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# ScotiaMocatta Metal Matters

**Gold's rally extended to \$573/oz on good buying by the funds, especially through the ETF market**

- Geopolitical tensions have escalated with Iran, Nigeria and Palestine in the spotlight
- Jewellery demand for Gold suffered as prices and volatility rose, while investment demand thrived
- The marco environment supports a strong Gold market, but a price dip to \$540 would not be surprising

**Silver prices shot to 18 year highs as investors piled into the market in the hope that a Silver ETF will be launched**

- The physical market has been quiet as demand fell and physical prices traded at a larger discount
- **Platinum hit 26 year highs at \$1083/oz as fund buying ravished the market**
- The PGM's continue to enjoy both good industrial and investment interest, but given recent gains prices look vulnerable in the short term



### **Gold's rally reached \$573/oz as fund buying chased the market higher**

The rally that started in November last year from the \$460/oz level, has now extended to \$572.60/oz - \$573.10/oz, a gain of 24.5%. The speed and extent of the move in January has caught many by surprise, but numerous events have developed concurrently to fuel the rally.

### **The simmering geopolitical scene provides a good excuse to buy Gold**

Bullish sentiment has increased significantly on the back of the deterioration in the geopolitical scene. This started with the US airstrike on the village of Damadola, in north eastern Pakistan on January 13. Around the same time, concerns over Iran's nuclear intentions heated up with much debate on whether the International Atomic Energy Agency would report Iran to the UN Security Council. This could lead to Iran, the 4<sup>th</sup> largest oil exporter, cutting oil exports to the West, which could escalate global tension. In addition, towards the month end, Hamas's election victory sparked further concerns over peace in the Middle East. If that wasn't enough, Nigerian oil supply was disrupted after militants attacked oil installations and Russian gas supplies were also disrupted for political and technical reasons. As a result, concern over energy supplies has increased markedly and the inflationary implications, as well as the threat to the global economy, have encouraged institutional and private investors to buy into Gold as a safe haven investment.

### **Physical demand under pressure**

Sharp increases in price and the rise in volatility have dampened physical demand significantly. Traders report that physical demand is running at very low levels and the market is awash with scrap which is being processed through the refineries. In parts of Asia discounts in the physical market and on exchanges have seen Gold imports fall sharply. When the latest statistics are published, they are likely to show a significant deterioration in jewellery demand from

November onwards. However, physical demand for investment purposes is expected to show a considerable gain, especially in areas where retail investors have no access to futures markets.

### **Less de-hedging equals more supply**

In recent months the level of de-hedging has declined. During 2005 as a whole, producers reduced their hedge book by 195mt, compared to 442mt in 2004. This fall in de-hedging means more production will have found its way on to the market. As new mining projects get underway, more hedging may be entered into in order to safe-guard the integrity of the projects. In addition, high Gold prices may encourage some miners to reconsider the merits of hedging, even if it is only via options. However, any dip in Gold prices may prompt producers to cut their hedges further and Barrick's recent takeover of Place Dome, may also enable them to reduce their hedge book.

### **Higher prices despite greater supply**

The combination of the pick-up in scrap supply, poor physical demand from the jewellery sector and less de-hedging, means that supply is on the rise at a time that jewellery demand is in decline. In theory this should be putting downward pressure on prices and it may still do so, but at the moment the opposite is happening. This suggests that non-fundamental issues are driving prices above their economic value. However, such a situation can often exist for much longer than people think possible as when investors get on board, armed with their view of the future, they can often see value in excess of the fundamental or economic value. In addition, if shorts enter the market too early and then have to cover, their short-covering just goes to drive prices even higher.

### **CFTC position well balanced**

With Gold prices pushing to fresh highs you would expect the net fund long position, as shown by CFTC data, to be at a high level too. This is not the case however. The latest data shows the net long fund position at 142,840 contracts,

well below the record high of 177,410 contracts seen in October 2005. The reason for this is that the gross short position has been building, while the gross long position has been slipping. With the gross long position still relatively large there is room for further liquidation selling, but as the short position also builds, there is a danger that if prices do not pull-back, then disappointed shorts may have to cover, which in turn would fuel the rally. Either way this suggests more volatility.

### **If the buying isn't coming from Comex, where is it coming from?**

As prices have continued to rally strongly, significant buying must be coming from somewhere and generally the funds are thought to be the source. As such, it looks like the fund buying has been channelled through the OTC market, with funds buying into commodity indexes as well as getting exposure through the Exchange Traded Fund (ETF) market. Recent reports suggest that commodity index funds had assets of \$70bn at the end of 2005, up from \$45bn at the end of 2004 and \$15bn in 2003. Although around 50 percent of these funds are likely to be invested in oil and energy products, there is little doubt that metals have received a growing share. The volume of Gold in the StreetTracks Gold ETF has grown from 263mt at the start of the 2006 to 333mt by the end of the January, a rise of 70mt over the month. Does this rush into Gold by retail investors suggest the rally is nearing a top? – Possibly.

### **All news is bullish**

The extent of the bullishness can be seen by the fact that the market seems to be interpreting all news as favourable. Rising interest rates would normally be a dampener on Gold as it raises the opportunity cost of holding Gold. But in the current climate, higher rates are seen as a warning that inflation is on the cards. Likewise, there are reports that central banks have been buying Gold. However, two reasons suggest this may not be the case, firstly those involved in

central bank business keep tight-lipped about what they are doing and secondly, if the likes of China or Japan were looking to diversify their dollar holdings, the Gold market simply would not be big enough for their needs. Smaller central banks may be buying Gold, although there is no evidence of this.



### **Technical**

Gold prices have risen in a parabolic fashion, although recently they have lost some momentum as they slipped below the steep trend line. However, with numerous trend lines below the market and with the 70 day moving average, around the \$508/oz level, prices could fall quite far without damaging the overall bullish nature of the market. The mid-January pull-back to \$540/oz is now likely to offer good support.

**Summary -** Gold prices have shot higher and their own upward momentum seems to be attracting even more buying. Given the geopolitical developments and threats, the market is not short of excuses to run higher, but the fundamentals in the physical market have deteriorated, which at some time should act as a drag on the market. Fresh fund buying throughout January from a broader base of institutional and private investors seems to be driving the market, but given the gains already seen, a period of consolidation would not be surprising. With pent-up demand from jewellery industry no doubt waiting for a sell-off, any dip may not run too far, especially if the jewellery buying finds itself in competition with scale down fund buying. Look for dips towards \$540/oz to be well supported and then if prices start to bounce it may be time to buy.

<b>Gold Statistics</b>	2002	2003	2004	2005	3Q 2005	4Q 2005	Dec-05	Jan-06
<b>London Prices (US\$/oz)</b>								
AM fix	310.44	363.83	409.33	444.87	430.94	485.40	509.42	549.43
Pm fix	310.21	363.32	409.21	444.88	431.02	485.56	510.10	549.86
Average	310.32	363.59	409.30	444.87	430.98	485.48	509.76	549.65
<b>Parity prices</b>								
Australian - A\$/oz	570	558	555	583	567	652.38	687	734
South Africa Rand/kg	101,068	85,445	81,868	87,876	88,875	98,597	101,094	104,352
Japan Y/g	1,203	1,305	1,371	1,519	1,475	1,765	1,873	1,971
India Rupee/oz	15,106	16,954	18,556	19,642	18,797	22,042	23,297	24,415
<b>Lease Rates</b>								
1 Month *	0.27	0.08	0.08	0.10	0.10	0.10	0.10	0.10
3 Month *	0.39	0.13	0.11	0.11	0.10	0.10	0.11	0.13
6 Month *	0.54	0.23	0.15	0.14	0.13	0.12	0.11	0.15
12 Month *	0.89	0.40	0.25	0.19	0.19	0.14	0.12	0.2
<b>COMEX - futures contracts</b>								
Stocks ('000oz)	1,692	2,643	4547	6178	5844	6,644	6,913	7,268
Vol (million contracts)	9.02	12.24	16.46	1.03				
OI ('000 contracts)	163	229	272	302	282	340	325	340
<b>CFTC (futures only data)</b>								
Net Spec position Long (Short)	31,940	70,888	78,084	109,798	112,880	155,593	154,522	142,879
<b>TOCOM</b>								
Stocks ('000oz)	242	234	207	193	174	215	236	236
Volume ('000 contracts)	1,544	2,220	1,429	1,094	1,015			
OI ('000 contracts)	384	413	333	315	285	363	303	353
<b>Other Indicators</b>								
FT Au Mines Index	1,142	1,395	1,617	1,696	1,586	1,974	2,170	2,568
Dow Jones Index	9,190	9,035	10,326	10,528	10,465	10,652	10,717	10,684
US\$ Index	111	95	87	88	89	91	91	89
<b>Gold Bullion Imports, tonnes (exports)</b>								
				1Q 05				
Dubai	156	195	195					
Hong Kong /China	(200)	(200)	(200)					
India	496	647	647	254				
Italy	260	260	260	59				
Japan	68	74	74	19				
Singapore	84	72	72	8				
South Korea	200	122	122					
Taiwan	9	12	12	7				
Turkey	226	264	264	84				
Data: Financial Times; Bombay Bullion Association; LBMA; TOCOM; COMEX; CFTC, REUTERS								
Figures are period averages unless marked by *, indicating the period end. OI= Open Interest on the exchange								
~ = data not available, <i>italics</i> = estimates								

## Silver started by following Gold, but then became the leader of the pack

Up until January 25, Silver traded either side of \$9.00/oz, in a broad range between \$8.70/oz and \$9.28/oz, with Silver generally following Gold's lead. However, towards the end of the month, Silver found its own feet as expectations grew that a Silver Exchange Traded Fund (ETF) would get regulatory approval. This led to a surge of buying from investment banks and commission houses alike. Option call buying was also reported as was forward borrowing, all of which fuelled sentiment and attracted even more spec buying. The result was that prices broke up through resistance at \$9.28/oz, which triggered short-covering and fresh buying that saw prices scramble to \$9.88/oz - \$9.90/oz.

## Little sign of physical interest

Throughout the whole of January there has been very little interest from the physical market as high prices and volatility has sapped interest in the price-sensitive jewellery and silverware markets. In addition, the supply of scrap has picked-up as these price levels have not been seen for over 18 years. However, producer stocks are also thought to be building up, especially in China, as the slowdown in physical demand has led to larger price discounts for physical metal. Therefore any dip in price that attracts consumer buying and reduces the physical discount may also see supply pick-up too.

## Fund interest sizzling

When the spotlight shines on Silver the investment appetite for the metal heats up quickly, this tends to lead to spikes. As such the Silver market may be more vulnerable than some of the other markets. The last time a Silver ETF was in the offering, in late 2004, prices shot from under \$5.50/oz to \$8.50/oz over a period of three months, only to collapse back to \$5.50/oz over a four-to-five week period. However, if the ETF does get off the ground, then Silver's attribute as a poor man's Gold may drive it considerably higher, especially as the

American public have a particular affinity for the metal.

## Broader based fund buying

Judging by CFTC data the normal funds are not the main drivers behind Silver's rally. This suggests that a broader and possibly longer-termed type of investor maybe buying into the market, if so then that is another positive development.



## Technical – 3 waves up?

Silver is on its third leg up at the moment, which suggests a possible target for this wave at around \$10.15/oz. Although, judging from the last time it touched the up trend line, the market is already looking over extended. Any pull-back is, however, likely to run into support around the \$9.30/oz level.

## Summary

Prices seem to be pulling away from the fundamentals, especially as scrap is coming out of the woodwork again. However, relentless fund buying, reports of option call buying and the possibility that the launch of an ETF will attract even more follow on buying in the market, seems to be fuelling sentiment. Needless to say the market is looking overbought in the short term, but as has been seen in Gold and across the base metals, especially in the case of copper and zinc, prices can extend well beyond where their economic values are considered to be. As such, unless the regulators say 'no' to the ETF, it looks likely that Silver will head higher. That said an intermediate correction towards \$9.30/oz to \$9.50/oz would not be surprising and may provide a good buying opportunity should prices then start to bounce.

<b>Silver Statistics</b>								
	2002	2003	2004	2005	3Q 2005	4Q 2005	Dec-05	Jan-06
<b>London Prices (US\$/oz)</b>								
Daily Fix	4.60	4.88	6.65	7.31	7.07	8.06	8.64	9.15
<b>Parity (London) prices</b>								
Japan (Y/g)	18	17	22.27	24.97	24.36	29.30	31.75	32.80
India (Rupee/oz)	224	227	301.35	322.83	308.93	365.98	394.87	406.44
<b>COMEX – futures contracts</b>								
Stocks (Moz)*	105.8	111.0	114.5	109.64	113.93	118.17	120.6	124.8
Vol (million contracts)	3.0	4.1	4.9	0.51				
OI ('000 contracts)*	79.5	94.7	103.4	117.9	122.8	139.9	132.0	133.0
<b>CFTC (Futures Only Data) non-commercial</b>								
Net Positions *	27,624	33,414	42,831	39,986	27,965	59,488	61,193	59,832
<b>TOCOM</b>								
Stocks (Moz)*	1.1	0.7	0.53	0.63	0.61	0.37	0.3	0.3
Futures Vol ('000 contracts)	72.6	89.7	121.40	68.11	53.10	88.0	117.8	72.0
Futures OI ('000 contracts)*	20.0	21.3	24.07	17.84	17.73	18.60	16.9	16.9
<b>Other Indicators</b>								
Gold/Silver ratio*	67.7	74.1	61.06	60.60	61.30	59.37	58.5	58.2
<b>Silver Bullion Imports (tonnes)</b>								
				Q1'05				
USA	4004	3998	4095	1156				
UK	2562	2141	1523	193				
Japan	794	1156	1591	328				
India	3400	3100	2000	900	700			
Italy	1497	1526	1638	352				
Hong Kong **	1400	(2500)						
Turkey	139	155						
* figures are period averages unless marked; ~ not available.								
** For 2003 data is for Hong Kong and China combined (exports)								

**Platinum accelerated to the upside on fund buying. Palladium had a quieter start, but jumped higher at month end**

After the early December dip in Platinum prices from \$1019/oz to \$948/oz, the metal has hardly looked back, with prices ending the month on the high at \$1079/oz - \$1083/oz. Prices suffered one significant dip to \$1021/oz, which was triggered by profit-taking following the sell-off in the Japanese equity market in mid-January, but the sell-off just provided another buying opportunity. Palladium on the other hand has had a more subdued month, trading either side of \$280/oz although it did spike higher into the month end as fund buying gained momentum. Rhodium has also been on the rise as sellers have been able to raise their offer prices in the absence of Russian selling.

**Industrial demand holds up**

Use of the PGM's in the auto industry continued to grow on the combination of strong Asian vehicle demand and the implementation of tighter emission controls. The outlook for this sector looks strong with demand expected to grow by around 8% to 10% per annum. This may well be helping to fuel investors' long term interest in the metal and explain why they continue to chase the market higher. With tighter pollution controls also being applied to industry in general and with demand from the glass industry also soaking up more PGM's, the demand outlook remains robust. In addition, much of the industrial demand remains price inelastic.

**Jewellery demand suffers, but remains an important swing factor**

Traders in Asia report that Platinum demand from the jewellery industry remains particularly quiet, which given the surge in price is not surprising. The slowdown in this sector, however, enables more metal to be diverted to industrial users. Palladium has benefited from this, with recent reports suggesting demand for Palladium jewellery now accounts for 20% of new mine output and increased by over 40% in 2005. As

the metal also gains in price, Palladium jewellery may become even more sought after as its image improves.

**But fund buying has lifted prices**

Although the fundamentals for Platinum are strong and Palladium's are improving, the extent of the price rise has been heavily influenced by the unrelenting level of fund buying. Although there seems no stopping this fund buying, caution is needed. If a scandal in a Japanese internet company can cause a sell-off in global equities and metals (albeit short-lived), there is obviously a lot of flighty money underpinning these lofty prices. As such the markets look vulnerable to any events that change the status quo and given the extent of the rises, corrections could be sharp.



**Technical**

Platinum's steep acceleration looks overextended and the turn down in the RSI suggests a correction is on the cards. Palladium on the other hand looks to be attempting to move above its upper trend line and the RSI is climbing in support.

**Summary**

Although fundamentals are strong, the excess fund involvement in the PGM's suggests some consolidation is overdue, especially in Platinum's case.



PGM Statistics										
	2002	2003	2004	2005 3Q	2005 4Q	2005	Dec-05	Jan-06		
<b>London Prices (US\$/oz)</b>										
Platinum	541	698	849	897	898	949	980	1,031		
Palladium	341	205	233	200	188	228	267	276		
Rhodium	841	531	980	2,039	2,158	2,840	3,015	3,122		
<b>Japanese Parity Prices (Y/g)</b>										
Platinum	2,095	2,501	2,845	3,060	3,096	3,448	3,601	3,697		
Palladium	1,325	736	781	684	649	830	981	989		
<b>South African Parity Prices (Rand/kg)</b>										
Platinum	175,810	164,523	169,994	177,105	181,589	192,699	194,350	195,794		
<b>NYMEX Stocks ('000oz)</b>										
Platinum	15.8	13.9	16	22	27	25	24.0	24.0		
Palladium	10.8	102.9	647	710	709	733	800	1,034		
<b>CFTC Futures Only Data Long / (short) non-commercial</b>										
Platinum	2,454	4,048	2,422	5,931	6,896	7,974	5,459	6,373		
Palladium	(137)	1,529	4,115	5,271	4,084	6,577	5,909	5,290		
<b>Tocom - Platinum</b>										
Stocks ('000oz)	8.7	16.9	15.5	16	13	15	15.5	16.1		
Vol (Million contracts)	1.2	1.1	1.1	0.7	0.6	1.0	1.2	0.9		
OI ('000 contracts)	218.8	220.4	183.6	137	125	133	117.0	130.7		
<b>Tocom - Palladium</b>										
Stocks ('000oz)	1.9	1.6	5.8	23	22	19	19	29		
Vol ('000 contracts)	1,200	3	25.7	27	16	55	76	36		
OI ('000 contracts)	117	3	11.1	18	14	19	19.2	22.6		
<b>Other Indicators (US\$/oz)</b>										
Pt-Au spread	208	234	337	457	463	477	454	511		
Pt-Pd spread	45	214	496	701	718	722	725	779		
<b>Platinum Bullion imports (kg)</b>										
				Q1'05						
USA	160,000	111,000	48,100	10,800						
Japan	43,750	50,000	57,000	11,800						
<b>Palladium Bullion imports (kg)</b>										
USA	117,000	83,000	50,900	7,000						
Japan	41,250	41,093	48,300	13,700						

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