GLOBAL MARKETS FOCUS

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CAPITAL ECONOMICS

Gold prices to fall back to $900/oz by year-end

- **Gold prices are struggling again.** We do not believe that prices had risen beyond levels that could ever be justified by fundamentals. Nor is it hard to imagine circumstances where they might spike higher in the next few months. However, the occasional short-lived rally and **the absence of a bubble in gold prices is unlikely to prevent them from falling well below $1000/oz by year-end as inflation fears fade and the US dollar strengthens further.**
- Admittedly, gold prices are still at or near record highs when measured in some other currencies such as sterling and the euro. However, that is a reflection of the weakness of those currencies against the dollar, rather than the performance of the metal itself.
- Three factors explain the recent slide in the gold price (in dollar terms). The first is that **the wave of central bank purchases towards the end of last year has not been repeated**. We would not be surprised to learn at some point in the next few months that someone, perhaps China, has taken advantage of the recent dip in prices to add to its holdings. But the official sector has already been a net buyer of gold in each of the last three quarters.
- **The second reason why the rally in gold prices has stalled is that inflation expectations have failed to take off.** It is no coincidence that gold prices started to surge in Q4 2008 at the same time as the market's fear of deflation began to fade. However, inflation expectations have simply returned to more normal levels and stayed there, rather than moving any higher.
- The third and arguably most important factor behind the recent decline in the gold price is the strong performance of the dollar. **It is particularly notable how it is the dollar that has benefited the most from the latest concerns about sovereign credit risk, rather than the traditional safe haven of gold**.
- Nonetheless, a reasonable case can still be made for buying gold as insurance against all sorts of tail events. What's more, gold is not obviously expensive compared to other assets, such as equities or oil. For example, **the ratio of the Dow Jones Industrial Average to gold prices is bang in line with its historic average since 1900**.
- We do not therefore believe that gold prices have risen to levels that could be described as a bubble. However, we are sticking with our view that gold will be back below $1000/oz by mid-year as inflation fears continue to fade and the dollar strengthens further. Indeed, **we are today revising our end-2010 and end-2011 forecasts down from $950/oz to $900/oz.**

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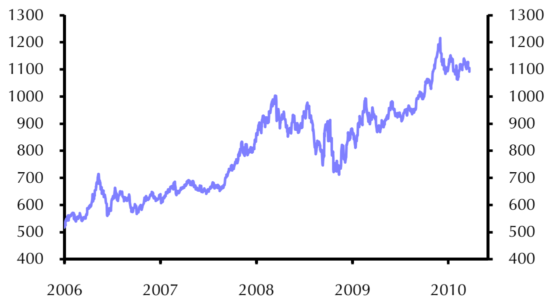
Gold prices to fall back to $900/oz by year-end

After reaching a record high of $1227/oz on 3rd December, gold prices have since drifted back to around $1095/oz. (See Chart 1.) Indeed, gold is one of only a handful of assets to have delivered a negative return over the last few months (although precious metals have at least done less badly than agricultural commodities).

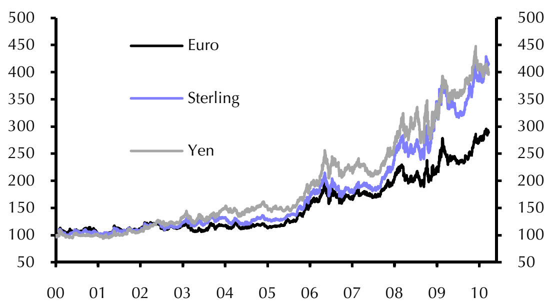
CHART 1: GOLD PRICE IN US DOLLARS ($/OZ)



Source – Thomson Datastream

Admittedly, gold prices are still at or near record highs when measured in some other currencies such as sterling and the euro. (See Chart 2.) However, that is a reflection of the weakness of those currencies against the dollar, rather than the performance of the metal itself. Put another way, European investors could have benefited from these currency movements by buying *any* dollar asset, and would actually have done rather better by holding almost anything other than gold.

CHART 2: GOLD PRICE IN DIFFERENT CURRENCIES (JAN. 2000 = 100)

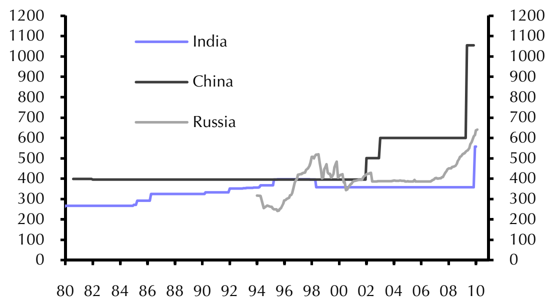


Source – Thomson Datastream

There are many potential drivers of gold prices. (See the World Gold Council's website for a very useful review of recent supply and demand trends.) But we would pick out three factors as crucial in explaining the recent declines (in dollar terms).

The first is that **the wave of central bank purchases towards the end of last year has not been repeated**. The markets were particularly excited in November by the announcement that the Reserve Bank of India (RBI) had bought 200 metric tonnes of gold from the IMF in late October, which was the first significant purchase of gold by the RBI since the mid-1990s. This followed China's announcement last April that it had increased its holdings of gold from 600 to 1054 tonnes since 2003, while Russia has officially been buying gold since 2006. (See Chart 3.)

CHART 3: REPORTED OFFICIAL GOLD HOLDINGS (METRIC TONNES)



Sources – Thomson Datastream, IMF

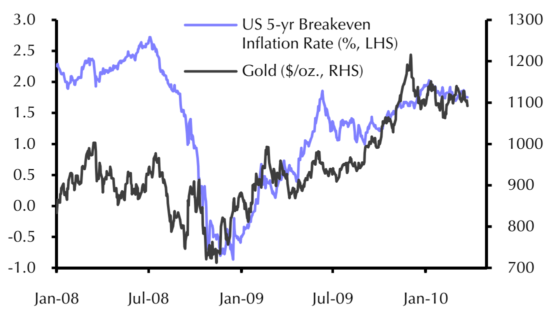
The markets took it for granted that the RBI's purchases were a signal of further substantial buying still to come, either by India or by other emerging economies, especially as many developing countries still hold a relatively small proportion of their reserves in gold. Indeed, Sri Lanka and Mauritius also bought a small amount from the IMF after the Indian move.

But in reality, **no major central bank purchases have been announced since November (aside from Russia's steady accumulation)**. Instead, officials from several countries who were assumed to be enthusiastic buyers of gold (notably China and South Korea) are reported to have said that prices are now too high. Some others, including Mexico and the Philippines, have actually taken advantage of these high prices to *sell* gold.

The upshot is that the gold market ran ahead of itself last year in expecting central bank buying to drive prices ever higher. We would not be surprised to learn at some point in the next few months that someone, perhaps China, has taken advantage of the recent dip in prices to add to its holdings. But while the likelihood of additional central bank purchases might limit the downside, it is no guarantee that prices will continue to rise. Indeed, **the official sector has already been a net buyer of gold in each of the last three quarters**.

The second reason why the rally in gold prices has stalled is that inflation expectations have failed to take off. Gold is of course traditionally seen as a reliable store of value in times of runaway inflation. It is therefore no coincidence that prices started to surge in Q4 2008 at the same time as the market's fear of deflation began to fade. (See Chart 4.) However, inflation expectations have simply returned to more normal levels and stayed there, rather than moving any higher.

CHART 4: GOLD PRICE & US INFLATION EXPECTATIONS

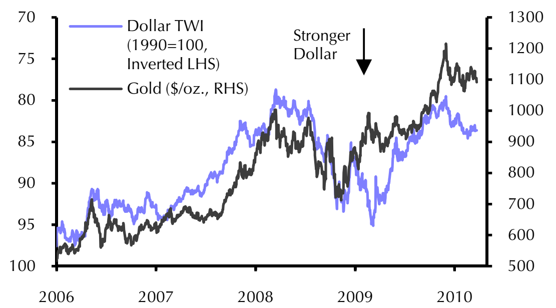


Source – Bloomberg

Looking ahead, it is possible that inflation expectations (and gold prices) will lurch higher again if central banks are perceived to be too slow in removing the emergency monetary stimulus. But we think it is much more likely that inflation expectations will drop back as the economic recovery disappoints and large amounts of spare capacity continue to put downward pressure on wages and prices. **Headline inflation has already peaked in most major economies, and core inflation has typically continued to fall**. (For a detailed analysis see our *Global Inflation Watch*, to be published next week.)

The third and arguably most important factor behind the recent decline in the gold price is the performance of the dollar. Gold is widely seen as a rival currency and the prospect of a collapse in the dollar is one of the standard arguments made by gold bugs. In fact, **the dollar has actually strengthened in the last few months, dragging gold prices lower**. (See Chart 5.)

CHART 5: GOLD PRICE & DOLLAR TRADE-WEIGHTED INDEX



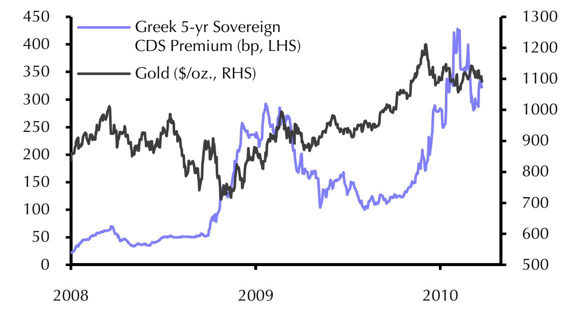
Source – Bloomberg

It is particularly notable how it is the dollar that has benefited the most from the global concerns about sovereign credit, rather than the traditional safe haven of gold.

As Chart 6 overleaf shows, gold has failed to react to the latest surge in the cost of insuring against a Greek default. Admittedly, the fiscal crisis in Greece (and the problems elsewhere in the euro-zone) are primarily a risk to the euro and hence a positive for the dollar.

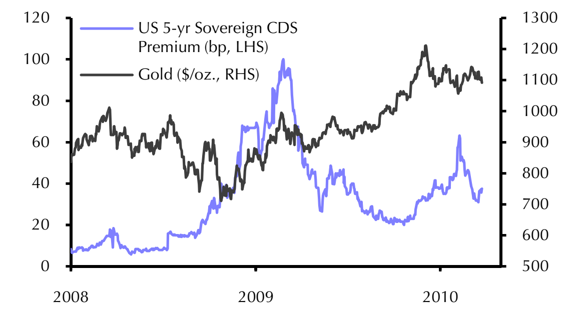
Nonetheless, **worries about *US* credit do not seem to have helped gold prices much either**. (See Chart 7.) In any event, these worries are still much less than they were during the depth of the financial crisis in late 2008 and early 2009.

CHART 6: GOLD PRICE & GREEK CDS



Source – Bloomberg

CHART 7: GOLD PRICE & US CDS



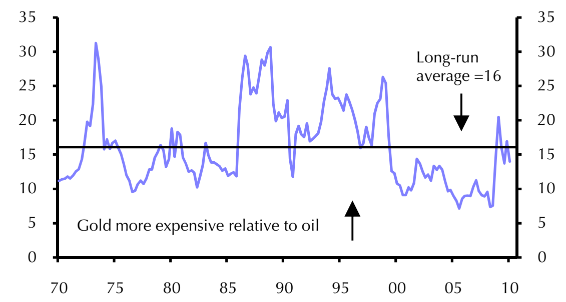
Source – Bloomberg

Nonetheless, a reasonable case can still be made for buying gold as insurance against all sorts of tail events. (For a full discussion of gold's many fundamental strengths see our *Global Markets Focus*, published on 15th October 2009.)

What's more, **gold is not obviously expensive compared to other assets**. For example, the ratio of the US Dow Jones Industrial Average to gold prices is now 10 (DJIA 10,896, gold $1095/oz), which is bang in line with the average since 1900. It could be argued that gold should actually be priced well above the levels implied by this historical average, given the unusually high degree of uncertainty about the economic and financial outlook.

Similarly, the ratio of gold prices to oil prices is currently 14 (gold $1095/oz, Brent $78/barrel), compared to the average since 1970 of around 16. (See Chart 8.) If you believe, as some do, that oil is heading for $90/barrel, then applying the historic average ratio of 16 implies a gold price of $1440/oz. (As it happens, though, we expect oil prices to drop back to $60 by the end of this year, which on this basis would imply gold at $960.)

CHART 8: GOLD PRICE ($/OZ) / OIL PRICE ($/BARREL)



Source – Bloomberg

Summary and conclusions

We do not believe that gold prices have risen to levels that could be described as a bubble. Nor is it hard to imagine circumstances where they might spike higher again, including another wave of Chinese official purchases, a jump in inflation worries linked to the resumption of credit easing by the US Fed, a surge in the oil price, or a major wobble in the dollar. The outbreak of a trade war between the US and China (or a conflict between the US and Iran) is another threat.

However, whilst acknowledging these upside risks, **we are sticking with our central view that gold prices will be back below $1000/oz by mid-year as inflation fears continue to fade and the dollar strengthens further**.

Indeed, we have today revised up our forecast for the dollar against the euro to $1.20 by end-2010 and $1.10 by end-2011, from previous forecasts of $1.25 for both horizons. (See our *European Economics Update*, "Fiscal fears and consumer caution darken euro-zone outlook", published today.) We have also become more concerned about political and fiscal developments in Japan. (See our *Japan Economics Weekly*, to be published tomorrow.) These should also favour the dollar over gold. Largely on the back of these shifts, **we are revising our end-2010 and end-2011 forecasts for gold down from $950/oz to $900/oz**.