The SA Bullion Gold Report

Q3 2013

Analyst: Hilton Davies

Date: 21st October 2013

Table 1: Gold Performance to 30 September 2013 (% per annum)[1]

	Quarter[2]	1 Yr	2 Yr	3 Yr	5 Yr	10 Yr
Gold in US Dollar	11.3	-25.3	-9.5	0.5	8.4	13.1
Gold in Rand	13.8	-7.9	1.7	14.0	13.0	17.5
Gold in Euro	7.2	-28.8	-9.8	0.8	9.5	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 September 2003	388.00	6.97	2702.42	1.17	331.19
30 September 2004	415.65	6.47	2691.33	1.24	335.12
30 September 2005	473.25	6.36	3008.78	1.20	393.13
30 September 2006	599.25	7.77	4655.06	1.27	473.15
30 September 2007	743.00	6.90	5124.29	1.42	522.98
30 September 2008	884.50	8.28	7324.23	1.42	624.03
30 September 2009	995.75	7.58	7545.29	1.46	682.62
30 September 2010	1307.00	6.97	9115.41	1.36	958.35
30 September 2011	1620.00	8.07	13068.70	1.34	1204.73
30 September 2012	1776.00	8.26	14671.89	1.29	1377.27
30 September 2013	1326.50	10.19	13519.96	1.35	980.41

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—$1,317.50 ; R12,869.84 ; €964.07

Table 3: Calendar Year Performance of Gold

	% US Dollar	% ZA Rand	% Euro
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
2012	8.3	13.6	6.2
2013 year to date	-20.0	-3.7	-21.8

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

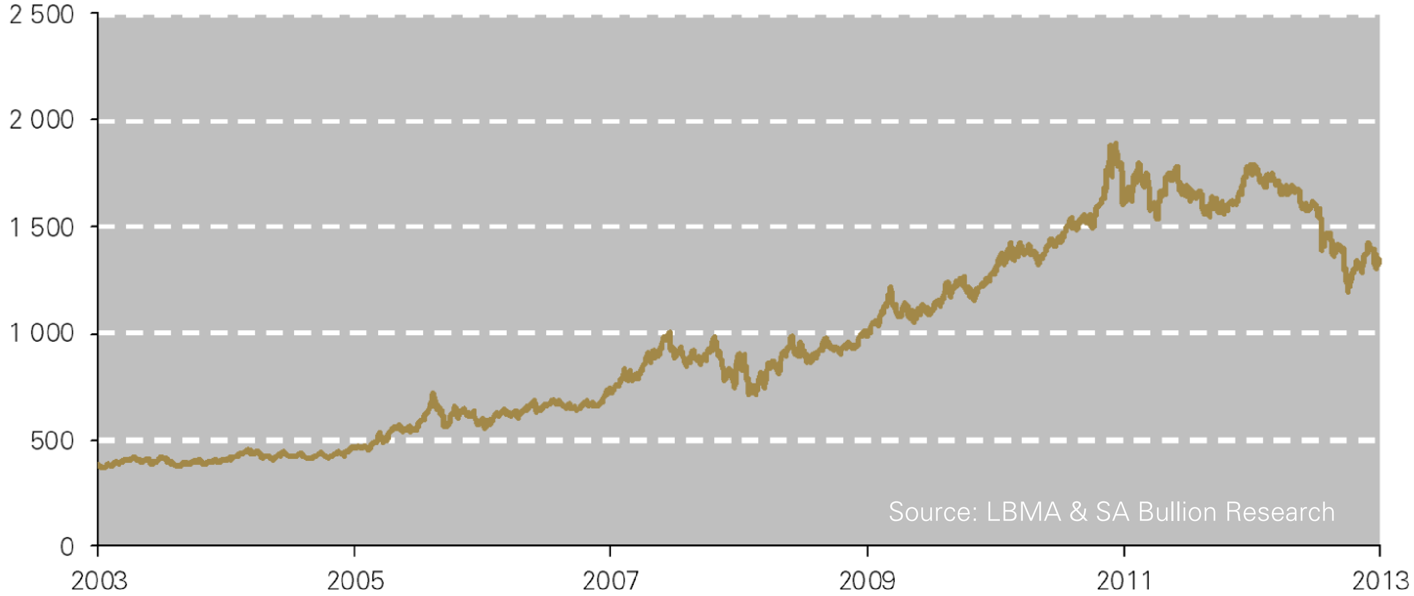
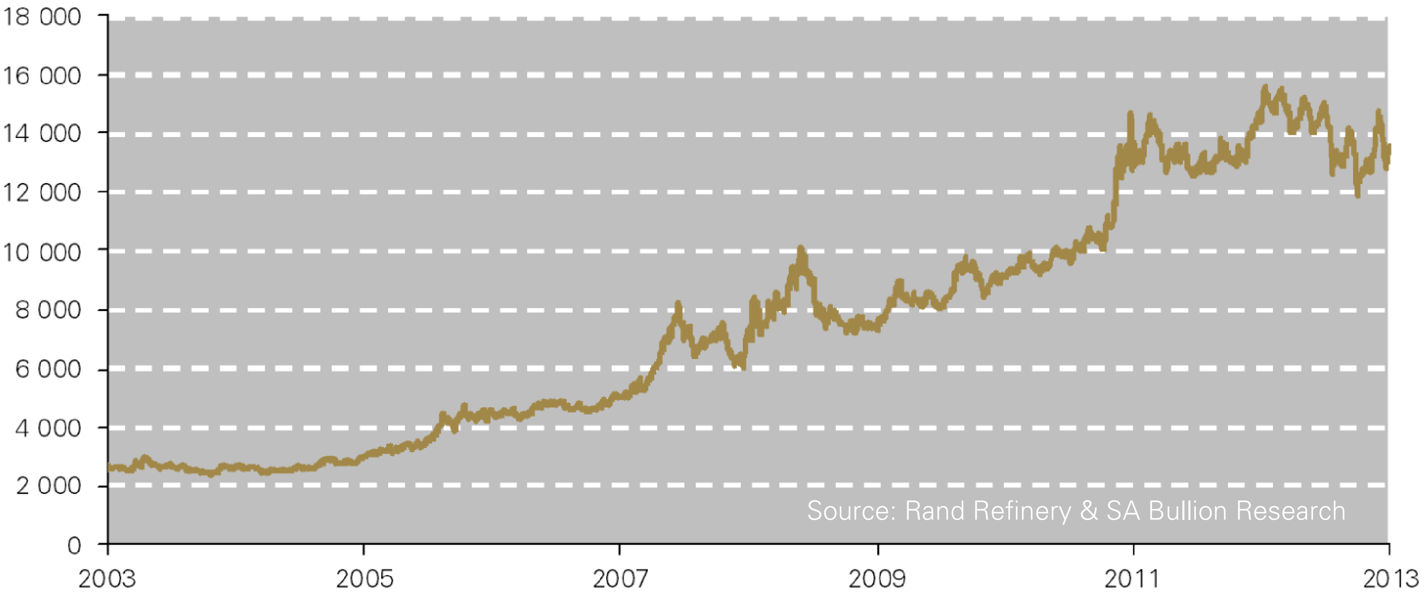


Figure 2: Ten-Year Chart of Gold Price in South African Rand



Gold Price Action

The third quarter was one of the best quarters for gold this decade. But this was on the back of one of the very worst quarters of all time. Gold was up 11.3% in this third quarter following a decline of 25% in the previous quarter.

The quarter was made up of a strong July, a strong August and a weak September. In these three individual months the movement was approximately +$120, +$80 and -$70 to give a total upward hike of $134.50. In ZAR gold gained R1272.59 and in Euro gold gained €66.02.

US Dollar Macro-Commentary

What a mess the Fed has made of their on-again, off-again comments regarding QE (quantitative easing) tapering! What a mess the US Congress has made of the sequestration, the government shutdown and the debt ceiling issues this year! These have been my predominant macro thoughts of recent times. Let me explain.

First the Fed:

The present financial crisis commenced in earnest with the collapse of Lehman Brothers in 2008. Asset prices plummeted in the wake of a banking crisis, and stock market collapses were followed by economic contraction and hardship. Since then the Fed (along with other central banks) has gone out on a limb with the most extreme monetary experiment of all time. And it is working, sort of….

The Fed has targeted two primary (and related) objectives:

- Low long term interest rates; and
- High asset prices

Some of the key reasons for the low long term interest rate objective include - suppression of mortgage rates so as to keep Americans in their mortgaged homes; containment of losses and facilitation of profits for banks on their risky investments; enabling of a lower discount rate so as to drive asset prices higher; and stimulation of credit consumption and thereby aggregate demand. I.e. this objective has been largely about enabling survival.

The key reason for the high asset prices objective is the wealth-effect phenomenon and the transmission of high-end consumption into business expansion, employment creation and aggregate demand. I.e. this objective has been largely about employment creation and economic stimulation.

The two objectives are of course closely related and intertwined.

The Fed has engineered the situation we now find ourselves in by taking the Fed Funds Rate to almost zero (i.e. short term interest rates to extreme lows) and by buying truly staggering amounts of US Treasuries and Mortgage Backed Securities so as to engineer ultra-low long term interest rates (by overpaying for those financial instruments).

In June of this year the Chairman of the Federal Reserve, Ben Bernanke, began making pronouncements to the effect that QE would soon be scaled-back or ended.

No sooner had Bernanke and various of his Fed governors made their QE-tapering comments than they were required to retract them and proceed full steam ahead with QE. The labour market and the economy did not agree with their misplaced optimism.

Next, Congress

At the beginning of this year we had the great sequestration debacle. Congress could not agree on new funding bills and so programmed spending cuts began to kick in. These cuts continue. The resulting effects were positive for the dollar (as government deficit spending was slightly reigned-in), but negative for the economy. Most importantly, the political handling of the matter was shambolic and reflected poorly on Washington.

In the last month we have witnessed abominable behavior in the corridors of power of the world's leading nation (economically speaking, of course). The vocal right-wingers of the Republican Party, the so-called Tea Party, attempted to strong-arm Congress and the President. Their objective was to de-fund (i.e. not permit funding for) the new Affordable Health Care Act, also known as Obamacare.

The action of the conservative Republicans was to cause large swathes of the US government to be closed down and the civil servants to be sent home on furlough. This went on for 16 days and ended with the conservatives losing the battle as they lost the support of the American public. This matter was then closely followed by what promised to be another big political battle – the raising of the debt ceiling. But first, an explanation of the debt ceiling….

The US federal government receives income from taxes, duties and many other smaller sources – collectively called Receipts. The federal government also has expenses, for such things as social security, healthcare, defence, education, federal agencies, etc., - collectively called Outlays.

In a financial year (with year-end being 30 September) when government is able to live within its means it produces a 'balanced budget'. This has become a rare phenomenon. The US government is living way beyond its means and the annual deficit is being finance by borrowings from the public. These borrowings, in the form of Treasuries (a collective term for bills, notes, bonds and TIPS) and various other instruments add to the debt pile which continues to mount up every year. To wit:

In the most recently reported month of August Receipts totalled $185 billion. Outlays came to $333 billion, leaving a debt-financed deficit of $147 billion.

In the first eleven months of the current financial year Receipts totaled $2,472 billion and Outlays came to $3,227 billion, leaving a debt-financed deficit of $755 billion.

Source: US Treasury Department

The aggregate of all deficits (and the occasional surplus, in the distant past) results in the Public Debt (also known as the National Debt, Federal Government Debt and Sovereign Debt). Five years ago, on 30 September 2008, this Public Debt figure stood at $10,024 billion, today, at 30 September 2013 this figure stands at $16,738 billion.

Source: US Treasury Department

So what of the “debt ceiling”? The extent of the Public Debit is limited by law so as to prevent runaway spending by a spendthrift President. In practice, this limit is controlled by Congress and is known as the Statutory Debt Limit. The reality of the situation is that spending is running away and has been doing so for a long time. To put the quantum of the current Public Debt into context, the size of the US economy (end-July GDP) is $16,661 billion. I.e. the US federal government owes more than the value of the total of US gross domestic product.

Of critical importance here is not only the size of the Public Debt or the size of the debt relative to the size of the economy, but also the cost of servicing the debt and herein lies the massive issue of the United States of America’s long term credit rating. In recent times the US authorities have not covered themselves in glory and without doubt have inflicted damage to their long term debt servicing costs. Here we need to look at credit ratings.

US Credit Ratings

US public debt has generally been regarded as the gold standard of sovereign debt. US Treasuries have enjoyed AAA ratings for a very long time and with this rating of almost zero risk of default, the US has enjoyed extremely low debt servicing costs. This is changing.

The three major ratings agencies in order of size are S&P, Moody’s and Fitch. In addition to the Big Three, four other agencies are approved by the US Securities and Exchange Commission (“the SEC”). These being DBRS (Dominion Bond Rating Service), Egan-Jones, JCR and KBRA.

S&P downgraded US government debt one notch from AAA to AA+ (with a stable outlook) during the prior debt ceiling impasse in August 2011. In the recent weeks Fitch placed its AAA rating on “rating watch negative”, meaning a downgrade is possible by the end of the first quarter next year. Moody’s has made no change from their highest rating.

DBRS, like Fitch, has acted in the last few weeks and placed US debt on AAA “under review with negative implications”. Egan-Jones cut AAA to AA+ in 2011. In 2012 they enacted two further cuts: from AA+ to AA; and then from AA to AA-.

The Chinese rating agency Dagong Global Credit Rating has US debt at A-.

The take-away from all this is that US management of its finances is not in line with a country that maintains a AAA credit rating. Looked at another way - the US is a deteriorating financial institution. And the knock-on effect will eventually mean that creditors will demand higher yields to keep them lending money to the US government. This can only translate into higher debt servicing costs for the US at a time when it is at historically high levels of indebtedness, and this in turn can only translate into a deteriorating dollar.

The South African Rand

In the last year the Rand has declined by 23.4% against the US dollar. This sudden and substantial step-down follows 10 years of a relatively stable and relatively strong Rand. Including accounting for this big recent retrenchment, the Rand has depreciated at an annualized rate of -3.6% over ten years against the dollar. This is more-or-less in line with the inflation rate differential of South Africa and the US and would therefore seem to be appropriate.

Why the recent big depreciation? The principal cause has been the recent threat of QE tapering. A winding-up of quantitative easing implies a strengthening dollar and commensurate weakening of other currencies. Additionally, as emerging markets and commodity producing countries have been substantial beneficiaries of the carry-trade due to their higher interest rates (and stable currencies) attracting capital flows, they will inevitably be substantial losers of foreign capital when ‘hot money’ portfolio capital flows back to the US to earn new, higher interest rates (and benefit from a stable or strengthening currency). South Africa has not been unique in this regard. Commodity currencies have all suffered in recent times.

South Africa does have unique problems that distinguish it from other commodity producers. Mining is a relatively small part of the economy but there is a massive multiplier effect that makes it very important for the country. And in this very important sector labour unrest has been highly problematic.

Lastly, it should be mentioned that GDP growth has slowed from 2.7% p.a. to 2.0% p.a. while the trade balance has been deteriorating.

Taken as a whole, we would not bet on much of a short term rally in the Rand and we would bet on long term weakening against the major currencies.

Closing

As analytical realists we can come to no other view than to be generally pessimistic regarding the US Dollar and the South African Rand. Whilst we do not mean to comment on other currencies in particular, this is a general view concerning global currencies.

It is our long term negative view on currencies that leads us to our long term positive view on the only 'hard' currency that the world has to offer – and that's gold.

Hilton Davies