KARVY
COMTRADE LIMITED

Gold Price Outlook

- **Gold price rally expected to continue this year and into 2007.**
- **We are targeting gold prices at $ 660 per ounce and on breach of that, around $730 by end of 2006.**
- **Major decline in the value of the dollar and/or any military action taken by the United States against either Iran or North Korea could see Gold prices heading towards $ 750 an ounce or even more.**
- **Gold is the only currency which acts as a long term hedge against inflation.**
- **Continued accumulation by the Central Banks of various countries will support higher gold prices in the long term.**

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Gold – An Investment Paradise

Gold has been synonymous to wealth and prosperity through the ages. The history of Gold dates back to as early as 4000 BC when the prehistoric men used it as a tool. Since then Gold has filled the pages of history as the divine metal that has attracted the attention of men – powerful and otherwise. Gold was the source of power for the kings. Wars were waged; lives were lost as kingdoms piled up and hoarded tonnes of Gold. In the modern history, Gold became the international currency as the Gold standard came into existence. Even after the dismantling of Gold standard, Gold existed as the backbone of international trade and economics as the US accumulated tones of yellow metal. Till today, Gold has retained its basic use as a commodity without losing its sheen as a currency.

Gold, because of its ability to protect the wealth of investors can be an ideal addition to a portfolio. Also the short-term fluctuations in Gold offer good potential for trading. Gold has been on its long-term upwards trajectory which began in early 2001. This long-term move has been punctuated by short-term pullbacks offering opportunities for late entrants to join the bandwagon. With the US economy outgrowing the league of developed nations during the last two years coupled with the worsening of long-term structural weaknesses and the subsequent movements in the USD have moved the focus away from Gold's use as a commodity. However the long-term fundamentals of the yellow metal have also undergone a significant change with the mining output falling quite steadily during the last decade coupled with an evergreen demand especially from Asia.

This report analyses the long-term and short-term fundamental factors expected to move Gold prices. We believe that the short-term weakness expected in gold is a great opportunity for the late-comers to join the great Gold.

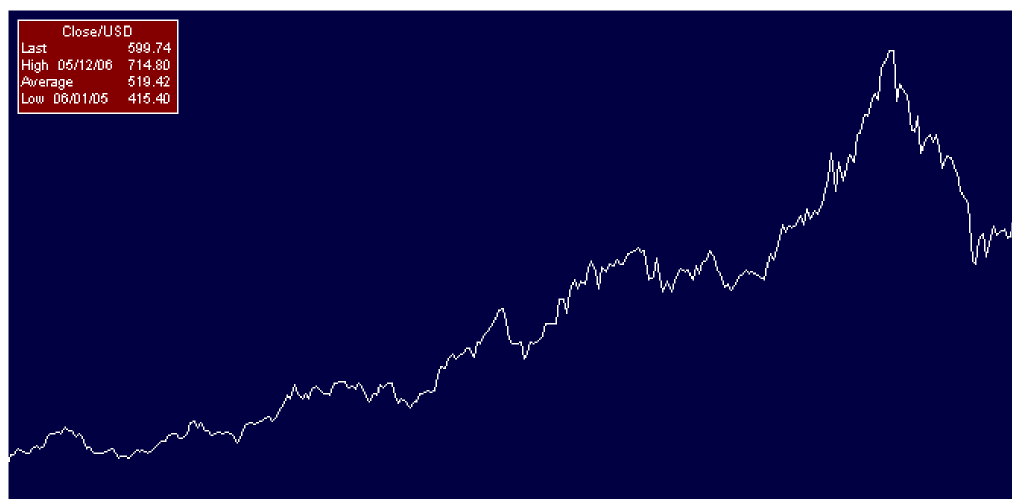
Strategically, gold is one of the two most important commodities on the planet along with crude oil. Gold has been historically recognized as the ultimate store of value and method of payment. The following characteristics of Gold have enabled it play this role:

- It is durable, homogenous and divisible
- Gold's rarity gives it intrinsic value and that value is high per unit of volume.
- Its value is recognized across the globe and is traded in a continuous market.

- Gold plays little role in economic growth and is produced for accumulation not consumption.

- Gold is the only financial medium of exchange that is not someone else's liability.

Since we came out with our first Gold price outlook of $ 550/oz in 2005, gold prices had risen to around $734 in April/May, 2006 although it has taken some correction and come down to $600 levels now. The very sudden spike in Gold prices had taken us unawares as we had expected a gradual bull run at a more measured pace. The following chart shows how the Bull Run occurred in gold prices over a period of one year.



Source: Bloomberg

In updating our price outlook, we have considered the following factors:

- Investment demand will continue to be the prime driver for the rally in Gold prices, as economic factors will make gold more attractive compared to other financial assets.

- Furthermore strong buying support from the Central Banks of Russia, China and Middle East countries will help support the rally in Gold prices.

- Mine production will not be able to meet current demand due to lack of new discoveries.

- The long term average in the Crude/Gold ratio has been around 16 times, but is currently only around 10 times. Even if we go by a conservative estimate of crude

prices at around $75 per barrel by the end of this year, we are looking at gold prices of around $750-$800 per ounce, considering a multiple of only 11 times.

In the remaining part of this report we will consider the major factors that are likely to drive Gold prices higher in the near future. We have divided these factors into two groups, the first one being the traditional demand-supply factors, and the second group pertaining to the economic factors prevalent in the United States, which in our opinion is the primary driver for gold prices.

Demand – Supply Factors

The demand – supply dynamics play an important role in determining the price of Gold. For a long time Gold prices have been suppressed as a result of concerted selling by Central Banks of various countries. However this trend has reversed, with Central Banks, especially those of Russia and China becoming net importers of Gold. The demand for Gold is primarily driven by three factors, namely,

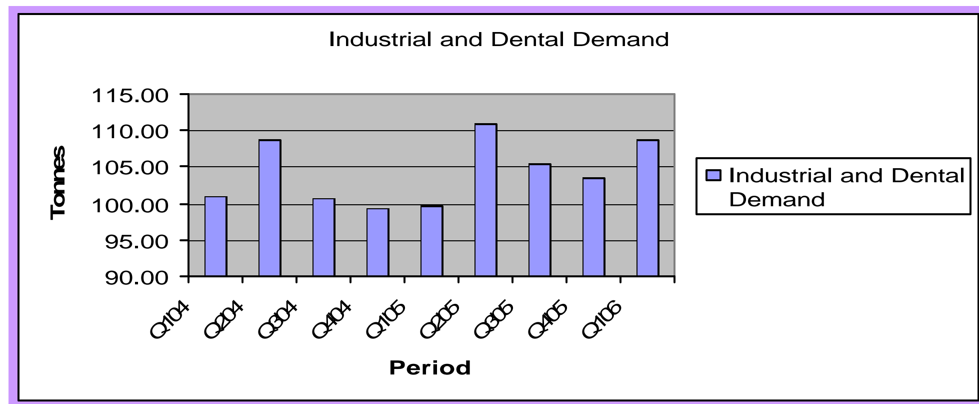
- Jewellery
- Industrial Uses
- Investment

As a result of the huge spike in Gold prices, Jewellery demand from countries like India and the Middle East fell by 22 % in tonnage terms from a year earlier. In Asia and the Middle East, which account for around two thirds of the Jewellery demand, consumers and the retail trade are very sensitive to price volatility. However we believe that consumers within these markets will continue to purchase Gold Jewellery if they are offered the right products at the right price.

Source: World Gold Council

INDUSTRIAL

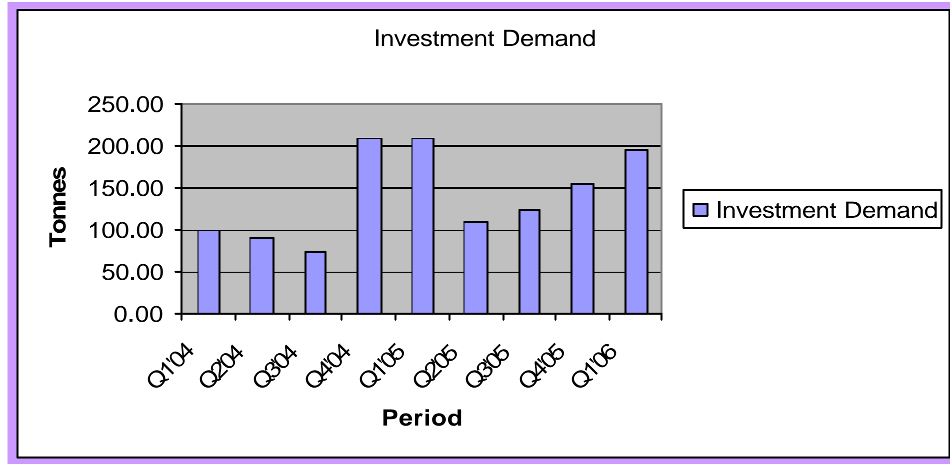
The robust global economy enabled electronics demand to rise strongly, causing overall industrial demand to increase by 5 % compared to a year earlier. This form of gold demand is not price sensitive since manufacturers of electronic goods which need electronic components, cannot change specifications overnight. The strong growth was due to a recovery in the Japanese market for Gold bonding wire. There was also a slight growth in the dental use of gold.



Source: World Gold Council

INVESTMENT

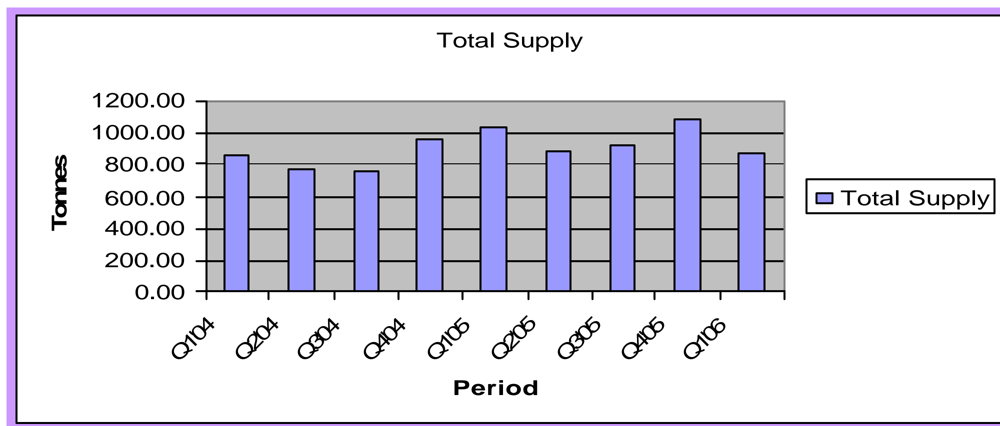
The main propellant for the high Gold prices was the investment demand. The increase in investment demand was due to the growing number of investors who are seeking to use Gold to hedge against different types of risk. In countries like the US and Switzerland, the rising price spurred interest from investors driving overall investment demand up. Moreover a recent development has been that in India where traditionally Gold has been consumed as Jewellery, increasing promotion of Gold bars and coins by several banks resulted in Gold being purchased for investment purposes. However the main driver of investment demand was the investment in Gold Exchange Traded Funds whose total off take for the first quarter was around 109 tonnes. At the time of writing this report, the total accumulation by all the ETF's amounted to around 630 tonnes. A growing understanding, especially among longer term institutional investors such as pension funds, about the attractiveness of investing in Gold, also contributed to the rally in Gold prices.



Source: World Gold Council

SUPPLY

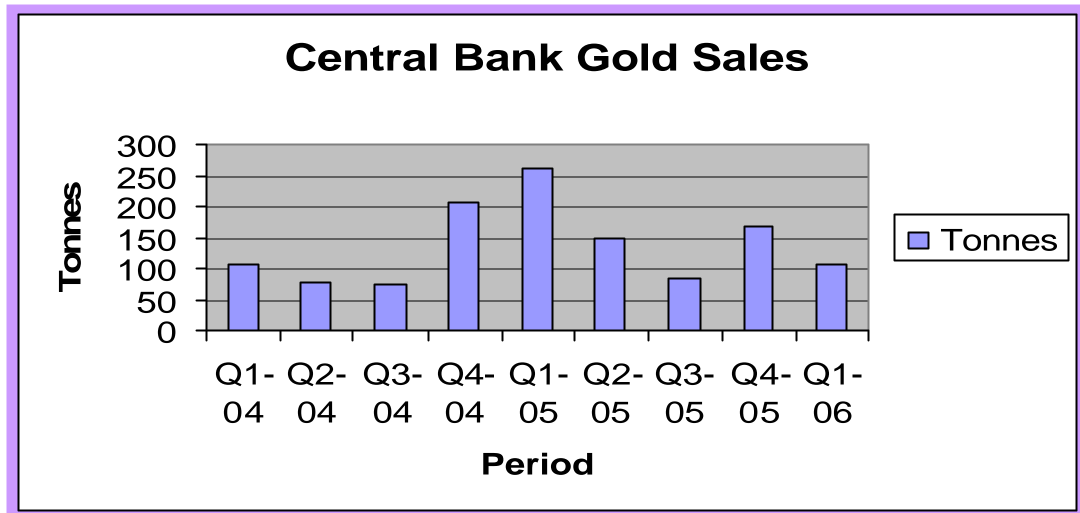
While investor activity was the main driver behind the rising Gold price in the first quarter of 2006, a contraction in supply also helped. Mine production plays a vital role in determining the price of Gold as it is the only way by which new stocks can be added to the existing above the ground stocks. A sharp decline in mining production in the first quarter of 2006 contributed to the high prices of gold during that period. Although Gold prices are attractive now, it will take at least 3-4 years to get a new mine into commercial production stage. So any near term increase of supplies can be ruled out.



Source: World Gold Council

But, the main factor constraining supply in the first quarter of 2006 was a sharp reduction in net central bank selling which, at 116 tonnes, was 57 % lower than the comparative period in the year 2005. This sharp decline in supply caused by the fall in central bank sales was partly

offset by a very substantial rise in scrap supply which in the first quarter of 2006 was higher by 51 % compared to the first quarter of 2005.



Source: World Gold Council

Huge sales by Central Banks were the primary factor in suppressing Gold prices in the nineties. Reduction in these sales due to the Central Banks Gold Sales Agreement will play an important role in supporting higher Gold prices.

The demand and supply factors as outlined previously do play a role in determining Gold prices; however they are not the most important ones. As we have outlined previously, since Gold acts as a reserve currency to the US dollar, the factors which work negatively for the US Dollar work positively for Gold and vice versa. These factors are outlined here in the following sections under various categories like GDP, Trade Balance, and the like.

In the Long-term we believe that USD may be expected to weaken further due to the following factors:

-The wide current account and the trade deficits could compel the USD to weaken so that a monetary correction can happen. The US may be compelled to allow the dollar to depreciate against other currencies in order to increase its exports. A weaker dollar makes US exports comparatively cheaper.

-The long-term effects of high crude prices may put huge pressure on the US economy considering that US is the largest consumer of crude oil in the world.

- Any possible slowdown in the foreign investments in the US may raise the short-term interest rates in US causing an economic debacle resulting in a major economic slowdown in the US.

Fear of Slowing GDP

It is widely believed that the global economy is facing a slowdown which is brought about by higher oil prices, rising interest rates and other factors. We have seen a spate of interest rate hikes throughout the world.

The United States embarked on its 17th consecutive hike and lifted interest rates to 5.25%. Similarly, the European Central Bank increased its rates by 25 basis points, followed by the Central Banks of China, India, Korea, and South Africa, who all increased their interest rates. This upward rise in interest rates is likely to negatively affect consumer sentiment, which in turn is expected to reduce global demand for goods.

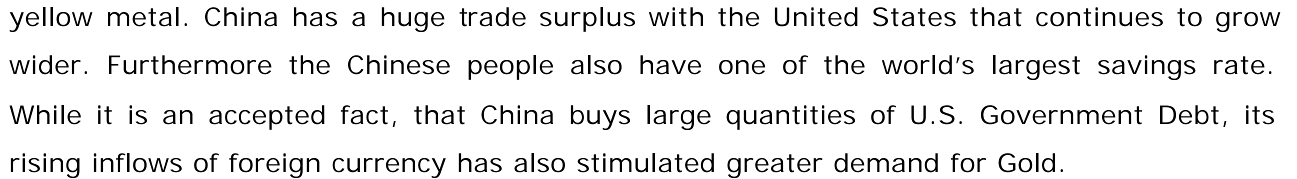
Furthermore, higher oil prices and increasing interest rates are expected to lead to negative Real Interest Rates. Negative Real Interest Rates means the inflation rate exceeds nominal interest rates. In such a situation, purchasing power of the consumers decreases which leads to reduced confidence in paper currencies. In such a situation, it is natural for people to gravitate towards Gold, as Gold acts as the ultimate store of value. Gold has and will always have an intrinsic value that paper currencies do not have.

Oil Exporters

The growing demand for oil in the United States and from the emerging economies of India and China has driven up prices and filled the financial coffers of oil exporting nations. Since, dollar is the primary currency used in the oil trade, the oil-exporting nations (including Russia) have been accumulating vast quantities of dollars. Due to the uncertainties prevailing in the Middle-East, we are observing that the OPEC members are diversifying, using more of their dollar reserves to buy Gold. Likewise Russia has also increased its Gold holdings as a part of its reserves from 5% to 10%. This continued diversification into Gold will be a booster for higher bullion prices.

The China Factor

Gold has long been prized in China which is one of the world's largest Gold consumers along with India. After the Shanghai Gold Exchange opened in 2002, the Chinese Government's five decade monopoly on the metal ended, leading more Chinese consumers to invest in the



yellow metal. China has a huge trade surplus with the United States that continues to grow wider. Furthermore the Chinese people also have one of the world's largest savings rate. While it is an accepted fact, that China buys large quantities of U.S. Government Debt, its rising inflows of foreign currency has also stimulated greater demand for Gold.

Low Gold Price in the 90's

After climbing as high as $ 850 per ounce in 1980, Gold dropped as low as $252 an ounce in 1999. Such dismally low prices discouraged mining companies from spending more money to find new supplies of Gold. Hence we cannot reasonably expect major new supplies in the coming years. The lack of investment during the low price years means that new sources of Gold have not kept pace with rocketing global demand.

Low Interest Rates

Although nominal interest rates are increasing, the real interest rates are not rising simultaneously. This is because inflation eats away a large portion of the nominal rates. Where real interest rates are low, many investors turn away from paper assets which decline in value and instead turn towards assets with real value like Gold. When interest rates are low, there is little incentive for hedging. As a result, the supply of Gold gets reduced in the market, creating a market imbalance especially during a period of escalating demand.

Deficit Spending

United States Budget deficits are expected to approach around $400 Billion in both 2006 and 2007, mostly due to the rising costs of wars it has to maintain both in Afghanistan and Iraq. Since 9/11, the United States has spent hundreds of billions of dollars for the global war on terrorism. In 2001 the Federal Government was running a surplus budget of $128 billions. However in 2002 this turned into a deficit of $158 billions. During the last three years this has widened into a deficit of $412 billions. At the end of 2005 the total reported budget deficit was $467 Billions. Any further widening of the federal deficits may push USD further down helping bullions prices to firm up consistently. Large budget deficits undermine the dollar's strength in the minds of overseas investors. Many of those investors will buy Gold as an alternative reserve asset.

The United States Trade Deficit

The United States trade deficit has been continually increasing and as of end April, the total Trade Deficit stands at $120 Billion Dollars. To reduce this huge trade deficit the United States

has got only one option and that is to allow the dollar to depreciate against other currencies. This will increase U.S. exports while reducing imports, thus effectively reducing the trade balance.

A Note of Caution

The continuous hike in US interest rates pose some threat in near-term. The Federal Reserve has been on an interest rate hike spree and has managed to raise the interest rates to 5.0 % from the historic low level of 1% during the period beginning May 2004 through a systematic 25 basis points hike. As of June, 2006 the Fed again hiked the interest rates by 25 basis points, raising the Fed rate to 5.25 %. As US began to rise the interest rates from June 2004, there has been a steep rise in the Net foreign investments in the US showing that the interest rate differential has worked in favor of the USD. We expect this factor to increase the flows into the US and strengthen the USD in the short-term.

The question that is before us now is whether the Fed will stop at 5.25 % or continue its rate raising spree in August. It has become very clear from the recent statements given by the Fed Chairman Ben Bernanke that he is more concerned with the inflationary pressures in the US economy than he is with the expected slowdown in the economy.

Furthermore as of today there are no discernable signals that the US economy is slowing down. New Home Sales for May surprised everyone by increasing by 54K from the previous month. There was also not much decline in the Existing Home Sales figures and the Consumer Confidence Index in fact increased. Moreover the final GDP figure for the first quarter of 2006 which is due on the 29th of June is expected to be revised upwards to 5.6 %.

What we have been observing is that the Fed policymakers are giving a lot of importance to containing inflation within range of 2 % levels. In March, core inflation measured by the Consumer Price Index (CPI) was + 2.1 % on Year on Year (YoY) basis. The May Core CPI showed an upward movement by +0.2 %. This means that the Year on Year CPI should be somewhere in the range of 2.4 %. Furthermore, if the June CPI data, which is due on the 19th of July and is also the last CPI reading before the August FOMC meeting, shows a monthly increase of at least 0.1 %, the YoY Core CPI will be somewhere in the range of 2.55 %. This range of inflation is broadly out of the Fed's comfort zone of 2 % and will make it difficult for the Fed to pause then.

OUTLOOK

Based on the detailed analysis of the various factors that are likely to affect the Gold price in near term and long term we believe that Gold prices are likely to rise to $680/ounce levels and if Gold prices happen to break that level, we may see Gold touching $730/ounce levels by the end of 2006. In a worst case scenario, if Gold prices happen to fall towards $530/$540 levels, we believe that would be an ideal opportunity to jump onto the Gold bandwagon.

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