Gold

As 2017 begins the United States is facing unprecedented political conditions and economic challenges. The entire world also is in a state of flux as dynamic, significant and unpredictable as was the collapse of Communism in the Soviet Union and East Europe and the demise of centrally planned economies elsewhere at the end of the 1980s and start of the 1990s. All of this results in a level of political, economic, financial and personal uncertainty far beyond even what hit American and other investors in 2007 – 2011. Furthermore: This time, it is occurring in the United States and Europe – to us – and not to people half the world away. Gold's roles as a wealth preservation mechanism, catastrophic insurance, a portfolio diversifier and a significant financial and monetary asset capable at times, of generating enormous capital gains all have become that much more important, all in a matter of a few months.

Before we embark upon a conventional review and outlook of the gold market, it seems appropriate to spend some time discussing why investors should be interested in buying and owning gold. Gold carries with it emotions, sentiments and beliefs unlike any other investment. You rarely if ever hear investors adamantly arguing about the virtues or foolhardiness of owning a given stock or bond the way people argue about the wisdom or folly of having some of your wealth in gold. There are two distinct sets of reasons for this: First, gold serves many positive functions for investors, from protection of wealth to potential generation of even greater wealth through price appreciation. It is a tool against all those economic and political things we fear might happen, but it also is a means of storing and potentially generating more wealth. On the flip side, many investors imbue gold with too many attributes. They believe it will protect them perfectly from all of the world's ills, and then they are disappointed when gold fails to live up to their overblown expectations for the metal.

Gold in fact performs many utilities for investors. It is a store of wealth, a means of diversifying your exposure to having all your wealth denominated in one national currency or, if you go to the effort, a handful of national currencies. It also is an excellent diversifier and hedge for your investment portfolio. Your investments are different from your wealth; investments are a subset of wealth. Investors should view gold as serving several distinct roles: as a catastrophic insurance policy, a portfolio investment and a shorter term event-driven investment capable of generating outsized returns at times.

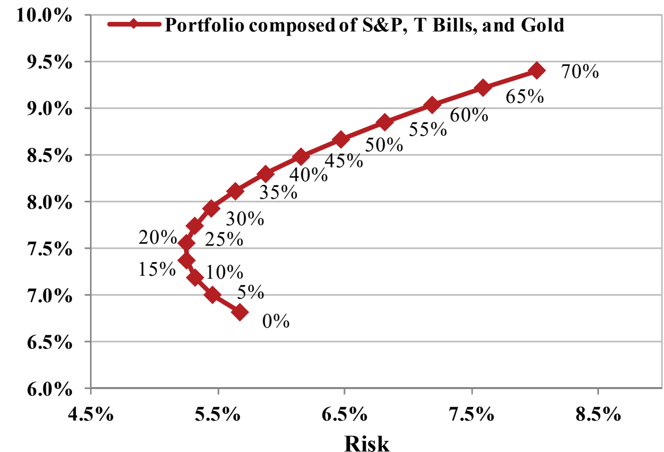
The chart below shows how keeping gold in one's portfolio of stocks and bonds can help reduce overall risk – the volatility of the value of one's investments while increasing the return over time. The chart below looks at how much of one's portfolio optimally would have been in gold from 1968 through 2015 – since gold prices were freed to float by central banks. The ideal portfolio in these calculations would have been 27%-30% of one's wealth in gold, with the other 60%-63% divided between stocks and bonds.

2016: Where Gold Has Been

Gold prices had a strong start in 2016, rising 20% over the first ten weeks of the year. Prices settled at $1,272.80 on 10 March, up from $1,060.20 on 31 December 2015. At the end of 2015 the gold market was pricing in the first interest rate hike by the Fed in nearly a decade and the potential for four additional hikes in 2016. These expectations had driven gold to a six year low at the end of 2015.

Investor attitudes shifted rapidly in early 2016 as concerns increased about economic growth in China, Europe, Japan and to some extent the United States. This resulted in investors reducing their expectations of further interest rate hikes by the Fed, in the face of weakening global

A portfolio with 15% - 20% of its assets in Gold had the best risk:reward ratio in the years 1968 - 2016 Nov



economic growth and loosening monetary policy by other major central banks. The readjustment in expectations of U.S. interest rate hikes resulted in the first leg up in gold prices. Prices remained at elevated levels, trading between $1,200 and $1,300 from March through late June.

Gold prices broke out of this range, settling above the $1,300 level on 24 June. On 23 June, the British voted to exit the European Union in a referendum popularly referred to as Brexit. The world was surprised by the vote, and there was no clear understanding of what the consequences would be for Britain, Europe and the world economy as a whole. The surprise element of the vote coupled with the ambiguity surrounding the consequences resulted in the second leg up for gold prices during the year. From July through September, prices moved between $1,300 and $1,377, a level last seen in early 2014.

Prices then drifted lower, and by early October broke below the $1,300 support which had held during the previous three months. There were renewed talks of a U.S. interest rate hike at this time. Prices held above $1,250 despite these renewed concerns, however, as markets awaited the outcome of the second big political outcome – the U.S. election.

While neither candidate, Donald Trump nor Hillary Clinton, was much favored by the public, the unknowns associated with a Trump presidency were more favorable for gold than a Clinton administration, or at least that is what it seemed like prior to the election. The markets responded as expected while votes were being counted and it was becoming increasingly apparent that Trump would be president. In overnight trading on 9 November the gold price spiked up while equity markets tanked. The price of gold touched a high of $1,338 during Asian trading hours. The sentiment reversed quickly, however, with the U.S. session on 9 November ending at $1,277.30. Donald Trump's victory speech had many believe, and which only time will tell if it proves to be true, that President Trump would be different from candidate Trump. This calmed nerves somewhat. Furthermore, during his victory speech he reiterated one of his campaign promises – on infrastructure spending – which was taken as being the one policy he is most serious about and most ready to act on. The potential positive impact of such a fiscal stimulus propelled higher stocks, base metals, and the dollar. Meanwhile, bonds and gold declined. This trend continued throughout November; post the election, investors were pushing stock indices to record high levels and gold and other safe havens lower.

The stock markets were also helped by an increased expectation that a Trump presidency would mean tax cuts for individuals and corporations as well as deregulation. The gold and bond markets continued to suffer losses as there were reduced concerns regarding Trump and there was a looming interest rate hike announcement at the December Federal Open Market Committee meeting. The expectation was for a 25 basis point increase and two rate hikes in 2017. When the announcement was made the interest rate hike came as expected but there was now the

Gold Prices

Comex Gold Prices, Daily, From 1 January 2000 to 6 January 2017

possibility that there would be three rate hikes in 2017 versus the two that had been expected. The gold and bond markets declined further following the announcement in mid-December as these markets priced in the prospects of three versus the previously expected two rate hikes. The gold price finished the year at $1,151.70.

2017: What Happens Next

We believe, the price of gold has greater upside potential during 2017 than downside risk. The gold, bond and equity markets were positioned at the end of 2016 as if all of the campaign promises that were made by Trump would be executed fully and would be net positive for the U.S. and global economy. Neither of these expectations is likely to prove correct.

Furthermore, the gold, bond and dollar markets are acting as if three interest rate hikes by the Fed in 2017 are a foregone conclusion. The equity markets softened somewhat on the day the interest rate hike was announced, but quickly shrugged off the rate increase and continued to march higher. The equity markets are not paying attention to the negative implications of some of these policies. If Trump's policies were in fact enacted in full, which actually does not seem likely, the Congressional Budget Office and other non-partisan research groups estimate that the U.S. federal deficit would rise from around $400 billion per year at present to more than $1.1 trillion annually. This would balloon Federal debt more rapidly than has been the experience over the past 16 years. This would have severe consequences for financial markets and economic growth prospects, squeezing out corporate borrowers. Such deficits and debt also could have inflationary implications. A rising inflation and interest rate environment is typically bad for equity markets, and stimulates investors seeking protection in gold and silver. The equity markets appear to be ignoring such possible long-term risks at present, focusing instead on the potential that massive corporate tax cuts would fuel further stock buy-back programs. At some point the focus will change. Any weakness in the stock market would be a positive for the gold market.

It is unclear at this time which of Trump's policies will be enforced, to what extent and when. It is equally unclear how many interest rates hikes the Fed will announce and when. The answers to these questions will guide the direction of various markets over the course of 2017. The gold market has relatively little to lose from here because the negative effects for gold from both the proposed fiscal policies and Fed actions already are mostly priced in. The fairly high possibility that all of Trump's campaign policies are not implemented and that the Fed is unable to raise rates three times in 2017 puts gold in a good position to move higher over the course of the year.

The Fed is going to find its hands tied to a great extent by the fragility of U.S. economic growth, a weak global economy and raising the cost of U.S. government debt when considering raising rates.

The cost of disrupting any of these factors is fairly large and the Fed will need to exercise a great deal of caution before raising rates, as the December FOMC minutes highlight. The U.S. economy definitely has been on the mend and is one of the better placed major economies in the world at this time, but growth since the global financial crisis has remained extremely fragile.

The global economy is in worse shape than the U.S. economy, and higher rates in the U.S. means monetary authorities in other markets, especially developing countries, would find it harder to lower their interest rates. The strength in the dollar resulting from higher U.S. interest rates would not only make imports into these countries more expensive, driving inflation higher, but also would raise the cost of dollar denominated debt. This would reduce growth in those countries and in the United States. For the U.S. to meet its full potential or even to sustain its present growth it will require a healthy global economy.

Beyond U.S. political and economic conditions the gold market also could benefit from political developments in Europe, where nativistic populism threatens to upturn seven decades of liberal democracy. Several of the European Union's member states head for elections during 2017, the largest of them being Germany, France, the Netherlands and Italy, which may possibly have an early election as a result of its referendum in 2016. The big concern in the market with regard to these elections is whether these countries will also get consumed in the wave of populism and anti-globalization that has been seen around the world lately, and what that would mean for the future of the European Union. This uncertainty is likely to be a double-edged sword for gold, however: Investors will seek protection in gold, but they also will use the dollar for such purposes. The strength in the dollar could be negative for the yellow metal.

In fact, the dollar is likely to be the strongest headwind for gold prices during 2017. The currency could rise relative to its peers on account of relatively tighter monetary policy in the U.S. compared to other countries and U.S. fiscal stimulus in the form of tax cuts that are expected to inflate U.S. assets and increase investor demand for dollars from overseas. While dollar strength can dampen strength in gold prices, both assets have risen in tandem on various occasions in the past. They only move in opposite direction about a third of the time.

To summarize: There are many reasons to own gold at present, from short-term to long-term economic, financial market and political reasons. It always is sensible to own gold, to have some of your wealth in gold and silver. Sometimes it is even more compelling than at other times. This year, and the foreseeable future, is one of those times when the reasons for holding wealth in gold and increasing one's investment portfolio exposure to gold appears much more evident than at other times.

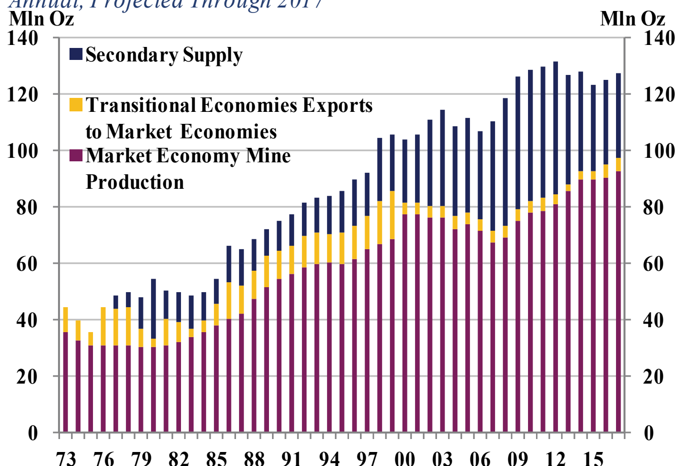
In this environment, any softness in gold prices should be considered as a buying opportunity by investors. Gold prices are expected to rise over the course of 2017 and beyond. Prices may be slow to increase at first, but at some point over the next five to ten years it seems likely that gold prices might rise sharply, as they did from 2008 through most of 2011, as the problems confronting the world come home to roost. Initially prices may rise only modestly, but as 2017 progresses financial market participants are likely to re-evaluate their political and economic expectations. When they do, gold is expected to benefit. Investors are expected to be net buyers of 22.5 million ounces of gold in 2017, up from around 20 million ounces in 2016 but perhaps 65% more than they bought in 2015. At the time of writing this report, gold prices were at $1,180 and CPM Group expects gold prices to be firmly above $1,300 by the end of 2017.

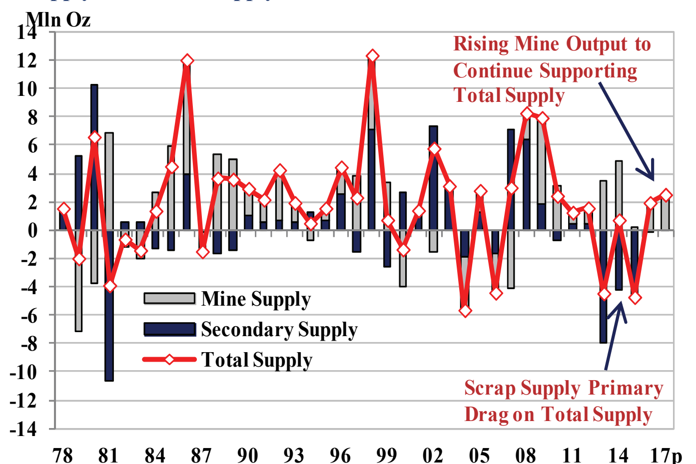
Supply

Total gold supply, which is composed primarily of mine supply and secondary or scrap supply, rose to 125.0 million ounces in 2016, up 1.6% from 2015. Total supply is forecast to continue rising in 2017, reaching 127.5 million ounces, up 2.0% from 2016. The growth during both years is primarily driven by an increase in mine production.

Mine production has been on a rising trajectory since 2008 and is expected to continue rising over the next few years. This increase in mine supply is being driven by the new capacity that was bought into production in recent years in response to the price increase between 2002 and 2012. While there has been a major scaling back in capital expenditures since 2013 in the gold mining industry as prices fell, this will only affect output with a lagged effect. It is expected to lead to significantly lower gold mine production beyond 2018. Projects that have been brought onstream since 2014 are lower cost projects, which have been able to operate in the challenging price environment of the past few years and have offset some of the declines in output from older, higher cost mines. Furthermore, around 5.8 million ounces of new capacity

Gold Supply





was added as recently as 2013, which in combination with the 3.8 million ounces of capacity added between 2014 and 2016, has more than offset any loss in output from existing mines.

Since 2013 mining companies also have been able to reduce their costs substantially, making them less vulnerable to softness in prices. Unfortunately, most of the cost cuts occurred in corporate general and administrative costs, sustaining exploration and study costs, capitalized stripping and underground mine development and capital expenditures. Slashing these costs are a mining company's first line of defense against weaker metals prices, as these costs do not negatively reduce production immediately and allow the mining company to weather a rough patch. However, cutting these costs to the extent that mining companies have reduced them in the past few years negatively affects longer term sustainability of the industry, setting up a positive outlook for the gold prices in the longer term by constraining supply. Mining companies have also been able to reduce their cash operating costs, but the reductions in these costs have been significantly smaller than those in sustaining costs. Part of the reason for this is that some of these costs, like energy and utilities, are outside the control of mining companies. Other costs like labor, which typically accounts for around 50% of cash operating costs, are very hard to reduce.

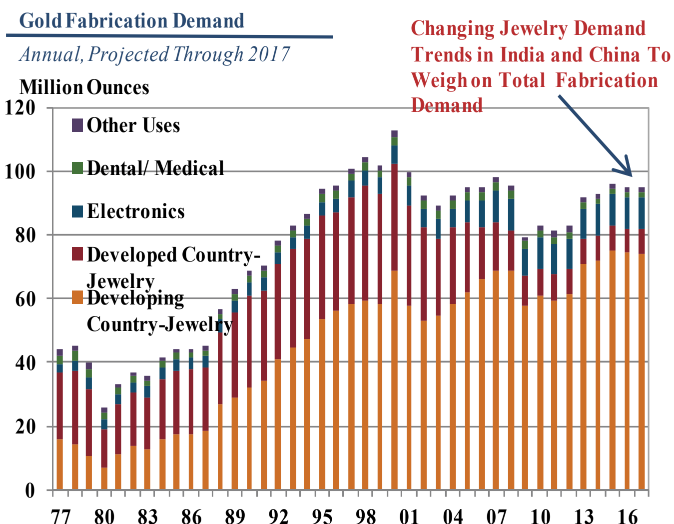
After falling sharply for three consecutive years, gold secondary supply stabilized somewhat in 2016 at 30.1 million ounces. Gold secondary supply is fairly sensitive to prices. The sharp decline in gold prices between 2013 and 2015 resulted in gold supply from this source slipping from 47.2 million ounces in 2012 to 30.1 million ounces in 2016. Gold scrap supply is forecast to rise marginally in 2017, to 30.12 million ounces. The lack of financial catastrophe or economic recession, and relatively soft prices are expected to keep people from selling their gold jewelry. One factor that is expected to provide support to gold scrap supply is recoveries from markets where their domestic currencies have declined substantially against the dollar. This results in a higher domestic price of gold, making it more attractive for holders of gold jewelry to sell it into the market for its gold content.

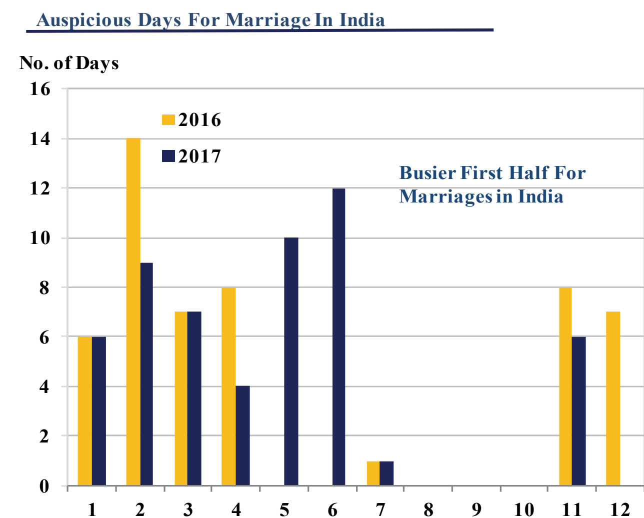
Fabrication Demand

Gold fabrication demand is estimated to have totaled 95.1 million ounces in 2016, down 1.1% from 2015. One of the primary factors that weighed on demand for gold during 2016 was the strengthening of gold prices during the first eight months of the year. It was also hurt by other factors such as the strengthening of the U.S. dollar versus the domestic currencies of some of the major consumers of gold, drought conditions in India, an ongoing effort by the Indian government to disincentivize investment in gold and an ongoing shift in demand trends in China and India toward owning non-gold jewelry and lower karat gold jewelry.

A lot of the weakness in demand was the result of reduced demand from India for a variety of reasons. Fabrication demand in India declined to 17.6 million ounces in

Fabrication Demand





2016, down from 18.2 million ounces in 2015. This 514,000 ounce decline in demand accounted for half the decline in global fabrication demand in 2016.

Heading into 2017, fabrication demand is forecast to remain flat, with many of the headwinds that weighed on gold fabrication demand during 2016 continuing to act as a drag on gold fabrication demand in 2017.

Investment Demand

Gold investment demand rose sharply in 2016, after declining for four consecutive years. Investment demand in 2016 rose to 20.0 million ounces, up sharply from 13.6 million ounces in 2015. It is worth mentioning that while gold investment demand declined during the previous four years from 2012 through 2015, it remained high by historical standards throughout that period and was mostly in line with the higher level of investment demand that has been in place since 2002. This increase in investor demand for gold, since 2002, has been driven by negative political and economic factors globally, some of the same factors expected to keep investors interested in adding gold to their portfolios in increasing volumes in 2017 and the years ahead.

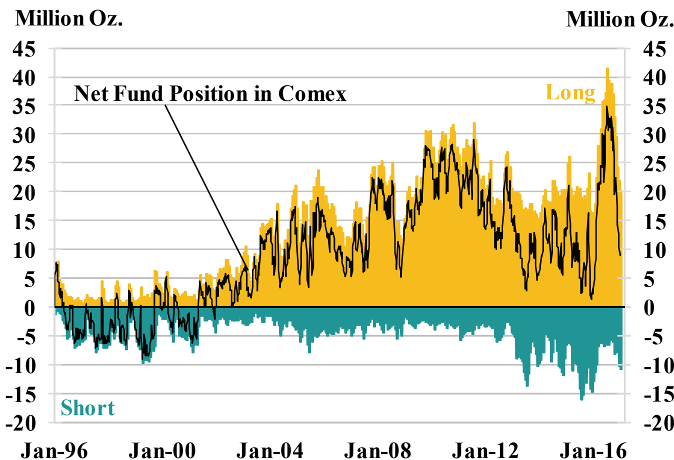
Many of the bad political and economic factors that drove gold investment demand higher have worsened over time, making gold a compelling investment for the future. Growing signs of nationalism globally, weakening and volatile currency markets, high levels of unemployment in certain parts of the world coupled with rising underemployment, political troubles similar to those of Greece appearing in other European countries and monetary policy that is failing to boost growth (although it has prevented outright economic depressions), are some of the factors that are driving investors toward gold as an investment asset.

Gold investment demand is forecast to rise to 22.5 million ounces in 2017. There is a close relationship between investment demand and the price of gold, which has been reflected in the metal's price performance in the past. Based on this, the increase in net investment demand during 2017 suggests an increase in price. Sometimes investors demand a lower price to absorb the newly refined gold entering the market, but this typically occurs in a scenario where the fundamentals for the market are working against it and economic and political conditions are so sanguine that investors feel they do not need to worry about the state of the world. This is not likely to be the case in 2017 or for many years to come.

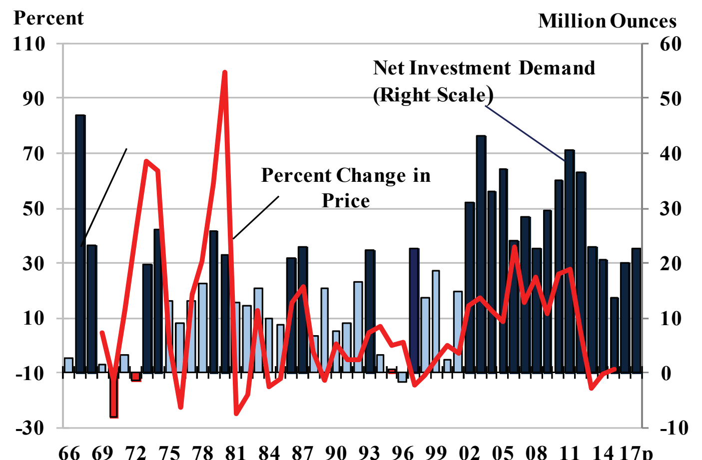
There is an interplay between the amount of investors want in any given year or period of time and the fundamentals of newly refined gold entering the market from mines and scrap recovery. If investors are concerned about the state of the world, they want more gold. If they are comfortable, they want less. If prices have fallen, supply stops increasing or even declines. If investors then grow concerned about the world again and want more gold, the flow of newly refined gold is not there for them. This leads them to bid gold prices higher to encourage

Gold Investment Demand

Gross Long and Short Positions of Non-Commercial Positions
Comex Gold Futures & Options. Weekly, through 27 Dec 2016



Investment Demand's Effect on Gold Prices



more gold to be sold into the market to meet their demand. This is likely to be the case in gold in 2017, and, again, for many years to come.

Central Banks

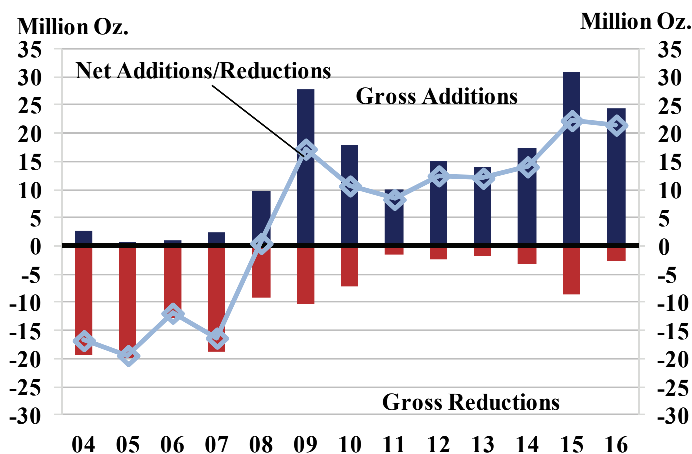
Some central banks have adopted policies in which gold is seen as a minor but significant monetary reserve asset. Some of these central banks, such as those in China, Russia, Kazakhstan and other emerging economies, did not have significant amounts of gold in their monetary reserves historically or recently. Some of these monetary authorities now are adding gold to their reserves as part of a long-term policy-based program. These programs are expected to continue for the foreseeable future. The countries doing much of the buying over the past several years, and expected to be significant acquirers of gold over the next decade, are largely countries that were not major international trading nations during the era up to 1971. Prior to 1971 gold was used for international currency and trade settlements among countries, which led to the buildup of large gold reserves in the monetary systems of major trading countries prior to 1971.

Central banks are expected to remain net buyers of gold for the foreseeable future. The primary goal for central bank gold purchases is expected to be the same as it has been the past few years – to diversify their monetary reserve assets by adding gold as well as foreign exchange reserves, presently held primarily in U.S. dollars.

Gold Official Sector (Central Bank) Activity

Annual Central Bank Changes in Gold Holdings

2016 Through November



Conclusion

The weakness in gold prices at the end of 2016 was the result of markets getting overly optimistic about economic prospects in the United States and interest rate increases. This weakness in prices provided a good buying opportunity for both shorter term and longer term investors. As have been highlighted in various parts of this report, the incoming U.S. Administration and the Fed are not likely to be able to deliver all of what the markets are pricing in. This mismatch in expectation and reality coupled with the numerous political and economic problems that the world faces should combine with price-supportive long-term supply, investment demand and central bank demand fundamentals to push gold prices higher in 2017 and on a long-term basis. This combination makes building and maintaining a long-term position in gold compelling at this time .

Gold Statistical Position

Million Ounces

Supply	2009	2010	2011	2012	2013	2014	2015	2016	2017p
Mine Production	**75.3**	**78.1**	**78.3**	**80.9**	**85.6**	**89.9**	**90.0**	**90.1**	**92.6**
Secondary Supply	**47.1**	**46.3**	**46.8**	**47.2**	**39.3**	**35.1**	**30.2**	**30.1**	**30.1**
Transitional Economy Sales	**3.9**	**4.3**	**4.8**	**3.5**	**2.2**	**2.8**	**2.9**	**4.8**	**4.9**
Total Supply	**126.3**	**128.7**	**130.0**	**131.5**	**127.1**	**127.8**	**123.1**	**125.0**	**127.5**
% Change Year Ago	*6.7%*	*1.9%*	*1.0%*	*1.2%*	*-3.4%*	*0.6%*	*-3.7%*	*1.6%*	*2.0%*
Fabrication Demand									
Industrial Demand	**12.4**	**13.5**	**13.6**	**13.5**	**13.4**	**13.1**	**13.0**	**13.0**	**13.0**
Jewelry Demand									
Developed Countries	9.3	8.7	8.2	7.9	7.8	7.9	8.0	7.7	7.8
Developing Countries	57.7	60.7	59.4	61.2	70.8	72.1	75.1	74.3	74.2
Total Jewelry Demand	**67.0**	**69.4**	**67.6**	**69.1**	**78.6**	**80.0**	**83.1**	**82.1**	**82.0**
Total Fabrication Demand	**79.4**	**82.9**	**81.2**	**82.6**	**92.0**	**93.0**	**96.1**	**95.1**	**95.0**
% Change Year Ago	*-16.6%*	*4.4%*	*-2.0%*	*1.8%*	*11.3%*	*1.2%*	*3.3%*	*-1.1%*	*0.0%*
Stock Demand									
Total Official Transactions	**17.3**	**10.8**	**8.4**	**12.5**	**12.1**	**14.1**	**13.4**	**10.0**	**10.0**
% Change Year Ago	*NM*	*-37.8%*	*-22.2%*	*50.0%*	*NM*	*NM*	*-5.4%*	*-25.2%*	
Net Private Investment									
Official Coins	6.7	6.1	7.0	5.6	8.2	6.1	7.0	7.1	5.5
Bullion	18.5	24.0	30.4	28.1	12.3	12.3	4.6	9.9	13.5
Medallions	4.5	5.0	3.0	2.7	2.4	2.2	2.0	3.0	3.5
Total	**29.7**	**35.1**	**40.4**	**36.4**	**23.0**	**20.6**	**13.6**	**20.0**	**22.5**
% Change Year Ago	*31.1%*	*18.4%*	*15.1%*	*-10.0%*	*-36.8%*	*-10.3%*	*-33.9%*	*46.5%*	*12.8%*
Total Stock Demand	**46.9**	**45.9**	**48.8**	**48.9**	**35.1**	**34.8**	**27.0**	**30.0**	**32.5**
% Change Year Ago	*102.4%*	*-2.3%*	*6.4%*	*0.3%*	*-28.2%*	*-1.0%*	*-22.4%*	*11.0%*	*8.5%*
Total Demand (Fabrication Plus Stock Change)	**126.3**	**128.7**	**130.0**	**131.5**	**127.1**	**127.8**	**123.1**	**125.0**	**127.5**
Price Per Ounce									
High	$1,218.30	$1,421.40	$1,889.70	$1,796.50	$1,693.20	$1,379.00	$1,300.70	$1,368.20	
Low	807.30	1,052.80	1,318.40	1,536.60	1,193.60	1,142.60	1,049.60	1,073.60	
Average	974.70	1,228.63	1,572.00	1,670.15	1,409.57	1,266.20	1,158.73	1,250.12	
% Change Year Ago	*11.7%*	*26.1%*	*27.9%*	*6.2%*	*-15.6%*	*-10.2%*	*-8.5%*	*7.9%*	

***Million Ounces; Source: CPM Group; Notes: There may be discrepancies in totals and percent changes due to rounding; Net official sales are indicated by negative numbers; The price is the Comex nearby active settlement. Longer term projections are available in CPM Group's Gold Supply, Demand, and Price: 10-Year Projections report; e -- estimates; p -- projections; NM -- Not meaningful; January 9, 2017**