



## Global Markets in Turmoil, the Impact on the Gold Price

» by Nikos Kavalis, Senior Analyst, GFMS

The dramatic financial crisis initiated by the collapse of the US sub-prime mortgage market has led to a profound change in investor attitudes. A number of the world's leading financial institutions have begun to face the consequences of overleveraging on an increasingly problematic sector. Although certain monetary authorities have provided support to the markets, through cutting back (or at least not increasing) interest rates and providing emergency liquidity where required, the writing is on the wall

that the outlook for securitised debt linked investments is increasingly bleak. Moreover, a move to more relaxed monetary policy in the United States has put further pressure on an already weak US currency.

A number of investors seem to be increasingly aware of these issues and gradually more sceptical of traditional investment and savings vehicles. After years of aggressive "yield-hunting" and, arguably, credit risk under pricing, a move away from risky assets and into safe haven

instruments is beginning to gather momentum. GFMS are confident that this has recently been very positive for gold investment demand, providing much of the fuel for the recent rally to the \$760 mark.

Our price forecast for the second half of 2007, together with projections on the main elements of supply and demand for gold are discussed in much detail in GFMS' latest publication on the gold market, *Gold Survey 2007 - Update 1*, which was released at the Precious and

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Base Metals Seminar, organised by GFMS and GFMS Metals Consulting, on 13<sup>th</sup> September. As the report was written at a time when the gold price moved within a \$660-\$680 range and given the impressive rally seen in recent weeks, the forecast included therein now seems somewhat conservative. Although at the time of writing we expected an investor-led rally would take the yellow metal through the \$700-mark, the extent of the inflows seen in the last few weeks, particularly from the speculative community, have exceeded our expectations. Given the latest developments in the gold market and our view that the problems the global economy is facing will persist, we now expect the gold price will average just over \$700 in the second half of the year.

It is worth adding here that, although we remain positive towards gold in the medium-term, it is unlikely that a short-term correction will be avoided. This is due to the speculative long overhang in gold, that has developed in the last few weeks, which suggests liquidation is due. (On 9<sup>th</sup> October, the combined non-commercial and non-reportable net positions in Comex futures were at a CFTC-reporting record high.)

Looking at the other main elements of supply and demand for gold, these are expected to be generally neutral, at least for the few months to follow.

Starting with jewellery fabrication, GFMS expect the underlying resilience demand has enjoyed so far this year has not evaporated yet. With prices around the \$760 mark, demand is currently under significant pressure and GFMS expect that this is likely to result in a second half figure lower than initially forecast. Nevertheless, some recovery is expected at price dips, with the price floor probably above \$700.

Elsewhere, net producer hedging, although markedly lower than that seen in the first half of 2007, will remain on the demand side. Bar hoarding, finally, is expected to be flat year-on-year.

Moving to the supply side, mine production in the second half of 2007 is forecast to fall marginally year-on-year. Although official sector sales are expected to be higher than in 2006, the essential cap imposed by the Central Bank Gold Agreement and the lack of substantial selling outside the Agreement remains in place. Finally, due to much of the "loose" scrap having been mobilised in the first half of 2006 and a weakening dollar translating into lower price increases in local currency terms in many price-elastic markets, recycling levels should remain contained, despite the recent dollar price rise (although most likely higher than in our original forecast).

Although the above-mentioned supply/demand elements provide a solid floor to the gold price, they are hardly capable of driving a rally such as that seen over the last few weeks, or sustaining it around \$760. The fuel for this recent increase, and the factor which is likely to be the main driver of gold prices during the fourth quarter and into 2008, has been investment demand. (Indeed, with current expectations of fabrication demand lower and scrap higher than initially forecast, implied net investment in the second half of the year looks likely to reach levels significantly higher than those suggested in Update 1.)

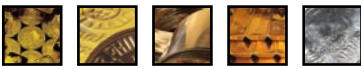
» **Copies of *Gold Survey 2007 - Update 1* can be bought from the GFMS Online Store:**  
<http://shop.gfms.co.uk>



*Nikos Kavalis  
joined GFMS on 1<sup>st</sup>  
September 2003. He  
is primarily working  
with Philip Klapwik  
on investment as  
well as official sector*

*activity research. He is also responsible for econometric modeling of precious metals markets and other quantitative work.*

*Nikos holds a first degree in Econometrics and Economics from the University of York, and an MSc in Econometrics and Mathematical Economics from the London School of Economics.*



# NEW AT GFMS

## GFMS' New Precious Metals Cost Service

**The GFMS Precious Metals Cost Service is a web based system updated on a quarterly basis offering users access to industry cost and production data.**

### Coverage

The gold section of the system captures cost and production data for around 200 operating mines controlled by 90 companies, a population that accounts for 1,400 tonnes of annual global mine production.

### Release Dates

The gold coverage of the Precious Metals Cost Service is now available to subscribers with silver and platinum group metal elements of the system to follow in 2008.

### Five Clicks!

A cost curve can be generated in less than five clicks with the option of plotting an additional curve enabling the comparison of archived data sets on a quarterly, half yearly, nine monthly or full year basis.

Datasets can be selected on a consolidated company basis or on a mine-by-mine basis. Further filters enable the analysis of cost data at the global, regional or country level, or grouped by underground or open pit operations.

### Easy to use Graphics

The user-friendly graphics options support both line and variable width histogram charts and labelling options allow both operations or multiple/individual companies to be highlighted.

### Cash Cost Charting and Data Downloads

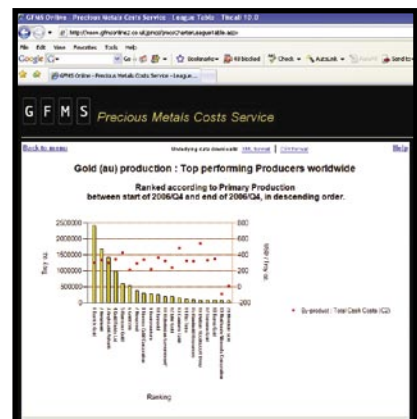
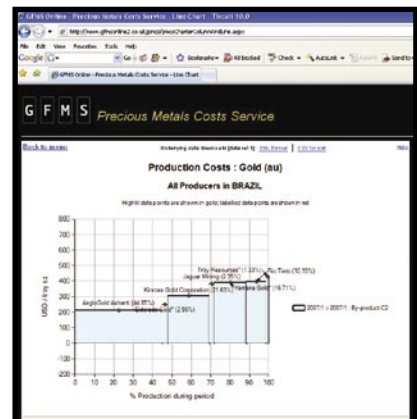
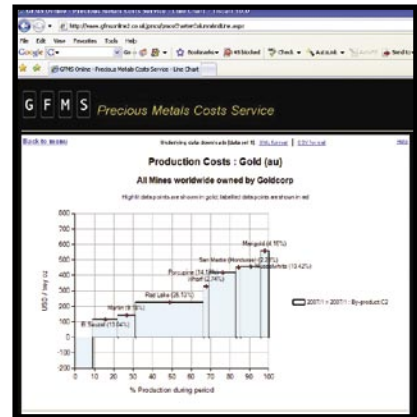
Cash costs can be charted as Cash Operating Costs, Total Cash Costs and Total Production Costs, respectively defined as C1, C2 and C3 costs. Users can download and save the data used to generate the charts.

### Generate League Tables

User friendly functionality makes the generation of league tables easy - both production and cash costs for the 20 largest producers can be created in a timely manner.

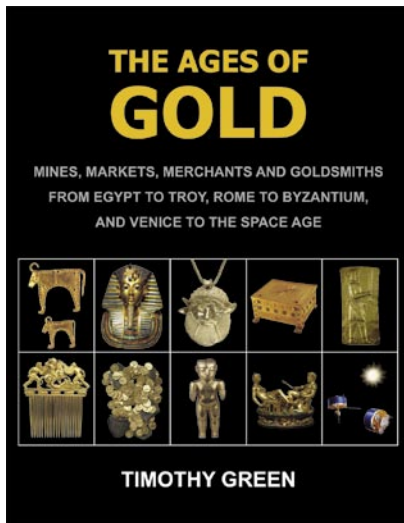
Primary product production league tables and consolidated company cash costs can be generated on a quarterly, half yearly, nine monthly and full year basis.

» **For further information, please contact Charles de Meester, [charles.demeester@gfms.co.uk](mailto:charles.demeester@gfms.co.uk)**





## Tim Green Captures 'The Ages of Gold' in a Book



GFMS will be publishing Tim Green's latest book *The Ages of Gold* on 14<sup>th</sup> November. This is the first book on the history of gold published by GFMS.

Tim Green is a well known author in the gold market having written *The World of Gold*, *The Gold Companion* and *The Millennium in Gold*. Tim also worked as a consultant on the annual *Gold Surveys* of Consolidated Gold Fields and Gold Fields Mineral Services (now GFMS) for almost three decades, focusing on the Middle East, India and the Far East.

### Synopsis

*The Ages of Gold* recounts the story of the mines, the markets, the goldsmiths and the merchants who, over the last 6,000 years, made gold a symbol of wealth and power, both in wonderful ornaments and

as money in people's pockets. Tim Green has sought out gold's ancient origins in Mesopotamia, Egypt, Troy, Minoan Crete, Greece, China, Rome, Byzantium, Venice and Precolumbian Latin America.

### Availability and Order Information

*The Ages of Gold* will be available to pre-order later this month through the GFMS online store. Discounts and company overprints are also available on bulk orders. Please contact GFMS at [info@gfms.co.uk](mailto:info@gfms.co.uk) for further details.

### *The Ages of Gold:*

Author: Timothy Green

ISBN 978-0-9555411-1-7

480 pages

Price £33 (+ postage)

Publication date: 14<sup>th</sup> November 2007

## GFMS Appoints New Staff

GFMS is happy to welcome the following people to our team.

**Matthew Piggott** joined GFMS in August 2007 and works with William Tankard in the area of worldwide mine production, having recently graduated from University College London with an MSc in Geology.

**Sierra Highcloud** holds a first degree in International Business from the Cracow University

of Economics, and an MSc in International Finance from the University of Westminster.

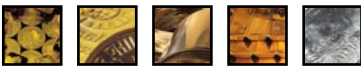
Sierra works within precious metals forecasting and also assists Peter Ryan in platinum/palladium demand. Prior to GFMS, Sierra worked in the investment management department of a corporate law firm in New York. He joined GFMS in August 2007.

**Shairaz Ahmed**, joined GFMS' sister company GFMS Metals Consulting in

October 2007 and assists Neil Buxton with the research and analysis of the steel and base metals markets.

Having recently graduated from Queen Mary & Westfield University of London, he holds a BSc degree in Economics and Geography. Prior to joining GFMS, he worked for Barclays Capital as an I.T. analyst.

**Jacky Foster** joined GFMS in October as the company's new accountant.



## EVENTS

### Launch of the GFMS *Platinum & Palladium Survey 2007* – Chinese Language Edition

» 23<sup>rd</sup> November, Shenzhen, China



*Last year's Launch*

GFMS, in association with the Beijing Gold Economic Development Center, are delighted to announce the launch of the 3<sup>rd</sup> Chinese language version of its annual *Platinum and Palladium Survey* in Shenzhen on 23<sup>rd</sup> November, 2007.

Presentations at the launch will focus on GFMS' latest views on platinum and palladium supply/demand developments and the likely future trajectory of PGM prices.

The 2007 Chinese language version is sponsored by Tanaka Kikinokoku Group, Norilsk Nickel, Palladium Alliance International and A-1 Specialized Services & Supplies, Inc.

The 2007 Chinese language version is supported by the Shanghai Gold Exchange and the Shenzhen Jewellery Association.

» **For further information on how to attend this event, please contact Veronica Han:**

**veronica.han@gfms.co.uk**  
**tel: +86 (0)10 65158811,**  
**fax: +86 (0)10 65227587**

#### GFMS DIARY



***Platinum & Palladium Survey 2007***  
***Chinese Language Edition***  
23<sup>rd</sup> November 2007

***Gold Survey 2007 - Update 2***  
January 2008



## GFMS Precious & Base Metals Seminar - The Highlights

### Precious Metals Session

The Precious Metals presentations of GFMS' Annual Precious and Base Metals Seminar in London on 13th September were given by a highly informed and engaging range of speakers.

**Philip Klapwijk** of **GFMS** gave a review of the state of the gold market, based on GFMS' *Update 1* of the 2007 *Gold Survey* (launched on the same day). Mr. Klapwijk particularly focused on the volume of producer de-hedging, which surged to an all time high in the first half as producers felt more confident within the higher price environment. In assessing the fundamentals, mine and scrap supply are forecast to decrease this year with fabrication demand set to remain fairly stable. However, a marked decline in producer de-hedging is expected along with moderate increases in official sector sales.

The presentation further highlighted the disappointment of investors in regards to the failure of gold prices to breach the \$700 mark in the first half, which led to net selling by 'Western' investors. The subprime crisis however, which saw an initial sell-off in gold, brought about a strong rally in the metal as investors sought a safe haven amidst the credit crunch. The continued subprime crisis, lowering of US interest rates and weakening dollar and are expected to boost investor demand in the second half.

A resultant slowdown in commodities could bear impact upon gold yet GFMS expect the metal to de-couple as its monetary values emerge as a key focus.

In his presentation, "The view from Istanbul: recent trends in domestic and export jewellery markets", **Cetin Binatli** of **Goldas**, covered a wide range of topics related to Turkish jewellery such as manufacturing, industrial enterprises, and global branding and franchising of Turkish products. The presentation also reviewed gold bar import volumes and Turkish demand, citing that the metal continues largely to be purchased not simply as a means of adornment but also savings. Mr. Binatli noted however that savings habits are changing as more Turkish people seek out alternative means of investing. The presentation concluded by noting that the Istanbul Gold Exchange has become a crucial factor in harmonizing gold with the financial system.

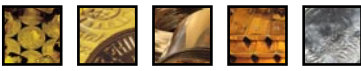
**Bill Hamelin** of **Ames Goldsmith**, in his presentation on, "The outlook for silver industrial demand", provided insight into the market areas of photography, catalysts, mirrors, batteries and electronics. Most notable have been the declines in consumer photographic and X-ray applications. Growth however remains strong in catalyst uses as well as silver-zinc cell batteries – which are experiencing increased demand due to military applications.

The presentation concluded that silver industrial demand is expected to remain robust in the future and – barring significant price fluctuations – should increase from present levels.

### **William Tankard** of **GFMS**

presented a discourse entitled "Margins and mining: an overview of cost pressures", where he gave a brief synopsis of the cost pressures facing modern mining companies and how GFMS collects and interprets this information. Moving on to address the rising gold price in recent times, William outlined the cash cost trends for the worlds historically high cost regions: namely Australia, Canada, South Africa and the United States and showed the relationships between rising gold prices and increasing cash costs, manifesting as a more moderate widening. Foreign exchange pressures, labour shortages, energy prices and the costs of mining consumables were all given as primary drivers of the global cash cost increase.

William noted that although cash costs have increased in the mining industry the rising gold price continues to give sustained leeway to gold producers worldwide, and with no respite in the near future, producers are having to address these problems themselves (for example commissioning new power plants) in order to preserve their currently reasonably stable margins. Several operations have already



succumbed to vanishing margins, such as Tabokoto in Mali, Tolukuma in Papua New Guinea and recently, the cessation of operations at the Indee mine in Western Australia.

Focusing on the jewellery market further **Neil Meader** of **GFMS** offered an exciting presentation - "High prices or other drivers - what explains the weakness of western jewellery consumption". Offering an analysis of recent changes in western world consumption, it can be seen that growth in the jewellery demand of the precious metals has either slowed, stopped or is continuing to decline (gold). With the recent price rises in precious metals correlating with lessening consumption, Neil proposed: "we must be brave to assume there is no link between price and consumption".

So what are these additional factors affecting consumption?  
Mr. Meader detailed rival competitors for consumer spending, such as technology, travel and other luxury goods; the difference in promotional spending between luxury goods and precious metal jewellery; the rise of non-precious jewellery materials such as rubber, steel and wood; the impact of branding and the change in spending habits - from investment in high-carat pieces to accessory based 'disposable' jewellery.

Concluding, Neil stated that price was an important short-term driver of jewellery consumption, but in the long-term we may see the same structural factors, which are driving changes in western precious jewellery consumption, in the Asian and Indian markets as they develop further.

### **Base Metals Session**

There were a wide variety of presentations in the afternoon base metal session at GFMS' 4<sup>th</sup> Precious & Base Metals Seminar.

**William Adams** from **Basemetals.com** focused on whether a supply response is finally starting to emerge in the copper market. A lack of investment earlier this decade together with a myriad of supply disruptions left the mining industry poorly placed to cope with strong demand, particularly from China. Initially this was met by rising secondary output, a reduction in metal and concentrate stocks and a slight rise in mine output. Now, however, the supply response is beginning to gather pace with 5% growth forecast for mine output in 2007 followed by 7.5% expansion in 2008. This is a considerable improvement compared to the average annual rate of growth of just 2% between 2001 and 2006. This should be enough to see the copper market return to surplus.

**David Wilson** of **Norilsk Nickel** also detailed the problems faced by producers in meeting strong demand. In every year since 2001, the production of refined nickel has been well below the projection made for production at the end of the previous year. In 2005 and 2006 the difference between forecast and actual output was 72,300 tonnes and 52,600 tonnes respectively, which is a massive difference in a market of just 1.4m tonnes. This production shortfall played a critical role in the bull market that sent prices briefly over \$50,000/tonne.

Looking further ahead, the market will be affected by substitution, while additional supply is coming from different sources than envisaged earlier in the decade, when it was assumed that the High Pressure Acid Leach (HPAL) process would generate the bulk of the extra production. However, the high capital costs and complex technology has seen huge delays in the next generation of HPAL projects. Filling the void has been the growth of low-grade nickel pig iron in China and a new generation of sulphide deposits such as Talvivaara, Tati, Nkomati and Honeymoon Well.

On the demand side, Norilsk noted the mounting substitution pressures as stainless mills try to raise their output of ferritic grades, which contain no nickel. The austenitic ratio has fallen from 76% in 1999 to 72% in 2007.

**James King** focused on the changing nature of the Chinese aluminium industry and its impact on primary aluminium. He concluded that China remains competitive for investment in smelting from integrated production, or by buying alumina. However buying bauxite for integrated alumina production, or buying metal for rolling or extrusion are less attractive.

Production costs up to smelting are competitive with elsewhere in the world. The main competitive edge lies in low capital and labour costs. Chinese production costs for rolling



and extrusion are low. This will offset high transport costs and will allow China to compete in "Western" markets for semi-fabricated products.

#### **Michael Widmer of Calyon**

analysed the prospects for the lead and zinc markets. The lead market is tight with reported stocks at record lows and premia well above long-term averages. The concentrate market is in substantial deficit that is reflected in low treatment charges (TCs). There has been a bounce in TCs, but this reflects an unwillingness of Chinese smelters to accept the existing terms rather than any major turnaround in the fundamentals of the concentrate market.

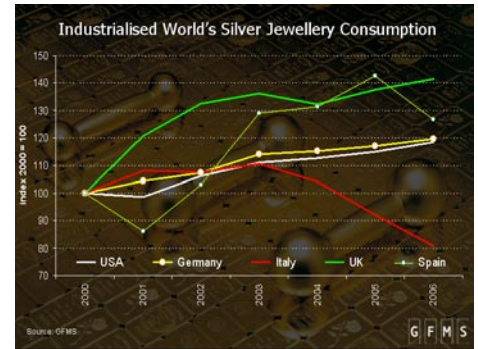
The other key driver of the market has been a significant reduction in Chinese exports of refined lead. This

reflects a slowdown in the rate of production growth, the imposition of a 10% export tax by the government and robust demand growth. All these features are likely to remain in place for sometime.

The situation in the zinc market is different. Given the substantial increases in zinc prices, miners have started to invest in new capacity and extra supply is starting to come through. As a result, large surpluses are expected in 2008 and 2009.

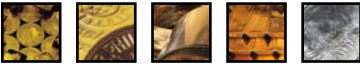
**Chris Welch of BME** analysed the changing stock to price relationships for base metals. He concluded that prices might stay above the production cost structure for much longer than most people expect.

It might take enormous stock increases to take prices all the way back to say 10% above the 9th decile of costs – in copper this might require LME stocks of 1.5m tonnes. This is because long-only investments in metals futures appear to have shifted the entire price to stock curve. Thus, medium-term price prospects and asset valuations may be being substantially underestimated.



» **Neil Meader's presentation on "High prices or other drivers – what explains the weakness of western jewellery consumption" can be downloaded by clicking on the image above.**

**The next GFMS Precious & Base Metals Seminar will take place in September 2008.**



## CHINA MINING 2007



*Last year's CHINA MINING  
Conference*

GFMS is pleased to inform you that the ninth annual **CHINA MINING Conference**, hosted by the ministry of mining and land resources will take place from November 13<sup>th</sup>-15<sup>th</sup> at the Beijing International Convention Centre, China.

Representatives, from both Chinese and foreign industries will gather to discuss the latest industry news and establish new business cooperation.

### **About the Conference**

CHINA MINING is Asia's Premier Mining Conference and Exhibition, featuring prevalent mining industry topics such as: mining policy, mineral markets, investment and risk management, sustainable development and environment, resource processing, as well as utilisation and transportation.

This year the conference will be in 3 main parts:

- Conference
- Exhibition
- Featured Events

GFMS will be represented at the conference by our Beijing based analyst, Veronica Han.

» **For further information please visit [www.china-mining.com](http://www.china-mining.com)**



# MARKET COMMENTARY

## Inflation on the Horizon?

» by Rhona O'Connell, Managing Director, GFMS Analytics

**This article is an extract from the October issue of GFMS Analytics' *Precious Metals Market Briefing*. To subscribe to this publication or to receive a free trial copy, please contact GFMS Analytics, [info@gfmsanalytics.com](mailto:info@gfmsanalytics.com)**

The recent 50 basis point cut in the Fed Funds target rate in the United States not only boosted the interest-rate sensitive sectors of the equity markets along with gold prices, but also raised fears in some quarters of inflation on the horizon. Dr. Alan Greenspan noted recently that the disinflation impact of the growing market share commanded by emerging nations, notably in Asia, has now more or less worked its way through the system. This may now suggest that underlying price pressures will start to move up, although the state of the housing market in the United States and the persistent weakness in the US auto sector may mean that inflation is not imminent in the United States. The fall in the 30-year bond price in the wake of the rate cut reflects the market's intuition that the government would prefer to inflate its way out of credit problems rather than allowing default.

Dr. Greenspan, in an interview on the UK's BBC radio in late September, stated that hedge funds

are "presumably the largest culprit" in the credit markets' problems, and that the US authorities refused to bail out operators with problems because they had been trading on their own accounts. He added that he had little concern for hedge fund operators whose net worth had fallen from very high levels merely to high levels. While Dr. Greenspan believes that the problems in the housing market have undermined economic performance, he still rates the probability of a US recession as less than 50:50.

In the short term the performance of the housing market continues to disappoint, with existing US sales at a five-year low in August, down by 12.8% against August 2006, inventories of unsold homes up by 0.4% to a ten-month rate of supply, and there was a hefty fall in new home sales, which dropped by 8.3% to a seven-year low. Median house prices in the United States were 7.5% lower than in August 2006, the largest fall in 37 years.

With the associated fall in US consumer confidence, which stood in September at less than 100 and which was at its lowest since November 2005, it would appear that for the time being at least, inflation is not too strong a threat to the US economy. This is further

underpinned by recent hawkish comments from Fed officials; the President of the Philadelphia Federal Reserve, for example, said at the end of September that the Fed has not changed its policy and that sins of inflation would precipitate an adjustment in interest rates, noting that the recent rate cut does run the risk of higher inflation. This gave the dollar a short-lived respite, although the medium term outlook remains bearish.

Fed watchers took the view that the rate cut and the associated statement were an astute mixture of hawkishness and dovishness - but also that the Fed is becoming more difficult to assess as it is harder to read the likely outcome of the Committee meeting than it used to be under the stewardship of Dr. Greenspan. It was noted that only seven of the twelve district banks requested a 50-point rate cut, which is more hawkish than the cut itself might suggest. The Fed's statement in the wake of the interest rate cut on 18th September continued its vigilant stance with respect to inflation, in that it included the observation that "readings on core inflation have improved modestly this year. However the Committee judges that some inflation risks remain. and it will continue to monitor inflation



developments carefully". The statement says that the Committee will continue to assess the effects of the developments in financial markets and that the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more regularly.

There is evidence at the start of October that the credit markets are settling, with investors prepared at in the last week of September to put up funds of the order of \$5 billion for merger and acquisition activity, and there were also reports that leading US investment banks were affirming that the investment banking pipeline was stronger than hitherto. Private equity is also expected to return to the markets, although not necessarily immediately. It has been estimated by the director of Merger

and Acquisition market analysis at Robert W. Baird and Co that there are "\$200 billion on the sidelines" looking for investment opportunities.

The results from the major banks and profit warnings from UBS and Credit Suisse in the wake of the credit market problems actually boosted the equity prices in the banking sector at the start of October, on the basis that the bad news was now all in the price and that the banks would be able to weather the storm, although there is clearly going to be some attrition in the workforce in the sector. The markets can expect a revival in deal flow, although to a lesser level than previously and the overall market recovery may take longer than expected.



**Rhona O'Connell**

*is a recognised authority in the metals markets, with over 20 years' experience as an analyst in the metals*

*sector. Rhona is the managing director of GFMS Analytics and ROC Consultancy, an independent consultancy specialising in metals markets analysis and comment. The specialist areas constitute gold, silver, platinum and palladium, looking at the markets themselves in the context of the economic, political and financial environments while considering also the performance of other asset classes and related mining equities.*



## Pakistan Fails to Keep up with Neighbour

» by Cameron Alexander, Senior Analyst, GFMS



After a brief hiatus, GFMS analyst Cam Alexander recently returned to Pakistan to uncover the drivers of this unique jewellery market and to better understand the reasons for the lack of fabrication and investment demand in the country this year.

Neighbouring India has experienced phenomenal growth in 2007, with jewellery fabrication increasing by 77% in the first six months of the year. However in contrast, Pakistan's local fabrication industry has failed even to match the disappointing volumes of 2006, and has not rebounded this year as the majority of global markets have done. So, why the slow down?

While higher gold prices have played a significant role in the downturn in local demand, traders reported to GFMS that there were also other contributing factors for the decline in offtake. Firstly, the introduction of

additional taxes on the importation of gold in July 2006 has driven both bullion and jewellery imports underground, with official trade almost non-existent as a result of the additional tariffs. The added cost of importing bullion has left fabricators searching for a secondary supply of gold, with most turning to scrap or "Tezabi gold" to meet production requirements. This material, typically of 990 purity emanates from the agricultural regions of Punjab, and is often obtained at a significant discount to the international gold price.

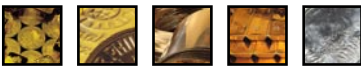
Secondly, and perhaps the largest single catalyst for the fall in fabrication demand has been the shift to imported jewellery, with several local traders indicating that imports now account for a far greater proportion of their inventory, with jewellery from East Asia (mainly Singapore and Malaysia) finding its way to the local market via the entrepôt of Dubai. Industry members believe that this substantial increase in unofficial imports (this jewellery is hand carried into the country and not declared) will have a detrimental affect on the thousands of small family run operations across the country who will struggle to compete with the finishing quality of the imported jewellery.

Finally, while jewellery demand among Pakistan's growing middle classes continues to strengthen,

offtake at the lower end of the market is suffering. Political uncertainty remains a key reason for the lack of activity at the retail level and with elections planned for later in 2007, all eyes will be on the local industry to see if it can bounce back, but with gold prices expected to move higher in 2008 consumers may have missed the opportunity.



*Cameron Alexander is an Australian based Analyst with GFMS and is responsible for research in South-east Asia, Australasia and the Gulf States in the Middle East. Prior to his joining GFMS in December 2005, Cameron worked for over seven years with precious metals refiner AGR Matthey.*



## Base Metals: One Year on and Nothing Has Changed...

» *By Neil Buxton, Managing Director, GFMS Metals Consulting*

At the time of the 2006 London Metals Exchange (LME) Dinner, we questioned whether LME Week would prove to be a key turning point as had been the case in October 2000 and 2002. We noted that:

- 1) Most aspects of the fundamentals remain favourable.
- 2) Underlying demand growth is firm after earlier destocking.
- 3) Robust activity in the semis sector is filtering through to improved demand for base metals.
- 4) The destocking process is a finite process and we expect stronger demand conditions in China in 2007 than 2006.
- 5) Tightness at the raw material stage remains a key driver of the bull market.

### Base metals ride-out the sub-prime crisis

Many, if not all, of these comments remain valid. Since the sub-prime crisis emerged, we have taken the view that the crisis would remain a fairly localised affair in terms of region (mainly the US with some knock-on effects in the Euro-zone) and in terms of industry – non-residential construction with some spill over to the auto sector. This remains our view, and prices have been quick to recover. The GFMS Metals Consulting index on October 12 stood at 387.55 compared to the recent low of 320.67 on August 17 and 290.03 a year earlier.

### Demand

Given the underlying health of many sectors of the economy within the OECD countries and the on-going rapid expansion in the BRICs (and other countries such as Vietnam and the Middle East), GFMS Metals Consulting believes the economic environment will remain benign for the base metals sector.

For the remainder of the year, we expect a repeat of what was seen in the first half i.e. weak US and Japanese demand, robust conditions in Europe, against a background of strong metals-intensive growth in China and India. In 2008, desynchronisation should remain in place with some recovery for example in the US and Japan, offsetting slower demand growth in the Euro-zone, taking place once again against a background of strong growth in the emerging markets.

### Supply

The supply situation continues to be characterised in most cases by structural shortages and temporary disruptions due to a combination of strikes and technical problems. Copper, lead and tin still have tight supply positions and this should continue to provide some support to prices. For nickel, the bulk of the growth remains focused on nickel pig-iron output in China, which the authorities are trying to curb. The two markets where supply is being boosted are zinc and aluminium.

### Funds and prices

We doubt whether the “funds” interest in the sector is over. The sub-prime crisis triggered some liquidation for technical reasons and encouraged some selling on fears that the crisis could lead to a sharp slowdown in economic growth. However, investment activity was quick to return given the still positive fundamentals. In some respects our views on the fundamentals and prices are largely unchanged from this time last year. Most aspects of the base metal fundamentals remain positive, although we are looking for lower average prices in 2008 compared to 2007. Nevertheless, we do not expect any major sector-wide correction to emerge next year.

» **In order to receive our detailed analysis on the individual base metals together with our supply-demand balance and price forecasts out to 2009, please contact: [info@gfms-metalsconsulting.com](mailto:info@gfms-metalsconsulting.com)**



## Steel: One eye on 2008

» *By Neil Buxton, Managing Director, GFMS Metals Consulting*

As we enter the final quarter of 2007, the build-up of analysis of 2008 pricing is gathering pace. The final quarter of the year is one when mills and suppliers begin to sit down and discuss the pricing for next year contracts. For mature markets and larger integrated mills, those contracts account for well over half of sales and are a major driver of profitability. The IISI meeting has set the high-level tone for much of the expectations for next year.

For our part, we will examine the outlook for 2008. We note the fact that current US spot prices are below this year's contract prices. Mills will therefore, have every incentive to try and push prices higher in Q4 to go into the negotiations with rising expectations, in order to avoid buyers moving to the spot market, and hoping to get at least some increase for next year's contracts.

European mills should have more luck despite the strong currency. Spot prices were much flatter over the year as a whole. With less price volatility, the mills should be able to point to rising input prices as a realistic reason for a contract hike, although we do note that the strength of the euro has reduced the proportionate increase in 2007 input prices that are largely quoted and sold in dollars, thus allowing an improvement in mill margins for continental mills.

For Q4, we continue to expect some weakening in Chinese export prices that will have a knock-on impact

on Asian and emerging market suppliers, although Indian and Middle Eastern markets could give buying support to alleviate CIS suppliers. US prices should gain incrementally, while European prices will be largely unchanged.

Annual contract negotiations are underway. With over 50% of the US market on contract pricing, mills during the final quarter of the year tend to pay close attention to the spot versus contract price. On the margin, end-use customers (including some service centres) may choose spot market pricing in 2008 over contract depending on the final price.

Current HR contract pricing is around \$560-580/ton ex-mill. This is above the current spot market price. The spot price over January-September 2007 has averaged \$533/ton based on our pricing analysis. Therefore, some buyers would have benefited by taking a higher proportion of spot over the year as a whole, and this could influence purchasing decisions in 2008.

In the short term, mills will want to raise prices in the final quarter in order to bring spot prices up into line with contract prices. This would entail a further price increase of at least \$30/ton. Going into 2008, mills will point to rising raw material prices (iron ore and coal) as another reason for higher prices. However, it will be difficult for mills to get higher contract prices if spot remains below 2007 contract prices. This certainly leads us to believe that mills will

try for a further price increase in the next few weeks. Nevertheless, we are more sceptical than some observers about the ability of the mills to get all the increase they are seeking.

We do believe that there is the potential for incremental price gains before the end of the year, as imports remain low and inventories are low. Yet domestic mills are running at higher levels – the utilisation rate moved over 90% in early October – the first time this has been reached for more than a year. Automotive and appliance demand is down year-on-year, while service centres continue to report deliveries down 10% year-on-year. The most likely scenario therefore is that mills will announce a \$30-40/tonne hike in the next few weeks (probably for January shipments) and that spot prices could head up by \$10-20/ton over October and November as some buyers look to secure material in advance of that.

GFMS Metals Consulting has recently launched a Five Year Forecasting Service. Please contact us for further details.

» **In order to receive our detailed analysis on the steel flat product markets contact: [info@gfms-metalsconsulting.com](mailto:info@gfms-metalsconsulting.com).**

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