The SA Bullion Gold Report

Q3 2012

SA Bullion

Analyst: Hilton Davies
Email: hilton.davies@sabullion.co.za
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Table 1: Gold Performance to 30 September 2012 (% per annum)[1]

	Quarter[2]	1 Yr	2 Yr	3 Yr	5 Yr	10 Yr
Gold in US Dollar	11.1	9.6	16.6	21.3	19.0	18.6
Gold in Rand	12.0	12.3	26.9	24.8	23.4	15.7
Gold in Euro	9.3	14.3	19.9	26.4	21.4	15.5

[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 September 2002	323.70	3,411.79	327.33
30 September 2007	743.00	5,124.29	522.98
30 September 2009	995.75	7,545.29	682.62
30 September 2010	1,307.00	9,115.41	958.35
30 September 2011	1,620.00	13,068.70	1,204.73
30 September 2012	1,776.00	14,671.89	1,377.27

Note 1: The above prices are LBMA Afternoon Fix prices
Note 2: At time of writing gold prices were $1,766.75 and R15,191.39 and €1,363.93

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 Sep 2012[2]	**1,776.00**	**8.26**	**14,671.89**	**1.29**	**1,377.27**

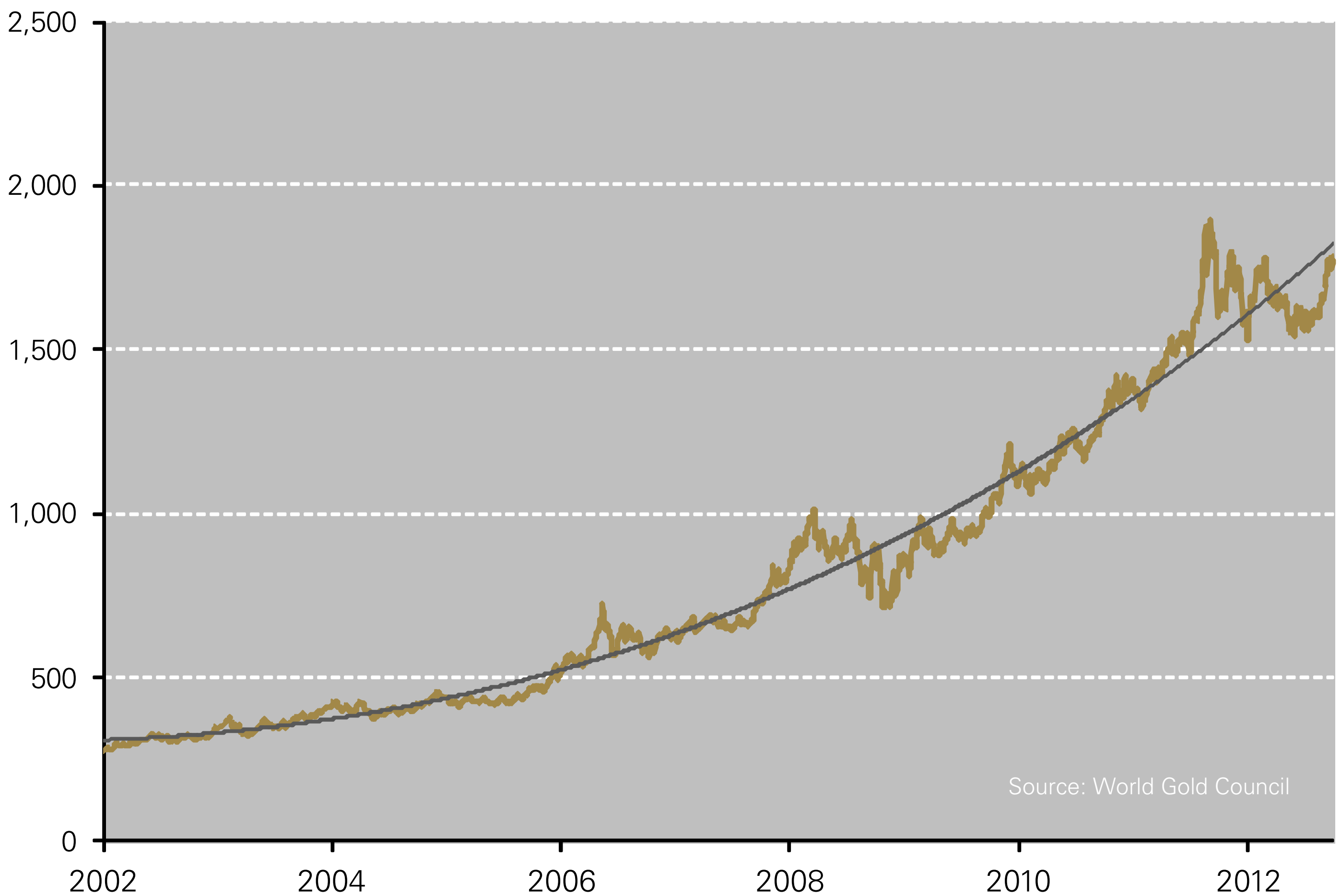
Note 1: The above prices are LBMA Afternoon Fix prices
Note 2: Most recent quarter-end price

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
9 mth 2012[1]	**16.0**	**18.7**	**16.8**

Note 1: Performance for 9 calendar months only.

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



Gold Price Action

The third quarter of 2012 was strong and evenly-paced for gold prices in all major currencies. In US Dollar gold went from $1,598.50 to $1,763.00 providing investors with an 11.1% wealth enhancement. Our European investors' saw their investments move from €1,259.60 to €1,377.27 to create 9.3% more value. In South African Rand the results were R13,096.67 to R14,410.06 for a 12% rise.

Whilst we are happy to bank the last quarter's performance, our joy is tempered by the fact that this gain is a recovery of a volatile and downward prior 12 months. Please cast an eye over the chart above. It is quite fascinating to observe that the general price movement of the most recent 12-month period is an almost-exact repetition of similar periods that occurred in 2008 and in 2006. The take-away point is that substantial retreats and consolidations are part and parcel of a long term bull trend. But a word of caution! Don't expect past patterns to provide you with a sure-fire method for successfully trading short-term gold. Our interest lies in the other notable feature of the chart above – that is, the long term trendline.

The Past Quarter in Central Banking

5 July: The People's Bank of China cut policy rates for the second time in a month – the first cuts in four years. The central bank response is a clear sign of an economic cooling.

12 Sept: The German Constitutional Court cleared the way for the European 'Bazooka'. The highest German court approved Germany's involvement in the European Stability Mechanism (the 'ESM') – the permanent Eurozone rescue fund. Germany is due to contribute 27% to the €500bn war chest! This in addition to €55bn already contributed to the temporary fund. Spanish, Italian and German bond markets cheered (As well they ought! Yield-oppression is a big part of the objective here).

13 Sept: The US Federal Reserve announced a further programme of quantitative easing ('QE3'). The undertaking is to buy $40bn of mortgage-backed securities each month! The total scope of this limitless programme could be anywhere between $250bn and $2 trillion! The Fed also committed to keeping policy rates at repressive levels at least into 2015 and to continuing with Operation Twist. (Well someone has to buy all those new bond issuances if the foreigners won't!)

19 Sept: The Bank of Japan announced increased monetary stimulus by way of asset purchases to the tune of $126bn so as to inject some vigour into a slowing economy. It also announced policy rates to be kept on hold at 0.1%. (With Europe cold and China cooling there's no surprise at Japanese weakness. But is it just us, or could there also be a little competitive currency depreciation going on as a sideline benefit perhaps?)

The Bernanke Put

Along with the ECB and the BoJ, in this past quarter the Fed announced an asset-buying programme (QE3) to breathe some life into an economy plagued by recession-like conditions and continued high unemployment. QE3 though, comes with a difference – it is open-ended and indefinite (I know this is a tautology but I like the emphasis!). Spurring growth is the intention, but the only certainty is that it will weaken the Dollar. As long as investors are guaranteed that Bernanke's Fed will mop up risk assets by over-paying for them, they will believe they have a synthetic put option on their shares, bonds and other risk assets. If their faith in the Fed should wobble, we have only this to say – watch out below!

A Lesson in Financial Booms and Busts

The greatest economic expansions and financial-market bull runs occur simultaneous to the greatest credit booms. These factors are not causally linked but when they occur together they result in financial euphoria and a loss of good sense. In these booms rapidly expanding credit assists to drive up consumption, business activity and asset prices. Governments also benefit (temporarily) by virtue of increased employment and increased tax revenues. These halcyon conditions morph into giddy times of wild asset inflation and speculative frenzy. Banks and businesses recklessly borrow short term money to lend long term to un-creditworthy borrowers. Innovative financial instruments proliferate. Eventually, more debt is created than can be serviced, and then it all come's tumbling down.

Sound familiar?

A Great Financial Boom is a rare thing and is years in the making. Our recent one extended from approximately 1982 until 2007. (Long term clients will know that I have been writing on this subject for years; newer clients are referred to our archived reports on www.sabullion.co.za). What happens following a Great Financial Boom, you may well ask? Before we get to that answer, let's take a brief look at the Great Financial Booms and Busts:

Financial Crisis of 1720

By 1711 the British Empire spanned the globe and was thriving. At this time the London-based South Sea Company was established as a competitor to The Bank of England (a public bank, not a central bank at that time). Its chief role was to act as a prime broker for government debt issuance. As a sideshow it had procured a monopoly on British trade with South and Central America. This sideshow was worthless though, as Spain exerted complete control over these affairs. Meanwhile, a share listing of South Sea began to cause much exuberance. The Mississippi Company entered the fray and a monstrous credit explosion and stock market bubble ensued. This came to a head in 1720 and the resulting asset price deflation and debt implosion caused severe recessionary times that persisted until 1770.

Financial Crisis of 1825

The Napoleonic Wars had been very profitable for British business; and expansionist policies following the wars resulted in a credit boom that helped fuel a massive frenzy in stock markets. The Bank of England was at the center of it all (again) creating credit liberally. Wild speculation in dubious investments ensued - in Latin American bonds – even in the bonds of a fictional country called Poyais, and in stocks. In the bust following 1825 the Bank responded with a series of knee-jerk reactions in monetary policy that ultimately made matters worse. One hundred and five banks failed or were suspended (18% of all British banks) and recessionary times persisted until 1844.

Financial Crisis of 1873

Following decades of hardship Europe slowly emerged into 'good times'. America did so too – following a brutal civil war that saw approximately 750,000 people lose their lives (out of a total of approximately 35 million). Speculation in stocks mounted. New technology stocks came into vogue (particularly railroad stocks) and speculation became frenzied. Eventually cracks appeared and Germany de-monetized silver. The ensuing and brutal credit contraction continued miserably until 1897.

Financial Crisis of 1929

The Roaring Twenties was an exuberant time when the world was in a period of regeneration following the devastation of the First World War. In this time the US Federal Reserve practiced expansion of the money supply that aided and abetted an unsustainable boom in stocks, bonds and capital goods. By the time the Fed tightened monetary policy in 1928 it was too late. The credit-fuelled boom peaked the following year and then proceeded to gut not only America but the whole world. The Great Depression witnessed US unemployment broach 25%, which proportion only became remedied by World War II. The war partially masked the perpetuation of the depression that ran until 1946.

Financial Crisis of 2007

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.

Key characteristics of a Great Financial Bust -

The first step in a Great Financial Bust is the bursting of the obvious asset bubbles – typically shares, bonds or property. This asset price collapse results in widespread insolvencies of individuals, businesses and banks. Banks will generally experience a 'double whammy'. They will experience loan defaults of newly-insolvent customers who had borrowed the money that helped drive up the asset prices. In addition, banks will commonly experience damage on their own proprietary investments in stocks and bonds. Bank runs are common at such times - where depositors withdraw funds en masse. Typically, monetary authorities will step in and rescue a financial system by pumping liquidity into the banking system and cutting policy rates.

Whilst a central bank's response to a great credit contraction (the opposite of the original credit boom) is typically to hose the system with more credit, its actions are of limited long-run value. Deflationary recessions and depressions are followed by weak recoveries, over and over again. Massive amounts of stimulus at enormous cost to the savers achieve weak and temporary recoveries at best. The debts slowly and painfully get worked out of the system. The dismal condition typically lasts twenty years or more.

In the modern era central banks intervene such that in the early stages of a bust the losses of the speculators come to be assumed as the shared losses of all via bailouts ('Socialization of losses'). This is done so as to prevent contagion in the banking system. Later the losses of the speculators become the losses of the savers via quantitative easing and repressively low real interest rates ('Debasement of currency'). This is done so as to stimulate the economy. Meanwhile deflationary forces in the economy are enormous, as the private sector deleverages. Central banks see credit contraction and economic contraction - which result in deflation - as the enemy, and fight the 'tough times' for all they are worth. The strategy chiefly entails manipulating interest rates to unthinkable lows (so as to prop up asset prices, forestall insolvencies and to make credit cheap to borrowers), and to pump up the money supply (so as to make credit readily obtainable). Politicians commonly cut tax rates so as to leave more cash in the hands of the taxpayers, and to assist business conditions thereby creating employment. In the process these governments, which invariably have no savings (with exceptions like some Gulf states and Norway), generally turn to the debt markets for funding, and so while private sector credit contracts, public sector credit expands and results in ballooning national debt. A deteriorating fiscal position and increasing money supply translate into a debasing currency.

Conclusion

QE1 and QE2 failed. They did not achieve the objective of putting the US back on a sustainable growth path. We are not surprised. QE3 is intended to take mortgage rates lower, raise house prices, support the stock market and stimulate the economy. It is intended to achieve what the other Fed-bombs failed to achieve. Will QE3 work? We don't know. The awful employment picture may improve a bit. The moribund economy may pull itself up a little. We are not at all convinced that central bank interventions are going to fix this Great Financial Bust, but we are sure that they will succeed in debasing the dollar. And therein lies the case for gold.

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