SA Bullion

The SA Bullion Gold Report

Q2 2012

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Table 1: Gold Performance to 30 June 2012 (% per annum)[1]

	Quarter[2]	1 Yr	2 Yr	3 Yr	5 Yr	10 Yr
Gold in US Dollar	-3.8	6.2	13.4	19.6	19.7	17.5
Gold in Rand	3.0	28.4	17.2	22.0	23.3	14.8
Gold in Euro	0.9	21.3	11.4	23.7	21.2	14.6

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

Table 2: Gold Prices[1]

	USD/oz	ZAR/oz	EUR/oz
30 June 2002	318.50	3,283.73	322.49
30 June 2007	650.50	4,587.33	481.65
30 June 2009	934.50	7,216.67	666.23
30 June 2010	1,244.00	9,536.25	1,015.59
30 June 2011	1,505.50	10,199.01	1,038.38
31 March 2012	1,662.50	12,715.63	1,248.40
30 June 2012	**1,598.50**	**13,096.67**	**1,259.60**

Note 1: The above prices are LBMA Afternoon Fix prices
Note 2: At time of writing gold prices were $1,601.00 and R13,519.96 and €1,319.75

Table 3: Year-End Gold Prices and Exchange Rates[1]

	Gold in US$/oz	R/$ rate	Gold in R/oz	$/€ rate	Gold in €/oz
31 Dec 2000	274.45	7.57	2,077.59	0.94	292.31
31 Dec 2001	276.50	11.99	3,316.62	0.89	310.53
31 Dec 2002	347.20	8.58	2,979.15	1.05	330.86
31 Dec 2003	416.25	6.67	2,778.47	1.26	330.00
31 Dec 2004	435.60	5.63	2,454.06	1.36	320.47
31 Dec 2005	513.00	6.32	3,253.70	1.18	434.91
31 Dec 2006	632.00	7.05	4,456.07	1.32	479.28
31 Dec 2007	833.75	6.83	5,698.14	1.46	570.26
31 Dec 2008	869.75	9.24	8,040.84	1.39	625.70
31 Dec 2009	1,087.50	7.36	8,008.08	1.43	757.97
31 Dec 2010	1,405.50	6.61	9,298.44	1.34	1 047.67
31 Dec 2011	1,531.00	8.07	12,360.37	1.30	1 179.37
30 June 2012[2]	**1,598.50**	**8.19**	**13,096.67**	**1.27**	**1 259.60**

Note 1: The above prices are LBMA Afternoon Fix prices
Note 2: Most recent quarter-end price

Table 4: Calendar Year Performance of Gold

	% US Dollar	% ZA Rand	% Euro
2001	0.7	59.6	6.2
2002	25.6	-10.2	6.5
2003	19.9	-6.7	-0.3
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
6 mth 2012[1]	**4.4**	**6.0**	**6.8**

Note 1: Performance for 6 calendar months only.

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

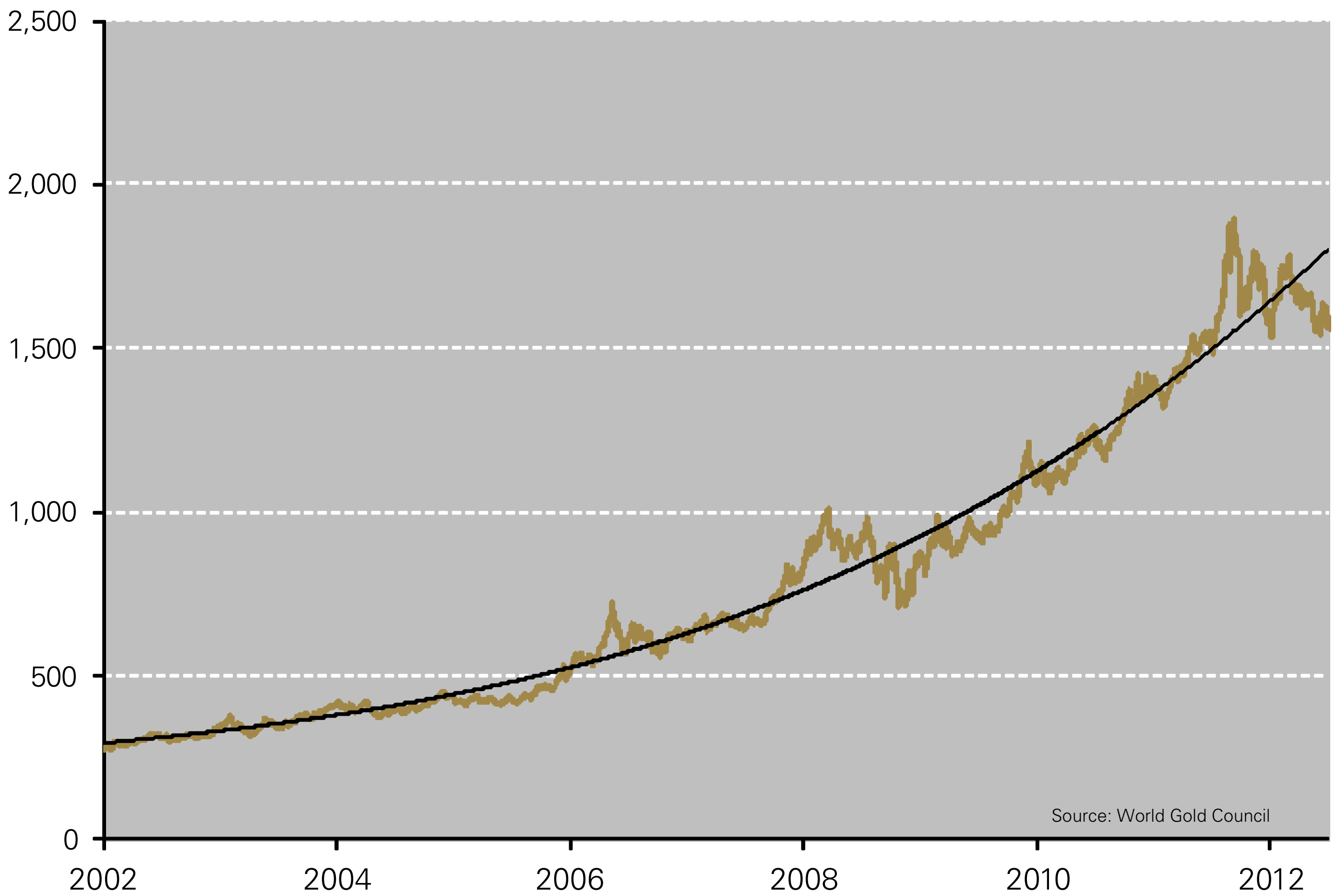
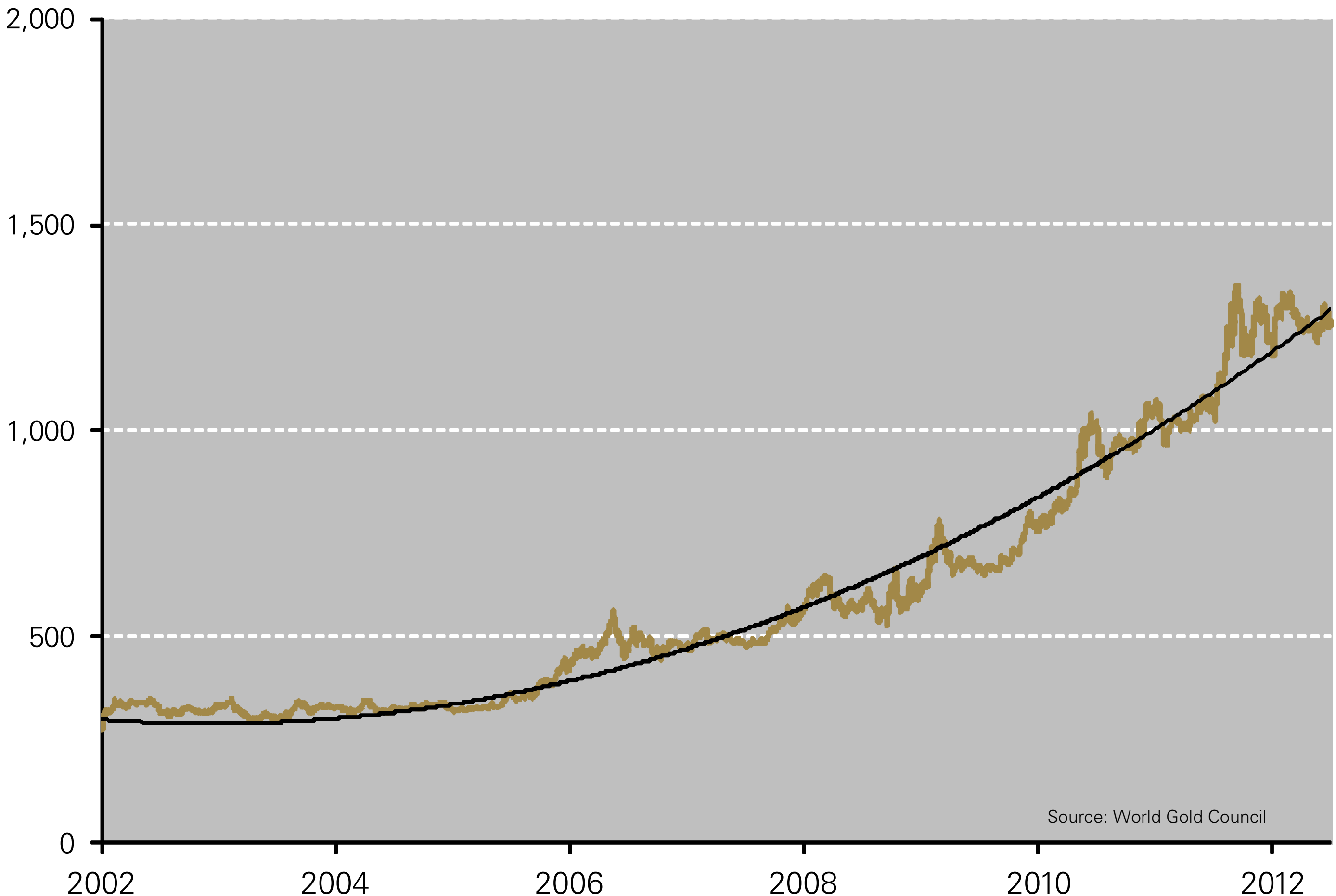


Figure 2: Ten-Year Chart of Gold Price in euro [LBMA PM Fix]



Gold Price Action

The second quarter of 2012 witnessed the gold price fall 3.8% in US Dollar terms. In euro terms, gold was up 0.9% and in Rand gold was up a strong 3% due to Rand decline versus the Dollar. It was a choppy and unlovely time to be in gold – this largely due to events in Europe. There are two massive currencies in the world – the United States' Dollar and the Eurozone's euro. In the long term, poor economic conditions in Europe, and a weaker euro, are almost certain to negatively impact the US economy and therefore also the strength of the Dollar, but in the short term a weakening euro implies a strengthening Dollar. And the knock-on effect of this currency action is a weaker gold price in Dollars. In other words, the weighing scale has the Dollar on the one end and – take your pick – either the euro or gold on the other. There is of course a lot more to it. For example, trouble in the Eurozone sets off alarm bells in capital markets resulting in 'risk off' and a flight to safety. And the number one safe asset remains Treasuries denominated in the global reserve currency – the US Dollar. The 'risk off' trade results in a strengthening Dollar and concomitant weakening gold price. The bottom line is that much of the time trouble in the Eurozone translates into a weaker gold price in Dollars, and there was no shortage of trouble in the Eurozone this past quarter..! By way of evidence:

7 May: President Sarkozy of France lost his re-election bid to a rival running on an anti-austerity ticket;

8 June: Fitch downgraded Spanish debt three notches from A to BBB, just two notches above junk;

13 June: Egan-Jones downgraded Spanish debt from B to CCC+. Moody's cut to Baa3, just one notch above junk;

14 June: Spanish 10 year bond yields rose above the red line level of 7%;

25 June: Spain approached the Eurozone partners with begging bowl in hand asking for €100 billion to rescue the teetering Spanish banks;

25 June: Cyprus became the fifth Eurozone nation to approach the Eurozone partners for a sovereign bailout as its Greek bonds collapsed in value;

All of the above largely deflected attention from the deeply troubled condition of the United States and the result was euro weakening and Dollar strengthening, in turn resulting in gold (in $) weakening for the quarter.

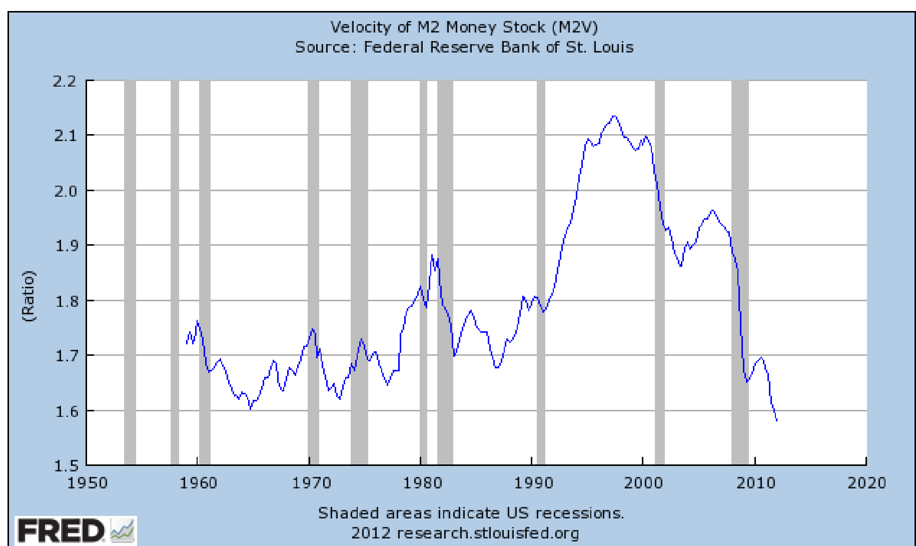
If one reviews gold performance over the first six months of this year one finds satisfying results of 4.4% ($), 6.0% (Rand) and 6.8% (euro). For the twelve month period to 30 June Americans received a reasonable return of 6.2% whilst South Africans and Eurozoners were rewarded with bonanzas in their own currencies of 28.4% and 21.3%.

US Economy Today

The US economy is in trouble. Economic growth is slowing rapidly and dipped to 1.9% on an annualized basis for the first quarter of 2012. This in the face of massive monetary and fiscal stimulus where policy rates are almost zero, quantitative easing persists in a semi-permanent state (currently the extended Operation Twist program), a smorgasbord of tax largesse remains on the table and government intervenes massively in the economy while running a $1 trillion per year funding deficit.

Public debt is piling up at around $100 billion per month, unemployment (when including discouraged and under-employed workers) is over 15%, and worryingly, the velocity of money is declining precipitously. See Figure 3 below.

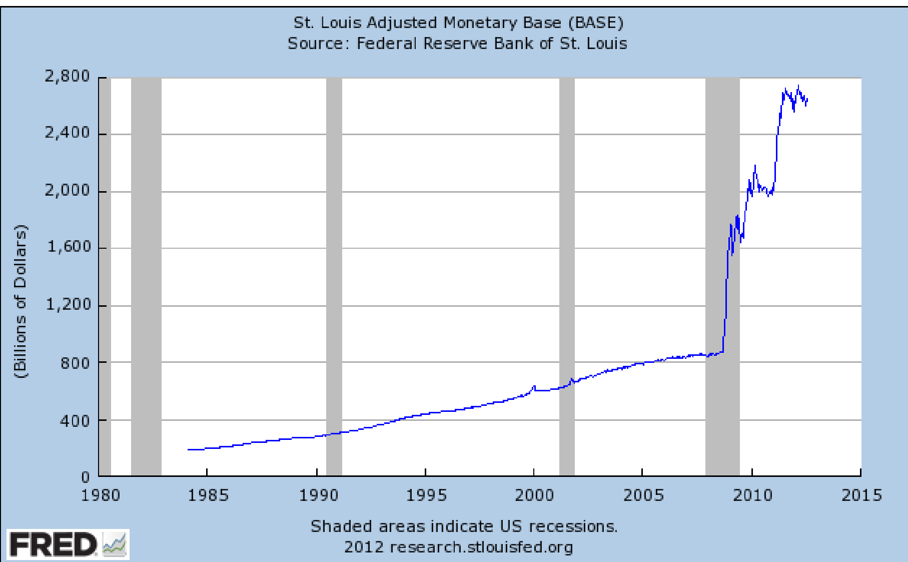
Figure 3: Long Term Chart of US Velocity of Money



Velocity of Money is the rate of turnover in the money supply. For M2 Money we review here on a quarterly basis. Through much of the 1990s the rate of turnover was well in excess of two i.e. on average, all of the money in the country changed hands more than twice in a quarter. This ratio has been collapsing for ten years and is deteriorating rapidly as the consumer pulls back on spending and deleverages whilst the state gears up. Whilst it may be a good thing that the consumer pays down debt and fixes his balance sheet, the problem is the negative impact of this saving on the overall economy.

The state has flooded the system with money through its quantitative easing programs and it is quite obvious that every new dollar in the system is of an ever lower power. See Figure 4 below. The trajectory of the velocity of money is disquieting to say the least.

Figure 4: Long Term Chart of US Money Supply (Base Money)

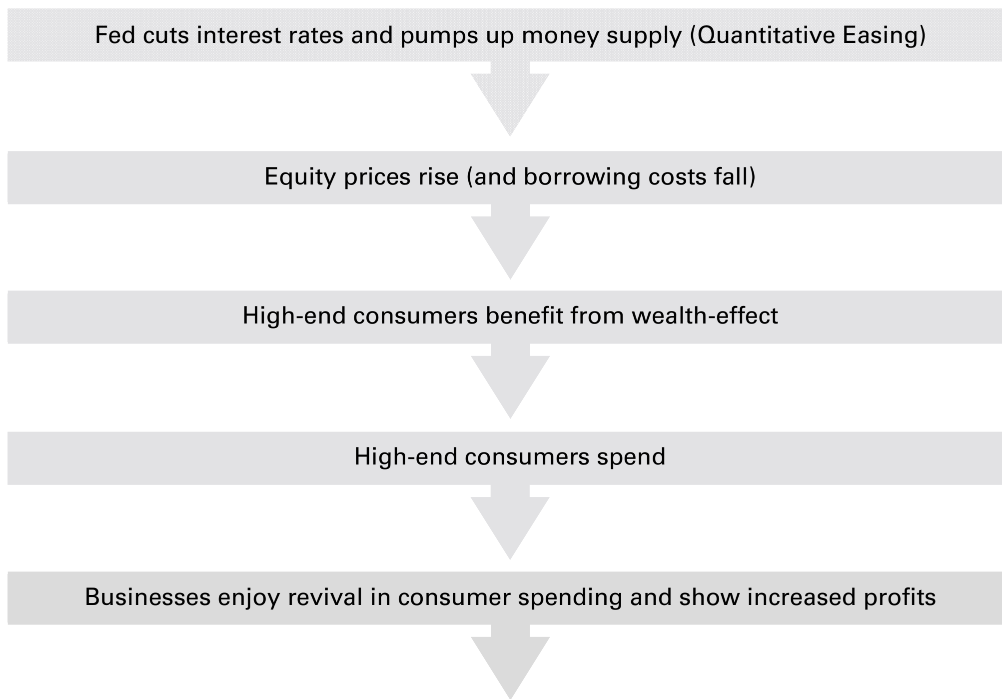


Many other intractable problems could be discussed, but of most interest is the imminent "fiscal cliff" – this being the automatic tax increases and simultaneous government spending cuts due to take effect on 1 January owing to the failure of the members of Congress to agree a formula to address federal deficits and the related national debt ceiling. Should there be no change on this matter it is highly likely that implementation in January will push the US into recession and a tougher journey.

Which 'Flation – Inflation, Deflation, Stagflation, Reflation?

Probably the most dangerous risk faced by the US economy is that of going into a deflationary depression. This could be brought on by deteriorating velocity of money or declining (or inadequate) money supply, etc. In such a scenario the economy would shrink, debts would become more burdensome, poverty and unemployment would increase dramatically as capacity excesses are worked out of the system, and the nation state would experience immense strain.

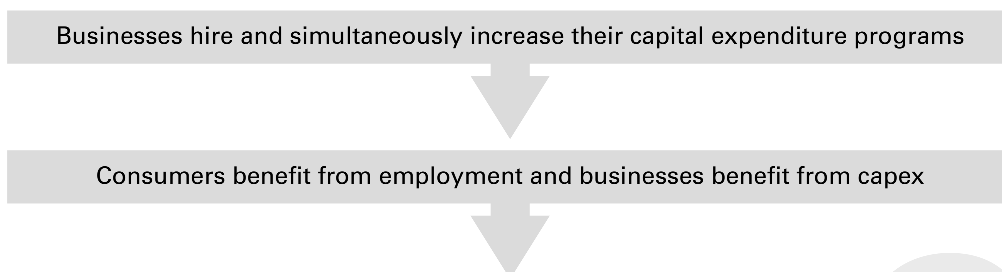
So far the quantitative easing programs have been effective by pushing up equity prices and staving off deflation. Simplistically, the transmission mechanism has been as follows:



That Quantitative Easing has resulted in higher equity prices is self-evident in Figure 5 following. What is also apparent is that termination of a QE program is followed by retracement in equity prices.

Figure 5: Fed Stimulus Programs and the S&P 500

A sustained rally in share prices and in economic growth has not followed any of the Fed's major programs. This is because the transmission mechanism appears to be jammed at the last stage mentioned above i.e. 'businesses enjoy a revival in consumer spending and show increased profits'. The following two stages are required:



US corporations have enjoyed excellent profits in the last two years, largely due to cost-cutting, but they are not hiring and expanding. Corporations appear to be doubtful of economic growth prospects and are stockpiling cash – currently at levels around $2 trillion! For those willing to do the research, history shows us that corporations do not increase hiring when profit growth is falling. This does not augur well for a sustained economic recovery in the US.

Regarding the 'flations, we see massive deflationary forces at play (predominantly declining velocity of money) and equally huge reflationary forces at work (monetary and fiscal stimulus i.e. Fed and tax programs). As we have said for years now, we anticipate stagflation (moderate inflation and low economic growth) to prevail.

US Creditors

In the past the US has enjoyed a very favourable seat at the table when it came to raising debt, or put another way, selling debt instruments (Treasuries) to creditors who would be willing to fund the US government for a reasonable return.

In the heydays of 2005 to 2007, foreigners (like China and Japan) bought 82% of all Treasury issuance. Today foreign creditors purchase 26% of Treasury issuance. US government overspending is not going to disappear or diminish anytime soon, and the federal deficit (and therefore Treasury issuance), continues bullying forward at approximately $1 trillion annually! During QE2 the Fed bought 62% of Treasury issuance. Whilst 'flight to safety' has recently provided the US Treasury with an opportunity to sell to hedge funds and investment managers pursuing the 'risk off' trade, this is not a sustainable financing strategy. The Fed will undoubtedly be compelled to re-enter the bidding market in a big way. In so doing it will be monetizing US government debt and debasing the currency. In a manner of speaking it is doing so presently with its Operation Twist. This while foreigners are diversifying out of US Treasuries, into gold and commodities.

Conclusion

The US faces exceedingly difficult economic conditions for many, many years into the future and the debt strain is only going to increase. In the absence of sufficient creditors willing and able to finance the US government, the Fed will be obliged to monetize Treasury issuance. The risks to the Dollar are palpable and considerable.

Quite where gold prices go in the short term is anybody's guess, but in the long term, with reflation, inflation and low economic growth a near-certainty, gold rather than cash is probably the easiest investment decision that we can come to in this day and age.

An Aside

The South African financial services regulator – The Financial Services Board – following years of planning, rolled out its Regulatory Examinations Program that requires tens of thousands of financial sector professionals to write various examinations – concerning all the applicable laws and regulations. Three of your SA Bullion directors were swept into the net and faithfully wrote five examinations between them. All the results were of the highest order – as you would expect and require of our firm. My thanks and congratulations go to Clint O'Brien and Imran O'Brien. I was the third, and will give myself a pat on the back!

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