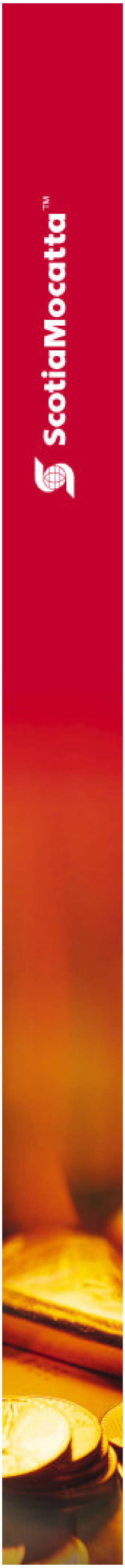

JULY 2006

ScotiaMocatta Metal Matters

Precious metals overshot on the downside, with Gold, Silver and Platinum falling 25%, 37% and 18% respectively

- The weakness came on the back of a move across the market to reduce risk
- The sell-off, however, played into the hands of longer term investors who bought into the weakness
- Physical demand from the jewellery sector has been slow to return
- The outlook for Gold is still bullish, especially as central banks and long term investors show ongoing interest

Silver has unwound its overbought condition and has built a base above $10/oz

- The physical market in India has suffered heavily and may take time to recover, although ETF demand remains strong
- **PGMs suffered liquidation selling to varying degrees, but all have run into good underlying support**
- Strong industrial demand for Platinum and Rhodium should underpin prices and Palladium is likely to follow suit

Gold unwinds its earlier overbought condition by falling $185/oz in 22 days

In last month's report we were looking for a lower base from which Gold could head higher again. This was established on 13th and 14th June, when prices cascaded down through $600/oz to set an overnight low in Asia at $543.50/oz. The subsequent bounce and then apparent support around $560/oz produced a good floor for the market to work with. Indeed the correction from May's highs at $727.75/oz to $543.50/oz represents a 25% pull-back, which in technical analysis terms is a fairly average correction. However, this may just indicate how strong the underlying case for Gold is. By month-end Gold was back above $600/oz and climbing rapidly.

Risk reduction triggered the sell-off

The sell-off that pushed Gold lower was part of a broad base sell-off across the majority of asset classes. It was triggered by heightened concerns that inflation was picking up and that in response central banks would raise interest rates, which in turn would slow world growth. The correction hit the emerging markets the hardest, but the commodities suffered heavily too as they had undergone such rapid gains since March. Given the fact that the sell-off was on the back of risk aversion and inflation concerns it is surprising that Gold fell as much as it did. Indeed it looks as though Gold suffered profit-taking as commodity index funds sold across the board. In addition as US funds liquidated overseas assets they then repatriated their profits, which meant buying the dollar. As a result the dollar rallied which added to the downward pressure on Gold. So although Gold corrected its overbought condition, the reasons behind the pull-back were not that fundamental to Gold. As such, the underlying case for being bullish for the metal remains relatively intact.

Mid super-cycle slowdown

For the moment the global financial markets seem to have come to terms with the threat of higher interest rates, inflation and slower economic growth, as seen by the rebound in the markets towards the end of June. However, this may be just a bounce within an emerging down trend. High interest rates, high debt and a slowing housing market in the US and attempts by China to cool economic growth may well lead to an economic slowdown. Indeed some prominent economists fear that the measures being taken to slow growth may tip the US economy into recession in 2007. If this does start to unfold, then equities, industrial commodities and the dollar may weaken significantly and Gold may well pick-up extra investment demand as investors seek-out alternative non-dollar cash investments. Gold could easily benefit under such conditions, especially as it also offers some insurance against any escalation in geopolitical risk that seems to be deteriorating again: Iraq, Afghanistan, Israel and Palestine, Iran and North Korea.

Funds liquidate Investors accumulate

When Gold prices peaked in May the amount of Gold held in the ETFs collectively was 491 tonnes, this fell to 478 tonnes in late May, but had already started to recover by the end of May. The deeper sell-off in Gold prices in June however attracted scale down buying as opposed to liquidation selling. By the end of June the volume held in the Gold ETFs had risen to 511 tonnes. This is in marked contrast to the behaviour of the funds as shown by CFTC data. In mid-May, when prices peaked, the fund Gold position hit a net long of 133,936 contracts, on 13th June, when prices were on their knees, this had fallen to net long 99,287 contracts and by 27th June it had fallen further to net long 85,624 contracts. So whereas long term investors have been buying into the price weakness and into the rebound, the more speculative hot money has been reducing its long exposure. This suggests that long term investors have not been put-off by the recent dip, which is an encouraging sign. All along it has been felt that Gold needed a broader base of long term investors if the rally was to last and this now seems to be the case.

More Central Banks also want in

In addition to the build up in ETF positions, it looks as though more central banks are also getting interested in diversifying into bullion. The latest to emerge was the UAE that has said it would like to hold 10% of its foreign reserves in Gold, although it did say it would switch into Gold gradually. If the UAE makes such a move, then other Middle East oil exporters may follow suit. The UAE now joins China, Japan, Russia and Argentina, all of whom have made similar noises about upping their Gold holding.

More room for pension funds as well

Although institutional money has been attracted to the Gold ETFs, a recent report suggested that the major investment funds would probably wait until the ETFs got big enough to handle their business in terms of track record and liquidity. This may not happen until the some 3,000 tonnes of Gold is held by ETFs. This is an interesting argument, but it also seems a bullish reason to buy into Gold sooner rather than later. If a further 2,500 tonnes of Gold is taken up by the ETFs, then prices are likely to be considerably higher than they are now and then the market would have the big investment funds' buying to look forward to. Given that the ETF's are just a vehicle backed by Gold it may well be that some of the big institutional money seeps into the market early.

Physical market battered and has missed the best buying opportunity

The sell-off was expected to see pent-up demand unleashed into the market, but the volatility over recent months has added considerable confusion. As a result, many operators simple missed the buying opportunity. A matter made worst in Asia as the emerging markets were also suffering the brunt of the correction. Overall fabricators and consumers alike remain cash-struck and are looking for higher prices to reduce their out-of-the-money positions. However the start of the wedding season in the south of India, followed by the religious festivals later in August should see demand kick-in again. In some regions, notably India and Asia the high prices of late have led some jewellery manufacturers to promote lighter jewellery to help alleviate the impact of higher Gold prices.

Technical

Gold reversed all the steep gains from March to May and now seems set to build a base above the higher of the two horizontal lines around $580/oz. Although after a period of consolidation it would not be surprising to see prices move up above the 70 day moving average which has tended to underpin the rally since July 2005.

Summary

Gold was in need of a correction and the 25% dip it saw unwound the overbought condition. Overall the bullish arguments for Gold have not changed, but have become more compelling. As access to the market has improved so has the catchment area of potential investors. In addition, central banks seem to be showing more interest in adding Gold to their reserves. With ongoing uncertainty over global growth and the drain of liquidity, the financial markets and the dollar may be in for further turbulence. Add to that the threat of geopolitical unrest and you are left with a situation that could damage the financial markets. As such Gold could act as a useful insurance. Expect Gold to be well supported into dips, but $650/oz may cap the market over the summer.

Gold Statistics	2002	2003	2004	2005	1Q 2006	2Q 2006	May-06	Jun-06
London Prices (US$/oz)								
AM fix	310.44	363.83	409.33	444.87	559.39	628.84	676.77	597.90
Pm fix	310.21	363.32	409.21	444.88	553.98	627.40	675.39	596.15
Average	310.32	363.59	409.30	444.87	556.69	628.12	676.08	597.03
Parity prices								
Australian - A$/oz	570	558	555	583	753	838	885	794
South Africa Rand/kg	101,068	85,445	81,868	87,876	106,431	124,001	132,395	123,832
Japan Y/g	1,203	1,305	1,371	1,519	2,018	2217	2,344	2,081
India Rupee/oz	15,106	16,954	18,556	19,642	24,718	28,573	30,646	27,612
Lease Rates								
1 Month *	0.27	0.08	0.08	0.10	0.10	0.10	0.10	0.07
3 Month *	0.39	0.13	0.11	0.11	0.12	0.10	0.12	0.07
6 Month *	0.54	0.23	0.15	0.14	0.14	0.11	0.13	0.1
12 Month *	0.89	0.40	0.25	0.19	0.17	0.12	0.14	0.1
COMEX - futures contracts								
Stocks ('000oz)	1,692	2,643	4547	6178	7453	7715	7,780	8,031
Vol (million contracts)	9.02	12.24	16.46	11.65	3.83	3.40	1.6	0.8
OI ('000 contracts)	163	229	272	302	336	303	287	293
CFTC (futures only data)								
Net Spec position Long (Short)	31,940	70,888	78,084	109,798	127,383	105496	101,487	85,624
TOCOM								
Stocks ('000oz)	242	234	207	193	262	324	370	289
Volume ('000 contracts)	20,506	26,637	17,385	17,958	3,366	4,574	2,488	2,509
OI ('000 contracts)	384	413	333	315	324	333	354	315
Other Indicators								
FT Au Mines Index	1,142	1,395	1,617	1,696	2,386	2,508	2,430	2,449
Dow Jones Index	9,190	9,035	10,326	10,528	10,929	11,228	11,168	11,150
US$ Index	111	95	87	88	90	85	84	85
Gold Bullion Imports, tonnes (exports)								
Dubai	156	195	502	522				
Hong Kong /China	(200)	(200)	(100)	(20)				
India	496	647	649	808				
Italy	260	260	260	225				
Japan	68	74	74	73				
Singapore	84	72	72	26 Q3				
South Korea	200	122	254	40				
Taiwan	9	12	12	22				
Turkey	226	264	251	281				

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, *italics* = estimates Q3 = up to Q3'05

The 37% fall in Silver prices attracted even more scale down investor buying

Since the market started to anticipate the launch of the Silver ETF in late 2005, the Silver price has been nothing but volatile. But now that prices have unwound much of the excessiveness seen in the run-up to the launch, Silver looks in a good position to benefit from the liquidity that the ETF should bring with it. After averaging $13.45/oz in May, Silver prices averaged $10.80/oz in June, a drop of some 20%.

Silver becomes an easier investment

There is little doubt that for the Silver market, 2006 has been wrapped up with the launch of the ETF and this has affected all aspects of the market. Ahead of the launch traders bought Silver knowing the ETF would have to buy the metal after the launch. Likewise with the ETF needing to take delivery of Silver, the pool of available metal was going to be partially drained as the fund needed allocated metal. This meant less availability for those traditional users who borrowed metal as part of their manufacturing process. And as a result lease rates shot up. Finally the high Silver price led to de-stocking, which saw the physical premiums drop, which in turn saw producers hold on to metal. However, the price correction has now given the market the opportunity to iron out these distortions and the market should be in a good position to get back to more normal trading.

The fundamentals are under pressure

The high prices in Q2'06 will have hurt jewellery and silverware demand. Indeed demand in India is described as being dead, but many other industrial applications are price inelastic enough not to be overly affected. In addition, the demise of film base photography is undermining demand and Kodak's announcement of a further two plant closures in Europe shows just how much the sector is suffering. As such, the pick-up in investment interest has been well timed.

Investors to the rescue

Indeed it looks like the investment side of the Silver market will become an increasingly important feature and may end up enabling Silver to sustain higher levels. Just as institutional investors are accumulating Gold the performance of the Silver ETF has been equally robust. When the market peaked on May 11 the Silver ETF held 2,021 tonnes, this initially rose during the early stages of the correction to 2,270 tonnes, but then slipped to 2,083 tonnes as the sell-off gain momentum. It has since climbed to 2,580 tonnes. As such the sell-off has generally been seen as another buying opportunity. Going forward, just as Gold is likely to attract greater investment interest from funds and possibly even central banks, Silver is expected to do the same.

Technical & Summary

Silver has undergone a decent correction, but prices have avoided doing too much damage to the chart, with prices holding above the February lows. Expect prices to trade in the $10.50/oz to $12.00/oz range, but to remain capped by supply above $12.00/oz for a while.

Summary – Overall now that Silver has corrected it's over bought condition and the physical market has had time to adjust to the impact of the ETF, we expect the rally to resume. Broad based investor interest should now prevail and although Silver may suffer with any economic slowdown that impacts the industrial metals, we feel the launch of the ETF has made Silver more of a precious metal in terms of giving greater access to the metal's safe-haven attributes. As such it has potential to attract good levels of investor interest.

Silver Statistics	2002	2003	2004	2005	1Q 2006	2Q 2006	May-06	Jun-06
London Prices (US$/oz)								
Daily Fix	4.60	4.88	6.65	7.31	9.69	12.29	13.45	10.80
Parity (London) prices								
Japan (Y/g)	18	17	22.27	24.97	35.13	43.40	46.64	37.64
India (Rupee/oz)	224	227	301.35	322.83	430.12	558.56	609.68	499.50
COMEX – futures contracts								
Stocks (Moz)*	105.8	111.0	114.5	109.64	125.90	111.50	108.2	102.7
Vol (million contracts)	3.0	4.1	4.9	5.5	1.20	1.32	0.37	0.38
OI ('000 contracts)*	79.5	94.7	103.4	117.9	132.0	110.4	109.7	109.0
CFTC (Futures Only Data) non-commercial								
Net Positions *	27,624	33,414	42,831	39,986	54,681	27,422	26,372	19,840
TOCOM								
Stocks (Moz)*	1.1	0.7	0.53	0.63	0.32	0.32	0.47	0.26
Futures Vol ('000 contracts)	931	1,160	1,473	818	245	269.50	86.5	
Futures OI ('000 contracts)*	20.0	21.3	24.07	17.84	19.20	20.73	20.7	16.6
Other Indicators								
Gold/Silver ratio*	67.7	74.1	61.06	60.60	55.14	52.08	52.5	55.0
Silver Bullion Imports (tonnes)								
USA	4004	3998	4095	4545				
UK	2562	2141	1523	1250				
Japan	794	1156	1591	1141				
India	3400	3100	2000	3400				
Italy	1497	1526	1638	1458				
Hong Kong **	1400	(2500)	1748	2576				
China (exports)		(2500)	(3500)	(3558)				

* figures are period averages unless marked; ~ not available, *italics* = estimate.

** For 2003 data is for Hong Kong and China combined (exports); [Q3] = up to Q3'05

The correction in the PGM's provided just another buying opportunity

After seeing prices accelerate from March to May, the PGM's underwent a correction in June. This saw Platinum fall 18% to $1,098/oz, Palladium drop 35% to $263/oz and Rhodium fall 32% to $4,090/oz. The sell-off in the metals however was short-lived and prices were racing higher again by the end of June. Needless to say given Platinum's superior fundamentals its sell-off was less severe than the other PGM's and its rebound has been more aggressive. All the metals, however, seem to have put the sell-off behind them and are heading higher again.

Risk aversion not surprisingly hits the riskier metals the most

The correction in the PGM seems to have been more panic driven by speculators reducing risk rather than due to any change in the fundamentals. Fears of inflation and higher interest rates changed the mindset in the investment arena and the more risky an asset was the harder it was hit, hence Palladium and Rhodium suffered the most, although for different reasons. Palladium is a high risk asset because there is no current shortage of the metal and Rhodium is a high risk because its market is so illiquid.

The strength of the rebounds, however, suggest ongoing strength

The underlying strength of the metals can be gauged by how they have recovered. Even Palladium which is set to see another year of supply surplus has still seen good fund and bank buying into the rebound, which says a lot for how the metal is viewed in the long term. While the demand profiles for Platinum and Rhodium remain robust due to the ongoing situation where demand for auto catalysts continues to benefit from tighter emission standards and geographical growth. In addition, Platinum and Rhodium are finding strong demand from manufacturers of LCD TVs and screens. Given strong fundamentals the sell-off also provided a good investment buying opportunity, that investors took.

Demand outlook remains strong, but..

The demand outlook for the PGM's looks strong for the moment. However even though the market has down-played immediate concerns over slower economic growth, there is a good chance that a slowdown is around the corner. As such at some stage it would not be surprising to see further corrections in the PGMs, especially those with less investment appeal. So we would be wary of chasing the markets too high.

Technical - Both charts show how prices corrected their overbought conditions, but the 70 day moving average in both charts shows the relative strength of Platinum. Indeed Platinum looks as though it can more easily continue its up trend, whereas Palladium may have more work to do to regain the upside initiative. This fits in nicely with the fundamental view of each metal. Overall it is easier to apply the phase 'stronger for longer' to Platinum than it is to Palladium

Summary – While good economic growth remains in place the PGM's are likely to be well supported which should see prices recover further. However, when the outlook for growth starts to slow, demand for the PGMs is likely to suffer and Palladium is likely to be hit the most. Whereas Platinum is likely to be cushioned by jewellery demand at lower numbers.

PGM Statistics	2002	2003	2004	2005	1Q 2006	2Q 2006	May-06	Jun-06
London Prices (US$/oz)								
Platinum	541	698	849	897	1,040	1,186	1,262	1,192
Palladium	341	205	233	200	293	348	372	318
Rhodium	841	531	980	2,039	3,492	4,975	5,543	4,926
Japanese Parity Prices (Y/g)								
Platinum	2,095	2,501	2,845	3,060	3,769	4,182	4,376	4,153
Palladium	1,325	736	781	684	1,063	1,230	1,290	1,110
South African Parity Prices (Rand/kg)								
Platinum	175,810	164,523	169,994	177,105	198,753	234,425	247,134	247,162
NYMEX Stocks ('000oz)								
Platinum	15.8	13.9	16	22	23	23	23	23
Palladium	10.8	102.9	647	710	1,132	1,141	1,158	1,112
CFTC Futures Only Data Long / (short) non-commercial								
Platinum	2,454	4,048	2,422	5,931	4,307	4,057	2,867	4,845
Palladium	(137)	1,529	4,115	5,271	6,608	5,428	7,357	1,368
Tocom - Platinum								
Stocks ('000oz)	8.7	16.9	15.5	16	16	14	15.9	11.4
Vol (Million contracts)	14.4	14.2	13.9	8.6	1.8	2	1.1	0.9
OI ('000 contracts)	218.8	220.4	183.6	137	126	111	106.0	100.0
Tocom - Palladium								
Stocks ('000oz)	1.9	1.6	5.8	23	28	26	28	24
Vol ('000 contracts)	88	275	439	323	88	119	34	29
OI ('000 contracts)	117	3	11.1	18	21	16	16.8	13.6
Other Indicators (US$/oz)								
Pt-Au spread	208	234	337	457	477	579	615	611
Pt-Pd spread	45	214	496	701	722	869	896	909
Platinum Bullion imports (kg)								
USA	160,000	111,000	48,100	28,800 [Q3]				
Japan	43,750	50,000	57,000	39,200 [Q3]				
PalladiumBullion imports (kg)								
USA	117,000	83,000	50,900	39,700 [Q3]				
Japan	41,250	41,093	48,300	51,300 [Q3]				

[Q3] = up to Q3'05

SCOTIAMOCATTA is a global leader in metals trading, brokerage and finance. As part of Scotia Capital and a member of the Scotiabank Group, clients can access a full range of financial products and services.

To obtain additional information on ScotiaMocatta products and services, call one of the offices listed below.

CANADA
Toronto
Scotia Plaza
40 King Street West
Box 4085, Station 'A'
Scotia Plaza
Toronto, Ontario
M5W 2X6

Andy Montano
andy_montano@scotiacapital.com
Tel: 1-416-866-7835
Fax: 1-416-866-6897

UNITED KINGDOM
London
Scotia House
33 Finsbury Square
London
EC2A 1BB

David Wilkinson
david_wilkinson@scotiacapital.com
Tel: 44-20-7826-5930
Fax: 44-20-7826-5948

UNITED STATES
New York
One Liberty Plaza
165 Broadway
New York, N.Y. 10006

Tim Dinneny
tim_dinneny@scotiacapital.com
Tel: 1-212-225-6200
Fax: 1-212-225-6248

INDIA
Mumbai
11-13 Maker Chambers VI
1st Floor
220 Nariman Point
Mumbai 400021

Rajan Venkatesh
rajan_venkatesh@scotiacapital.com
Tel: 91-22-2288-0994 (Direct)
Fax: 91-22-2288-1078

New Delhi
Upper Ground Floor
Dr. Gopal Das Bhavan
28 Barakhamba Road
New Delhi 110001

Prem Nath
Prem.nath@scotiabank.com
Tel: 91-11-5535-2420
Fax: 91-11-2335-9342

Bangalore
25/2 S.N. Towers
M.G. Road
Bangalore 560001

Mahendran Krishnamurthy
mahendran.Krishnamurthy@scotiabank.com
Tel: 91-80-2532-5325
Fax: 91-80-2558-1435

Coimbatore
Classic Towers
1547 Trichy Road
Coimbatore 641018

Shankara Subramanian
shankara.subramanian@scotiabank.com
Tel: 91-422-2301-595
Fax: 91-422-2301-596

HONG KONG SAR
25th Floor, United Centre
95 Queensway
Hong Kong

Alastair McIntyre
alastair_mcintyre@scotiacapital.com
Tel: 852-2861-4788
Fax: 852-2573-7869

SINGAPORE
#15-01, Ocean Building
10 Collyer Quay
Singapore, 049315

Swee Kiang Teo
Sweekiang_teo@scotiacapital.com
Tel: 65-6536-3683
Fax: 65-6536-9138

UNITED ARAB EMIRATES
Dubai
c/o National Bank of Dubai
P.O. Box 777
Dubai

Pramod Mohan
Pramod_mohan@scotiacapital.com
Tel: 97 14 228 4757
Fax: 97 14 228 9090