BBGI GROUP Global Investments

June 7, 2016

Gold posts biggest quarterly gain in 30 years: the sign of a new beginning?

Global demand for physical gold up +21%. Investment demand returns in force. Supply limited by weak margins and capex cuts.

Key points

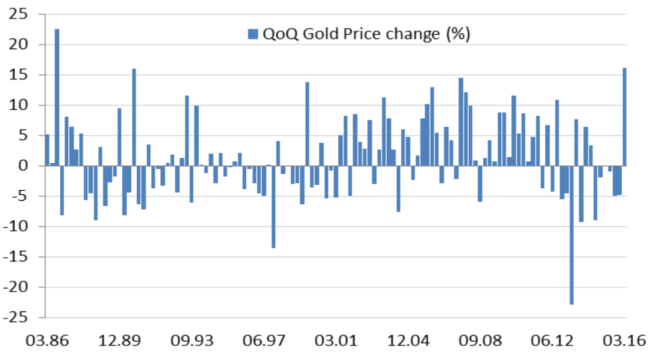
- Rise in gold prices in the 1st quarter of 2016: a record since 1986
- +21 % rise in global demand fuelled by ETF purchases
- Response to Brexit fears
- Gold rises in all currencies
- Strikes in India temporarily hinder demand for jewellery
- 21st straight quarter of net purchasing by central banks
- Gold production limited by capex restrictions
- Limited rise in hedging operations
- Gold produces no earnings… nor do government bonds
- Gold once again considered a safe haven
- Fundamentals favourable to a continuous rise in gold prices in 2016 and 2017

Gold prices reach a record high since 1986 in the first quarter of 2016.

The +16.4% rise in gold prices in the first quarter of 2016 is the largest quarterly rise recorded since 1986. Indeed, we have to go back to the third quarter of that year to find a larger rise (+22.49%). At that time, the price of an ounce went from $345 to $423 before reaching $500 in December 1987.

The first quarter was also characterised by the largest rise (+20.58%) in investments in physical gold held in ETFs since March 2009. The return of investors to gold after the first stage of normalisation of U.S. monetary policy and some 12 quarters of regular and almost uninterrupted divestments from ETFs except for a slight increase in demand in the first quarter of 2015 (+1.43%) is certainly significant.

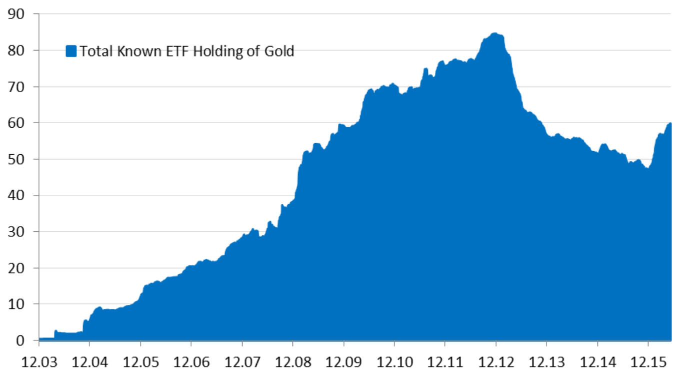
Quarterly performances of gold (1986-2016)



Sources: Bloomberg, BBGI Group SA

Investment demand was one of the main factors driving gold prices down since 2012. Global ETF holdings of physical gold fell from 84.6 million ounces in December 2012 to a mere 46 million ounces as of 31 December 2015, indicating a complete lack of interest on the part of investors resulting in the sale of 38.6 million ounces, i.e. approximately 1,200 tons of gold.

Total known ETF holdings of gold



Sources: Bloomberg, BBGI Group SA

Compared with the annual worldwide production of gold (an average of 3,000 tons/year over 5 years), the sale of 1,200 tons corresponds to 40% of the entire production of mining companies worldwide. Even spread over three years, this large influx of physical gold in the market considerably disrupted the balance between supply and demand and drove prices down.

However, the excess supply was mainly absorbed by Asian investors, who hold physical gold in other forms than dollar-denominated ETFs, as suggested by gold exports to Hong Kong and China.

The return of mostly Western investors in this market segment and in listed ETFs will once again be an essential determining factor in the future movements of gold prices. The normalisation of private and institutional investor exposure to this asset, which is currently almost entirely non-existent, will have positive long-term effects on gold prices.

+21% rise in demand fuelled by purchases in physical ETFs

Investment demand has increased by +363 tons in the first quarter, pushing global demand for gold to 1,289 tons. This increase is significant and represents a +21% rise relative to consumption in March 2015. At the same time, demand for jewellery decreased by -19%, from 596 tons in Q1 2015 to 481 tons in Q2 2016. In comparison, other demand segments showed no significant increase, while industrial/technology demand and demand from central banks decreased slightly (-3%).

Many factors have been mentioned to explain gold's return to favour with investors, though none of them seem very new. They include chiefly accommodative monetary policies, marked in Europe and Japan by negative interest rates and unconventional policies, the effects of which remain difficult to assess and are a source of uncertainty. The fall in oil prices, the consolidation of the dollar and a renewed sense of wariness regarding global economic growth were also mentioned at the beginning of the year as new risk factors, which raised further questions in relation to the rhythm of normalisation of key rates in the United States. Uncertainty in the first weeks certainly supported the rise in gold prices. Yet, even though uncertainty has since subsided somewhat, to the substantial benefit of equity markets, gold has not suffered any significant profit taking.

Could the uncertainty of the result of the Brexit vote, which will take place on 23 June, be buoying investment demand in the short term?

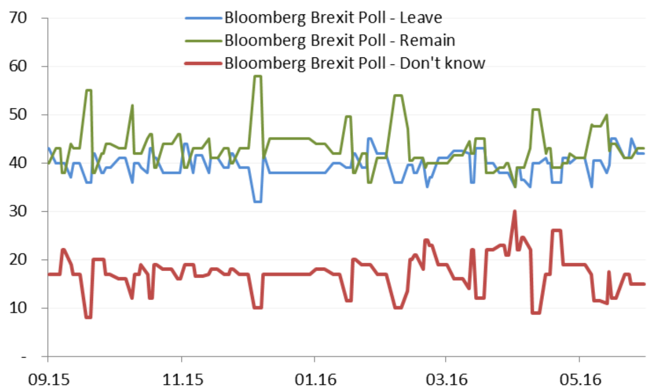
It would seem that inflows are originating from a broad investor base, both institutional and private, taking long-term positions once again after three years of consolidating prices and a positive test at the $1,200/ounce level. Thus, these investors have joined those who had positioned themselves to capitalise on the momentum of the rise in prices that began in the first week of the year. It is also particularly interesting to observe demand trends in ETFs in China, which have grown exponentially these last few months. Although not decisive on the international ETF market, Chinese ETF assets have nevertheless doubled thanks to new investments representing over 11 tons.

This favourable trend seems to have continued in recent weeks, with Brexit fears still in the background.

A response to Brexit fears?

Two weeks away from the referendum in the United Kingdom, fears could grow regarding the effects of voting against remaining in the European Union. Indeed, surveys point to a tight result, as shown by polls published by Bloomberg, which indicate an equal amount of positive (43%) and negative (42%) opinions – the 15% of undecided holding the key to the final result. This extreme situation reinforces the unpredictable character of the vote and its consequences by a 50/50 probability.

Bloomberg Poll on EU Referendum – Brexit



Sources: BBGI Group SA

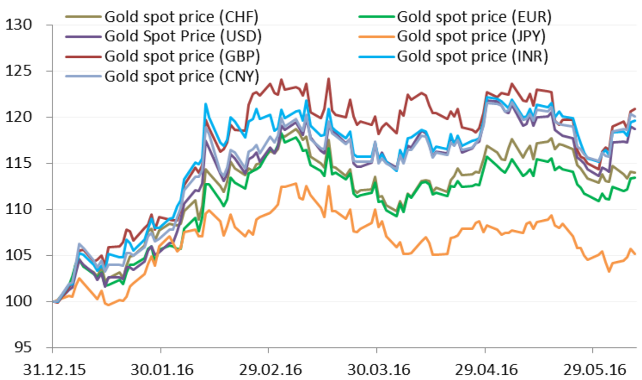
Traditional methods of management and risk diversification do not work as they would in normal circumstances in such a bipolar situation. If the vote is positive, the United Kingdom will remain in the European Union and all other factors mentioned above will remain positive and will support a new rise in gold prices.

Otherwise, the initial reaction will most certainly be even more favourable towards gold, due to rising uncertainty and the potential consequences of the vote, not only for the United Kingdom but also for the world economy.

Gold rises in all currencies

The performance of gold since the beginning of the year has been positive in all the main currencies. Investment demand increased in most regions, including the United States (+55%) and the United Kingdom, where the percentage demand for gold and coins has soared (+61%), but it is in Germany that demand has proven to be solid, thereby underscoring the importance of the European market (58.4 tons).

Performance of gold (2016 YTD) in USD, CHF, euro, yen, GBP, rupee, yuan



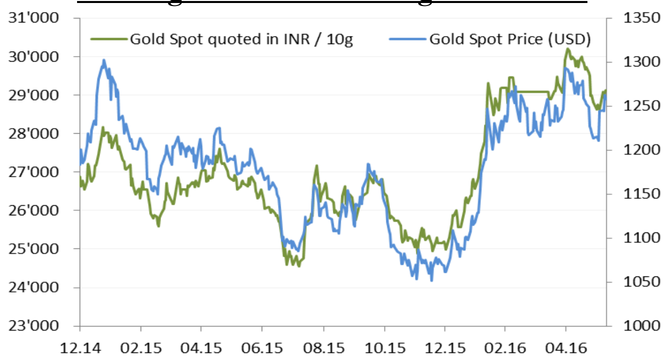
Sources: BBGI Group SA

In Asia and the Middle East by contrast, the rise in prices was accompanied by a decrease in demand, probably more sensitive to price developments. In India, demand for bars and coins thus fell by -38% to 28 tons, among the lowest levels since 2000. This weak demand can also be explained by domestic factors. In the Middle East, Iran is an exception with a +10% rise in demand (9.9 tons).

Strikes in India temporarily hinder demand for jewellery

The jewellery industry reacted to the introduction of government taxes by halting purchases as gold prices in rupees peaked and by causing a national strike, followed by the closure of most of its sale outlets. This decline in demand is clearly visible in the price differential between local and international markets, which has reached a discount of almost $40 (according to estimates by the World Gold Council). Demand for jewellery in India has thus fallen by -41% (-61 tons) compared with the corresponding quarter in 2015 to a mere 88 tons, i.e. one of the worst quarters in recent years. We believe that this drop represents postponed demand and that it will have a positive impact on consumption in the second quarter.

Indian gold – international gold discount



Sources: Bloomberg, BBGI Group SA

It is also interesting to note that demand for jewellery posted a ninth straight quarter of growth in the United States with a small +2% rise, though in a generally unfavourably climate for supply. The level of American imports seems to confirm restocking by retailers.

21st straight quarter of net purchasing by central banks

Central banks have maintained net purchases of physical gold representing approximately 110 tons this quarter. Russia and China, already the largest purchasers in 2015, were once again the most active buyers in the first quarter, acquiring 45.8 and 35.1 tons of gold, respectively. Sales by central banks were almost non-existent at approximately 6 to 8 tons.

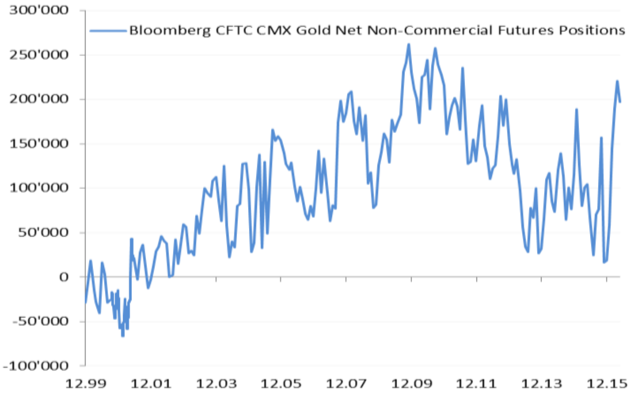
Gold production limited by capex restrictions

The nominal supply of gold produced has risen from 717 to 774 tons, while recycled gold decreased from 363 to 360 tons. Unhedged production only amounted to 729 tons, indicating stagnation in mining activity following the decrease in gold prices in the last few years. Mining companies are still focusing on rationalising production processes, seeking to reduce costs by focusing on their most profitable mines while cutting back on more poorly performing assets. New projects are also scarcer, and the decrease in capex observed in recent years will undoubtedly cause future imbalances in the market. Company rationalisation seems to be paying off, if we consider that recent assessments now indicate an average production cost ('all-in sustaining costs') of $850/ounce approximately.

Rise in hedging operations

Producers' hedging operations have intensified in the first quarter and amount to 40 tons, bringing total business hedging positions to 253 tons. The rise in gold prices was seen as an opportunity to protect margins for producers in this first quarter. Most hedging positions also seemingly aim at securing cash flow to fund operations or repay debts. These operations remain marginal by historical comparison, as they are close to levels observed since 2009, but far from the peaks that were reached in the previous decade.

CFTC gold long/short non-commercial futures



Sources: BBGI Group SA

'Speculative' positions reported to the CFTC (non-commercial long futures contracts) have also increased significantly since January, reaching the same total number of 'net long' contracts as in 2011.

Gold produces no earnings, nor do government bonds!

Investors and pension funds in particular sometimes feel that the absence of yields in this asset class is enough to remove it from any strategic allocation. Yet the long-term performance of gold since 1970 amounts to +8% per year, i.e. a little lower than international equities measured by the MSCI World Index (+9%) and a little higher than commodities (+7%), which were strongly affected by the -66% correction of the last two years.

Investors are currently faced with an unprecedented issue: most government bond yields are negative or inferior to 1%. In real terms, earnings have become even more negative since the recent pick-up in inflation. Ultra-accommodative monetary policies have not yet reached their 2% inflation objective, but inflationary expectations have increased in April to 2.8% over three years in the United States. Moreover, equity markets have been on the rise since 2009 and are beginning to reach relatively rich valuation levels. Gold has always outperformed inflation in the long term, even more so in extreme periods.

Conclusion

We believe that more and more investors will reconsider their asset allocation in 2016 and favour commodities and gold in particular in a context that is more and more risky for bond and equity markets.

Gold could act as a performance stabiliser in portfolios at a time when bonds have shed this status in an environment marked by a gradual increase in inflation and interest rates.

BBGI Group
Rue Sigismond Thalberg no 2
1201 Genève -Suisse
T: +41225959611 F: +41225959612
info@bbgi.ch - www.bbgi.ch