CPM Group

Market Commentary

No. 1 27 June 2013

A Qualified Buy Recommendation On Gold

Gold prices have fallen sharply this year, in a series of sharp moves lower followed by weak recoveries. The first decline occurred in the middle of February, followed by drops on 12—15 April, and again over the past week in the middle of June.

The failure of investors worldwide to step in as bargain hunting buyers of gold in the wake of the June sell-off suggests that while they saw the sharp drop to $1,320 in the middle of April as a buying opportunity, investors now are not buying gold for two reasons. Some investors are waiting for still-lower prices before they buy. Others are shifting their opinions about future gold price trends and directions, away from expecting higher prices toward expecting lower prices.

CPM Group's view is that prices may have more short-term downside, but they are approaching fundamentally unsupportably low levels. While prices may move lower in the next two months, from an intermediate term perspective prices may be at or approaching their cyclical lows. Accordingly, **CPM Group issued a qualified buy recommendation to its clients on 14 June 2013** (***Market Alert*** *XXVII, 14 June 2013*).

Bank analysts are responding to the steady decline in gold prices by shifting from their earlier bullishness (many banks were still calling for record prices earlier this year) to now calling for further sharp declines to price levels around $1,000—$1,100, which would be unsustainably low in the long run (although not in the short run).

First We Sell...

In January 2012 CPM Group issued a sell recommendation in gold (***Precious Metals Advisory***, *XXV-1, 5 January 2012*) after writing repeatedly we had warned that gold was likely to reach a cyclical peak in a secular bull market sometime around 2011.

That January 2012 sell recommendation was for intermediate term investors in gold and silver. It stated that investors with a time horizon of two to five years might wish to take profits in their gold and silver positions, or at least hedge them with puts. At that time most bank analysts were still calling for $2,000— $2,400 prices for 2012.

Our analyses at that time suggested that gold prices had passed a cyclical peak in September 2011 and were likely to decline to around $1,400 on an annual average basis, and $1,300 - $1,400 on an intraday basis, and then trade sideways for a few years, perhaps until around 2015.

Then We Buy

As stated in bold type at the outset of this Commentary, CPM Group issued a buy recommendation on gold two weeks ago. The price was $1,390 when we released that report.

We qualified the buy recommendation in two regards. First, we wrote that prices were likely to spike sharply lower, possibly to $1,260 soon. We suggested such a sell-off might occur after the FOMC meeting ended on 19 June. We also put in some provisos related to the opportunity cost of going long gold if prices were not expected to rise sharply again for a couple of years, which is our view of the gold price. More on that later.

Prices did fall. And, there was no real rebound. Investors stood aside, waiting for still lower prices, as mentioned earlier. The market is delivering on this demand. Prices fell to around $1,275 after the FOMC meeting. They have continued to fall through today, breaking below $1,200 in New York trading this afternoon.

What We Expect Next

We expect gold prices around present levels to be the cyclical lows for gold. We are expecting another leg down on a short-term basis, most likely in the period from now through August. The reason for this is the fact that investors, at least through today, have not signaled that they view prices all the way down to $1,200 to be low enough to whet their appetite for gold.

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Beyond that, we expect gold prices to consolidate, moving sideways perhaps between $1,350 and $1,550, through 2015, before possibly rising again. These views are based on our analysis of gold market fundamentals and the macro-economic outlook.

Our silver analysis was that silver prices might decline to around $20 or $21 over the next several years. We expected platinum and palladium prices to weaken in 2012 but then begin to recover in 2013 and beyond.

As stated above, the gold market fundamentals and macroeconomic environment that we anticipated when we said to sell in January 2012, which were the bases for our price forecasts, have unfolded pretty much along the lines we had projected.

All of this leads to the question as to whether now is a good time to buy gold again for an intermediate-term investor. At these levels at this time gold may make sense as an intermediate to long term buy. Silver is looking less attractive. Platinum and palladium continue to look more attractive.

Several issues must be considered by individual investors in determining whether gold makes sense to buy at this level. Some of the issues are specific to individual investors, and some are related to the opportunity costs, or benefits, of moving more assets into gold at this time.

Short Term Considerations; The Risk of A Spike Lower

For one thing, on a short-term basis, the gold price still is vulnerable to a spike lower in the near term. Some investors may want to hold off on making fresh purchases at present levels, but should be prepared to purchase gold on a possible steep decline in prices at some point over the next two months, during the period of seasonal weakness in gold demand and prices, and the time of greatest risk to such a move downward in prices. Other investors may well be content to purchase gold at current levels and not try to pick the low of the market. Still others may want to wait to see where gold prices are in September, after the period of seasonal price weakness and heightened risks of a sell-off are past.

Whether or not investors see the current lower prices as another opportunity to stock up on gold is critical to the short term gold price, and also bears important implications for prices over the next few years. If investors have shifted their views and do not see prices around $1,200—$1,250 as a bargain, if they refrain from buying either because they do not think prices are low enough yet, as they did in April, or because they have decided prices are heading lower on a longer term basis and thus a sell off is no longer a buying opportunity, then prices are at risk of another leg down.

At present, there are few signs of strong demand at these lower prices. Indian market sources reported increased demand, but said the buying levels were less than half the volumes seen in the first week of May. Chinese dealers reported modestly stronger purchases, but said investor appetite was well below the levels seen during the sharp sell-off in April.

Following the sharp decline in the middle of April, which had pushed gold prices to two-year lows, there was strong demand for buying the metal from investors around the world. While much of the market press focused on demand in Asia, investors in North America, Europe, the Middle East, Latin America, and other quarters all participated in what they saw as a bargain hunting opportunity. Those shorter term funds that had shorted gold around $1,560 before the sell-off bought back their shorts, and in some cases went long on a short-term basis, adding to the strength of the price rebound. As a result, prices quickly rebounded to around $1,480 in nine trading sessions. This was not as high as gold prices were before the selling began on 12 April, and the rally stalled out. This signaled likely further weakness in prices, which was seen in May and then again late last week and this week.

The decline in prices in the middle of April had been very timely, occurring just prior to the wedding seasons in India and China. This resulted in a substantial amount of buying from consumers in those countries, especially India. This demand helped push gold prices higher through the end of April.

Some investors were taking advantage of the increase in prices during the second half of April to exit their long positions in gold, however. Physically backed exchange traded product (ETP) holdings continued to decline through the rest of April and May, and non-commercial market participants on the Comex were building even larger net short positions, taking gross shorts to record levels by late May. These investors were disillusioned by the lack of gold's inability to rise for more than 18

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months past its 2011 highs, and by the fact that the late April rebound only saw a partial recovery that fell far short of the ranges of prices prior to 12 April.

The premia on gold products issued by the U.S. Mint resumed their earlier slide in May, after rising in the second half of April. With a majority of the buying from the Indian and Chinese wedding season done during the second half of April there this one large factor no longer was providing support to gold. Prices fell back in May, and staged an even less healthy recovery in late May and early June, signaling vulnerability to another steep decline. Comments regarding the winding down of monetary accommodation by the Federal Reserves chairman, Ben Bernanke, on 19 June pushed most asset prices down sharply on 20 June. The negative impact of these comments lingered into this week, with prices declining to $1,196.10, on a intraday basis, on 26 June.

This time around there maybe little reason to expect gold prices to rise after the sharp decline in prices, as was seen in the middle of April this year. The inability of gold prices to sustain the gains seen during the second half of April may cause gold market participants to wonder if they should wait for prices to decline further before they step in as buyers.

Even in countries like India and China, where there is a great deal of demand to own gold, there is less incentive to rush in and buy at present levels. It is not clear if investors this time have the same sense of urgency to purchase gold as they did in the middle of April.

In India, any weakness in the gold prices is likely to be offset by a decline in the Indian rupee against the U.S. dollar and an increase in import duties by the government. Both of these factors would make imports into the country more expensive. The next marriage season in India is not until November. The next round of gold buying for weddings in China is not expected to occur until September, ahead of October when there would be an increase in the auspicious days for weddings. The gold market is moving into a seasonally weak period, typically both fabrication demand and investment demand slow over the next few months.

Investors in gold ETPs have been selling into prices rallies and price declines, which suggests that there is an eagerness among these investors to exit their gold positions. Gold ETP holdings were down to 67.85 million ounces on 26 June, down 21.5% or 18.6 million ounces from the end of 2012. There was a marginal increase in the premia on U.S. Mint gold coins following the sharp decline in gold prices on 20 June. Total open interest in Comex gold has been rising alongside the sharp decline gold prices, which suggests that investors are building fresh short positions.

The next support level for gold prices is $1,200, being tested as this is being written today. If there is not sufficient demand for gold at this level prices could see another round of declines, possibly toward $1,150 or even $1,100. Gold market participants who have not been buying or have been selling gold may be more inclined to see value in owning gold at those levels.

Silver

Silver prices broke below $20 on 20 June, settling 8.3% lower at $19.82 from the previous day. Similar to gold, the catalyst for this daily decline was the announcement by Ben Bernanke related to tapering monetary accommodation.

Physical demand for silver appears subdued. Physical silver ETP holdings have moved into a declining trend since the third week of May and the weakness intensified this week. At the end of last week, combined physically backed ETP holdings were at 617.7 million ounces, down 1.3 million ounces from the end of last year. As of 26 June holdings had declined to 611.1 million ounces, down 7.9 million ounces from the end of 2012. Premia on American Eagle silver coins sold by authorized dealers have risen since the decline in prices began again last week. Premia on coins were at 16% on 26 June, up from 12.8% on 19 June. There is potential for prices to leg lower over the next several weeks. Prices could potentially touch $16.80, but may move higher thereafter.

Long Term: Opportunity Cost, or Benefit

On a longer term basis, the idea that gold prices may consolidate broadly between $1,350 and $1,550 for the next two years presents investors with a quandary.

What is the opportunity cost of buying gold today, around current levels, versus waiting a couple of years. The gold price in 2015 might be $1,450 or $1,500. Does it make more sense to wait, and to put one's investments in other assets in the interim?

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The answer to that depends in part on where else one might put investible funds. If the money is going to be parked in cash and cash equivalents, the opportunity cost is relatively low, given current and projected interest rates over the next year or so. If one's assets are in bonds, the risks of substantial losses should interest rates begin to move even slightly in the next year or so possibly is greater than the potential further losses in gold. If one's assets are in stocks, the risk-reward ratio may be far more skewed to the risks of losses in stocks than in bonds or gold.

Given the greater risks of losses that may exist in stocks and bonds over the next two years compared to gold, which already has lost around 28% of its peak value of September 2011, it may be that investors would see the opportunity cost of moving some more of their money into gold now rather than later as a more prudent move, as a way to provide increased portfolio diversification and protection against losses in stocks and bonds, rather than foregoing potential capital appreciation in these other assets.

Silver

There are more bearish factors weighing on silver prices than any of the other precious metals. Investor sentiment toward the metal is being weighed down by similar reasons as gold as well as an anticipated slowdown in fabrication demand growth due to slowing industrial activity.

Silver prices are vulnerable to further declines over the next few months. CPM Group had projected that prices would potentially break below $20 and drop to around $18. Silver prices have achieved these lows. CPM Group is holding them for now, but will be re-evaluating whether we should lower the floor price we are projecting for July and August over the next two weeks, as we preparing our monthly **Precious Metals Advisory** for its 11 July release. During this time we will be monitoring our host of market metrics to gauge whether investors are sufficiently stimulated by prices at these levels to start buying again, or whether they are continuing to wait for and anticipate lower prices.

Platinum and Palladium

Platinum and palladium have price supportive supply and demand fundamentals. The potential for further weakness in gold prices in the short term could drag PGM prices lower. The gold market has a strong short-term influence on the prices of the entire precious metals complex, which can cause PGM prices to fall irrespective of its positive fundamentals.

Any weakness in PGM prices most likely will be treated as a buying opportunity by investors, based on the upside potential in these markets. In the short term, if precious metals prices decline as expected platinum prices could head toward $1,250 while palladium prices could be dragged down to $580. Over the medium term platinum prices could rise toward $1,800 and palladium prices could rise back to $850 or higher.