



JUNE 2005

ScotiaMocatta Metal Matters

Gold was under pressure throughout May as the dollar's climb prompted fund selling

- CFTC data shows the net long fund position fell from 137,777 contracts to net long 39,509 contracts
- Strong physical demand has been seen into the price dip, but this may now slow, especially in India
 - Current dollar strength may not last long. A combination of renewed dollar weakness and euro weakness could be very bullish for Gold
- Technically Gold is testing support, but is also looking vulnerable. Next support between \$400 - \$395

Silver has managed to ignore the stronger dollar

- Buying ahead of the possible launch of a new Silver ETF is tightening up the Silver market
- **The PGM's are suffering as the dollar strengthens, especially as production prospects increase as the Rand moves back above Rand 6.50**
 - Despite improving demand outlook for Palladium, prices remains under pressure as supply looks plentiful



Gold drops as the dollar climbs, but good physical demand cushions the fall

Gold prices started May at \$433/oz, the highs of the month and ended on the lows with prices trading down to \$413.40/oz - \$413.90/oz. The overriding factor pushing prices lower has been the rise in the dollar. As measured by the dollar index, the dollar has traded in May from 83.75 to 88.06. The move up through 85.44, has signalled a change in trend for the dollar, which now opens the way to further gains. The sell-off in Gold prices has been driven by fund liquidation selling, but the weaker price has also encouraged good physical demand, especially in Asia. But if prices continue to weaken then consumer buying and restocking may move to the sidelines, in which case continued fund selling could see prices fall further and possibly faster. That said, the sell-off is also approaching strong support around \$410/oz and there are still a host of reasons to remain friendly towards Gold, especially in the medium term.

What's behind the dollar's rise?

The economic data emerging from the US is still mixed, but the tone in May was more encouraging. Most noticeable was the recent international trade data that narrowed from \$60.6 billion in February to \$55 billion in March, when the market had expected the trade gap to widen further. This linked in with much earlier comments from Fed Chairman Greenspan that the deficit would begin to show some improvement. As well as the improving sentiment towards the US economy, the growing call for a 'No' vote from France for the European constitution, brought downward pressure on the euro.

May was a month of trend change

With the dollar climbing steadily and with many other commodities also suffering set backs, May seems to have been a month when consolidation turned into trend reversal. At the start of the year, the dollar was seen as a one way bet to the downside, but since the end of the year it has climbed 9%. Likewise the

metals, especially the base metals, were expected to out perform, but have turned lower, with zinc, aluminium and copper at one stage off an average of 12% from the highs seen in March and April.

What caused the change in trend?

Sentiment in the markets started to turn less positive with the string of poor economic data released in April and as the higher oil price threatened industrial output. But in addition, institutional investors, especially hedge funds, seem to have run into trouble following the down-grading of GM and Ford's credit rating. It is quite likely that funds had to liquidate other parts of their portfolios to raise cash needed to pay margin in the areas that were hurting. This would partially explain the extent of the trend reversals that have since been seen.

Data corroborates the fund sell off

At the end of April, the net fund long position stood at 137,777 contracts, by the end of May the position had fallen to a net long 39,509 contracts. The rapid fall in the net long fund position came about as 58,861 long contracts were closed out, while 39,407 new short positions were opened. At the end of May, the funds held 114,965 longs and 75,456 shorts. The significant change in the funds' long position does not necessarily suggest a change in sentiment, as the selling may have been necessary to raise cash, but the pick-up in the short position does suggest a change in sentiment towards Gold, especially as this is the largest gross short holding since February 2001.

Commercials unwind short hedges

Perhaps a better indicator that the sell-off is running out of steam is the change in the commercials net short position, which during May decreased from net short 169,289 contracts to net short 60,463 contracts. If the commercials are buying back their shorts, then they must be fairly confident that prices do not have too much further to fall.

Booming physical market may slow

According to the June 2005 World Gold Council report, Q1'05 end-user Gold consumption rose 26% yoy, with demand absorbing an additional 200 tonnes of supply. However, Q1'05 compared to the average 2004 quarterly end-use consumption was up a more modest 12%, with jewellery demand up 5%, and investment demand up 58%, with the bulk of the increase coming from Exchange Traded Funds (ETFs) and other funds. With the Indian wedding season tailing off, the exceptionally good demand seen over recent months is likely to slow considerably, especially as jewellery manufacturers and stockists are thought to have been keen buyers during the recent price weakness. This may now lead to destocking over the next few months and even lower prices may not be enough to see demand pick-up.

Big picture considerations

The combination of a stronger dollar, the possibility of further liquidation selling by institutional investors and better yields in other financial products, may well keep Gold under pressure, especially as in the physical market there seems to be no shortage of Gold. In addition, the US administration seems to be making a concentrated effort to support the dollar by keeping interest rates on a steady rise. It is also encouraging its trading partners to help reduce the US trade deficit by buying large ticket items from the US. Little wonder Boeing is winning a lot of orders for aircraft and the US is challenging European subsidies to Airbus.

But will the US problems go away?

The late-in-the-day effort by the US to tackle the deficits and to support the dollar may well delay further dollar weakness, but given the state of the US economy, consumer debt and the large deficits, there is still a high risk that the US financial markets will run into trouble. In addition, with the Euro zone in the doldrums, there is every reason for the euro to stay weak. This may evolve into a situation where both the euro and

the dollar head lower later in the year. If this turns out to be the case, then Gold's safe haven status may well receive a significant boost. In addition, if concerns over hedge fund redemptions are causing liquidation selling in the commodities and short-covering in the dollar, then these same concerns may in turn swing round to support Gold. If investors' confidence in the more traditional financial markets wane, then investors may increase their Gold holdings. Given the establishment of numerous ETFs, this could see a larger and broader move by institutional and individual investors into Gold which may be enough to push Gold up through recent highs.



Prices approaching chart support

Technically, prices have now breached the trend line that started in April 2003, which puts the focus on the February lows around \$410.50/oz and the 400 day moving average at \$412.50/oz. A break down below these levels could lead to a test of the longer term trend line at \$400/oz with possible dips to \$395/oz.

The Outlook - Overall, Gold has been under pressure as the dollar has strengthened, but the dollar's strength may not last too long, especially as the worst of the news over the European constitution should now be in the market. That said physical demand may weaken over the summer and there may still be distress liquidation to be done in the dollar and in commodities. However, if the financial markets become more hostile, then safe-haven buying is likely to be attracted back into the Gold, especially at these low prices. Overall, there may be room over the summer to see lower prices, but such a development is likely to be a good buying opportunity.

Gold Statistics	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>4Q 2004</u>	<u>1Q 2005</u>	<u>Apr-05</u>	<u>May-05</u>
London Prices (US\$/oz)								
AM fix	271.19	310.44	363.83	409.33	434.08	427.29	429.14	422.90
Pm fix	271.04	310.21	363.32	409.21	433.97	427.23	429.23	421.87
Average	271.12	310.32	363.59	409.30	434.03	427.25	429.19	422.39
Parity prices								
Australian - A\$/oz	523	570	558	555.37	573	549	545	551
South Africa Rand/kg	72,393	101,068	85,445	81868	81,532	79,655	80,108	83,034
Japan Y/g	1,022	1,203	1,305	1371	1,423	1,384	1,397	1,397
India Rupee/oz	12,910	15,106	16,954	18556	19,519	18,674	18,755	18,386
Lease Rates								
1 Month *	1.3	0.27	0.08	0.08	0.10	0.09	0.09	0.15
3 Month *	1.32	0.39	0.13	0.11	0.12	0.10	0.09	0.15
6 Month *	1.4	0.54	0.23	0.15	0.16	0.14	0.11	0.19
12 Month *	1.68	0.89	0.40	0.25	0.22	0.18	0.18	0.24
COMEX - futures contracts								
Stocks ('000oz)	1,096	1,692	2,643	4547	5,501	5952	6,037	6,037
Vol (million contracts)	6.79	9.02	12.24	16.46	3.98	1.22	0.94	0.94
OI ('000 contracts)	85	163	229	272	328	279	298	256
CFTC (futures only data)								
Net Spec position Long (Short)	40214	31,940	70,888	78084	121,760	56257	137,777	39,509
TOCOM								
Stocks ('000oz)	234	242	234	207	186	185	189	235
Volume ('000 contracts)	9,791	1,544	2,220	1,429	1,273	1264	835	
OI ('000 contracts)	308	384	413	333	332	319	277	306
Other Indicators								
FT Au Mines Index	824	1,142	1,395	1617	1,767	1617	1,432	1,447
Dow Jones Index	10,130	9,190	9,035	10326	10,413	10586	10,192	10,467
US\$ Index	117.8	110.6	95.2	87	83	83	84.4	87.8
Gold Bullion Imports, tonnes (exports)								
Dubai	270	188	156	195				
Hong Kong /China	na	na	(200)	(200)				
India	709	504	496	647				
Italy	375	315	260	260				
Japan	43	84	68	74				
Singapore	125	84	84	72				
South Korea	125	164	200	122				
Taiwan	52	13	9	12				
Turkey	104	129	226	264				
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 shines while Gold cowers

Whereas Gold opened on the highs and closed on the lows in May, Silver did the opposite. Silver opened around \$6.92/oz and closed at \$7.47/oz. This is an unusual development, especially when Gold has been under such pressure, but it was enough to take the Gold:Silver ratio back to 56 from 63 last month. Silver lease rates have also climbed with one year rates moving from 1% to over 2.5% during the month. There is talk that much of the buying may be to do with a new Exchange Traded Fund (ETF) that is to be launched and that speculators are also buying ahead of its launch.

Fundamentals fairly balanced

The recent Silver Institute report suggested Silver prices may rise later in the year and one of its main reasons for this was that they expected Gold prices to rise. Although this fits in with our outlook for Gold, the report seems to paint a fairly balanced picture of Silver's fundamentals. It showed fabrication demand fell 2% in 2004 to its lowest level in six years and that mine output rose 4%, although with less scrap from the photographic industry and lower official sales from China, net supply eased over the year as a whole. The report also highlights how important the investor has been and will continue to be over the next year or so.

Is Silver bolting too early?

However, with Silver's outlook relying on Gold's performance and on the investor, there is a danger that Silver prices may have charged out of the gate too soon. Gold is under pressure, the dollar continues to strengthen, physical demand in India has entered a quite period and Indian demand for Silver has proved to be more price elastic than Gold. In addition, with base metal mine output set to pick-up, Silver mine output on a by-product basis is set rise. With global economic activity also looking set to fall, there is a danger that industrial demand for Silver may also suffer. On top of this, demand from the photographic industry seems to be falling

faster than expected. In 2003, it was estimated that the film industry would decline by 6% a year worldwide, but in 2005, revised estimates put the likely fall worldwide nearer to 20%.

Is a broad based fund rally starting?

Fundamentally the Silver market looks well balanced, but there is little reason for a sustained rally at the moment. As such, the current rally may not last too long, especially if it is just down to the reports of the ETF launch. Such an event on its own is unlikely to draw in the large fund players, which are likely to be needed if a sustained rally is to develop. At a later date, the problems facing the US economy may resurface and turn the dollar lower again, in which case a broader based investors rally may get underway in Gold and Silver, but this does not seem to be the case yet.



Technical comment

Silver has put in a strong rebound off trend line support below \$7.00/oz (not shown) and is rebounding to challenge March's highs at \$7.66/oz, but the move higher while Gold is hovering just above recent lows, is a concern. A move above \$7.66/oz would make the chart look more bullish, but the move still looks like a spike.

Summary - Silver prices are bucking the trend, but it is too early to tell whether they are the leading scout or the lost sheep. Without any pick-up in unrest in the geopolitical arena or on going scares in the financial markets, it seems strange that Silver is going it alone; as such expect Silver to fall back and to follow Gold's lead. This is especially so if Silver's buoyancy is purely a speculative driven rally ahead of an EFT launch.

Silver Statistics										
	2001	2002	2003	2004 4Q	2004 1Q	2005	Apr-05	May-05		
London Prices (US\$/oz)										
Daily Fix	4.39	4.60	4.88	6.65	7.23	6.97	7.12	7.02		
Parity (London) prices										
Japan (Y/g)	17	18	17	22.27	23.70	22.57	23	23		
India (Rupee/oz)	207	224	227	301.35	325.26	304.49	311	306		
COMEX – futures contracts										
Stocks (Moz)*	104.5	105.8	111.0	114.5	103.7	101.97	104.0	104.3		
Vol (million contracts)	2.6	3.0	4.1	4.9			0.5	0.5		
OI ('000 contracts)*	63.0	79.5	94.7	103.4	111.7	99.90	106.4	105.0		
CFTC (Futures Only Data) non-commercial										
Net Positions *	7,284	27,624	33,414	42831	53,186	35170	40,365	24,954		
TOCOM										
Stocks (Moz)*	1.3	1.1	0.7	0.53	0.7	0.82	0.5	1.0		
Futures Vol ('000 contracts)	660.8	72.6	89.7	121.40	89.65	65.66	57.3			
Futures OI ('000 contracts)*	22.1	20.0	21.3	24.07	18.13	16.73	17.6	18.6		
Other Indicators										
Gold/Silver ratio*	59.2	67.7	74.1	61.06	60.47	61.20	62.9	55.7		
Silver Bullion Imports (tonnes)										
USA	2938	4004	3998							
UK	3403	2562	2141							
Japan	711	794	1156							
India	4540	3400	3100							
Italy	1766	1497	1526							
Hong Kong **	1540	1400	(2500)							
Turkey	59	139	155							
* figures are period averages unless marked; ~ not available.										
** For 2003 data is for Hong Kong and China combined (exports)										

Volatile trading seen in Platinum, while Palladium drifts lower in May

The PGM's have generally been under pressure in May as a result of the stronger tone in the dollar. Palladium mirrored Gold's performance with prices opening on the highs of the month at \$197/oz and hitting a low at \$176/oz at the end of the month. Platinum on the other hand initially moved up to \$882/oz on fund and speculative buying ahead of PGM week, but then started to fall sharply after the release of the US trade data that showed a narrowing of the trade deficit, which in turn saw the dollar embark on a journey to fresh 2005 highs. The weaker tone in the market sparked fund liquidation selling, that started in Tokyo and the rolled over into Europe and America and ended up with Platinum prices falling to a low at \$844/oz, levels not seen since February 2005. Good consumer buying, especially from Chinese jewellery manufacturers, then lifted Platinum prices back above the \$860/oz level.

Platinum supply & demand in balance

In 2005, Platinum's supply and demand are expected to be well balanced, although with the strong pick up in investor interest in 2004, any decline in 2005 may lead to lower prices. Also South Africa PGM producers are now in a much more comfortable position now that the dollar has strengthened from Rand 5.70 at the start of 2005 to over Rand 6.80. This improves the prospects for PGM production increases, which may dampen the longer term PGM outlook. In turn this may make the funds feel less inclined to chase Platinum prices higher or indeed hold Platinum.

China remains the swing factor

At the moment, Platinum prices are underpinned below \$850/oz as Chinese jewellery manufacturers remain a swing factor. But if the outlook for Platinum prices deteriorates, then Chinese buyers may well step aside to see how far prices fall on fund selling before stepping into restock.

Palladium still faces a supply surplus

Despite improving prospects for demand growth from jewellery, electronics, and autocatalysts, especially as Palladium is starting to be used in diesel catalysts, Palladium supply is also on the increase. In addition, if the pace of South African expansion projects increases this will only add extra supply of Palladium. Given this outlook, it is less likely that Palladium will attract high levels of fund interest in the medium term. As such Palladium is likely to remain subdued.



Technical Outlook

The weekly Platinum chart not only shows how extended the long term up trend is, but it also shows how vulnerable it looks. With so much sideways trading above the line, a sustained move below the line, a sustained move below could lead to considerable liquidation selling. Palladium on the other hand is holding on its depressed base line and therefore should continue to find underlying support.

In summary - At the start of the year the dollar was expected to remain weak, the fact that it has strengthened some 9% may make it increasingly hard for long term investors to hold on to long positions. In addition, if the market has found comfort in the prospect of good underlying Chinese buying, the buying may not be there in volume if the outlook deteriorates. Overall, downside favoured.

PGM Statistics								
	2001	2002	2003	2004 4Q	2004 1Q	2005	Apr-05	May-05
London Prices (US\$/oz)								
Platinum	533	541	698	849	852	867	868	868
Palladium	613	341	205	233	210	191	200	191
Rhodium	1,604	841	531	980	1,302	1,523	1,509	1,557
Japanese Parity Prices (Y/g)								
Platinum	2,009	2,095	2,501	2,845	2,793	2,807	2,826	2,871
Palladium	2,309	1,325	736	781	690	617	652	632
South African Parity Prices (Rand/kg)								
Platinum	142,398	175,810	164,523	169,994	160,147	161,554	162,022	170,719
NYMEX Stocks ('000oz)								
Platinum	20.0	15.8	13.9	16	19.1	19	18.5	17.0
Palladium	40.1	10.8	102.9	647	729.2	687	707	707
CFTC Futures Only Data Long / (short) non-commercial								
Platinum	864	2,454	4,048	2,422	2,629	3,501	5,176	3,451
Palladium	~	(137)	1,529	4,115	4,937	5,945	6,064	4,472
Tocom - Platinum								
Stocks ('000oz)	18.1	8.7	16.9	15.5	13.5	19	18.5	14.5
Vol (Million contracts)	16.2	1.2	1.1	1.1	1.0	0.7	0.5	
OI ('000 contracts)	260.5	218.8	220.4	183.6	179.7	155	143.2	134.6
Tocom - Palladium								
Stocks ('000oz)	1.9	1.6	5.8	9	8.2	24	24	28
Vol ('000 contracts)	1,200	3	25.7	30	18.8	23	14.4	
OI ('000 contracts)	117	3	11.1	21	22.3	20	20.8	20.6
Other Indicators (US\$/oz)								
Pt-Au spread	208	234	337	439	448	440	446	454
Pt-Pd spread	45	214	496	618	635	673	680	690
Platinum Bullion imports (kg)								
USA	84,200	160,000	111,000					
Japan	40,937	43,750	50,000					
Palladium Bullion imports (kg)								
USA	160,000	117,000	83,000					
Japan	42,812	41,250	41,093					

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