

Investment Themes

7 September 2011

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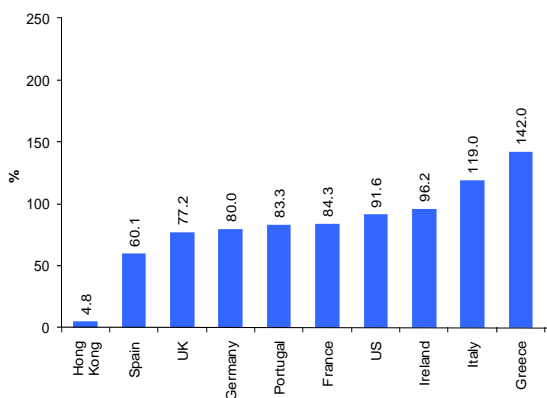
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Gross government debt/GDP at 'default' levels



Source: Bloomberg, Standard Chartered

The case for gold and silver equities

Summary

- We have long been stressing that gold is expected to perform well.
- We continue to expect gold to hit USD 2100 in 2014 and see significant diversification benefits from the inclusion of gold in investment portfolios.
- Other precious metals, such as silver, are also looking increasingly attractive.
- The negative spread between platinum and gold prices suggests potential relative value for platinum, although concerns about the economic environment and palladium's potential to replace platinum in the auto sector are risks to this outlook.
- **Given the sharp increase in the gold price in recent times, we believe gold and silver equities offer a better way to add to this exposure at this juncture.**

The outlook for gold

We remain constructive on the long term (to 2014) outlook for gold for the following 5 reasons:

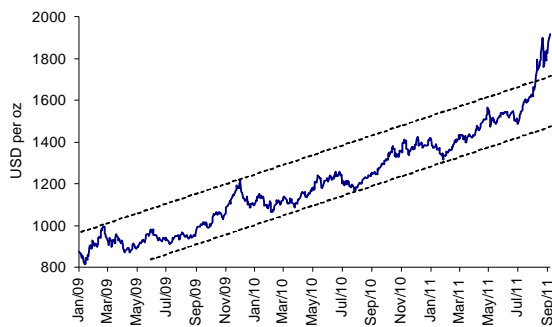
1. G7 debt levels continue to rise significantly, increasing the incentive to inflate via quantitative easing in need
2. Real interest rates are negative
3. Central banks turned net buyers of gold in 2010 according to the World Gold Council and we expect the pace of net purchases to accelerate in 2011
4. Strong demand from China and India as incomes rise
5. Analysis conducted by our Equity Research team indicates gold supply increases over the next 3-4 years are unlikely to be sufficient enough to meet increased demand.

Negative real interest rates have been associated with strong gold gains

	Real interest rates	Cumulative gold return
Mar-71 - Dec-73	Positive	175.5%
Jan-74 - Jan 78	Negative	64.7%
Feb-78 - Feb-79	Positive	43.0%
Mar-79 - Sept-79	Negative	58.1%
Oct-79 - Mar-80	Positive	24.5%
Apr-80 - Sept-80	Negative	34.8%
Oct-80 - Sep-92	Positive	-47.5%
Sep-92 - May-93	Negative	7.1%
May-93 - July-02	Positive	-19.0%
July-02 - Oct-05	Negative	53.2%
Oct-05 - Dec-07	Positive	-20.7%
Dec-07 - Aug-11	Negative	95.2%

Source: Bloomberg, Standard Chartered

Gold rallies strongly



Source: Bloomberg, Standard Chartered

Silver cheapens relative to gold in past three months



Source: Bloomberg, Standard Chartered

Therefore, we expect gold to continue to perform well in the coming 3 years. Only when governments plot a plausible way out of the current high debt and low growth environment that does not rely on significantly higher than average inflation levels will gold look less attractive. This outcome looks unlikely for the foreseeable future.

Short-term risks - The appreciation of gold has accelerated sharply in Q3, which makes timing gold purchases and sales difficult to manage. For instance, gold could fall to 1750 before breaking through previous resistance and 1500 without breaking the uptrend support (from 1874 currently). This has led investors to look for alternative ways to protect wealth in a world of heightened volatility and inflation risks.

Other precious metals may offer opportunities

While the outlook for other precious metals is more complicated given their use in manufacturing processes, there are still potential investment opportunities here.

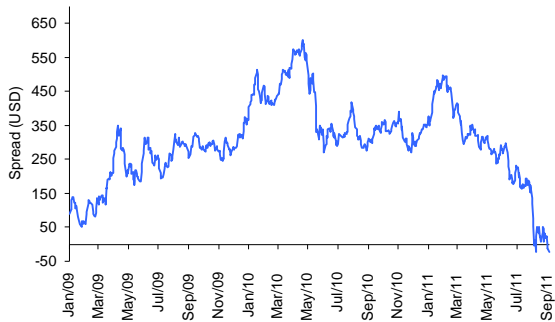
Our favoured alternative is silver which has become significantly cheaper on a relative basis versus gold in the past two months. Here are some of the other reasons to be bullish on silver:

- Less silver than gold above ground.
- Silver is largely a by product of industrial metals mining – so a global recession may cut output.
- Industrial usage is for the electronics sector which is not price sensitive – silver a very small component of overall cost.
- The silver content within electronic products is largely not recycled.
- Silver is poor man's gold and has been a currency for as long as gold.

Platinum is also a potential alternative investment. Historically, platinum has almost always traded at a premium to gold. Given that this spread is negative at the moment, it may suggest that platinum is opportunistically a better investment than gold.

However, the key risk here is that around 50% of platinum demand comes from the auto sector. Given the slowdown in the global economy, the near-term prospects for the auto

Platinum trades below gold



Source: Bloomberg, Standard Chartered

Gold equities lag gold performance

Gold/GDX ratio



Source: Bloomberg, Standard Chartered

sector look increasingly challenging. Meanwhile, platinum can be replaced by palladium in the production process which means there is a risk that platinum could trade below gold for an extended period.

Gold and silver related equities seen as good value

Given the Fed's very clear message that measures will be taken to provide stimulus in some shape or form, we continue to expect the 2 currency-commodities, gold and silver, to outperform. With this in mind, we are extremely positive on gold and silver related equities. Gold-related equities have lagged the performance of gold. Gold-related equities are up 5.6% year-to-date compared to gold's 33% ascent. We argue the recent under-performance against the underlying metal provides a good opportunity to enter the trade.

Those un-hedged gold and silver miners that have operational leverage to the underlying metals' price are thus another very attractive way to play the commodity. In fact, it can be argued that they are a far better way to play the metals than through holding 'paper gold', such as those ETFs which may have an element of exposure to futures and thus counterparty risk.

For those investors that are concerned that the sector is getting too 'hot', we would advocate that they consider the following:

- Many of the miner stocks are trading well below their levels of 2007 even though silver and gold prices have more than doubled over the period.
- With both the Fed and the ECB likely to undertake further quantitative easing and slower growth it is likely for real rates to remain low if not negative for some time.

It's worth highlighting that we would advocate a significant allocation to gold and silver miner related equities, within a global equities portfolio. A 10-20% allocation would reflect a significant overweighting, but we would look at it not only as a form of protection against further market declines, but also a way to profit from such declines.

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