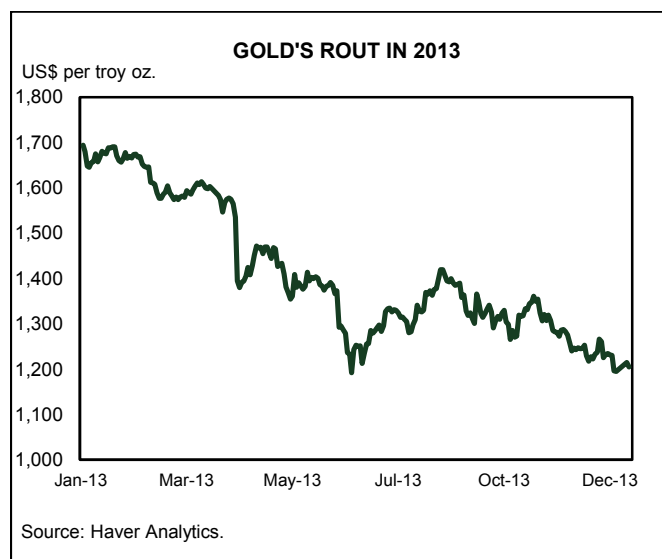
The factors that led to the gold balloon popping

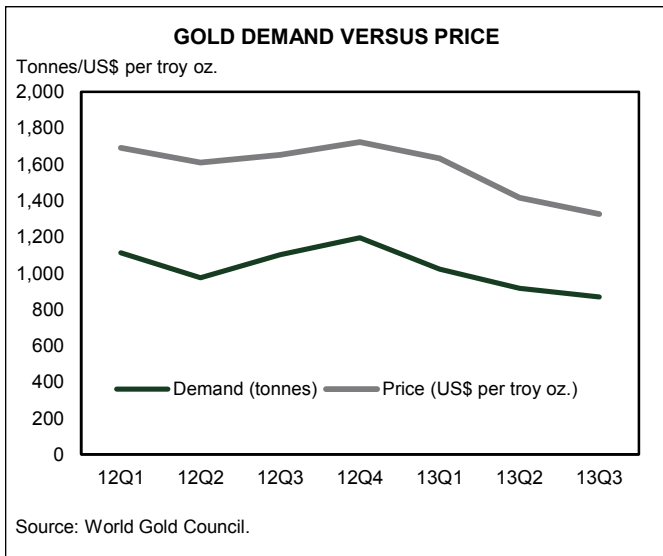
There was not one thing that popped gold's balloon in 2013, but many. We are able to identify four developments that collectively brought the metal down, bringing an end to gold's decade-long bull market rally.

a) The Cyprus bailout discussion spooked markets

In April 2013, speculations grew rampant that Cyprus might be forced into selling its gold to finance a €400 million bailout. While Cyprus' share of the global gold supply (roughly 10 tonnes)

is negligible in the grand scheme of things, the possibility of a euro zone country selling off its entire reserves to meet fiscal funding pressures spooked markets, as it triggered speculation that the same recipe





could be imposed on Italy. The latter holds around 2,500 tonnes of bullion. In light of the uncertainty and speculation, the precious metal fell below US\$1,500 per troy oz for the first time in eighteen months. After some intense negotiations, Cyprus received its bailout package and did not have to sell-off its gold reserves. The market breathed a huge sigh of relief in response. In the weeks that followed, gold rebounded from a low of US\$1,380 to a high of US\$1,470 in early-May.

b) Gold investment demand wanes due to better alternatives

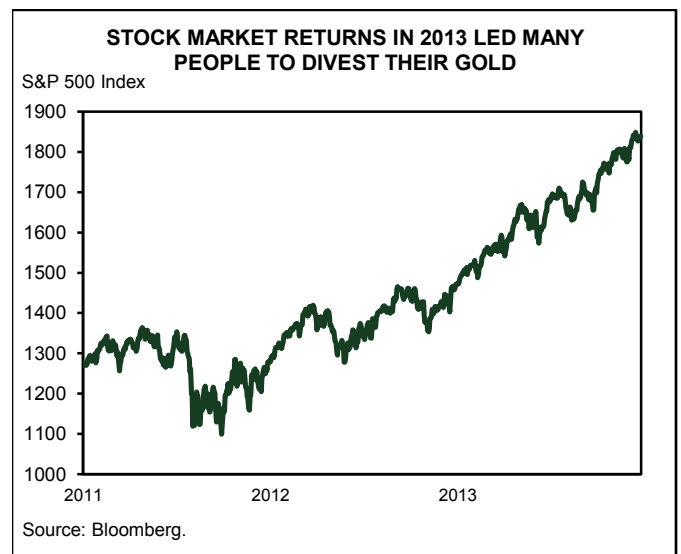
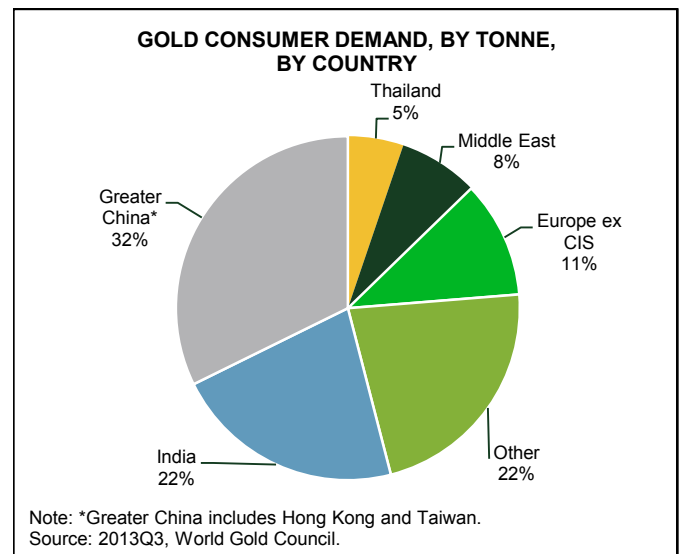
When speculation grew rampant surrounding Cyprus, gold exchange-traded funds (ETFs) were the first to feel the pinch. This is not surprising, as money flowing into these funds, combined with the physical purchases of bullion to back the funds, tend to accentuate both upward and downward price movements. The world’s largest gold ETF, the SPDR Gold Trust, saw the third-largest withdrawal in history in a period of just four days. As the year progressed, investors continued to move away from gold ETFs. According to the World Gold Council, gold investment demand, as measured in tonnes, fell 56% in large part due to the outflows of ETFs in 2013Q3. Preliminary numbers from Q4 do not point to a noticeable improvement.

Beyond sour sentiment, why were investors suddenly flocking away from electronically-traded gold? One plausible explanation is that there were better return alternatives for investors. In 2013, stock markets around the world registered double-digit increases. A case in point, the S&P 500 saw a 26% year-over-year increase in 2013, the largest annual gain in fifteen years. Double-digit gains were re-

corded in other international markets as well, including the Nikkei 225 and the FSTE100. Generally speaking, yields on equities outstripped those of fixed income products in 2013. Gold could not keep up with the rest of the pack, especially because physical gold is illiquid and, much like electronic gold, it offers no dividend payment. Yields on U.S. Treasuries also rose during the year, increasing the opportunity cost of holding gold as an asset. Simply put, gold lost some of its investment lustre, in large part because investors saw greater opportunities outside of the metal.

c) India imposed import restrictions

The drop in ETF holdings led to a near simultaneous drop in gold demand. However, there was a silver lining which provided a much needed offset. Cheaper gold led to an increase in consumer demand, particularly in the jewel-



lery, gold coins and bar segments.

The spike in consumer demand was especially noticeable in India, the second largest consumer of gold in the world. Annual inflation was accelerating in the country at the same time the price for gold was falling. These two simultaneous trends reinforced the incentive for Indian citizens to buy more gold. In a mini gold rush, they purchased 15 tonnes in just three days. The increase in gold imports widened the country's current account deficit and in response, the Reserve Bank of India (RBI) imposed restrictions on imported gold in early-May. Two months later, the RBI introduced a ban on gold trading in certain special economic zones and stipulated that 20% of the imported gold had to be exported back to the source country. The government also raised import duties on gold several times. According to the World Gold Council, the policy changes collectively led to gold consumption dropping in India by 50% in Q3, although this does not capture the unofficial inflows which took place. Amid all the changes, gold prices hovered at around US\$1,192 by the end of June.

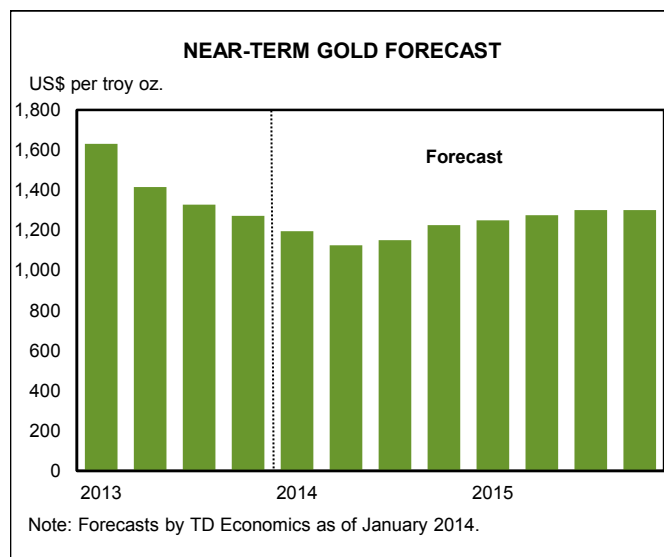
d) Central banks slowed down gold buying and U.S. QE taper talk

QE in the U.S. and the euro zone sovereign debt crisis emboldened the role of gold as both an inflation hedge and an alternative investment vehicle away from government bonds. When the euro zone crisis abated and the market began to speculate about the end of QE, and inflation fears proved squarely wrong, gold simply lost its appeal.

In the months that followed Chairman Bernanke's comments about a near-end to QE, capital outflows, particularly in emerging markets, reduced central bank's ability to purchase gold. Additionally, the comments lent strength to the U.S. dollar. On a trade-weighted basis, the greenback increased by 3.2% in December 2013 versus the year prior. Commodity prices, including gold (which are priced in U.S. dollars) experienced downward pressure. Markets would have to wait for the actual QE taper until December 2013, but at that point, they had largely priced in the lesser stimulus. All told, gold was worse for the wear, closing 2013 at close to US\$1,200.

What's in store for gold in 2014-15?

We do not foresee another rout for gold in the cards for 2014-15. In fact, the metal is up 3.8% since December 31st, as of the time of writing. Although some of the recent headwinds will ease, the outlook for the metal still harbours some challenges. Moreover, we believe supply/demand



expectations and fluctuations have already been priced into the gold market. As a consequence, we project that gold prices will stabilize over the next two years, hovering around US\$1,175 in 2014, before rebounding to US\$1,280 in 2015.

The U.S. Federal Reserve will proceed with tapering its asset purchases, which will likely further drive up the U.S. dollar against other major currencies. The currency trek upward will create a headwind for commodity prices, including gold. However, the Fed will be very patient in its unwinding efforts in order to keep a lid on bond yields. Accordingly, while U.S. bond yields look set to rise further in 2014 and 2015, the increases in store will be modest and gradual in nature.

Low interest rates give support to investment demand in gold, but overall investor appetite will be compared to other return-generating assets. Over the near-term, equity markets are likely to remain a strong competitive lure for investment flows, but broad returns – particularly in the U.S. – are likely to cool compared to 2013. As short- and medium-term interest rates move off of record lows, fixed income instruments will also grow increasingly more attractive as an alternative to gold.

On the plus side for gold, the Bank of Japan will continue to print money and other central banks will keep ultra-easy monetary conditions in place. We do not expect central bankers to become net sellers of gold over the near-term given the continual need to diversify foreign reserves.

China is now the largest consumer and producer of gold in the world. India is not too far behind in terms of consumer demand. We forecast that physical gold demand for these two countries will stay strong, particularly for coins, bars and jewellery. The media have speculated that the India

government may soon reverse course on some of the import restrictions implemented in 2013. Two reasons have been proposed. First, the policy change led to an unintended increase in unofficial inflows. Second, the current account deficit in India has noticeably improved since the measures were implemented. If restrictions were made less stringent, gold prices would face upward pressure. A growing middle class and rising personal disposable incomes in China, India and other emerging markets also lends support to relatively strong consumer demand over the near-term.

According to the World Gold Council, a fluctuation in gold supply is not poised to be a major factor over the forecast horizon. The lower gold prices of late have likely tempered the amount of supply added onto the market. Producers have also ramped up efforts to cut exploration costs, in order to maintain mine profitability. However, if gold import restrictions were to be relaxed in India, gold supply may once again come under pressure.

Conclusion

In light of all the moving parts, gold prices will likely stabilize over the next two years. The forecast is split across advanced and emerging economies and the type of demand. With improving consumer and business confidence and better performances for advanced economies, the opportunity cost of holding an asset such as gold, which does not generate a stream of income, vis a vis equities or fixed income will continue to rise. By contrast, emerging markets will likely still rely on the metal as a means to diversify foreign reserves and a hedge against U.S. dollar weakness. Consumer demand for physical gold in China, India and other markets is also expected to stay strong due to a growing middle class and greater disposable incomes.

From a portfolio perspective, there is still room for gold to help hedge against nasty, unexpected surprises. However, investors will likely see a smaller return on the precious metal than has been the case over the past decade.

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