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### Gold kneels before its new QEeen

Precious metals have had a poor November so far, falling from USD \$1324 for gold and USD \$22.20 for silver on the 31<sup>st</sup> October.

With prices currently sitting at USD \$1274.75 and USD \$20.35 respectively, prices are down 4% and 9% respectively for the month, as the confirmation hearing of Janet Yellen, a continuation of the current QE programme, and relatively soft economic data have all failed to spark buying interest for either metal in the past fortnight.

Sentiment towards precious metals is still incredibly weak, with net long positions cut by speculators in the week ending 12<sup>th</sup> November to just 55,456 futures and options, whilst short bets have increased to the highest levels since mid-August.

The 'gold to USD \$1000' crowd is again out in force and we are again seeing [talk of Goldman Sachs 'slam dunk' sell recommendation](#) on bullion, something I wholeheartedly disagree with.

In terms of what has caused the weakness in bullion over the last two weeks, it would seem that the strong headline non-farm payroll print from the 8<sup>th</sup> November was where it started, as that took the wind out of the precious metal sails, leading to gold falling back through USD \$1300.

It has not made it back to that level since, despite the fact that the strong headline print was accompanied by a huge drop in the labour force, as well as a reduction in average weekly hours worked, and weak growth in average hourly earnings.

Since then, in the US we've seen unit labour costs fall, industrial production fall, a deteriorating trade balance, a declining NY State Empire Manufacturing Index, declining capacity utilization and total outflows of capital out of the US of over \$100 billion.

All of this data has been particularly soft, and supportive of the notion that tapering of the Federal Reserve's (the Fed's) QE programme will not happen until some point in 2014, if at all.

This sentiment was reinforced with the confirmation hearing of Janet Yellen to head up the US Federal Reserve once current Chairman, Ben Bernanke, steps down. Her confirmation hearing, late last week was undoubtedly [the 'highlight' of the global economic calendar](#).

In a surprise to no-one, Yellen very much followed the status quo with her prepared remarks, and in the Q&A session that she engaged in, stating, amongst other things that:

- The jobless rate in the US remains high
- The Fed mustn't remove stimulus while the economy is 'fragile'
- Weak demand was a drag on the economy
- The benefits of QE outweighed the cost
- The Fed sees no build up of financial risks or misalignment of asset prices
- The Fed doesn't see a bubble in housing prices
- **A normal economy will restore normal interest rates**
- The Fed takes the risks of QE very seriously
- The Fed acknowledges savers are hurt by a low interest rate policy
- **She favours a fiscal policy that 'did no harm'**

She also re-iterated the current Fed Chair's position on gold, stating that no one really had a good model for gold prices and that gold often rose when people wanted a haven against risk.

Most of what she said was very run-of-the-mill and was a surprise to no-one, which is why markets didn't overreact in any major way.

I chose to highlight a couple of comments above, starting with the comment that interest rates won't go back to 'normal' until the economy is functioning 'normally' as well.

The obvious question is this: if, in the words of the incoming Fed chairperson, the economy is not operating in a normal fashion, justifying extreme monetary policy, then how is it justified for asset markets to be at near-enough all-time highs, all around the world?

And acknowledging that this is the case, how can she be so sure that there isn't a bubble in housing specifically, or in asset markets in general?

Food for thought!

I also chose to highlight the last comment above, as it shows how out of touch with reality central bankers are today, and that they are not willing to deal with the economic reality we face.

In the 12 months leading up to September 2013, the US Government ran a deficit of \$680 billion. It's set to worsen towards the end of the decade.

Unless she genuinely believes that the US Government can spend more money than it earns forever, this **deficit** will have to be eliminated, either through tax rises (which will harm people), spending cuts (which will harm people), or a combination of both (which will harm people).

That's before they even think of paying any money back!

Either that, or the government does continue to run huge deficits and add to the national debt, which you guessed it, will harm people, as it's a burden the nation's workers will have to carry forward.

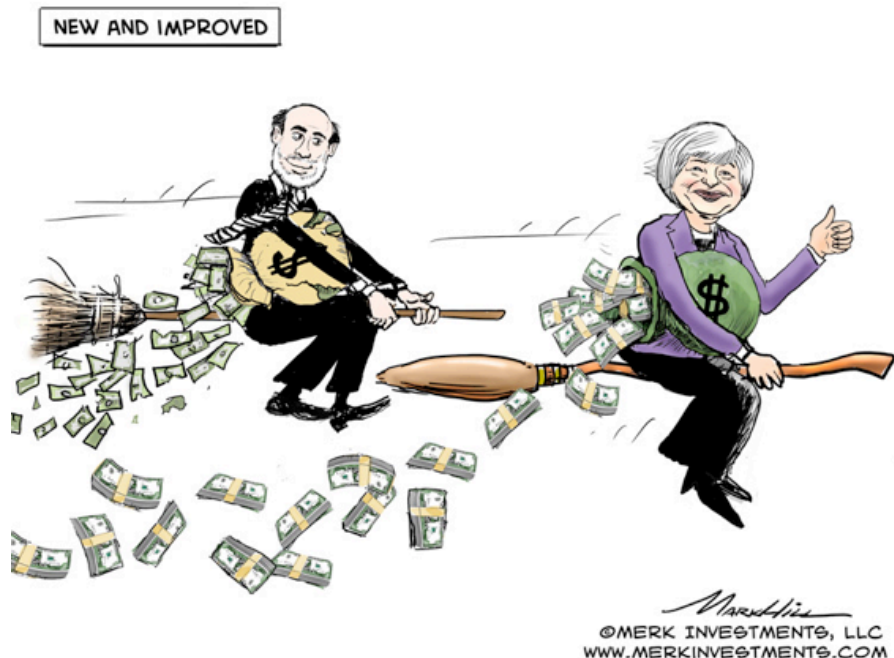
There is \$17 trillion of debt that needs to be reckoned with, and it grows by the day.

There is no way it can be dealt with in a way that 'does no harm'.

Saying that you want fiscal policy settings that will do no harm is a disingenuous, childish fantasy. We should expect more than this from a chairperson of the world's most powerful central bank.

Knowing that she would be aware of this, I therefore found the following cartoon of both Mr Bernanke and Ms Yellen strangely appropriate, as well as deeply concerning.

Based off her public comments, it is obvious that she believes strongly in the power of further and prolonged central bank intervention in the economy, irrespective of the negative consequences it causes, and the imbalances and risks to the economy they pose.



We may or may not see a tapering of QE by the Fed at some point next year, but we'll almost definitely see a continuation of money printing all around the globe in 2014 and beyond.

## What has QE done anyway?

On that note, there was an interesting discussion paper released from Mckinsey recently into the impact that central bank money-printing and ultra-low interest rates have had on markets over the past few years, and who the winners and losers of this process have been so far, or as Mckinsey put it, “*distributional effects and risks*”.

Some of the observations of the paper included the following:

- *“Rising bond prices are the flip side of declining yields, and the value of sovereign and corporate bonds in the Eurozone, the United Kingdom, and the United States increased by \$16 trillion between 2007 and 2012. Investors that mark the value of their assets to market have therefore seen a significant gain on their fixed-income investments, at least on paper.”*
- *“Ultra-low interest rates are likely to have bolstered housing prices by lowering the cost of mortgage credit.”*
- *“We found little evidence that ultra-low interest rates have boosted equity markets. We cannot discern a large-scale shift into equities as part of a search for yield by investors, and price-earnings ratios and price-book ratios in stock markets are no higher than long-term averages. Although stock prices do react to announcements by central banks, these are transitory effects that do not persist.”*

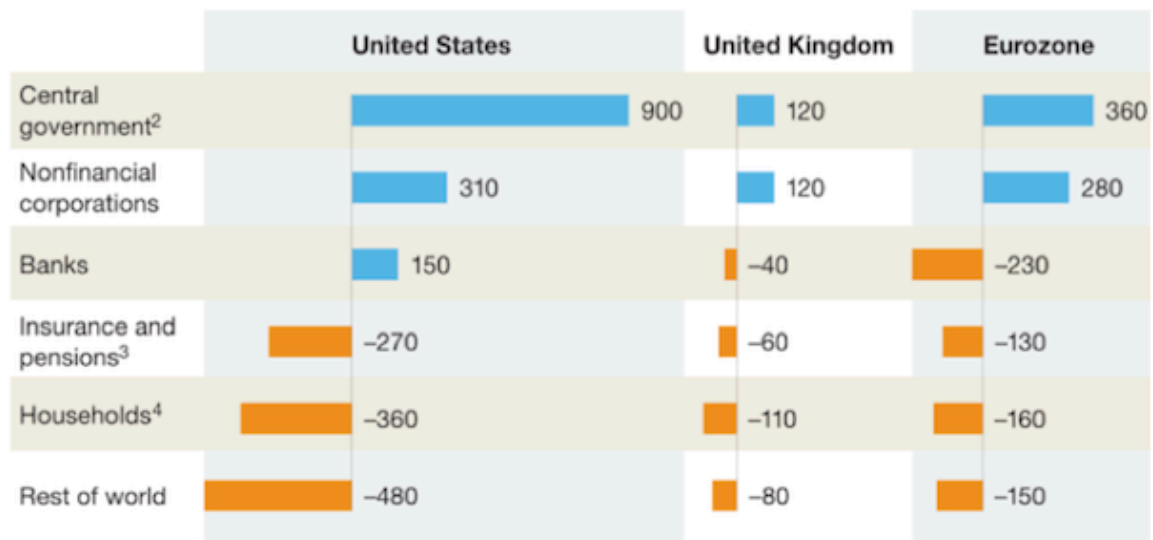
Based on the extremely high correlation between the expanding Fed balance sheet and the rising Dow Jones or S&P500 stock market indices, I would disagree with the final observation included there, in that I think that the stock market has benefited enormously from QE and ultra-low interest rates.

Nevertheless, the report does agree that the major ‘benefit’ of QE has been elevated asset prices, even if they are divorced from economic reality.

One very interesting component of the report is summarised in the graph below, which shows the estimated cumulative change in income between 2007 and 2012 for various constituents in the economy, who has benefitted from QE, and who has paid the price.

Broken down between the United States, the United Kingdom, and the Eurozone, we can see that, with the exception of the banking sector, the trends have been largely similar wherever you look in the ‘post-GFC’ world.

Estimated cumulative change in net interest income, 2007–12, \$ billion<sup>1</sup>



<sup>1</sup>At constant 2012 exchange rates.

<sup>2</sup>Excludes added central-bank profits.

As you can see, the major beneficiaries of low interest rates and QE have been the governments of the Western world, with ‘savings’ of some \$1.6 trillion, because QE and lower interest rates have led to a lower interest repayment bill on their burgeoning levels of sovereign debt.

Repatriation of interest income from central banks to their respective treasuries will also have benefitted governments in the last few years.

Non-financial corporations have also benefitted in all 3 regions, whilst the big losers have been the households of the developed world, who’ve foregone hundreds of billions in interest income they would have otherwise earned in a more ‘normalised’ environment for interest rates.

When you add the anaemic recovery in employment in the past 5 years, and it’s no wonder Main Street isn’t quite so convinced about the economic recovery, no matter how many times those working on Wall Street say otherwise.

With that in mind, perhaps it’s no surprise Americans [don’t look like they’re going to be fully embracing the festive spirit this year](#), at least not in a way that will make retailers happy, with a Gallup poll showing that they plan to reduce their spending plans this year, some 10% below what they planned on spending at this time in 2012.

[The report by Mckinsey can be found here](#), although it’s a very long read.

## The latest on gold demand

The World Gold Council recently released its Q3 report into gold demand, which showed a headline decline of just over 20%, to 868.5 tonnes for the quarter, or just over 230 tonnes less than the amount demanded in Q3 of 2012.

Whilst on the surface this number appears very weak, it must be stressed that it was all due to continued divestment from ETFs and other similar products, which saw a decline of over 256 tonnes.

Were it not for continued ETF selling (a trend that has been in place all year), demand would have been higher, as total consumer demand, up over 40 tonnes vs. the same point last year was still strong, as was central bank activity, even if the pace of their purchasing has eased off in the past year.

Even in India, despite all the efforts by the government to curtail gold investment, demand YTD has exceeded the figures for 2012, and could well pick up in the final quarter of the year. We're also seeing unprecedented volumes of physical silver entering India, with over 4,000 tonnes entering the country year to date, more than double the total for all of 2012.

At this pace, [we might see silver imports into India exceed the record](#) set in 2008, when 5,048 tonnes of silver entered the country.

On the supply side, whilst mine production has risen by 4%, overall supply fell sharply as recycled gold fell by nearly 15%, it's sixth consecutive quarter of shrinkage.

For more information on the World Gold Council report, [please click here](#)

In other news related to precious metals and who's buying and who's selling, this past week we've seen news that:

- ETF holdings are now down 30% for the year, reaching the lowest level since 2010
- John Paulson, who sold a substantial portion of his holding in GLD between March and June (potentially due to forced redemptions from his investment funds), held onto his position in Q3 this year
- George Soros bought up shares in the Market Vectors Gold Miners ETF, indicating that he might be turning bullish on the precious metal sector if he's willing to purchase gold stocks

All in all, the picture for physical gold demand looks robust, with central banks continuing to buy, and investment and jewellery demand still strong. Whilst continued selling from ETFs is putting a dampener on prices, with holdings already down over 30% we believe the worst of the ETF selling is behind us, indicating that potentially, there is little more damage to come from this area.

Finally, not that it represents physical demand per se, but I thought that [the following article from Sprott](#) was worth sharing, highlighting the incredible demand for physical gold vaulting which is springing up in Asia.

The opening of these vaults and increased demand for such services is a not entirely unexpected development in light of the thousands of tonnes of gold that are being shipped from West to East as emerging markets continue to find shelter from the fiat currency storm in the form of the safe haven of physical precious metals.

### **A big day ahead**

There's a lot of data to look out for in the next 24 hours. We've got Bernanke speaking shortly, the Bank of England minutes on monetary policy, CPI, existing home and retail sales data in the US, and the 'must see' minutes from the last Fed meeting. There's also the MBA mortgage applications report, a good barometer of the housing market in the USA.

It promises to be an interesting 24 hours.

Until next week,



**Jordan Eliseo**  
CHIEF ECONOMIST

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ABC Bullion

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