Economic Research

WEEKLY ANALYSIS

Alain Freymond – Partner - CIO

February 13, 2015

Investment demand in gold ETFs is turning around in 2015

+5% rise in gold ETFs holdings in January. Central banks continue to buy gold, up +17% to 477 tons in 2014, the previous high was in 2012 (544 tons).

Key Points

- Gold prices stabilize above $1,200 an ounce since June 2013
- Global liquidity is supported by EU QE programme and Japanese QQE
- Profit-taking phase after the sharp rise in January
- Consensus is negative in the short-term with only 27% bullish supporters
- ETF investment demand was up +5% after a -40% decline since 2012
- +17% increase in gold demand from central banks, Russia accounts for 36% of gold purchases
- Increase in U.S. jewelry demand
- Gold global production is stable but the recycling offer is the lowest in seven years
- Upward momentum struggles to settle despite positive fundamentals for 2015

The price of gold has stabilized since June 2012 above $1,200 per ounce but the upward dynamic has barely started

Gold and silver's bear market, which initially started in June 2011 for gold and in April of the same year for silver, lasted 3 years and probably bottomed in fall 2014.

This was about the same period when the Swiss population would also vote on the inalienability of the SNBs gold reserves which required the central bank to hold at least 20 percent of its assets in gold.

The abrupt decline in crude oil prices following the OPEC member countries meeting on November 28 and the decision not to cut production levels actually revived further uncertainties which were ultimately favorable to precious metals.

But it is most definitely the return to the forefront of the action of the Bank of Japan and the European Central Bank that mostly contributed to the return of investors' interest in the yellow metal.

As the Federal Reserve communicated the end of its last round of quantitative easing in October 2014, the Bank of Japan announced on November 1st that it would further increase its already very significant monetary stimulus program. The Bank of Japan and the Japanese pension funds in fact announced a tripling of asset purchases to **$60 billion per month**. There was also a shift to Japan's national pension fund investment strategy to allow an expansion into Japanese and international equities. In Europe, the economic situation was sufficiently alarming for an EU QE package to be announced. We had to wait until January 22, 2015 for details of the EU programme to be unveiled, including the **€60 billion asset purchase**. The ECB was already under pressure in autumn 2014 and this contributed to expectations for further rate declines that would lead to a reduction of the cost of holding physical gold.

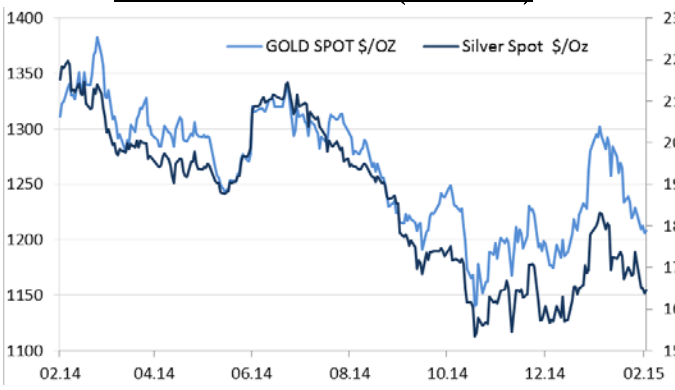
Gold and Silver Spot Price (2000-2015)

Sources: Bloomberg, BBGI Group SA

The new upward trend which has been observed since November 2014 and pushed gold prices up by +15% to $1,300 and silver prices up by +29% in just a few weeks, obviously prompted some profit-taking in February.

The rapid rise which took place early this year could not avoid triggering a few sales while approaching the technical level of $1,300 for gold and $18 for silver. Gold and silver will ultimately benefit from the fundamental improvement in the precious metals market in 2015.

Gold and Silver Prices (2000-2015)



Sources: Bloomberg, BBGI Group SA

Factors to be considered for the future of precious metals in 2015

While consensus still seems largely convinced of the end of the bull market for gold and silver, on the contrary we believe that it is intact after a mid-cycle severe correction, but historically comparable to the 2008-level. **The proportion of bullish supporters has actually dropped from 78% to 27%** over the past six weeks (Bloomberg Gold Bullish Readings), which seems to actually be a contrarian indicator in favor of a bullish pick up in gold.

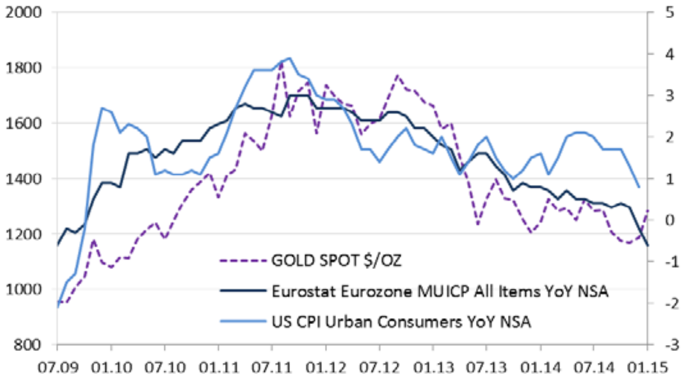
The systemic risk factor, which had supported the rise in gold prices until 2012, was certainly one of the unfavorable elements later in time. The decrease in financial systemic risk and the deterioration of the euro area economy linked to the crisis of confidence in Europe has changed investors' risk perception. The normalization of risk in financial markets as a result of bold monetary policies and the decisive action taken by central banks have changed investors' risk tolerance and the constant need for an insurance policy, which was previously represented by gold and silver positions. This factor, along with the remerging Greek issue, has in our opinion, little risk of directly affecting the price of precious metals in 2015.

The inflation factor does not seem to be favorable to precious metals, due to the breakout of deflationary tendencies in 2011 (inflation dropped from 3.9% to 1% in the U.S. and from 3% to 0% in Europe).

But we must recall that the 12-month correlation measured during the last 45 years between gold and inflation is ... zero. This finding does not call into question the "inflationary psychology" and the protection role against the gold inflationary effects, but relativizes the statistical relationship.

However, the +3.5% global growth in 2015 and a potential recovery in oil prices could positively contribute to a pick-up in the second half of the year.

Gold Price - Inflation United States and Europe



Sources: Bloomberg, BBGI Group SA

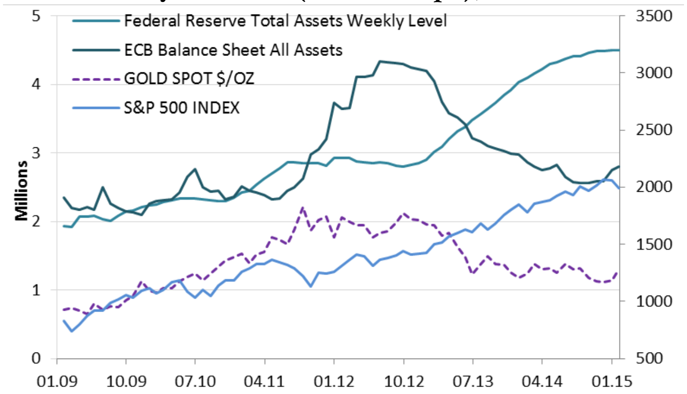
The interest rate factor, indirectly affects the cost of holding gold, and the relationship between nominal interest rates and gold prices is also not very stable. At the same time, another negative factor was the rise in real interest rates which was induced by a stronger plunge in inflation further exacerbated by the plunge in oil prices. Real interest rates should eventually fall back in the second half of the year when crude oil prices should have stabilized closer to a $65-average.

The decline in real interest rates is expected to become a positive factor.

The liquidity factor has gradually become less favorable as hopes are higher for an economic recovery in the U.S. and the announcement of the Fed's tapering programme. The contraction of the ECB's balance sheet between 2012 and 2014 before the recent QE announcement contributed to the slowdown in the central banks' money creation, all despite an ultra-accommodative policy in Japan and a reduced appeal in the yellow metal. In 2015, the EU QE programme will add another €60 billion to global liquidity beginning this March, while Bank of Japan's QQE should be worth $60 billion monthly purchases.

The liquidity factor should further sustain the prices of precious metals in 2015.

Monetary Creation (USA-Europe), SPX and Or



Sources: Bloomberg, BBGI Group SA

In our opinion, **the geopolitical factor** should not be overestimated in 2015 despite the Ukrainian crisis and the rise of the Islamic State (IS). Moreover, this factor tends, in most cases, to only have a limited short-term effect on gold prices.

The currency factor is often indicated as a key element, but we must also mark that the inverse relationship between the U.S. dollar and commodities only occurred in 55% of cases. Between 2012 and 2013 the trade weighted U.S. dollar remained stable while gold prices dropped. On the contrary and more recently, the 20% soar in the U.S. dollar occurred as gold prices stabilized around $1,250 an ounce.

The risk perception factor has not been positive for gold in a long time. This was due to positive effect on investors' confidence and they have contributed to creating a positive investment climate favoring risk taking policies. This also contributed to shifts in risky assets and out of safe haven assets such as gold and silver. This opportunity cost, after six years of bull market and rising U.S. equities, was definitively not favorable to gold.

We believe that in 2015, most of these factors will strengthen the fundamentals which are already favorable to a resumption of gold prices.

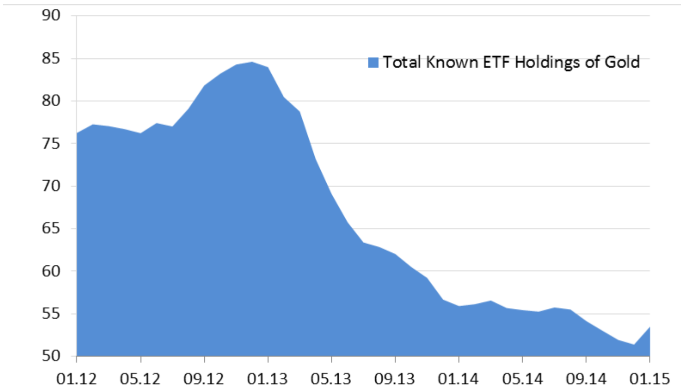
Investment demand picks up after a -40% fall in 2 years in ETFs physical gold positions

Total physical gold demand reached 3,923.7 tons in 2014, of which 904.6 tons came from net investment demand. This represented a +2% increase compared to 2013 figures (885.4 tons). This increase is primarily supported by the decrease in sales in physical gold ETFs. Truly, sales of ETFs that were approximately 880 tons in 2013 gradually shrank to finally represent only 159 tons in 2014. We must also note that for the first time since December 2012, ETFs physical gold in the world increased in January 2015.

Within a few weeks, the amount of gold ounces jumped from 51 million ounces to almost 54 million, corresponding to a +5% increase.

The return of investors in physical gold ETFs is an encouraging sign indicating a gradual return of investment demand when the ECB announced a QE programme of €1.3 trillion. Funds based in the United States were the first to benefit from the return of investors on the gold market.

Total physical ETF gold holdings



Sources: Bloomberg, BBGI Group SA

Aside from this element, total investment demand as measured by the World Gold Council showed a rise of +18% to 1,259t from 1,071t in 2013.

Jewelry demand down -10% but still above the 5-year average

Jewelry demand faltered in 2014 as it slipped by -10% to 2,152.9 tons. However, this is not surprising given the record-breaking demand in 2013 following a fall in prices, especially in Asia. The annual demand remains above the 5-year at 2,053 tons. But it is the flocking demand in the 4th quarter 2014 (strongest quarter since 2007) which is a good surprise.

China had become the largest gold importer thanks to over 1,000 tons of imports in 2013. In India despite major tax obstacles, demand for jewelry reached a record 662 tons, as it stepped over Chinese demand which has been estimated at 623.5 tons, down -33% compared to the previous year.

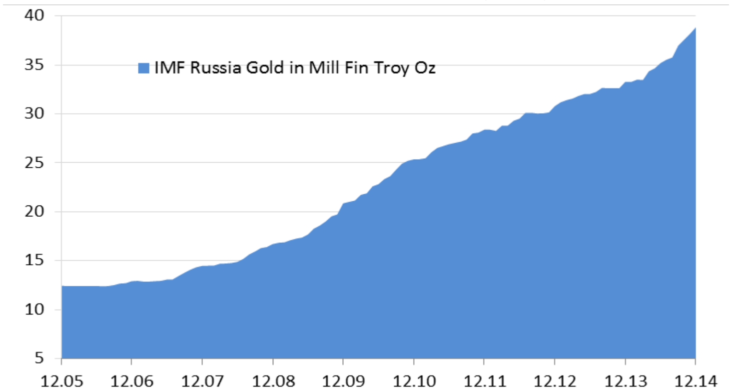
Interesting phenomenon in 2014 was the recovery in jewelry demand in the United States (+9%) and the United Kingdom (+18%).

Jewelry demand has considerably increased to 132.4 tons in the United States, this being the highest demand since 2009.

Central banks further reinforce physical gold purchases by +17% in 2014

After having been net gold sellers between 1989 and 2009, central banks bought another 477 tons of gold in 2014. After an excellent 2013 (409 tons), central banks further increased their purchases in 2014 and recorded the second highest peak of gold reserves in 50 years. Russia was the main player among central banks as it added 173 tons of gold to its inventories in 2014. Since 2007, Russian gold reserves have increased from 400 to 1,280 tons.

Gold Reserves – Russia - (IMF)



Sources: Bloomberg, BBGI Group SA

Global supply is stable in 2014 but should suffer a setback in 2015

Global supply declined in the 4th quarter 2014 due to the fall in recycling supply. The gold recycling activity is at its lowest in seven years, standing at 1,121.7 tons, down by 140 tons. Gold mining production stood at 3,144.4 tons in 2014, a +2% increase. The latest increase is expected to be followed by a production decline in 2015.

Conclusion

The gold price has stabilized above $1,200 an ounce since June 2013, but the bullish momentum is still struggling to settle in.

Yet global liquidity is supported by the new European QE programme and Japanese QQE and negative factors are gradually starting to disappear.

Consensus is still negative in the short-term with only 27% of bullish supporters. We think this is a contrarian indicator favorable to precious metals.

For the first time since 2012, there is renewed investors' interest in physical gold ETFs (up +5% after a -40% decline since 2012).

On the fundamentals side, the components of demand are still strong, while supply is stabilizing and will decrease in 2015.

Precious metals should benefit from these factors to return to the levels of $1,400 for gold and $20 for silver in 2015.

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