The SA Bullion Gold Report
Q1 2014

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Table 1: Gold Performance to 31 March 2014 (% per annum)[1]

	Quarter[2]	1 Yr	2 Yr	3 Yr	5 Yr	10 Yr
Gold in US Dollar	7.2	-24.6	-14.9	-5.8	5.6	11.0
Gold in Rand	10.9	-7.8	3.7	12.2	15.0	17.8
Gold in Euro	7.3	-24.8	-13.3	-2.6	6.3	10.5

[1] Based on LBMA Afternoon Fixes
[2] not annualized for periods of less than 1 year

Table 2: Quarter-End Gold Prices and Exchange Rates[1]

	Gold in US$/oz	R/$ rate	Gold in R/oz	$/€ rate	Gold in €/oz
31 Mar 2004	423.70	6.30	2,670.37	1.22	345.96
31 Mar 2005	427.50	6.22	2,660.65	1.30	329.22
31 Mar 2006	582.00	6.16	3,587.74	1.21	480.11
31 Mar 2007	661.75	7.25	4,799.34	1.33	496.70
31 Mar 2008	933.50	8.13	7,586.09	1.58	589.59
31 Mar 2009	916.50	9.86	9,032.22	1.33	688.99
31 Mar 2010	1,115.50	7.31	8,154.49	1.35	825.07
31 Mar 2011	1,439.00	6.75	9,717.63	1.42	1,014.52
31 Mar 2012	1,662.50	7.68	12,776.01	1.33	1,246.63
31 Mar 2013	1,598.25	9.32	14,902.44	1.28	1,245.90
31 Mar 2014	1,291.75	10.57	13,737.29	1.38	936.59

Note 1: Gold prices in US$ and € are LBMA Afternoon Fix prices
Note 2: Gold price in Rand from Rand Refinery
Note 3: Gold prices at time of writing—$1,301.50, R13,746.96, €941.61

Table 3: Calendar Year Performance of Gold

	% US Dollar	% ZA Rand	% Euro
2004	4.6	-11.7	-2.9
2005	17.8	32.6	35.7
2006	23.2	37.0	10.2
2007	31.9	27.9	18.9
2008	4.3	41.1	9.7
2009	25.0	-0.4	21.1
2010	29.2	16.1	38.2
2011	8.9	33.0	12.6
2012	8.3	13.6	6.2
2013	-27.3	-11.8	-30.3
2014 year to date	7.2	10.9	7.3

Q1

Figure 1: Ten-Year Chart of Gold Price in US Dollar [LBMA PM Fix]

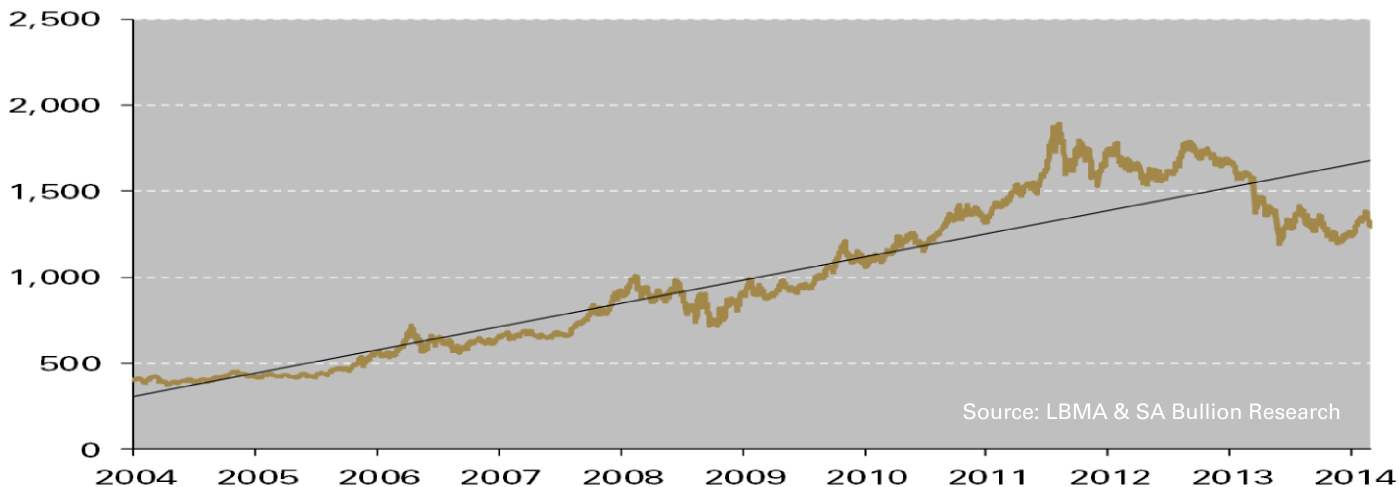
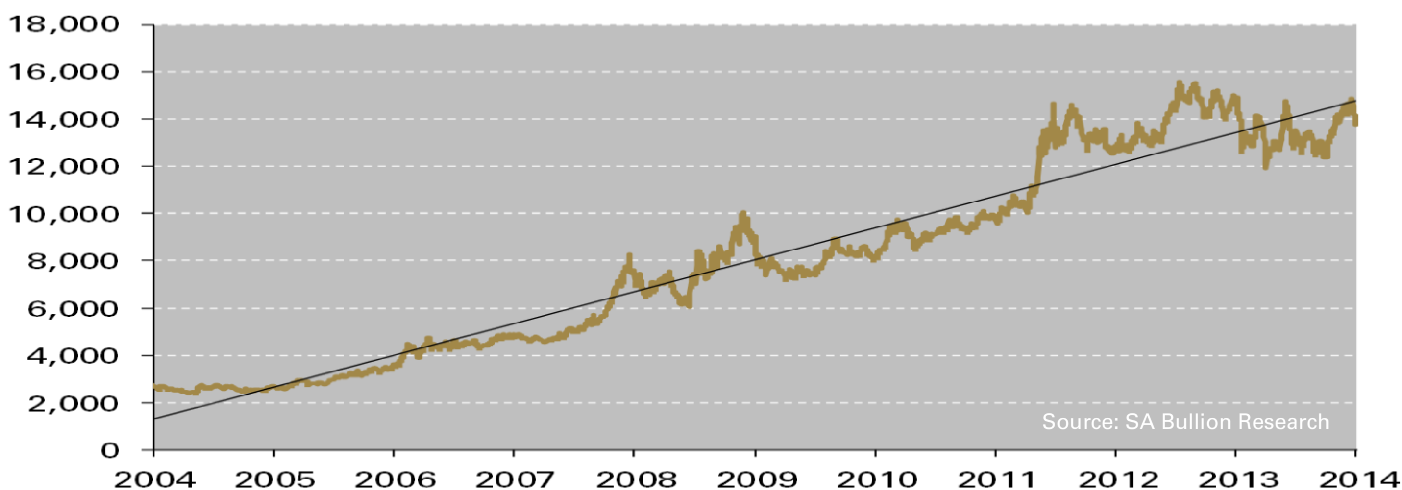


Figure 2: Ten-Year Chart of Gold Price in South African Rand



Gold Price Action

Gold prices experienced a strong start to the year. In US Dollar gold was up more than 7% in the first quarter. When taking currency depreciation into account, gold was up almost 11% in South African Rand in the first three months of 2014.

Gold peaked in September 2011 and since then it has spent two years putting in a big technical bottom. The technical indicators would seem to suggest that the bottoming process will be resolved in the next couple of months. Certainly from a fundamental perspective, the supply-demand picture is a healthy one for price support as is the cost of new production.

Post-Crisis Chronic Weakness

As students of gold, and therefore global economics too, we devour good macro-economic data and research. While there is much to be had, unfortunately not much of it is particularly good. Our favourite source of really top-notch research is the Bank for International Settlements ("BIS"). The 'bank of central banks' has in recent times produced some excellent research regarding the type of post-crisis recovery that we are in, and the forms of policy response that may best be taken. The Bank's material does not make easy reading for the layman and so we endeavour to produce here a simplified, bullet-point summary of their key issues, followed by our position on how this ties in with gold in the longer term ahead. Here goes:

Bank for International Settlements thesis -

It has been over five years since the height of the global financial crisis, but the global economy is still struggling. The chronic weakness can be characterized as follows –

1. Output is disappointing and remains below its pre-crisis path. Unemployment is still worse than pre-crisis. Productivity appears to be on a gradual trend decline.
2. Inflation is low and in some areas there are concerns around deflation (euro areas).

3. Private sector balance sheets remain burdened by debt and Private Sector Debt:GDP ratios continue to deteriorate.
4. There remain issues around banks' balance sheets and quality of assets.
5. Fiscal deficits have ballooned and Public Debt:GDP ratios continue to deteriorate along a path of unsustainability.
6. US and Eurozone monetary policy has been testing the limits with effectively zero policy rates, forward guidance, asset purchases and long-term lending.
7. Difficulties are developing in emerging markets caused by US policy actions resulting in high credit growth, asset price booms and financial imbalances.

The BIS theorises that the generally held (and incorrect) view is that the key problem is one of weak global aggregate demand that calls for further expansionary policies (the 'aggregate demand view'). On the other hand, the BIS advocates that the key problem is in fact the legacy of a balance sheet recession (the 'balance sheet view'), and that this perspective implies different remedies to those being meted out.

Before we move on to the BIS' balance sheet view one should note that the BIS does recognize that:

- Not all recessions are born equal and that this post-crisis recovery has its roots in a financial boom and bust.
- The policy response has been unbalanced with an emphasis on fiscal and monetary stimulus and not enough attention to balance sheet repair and structural reforms.
- Monetary, fiscal and prudential policies need to be more symmetrical over the financial cycle.

The 'balance sheet view' of the BIS does acknowledge shortfall of aggregate demand as a major problem in economies that were directly hit by the crisis, but more importantly it highlights how its financial-crisis induced nature makes it unresponsive to usual aggregate demand policies that seeks to pump-prime demand. The view can be summarized as:

1. The crisis was the inevitable collapse of an unsustainable boom. Features include large sectoral as well as aggregate debt and an impaired financial sector.
2. Deleveraging is necessary to achieve a self-sustaining recovery.
3. A key factor restricting aggregate demand is the desire of borrowers to pay down debt thereby diluting the effectiveness of stimulus.
4. Easy money policies in crisis-hit major economies have led to imbalances in the rest of the world. Zero-bound policy rates in major economies have forced non-crisis-hit countries to reduce rates leading to unsustainable financial booms. The result is expansionary in the short term but contractionary over the longer term.
5. The system is not only a function of current inputs but is also a product of the history of inputs, especially misallocations of credit, capital and labour that built up in the prior boom. In fact the prior allocation of credit is of more importance than the total amount of credit extended.
6. Negative real interest rates in crisis-hit countries are inappropriate and dangerous. They risk collateral damage in the crisis-hit countries and in other parts of the world as financial imbalances build up.
7. Disinflationary and deflationary pressures may have less to do with weak aggregate demand and more to do with underlying forces – notably global competition – resulting in the export of disinflation from cheap manufacturing countries. The focus then ought to be the harmful interaction between debt and asset prices.

The BIS advances evidence of their 'balance sheet view' predominantly in six areas:

1. The relationship of systemic banking crises with financial cycles:. BIS research indicates that banking crises tend to occur at the peak of financial cycles. These financial cycles last 16 to 20 years as opposed to business cycles which last 8 to 10 years. Leading indicators of systemic banking crises include behavior of credit and property prices.
2. Output: Systemic banking crises are associated with large permanent output losses. This results from the unsustainable expansion of output before the crisis.
3. Deleveraging: a balance sheet recession requires deleveraging. "Credit-less recoveries" are the rule following balance sheet recessions.
4. Hysteresis: Output problems are a function not only of current inputs but of inputs in the past as well. Misallocation of credit and real resources in the early years following the bust traps resources in inefficient companies at the expense of more profitable ones. In the current scenario forbearance (the postponing of foreclosures) and delaying of balance sheet repair are evident.
5. Deflationary pressures: Deflations are often associated with sustained growth in output. The entry of China and former communist countries into the world trading system produced disinflationary tailwinds which are probably still at play.
6. Asymmetries in the international monetary system: Persistently low policy interest rates have resulted in unbalanced expansions. For political and economic reasons many non-crisis-hit countries have found it difficult to operate with rates that are considerably higher than those in core advanced economies. The compulsion to lower policy rates has, in many instances, introduced problems into the economies of countries that were uninvolved in the crisis. This is especially the case for small open and emerging market economies.

It is the view of the BIS that some countries have gone through an exaggerated financial cycle and face full-blown balance sheet recessions. These include the United States, the United Kingdom, Spain and Ireland.

In terms of policy prescriptions, the BIS is of the view that were the current situation an aggregate demand problem, the remedy would be demand management stimulus. However, the situation is actually a balance sheet problem and therefore the solution does not lie in trying to fill an output gap through demand management.

Rather, the solution lies in aggressive balance sheet repair, resolving the legacy of the crisis, and limiting the risk of chronic weakness. Monetary policy should work with prudential and fiscal policies in these objectives.

In these balance-sheet-problem circumstances standard aggregate demand stimulus fails to produce any lasting traction. Fiscal stimulus risks undermining public sector finances. Persistent aggressive monetary policy risks collateral damage at home and abroad. Furthermore, when aggressive central bank monetary policy fails to deliver, it can sap credibility and therefore effectiveness.

Perhaps more importantly, the big picture is one of policymakers conducting asymmetric policies through the financial cycle that entrench problems. At the heart of this asymmetric macro problem is weak policy tightening leading to the peak of a financial cycle and then very aggressive easing at the bottom. Logic would indicate that symmetrical tightening and easing would foster stability and a lessening of the amplitude of the boom and bust cycle. Of course policymakers come under huge pressure from the political economy and "no one objects during a boom; everyone demands support during a bust". Governance arrangements should be in place to insulate policymakers from those who seek to influence them for self-serving political reasons.

Perspective

Our Third Quarter 2012 report concentrated on the subject of financial booms and busts. We looked at the five great booms and busts in history and had this to say about the current one:

"Following the oil crisis of the 1970s, interest rates reached a high in the early 80s, at the same time as debt levels (leverage) reached a low. For the next 25 years rates would go down and leverage would go up – both to extremes. As with all great financial booms many factors played a role. In this time we witnessed extravagances of deregulation, cheap and easy credit, financial over-engineering, incorrect pricing by rating agencies, a technology boom, a housing boom and a stock market boom. These and other factors culminated in a monstrous speculative frenzy in tandem with the greatest credit boom of all time. Following the bursting of the subprime mortgage bubble in 2007, the first period of the bust was characterized by collapsing stock markets and thereafter by a wave of personal and business insolvencies, bank bankruptcies and emergency bailouts. Business failures resulted in a tsunami of job losses (8.8m in the US alone). Private sector credit contraction caused central banks and treasuries to expand public sector credit and to monetize debt. Many countries went insolvent. The US unleashed QEs 1, 2 and 3. The Eurozone and the European Central Bank implemented their own forms of quantitative easing; as did Britain, Japan, China, and many other nations. Five years into this Great Financial Bust there is no end in sight."

We would say that our analysis of the current boom-bust accords with that of the Bank for International Settlements. We would say that, similar to the BIS, our view is that the G20 policymakers are misguided in their responses to the crisis. Finally, we would say that their policies are almost certainly unduly and heavily influenced by the ambitions of the political economy.

The upshot of these policies that treat a balance sheet problem as if it were an aggregate demand problem is that the world economy faces increasing financial imbalances and growing risks with larger possible negative consequences. While the leading currencies will most definitely experience long term negative consequences, most at risk at the present time are the currencies of countries that are small, open and are commodity producers. South Africa is one notable example.

Considering record high asset prices and highly risky currencies the case for diversification has never been stronger. This combined with its low current price presents a compelling proposition for a portfolio investment in gold and we encourage private individuals to take action without delay.

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