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Commodities Market Update – Gold

5 December 2012

OVERVIEW

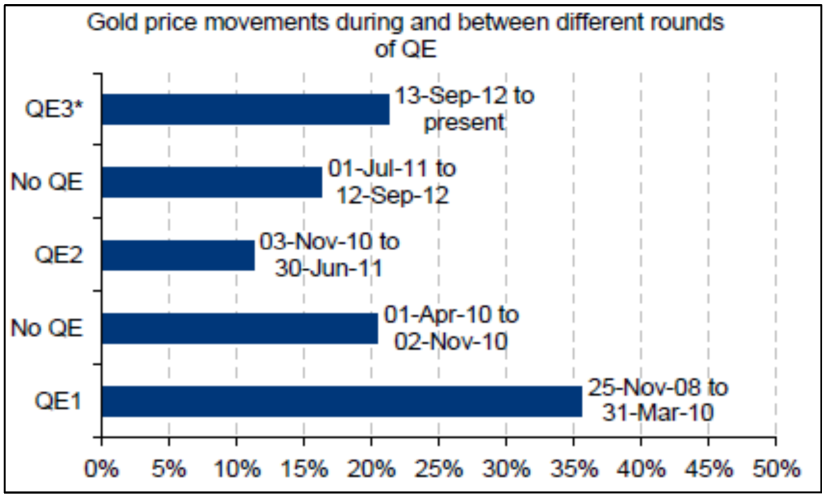
Lion Global Investors shares its views regarding the outlook for gold in this Special Report.

2012 has been a volatile year for gold. Even though the gold price is up almost 10% on a year-to-date basis, it has struggled with its safe-haven identity and has for the most part tracked the equity market. However, as we near the end of 2012, the gold price is expected to find support as concerns over the fiscal cliff in the US, and rising geopolitical tensions in the Middle East and elsewhere present themselves. As such, we remain positively disposed to gold as part of an investor's diversified portfolio.

Source: Bloomberg, as of 3 Dec 2012

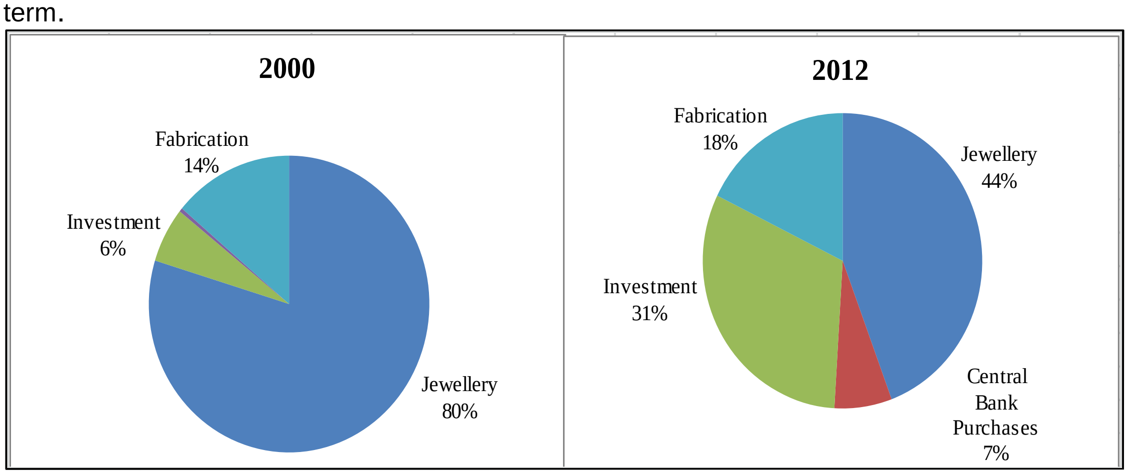
Monetary policy is likely to support the gold price. Continued loose monetary policy is expected to be a substantial incentive to investors to increase their precious metal holdings in 2013. While it is tempting to argue that gold prices have already discounted the recent measures, it is important to note that gold and other commodity prices continued to rally during the implementation phase of the first two rounds of Quantitative Easing (QE1 and QE2) by the US Federal Reserve (Fed). Given the open-ended nature of the latest round of easing (QE3), the upward pressure on gold prices should continue until employment is strong enough to warrant a change in policy.

The upward pressure on the price of gold has partly come from a rally in inflation expectations, which have surged in recent months as asset markets started to anticipate further monetary easing. In our view, the Fed's announcement lifting the expected rate of inflation over the five years starting in 2017 to above 3% was more aggressive than the market had been expecting. However, inflation of c. 3% is in-line with average US inflation rates of 3.2% during the last 100 years, but significantly above inflation in the past two years of 1.8%.



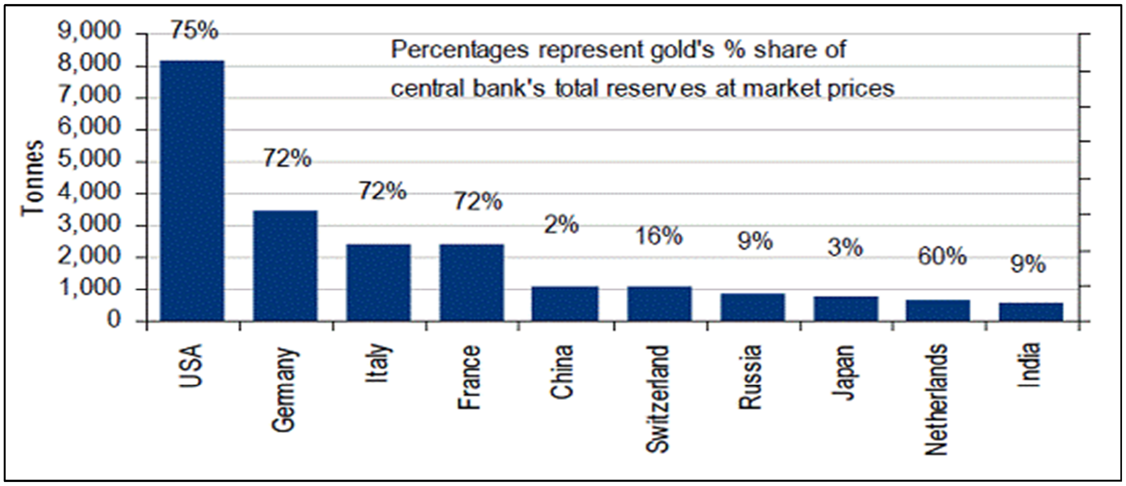
Source: BAML

Investment demand for gold is now 40% of the total and is expected to keep growing. One of the key long term trends in gold demand has been the rapid growth in investment demand which has crowded out jewellery demand. Investment demand for gold includes ETFs, physical bar purchases and central bank buying, and has risen from 6% of total volume in 2000 to an estimated 38% in 2012; jewellery demand's share has declined from 80% to 44% over the same period. With emerging markets getting richer, budget allocation to non-essential items such as jewellery should increase over time, which may mean that the marginal importance of those buying gold as an investment could soften in the longer term.



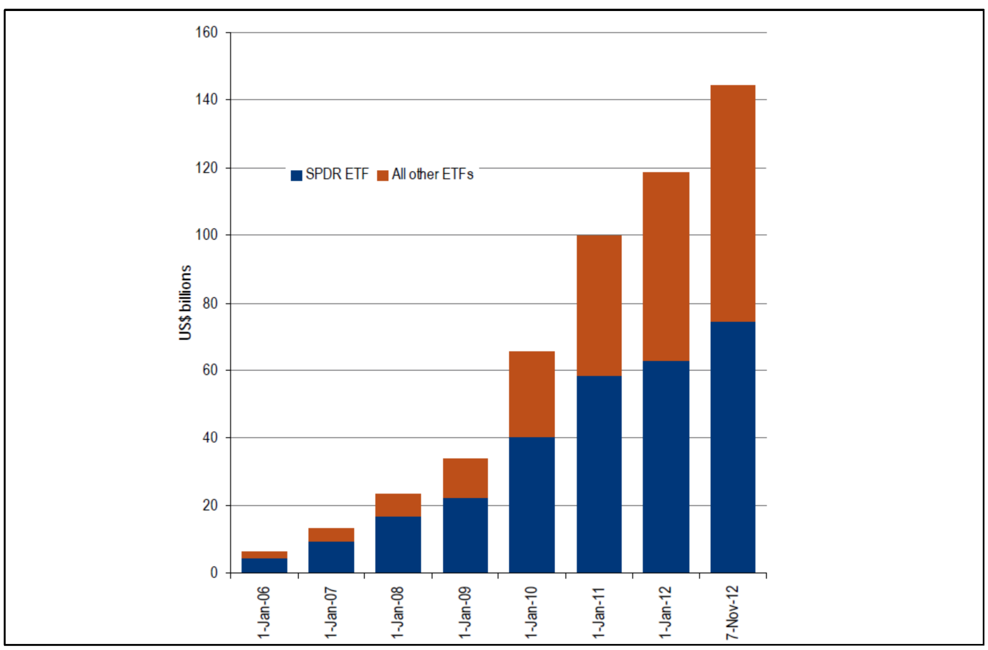
Gold Demand Split, Source: World Gold Council, BAML

The biggest swing factor in investment demand has been from central banks which turned from net sellers to net buyers in 2010. The chart below shows gold as a percentage of total reserves for a number of the G20 countries. Almost all of the countries at the bottom of the list are looking to grow their gold reserves as a form of asset diversification, given that confidence in the USD and EUR has been undermined by the fallout from the Global Financial Crisis. Recently there has been news of Korea, Kazakhstan, Brazil and Russia adding to their reserves while China has also been an aggressive buyer.



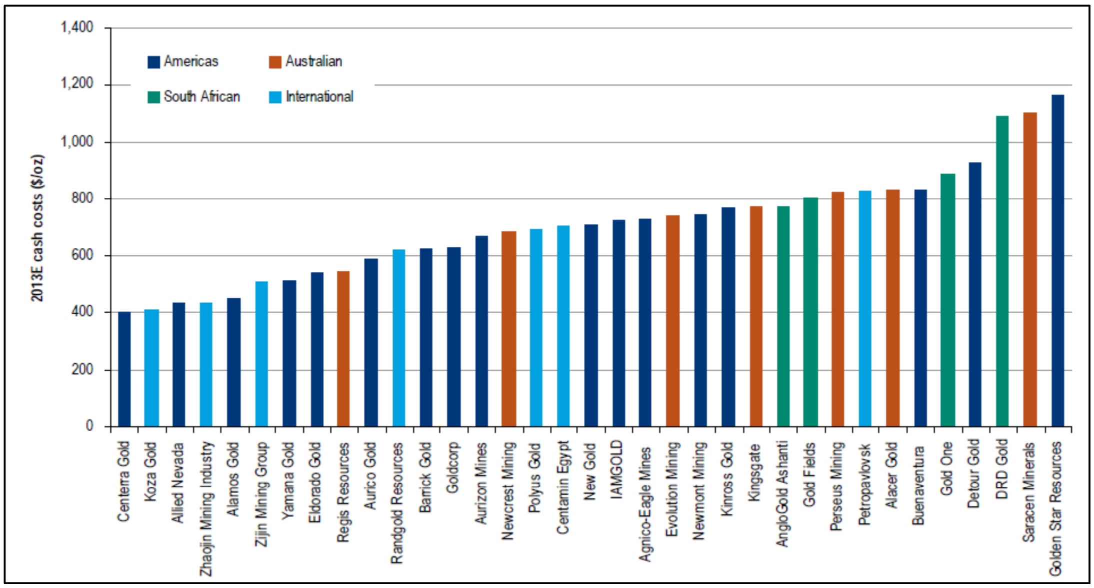
Source: IMF, PBOC, World Gold Council, BAML

ETF demand has also grown exponentially as investors have sought gold as a means to diversify out of currencies and equities. This is a medium-term risk for the gold price in our opinion and will keep prices extremely sensitive to the global interest rate environment.



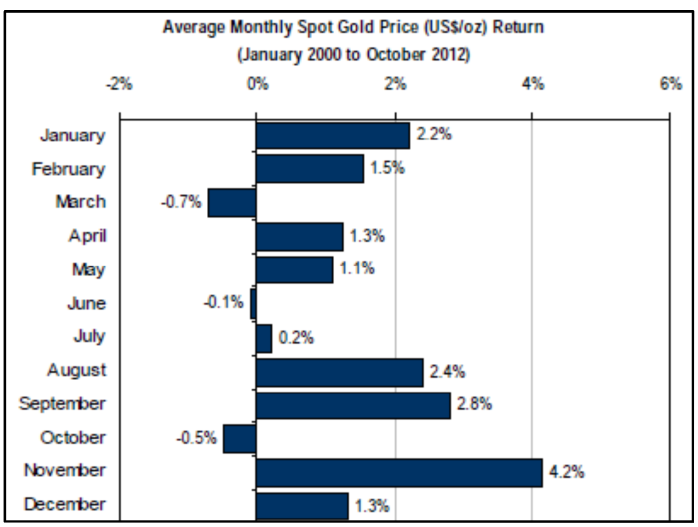
Source: BAML, as of 7 Nov 2012

Rising costs of production are likely to keep a floor under prices. One of the reasons for the disconnect between the gold price and gold equities has been the rising cost of production due to rising royalty charges, increasing labour and consumable costs and the lower ore grades mined. Capital costs, both growth and ongoing, are also up sharply, placing additional pressure on the viability of new projects. We estimate average cash costs in the sector to be US$600 per ounce. However, if exploration expenses are taken into account, the price of gold required to incentivize new projects to earn a reasonable rate of return is closer to US$1,200 per ounce and could be as high as US$1,500 per ounce, depending on its geographical location.



Global Total Cash Costs, $/oz (2013E), Source: BAML

Seasonality supports price in the near term. The chart below shows the average monthly spot gold price return over 2000-2012. Over the last 12 years on average, Nov-Feb has been the best period for the gold price with an average return of 9.2% over the four months.



Source: Bloomberg, as of Oct 2012

Risks to our view: A firm recovery in the US and the global economy or a relapse into recession on the back of the US economy falling off the fiscal cliff will remain the two greatest risks to our positive call on gold. In short, any abrupt spike in real interest rates that puts an end to the ongoing monetary easing cycle may drive investors out of gold and create substantial downside pressure on the gold price. However, given that the overall global growth trend going forward is expected to be restrained by the impact of various austerity measures put in place by several governments in 2012, monetary policy is expected to remain loose. As such, the current environment is expected to remain supportive of low interest rates, thus maintaining an upward support for the price of gold price.

About Lion Global Investors

Lion Global Investors, a member of the Oversea-Chinese Banking Corporation Limited (OCBC) Group, is one of the largest asset management companies in Southeast Asia, with total assets under management of S$30.1 billion (US$24.6 billion) as at 30 September 2012. Established as an Asian asset specialist since 1986, Lion Global Investors' core competencies are in managing Asian equities and fixed income strategies and funds to both institutional and retail investors. It has one of the largest and most experienced investment teams dedicated to regional and global equities and fixed income markets, with 45 investment professionals averaging 14 years of relevant investment experience.

Lion Global Investors' network of regional offices outside of Singapore includes Malaysia, Brunei and China (Shanghai). For more information about Lion Global Investors, please visit www.lionglobalinvestors.com.

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