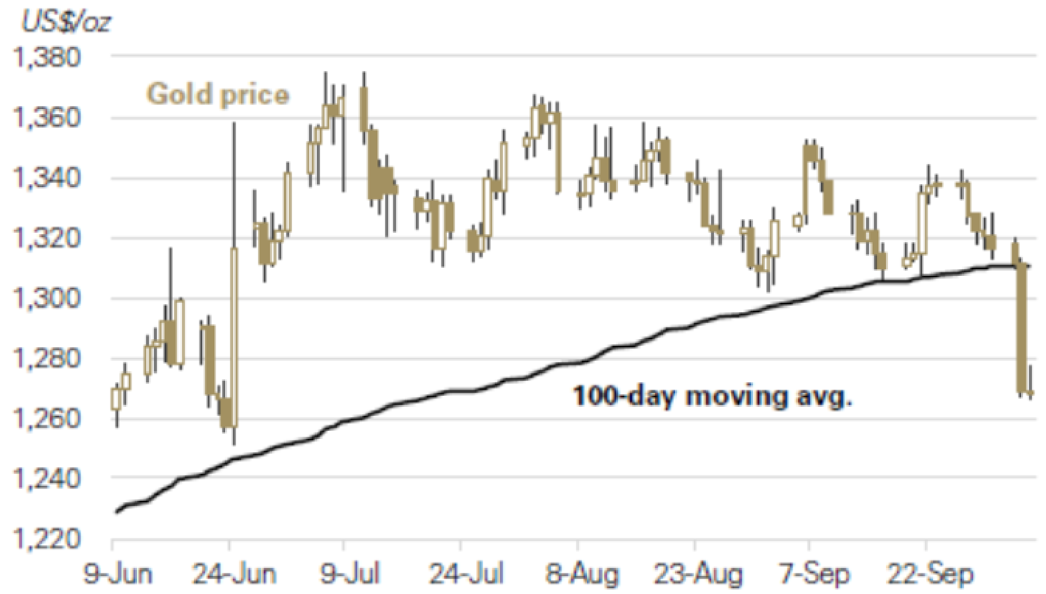
Gold Buying Opportunity as World Financial Market Volatility Remains

We've consistently stated that along with gold's strong run so far in 2016, any period of price weakness should be viewed as a buying opportunity. We haven't changed our view in the wake of gold's 3% price decline a fortnight ago.

For starters, any price weakness is likely to result in physical buying. There are various reasons for this that haven't gone away – and in fact could see gold rally just as quickly as it fell. Uncertainty related to the US election, the inevitable Brexit and weak inflation, could all combine to lift gold prices once again.

Interestingly too, despite the selloff in physical gold prices, investors are holding onto exchange-traded funds (ETFs). The latest Bloomberg data shows that ETF holdings climbed by 3.1 metric tons to 2,036.5 tons on the date of the price fall – which represents the highest level since 2013.

Chart 1: Gold fell below its 100-day moving average prompting further tactical selling



Source: Bloomberg

What triggered gold's fall in the first place? Well, it seems to have been driven by speculation of a scaling back in the European Central Bank's (ECB) asset purchase program, combined with rising expectations of a US rate hike in December. The fall effectively triggered stop-losses and further tactical selling.

Now as we've stated for some time, the US Fed has been a laggard on interest rates – with just one rate rise – by 0.25% - since the GFC. It's tried to jawbone rates, without actually doing anything. Anyhow, surely markets would already have factored in another 0.25% rate rise - whenever it eventually occurs?

Remember the Fed in late 2015 indicated that there would likely be 3 – 4 rate rises during the next 12 months, but we're yet to see a single one. Hardly a ringing endorsement of the US economy is things are as robust as the Fed guesses.

We *MIGHT* see a Fed rate rise before the end of 2016 – but then again the market has been playing this endless speculation game for several years now. The Fed's inaction speaks volumes.

As we've previously discussed, there are various reasons as to why a Fed rate rise won't automatically lead to a weakening in gold prices. For starters, there's likely to be more physical buying, as bargain-hunters in the form of consumers, long term investors and central banks, take advantage of price weakness.

Just as importantly the economic landscape remains unchanged - low and negative interest rates, coupled with continuing political, economic and policy uncertainty - are all positive factors for gold.

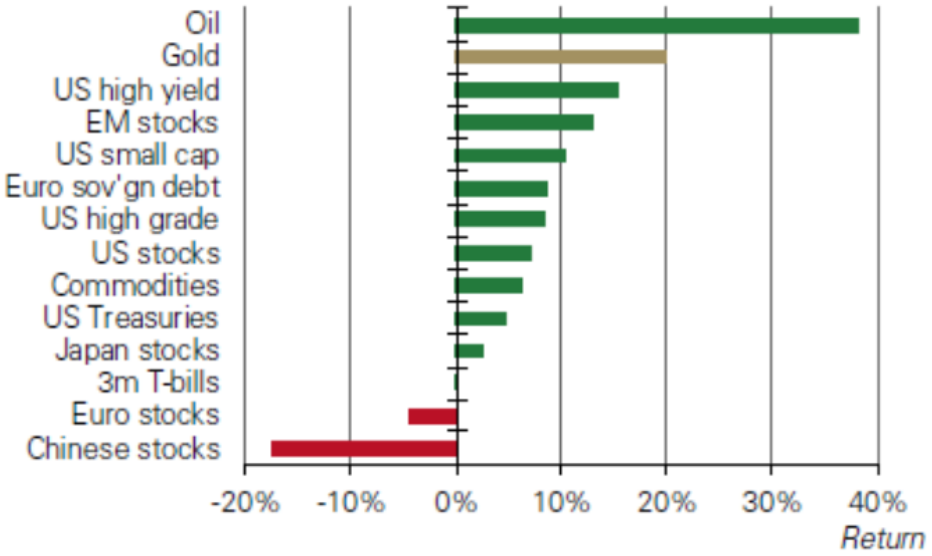
There's also the commonly-held misconception that rising interest rates are bad for gold.
As we've discussed in previous gold commentary, it's not about rising rates *per se*, but the *REAL INTEREST RATE LEVEL.* In the US at the present time even if rates rise, they will still be well below the overall level of inflation.

What we've witnessed is that over the past six decades or so, when real US rates have been negative, is that gold has also risen even when rates have increased. So forget the rate/gold baloney that's typically trotted out by the media when rising rates are discussed. There is no clear evidence that gold should fall when rates rise – it's all about the REAL interest rate level.

Let's reflect again on gold's price performance do far this year. Just about every so-called financial expert had written off gold during late 2015, as the US Fed implemented their first interest rate rise since the GFC. There seemed to be an automatic expectation that further rate rises would follow – which of course they haven't.

So in 2016 (contrary to expert opinion) - demand for gold has surged and so has the price. Despite the decline, gold remains one of the best-performing assets this year, rising by 20% in US dollar terms.

Chart 2: Gold remains one of the best performing asset classes this year



Source: Bloomberg, ICE benchmark Administration, World Gold Council

For the past three months, the gold price has traded in a range between $1,310/oz and $1,370/oz. However on October 4, the gold price pushed below US$1,310/oz (representing gold's 100-day moving average), which meant that technical selling increased sharply.

This exacerbated the fall and triggering stop-losses and further tactical selling, which we discussed earlier. Meanwhile, Chinese investors, who have historically bought on dips, were celebrating Golden Week national holiday, leaving domestic markets closed.

The World Gold Council has made some interesting points:

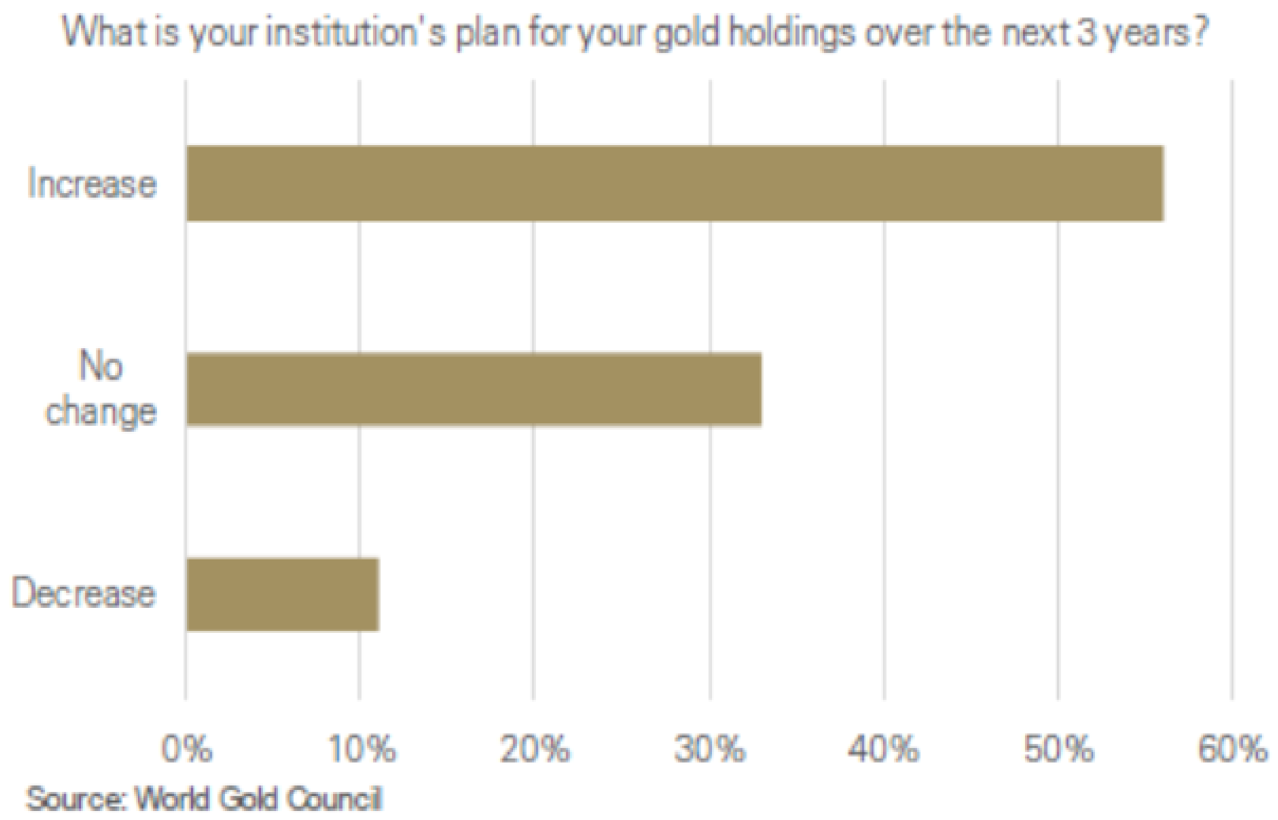
- When real rates are negative, gold returns tend to be twice as high as the long-term average
- Even if real rates are positive and as long as they are not significantly high (4% in the WGC analysis), average gold returns remain positive
- Falling rates are generally linked to higher gold prices; yet rising rates aren't always linked to lower prices.

Furthermore, the WGC supports our view that consumers and investors are likely to view the price decline as a good buying opportunity. It points out that many have been waiting for a price pull-back before entering the market. If we look at recent history, Q3 2015 serves as a good example, when a 7% decline in the gold price triggered a sharp increase in demand for jewellery, bars and coins.

In fact some data already points to an uptick in consumer interest. The top five countries where consumers were searching for gold following the price drop were in the Middle East, with the UAE being number one. Anecdotal evidence suggests that consumers had been holding off purchases in previous months, so this could well trigger an increase in demand.

The price correction also comes at a good time for Indian consumers. With a good monsoon, the upcoming wedding season and Diwali and Dhanteras festivals, demand could pick up after subdued activity year-to-date.

Chart 3: Central banks are looking to add gold to their reserves



Source: World Gold Council

Central banks, a major driver of gold demand, continue to be strong buyers of the metal to diversify their reserve asset holdings, considering the shrinking universe of non-negative yielding assets. The Russian central bank recently said that it had no specific target for its gold holdings and continues to buy regularly every month.

Meanwhile, a recent World Gold Council survey of 19 central bank reserve managers shows that nearly 90% of them will either increase or maintain their current gold reserve levels, indicating a strong floor of support for gold demand.

Summary

Market fluctuations will naturally occur from time to time, but the fundamental environment for gold remains overwhelmingly supportive in my view. The broader market environment of ongoing low and negative interest rates, coupled with continuing political, economic and policy uncertainty remains unchanged - and are all strongly supportive positive for gold. US Fed Governors will continue to talk tough on rates, there will continue to be enormous speculation around rates on a daily basis in the media, but any potential rises will be modest – and essentially already factored into the equation. We therefore remain bullish on gold and retain our gold price trading range of between $1200 and $1500 for 2016/2017.