

## Gold prices warm to 25-year highs but physical demand is left in the cold

*Strong Fund and professional buying interest has propelled the price of gold to a 25-year high over the past quarter; however this fervor for the metal has come at the expense of gold's traditional support base.*

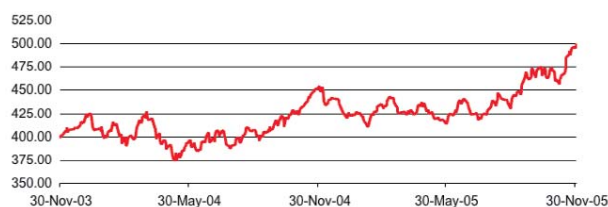
Demand for physical gold has fallen markedly over the past quarter – a period normally associated with strong off-take from festival goers in the Middle East; the resumption of the wedding season in India; and a build up of manufacturing demand from jewelers ahead of the Western hemisphere's holiday season. Expectations of a material increase in consumption over this period have instead vanished as the gold price has breached price levels around US\$460 achieved as recently as September this year. The rapid increase in price has forced physical buyers to the sidelines and left markets in Asia and the Middle East despondent at the fact that global commodity analysts seem to be missing the point.

In the midst of all the media hype of supposed high demand from India, China and the Middle East, the

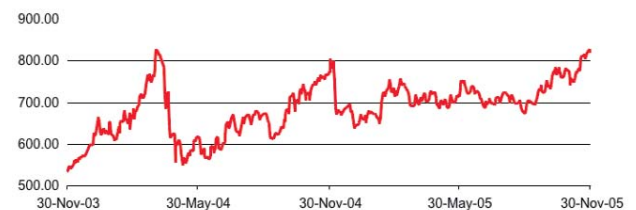
lack of actual jewellery demand in these countries is slowing squeezing jewellery manufacturers and retailers to the point where some manufacturers are considering closing down parts of their operations in a bid to save costs.

It is not at all uncommon to expect a decrease in gold demand in response to higher prices as consumer-buying power is eroded (and less gold can be purchased for the same amount of money), however the past quarter has also seen a drop in the US dollar equivalent of purchases. Some of this decline can be attributed to an increased level of incoming scrap material, especially in the Far and Middle East, which has resulted from retail clients trading in older secondhand jewellery for newer styles rather than purchasing the new styles outright. Another contributing factor to the lower volumes has been the volatility in price. Traditionally physical buyers have tended to wait for prices to stabilize at new levels, or pullback, before placing orders, however the volatile trending nature of the current market has offered little comfort that the market will remain steady at any given price point.

**London PM Gold Fix (\$/oz)**



**London Silver Fix (¢/oz)**



**Market closing prices** (December 9, 2005)

Gold (US\$/oz)	525.70	Silver (US\$/oz)	8.98
Platinum (US\$/oz)	1,000.00	Palladium (US\$/oz)	286.00
Euro/US\$	1.181	Canada/US\$	1.157
Copper (US\$/tonne) (3-mth LME)	4,455.00	Oil (US\$/barrel) (NYMEX Light Crude)	59.39

**Marked slowdown in physical off-take contrasts traditional period of strong demand.**

Sources in Dubai, India, Singapore and Hong Kong tell of jewellery stores empty of customers and confidence. Moreover there are reports of increasingly large numbers of people in stores selling scrap jewellery and bars in a bid to profit from 25-year high prices of over \$500 per ounce. The trend is repeated throughout India where local exchanges have recently reported gold prices trading at up to a US\$6/oz discount to international prices. All this comes at a time when the wedding season is at its peak, (the capital Delhi recorded 27,000 weddings on one day last week), and gold demand should be high.

Likewise in Dubai at the Gold and Commodity Exchange, (the world's newest exchange which only opened in late November), gold is regularly quoted at discounts of up to US\$1/oz under international prices, and trading is characterized by low volumes – less than 10,000 ounces per day. Shopkeepers in the famous Dubai gold Souk are forced to hope for an increase in tourist traffic (expected closer to Christmas) because local buyers are staying away from the stores while prices remain high.

The same for silver. The Indian Government reportedly still has 1,500 tons of the metal to sell but is unable to find buyers in the local markets despite offering a 3% discount to the international price. No one apparently wants physical silver at \$8.50/ounce and higher.

Throughout the rest of the Middle East the story is the same with the general level of activity in the gold and silver markets down in recent weeks due to high prices. Earlier expectations of good demand for gold during the fourth quarter, driven by high demand for jewellery during the Ramadan holiday period and the approach of the end of year holiday, have failed to eventuate and several physical dealers and manufacturers have reported a

marked drop in turnover. As is the case in Hong Kong and India, scrap gold supply has increased during this period reflecting consumers' negative attitude towards high prices. The increased supply of scrap has been used to finance what demand remains, and there are also regular reports of scrap being sent to refineries in Switzerland for recasting into good delivery bars for the London and Zurich markets.

All of this directly contradicts recent industry reports which have pointed to strong income growth in the oil-rich countries of the Gulf and argued that demand for gold should be rising in line with this increase; yet there is no direct evidence of this occurring so far.

**Demand in the West is faring no better.**

In the western hemisphere where retail jewellery margins are typically 300 – 400% above the cost of the precious metals contained in them, (compared with a 5 – 10% markup in the eastern hemisphere), one would normally expect less immediate impact on jewellery demand caused by the more costly inputs, since manufacturers have more room to absorb price increases in the short-term. Despite this, manufacturers in Italy and France are also reporting weaker demand for their product.

Italy is the largest exporter of gold jewellery worldwide and manufacturers have been busy as usual in the past couple of months with pre-Christmas production orders targeted to be in stores by early December. This year however it is reported that order sizes have shrunk as a result of wholesalers and retailers fearing over-stocking at high prices, and manufacturers find themselves carrying larger than normal inventories of ready-made jewellery. Associated with these larger stocks are volatility risks and financing costs, which eat into profit margins.

Jewellery production in Italy typically slows down during December and most companies will close over the festive season. In the New Year the market will begin to watch for new design trends that will be presented at the Vicenza International Gold Jewellery Exhibition. This exhibition is arguably the most influential worldwide jewellery trade event and will be watched keenly for any signs of renewed demand.

**Japan is the only bright spot**

In contrast to the poor level of physical demand throughout most of the world, Japanese demand for gold has been very strong over the past several weeks. Driven primarily by foreign exchange markets, the recent depreciation of the Japanese Yen against the US dollar has resulted in two important trends - increased retail investment demand for gold as a proxy currency hedge, and increased industrial demand due to a pickup in exports of electronics.

Market sources in Japan report that retail investors have been regular buyers of gold futures, (and in fact bought over 10,000 kilograms of gold in one day on the Tokyo Commodity Exchange earlier this month). Expectations from Japan are that demand for gold futures will continue with the metal offering the retail investor a simple hedge against further currency depreciation. Current demand is such that premiums for gold on TOCOM have been as high as US\$20 /ounce over the international price, but having seen this same trend some years ago we caution against the impact on the market when these retail investors start taking profits.

Finally it is worth noting the growth in physical demand associated with the various gold ETF's launched around the world in the past 18-months - the combined assets of which have risen to over five billion (US) dollars from nearly nothing over this time period. These funds, which are backed by physical gold holdings, are an important new source of demand that have removed over 320 tons of gold from the market to date, and who's continued success will be an important replacement for the lack of demand from traditional sources if the current bull market in gold prices is to continue.

**World Official Gold Holdings** (September 2005)

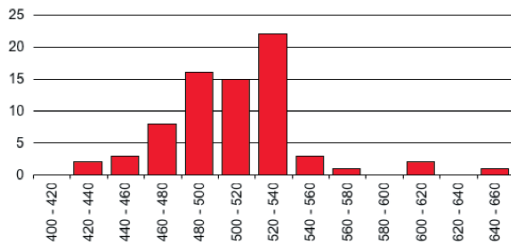
	Tonnes	Change <sup>1</sup>	Gold % share of reserves <sup>2</sup>
United States	8,133.5	-	63.8%
Germany	3,427.8	(5.4)	50.5%
IMF	3,217.3	-	Note (3)
France	2,892.6	(52.6)	56.4%
Italy	2,451.8	-	56.7%
Switzerland	1,290.1	-	33.3%
Japan	765.2	-	1.3%
Netherlands	722.4	-	51.3%
ECB	719.9	-	20.6%
China, Mainland	600.0	-	1.1%
Spain	493.3	(30.0)	42.8%
Taiwan	423.3	-	54.0%
Portugal	407.5	(34.8)	2.4%
Russia <sup>4</sup>	386.6	(0.2)	3.6%
India	357.7	-	3.6%
Venezuela <sup>4</sup>	357.4	-	17.6%
United Kingdom	311.3	(0.1)	9.4%
Austria	307.5	-	37.5%
Lebanon	286.8	-	28.7%
Belgium	227.7	(30.0)	25.7%

Notes:

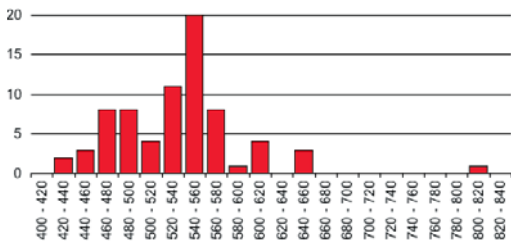
1. Data as of September 22, 2005 (change from June 2005)
2. Value of gold holdings calculated using gold price of US\$429/oz.
3. Unable to calculate from BIS balance sheet.
4. Excluding gold on swap. *Data courtesy of World Gold Council.*

# ScotiaMocatta Client Sentiment Survey

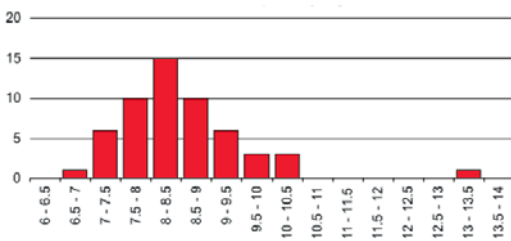
## 3-month gold forecast responses by range



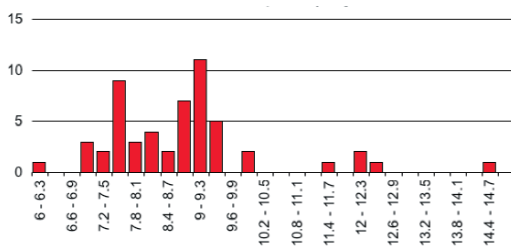
## 12-month gold forecast responses by range



## 3-month silver forecast responses by range



## 12-month silver forecast responses by range



## About the survey

The ScotiaMocatta client sentiment survey was conducted during the period November 29th – December 9th, 2005 among a cross-section of ScotiaMocatta’s clients worldwide. Survey participants were asked to forecast prices for gold and silver 3-months from the date of the survey and 12-months from the date of the survey. Participants were also asked to rank in order of importance the three factors they felt would most impact the precious metals markets over the same time periods.

## About ScotiaMocatta

ScotiaMocatta is the precious metals division of Scotiabank and is a global leader in precious metals trading and finance with roots dating back to 1671. ScotiaMocatta is a leading market-maker with operations worldwide serving a diverse clientele of producers and consumers of bullion across a variety of industries.

## Survey results

Following the large price increases of the past 3-months, Survey respondents remain generally upbeat about the short-term (3-month) and medium-term (12-month) prospects for gold and silver, however both metals are expected to enter a period of overall consolidation rather than record further dramatic price appreciation. The average 3-month gold forecast was US\$506.87/oz suggesting some profit-taking from current levels while the average 12-month gold forecast of US\$532.36 /oz pointed to a modest recovery later in the year. Silver showed a similar pattern with forecasts for 3 and 12-months of US\$8.44 /oz and US\$8.91 /oz respectively and the majority of respondents looking for the metal to correct in the short-term. Individual forecasts reflected the general view with a handful of high forecasts pulling up the overall average, but most respondents looking for lower or steady levels.

When asked to name the 3 most important factors impacting the gold and silver markets over the short and medium term, respondents cited a wider range of factors than they did 3-months earlier when the US-dollar and the oil price dominated.

The US dollar retained its position as the most important factor for the gold price in both the 3 and 12-month categories, although its response rate was markedly lower over both time periods. The second most important factor impacting the market over the short-term according to respondents was



# ScotiaMocatta Client Sentiment Survey

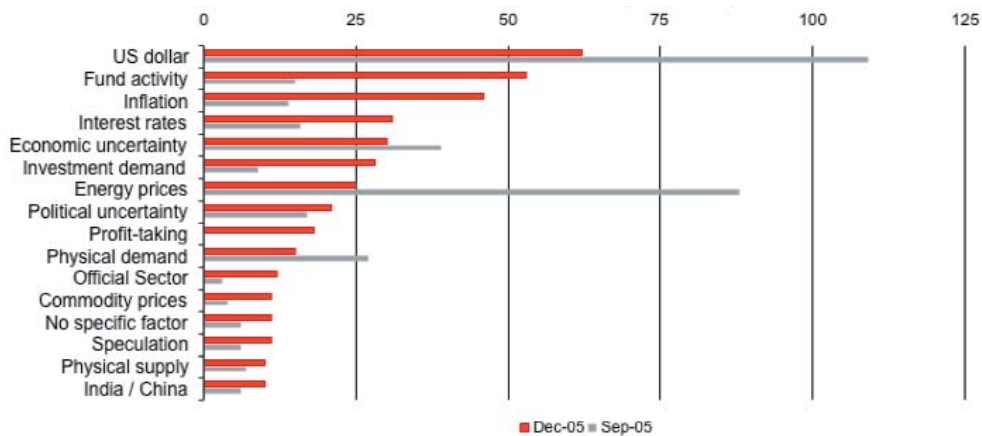
fund activity (up from 7th position last quarter), while inflation and interest rates also showed big jumps. Last quarter's 2nd place "Oil price" factor could manage no better than 7th this time around, and physical demand was identified as only the 10th most important factor for the short-term market, reinforcing the dominance of financial factors in this quarter's survey.

Of special note terrorism and Middle East tensions barely rated a mention in this quarter's survey (the threat of terrorism was only rated 20th in the short-term and 21st in the medium term, while Middle East tensions were not specifically mentioned as a factor).

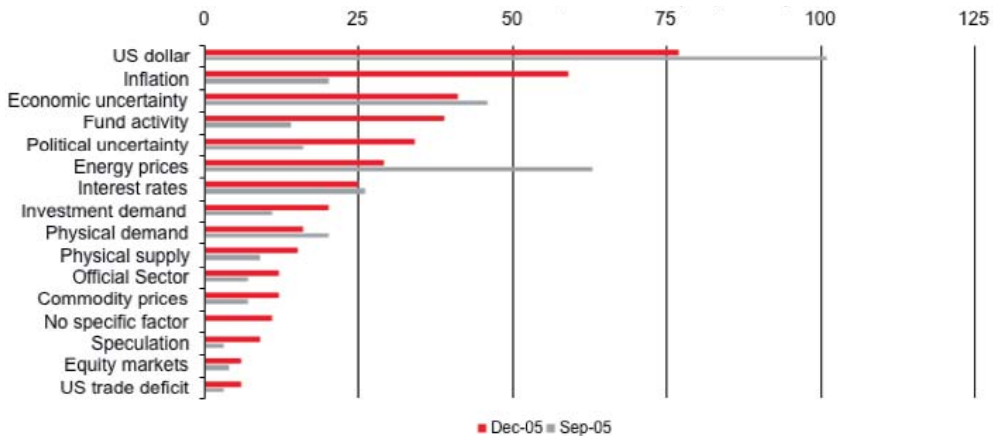
### Overview of survey results

	Gold 3-mths	Silver 3-mths	Gold 12-mths	Silver 12-mths
High	\$ 650.00	\$13.38	\$ 800.00	\$ 15.00
Low	\$ 430.00	\$ 6.80	\$ 425.00	\$ 6.20
Average	\$ 506.87	\$ 8.44	\$ 532.36	\$ 8.91
Number of respondents	73	55	73	55

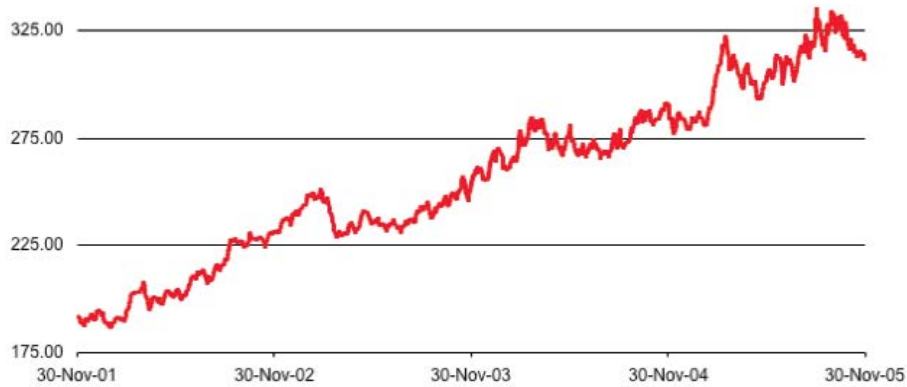
### 3-month market impact factors (responses)



### 12-month market impact factors (responses)



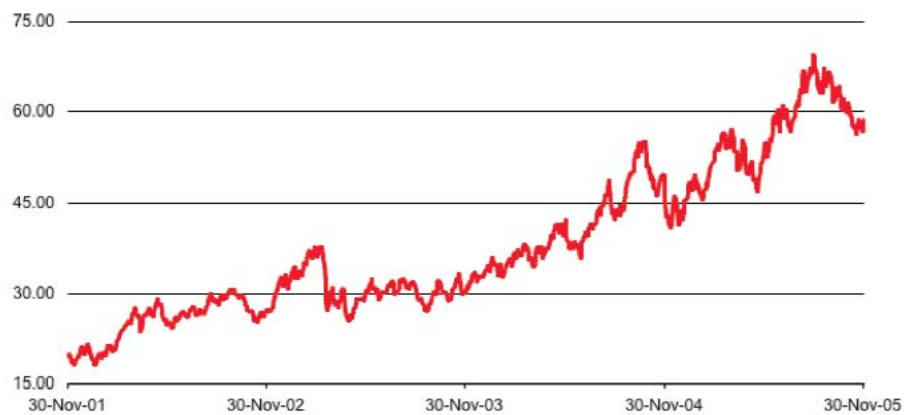
**Commodity Research Bureau (CRB) Index**



**Euro/US-dollar exchange rate**



**NYMEX Light Crude Oil (Nearby contract \$/barrel)**



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