Global Macro Research | US
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MF Global Daily Report

COMMODITIES | PRECIOUS METALS

Precious Metals

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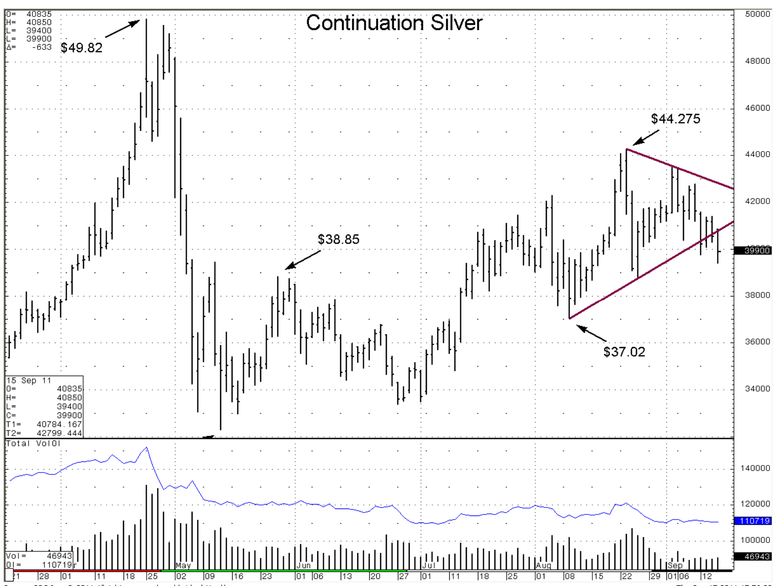
Price Outlook

Precious metals are expected to maintain their mixed-to-lower trend in the near-term, with gold falling toward the $1,750/oz price level. Silver could reach support at $38.76 from the Aug 25th low. Metals weakened yesterday on signs of increased risk appetite, which could continue into next week's FOMC meeting and/or even the end of the month/quarter. Additional pressure will come from low expectations for QE at next week's FOMC meeting, and from technical factors which argue for a move down to $1,700-$1,750/oz in our opinion. The bullish side will look to weakness in economic data, growing purchases of gold by India, and potential supply issues in Peru. We favor maintaining our negative trading affair bias in today's trade.



Yesterday's trade in gold fell as much as $51.50/oz intraday before settling $45.10/oz on the downside. Silver ended $1.03/oz lower and only 10c/oz off its low. Pressure was applied by news that the ECB is working with four other central banks to offer dollar liquidity through three operations. There had been two requests for dollar liquidity in the last few weeks, and it appears that these new additions may be in response to needs from French banks. We take a look at the Fed's efforts to supply liquidity back in 2008 & 2009 in the Analysis section below and found that it didn't have much impact on gold prices. Gold seemed to be more sensitive to the impact of the credit squeeze on the economy and to events in the stock market with regard to "risk-on/risk-off." Gold prices actually moved lower during the period that liquidity swaps were made available, but it was likely because stocks were falling sharply at the time and gold positions were likely sold in order to raise capital. Given that yesterday's trade in equities moved higher, the fall in gold prices wasn't much of a surprise, in our opinion. There's another negative aspect for the yellow metal, in that some European banks have been selling gold in order to raise dollars.

We thought it was interesting that stocks were able to rally as much as they did despite economic data showing that September purchasing managers surveys are not recovering. It appears as though the market is anticipating the FOMC meeting next Tuesday & Wednesday and the likelihood that the Fed unveils a new policy initiative. In a survey of primary dealers yesterday by Reuters, 15 of them expected the Fed to act by implementing Operation Twist while 2 of them expected the Fed to remain on hold. We personally would like the Fed to remain on hold and left markets find natural price levels rather than artificial ones. However, weak data may compel the Fed to act. Gold bulls may remain optimistic that Operation Twist is bullish for gold or that it signals more accommodative policies coming down the line. Bulls may also look to the statements from GFMS yesterday suggesting that gold prices could move above $2,000/oz by year-end due to increased investment sparked by fears over global growth.

TRADE: None

Upcoming Metals/Dollar Events

Sep 20th-21st - FOMC Meeting
Sep 29th - German vote on expanded EFSF
Nov 1-2 - FOMC Meeting, Bernanke Press Conference

Global Economic & Dollar News

The dollar fell throughout the day yesterday, with a larger fall noted around 9:00 am EDT. The fall was prompted by news that the ECB had joined with four other central banks to provide dollar liquidity to banks that needed it. The news was beneficial to risk markets and economically sensitive commodities but slightly negative for gold.

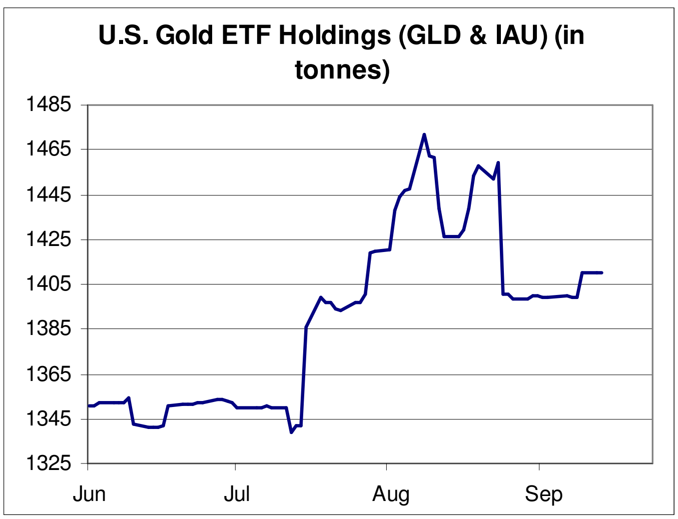
» **Chinese Inflation Expectations** are on the rise, according to a central bank survey.
» **A Top Chinese Economic Planner** said that inflation has reached a turning point and is likely to fall steadily in the coming months.
» **China's CIC** could take a 20% stake in Italy's strategic investment fund.
» **European Growth Estimates** were cut by the European Commission to +0.2% in Q3 and 0.1% in Q4 from 0.4% in both periods estimated in March.
» **ECB's Bini Smaghi** said that Eurozone inflation will remain over the 2% target in coming months.
» **Germany's Merkel** said that there's no easy solution to the Eurozone crisis.
» **Spain** auctioned debt successfully. Officials said they were pleased and that the country had no problems funding itself.
» **Dollar Liquidity** was boosted by five central banks yesterday including the Fed and ECB. The 3-month liquidity operations will resume in the fourth quarter.
» **UBS** said it had a $2B trading loss from unauthorized trading and arrested a 31-year-old man on suspicion of fraud. Share in UBS fell 10%.
» **WSJ** reports that Pres Obama's long-term deficit plan to be released on Monday won't call for large entitlement changes. For Medicare, instead of changing eligibility ages, it may call for cuts to providers and higher premiums for wealthier recipients. Makes no changes to social security.
» **Washington Post** said that Obama is backing away from some of the deficit reduction ideas agreed to over the summer debt ceiling talks with Boehner.
» **Empire State Survey** was -8.82 in Sep vs. -4.00 expected and vs. -7.72 in Aug.
» **Initial Unemployment Claims** were 428K vs. 410K expected and 417K previously. Continuing claims were 3.726M vs. 3.738M previously (revised up from 3.717M originally).
» **U.S. CPI** was +0.4% vs. +0.2% expected and +0.5% previously. CPI y/y was +3.8% vs. +3.6% previously. Core CPI was +0.2% which was unchanged and as-expected.
» **U.S. Q2 Current Account Deficit** fell slightly to $118.0B from $119.6B previously.
» **U.S. Industrial Production** was +0.2% in Aug vs. +0.1% expected and vs. +0.9% previously.
» **Philadelphia Fed Index** was -17.5 in Sep vs. -15.0 expected and -30.7 previously. The prices paid index was 23.2 vs. 12.8 previously, while employment was +5.8 vs. -5.2.

Precious Metals News Stories

- **GFMS** said that gold will break $2,000/oz by year-end as investment demand for the metal continues to grow based on persistent global growth fears.
- **European Banks** are rushing to use gold as collateral to gain dollar funding, according to FT. Lease rates have fallen and the surge in lending is seen as one reason why gold prices have struggled.
- **HSBC** was dropped as a defendant in the lawsuit that alleged manipulation of the silver market. JP Morgan remains the sole defendant.

U.S. ETF Holdings

	SPDR Gold Shares ETF Holdings	iShares Gold ETF Trust Holdings	iShares Silver ETF Trust Holdings
As of 9/14/11	39,909,403 oz	5,420,349 oz	320,103,182 oz
As of 9/13/11	39,909,403 oz	5,420,349 oz	320,103,182 oz
As of 7/1/11	38,767,956 oz	4,638,616 oz	306,610,335 oz

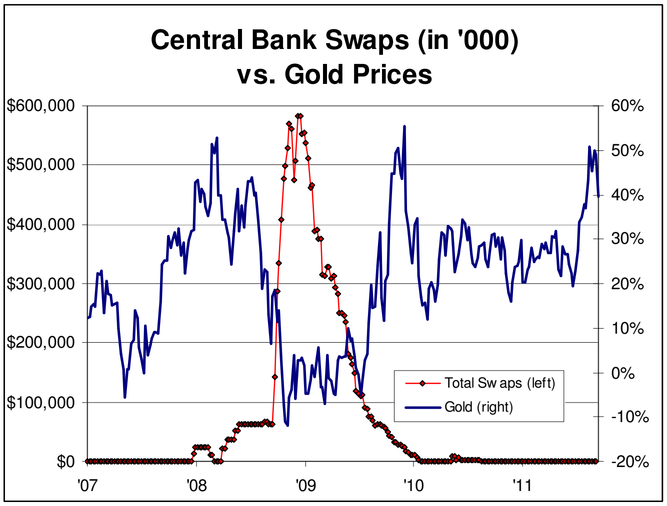


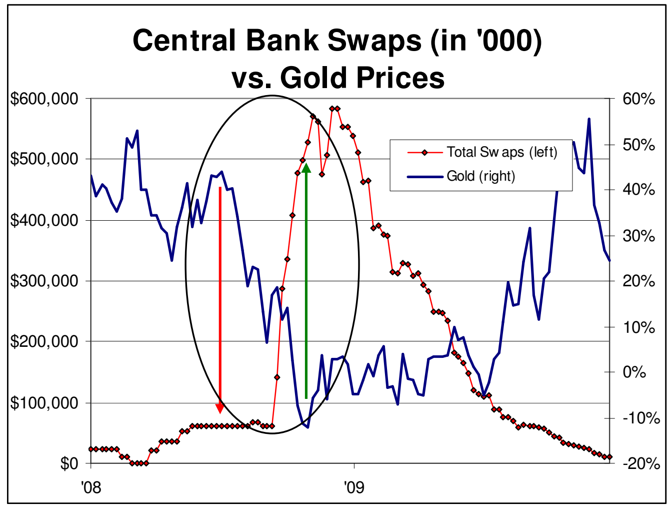
ANALYSIS

ECB Holds Liquidity Operations

The ECB announced three separate liquidity operations that it would conduct between October and December to help banks with year-end liquidity needs. The moves will be coordinated with the Fed, BOE, BOJ, and SNB. Recent distrust between banks sparked by European sovereign debt issues and downgrades of French bank credit ratings helped create the need for the extra liquidity. Some European banks were also said to be selling gold holdings in order to raise dollars as well. European and U.S. equity markets rallied on the swap line news while gold prices showed little reaction.

The reaction of gold prices wasn't that surprising in a historical context. Swap lines were first used in the liquidity crisis in December '07 through the Term Auction Facility so that banks could gain liquidity without going through the discount window and facing stigma of potential failure in financial markets. Funds issued via swaps eventually peaked just below $600M as shown in the red dotted line in chart 1. The y/y change in gold prices is plotted by the blue line in both charts below, with 2008-2009 zeroed in on chart 2. The gold market began falling in March '08 as the late-'2007 rally became overdone and after the rescue of Bear Stearns implied an "all-clear" in the banking meltdown. In July-September '08, further bank problems were becoming evident and led up to Lehman's bankruptcy in September 2008. Gold prices continued falling as the metal was used for funding needs for losing stock market positions, and didn't bottom until late-Oct. The second chart shows that by the time gold bottomed, the level of swaps were near a peak and a month away from beginning a decline.





Gold rallied from October '08-February '09 but the rate of gain matched the rally in the same period of '08 resulting in a flat y/y change. The stock market fell during that period which implies that gold's strength was at least partially based on safe-haven inflows. The level of swaps peaked in December '08 while gold completed the second month of its four month rally. The swap lines helped alleviate the liquidity crisis and helped ease fears about slowing bank lending but didn't appear to provide much support to gold prices. They weren't a sign of stimulus that could potentially be monetized and eventually were paid back.

The impact may be diminished further by the fact that they were essentially swap lines that were already in place. A former Fed associate director said that it was standard procedure and not a big deal. The FOMC meeting is next Tuesday & Wednesday and will likely exert a larger impact on the market than the swap line news. The central banks stepped in to where private banks did not want to go.