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Gold For Beginners (Transcript)

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www.ubs.com/economics

Jonathan Anderson
Economist
jonathan.anderson@ubs.com
+852-2971 8515

Julien Garran
Analyst
julien.garran@ubs.com
+44-20-7568 3540

Edel Tully
Strategist
edel.tully@ubs.com
+44 20756 76755

I hate television. I hate it as much as peanuts. But I can't stop eating peanuts.

– Orson Welles

How should we think about gold?

This has to be one of the favorite questions of nearly every investor we encounter, and despite our lack of specialized knowledge and our relative focus on the emerging universe we very often get dragged off into speculative discussions on the nature of gold demand and what gold prices are "telling us".

With this in mind we felt it was high time to host a conference call on the topic, and last week we invited our true specialists, UBS global commodity research analyst **Julien Garran** and precious metals trading strategist **Edel Tully**, to give their views on the underlying nature of the market and their forecasts for pricing and volumes going forward.

Forget the fundamentals, for now

If we had to summarize the conclusions on gold in a single phrase – keeping in mind that this is a bit of an exaggeration, and one to which Julien and Edel might well take exception – we would say "forget about the fundamentals".

What do we mean? Well, one of the key messages from the discussion below is that more traditional supply and demand factors such as mine production and jewelry demand have clearly had only a very limited impact on price dynamics over the past half-decade. Instead, the biggest driver of demand has been investment-related purchases.

And when we talk about investment demand, there are two main drivers: inflation and risk. I.e., gold does well when buyers are worried about inflation prospects, debt monetization and the debasement of national currencies, and also does well in an environment of heightened volatility and fear about the global economy.

This report has been prepared by UBS Securities Asia Limited

ANALYST CERTIFICATION AND REQUIRED DISCLOSURES BEGIN ON PAGE 18.

What do we expect going forward? For the time being we expect the “fear trade” to continue to support gold prices – and over the medium term, ongoing monetization of the developed sovereign debt overhang also suggests that gold will outperform. The likely transition of global central banks from net sellers to net buyers is also a significant positive factor. And again, this despite relatively flat mine supply and falling “underlying” jewelry and technical demand.

The following is the full transcript of the call.

[Note: the original call featured a powerpoint presentation as well, and all the charts referred to in the text are provided at the end of the report below]

Part 1 – The macro backdrop

Julien: I’m just going to cover three charts and take a “waving-my-arms-in-the-air” top-down view on gold before passing on to Edel to cover the details on supply and demand dynamics.

Let’s kick off with Chart 1 of the presentation (*see the end of the report below*), where we show the persistence of gold’s bull run. We’ve seen gold rise four-fold since early 2002, with price action accelerating especially from early 2009.

Gold and the reflation trade

Now, for us gold is basically a schizophrenic metal. We remain extremely constructive on the outlook for gold, but it’s a schizophrenic metal in that it reacts to two very distinct drivers. The first is that gold tends to behave very well when the US is trying to reflate its own economy. This was the story for gold really from the middle of 2002 all the way through to the middle of 2008 and again over recent months.

We highlight the main reason why that happens on Chart 2. When the US authorities try and reflate, you get into a virtual circle of credit growth in emerging markets that is very positive for gold. Capital flows out of the US into emerging economies, and you tend to see local central banks printing money to buy up those dollars and prevent their currencies from appreciating too quickly. In doing that, they see a strong rise in their reserves.

That’s the first point at which gold receives a positive impulse, if you like. As global foreign exchange reserves rise, this induces interest in buying gold for foreign exchange reserves to balance out FX exposure, so that it’s not just purely dollar exposure. And as Edel will discuss later, Asian central banks in particular have very low holdings of gold as a percentage of total reserves.

The next thing that happens on the back of this kind of money printing in local emerging market currencies is that you see strong growth in deposits at local banks. That in turn induces strong loan growth, i.e., an upturn in the credit cycle with strong lending, both for assets like property or equities and also credit to companies. All of this creates a very strong self-reinforcing dynamic within emerging markets that leads to high wage growth and high growth in wealth.

Again, this was the key story for the global economy over the 2002-08 period. And when this happens, when you see rising wealth and incomes in emerging markets, you also tend to see very strong gold demand coming through, because of the high attraction to gold in those emerging market counties. In sum, this is the process that provides a strong boost to gold when the US authorities are trying to reflate.

And gold tends to behave like a risk asset, because at the same time that this process is occurring you tend to get strong rises in commodity prices; you get strong rises in risk assets such as emerging market equities. So gold tends to rise in line with risk assets while US authorities try to reflate.

And gold and the monetization trade

But as I said, gold is also a schizophrenic metal. It doesn't just go up when the US authorities reflate. Rather, it also has a second very interesting characteristic, which is that it acts almost like a call option on monetization of debt. In a sense, when conditions start getting much more difficult, as they clearly were as we went from mid-2008 through to the end of that year, and as they have in part once again over the last couple of months, then gold will tend to start rising on the anticipation that the monetary authorities globally are going to have to start printing money in order to effectively bail out governments by buying up their own sovereign debt.

Now, what was very interesting in 2008 was that gold started falling, as you can see in the chart; gold was falling kind of in line with copper prices and other commodity prices. But then, as we saw the US authorities coming under increasing stress and the potential for monetizing their own debt increasing, gold suddenly started rising very aggressively in October and November of 2008, even while we were seeing a continued drop in other metals and in other risk assets.

The asset allocation clock

So in essence gold started rising in anticipation of action by the US authorities. And on Chart 3 I highlight how we can think about gold: in what kind of global economic environment would we want to buy gold? This is the "asset allocation clock" that we use to drive resources strategy.

To put my recent remarks in context, in the period from 2002 through the first half of 2008 we were very firmly in quadrant one on the top left-hand corner of the chart. We were in a reflationary boom; the US authorities were reflating, money was going overseas and into emerging markets, and it was right to be long gold, commodities and emerging market equities and right to be short the US dollar and bonds.

Then, as we moved into the second half of 2008 and the credit crunch to came to a head, we saw a deflationary bust. Gold went down in anticipation, but then as it became clear that the US authorities were going to have to monetize and that the Fed would have to raise the size of its balance sheet, gold started rising – in anticipation, if you will, of the reflation to come.

Now, from March of 2009 to March of this year, we moved back up into the top left hand quadrant once again; again we saw reflation and gold performed solidly. But interestingly, just as pressure on the global system came to a head and concerns over the European debt defaults mounted during the course of the early part of this year and then again in April and May, gold has continued to rise. And once more this is in anticipation of potential monetization.

The key point that we would highlight right now with respect to this particular issue is that we think there's now an increasing chance that we will see another round of reflation, and we have increasing signs that this may be taking place.

Why more reflation now?

For me the first is that the Fed has now started talking about making more swap lines available. Last Wednesday the chairman of the St. Louis Fed said that there was half a trillion dollars worth of swap lines available; these swap lines are provided to foreign central banks so they can lend to their local banks to prevent solvency problems. The Fed has clearly been pushing these swap lines, and this indicates that there is potential for another round of reflation.

Over the last week or two we've also seen that Libor rates – which are the cost of borrowing in dollars for the European banks – have stopped rising, indicating that there's been an easing of tension for the European banks, and that dollars are becoming more available. In addition we've also seen strong rises just over the last two to three weeks in global foreign exchange reserves. Again, this a sign that dollars are becoming more available.

If that's right, and if we do move further towards clear policy intervention and a clear freeing-up of dollar funding markets – which we think is now becoming increasingly likely – well, that's going to spur another round of reflation that will push us up back into that top left quadrant. Gold, because of its nature as a “call option” on the monetization of debt, has started to move early, and so we’ve seen a strong rebound in gold prices up to US$1,243 an ounce today in anticipation of this reflation that we think is increasingly likely.

Part 2 – The gold market

Edel: I think we timed this call pretty well with gold hitting fresh highs today; clearly our crystal ball works sometimes.

Now, to begin I should mention that it’s very common in the gold world that fundamental factors have limited consequences for short term direction. Quite often it’s the externalities, be they macroeconomic, financial or political forces, that influence direction. As you can see in Chart 4, European sovereign risk has been one of the driving forces of the gold price in Q2 of this year; this has fueled considerable safe-haven demand, particularly in Europe and particularly in Germany, which is something that I will come back to in later slides.

And it’s not just a US dollar story; gold in multiple currencies has been extending all year, whereas gold in US dollar terms really just kicked off in April. In particular, gold in euro and sterling terms has been outperforming US dollar gold. This has been the theme all year.

Gold and the dollar

Just to understand gold’s relationship with the US dollar, I included a historical chart (Chart 6) of gold’s correlation with the dollar (in this case, it’s the dollar trade-weighted index). Typically there is a negative relationship between gold and the US dollar, in that when the US dollar is falling you would see normally gold rising. However, right now, this relationship has turned positive – and as you can see in the chart it’s quite unusual for a positive relationship to prevail.

In many ways, the current market resembles that of Q1 2009, when the US dollar and gold had a positive relationship. At that point gold was climbing towards US $1000; coin and bar demand was very high, as has been the case over the last month as well, ETF demand was surging, again something we see today, and Comex positioning was on the rise.

Gold and risk appetite

Another factor, looking at Chart 7, is risk aversion, and that has been a very obvious driver prompting considerable interest in gold of late. In the chart we show the UBS FX risk index versus the gold price, and it’s plain to see that the recent tide of risk aversion that has swept over global markets has encouraged a stronger gold price.

Gold and inflation expectations

But as Julian discussed at the beginning, another backdrop to the gold market relates to inflation, or better said the expectation of inflation. Gold is typically viewed as an inflation hedge, and last year one of the big factors that fueled increased investor interest in gold was the expectation of reflation.

The next few charts go into a little more detail about what has happened and what potentially may lie ahead. First we have Chart 8, which shows how monetary policy normalization has begun. Essentially, this is a chart from earlier this year, and I felt it was important to include it. We know that certain central banks have already started raising interest rates. Currently the UBS house view is that it expects US Fed rate hikes from September, with ECB following much later than that.

However, there are really only two options to get out of the current debt crisis: first, austerity packages, or second, to try and grow our way out of the problem. For the ECB and others they have little choice but to follow option one, which is through austerity packages – but for this to happen it's important that very loose monetary policy prevails.

Therefore we could anticipate that the ECB and others will keep rates low for an extended period. Such a scenario would be positive for gold, because the alternative path of rising interest rates without an inflation backdrop would be a negative driver influencing the gold price.

Looking at Chart 9, which shows gold mapped against the University of Michigan inflation expectations index, it's clear that inflation expectations have stalled. Even so, however, in many quarters concern for inflation remains, even if it's proper to say that the time horizon has been extended.

By contrast, the next chart (Chart 10) from emerging markets is definitely telling an inflation story. Where inflation is most prevalent in emerging markets is largely in Asia, and when we drill down into the numbers we find inflation is evident in China and India. This is important to highlight because these are two markets that have a strong affiliation to gold.

Fiscal risk and debt monetization

Just returning to the fiscal indicators in Chart 11, the current debt burden does present a potential inflation risk, as Julian highlighted in the beginning. In Chart 12 we've gleaned some of our thoughts on this topic, and we agree that long-term fiscal imbalances do pose a risk of inflation through the potential for debt monetization. In such a scenario, increasing the money supply leading to rising inflation has the potential to see gold drive higher. Also, hiking interest rates to combat a potential inflation problem is a difficult path to pursue, as rising interest rates would only add to the debt burden.

Looking at it another way, rising inflation would also lower the monetary value of debt. There is a very interesting paper that the BIS issued earlier this year, looking at the future of public debt prospects and implications. One quote that I include in Chart 12 highlights that historically, countries who run high public debt eventually end up with high inflation, as governments are unwilling to pay high interest rates. The paper gives examples of Belgium, Spain and Italy resorting to debt monetization during the inter-war period. Such a scenario would be a very positive angle for gold.

Before I delve into gold's fundamental story, I want to stress that in many respects, the current sentiments towards gold reflect a lack of confidence in our current monetary system. In Chart 13 include a quote from Robert Mundell, which I think captures the prevailing sentiment towards gold, particularly in Europe. And as he said, "I firmly believe gold will be part of the international monetary system sometime in the 21st century."

Turning to the fundamentals

Now, turning to the specifics on gold's fundamentals, for those of you who are not too familiar with the gold market I would point out that gold supply and demand fundamentals are broken down as follows: On the supply side, we have mine production and scrap supply; in the recent past we have also had net official sales of gold, as well as hedging. I'll go through some of these factors in more details because in fact, some of these supply factors have now turned into demand factors.

Typically, on the demand side we have jewelry demand, electronics demand, dentistry demand, one or two other small areas, plus coin purchases, bar hoarding and other types of investment demand such as ETF, etc.

Demand – central banks

To start with the official sector, traditionally central banks have been net sellers of gold, and this has been the case for the last two decades. However, 2009 was a historic year. Central banks were net sellers of 41 tons for the year, but those net sales all took place in the first quarter of the year – central banks were actually net buyers in Q2, Q3 and Q4.

And in many ways this is one of the largest fundamental shifts that the gold market has experienced in its recent past. The large purchases last year came from China, from India, from Russia and a few other countries. The expectation for 2010 is that the official sector will be a net buyer of gold (Chart 15). Chart 16 breaks down the official sector by region, and in essence this chart shows how Asia is underweight gold, certainly relative to Europe, and particularly how China is very undersubscribed. In short, this shows the potential for increased gold holdings particularly for Asia.

Chart 17 highlights central bank gold agreements. We are now in the third central bank gold agreement; the first one kicked off in September 1999. Central bank gold agreements were introduced to place a ceiling on the level of gold selling. The current quota is for 400 tons per year of official-sector selling among the participants for the next five years, so in total we would have 2,000 tons potentially over the next five years.

But as you can see in the first year, which runs from September through September, we have seen very limited selling coming through, which has been dominated by about 41 tons of selling from the IMF. I.e., it's clear that central banks are not pursuing a strong path of selling, and this confirms our belief that the official sector will be a net buyer of gold in 2010.

But it's not just the official sector which altered its gold course in 2009. In 2009 we also saw gold investment becoming larger than gold jewelry demand; this is the first occasion since 1980, and again it marks a fundamental shift in the market (Chart 18).

Supply – mine production

Now, let me return back to mine supply just for a moment. Typically mine supply for gold follows a downward trending path; last year, however, primary mine supply increased 7% to 2,570 tons. Even so, our expectation for this year is that supply will decline again (Chart 19). Just for example, South African production fell 12% y/y in Q1 2010, and then there's the potential for the Australian Henry Tax and what that might mean for mine supply.

Demand – jewelry purchases

Coming back to jewelry demand, the negative trend that we have seen for three or four years has now certainly extended last year. In 2009 gold jewelry demand declined significantly, largely impacted by the rising gold price (Chart 20). And indeed, jewelry fabrication represented just 43% of global mine production; again, for the first time since 1980 net investment demand outweighed jewelry demand.

In Chart 21 I show jewelry sales to India; this is a UBS sales index that runs back to 2007. As you can see from the chart sales have been rather mute of late, and this is very much a reflection of the current gold price. The current gold price is prohibitively expensive, and this is reflected in sales across China and a lot of the other physical hubs.

Chart 22 puts jewelry and investment demand side by side, and indicates the dominance of the investor sector in the gold market, with investment demand now the more dominant player. It's quite clear that many of the fundamental factors in the gold market have shifted, and this is a market that's currently very driven by investment.

Demand – producer hedging

The next chart (Chart 23) looks at producer hedging. Essentially the story here is unchanged, and it has limited impact on the current gold market compared to the situation some years back. In earlier times gold producers hedged their production, and at the peak the global hedge book was over 3,000 tons, but over the past decade producers have been de-hedging; they've been buying back positions.

So producers have, in essence, been an additional “buyer” in the market and this has naturally assisted gold’s move higher. These positions are now sitting at about 236 tons as of the end of last year, and it’s clear that the global hedge book is at or near the minimum level. I.e., producers have very limited gold positions to buy back, and as a result we don’t think this will have a big impact on the gold price going forward.

Supply – scrap supply

Looking at the other slide of the supply market, we have scrap supply. Last year scrap was coming in at about 1,674 tons (Chart 24); this was a record year for scrap supply in the market, largely prompted by the higher gold price. For those of you who follow the gold market regularly, you may remember that in Q1 2009, when gold was dropping to US$1,000, the force of scrap supply in the market was one of the largest factors that actually stalled gold’s rally.

The supply of scrap gold typically comes in from the east, but last year it also was arriving from western markets, and it certainly has the ability to dampen rallies. In May, just last month, scrap supply from the east was mostly coming in from Japan, against hefty buying from the west, so scrap supply from the east was one of the contributing factors to gold’s retreat. And on current price trends scrap supply should pick up once again, so we would expect that a high scrap supply number in 2010 in line with last year.

The investment side

Moving over to the investment side of the market, as we said, in many ways this is the driver of the gold market price (Chart 25), and macroeconomic forces and the sudden crisis have no doubt prompted heightened investor flow. We’ve seen this in the futures market through Comex; we see it in OTC, we see it in the ETFs, and particularly in the bar and coin side of the market. We have seen an increase in demand for bars and coins out of Germany, Switzerland, Greece, generally across Europe, which reflects what we term the “fear trade”.

We’ve also seen a greater movement towards diversification. You may have noticed that there has been an increase in the number of stories reported by Bloomberg and Reuters confirming that pension funds are allocating greater resources toward commodity investment. A small part of this is the “Armageddon trade”, i.e., the fear that the financial world as we know it is coming to an end, and we do have a portion of investors who approach gold with that mentality.

But what we’re also seeing is diversification within diversification. And by that I mean investors who currently do have exposure to the gold market but are now looking perhaps to change that exposure; for example, they want to move away from an OTC or Comex position, or indeed an ETF position, towards allocated metal, i.e., they want to be able to see and feel their gold, and in many cases it’s this “diversification within diversification” trade that is one of the strongest drivers out there.

ETF positioning

I’ll show you a few graphs of the recent investor trend, and the first one to look at in Chart 26 is the ETF market. Nearly every day we reach a new high for global ETF holdings; they currently sit at just under 65 million ounces, and the GLD is the largest of the ETF contracts out there.

In the first quarter the pace was very, very slow; we weren’t seeing much redemption activity, and the market was quiet, but since then ETF buyers have returned in force. May’s inflow of 4.8 million ounces was the largest we’ve seen since February last year. The next chart (Chart 27) goes into a little bit more detail of the daily flows in the ETF market, and it’s clear that the spike that occurred in May has been continuing in June. In many ways ETF demand reflects what we are seeing in the physical market, so they’re very much aligned right now.

Comex futures

Looking at the Comex futures exchange in Chart 28, you can see that longs are content to get longer. Comex investors are now just under 3 million ounces shy of the all-time record from October last year. As long as the risk aversion trade remains in place and gold is the asset is choice, this positioning should not turn into an overhang.

Coin and bar purchases

Chart 29 shows US Mint coin sales of one-ounce gold coins. I'm sure many of you have seen all the articles in the press and in Reuters and Bloomberg about the level of demand for bars and coins, as reported by various mints and refineries around the world. We don't release our own coin sales or physical sales data, but the best-available source is sales by the US Mint of their American eagle coins, which is available, if anybody is interested, on their website. May sales came in at 290,000 ounces, which is the strongest level seen since 1999.

This is replicated across other mints, and it's very much replicated in the demand that UBS has also seen. As I said earlier, this demand is particularly obvious in Europe and very much Germany- and Switzerland-based, which reflects the fear surrounding the health of the euro. I should point out that over the last five or six days, physical sales have been not quite as strong as they were in May. I highlighted this in today's Daily as a note of caution, i.e., that the rally that has taken place in gold this week occurred without the heightened physical demand that was present in May.

Summing up – near-term and medium-term outlook

Just to wrap up, in terms of our short-term and longer-term views, we do expect that investment demand will persist through the ETF side, through Comex and through persistent coin and small bar demand. At current prices, we expect jewelry demand to remain sluggish. There is some scrap supply risk, as I highlighted earlier; this helped stall gold's rally in Q1 2009, and US$1,250 appears to be a significant supply point.

Longer-term, as long as fears surrounding the world's debt sustainability remain heightened, and those sovereign risk concerns continue to surround us, then gold should benefit. There is a danger of gold being caught in the crossfire of another extreme de-risking event across markets. In such a scenario, we would suggest buying gold on dips and taking short-term tumbles with other markets.

Our one month price forecast sits at US$1,300. Within that, we suggest keeping a keen eye on European and US physical demand for small bars and coins, as this represents the "fear indicator". If ETF players are buying, it indicates more broad-based support for gold. As I said, it's useful to monitor scrap flows as well.

Then, looking at a little bit further out, we expect gold to average US$1,135 this year and US$1,250 next year. This is where we're currently sitting right now, in the sense that the average for the year is currently very close to our average price. We do expect new highs later this year after our new highs today. We expect investment demand to remain firm.

In the longer term, we look for central banks as net buyers rather than net sellers, as was the case previously; we also look for the extension of safe-haven demand. We anticipate greater diversification of flows towards the gold market; after all, the gold market is still a tiny place compared to the wider money market. We expect the inflation threat to grow and to see a corresponding response in gold. And just to repeat, so long as fears surrounding the world's debt levels remain in place and sovereign risk concerns continue, gold should benefit.

Part 3 – Questions and answers

How do these calls compare to consensus?

Question: The calls that you just outlined as to where we see gold this year, next year and the main drivers, how do all these stack up against consensus? What is the market consensus on gold, either in terms of positioning or price, and where do you see yourselves relative to that?

Edel: In the earlier part of this year we were probably below consensus. Now we're more likely in the middle, but I would suggest that we are perhaps ahead of the market in terms of looking at gold from the debt monetization perspective. Again, this could be one of the most significant driving forces of the gold price in 6 to 12 months' time.

What about the downside risk to levered gold positions?

Question: I fully understand and appreciate the debt monetization arguments and the special store of wealth that gold has offered over centuries, but one of the concerns we have, in light of the incredibly rapid buildup of the ETF demand, is that if demand starts to go the other way, the massive exposure of the ETFs could lead to sudden outflows and overshoot sharply on the downside.

Edel: You do raise a valid point, and there are no certainties in this market. The introduction of ETF products in 2003 have in essence opened up the gold market to a much wider audience; there's no doubt about that. The current level of 64 to 65 million ounces certainly represents a large part of gold's ground supply.

However, what these ETF buyers have also shown us is that they very much have a buy-and-hold mentality. We have seen episodes of liquidation on this side of the market, but these episodes were quite contained. That has been the trend since 2003, so I do feel relatively confident that these players will maintain their buy-and-hold strategy. In our view buyers here don't take a short-term view of the market; it's very much a long-term perspective. This has been the case for the last seven years, and I don't see it changing any time soon.

Julien: I agree. For us, the incentives for continued ETF buying remain very much in place, particularly because of the ongoing pressures to reflate the US economy and the ongoing pressure to monetize debt, in light of the considerable debt problems we see globally.

However, probably the biggest risk to gold that's out there today is the potential for the genuine, sustainable US recovery. If we do see such a recovery, with the economy driven by strong profitability in the corporate sector, a steady rise in employment and a return to relatively full capacity utilization, then we could also see the US authorities seeking to raise the cost of capital. This in turn could lead to a repeat of the events that took place in the second half of the 1990s.

At that time the US was running a very high cost of capital, and it caused disinflation and deflation in emerging markets; this was an extremely difficult time for gold. So for us the biggest risk to gold is a change in the macro backdrop, which would be led by a much stronger or much more robust US economy. This is not our base case for the next year or two, but we do remain vigilant, since if the US recovers very strongly and the Fed is forced to raise the cost of capital, that's when the greatest risks to gold will start to arise.

Edel: And if we did find ourselves in such a scenario, the initial reaction would probably come through Comex, because that is very much the avenue where you do see steep changes on a weekly basis through the CFTC numbers rather than on the ETF side. So in such a scenario, I would expect Comex to liquidate initially, perhaps then followed by the ETF side but with a large lag.

How big is the Indian gold market?

Question: I'm interested in the Indian gold market, and I believe that India is the key gold consuming country. How big do you think the Indian gold market exposure is to the global gold market in terms of total consumption, and what is the possible demand from the Indian market in the next few years?

Edel: The case for India has been that in this era of very high prices, the Indian market has largely not quite stepped back from the gold market, although certainly in volume terms they have reduced their annual demand. We've just come to the end of the wedding season, so looking at the next three or four months we'd expect Indian demand to be relatively tame.

But the Indian market is influenced by two factors: first, the current price of gold in rupee terms, and second, the volatility of the gold price. So even if the gold price is trending downwards, which of course would be favorable for demand from one angle, if it's behaving in a very volatile manner then the Indian market will not step forward and buy gold. This is certainly what the path has been over the previous 12 months.

What do I expect going forward? Given our expectation for gold prices, I would expect India to maintain the path that it has followed over the last 12 months. In 2009, for example, India imported 715 tons, very much down from the highs we saw in the earlier parts of the decade. With expectations for higher gold prices going forward, we'd expect India to be impacted and to step back to a certain extent.

Again, the next four months should be relatively quiet because the monsoon season is currently underway and the wedding season is finished. We'd expect India to be quiet until close to the end of the third quarter or the beginning of the fourth quarter.

Gold and the dollar

Question: Edel, you talked about the positive relationship between gold prices and the US dollar. To my knowledge, this has only happened two times in the last 30 years, and each period only lasted six months. If I look at the 2010 trend, it's been going on for exactly six months, so my question is whether you think the US dollar will soften from here onwards, or do you think the gold price will continue to support?

Edel: I'm not an FX strategist, but the UBS house view is that we will continue to see the euro weaken and the dollar strengthen, and our expectation is that gold prices will continue to rise. In other words, we expect that the positive relationship between gold and the US dollar that currently exists will prevail for another extended period.

You mentioned six months, but I think the current dynamics in the global financial market are quite different than what we have seen for some time. Therefore, I think it's quite reasonable that your two safe-haven avenues, the US dollar and gold, will continue to track quite closely together going forward.

Gold, commodities and equities

Question: Would you be able to comment, from a diversification perspective, on how gold has been correlated with equities and bonds in the past, and whether you've seen any changes in these correlations recently?

Edel: What we have seen from our own client inquiries and client flow in the recent past is increased interest in looking at having gold diversification of between 5% to 10% in portfolios, not necessarily more than that. As we have seen over the last two years of performance in equity markets, it's now more important than ever before to have a certain level of diversification within our portfolios. Typically gold has performed negatively to equity markets; obviously we can look at periods where that has not been the case, but certainly in the current situation gold is the "anti-equity" market, so it's very much an inverse relationship with equity markets.

In the current environment of de-risking, I would expect that equity markets would continue to contract, and if that de-risking appetite remains gold will continue to gain ground. Therefore, I expect gold and equity markets to continue to diverge. So again, from a diversification perspective it makes sense that we're seeing increased inquiries about gold in that role.

Question: But if I look at correlations starting from 1988 all the way to now, and then compare with what's happened over the last 10 years, a lot of commodities have turned to a positive correlation. Is that something you have noticed as well?

Edel: This is a difficult question. Sometimes gold likes to perform in line with the rest of the commodities group, but at present it has divorced itself from the rest of the group. If we just look just at precious metals, in

2010 through April you had platinum and palladium surging ahead, while in many ways gold was the forgotten metal, as reflected in ETF flows, etc.

Then we get to May and we see an extreme de-risking event; platinum and palladium got hammered, and gold really grabbed the opportunity to shine and to surge ahead. So gold is performing right now very much against what is happening in the wider commodity space, and in many ways you need to exclude gold when you're looking at the correlation between equities and commodities in general.

And as an investor, you need diversification within the commodity spectrum. It doesn't make sense to put all your money into just one commodity, because you want exposure to a certain range of commodities which have different selling points.

Central bank sales

Question: I have two questions. The first is on central bank sales; could the eurozone become a net seller in view of the funding needs for their debt? And second, Julien, what are your thoughts on general base metals after the recent correction?

Edel: The question on the central bank side is certainly one that has been asked many, many times over the past few months, i.e., whether Greece or Portugal would look to offload some of their gold holdings. But first, we have to remember that the European central banks are confined through the central bank gold agreement as to what gold they can sell each year; currently they are limited to 400 tons per annum for the next five years, so that means 400 tons this year. So far we've only seen about 41 tons since September, so clearly there is a good bit of room within this year's quota should central banks look to sell.

However, I would be quite surprised if we did see selling momentum coming through from the European central banks. If we think about it logically, right now is not exactly a good time for a central bank to start selling gold holdings. Rather, tight now is when the central banks should maintain their gold holdings. If you look for example at the World Gold Council's website, it lists all the reasons why a central bank should own gold. And looking at it from another angle, if we were to see some selling activity in the west it would not surprise me at all if those Asian central banks who are underweight in gold take on part of this load. So in essence you could see a shift in gold moving from west to east.

The view on other base metals

Julien: If I could follow up on the base metals question, you're asking how we look at base metals given the recent sell-off. Basically, we look at two main drivers for base metals: the first are the cyclical fundamentals, and the second is risk positioning in the base metals sector.

On the cyclical fundamentals, we've felt for some time that we were headed for a cyclical headwind, i.e., that we were going to see a synchronized global slowdown over the summer and into the fourth quarter of the year. In the west, this comes from the end of restocking, as we've seen some very aggressive inventory rebuilds in the west in the first half of this year. In our view this trend will run its course by July, and so we'll see weak sequential demand over the summer and going into the fourth quarter.

From China, we're also seeing a seasonal slowdown that happens every year from May through to July or August, but this time it's being exacerbated by a property slowdown following the tightening measures earlier this year, and this will be noticeable.

It's also being exacerbated by the end of stimulus in certain areas. For instance, when I was in Shanghai two weeks ago I met up with the purchasing manager of the national grid, who said that his copper purchases were likely to fall from a million tons to around 900,000 tons for this year. The national grid accounts for around one quarter of Chinese purchases of copper, so this is a sign that we are facing a cyclical and seasonal slowdown.

However, this is not the only story for the metals, and I think a very big issue is the existence of capital flows. There's now about US$200 billion of global capital invested in commodity indices – that's up from around US$100 billion at the beginning of 2009. Part of these flow go into base metals, broadly speaking around 20% so. And as those flows come in they effectively forces traders to "ring-fence" a certain amount of material that's on the LME and other exchanges to back up those futures commitments.

What this has done is to create a much tighter market for commodities and base metals than appears on paper alone, so prices tend to rise more significantly for a given level of inventory on the LME compared to what they used to do, say, 10 or 15 years ago.

In short, it means that base metals are much more of a pure risk asset than they were 10 or 15 years when I felt that they were fundamentally-driven assets. Most of commodity index buying is from large funds seeking to diversify and especially to protect against inflation and to diversify away from their fixed income or bond positions. So the main driver of purchases from that side of the market consists of flows into large fund management businesses, which is basically a risk-attraction trade.

So we were very cautious around Easter time because we felt that we were going to see this synchronized cyclical slowdown for commodities demand through the summer and into the fourth quarter of the year. We were also cautious at that time because we were very concerned that we would see a "risk-off" environment because of the tightness in dollar funding, which could be very dangerous in terms of the impact on capital flow-dependent commodities.

Now, however, we've already had a significant move over the course of the last two months; copper is down 20%, for instance, and we now suspect that "risk-off" capital outflows from commodity funds have passed their peak. As a result, we anticipate that those flows will gradually turn positive over the course of the summer and through the end of the year.

For us, this implies that commodities and base metals are going to trough and we would expect to see prices begin to increase more strongly as we go through the fourth quarter and into 2011, when we would expect to see some improvement in Chinese property activity in particular.

When do the Chinese really buy?

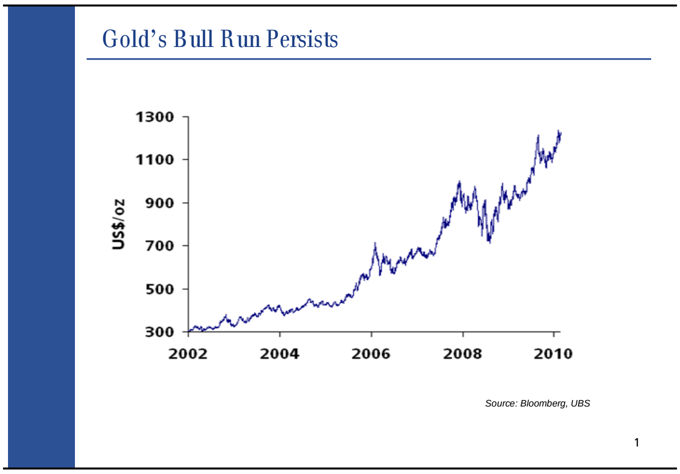
Question: In Chart 16 you show the proportion of central bank gold holdings to total foreign exchange reserves. What do you think might be the catalyst to push China to the right, towards the US or even Europe in terms of the proportion of total foreign reserves held in gold?

Edel: You may remember that China announced in April last year that it effectively had doubled its gold holdings. This was reflected in the change in the template between 2003 and 2009. So even if China is increasing its gold reserves today, we would have to expect that we wouldn't find out for a long period of time, just as we saw last year. Typically, China is a self-sufficient market; it's the largest producer of gold, and last year we didn't see the Chinese coming onto the international market to a large degree.

This changed in December 2009, when we saw a large amount of Chinese buying of physical gold coming out of the domestic market; this lasted until February of this year. Part of this can be attributed to the Chinese New Year, where typically we would expect a decent gold buy and also a decent platinum buy. Chinese purchases went quiet in the latter half of February, spiked up again briefly in March and have been quiet again since then.

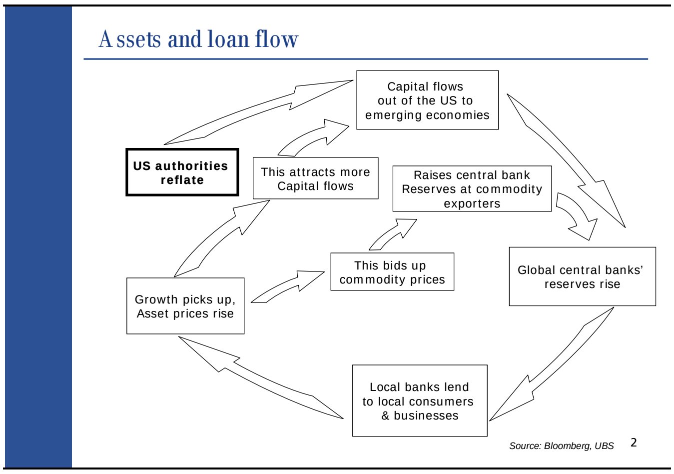
So you have to ask yourself why the Chinese would now be coming onto the international market to source gold; it does perhaps indicate that there's not enough domestically-produced gold available. You can draw your own conclusions from here, but generally I think it's fair to say that the market consensus expects China to increase its gold holdings over the coming years.

Chart 1



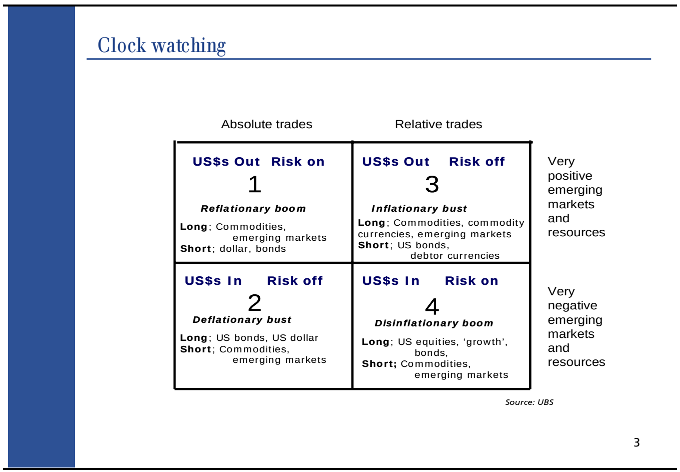
Source: UBS

Chart 2



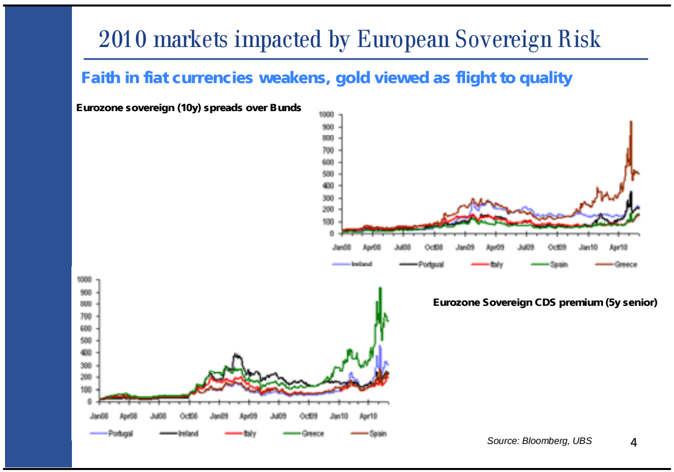
Source: UBS

Chart 3



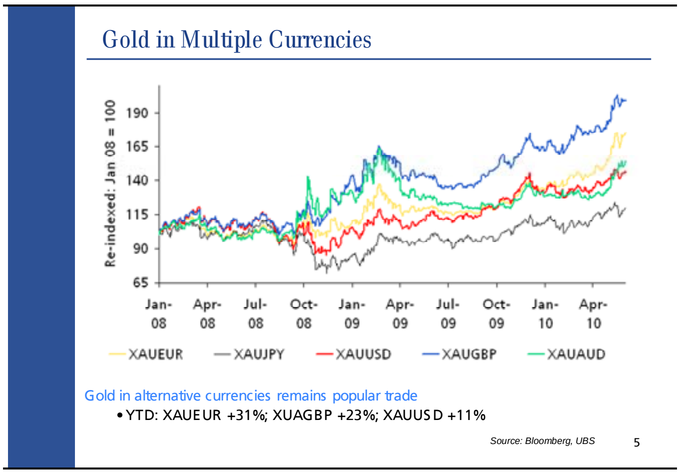
Source: UBS

Chart 4



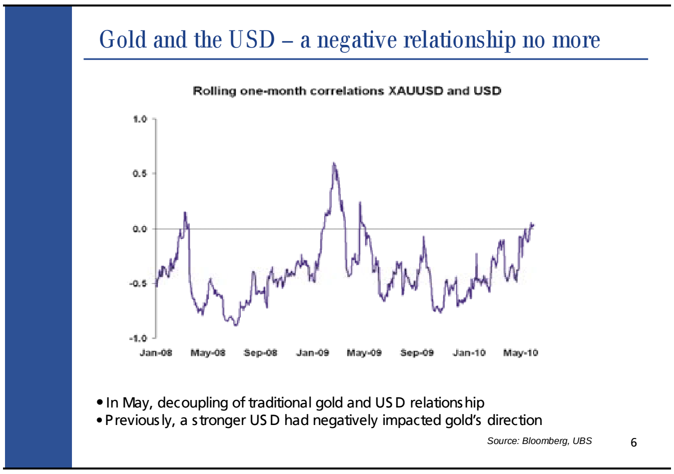
Source: UBS

Chart 5



Source: UBS

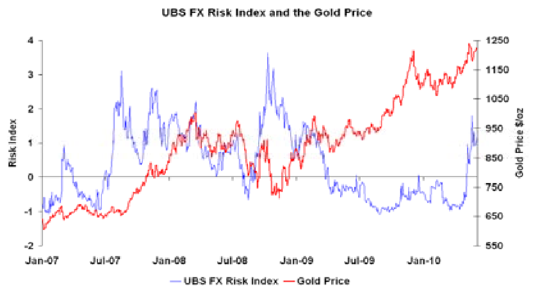
Chart 6



Source: UBS

Chart 7

Gold versus the UBS Risk Index



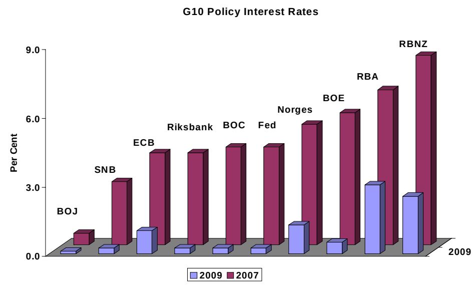
• Risk averse market conditions in Q2 – fuels gold strength

Source: Bloomberg, UBS 7

Source: UBS

Chart 8

The Path to Monetary Policy Normalisation begins…



RBA and Norges Bank have already raised interest rates

- UBS economists expect a US rate hike from September, ECB much later
- Rising US interest rates (in particular) without an inflation backdrop could be negative for gold

Source: UBS FX Strategy 8

Source: UBS

Chart 9

Gold and Inflation Expectations

QE actions of 2009 created an inflation potential…

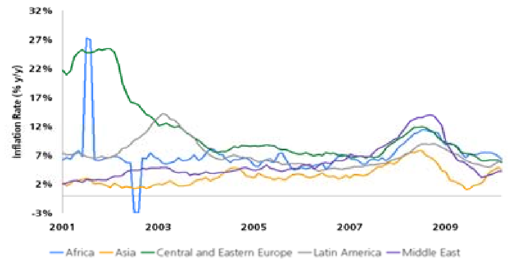
• Prompted gold buying but those expectations now stalled
• Some concerns for anticipated inflation remain, but time horizon extended

Source: Bloomberg, UBS 9

Source: UBS

Chart 10

Emerging Markets are telling an inflation story though…



Era of declining inflation in emerging markets is over

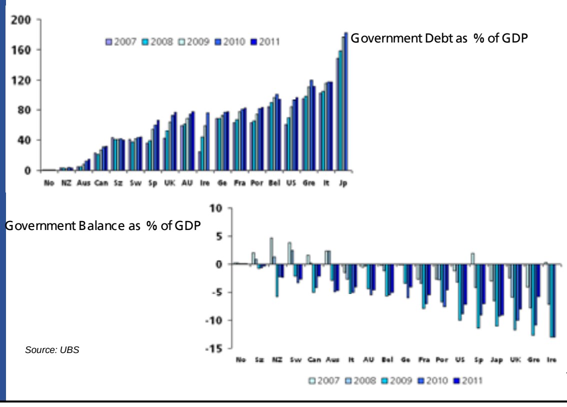
• Inflation is largely concentrated in Asia
• China and India centred – gold positive

Source: Bloomberg, UBS 10

Source: UBS

Chart 11

Fiscal Indicators – Past, Present and Predicted – inflation risk?



11

Source: UBS

Chart 12

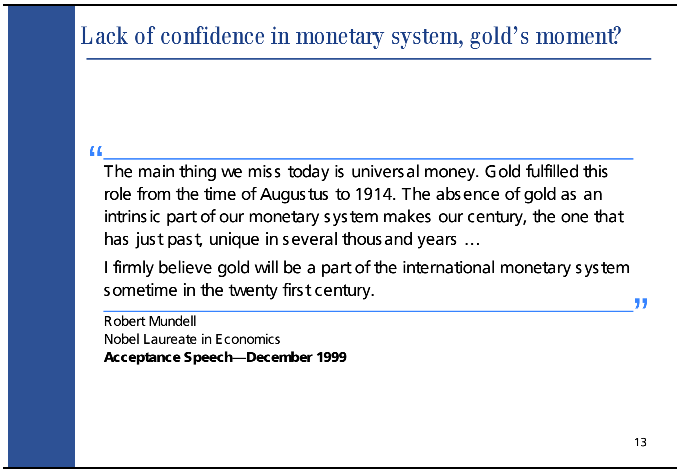
Unstable Debt Dynamics - Potential for Inflation

- QE actions of 2009 fuelled significant gold demand
- Risk that persistently high levels of public debt will drive down capital accumulation, productivity growth and long term potential growth.
- Long term fiscal imbalances pose significant risk of higher inflation:
  - Through Debt Monetisation (quantitative theory of money)
    - But increasing interest rates to fight inflation equals larger debt burden
  - Potential to inflate away the real value of debt
- **BIS Paper: The future of public debt: prospects and implications**
  - "History shows that countries that ran high public debts eventually ended up with high inflation because governments were unwilling to pay high interest rates"
  - Examples of Belgium, Spain and Italy pegging interest rates and resorting to debt monetisation post WW1

12

Source: UBS

Chart 13

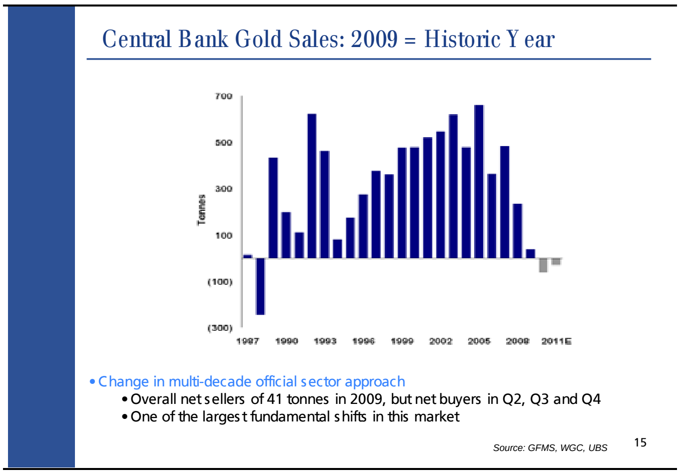


Source: UBS

Chart 14

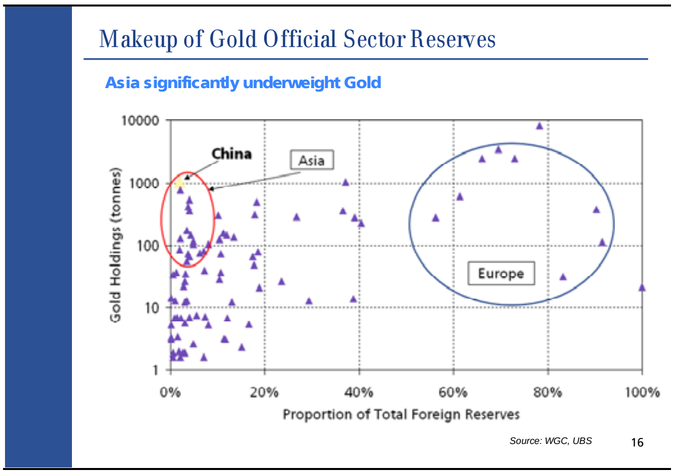
Source: UBS

Chart 15



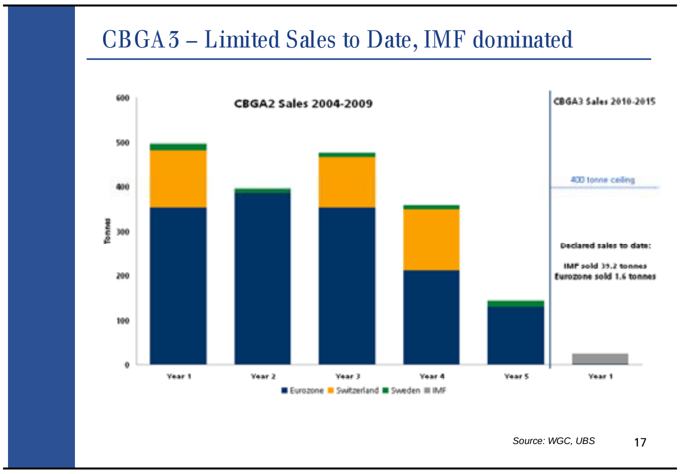
Source: UBS

Chart 16



Source: UBS

Chart 17

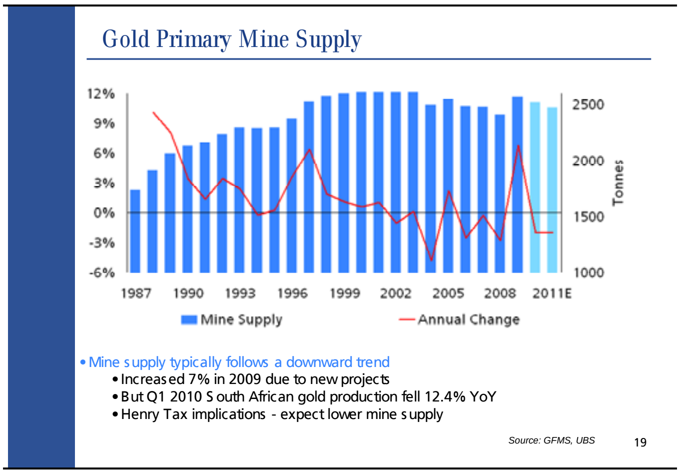


Source: UBS

Chart 18

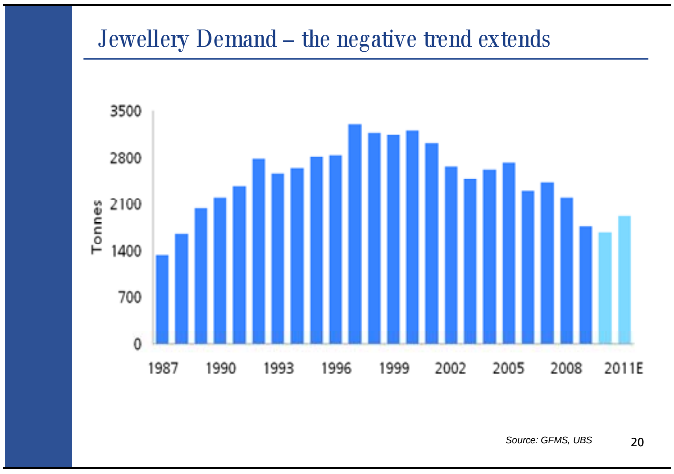
Source: UBS

Chart 19



Source: UBS

Chart 20



Source: UBS

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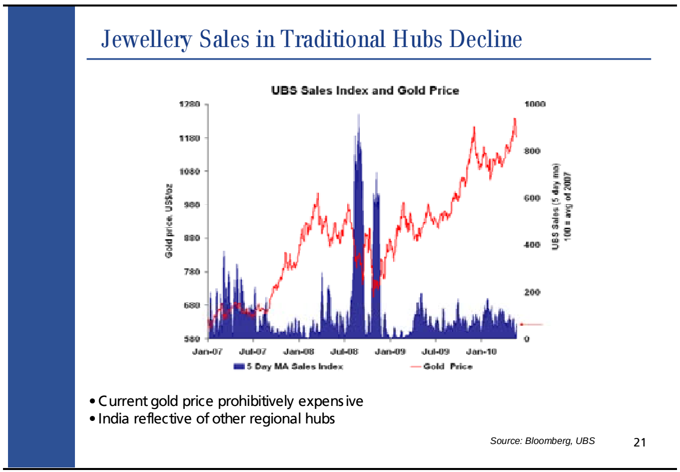
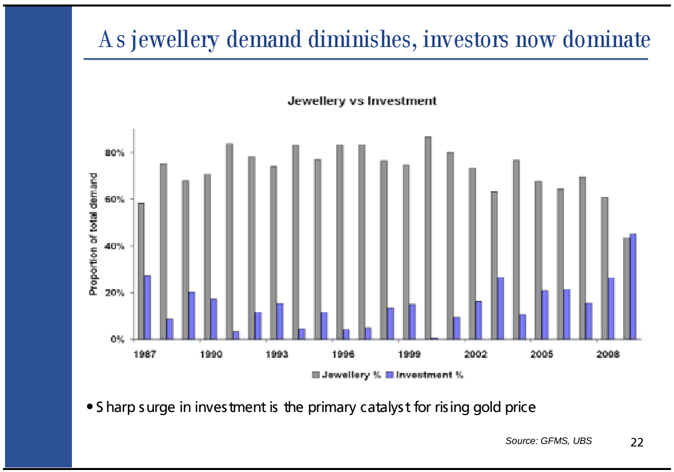


Source: UBS

Chart 22



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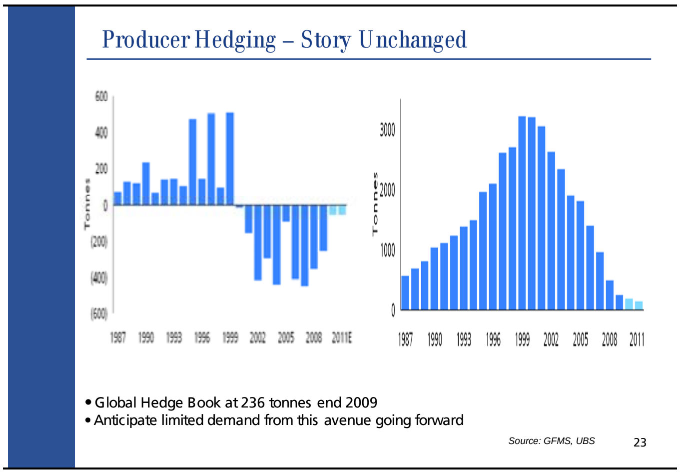

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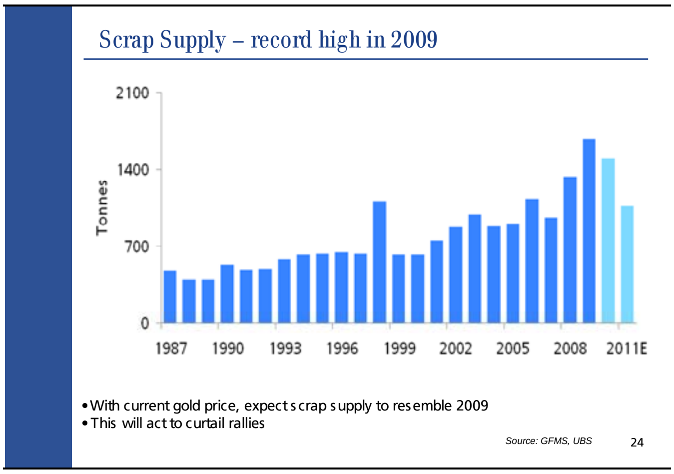
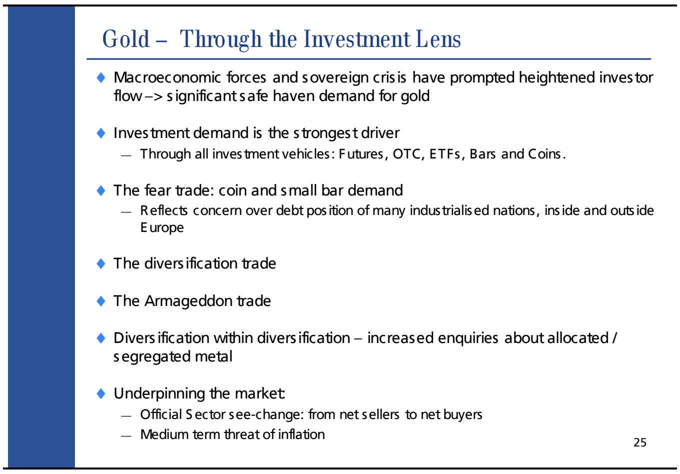


Source: UBS

Chart 25



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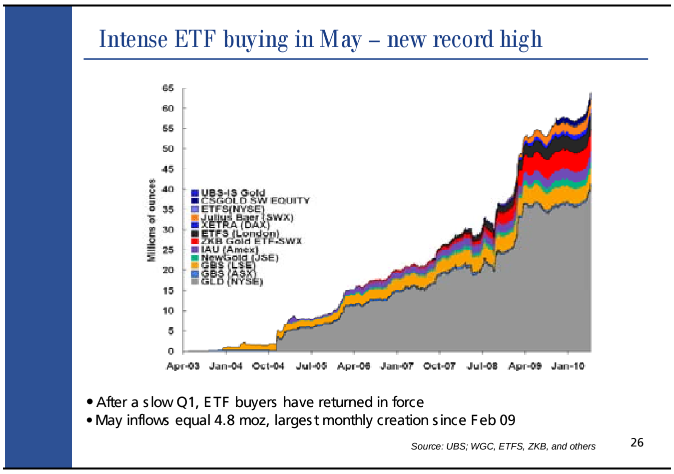
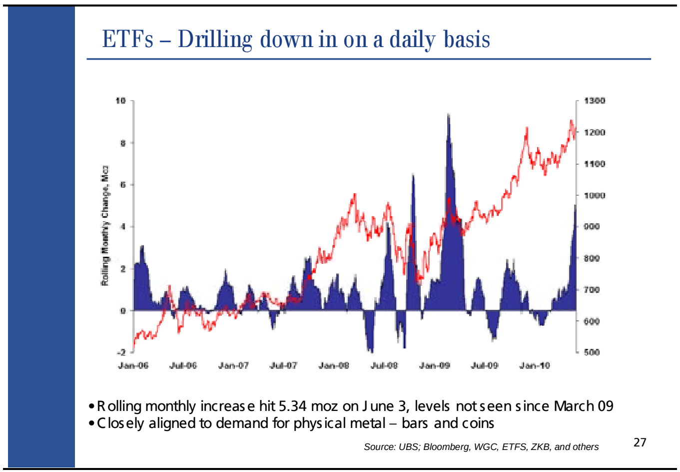


Source: UBS

Chart 27



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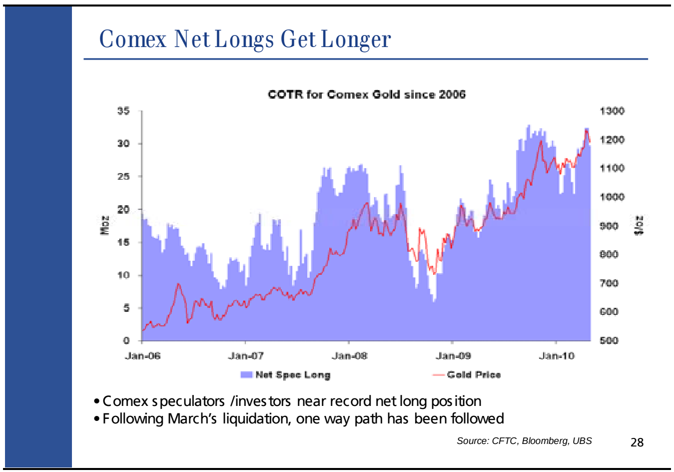

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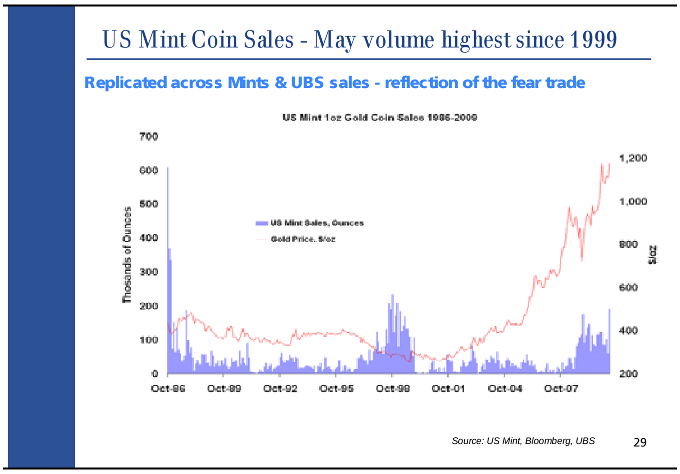

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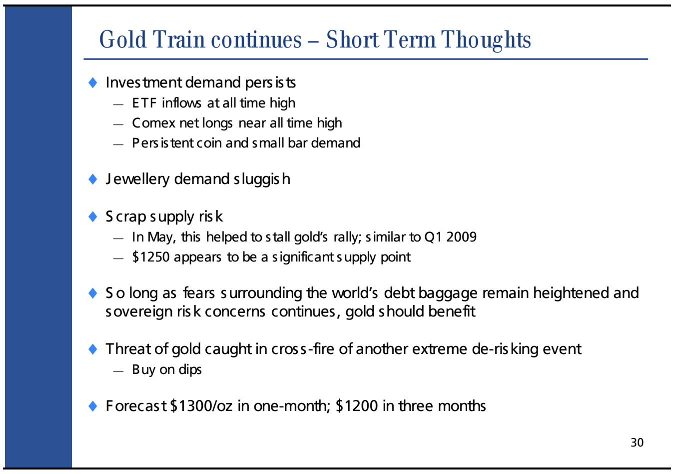
Chart 30



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