Deutsche Bank

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Why The Gold Price Rally Will Continue

Commodities Special

- **Gold prices hit a new all time nominal high this week. We believe this rally has further to run. Indeed at the end of June we highlighted why gold prices would need to surpass USD1,455/oz to be considered extreme in real terms and hit USD2,000/oz to represent a bubble.**
- **For the time being we believe the drivers of this rally are fundamental rather than speculative. However, we admit physically backed gold ETFs are playing an important role in the gold market.**
- **However, we view interest rate and exchange rate trends as gold price bullish. Indeed history would suggest a collapse in the US dollar can not be dismissed out of hand. Moreover central banks have become a new source of gold demand while gold mining companies remain committed to closing their hedging programmes.**

The rally in the gold price has been underway since April 2001. Since the current rally is now in its ninth year, and that historically gold price rallies last no longer than four years, this represents the most durable rally in history. Moreover, the gold price has rallied by just over USD1,000/oz, representing the most powerful gold price rally in US dollar terms on record. However, to represent the most powerful rally in percentage terms then the gold price would need to hit USD2,100/oz as this would then be on a par with the 720% rally in the gold price between 1976 and 1980, Figure 2.

As these records have occurred there has been increasing debate that the rally in the gold price has either moved into over-extended territory or a bubble has formed. When one examines the performance of the gold price since 1800 these fears appear justified, Figure 1.

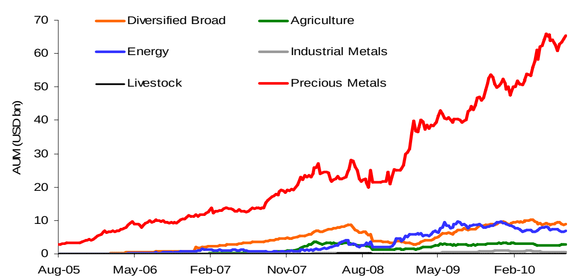
Figure 2: Gold price rallies compared

	Low (USD/oz)	High (USD/oz)	USD change	Magnitude	Duration (months)
Jan-71- Feb-75	37.9	185.3	147.4	389%	42
Aug'76 - Jan'80	103.5	850	746.5	721%	41
Jun'82 - Feb'83	296.8	509.3	212.5	71.6%	8
Feb'85 - Dec'87	284.3	499.8	215.5	75.8%	34
Sep'93 - Feb'86	345.2	415.5	70.3	20.4%	18
Apr'01 - current	255.6	1270	1014.4	397%	113

Source: Deutsche Bank

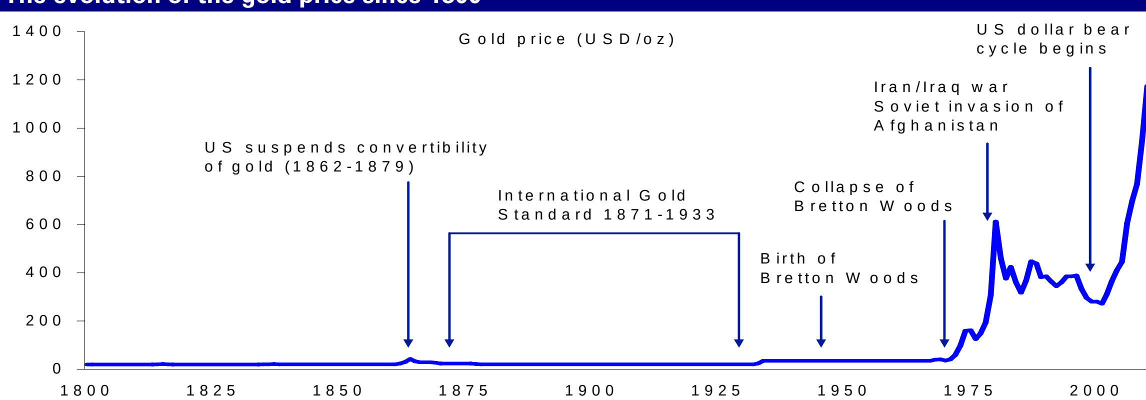
Indeed investor flows would seem to corroborate the view that the rally in gold is more speculative than fundamental. Figures 3 & 4 examine assets under management in commodity ETF in the US and Europe by sector. These two regions constitute approximately 95% of all listed commodity ETFs globally. We find that in both regions assets under management are skewed to the precious metals sector and specifically gold.

Figure 3: Assets under management of US commodity ETFs by sector



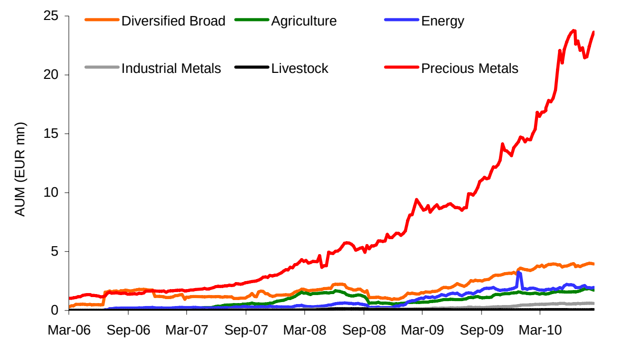
Source: Deutsche Bank

Figure 1: The evolution of the gold price since 1800



Source: Deutsche Bank, Bloomberg Finance LP, http://www.measuringworth.com

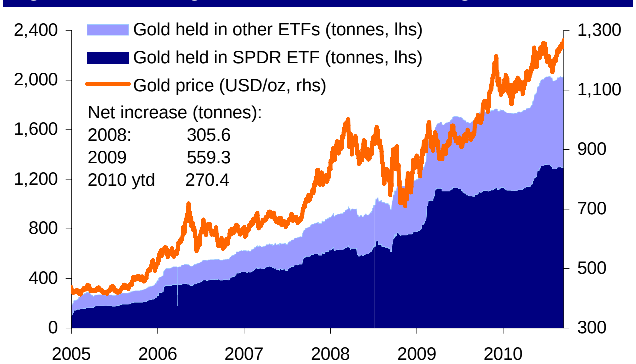
Figure 4: Assets under management of European commodity ETFs by sector



Source: Deutsche Bank

However, part of the surge in AUM in precious metal ETFs has been driven by price appreciation across the precious metals complex over the past few years. Consequently, we believe AUM figures exaggerate the inflows since on a volume basis the increase in physically backed gold ETFs has been more modest. Indeed we find that inflows into physically backed gold ETFs have slowed this year, Figure 5. So far this year physically backed gold ETFs have increased by 270 tonnes, compared to approximately 560 tonnes in 2009.

Figure 5: Holdings in physically backed gold ETFs



Source: Deutsche Bank (Data up to September 14, 2010)

Rather we view the rally in the gold price as fundamentally based. Indeed all the forces that drove gold prices lower during the 1990s have been moving in reverse since 2001, Figure 6. For example, the past decade has been marked by a new long term downtrend in the US dollar. Given the increasing likelihood that the Fed will delay monetary tightening until the second half of next year, we believe another collapse in the US dollar can not be ruled out of hand.

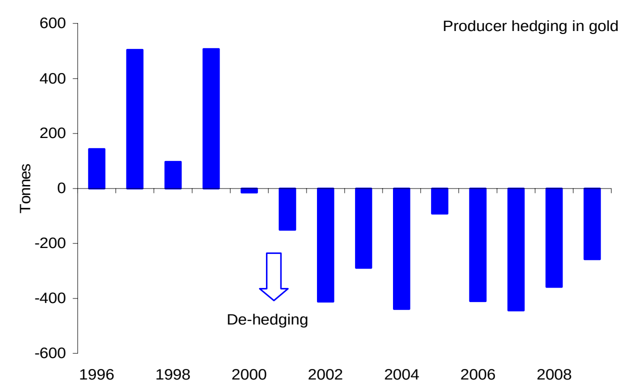
Figure 6: The new world order for gold

Forces driving gold prices lower during the 1990s	Forces driving gold prices higher during the 2000s
* A super strong US dollar	* A collapse in the US dollar
* High real interest rates	* Low or negative real interest rates
* Rampant global equity markets	* Skitish global equity markets
* Disorderly central bank sales	* Coordinated central bank gold sales
* Producer hedging	* Producer dehedging
* The rising peace dividend	* New gold investment vehicles
and the collapse of communism	* Falling mine production and rising costs
	* Terrorism & rising geopolitical risk

Source: Deutsche Bank

Another potential support for the gold price has been the elimination of gold hedging programmes across the mining sector. This week Anglogold confirmed its ongoing de-hedging programme which has been underway for several years. On an aggregate basis, the scale of de-hedging has been a reliable feature of the gold market for the past 10 years, Figure 7.

Figure 7: Producer (de)hedging in gold



Source: Deutsche Bank, GFMS

Conclusion

At the end of June we examined at what point gold prices could be considered extreme. This followed research conducted at the beginning of 2008 where we attempted to answer the same question for crude oil. At that time, we stated that for oil prices to be considered extreme prices would need to trade between USD90-USD150/barrel and beyond that range oil prices would move into territory that would represent a bubble.

Given the concerns that the gold market might repeat the price process of crude oil, three months ago we replicated this analysis for gold. We found the results interesting on two fronts. First, on none of the measures under investigation could gold prices be considered extreme at USD1,250/oz. Rather prices would need to hit

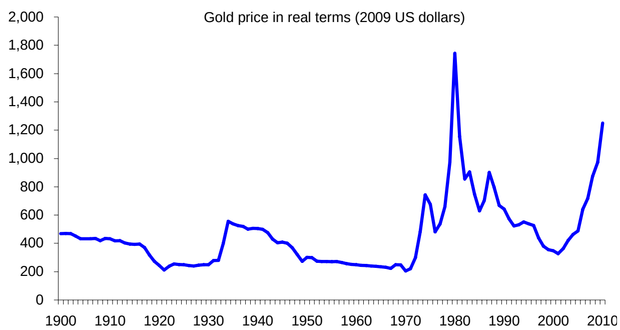
USD1,455/oz to be considered extreme in real terms. Second, in terms of a bubble forming the gold price would need to reach USD2,000/oz, Figure 8. As a result, we believe our USD1,600/oz target for gold in 2012 is not excessive given favourable interest rate and exchange rate trends and the appearance of new sources of demand for gold from both the private and public sectors.

Figure 8: The level of gold prices required to represent extreme levels of valuation versus a variety of indicators

Indicator	Gold price level
Analyst forecasting error	1,300
In real terms (PPI)	1,455
As a share of global GDP	1,500
In real terms (CPI)	1,880
Versus base metals	2,100
Relative to per capita income	2,390
Versus crude oil	2,890
As a share of the S&P500	2,960
Average	**2,059**

Source: Deutsche Bank

Figure 9: Gold prices in real terms since 1900



Source: Deutsche Bank

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Appendix 1

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