

# The SA Bullion Gold Report

Q3 2011

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 Date: 17th October 2011

## Gold Performance to 30 September 2011 (% per annum)

	Quarter <sup>2</sup>	1 Yr	2 Yr	3 Yr	5 Yr	10 Yr
Gold in USD	7.6	30.2	27.6	22.4	22.0	18.6
Gold in ZAR	28.1	37.4	31.6	21.3	22.9	17.3

<sup>1</sup> Based on LBMA Afternoon Fix

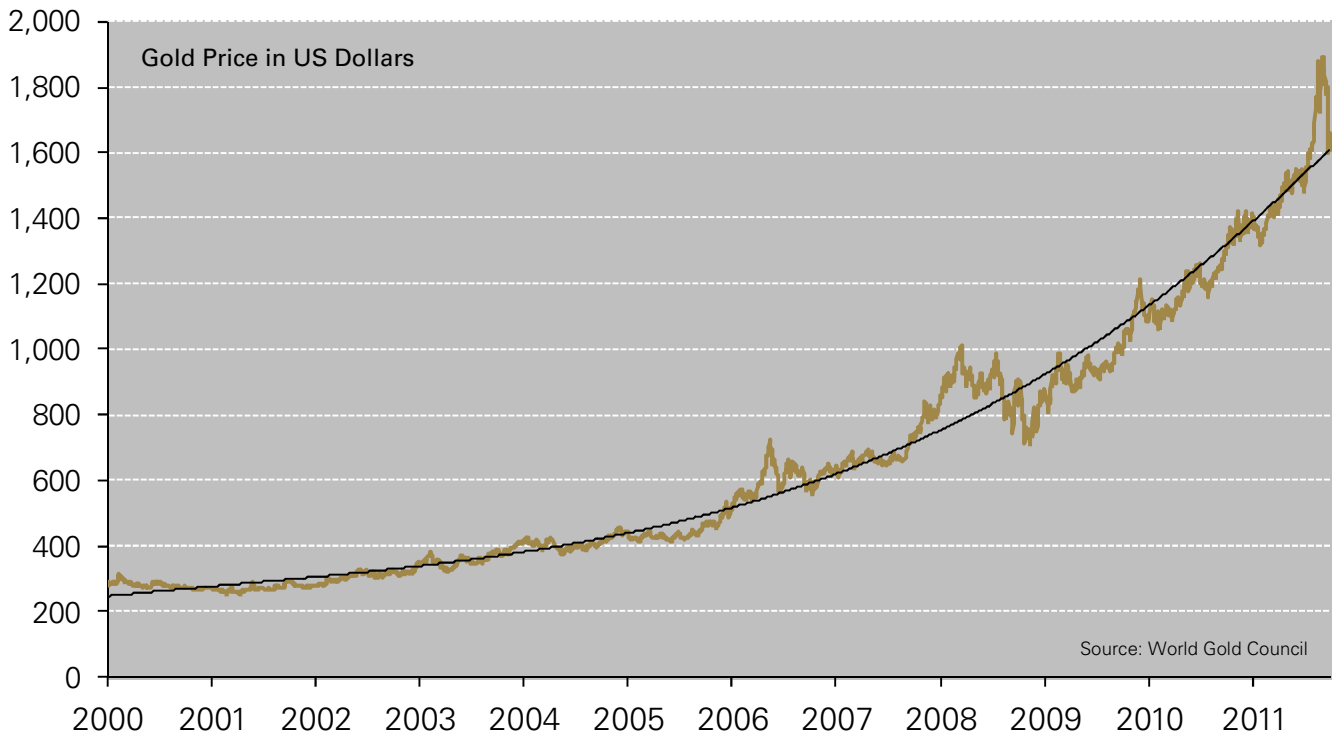
<sup>2</sup> not annualized for periods of less than 1 year

## Gold Prices

	Gold in USD/oz	Gold in ZAR/oz
30 Sep 2001	293.10	2,639.95
30 Sep 2006	599.25	4,655.06
30 Sep 2008	844.50	7,324.23
30 Sep 2009	995.75	7,545.29
30 Sep 2010	1,244.00	9,508.89
30 Jun 2011	1,505.50	10,199.01
30 Sep 2011	1,620.00	13,068.70

Note 1: The above prices are LBMA Afternoon Fix prices.

Note 2: At time of writing gold prices were \$1,678.00 and R13,176.99



## Gold Price Action

The most striking aspect of price action in this past quarter was the massive run-up to new all-time highs followed by a large retreat. Looking through all the noise and clutter, the big picture information is as follows:

	In US Dollar	In Rand
Start of quarter	\$ 1,505.50 (30/06/2011)	R 10,205.78 (30/06/2011)
Followed by price rise of	25.9%	39.6%
High point of	\$ 1,895.00 (05/09/2011)	R 14,243.26 (22/09/2011)
Followed by price decline of	-15.7%	-10.8%
Low point of	\$ 1,598.00 (26/09/2011)	R 12,709.55 (29/09/2011)

The obvious question to ask:

In this gold bull-run that commenced in 2000, is this price action with or without precedence?

The simple answer is that the big swings we saw this past quarter pale in significance compared to the swings that we saw at the time of the first banking crisis in 2007-2009. The movements that we saw at that time are summarized as follows:

	In US Dollar	In Rand
Start	\$ 657.50 (21/08/2007)	R 6,210.00 (15/08/2008)
Followed by price rise of	50.3%	62.6%
High point of	\$ 988.50 (03/03/2008)	R 10,098.00 (20/02/2009)
Followed by price decline of	-27.2%	-28.1%
Low point of	\$ 720.00 (23/10/2008)	R 7,263.18 (01/07/2009)

Subsequent to quarter-end, prices have risen in both US Dollar and Rand and at time of writing post prices of \$1,678.00 and R13,176.99.

The next question would be:

Has this big swing altered the long term picture for gold?

Again, a simple answer: no. This bull-run for gold is structural and fundamental. It does not find its cause in short term technical factors but in macro issues that will take decades to resolve.

And finally: By way of comparison, what did some of the major markets and indicators do in this past quarter and year?

	Third Quarter	Last 12 Months
Dow Jones	-13.3	1.2
S&P 500	-15.6	-0.9
Nasdaq	-14.2	2.0
FTSE 100	-14.4	-7.6
Paris CAC	-25.6	-19.7
Frankfurt DAX	-25.8	-11.7
JSE All Share	-7.1	0.7
Rand/Dollar	-21.1	-17.1
Rand/Euro	-11.1	-14.2
Gold (\$)	7.6	30.2

As you will have noticed from the table above, this past quarter was truly awful for almost all investors. About the only investors who were spared were those in gold and cash - but not South African cash. Or for that matter, European, British or Japanese cash either. The currency of the quarter was the US Dollar. We will discuss the reasons in the next section.

## Macro Picture

Physical demand for gold bullion has been firm throughout the quarter, but the big variable has been institutional speculators who increased their 'long' positions in the derivatives market and in so doing drove the price of gold up too far and too fast, followed by their mass stampede for the exits when other asset markets sold-off and caused forced liquidations in the gold markets and some panic selling.

### *Europe*

The big news driver this past quarter was the US credit rating downgrade by S&P on 5 August followed by an even more important Spanish credit rating downgrade. Along with the Greek sovereign crisis, French and German bank crisis, Italian debt problems and EU/ECB/EFSF leadership issues, we witnessed Europe in trouble and a flight from the Euro to the dollar. And gold was a victim in this flight to safety. More recently, a Franco-German plan to support banks in danger of going bust has assisted in returning some order to Europe and optimism to the Euro. Gold has rallied accordingly.

The emergence of the EFSF (European Financial Stability Facility) is the first properly coordinated effort of the Eurozone. The primary objective of the EFSF is to assist member countries when they experience difficulties in raising capital and their debt yields are skyrocketing. The EFSF will also loan funds to member countries such that they may on-lend to banks in order to strengthen their balance sheets or to provide liquidity in times of crisis. The facility is enormous at Euro 440 billion. But in a true 'liquidity event' it will undoubtedly prove to be too small. As will any amount that governments might try to package.

The EFSF follows the ECB bailouts of \$1 Trillion in May 2010. The bailouts thus far have prevented the 'first domino' from knocking over the 'second domino' and have therefore averted contagion. We don't expect contagion and a collapse of the financial system. We expect the best possible outcome – many years of ongoing crises which get fixed by taking the pain in the currency.

In one of the most astounding moves of recent times, on 6 September the Swiss National Bank (SNB) announced a ceiling to the value of the Swiss Franc (CHF) in its exchange rate with the Euro. The central bank announced that they would not permit their currency to become worth more than 83 Euro cents. [Note: In actual fact they stated the peg the other way around by saying that they have put a floor in place and will not permit their currency to be worth less than 1.2 Euros – but I find these double negatives not to be intuitive and so I have turned the equation around and made the floor a ceiling. I hope you also find this easier to understand!].

In the last year or two the Swiss Franc has appreciated dramatically relative to the Euro. This of course is due to both the collapse of the Euro and the flight into the CHF as it has been one of the ultimate safehavens for a very long time. What astounds us now, is not that the Euro is collapsing, but that Switzerland has come out and stated that they will not be beaten in the 'race to the bottom' and that they have thrown in their lot in the great currency race to the bottom. If this isn't a ringing endorsement of our 'race to the bottom' thesis regarding currencies, nothing is!

Eurozone problems can be negative for gold in the short term but long term these problems are very supportive of gold prices, particularly as they are issues related to global growth which in turn have a very substantial bearing on the future economic wellbeing of the United States.

### *United States*

The other big news of this past quarter was the announcement by the US Federal Reserve of its plans to implement 'Operation Twist', as previously performed in 1961. This operation entails the Fed selling \$400 billion of its short-dated debt portfolio and using the proceeds to purchase long-dated government bonds. In so doing, the Fed intends to overpay for the long bonds and in the process lower the yield on these bonds. The primary objective of this massive market manipulation is the lowering of long term interest rates so as to prop up the US housing market and assist business investment.

Keen students of Fed activities will recall that the Fed believed it could successfully kick-start the US economy with Quantitative Easing. Following this failure it believed it could succeed with QE2. This plan didn't work either. And we have very serious doubts about the likelihood of success with Operation Twist. The bottom line is that a great global credit contraction is far, far bigger than can be controlled by any government or government agency. With high structural unemployment, high household debt, high corporate debt and high government debt, any great increase in final aggregate demand is many, many years away. Tough times and economic hardship are unavoidable for a decade or more, and deteriorating currencies, including the US Dollar, will be a reality as governments work off their debts in depreciated currency units.

Presenting a very conflicting picture coming out of the US is that while the Fed works to 'ease', so the political parties fight to trounce each other with austerity plans. The government is working to tighten up on budget deficits and even increase taxes and allow previous tax breaks to expire! It is no wonder that the youngsters in the 'Occupy Wall Street' movement don't understand causes and consequences!

Of this we can be sure – interest rates will stay ultra-low for very long. In keeping rates close to zero while inflation is in high single digits, savers will continue to be damaged and the currency will continue its bumpy decline. Gold will be a beneficiary of Dollar decline.

### Deleveraging – An Illustration

Clients of SA Bullion know that our investment case for gold turns on an understanding of ‘the bad times’. Naturally, therefore, I am often asked to describe the defining characteristics of ‘the bad times’. My answer usually begins with the words ‘great credit contraction’ or ‘great deleveraging’. Whilst I don’t propose to restate our investment case here (It can be found on our website, unchanged since 2007), I wish to entertain you with an illustration of a contraction effect.

In the good times credit is cheap (low interest rates) and plentiful (banks and businesses actively promote uptake of credit). During this time asset prices rise as interest rates decline and credit chases after investments.

- Many business people expect that the conditions will persist indefinitely and they develop their businesses based on inexpensive credit.
- Many ordinary people with savings watch the fortunes being made in the asset markets and can’t resist borrowing money to buy shares, houses and so forth to participate in the great ‘wealth creation’.
- Many consumers without savings can’t resist the trappings of wealth and good-living and borrow to spend on cars, holidays, plasma screen TVs and granite counter tops.
- Many pensioners can’t get by on the meager interest paid by banks in these times and “invest” in risky assets for capital gains.
- Governments massively overspend on pet programs and projects and run up huge debts.

### Then the deleveraging begins....

Some unlikely and seemingly arbitrary event (such as a change to an accounting rule) exposes a business that then goes bankrupt. A bank gets knocked over by that business, and in turn knocks over some related banks. Banks become panicky and tighten credit conditions by making new credit virtually impossible to obtain. Businesses and people suffer cash flow problems and go bankrupt. Asset prices fall in the face of negative sentiment setting off a wave of bankruptcies.

In the face of a financial system melt down, the already highly indebted governments step in to rescue the banks, and in so doing incur vastly more debt (known as the ‘socialization of debt’).

The vulnerable sovereigns (countries) watch their national debt levels reach the size of their economies (e.g. US national debt is \$15 trillion. US economy is \$15 trillion) or greater. These nations then receive credit rating downgrades as the risk of default rises. New government bonds are issued at much higher yields (i.e. the new creditors demand higher rates of interest for new higher levels of risk) and in so doing re-price all the bonds in existence – downwards. As major holders of government bonds banks take a hammering as the value of their assets get revised downwards. These banks start looking tenuous and depositors start withdrawing their cash. The threatened banks now face not only a solvency issue but also a liquidity issue, as they scramble to find cash to repay to the fleeing depositors. The ‘run on the bank’ causes a complete seizure of operations and the previously vulnerable bank goes bankrupt.

At this point the banking regulator and government should step in to ensure that the failure of a bank does not result in a domino effect for other banks. Government might have to provide a ‘bailout’ to the failed bank to ensure there are no further repercussions.

Unfortunately however, the bailouts themselves put pressure on government resources, and in difficult times with high levels of national debt governments are usually not in a position to provide support to banks without consequences. And so we see that an ugly cycle becomes self-sustaining and repetitive. This carries on until there has been a massive purging of the entire system and unfortunately there is a very big price to be paid.

In a great deleveraging everyone is affected, even those with no debts and with intact savings. Ultimately the price has to be paid in the currencies. Currencies decline in value for years and years and rising inflation relentlessly eats into the wealth of the citizens. One doesn’t own gold because of the likelihood of a systemic meltdown. This is why one owns gold.

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