The SA Bullion Gold Report

Q2 2014

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Table 1: Gold Performance to 30 June 2014 (% per annum)[1]

	Quarter[2]	1 Yr	2 Yr	3 Yr	5 Yr	10 Yr
Gold in US Dollar	1.8	10.3	-9.3	-4.4	7.1	12.8
Gold in Rand	1.8	17.7	3.2	10.7	13.9	19.0
Gold in Euro	2.8	5.3	-12.6	-2.5	7.7	11.5

[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
30 June 2004	395.80	6.21	2,458.81	1.22	324.92
30 June 2005	437.10	6.67	2,917.05	1.21	361.74
30 June 2006	613.50	7.13	4,375.33	1.28	480.72
30 June 2007	650.50	7.05	4,587.33	1.35	481.49
30 June 2008	930.25	7.83	7,282.13	1.58	589.21
30 June 2009	934.50	7.82	7,305.13	1.41	664.89
30 June 2010	1,244.00	7.59	9,443.93	1.23	1,012.70
30 June 2011	1,505.50	6.86	10,321.86	1.45	1,040.07
30 June 2012	1,598.50	8.21	13,123.35	1.27	1,260.45
30 June 2013	1,192.00	9.97	11,881.85	1.30	914.39
30 June 2014	1,315.00	10.64	13,986.58	1.37	962.66

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—$1,282.75, R13,736.41, €973.47

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	9.2	12.9	10.3

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

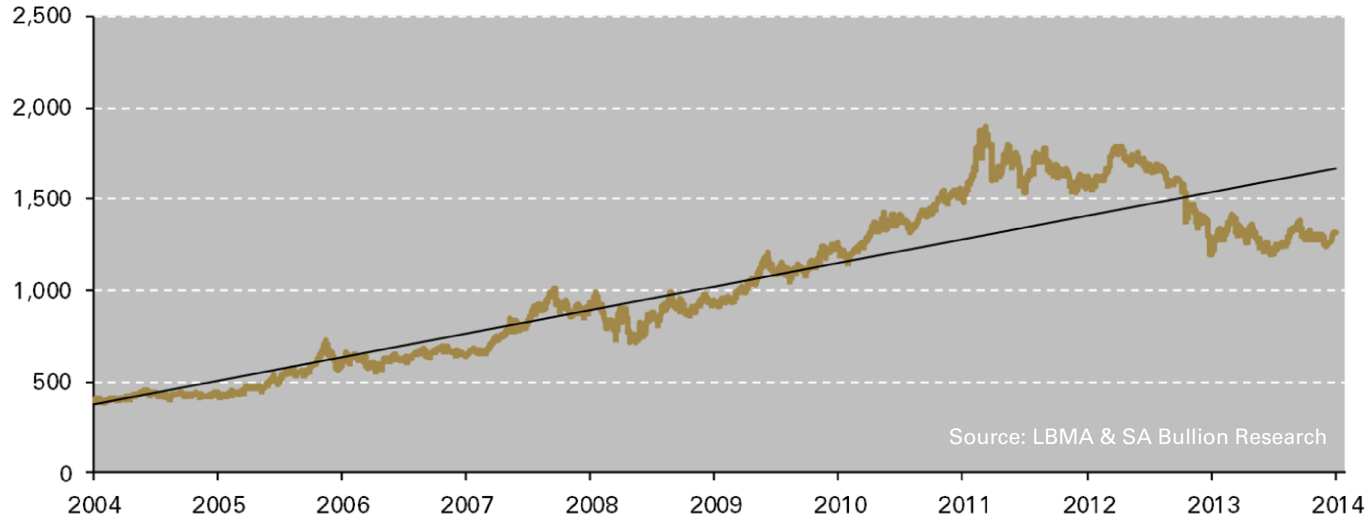
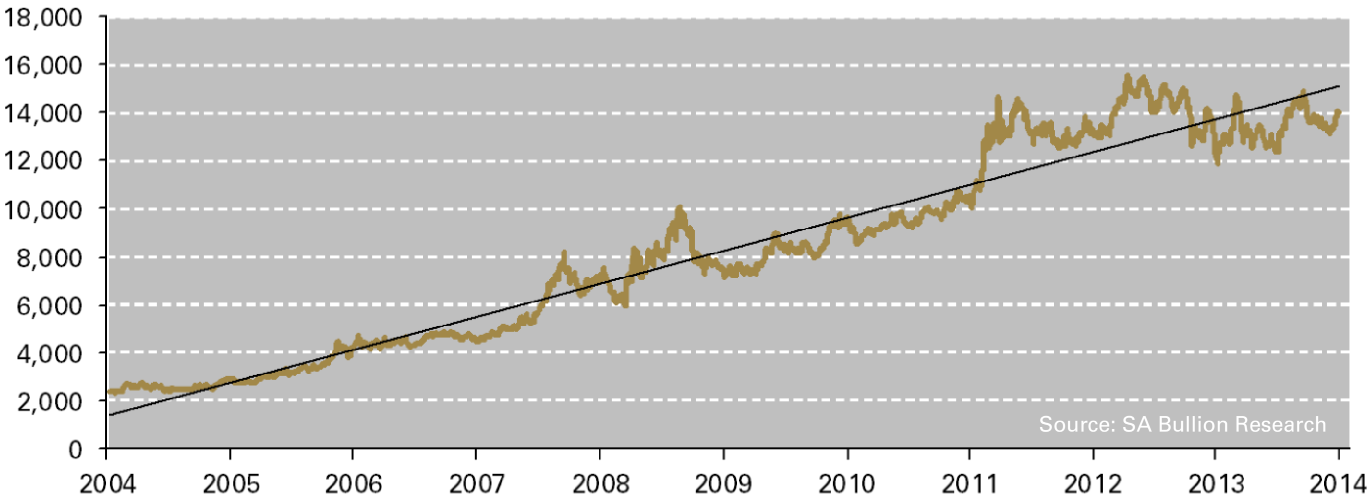


Figure 2: Ten-Year Chart of Gold Price in South African Rand



Gold Price Action in the Second Quarter

Gold has had a good second quarter following a very strong first quarter in 2014. In the six months year-to-date gold is up approximately 10% in most currencies. In the last 12 months gold has proved to be a very good investment for US investors, a superb investment for South African investors, and an acceptable investment for European investors who experienced a very strong rally in their currency.

Historical performance of gold in major currencies in the medium term has been poor, following the large Dollar price declines post-September 2011. In the two-year and three-year periods up to 30 June gold performance has been dismal for US Dollar and Euro investors, but due to currency depreciation, fairly good for South African Rand investors.

Long term investors have been handsomely rewarded for holding gold. In the last 10 years gold price appreciation has produced annualized returns of 11.5% for Euro investors, 12.8% for US Dollar investors and 19.0% for South African Rand investors.

United States, Dollar and Gold Commentary

For five years or more - the period following the financial crisis of 2008 – we have been saying that the primary objective of the US Federal Reserve ("Fed") will be reflation. We have also been saying that we expect the Fed to be successful, but at a cost. Long term readers of the SA Bullion Gold Report will recall our essays on the *Wealth Effect* and the transmission mechanism that enables economic stimulus.

What we see today is that asset inflation has been achieved. The cornerstones of personal wealth - shares and houses – are up tremendously. Household net worth is up by $20 trillion. And yet consumer spending is in the doldrums!! Corporations have been achieving record profits and returning vast sums of cash to wealthy households via dividends and share buy-backs, yet the forces of deflation are omnipresent. What gives?

Early in 2013 it appeared to the US regulators that stock markets were perhaps a little over-cooked and that Quantitative Easing ("QE") – the radical monetary stimulus program of the Fed – had achieved its asset inflation objective and could be cooled off. In May of last year the Chairman of the Fed, Mr Ben Bernanke, announced the beginning of the end i.e. the winding-down of QE3 and more popularly known as the 'Taper'. The immediate effect of the taper was to hurt house prices but as share prices remained unaffected, Mr Bernanke would have maintained his hopes regarding the wealth effect and its transmission into economic growth rates so as to attain historic norms of around 6.3% per annum once again.

US share prices have continued their unrelenting march to ever higher levels. The most reliable valuation measures would indicate that US equities are 75% to 100% above historic norms. The valuation measures we refer to are:

Price to revenue
Price to normalized forward operating earnings
Price to 10-year earnings adjusted for profit margins
Price to 10-year inflation-adjusted earnings (Shiller)
Market cap of non-financials to nominal GDP

All these crucial valuation methodologies tell the same story. US equities are at exceptionally elevated levels. History is not on the side of share investors today.

But why would share prices not remain at these stratospheric levels and thereby cause the desired economic stimulus via the wealth effect? - you might ask. First one needs to understand what it is that has been the driver of share prices.

Corporations have been immensely profitable in these last few years - staggeringly so. How come? There have been three key drivers of company profits:

- *A reduction in interest expense (due to QE)*
- *A reduction in labour costs (due to newfound corporate power following the 2008 crisis)*
- *A release of loss provisions for financial institutions (due to FAS 157* and reflation)*

These three items have been the drivers of profits and the boom in the US stock market. What is interesting to note though, is that these are all once-off bonanzas and not repeatable. The phenomenal profits therefore had nothing to do with the economy and everything to do with interventions.

In an attempt to understand the state of the economy, a useful place to start is by taking a look at consumer demand and consumer spending. But importantly, when looking at consumers you want to tease out a truth - are consumers spending more because they are buying more, or are consumers spending more because prices have gone up.

When analyzing discretionary retail spending units and prices we find that consumers are spending more because prices have gone up. The "recovery" since the crisis has been a result of inflation and not because of an improvement in consumer demand. Households are struggling to maintain their pre-crisis, credit-fuelled lifestyles by dissaving, cynically defaulting on homeloans and by taking out student loans.

QE gave households a $150 billion bonanza with respect to their interest expenses over the last five years, but that is now all but over. Furthermore, the circumstances of this period enabled a re-fi boom and households seized the opportunity to use their mortgages as ATMs once again and cashed-out $350 billion. The consumer has made use of extraordinary monetary circumstances to hang onto an old credit-fuelled standard of living. The taper will end that. Already the interest expense for households is moving higher as mortgages rates have lifted.

So what then is going to support and drive corporate profits following the fizzling-out of the three 'once-offs'? Strong aggregate demand? – nope. A robust economy? – nope again. We don't see any new supports coming along.

Quantitative Easing has been helpful for asset reflation but has been destructive for the dollar, at least until the start of QE3. The mainstream investment community saw the start of QE3 as the panacea to America's economic woes and the effects of this view were:

1. *To strongly support investment into shares;*
2. *To rate the leading western economies as superior investment destinations to emerging countries;*
3. *To bolster the US Dollar in relation to emerging currencies;*
4. *To knock gold off its pedestal and to de-rate it as an investment currency.*

Essentially, the US stockmarket has acted as a competitor to gold as a destination for investment dollars. And as equities have performed so strongly, that competition has been fearsome and continues to be so. But for how much longer? That is the question.

We would not like to bet against the powerful momentum that has built up in US stock markets, but equally, we would not like to have all our eggs in that basket! In the last year the case for a portfolio investment in gold has become stronger and stronger by the day.

SA Bullion News

For almost a year we have been working on a new website for our firm. The old ‘home-grown’ one is about to be replaced by a modern interactive one and should be live by the time that you receive this report. We hope that the new site will convey the way we feel about our business and we hope that the new functionalities will be of great benefit to prospective clients, existing clients and financial advisors. Whilst each of us at SA Bullion has played a role in the development of this new website, the champion of the project has been my fellow-director and friend Imran O’Brien. My sincerest appreciation goes to him. Please visit www.sabullion.co.za.

Please accept my apologies for a very tardy quarterly report. At the time that I would normally have been diligently writing this report I had the misfortune of nursing my beloved old father in his final days. He passed away on 7 August.

With best wishes,

Hilton Davies

**FAS 157 is the Statement of Financial Accounting Standard 157 as directed by the Financial Accounting Standards Board of the USA. The effect of FAS 157 was to give financial institutions a tremendous degree of latitude in determining fair value of assets and liabilities*