ABC BULLION™

GOLD DIRECTIONS REPORT

4th October 2012

Gold prices closed the September quarter at USD $1776 per ounce, a rise of nearly 7% from the end March price of USD $1662.50. This increase was also matched in the silver market where prices rose 9% to close the September quarter at USD $34.65

In this edition of the Gold Directions Report, we'll be covering a few topics. Up first is a review of the last 12 months of gold price movements, which will help give a longer-term perspective to recent gold price movements to our clients and readership.

Secondly, we'll be taking a looking at what is happening in regard to the global debt crisis, and also an update on the latest news on central bank money printing. The announcement of the initiation of QE3 (Quantitative Easing, Round 3) by the US Federal Reserve, as well as actions from both the European Central Bank (ECB) and Bank of Japan (BoJ) have certainly put the spotlight back onto precious metals.

This edition of the Gold Directions Report will finish with a look at Central Bank gold buying, and what ended the last gold bull market, in an attempt to illustrate why we think the present precious metal bull market has a lot further to run.

Before we get into these topics, please see below our standard disclaimer,

> *ABC Bullion is a commodities trading business, and we make profit buying AND selling precious metals. Nothing in this report is intended as investment advice, either general or individual in nature. Before you make any investment decisions you must consult a financial adviser.*
>
> *Please try to find one who's up to speed on precious metals though - they can be hard to find but we know of a few.*

With that in mind, let's get started -

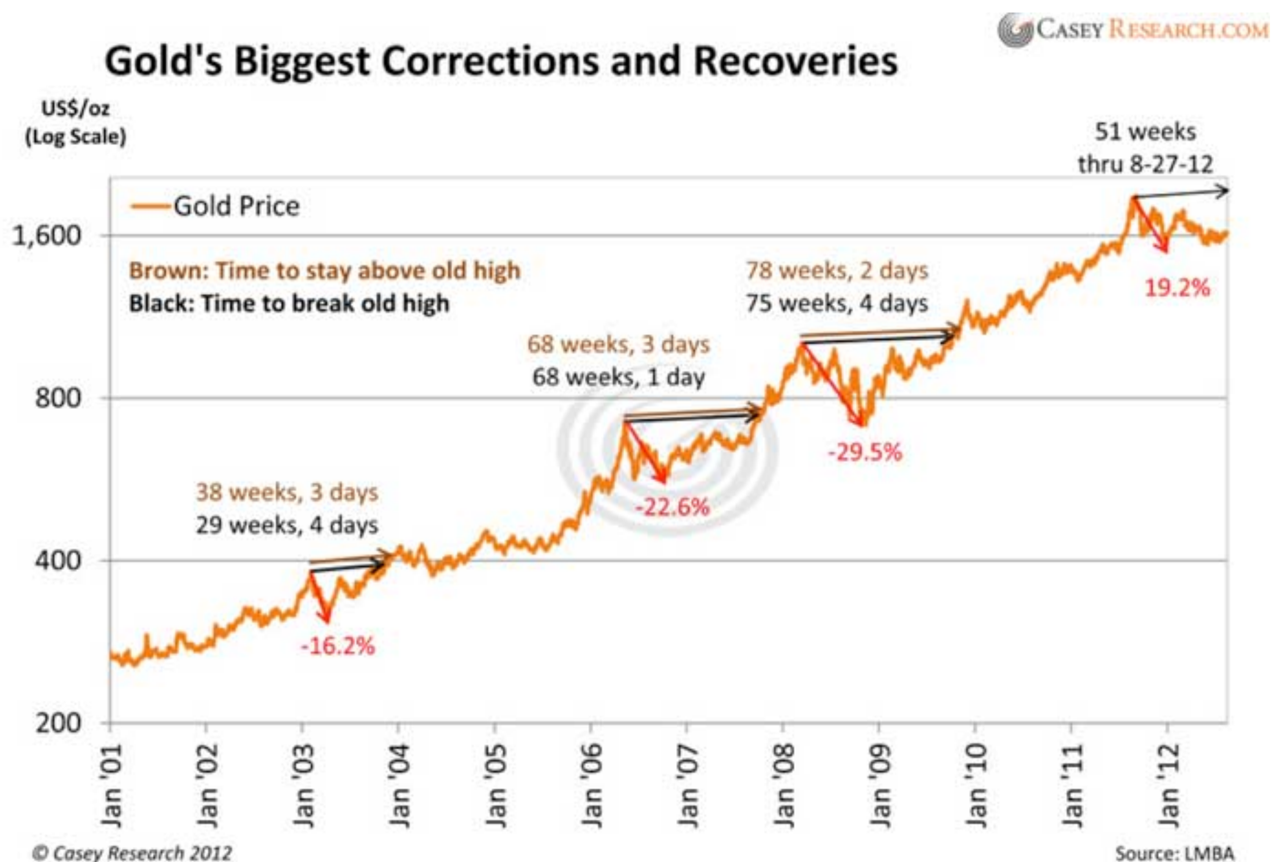
The Last Year In Perspective

There is no doubt that the last 12 months have been trying for precious metal investors, especially those new to investing in gold and silver. After closing the month of August 2011 at over USD $1830 an ounce, gold (and silver) experienced significant corrections, with gold closing out the year trading at around USD $1530. This

variation in the gold price continued into 2012, with gold rising as high as USD $1770 in February before correcting again to around USD $1550 by May 2012.

Whilst we understand our clients' angst when they see prices correct and move around like this, it does pay to put the corrections we've seen into some perspective. Over the course of the last decade (a period in which gold has gone from USD $255 to USD $1776) there have been a number of major corrections along the way. These corrections (as well as the time it has taken for gold to recover and reach new highs) are captured neatly in the chart below and have ranged in severity from between 16% to 29%. In some cases, these corrections have taken over a year to recover from before gold continues onto new highs.

This should help put the pullback from USD $1895 (in September of last year) to USD $1530 in December in some context, as that is a fall of roughly 19%, and gold has been climbing back since towards that mark since then.



To give even more historical context to gold price corrections within a bull market, it is worth pointing out that back in the 1970's gold bull market, there was actually a period where the gold price fell just under 50% at one point (from USD $193 in December 1974 to USD $104 in August 1976).

No doubt investors who bought-in at around USD $190 felt very nervous about their gold holdings after a fall like that. Had they sold their gold after that correction, they would have not only locked-in a loss on their investment, but more importantly, missed out on one of the great bull markets of our time as over the next 4 years, gold went on to trade at over USD $850 an ounce.

Considering the troubles Europe has had over the past 12 months with Greece, Italy, Spain and Portugal, it is not surprising that the USD has strengthened and that this had a short term, negative impact on the gold price.

However, the flow of money into US currency, and into the US bond market is not a sign of US economic strength, and does not portend the end of the gold bull market.

As we'll discuss in the next section, the debt crisis is not only unresolved but is, in many ways, accelerating. The economic picture in Europe and the US continues to deteriorate. As a result, there is good reason to expect gold to continue performing well, going forward.

The Global Debt Crisis – Update

The GFC has been with us with for a number of years now, causing volatility and uncertainty in asset markets since 2007 and 2008. The impact on Australian investors has been severe, with the average return on Australian superannuation funds slightly negative over the 5 years from June 2007 to June 2012 according to Chant West. Over the same period, the USD price of gold went up by nearly $1000 per ounce.

Despite the troubles caused over the past few years, the global economy is in an arguably worse place today, with sovereign debt levels far higher than they were a few years ago, as the following table, using data from the OECD (Organisation For Economic Co-Operation and Development) clearly illustrates:

COUNTRY	2007	2012
Germany	65.60	87.30
France	73.00	102.40
Japan	167.10	219.10
Uk	47.20	97.20
USA	62.10	103.60

Since the 1990's, public debt as a percentage of GDP in OECD (Organisation For Economic Co-Operation and Development) countries has grown sharply, from around 70% to over 100% today. This number is predicted to increase, with projections highlighting that it will grow towards 110% in the next few years. Note that this number does not account for the future liabilities that governments will need to pay in order to satisfy the increased social spending that will come as a result of the ageing population. Along with too much debt, the burden of paying for an ageing population is another trait that most developed-world nations will have to contend with going forward.

In terms of whether or not this additional debt is helping stimulate an economic recovery, it is worth pointing out that unemployment in Europe is still at record highs. Roughly 25% of Greeks and Spaniards are unemployed, with the problem even more severe amongst the youth of these countries. In Spain for example, over 50% of the population under the age of 25 are unemployed.

If we were to look at the USA in more detail, we would also see that the economy is clearly deteriorating, despite the unprecedented stimulus steps taken so far by the Federal Reserve namely QE1 and QE2 (Quantitative Easing), as well as the unprecedented fiscal deficits the government has been running.

Since 2008, total US government debt has risen from roughly $10.3 trillion to nearly $16 trillion today. The number of people in the USA relying on food stamps for their day-to-day survival has risen from 32 million back then to nearly 47 million today. Finally, the employment situation is far worse today, with the actual number of people unemployed (according to the U-6 definition) rising from roughly 13.5 million to 22.5 million Americans.

This information highlights the fact that the problems caused by borrowing too much money and building up such high levels of debt are still with us. The debt problem the developed world faces today is a result of several decades of over consumption, and solving the problem will not be easy. Efforts thus far by governments and central banks to re-stimulate the economy with even more borrowing and even more debt are not only failing, but are actually making the imbalances even larger.

Since the GFC, governments around the world have had to resort to printing money in order to finance their own spending, a situation which carries the obvious and not insignificant risk of much higher inflation in the future. With that in mind, it's worth looking now at why, years from now, QE3 will be seen as a 'game changer'.

Central Bank Money Printing – why QE3 is a 'game changer'!

The announcement by Ben Bernanke, Chairman of the US Federal Reserve (the Fed) on September 13th 2012 that they were initiating a third round of quantitative easing (QE3), was widely anticipated by the majority of the market. Initiated in order to '*put downward pressure on longer term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative*', the Fed will buy $40 billion in mortgage-backed securities each and every month going forward.

Whilst the amount of USD $40bn a month is not large (at least, not relative to the size of QE1 and QE2, which collectively led to the printing of over USD $1.5 trillion) what made the announcement a 'game-changer' per se was the following comment by Mr Bernanke:

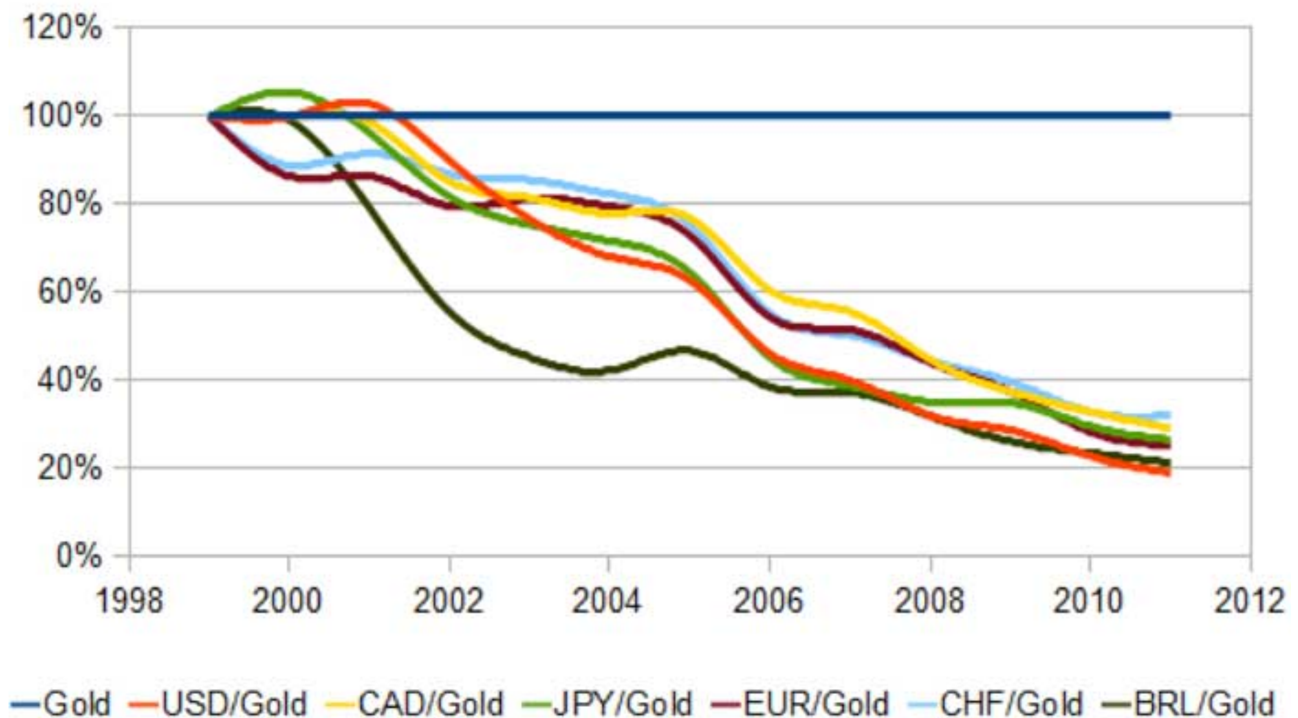
> *"If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability… [A] highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens"*

In neither putting an end date on this asset purchase programme, nor specifying a maximum dollar amount, in effect what Mr Bernanke has announced is that money printing is the **new normal**. Not only could money printing continue in perpetuity, but the dollar amount printed per month could also increase. Mr Bernanke has even left the door open for The Fed to start buying up additional assets in order to support markets.

The Fed is not the only central bank trying another round of monetary stimulus, with their behaviour matched by their counterparts at the European Central Bank, the Bank of Japan and the Bank of England. Whilst the latest announcements by these institutions have some differences to what The Fed is doing, they all ultimately translate to additional money printing, which, of course, risks higher and higher inflation down the line.

All of these policies are designed to weaken the currencies these institutions are meant to protect, in the hope a weaker currency will stimulate demand for exports. Whilst the rate of currency depreciation between the EUR and the USD, or the YEN and the GBP will vary, in an environment like this, all currencies are likely to continue to losing value against gold, the one form of money which is immune to central bank creation.

The outperformance of gold relative to all major, paper currencies is highlighted neatly in the following chart, which begins back in 2000.



As you can see, no matter whether we are looking at the US Dollar, the Canadian dollar, the Euro or the Yen, all are losing value against gold. In an environment where interest rates are likely to remain low for many years (due to the debt problems mentioned above), and the threat of higher inflation will be ever present, there is good reason to believe that more and more people will consider saving their wealth in gold, rather than in a traditional bank account. This week's (October 2nd 2012) announcement by the Reserve Bank of Australia to cut interest rates again (to a 3-year low of 3.25%) is a timely reminder that poor returns on cash may well affect Australian savers in the future.

The threat of continued rate cuts should not be overlooked. Many economists are predicting further rate cuts ahead in order to boost our economy, which is starting to struggle due to a stagnant/falling housing market, as well as a slowdown in China, which has seen the prices of key export commodities like iron ore and coal fall significantly the past few months.

There has even been talk of the RBA printing Australian dollars in an attempt to weaken our currency, which would also likely add impetus for further gold buying.

Central Bank Gold Buying

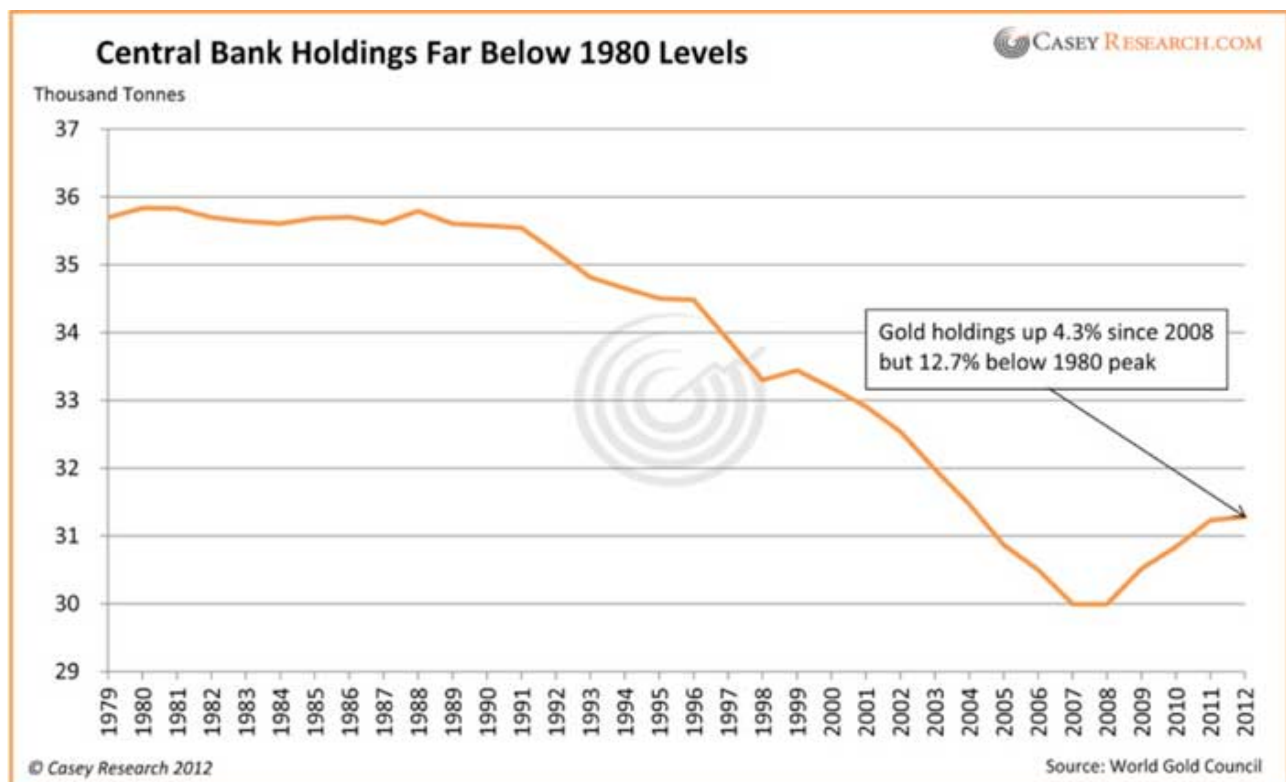
On the flip side of the coin from central bank money printing in the developed world, is central bank gold buying, especially in the developing world, with emerging market nations looking to increase their exposure to gold.

Since the end of 2008, central banks have added nearly 1,300 tonnes of gold to their foreign reserves (excluding

China which we'll touch on separately). In terms of what some individual nations have been up to in the gold market, the following might shed some light on how keen emerging market nations (who traditionally just held $US or US government debt as their reserve assets) are to get some exposure to 'real money'

- Turkey has bought over 120 tonnes in barely 1 year
- Since February of 2011, Mexico has bought over 100 tonnes
- In March 2012, the Philippines bought around 32 tonnes, their 2nd largest purchase ever
- Russia increased its holdings to about 911 tonnes, the highest amount since 1993

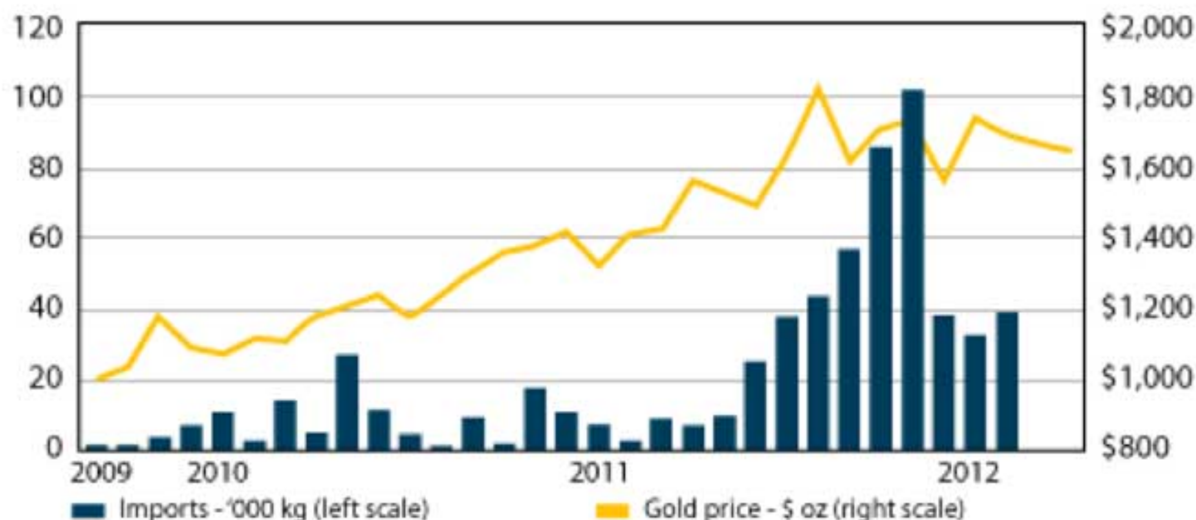
However, despite the increased activity of central bank gold buying, they have a lot of 'catching up' to do. Due to nearly 2 decades of constant gold sales by central banks globally, their holdings are still well below where they were back in 1980, as the chart below shows:



If central banks were to buy enough gold to get them back to the level they were at in 1980, they'd need to buy around 5000 more tonnes, or nearly 2 year's worth of annual production. That figure doesn't take into account the obvious fact that the total value of all assets central banks hold is much higher today than in 1980 (in fact, it has risen by over 600% since 1995 alone). Obviously, if central banks wanted to own the same percentage of their reserves in gold as they did back in 1980, they'd have to hold far more than 36, 000 tonnes of gold.

The role of central bank gold buying is especially relevant to China. Despite their rise as an economic superpower, and their historical affinity for gold ownership, the Chinese government today owns very little gold relative to their total foreign reserves. At present, China only holds about 2% of its foreign reserves in gold. This number is a long way below that which might get you into the 'traditional economic superpower club', with countries like the USA, France and Germany holding up to three quarters (75%) of their foreign reserves in gold bullion.

This is a situation China trying to address urgently, with imports of gold into China from Hong Kong growing substantially over the last few years, despite the increase in price, as the following chart shows:



Continued central bank buying, especially from the developing world (Russia, Brazil, India etc. as well as China) is likely to provide ongoing support to the gold price in the years ahead.

Is the Bull Market Over?

From where we stand, there is no good reason to believe that the bull market in precious metals is over. Whilst the price has risen substantially over the past 10 years (from around USD $250 to USD $1766 today) there are many reasons to think that the gold price could increase further.

Whilst there are a number of ratios we could look at to help illustrate this fact (gold vs. inflation, gold vs. equities or gold vs. US money base are other oft-quoted ratios) the one we will focus on in this report is gold as a percentage of total global financial assets.

As the following chart shows, at the end of a typical gold bull market, the value of all the above ground gold in the world tends to be worth somewhere between 20 and 30% of total global financial assets. You can see this in 1921 (start of 'The Roaring 20s'), in 1932 (Great Depression), 1948 (not long after WWII ended) and again in 1981 (end of Stagflationary 1970's and gold's last great bull market).

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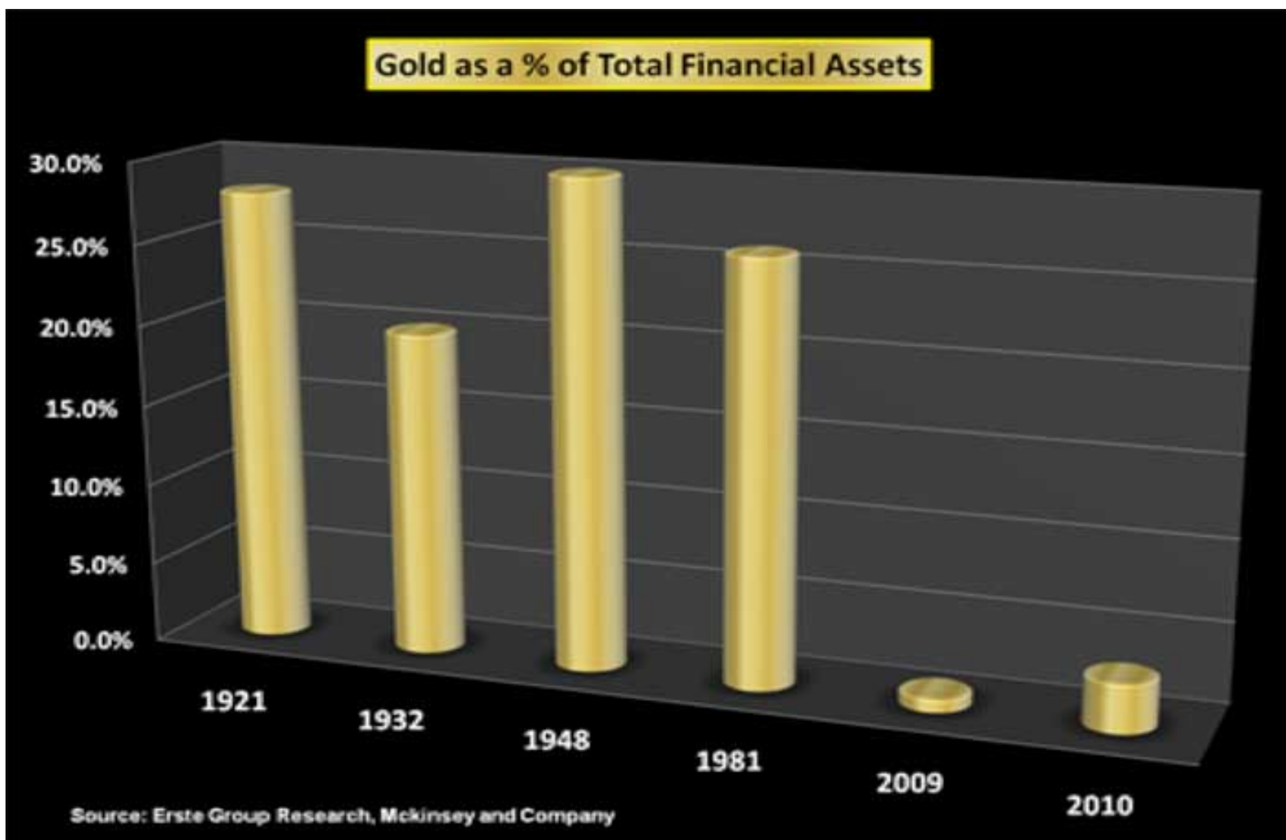


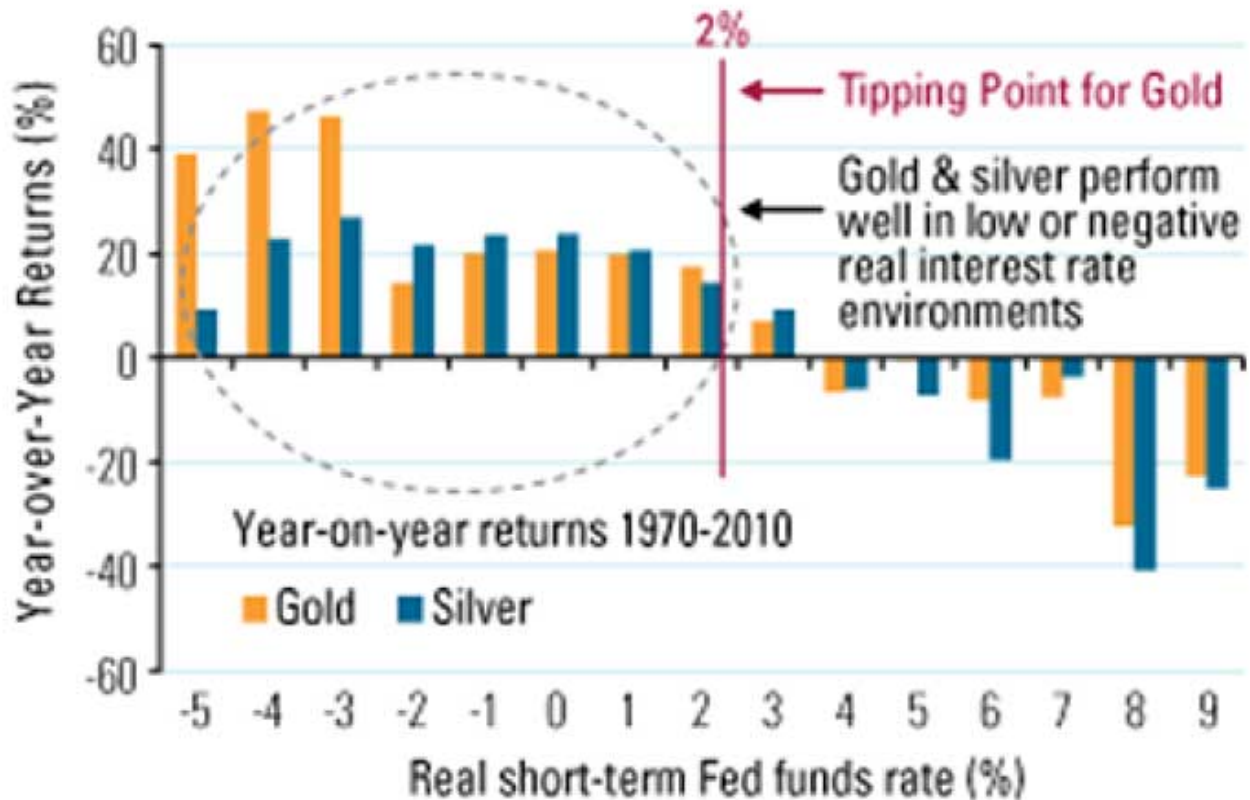
At present, there are roughly 170,000 tonnes of above ground gold supplies in the world. Remembering that there are 1000 kilo's in a tonne, and 32.15 troy ounces in a kilo, this means there are approximately 5.5 billion ounces of above ground gold. Using the price above of USD $1766 per ounce, this comes to an approximate market value of just over USD $9.5 trillion (nearly 7 times the size of Australia's stock market).

Whilst USD $9.5 trillion is indeed a lot of money, it is worth noting that, as at the end if 2010, the Mckinsey Global Institute estimated that the total global pool of financial assets (all the stocks, bonds, cash on deposit etc. in the world) was circa USD $212 trillion.

As a result, as you can see by the graph above, the value of all the world's gold today is still less than 5% of the total pool of global financial assets. Whilst no one can predict the future with 100% certainty, data like this gives us confidence that gold is not 'in a bubble' and that the bull market is not over.

We are further encouraged in our positive outlook on gold due to the activities mentioned above by the world's economic powerhouses. As we mentioned, globally, central banks continue to print money, and interest rates in the majority of the developed world are still negative in real terms. These two forces have historically led to stronger gold prices.

The chart below helps to highlight this clearly, in that it shows that the annual average return of gold and silver over the past 40 years has been very strong in periods where real interest rates are below 2% (as they are now in the US, UK and Europe)



The information in the graph above is further backed up by the table below, which highlights how high interest rates on financial products (cash, bonds and equities) were back in February of 1980, when the last gold bull market ended.

Remembering that gold is, of course, a monetary asset, it is logical that the higher real interest rates (ie. after inflation) are on financial products, the less attractive gold might be as an investment.

STATISTICS	FEBRUARY 1980 PEAK	CURRENT LEVEL
Federal Funds Rate	14.13	0 - 0.25
10 Year Bond Yield	12.41	1.82
S&P 500 Dividend Yield	4.99	1.94

As you can see, back in 1980, one could earn interest of over 14% simply leaving money in a bank account, whilst you could get over 12% lending money to the US Government for 10 years.

Wind the clock forward to today, and interest rates on cash are essentially zero, whilst the return for lending to the US Government is around 1.82%, at a time when the US Government owes over $16 trillion in debt.

Both of these rates are already below the official rate of inflation, with the last core CPI reading (as at August

2012) coming out at 1.91%. With potentially unlimited money printing going forward (based off the QE3 announcement by The Fed), there is a good chance we will see much higher rates of inflation going forward.

The potential for higher inflation going forward is likely to continue to lead individuals to consider alternate stores of wealth, as the attractiveness of storing wealth in dollars continues to diminish.

In our opinion, gold will be a key beneficiary of this trend, and we see the price of gold continuing to be supported up until central banks around the world not only stop printing money but raise interest rates on paper money to a level far higher than they are today.

Considering the additional financial burden that higher interest rates would place on the governments of the western world, who are already spending sizeable percentages of tax revenue on debt interest payments (despite interest rates being at record lows in countries like the US, Japan and Germany), this process is unlikely to happen for many years.

Before finishing this edition of The Gold Directions Report, it's worth pointing out that we are right now in the 'sweet-spot' for gold price appreciation. Over the course of the bull market the average price appreciation for the August to February period has been circa 20%.

If we think that gold closed out the month of August around the USD $1650 mark, a continuation of this trend could see the gold price hit USD $2000 at some point in the first quarter of next year!

If you have any questions or enquiries regarding anything mentioned in this report, you can contact one of our staff on 02 9231 4511, but please bear in mind, they won't be able to tell you what the gold price will be next week!

The Client Service Team

ABC BULLION

Australian Bullion Company (NSW) Pty. Ltd.

Suite 30, Level 6, 88 Pitt Street, Sydney I GPO Box 2435, NSW 2001 I t 61 2 9231 4511 I f 61 2 9233 2227

www.abcbullion.com.au