VAKIFBANK GLOBAL ECONOMY WEEKLY

The main factors behind gold and silver price movements

VakıfBank

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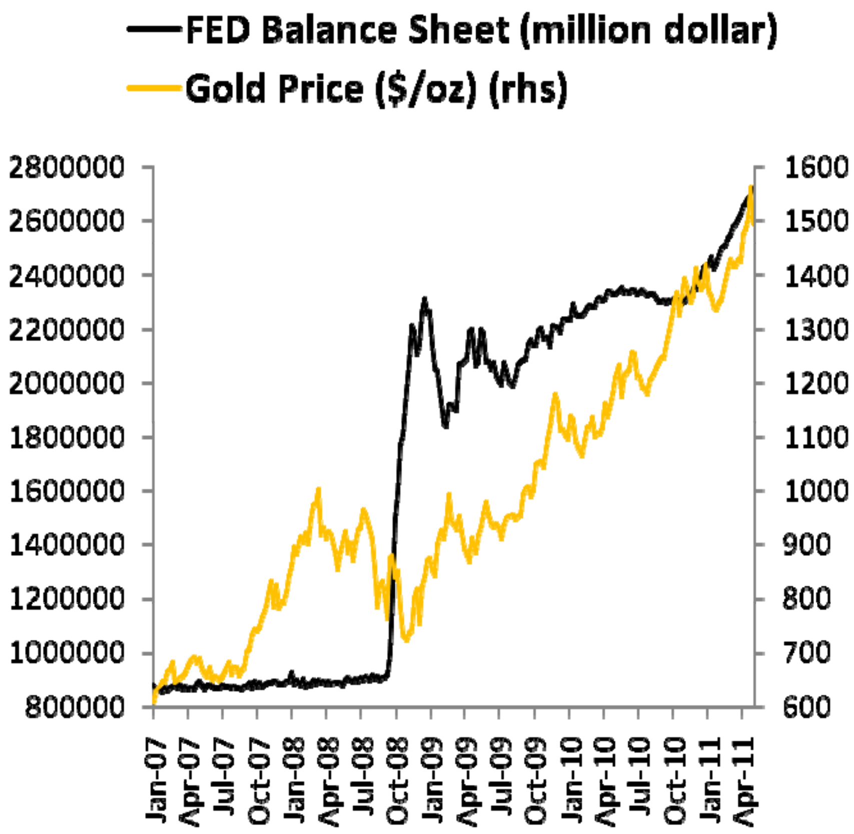
Introduction...

Loose monetary policies carried out after global crisis, lead to liquidity flood and this liquidity flood increased commodity demand. With rising demand and weak dollar, precious metal prices especially gold and silver reached to record levels. Recent volatile price movements in gold and silver raised worries that a bubble was developing in gold and silver prices. In parallel with the recent developments in commodity markets, in this study we try to analyze the main factors affecting price movements and the possible price movements during the coming periods .

QE2 has led to a raise in gold prices...



Source: Bloomberg

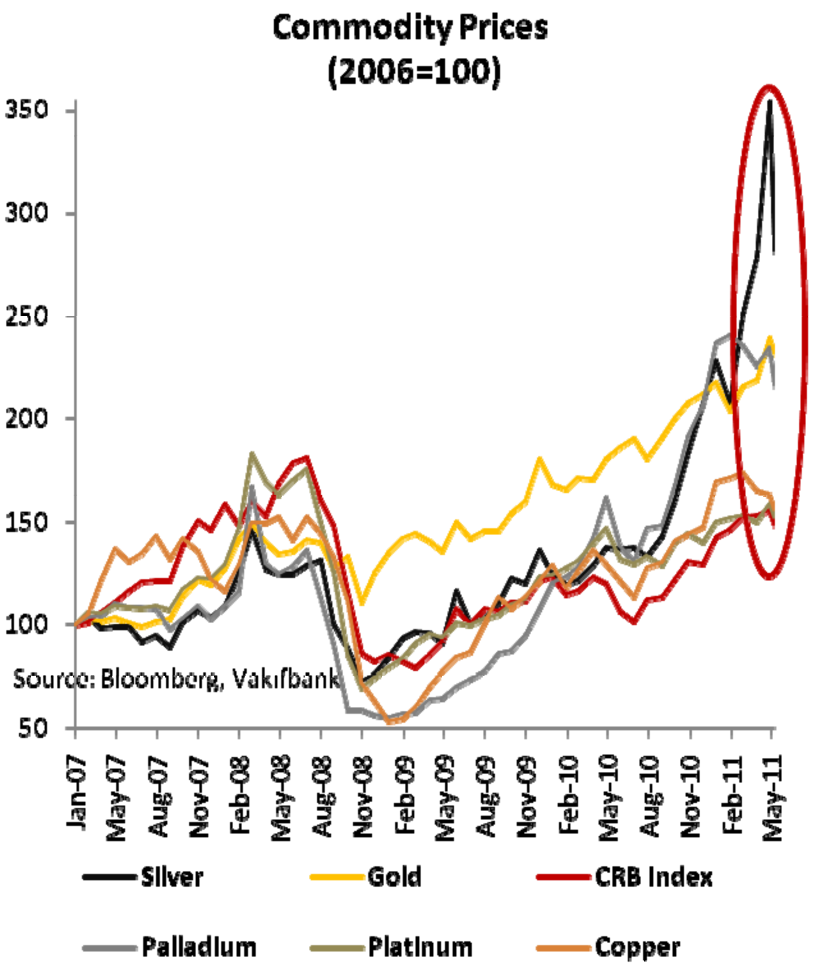
Before QE2

- After the global crisis in 2008, liquidity crunch in markets has forced developed countries' central banks to take increasing liquidity measures. Thus, the demand for risky assets increased.

QE2 After

- When QE2 put into practice by FED to support the economic recovery, it also supported gold demand and the inelasticity of gold supply raised prices to record high levels.

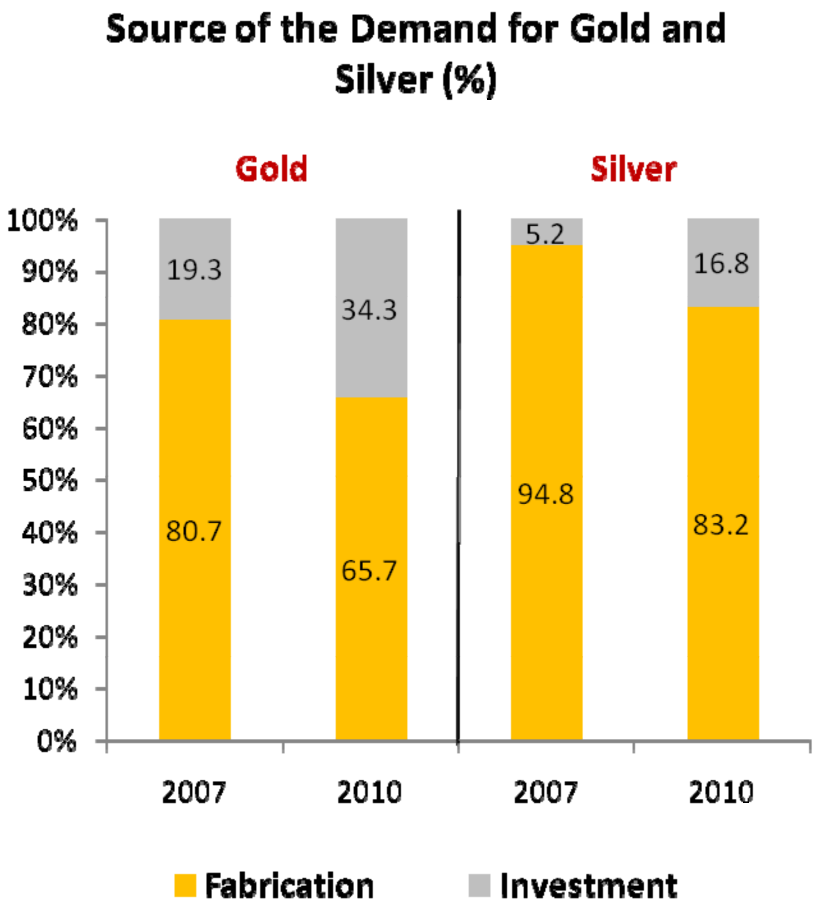
Rising safe haven demand due to excess liquidity increased gold prices...



- The increasing interest of investors has affected the commodity prices upwardly since 2009 and inflation concerns at the end of 2010 have continued to support commodity prices.
- Depending on the political instability in Middle East, remarkable increases have occurred among precious metals especially in gold and silver by the effect of safe heaven demands.
- As shown in the graph lefthand side, while all commodity prices have been moving parallel with each other between 2006 and 2008, after QE2 began in November 2010 all commodity prices, especially silver, palladium and gold, have started to move above the CRB index .

*CRB Index is a commodity price index which is composed of 19 commodities and used as a global benchmark for measuring commodity price movements

Investors demand for the silver is increasing...



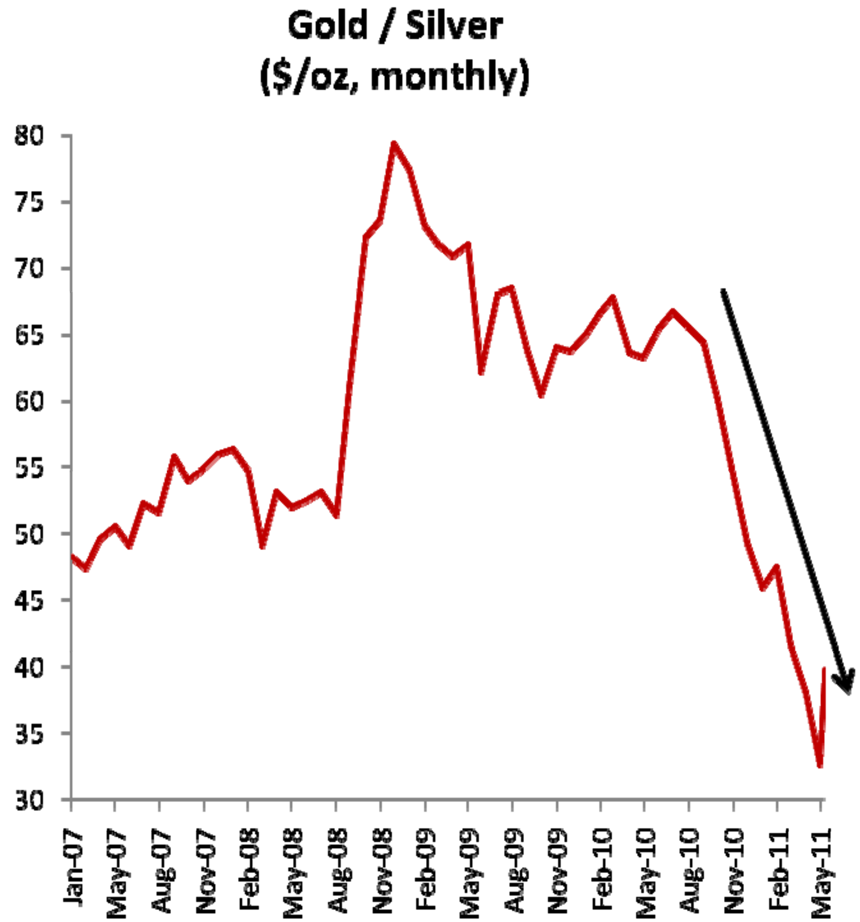
Source: Bloomberg, Vakıfbank

- Rise in silver prices is based primarily on increasing industrial demand including electrical, medical and photography and also in jewellery and silverware. But the main reason of the high prices is silver's recent role as a store of value.

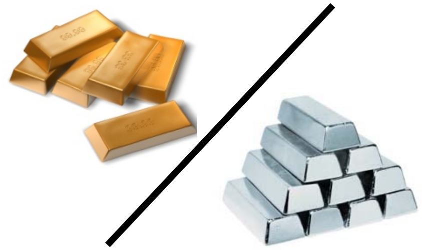
- In order to analyze gold and silver demand, 2007 and 2010 data used in the graph lefthand side. As it is seen in the graph, the share of investment demand for silver was only 5% in 2007 and increased to 17% in 2010. This indicates the increasing number of investors who prefer silver as a saving instrument.

- Another reason of the price rise is the inelastic supply of silver and the expectations of supply decreasing in the coming years.

Gold/Silver ratio has decreased to 30 in April 2011 which was 70 in 2010 ..



Source: Bloomberg, Vakıfbank



- Silver which has started to increase since July 2010, reached the highest level in the last 31 years with $ 50 oz at the end of the April 2011.

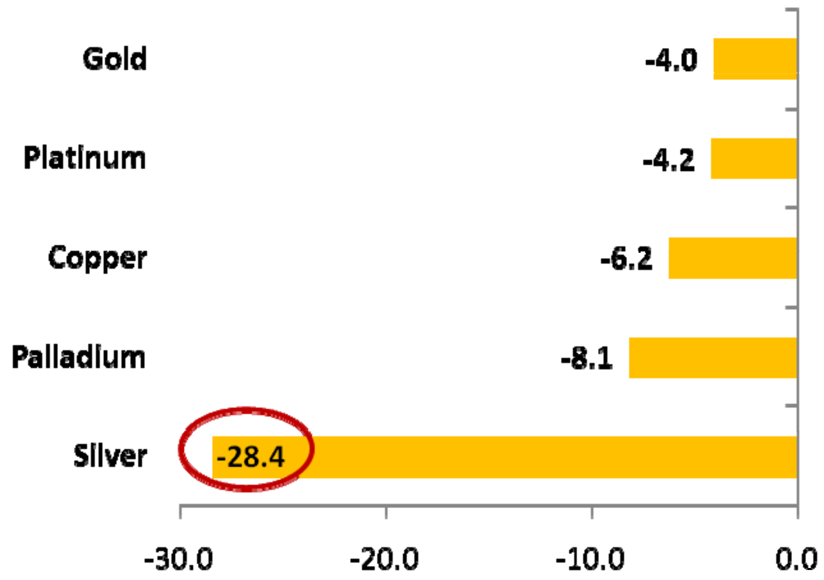
- While gold prices has increased by 40% roughly, silver prices has risen by 195% conspicuously.

- As shown in the graph lefthand side, the recent decrease in gold/silver ratio to 30 in April 2011 from 70 in 2010 is a result of the over valuation in silver prices.

What is the reason behind the sharp fall in commodity markets in May?

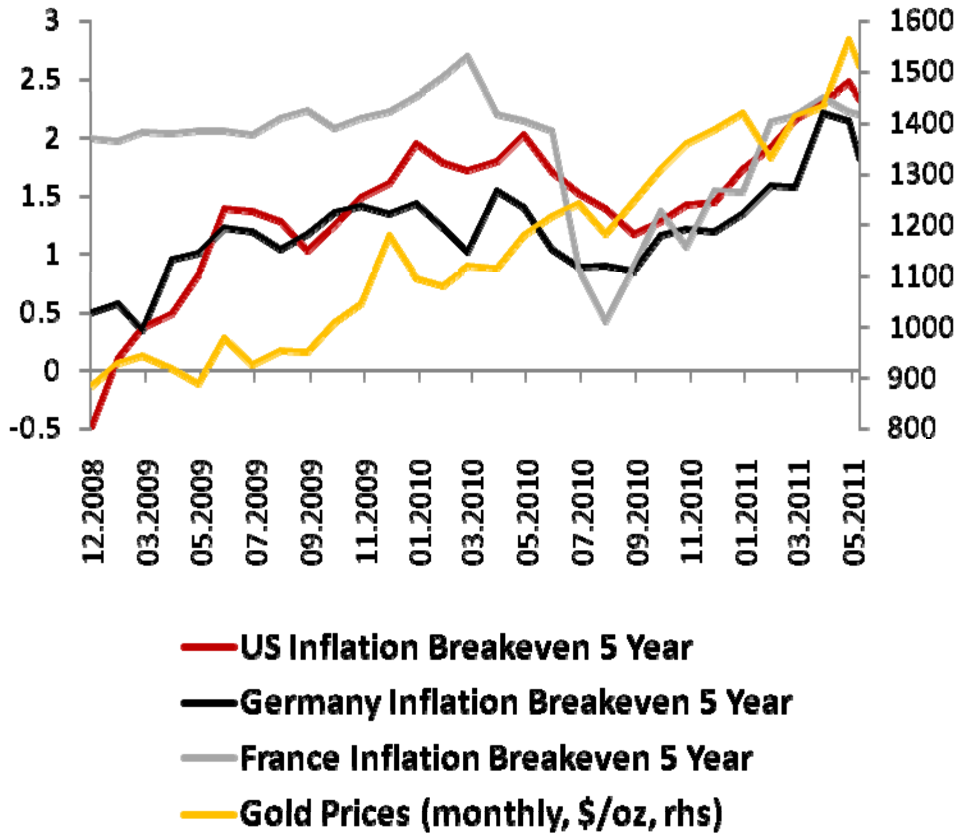
- Commodities fell sharply on the 5th of May and silver decreased higher than other commodities.
- While the silver decreased by 28% between the 28th of April and 5th of May, the decrease in gold prices was limited.
- Rise in dollar after the killing of Osama Bin Laden can be a reason for the volatile price movements in commodities during last week.
- Moreover, it can be also a correction movement in the commodity prices that have countinously risen since the beginning of 2010.

Changes of Prices Between the 28th of April and 5th of May (%)*



Source: Bloomberg, Vakıfbank
*on April 28th, gold and silver reached the all time records and on May 5th, commodities decreased sharply

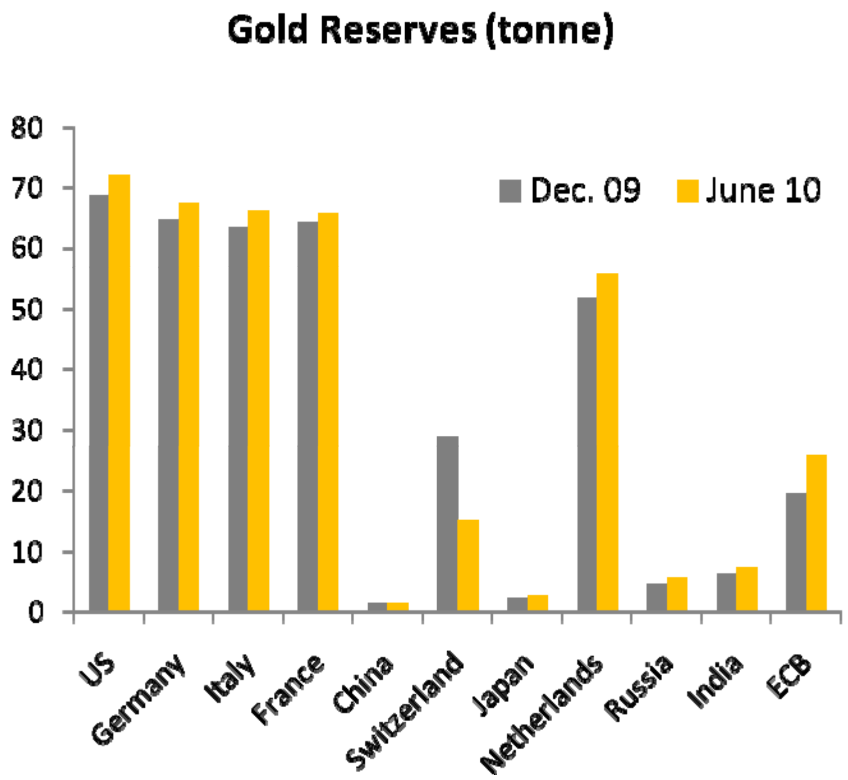
Will commodities continue to rise?



Source: Bloomberg

- It is widely known that gold is seen as an ultimate hedge aganist inflation.
- When US 5 year Breakeven inflation rates and two European biggest countries as France and Germany's 5 year breakeven inflation rates are analyzed, it is seen that inflation expectations in US and Europe have increased after QE2 .
- Although some countries Europe, Brazil, India and China have already started rate hikes, US seems to keep rates on hold for an extended period of time as US economy is still on recovery path. This will likely to support commodites' especially gold prices.

If central banks continue extending gold reserves there will be strong support for gold over the long run...



Source: World Gold Council (WGC)

- Due to weakness in US, and ongoing debt crisis in Europe, central banks have diversified reserves into gold. The high share of gold in central banks' reserves singnalling their anxiety towards fx markets.
- Some EM central banks as Thailand, Russia, China and Mexico still continue gold purchasing in high amounts. And the potential interest of central banks in gold is expected to be continue in the forthcoming months.

To sum up...

- Fed's monetary policies could continue to influence gold and silver prices in the long run.
- As Fed maintains loose monetary policies, poor fiscal outlook for many OECD countries remains, debt crisis in Eurozone and political instability in the Middle East continues, precious metals will continue to be bought as hedges and for safe haven purposes. This should lead to the continuation of gold and silver's secular bull markets.
- Even though silver prices have reached a 30-year high recently, prices will continue to rise, due to increasing industrial demand and its recent role as a store of value and protection against inflation.
- Addition to strong demand from countries like China and India, the reconstruction facilities in Japan that will be started in the second half of 2011 are set to increase commodity demand. İn the coming period.
- So in the long run gold prices could hit $ 1,650/oz and silver prices could see $ 50/oz.

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