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RBC Dominion Securities Inc.
Stephen D. Walker (Head of Global Mining Research)
(416) 842-4120;
stephen.walker@rbccm.com
Dan Rollins, CFA (Analyst)
(416) 842-9893;
dan.rollins@rbccm.com

RBC Europe Limited
Jonathan Guy (Analyst)
+44 20 7653 4603;
jonathan.guy@rbccm.com

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Gold: We see Similarities with the 2005 to 2008 rally

Chinese demand could replicate the 2005-08 ETF driven gold rally

Elements now in place for a sustained gold rally

We see similarities between the 2005 to 2008 gold price rally and the current gold price environment, which ***we believe could lead to a sustained gold price rally over the next 12 to 24 months.*** While still early in gold recovering from its $1,178/oz lows, we believe that Chinese and emerging market gold demand combined with the absence of Central bank selling both offset any ETF liquidation related to tapering and create the environment for a sustained higher gold price move characterized by "***higher lows as investors buy the pullbacks***".

Gold ETF products provided new demand in 2005

The creation of gold ETF products nearly a decade ago provided US and many global investors with exposure to gold that could previously only be obtained with gold equities. This new investment demand, estimated to be 5 to 7% of the 4,500 tonne annual global gold bullion market is believed to have been the key driver for the $450/oz to $900/oz price rally over the 2005 to 2008 period (Exhibit 4).

China is now a significant and likely sustainable demand component

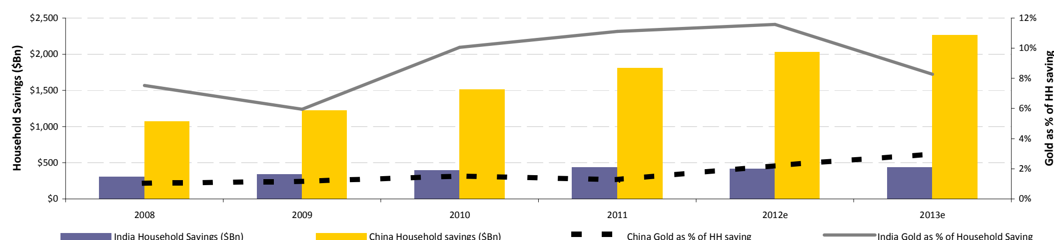
A major change in y-o-y demand has been the emergence of China as the world's largest consumer of gold. In 2013 Chinese gold demand was estimated to be 34% of global demand in a remarkable steady fashion (Exhibit 3). **We estimate that the 1,497 tonnes (gross) to the mainland from Hong Kong in 2013 represents ~0.7% of GDP, ~3% of household savings & ~14% - 16% of urban household savings (Exhibit 1).**

An important consideration is the increased availability or liquidity for physical gold in the Chinese Mainland market that began in 2011 (Exhibit 2). We believe that between the inability to own gold on Mainland China before 2005 and the illiquid nature of the bullion market prior to 2011, with little or no retail distribution of physical gold coins and bars, has set the stage for sustainable demand for gold, especially with an estimated ~40% pullback in the Renminbi gold price since late 2011.

Near term risks to downside are moderate

Risks include significant new IMF/Central bank selling as part of the European Central bank gold sales agreement that is expected to be renewed upon the September 27th, 2014 expiry. Also should the Emerging market currency/economic crisis escalate, then their central banks could begin to sell gold holdings similar to the Asian Tiger currency/economic crisis in 1997-98 (Exhibit 8).

Exhibit 1: Scope for further increase in Asian Demand



Source: RBC Capital Markets Estimates, World Bank, RBC Capital Markets Economics Research, World Gold Council, GFMS

Priced as of prior trading day's market close, EST (unless otherwise noted).
All values in USD unless otherwise noted.

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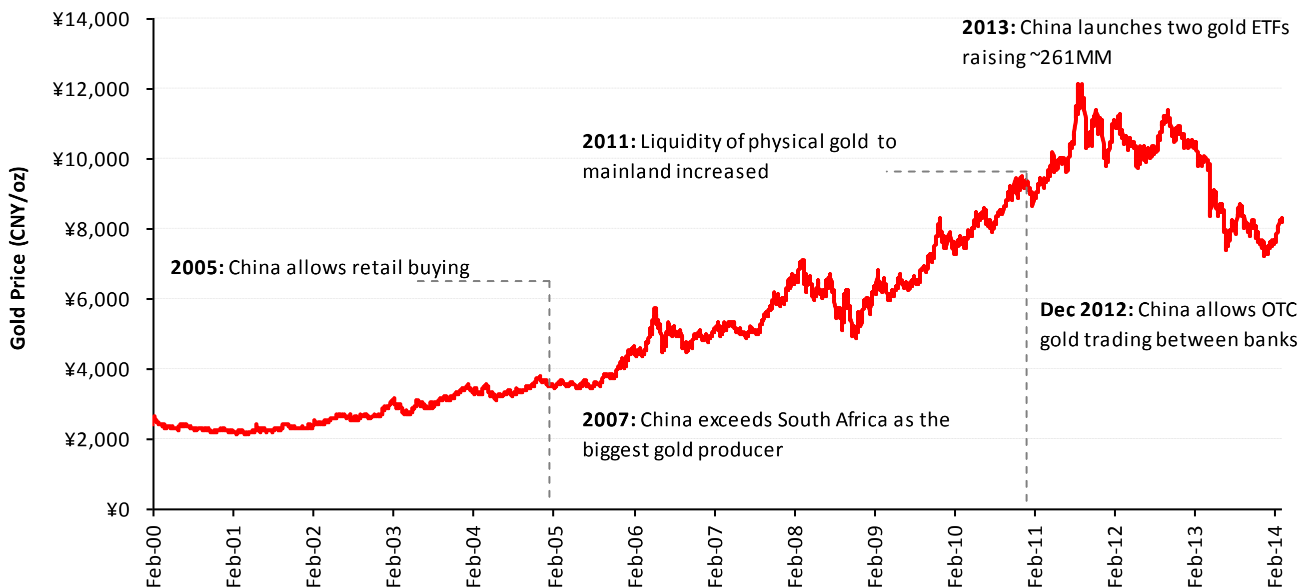
Chinese demand fundamentals remain robust

The gold price in Renminbi has contracted ~40% since August 2011 and offered buyers a relatively attractive entry point (Exhibit 2). Most Chinese citizens were unable to buy gold bars and coins prior to 2005, and significant purchases of gold did not begin until 2011. **Without a period of significant liquidity or availability on the Mainland of gold bars and coins prior to 2011 (Exhibit 3) we believe the Chinese market is not as price sensitive as the North American or Indian markets.**

Exhibit 2: Chinese Renminbi denominated gold price.



Source: Bloomberg

In addition, the level of savings, which has increased from 6,000 billion yuan at the beginning of 2000 to 47,000 billion yuan at the end of 2013 (approximately US$7.5 trillion) suggests that Chinese households have the capacity to continue to buy jewellery and invest in gold, and may choose to do the latter rather than holding all of their savings within the Chinese banking system.

In 2013, we estimate that Gold imports from Hong Kong were an estimated 3% of Chinese household savings and 14-16% of urban savings (Exhibit 1). We believe that this level of gold demand could remain stable or even continue to rise owing to:

1) **Growth in GDP:** World Bank estimates annual Chinese GDP growth rates of 9.8% between 2004-08 and 7.8% between 2009-13. We believe that a continuation along a 7% trend could mean additional fund flows being directed toward purchasing physical gold for 2 reasons: a) Assuming the proportion of spending on gold as a % of savings remains constant, higher per capita wages should directly correlate with increasing gold demand and b) a burgeoning middle class could seek avenues for wealth diversification, with Gold representing a "hard asset", especially in light of the recent crisis related to the shadow banking system.

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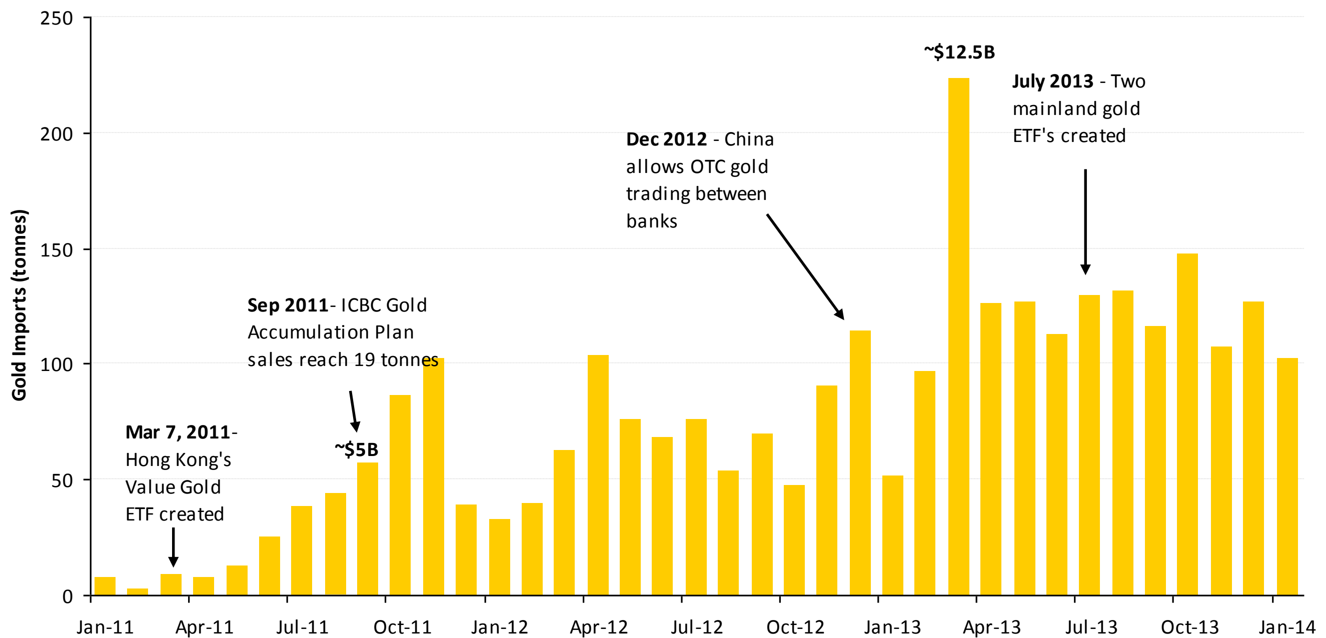
2) **Chinese central bank diversification from its significant USD exposure** has been a consistent trend over the medium term (Page 6) and we expect resource related investments to remain a key theme going forward.

Exhibit 3: The increase in Mainland Chinese gold imports YoY from 2012 to 2013 represented ~14% of 2013 global gold supply

Total Monthly China Imports of Gold from Hong Kong including bars, jewelry and coins



Source: GFMS, Hong Kong Census and Statistics Department

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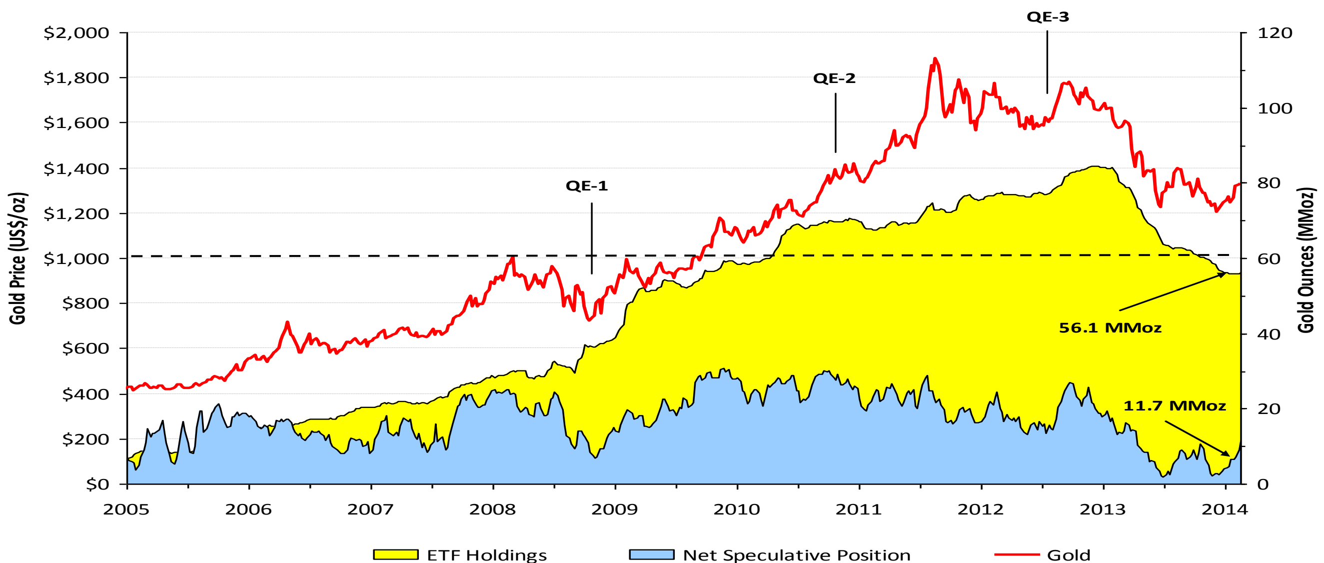
Slowing of ETF disinvestment supportive for gold

During the 2005-2008 period ETF holdings surged from 5.3MMoz held to 28.3MMoz held, which represented 5%, 7% and 6% of aggregate global gold demand in 2005, 2006 and 2007, respectively. This level of ETF demand is well below the ~14% YoY increase in global demand by China in 2013 (Exhibit 3). Gold prices nearly doubled from $450/oz to $900/oz over 2005-08 as a result of this increased demand. Throughout this period the geopolitical and economic risks were relatively benign and investors appeared to be buying gold in an environment with an accommodative Fed monetary policy.

We believe the market likely began pricing in QE-2 and the Eurozone sovereign debt concerns in early 2010 when gold was in a $1,100-1,200/oz range and the flow of funds into ETFs was driven more by speculative flows ahead of QE-2 and subsequent QE-3 expectations, rather than improving fundamental demand from holders of physical gold, such as jewellery and central bank holdings (Exhibit 4). As a result, we believe the current 56.1Moz gold holdings in ETFs reflect a level that discounts the impact of quantitative easing.

Following a sustained period of ETF liquidation during 2013, we have begun to see consolidation around the 55-56MMoz mark, which represents a ~33% fall from the 84.3MMoz level seen at the beginning of 2013. The stalling of the rally across broader equity markets since the beginning of 2014 has corresponded with a slowdown in outflows with a return to marginal net inflows over the past fortnight.

Exhibit 4: ETF Holdings weakened in 2013 but this was partially offset by strong bar and coin demand and outflows have slowed in 2014



Source: Comex, Bloomberg

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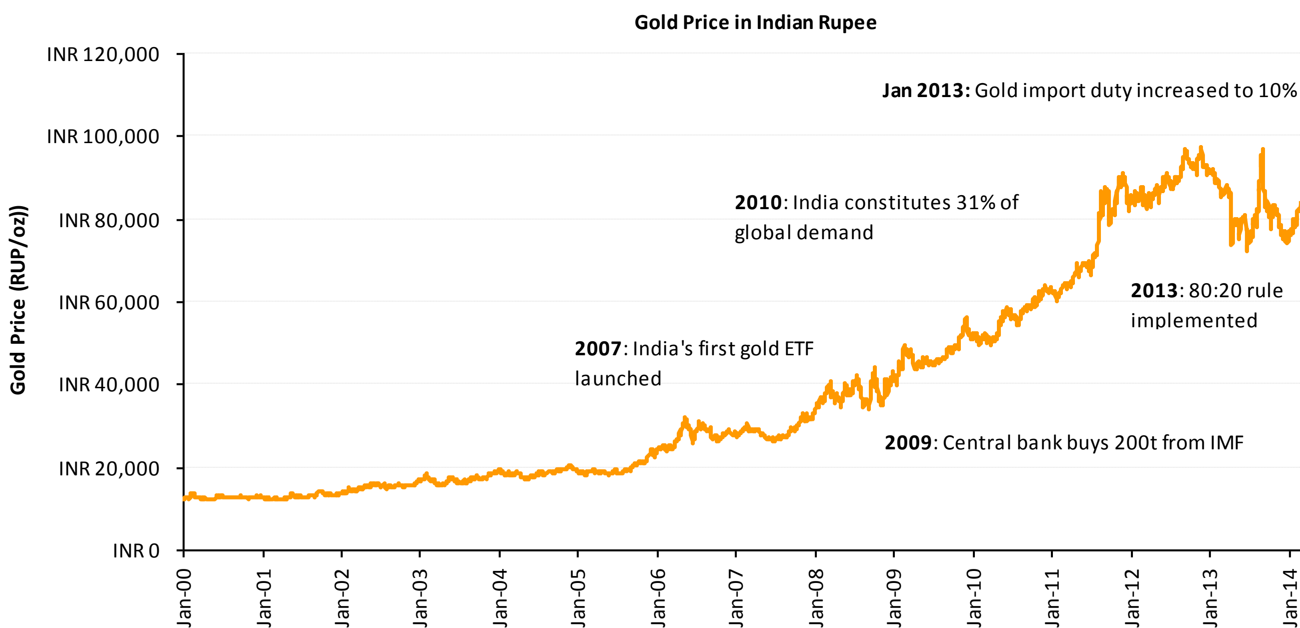
Indian Demand poised for a rebound

The imposition of two Government regulations in 2013 aimed at addressing the country's current account balance, namely : (1) a 10% import duty that has grown from 2% nearly 2 years ago, and (2) the 80:20 rule, requiring 20% of imports to be re-exported before further imports are permitted, have depressed official gold import figures. However, a concurrent spike in imports in surrounding regions suggests heightened smuggling activity into India. **With a marked improvement in the current account balance as well as political sentiment ahead of elections in April-May, that may well result in reducing/repealing the 80-20 rule as well as the 10% import duty, a re-emergence of Indian consumer demand in-line with levels observed in the 2010-12 period cannot be ruled out. Spot-premiums in excess of $150/oz observed during 2013 bear testament to the resiliency of underlying demand in the region.**

Between 2005 and 2007, we estimate official Indian gold demand averaged between 1.2% and 1.4% of annual GDP and constituted 5% to 8% of annual household savings. 2008-13 however, has seen demand increase, averaging 2.1% of GDP and 9% of household savings (Exhibit 1). Furthermore, Personal Disposable Income has grown at a CAGR of nearly 11% from 2005 through 2012; should this trend continue in broadly similar fashion, the increase in the potential fund-flow that could be directed toward investment in gold is substantial.

Short term trends also appear favourable: the spike in Gold in June 2013 was due to the sharp sell-off in the Rupee/USD exchange rate and there was no significant destocking of gold. The Rupee has strengthened significantly since its September lows and the Rupee denominated gold price has pulled back ~15% from the September price spike, making this a more attractive entry level for Indian buyers.

Exhibit 5: Indian Rupee denominated Gold Price. The recent pullback should generate buying post a weak demand period.

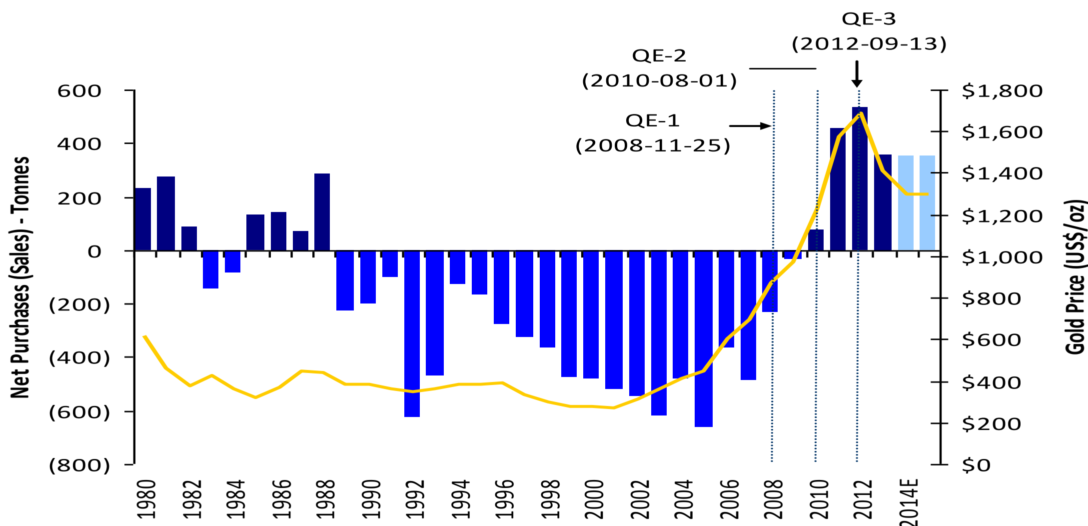


Source: Bloomberg

Significant positive impact from central bank buying – China's holdings are unclear

A significant positive impact on the gold market has been European central banks' stopping their ongoing sales of gold in 2009 and Emerging Markets central banks beginning to accumulate gold (Exhibit 6). Central banks that have been most active in increasing their holdings of gold include Mexico, South Korea, the Philippines and India. In addition, in 2013 both China (413 tonnes) and Russia (230.1 tonnes) are believed to have been accumulating significant portions of their annual domestically mined gold production. A number of Central Banks have continued to be active purchasers of gold in 2013, especially amongst countries in Asia and the FSU with Kazakhstan, Russia, Korea and Turkey all making significant purchases throughout the year.

Exhibit 6: Notable Central Bank Participation – Central banks remain clear net buyers with Asia and FSU being key in 2013



Source: GFMS, Bloomberg

We expect the central bank purchases to remain below the 2012 high over the next few years, however we do not expect net Central Bank selling in the current gold price environment. However, we do expect to see China and Russia continue to accumulate the majority of their domestic production in order to increase their gold holdings as part of their foreign exchange holdings.

China has recently released its official reserve number, again claiming no change from the 1,054t, which was last announced in 2009, representing approximately 1.3% of the country's overall foreign exchange reserves. The Chinese Gold Association claimed that the country consumed 1,176t in 2013 and the official import data suggests that the country imported 1,150t though Hong Kong with additional imports through Shanghai**. Including domestic annual gold production since 2009, we estimate that China could have an estimated 2700 to 3000 tonnes or 2.7% to 3% of its foreign exchange holdings.**

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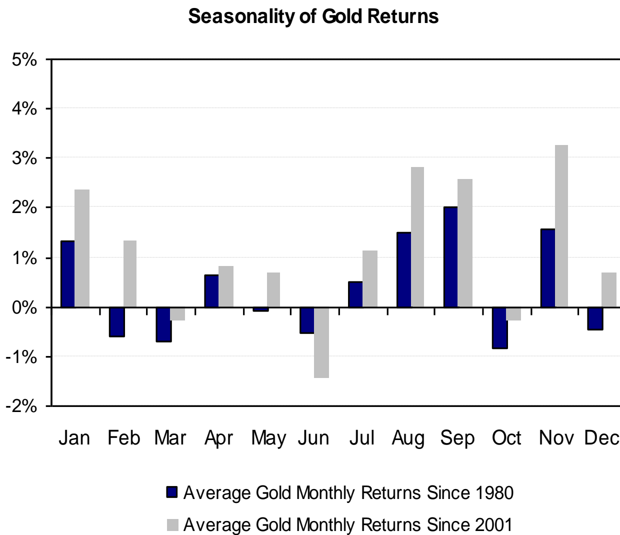
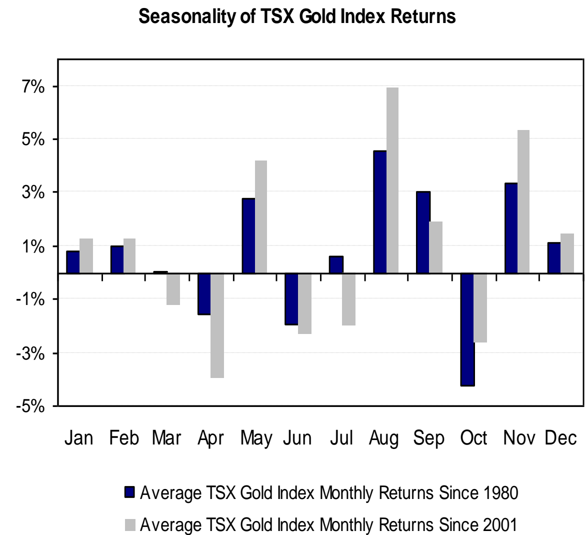
Exhibit 7: Seasonality in Gold Price Returns and Gold Equity Returns – Q1 is usually weaker, however, gold has remained strong post Chinese New Year. Also, an early start to preparation for the upcoming Indian wedding season appears on the cards as a result of volatility in domestic supplies due to the recent legislation impacting gold.





Source: Bloomberg

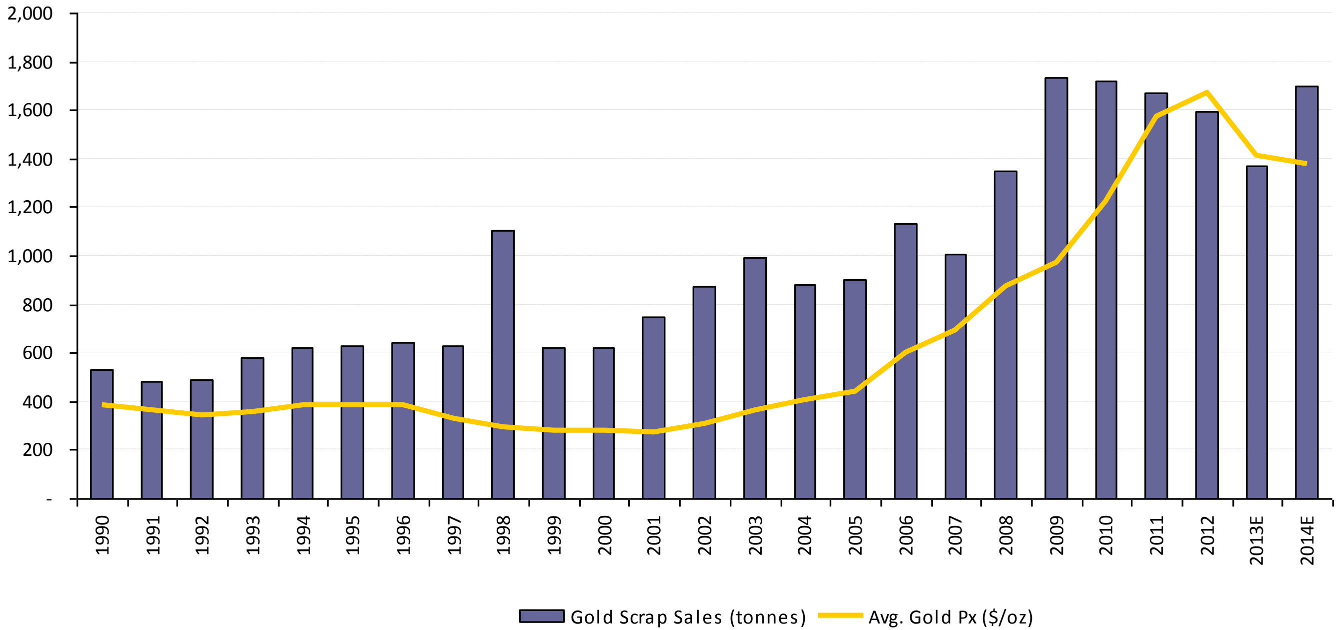
Moderate Downside risk in near-term

Risks include significant new IMF/Central bank selling as part of the European Central bank gold sales agreement that is expected to be renewed upon the September 27th, 2014 expiry. Also should the Emerging market currency/economic crisis escalate, then their central banks could begin to sell gold holdings **similar to the Asian Tiger currency/economic crisis in 1997-98 (Exhibit 8)**.

The gold price has historically shown a strong negative correlation with real interest rates, (Exhibit 9) and a slightly negative beta to the broader equity markets. Between late 2007 and early 2013 investors looked for safe haven assets and central banks have looked for diversification of their currency reserves. Over this period of time, this resulted in US treasury yields declining and the gold price moving higher. Lower yields also reduced the cost of carry and the opportunity cost of holding non yielding commodities. **We have also observed that a Fed rate hike cycle would be negative for the gold price.**

Indian demand did see a pullback in 2013 as a result of the imposition of a 10% import duty aimed at addressing current account imbalances (Exhibit 5). However, a reduction in the duty following mid-year elections remains a distinct possibility to offset this risk, and there is risk that destocking can occur as the rupee price of gold increases further.

Exhibit 8: Historical Gold Scrap Sales vs. Gold Prices



Source: GFMS, Bloomberg

Exhibit 9: Gold v/s. 10 Year TIPS Yield (Inverted) – As yields have risen during 2013, the gold price has pulled back

Source: Bloomberg

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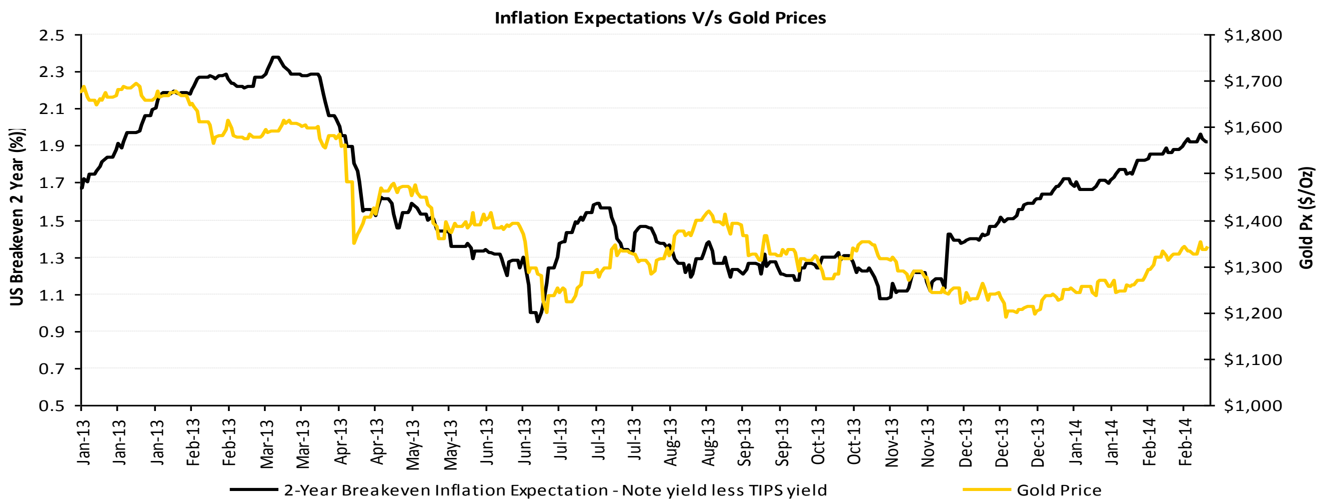
An interesting correlation since early 2013 is the relationship between the 2 year benchmark inflation expectation (2 year yield – Tips) and gold prices. In March 2013 the sharp drop in the inflation expectations, in the short end of the curve, clearly led the sharp sell-off of gold in April.

In late 2013, the 2 year breakeven inflation began to rise toward the 2% mark, following a stabilization in North American, European and Asian markets, resulting in gold prices enjoying a successful start to 2014, gaining nearly 14% so far in 2014.

Exhibit 10: Inflation Expectations continue to rise, which could serve to partially explain Gold prices edging higher in 2014



Source: Federal Reserve, RBC Economic Research

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