Emerging Market CBs: cutting (rates) and buying (Gold)

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Its been a market known known that Central Banks have been accumulating Gold at an incremental solid pace beginning in 2018. The part worth flagging is that 2019s purchasing pace started off strong (Januarys net increase of 35 tonnes was the largest January increase in gold reserves in WGC records) illustrating the continued strength in gold accumulation, with new & interesting purchases. That has not accidentally coincided with an acknowledgement of sobering growth rates, rate cuts and collective shift in dovish policies in an attempt to combat typical late cycle volatility and slower growth.

Takeaways:

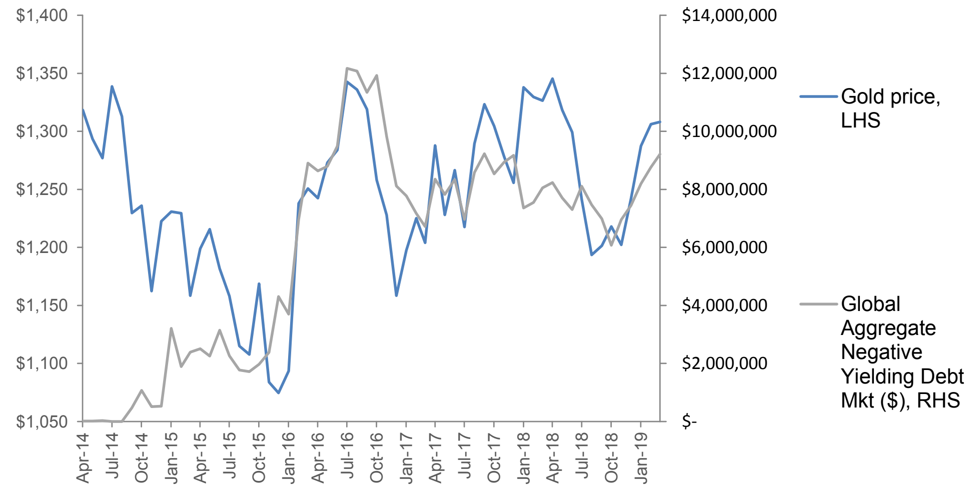
- EM CBs switched into easing mode in February, post the Feds dovish tilt in January, earmarked & kicked off most notably by RBI unexpectedly cutting rates in the beginning of February. This ended a 9 month hiking streak (the longest stretch since 2011) in which 37 EM economies showed 3 NET rate cuts in February (from 1 hike in January). Page 3
- **Theres a negative correlation between EM CB rate cuts and Global CB Gold purchases, although it isn't very strong (-0.40).** During the EM hiking cycle of 2010-2011, Global CBs bought on average around 7.5m oz of Gold, compared to the 2012-2015 ultra loosening cycle in which Global CB s bought on average significantly more (12.8m oz). Page 3
- Golds traditional attributes—a **safe haven, reserve asset, fiat currency hedge, a geopolitical hedge, a $ hedge, and a diversification tool for portfolios—are well known, so page 2 lists some new recent macro drivers that may have induced a shift in EM CB buying trends. Those include being a liquidity hedge (against swelling pool of negative yielding assets), and** hedge against protectionism, geopolitics and a recession few CBs are 'prepared' for.
- The usual EM Gold buying suspects like China, Turkey, India and Kazakhstan all continue to accumulate the past few months, however new participants have emerged (in January, Colombia with their largest monthly purchase of 5.3tonnes). Colombia joins Mongolia, Hungary and Poland who were the cited **new Gold buyers** in 2018. **That is generally a constructive development for Gold if new (known) Gold buying offsets old (unknown) CB selling/lending. Page 3**
- **China** bought about 32 tonnes of Gold the past three months (December through February); if it keeps purchasing at that rate, they would surpass Russia and Kazakhstan (who led buying in 2018) as the most aggressive CB gold buyer. Its tough to know exactly when these purchases were actually made (or when they were sourced internally from local production). However **the timely (during ongoing fraught trade tensions and when their FX reserves are flat-lower) and consistent release of data (3 consecutive months after spending long periods without revealing gold holdings) is important & telling**—it signals a commitment to de-dollarizing. This subtle statement perhaps matters more than the fact that the total amount accumulated the past 3months is ~1/6th of the persistent buying seen over 2015-2016 (of a total of ~6m oz). Page 4
- In 2018, Central Banks bought over twice as much Gold than what **net investors** (ETF + COT) offloaded. In 2019 (at an annualized rate, which is *overly simplified*) that general trend has persisted, but slowed somewhat—CBs are on track to buy 13.5m oz vs investor liquidation of 9m oz, 1.5x more, and pretty much matching 2018s CB accumulation.
- Overall, **this newfound appreciation by incrementally more EM CBs for Gold is price supportive, and reinforces the new higher foundation Golds in; $1300 is the new $1200**. However, the tactical investor is not on the prowl for dip-buying opportunities like Gold when other real assets provide higher yielding opportunities in a low-vol/equities-rally-at-any-cost regime due to the collective rollover in CB policies. Official and strategic buyers seem to disagree.

Why the newfound love for Gold *now?*

The decision making process around large strategic changes in CB policies, activities and/or buying trends is very opaque and even the Gold flow data can be flawed or delayed (countries have different reporting schedules to the IMF and need not report ALL transactions). Golds traditional attributes—a **safe haven, reserve asset, fiat currency hedge, a geopolitical hedge, a $ hedge, and a diversification tool for portfolios—are well known, so the below list is a shot in the dark at attempting to name new recent macro developments the past 6months that have induced a shift in EM CB buying trends.**

- The U-turn from global (Fed) quantitative tightening to an easing bias the past 3months, has signaled a market regime shift from expecting a higher vol environment (fueling concerns over tightening liquidity, a $ shortage, equity market volatility & EM vulnerabilities) to a lower vol regime (fueling concerns over typical late cycle exuberance like rallying equities at any cost, inflationary repercussions, a CB policy misstep or use of alternative policy tools). **Golds a liquidity (inflation) hedge—albeit a poor one when yielding real assets outperform— against the newly adopted dovish reaction function by Global CBs. This has created a rally in bonds forcing the pool of negative yielding assets to swell to almost $10bn (chart 1)**

Pool of (swelling) negative yields* and Gold



Source: Scotiabank Commodities Strategy, Bloomberg, Barclays

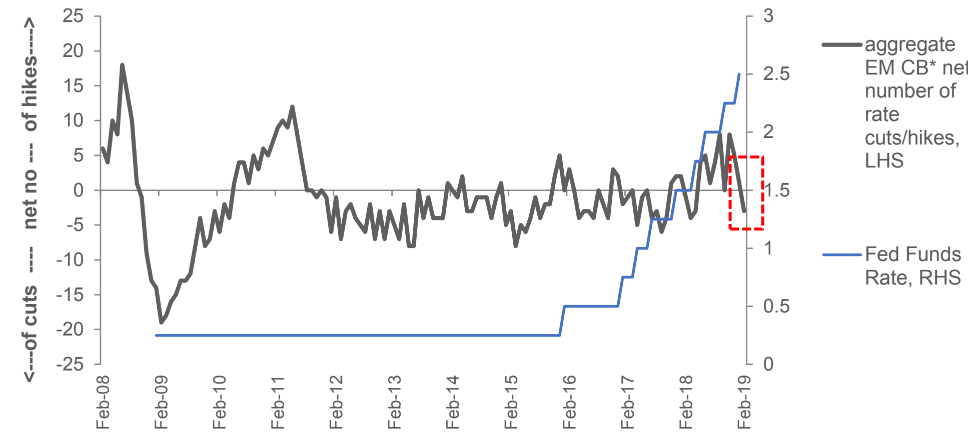
- Trade war/tariffs, a protectionist US administration and overall complex politics is now an even greater threat to international action as the rise of populism globally complicates the task of large economies and CBs working together in times of need. **Gold becomes a hedge against growing protectionism and polarizing world politics that began with Brexit and US 2016 elections** and the new buying trends could be a (delayed) reaction to these major past geopolitical events. If that's the thinking, **2018s volatile year with the emergence of renewed trade tensions could only fuel further diversification inflows as has been the case with Chinas timely notification if its purchases**.
- **Gold buying could be a recession hedge** especially as the Fed now has only half as many % points in its arsenal that it typically 'uses' in a downturn.
- **Gold prices, and also importantly Gold volatility, is relatively cheap** vs bonds and stocks, and Decembers global stock rout warned of expected market stresses
- **Gold is arguably also an alternative to the expected** general shortage of dollars globally (not a hedge to the $ which would arguably rise further IF the Fed returns to a tightening cycle). There is now officially more $100 bills in circulation than $1 and $20 notes, due to international demand as a hedge against economic instability/inflation, a global fear of negative interest rates (Japan, Europe), and demand from the underground economy. Cash ($) is king but only until a price, at which point alternatives come back into favor.

Emerging Market CBs rate cuts

- Reuters analyzed and posted a neat graph highlighting **EM CBs switched into easing mode** in February, after the greenlight from the Jan FOMC. They analyzed 37 EM economies which showed 3 NET rate cuts in Feb (vs 1 net rate hike in Jan). Up until Jan '19, EM policymakers battled the fallout from the stronger $ (and thus inflation) by hiking for 9 straight months (which was the longest stretch since 2011). Graph 1.
- Graph 2 shows an **(expected) negative correlation between EM CB rate cuts and Gold purchases, although it isn't very strong (-0.40).** During the EM hiking cycle of 2010-2011, Global CBs bought on average around 7.5m oz of Gold, compared to the 2012-2015 ultra loosening cycle in which Global CB s bought on average 12.8m oz.

- **Emerging Markets** (who traditionally have a much smaller share of FX reserves in Gold) have been **avid Gold purchasers** , with the usual suspects like China, Turkey, India and Kazakhstan all continuing to accumulate the past months. However, new participants—in January, Colombia with their largest monthly purchase of 5.3tonnes - is generally a constructive development for Gold. Colombia joins Mongolia, Hungary and Poland who were the cited new Gold buyers in 2018.

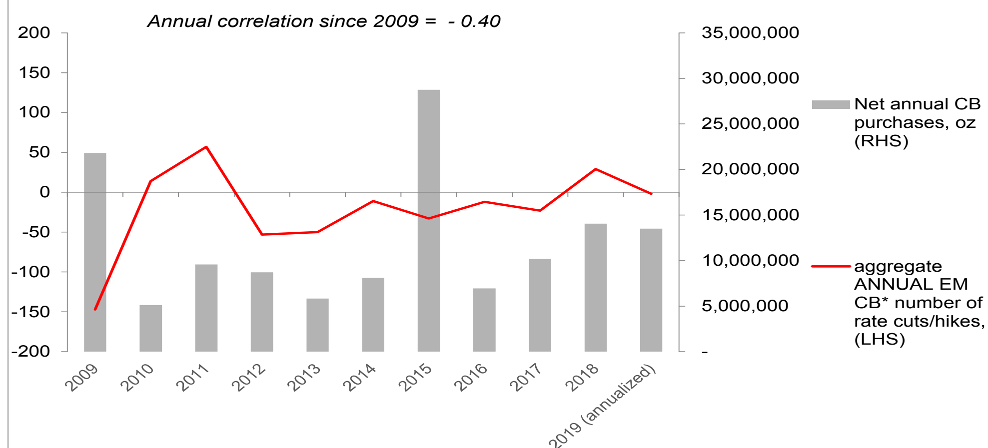
Current Net EM CB rate cuts.. After 9mo of rate hikes battling a stronger $ (inflation) and in response to synchronized global growth



·Reuters News data ashowing the net monthly aggregate of cuts & hikes from 37 Emerging Market Central Banks

Source: Scotiabank Commodities Strategy, Bloomberg, Reuters

Annual Global CB Gold purchases vs aggregate annual EM rate cuts/hikes



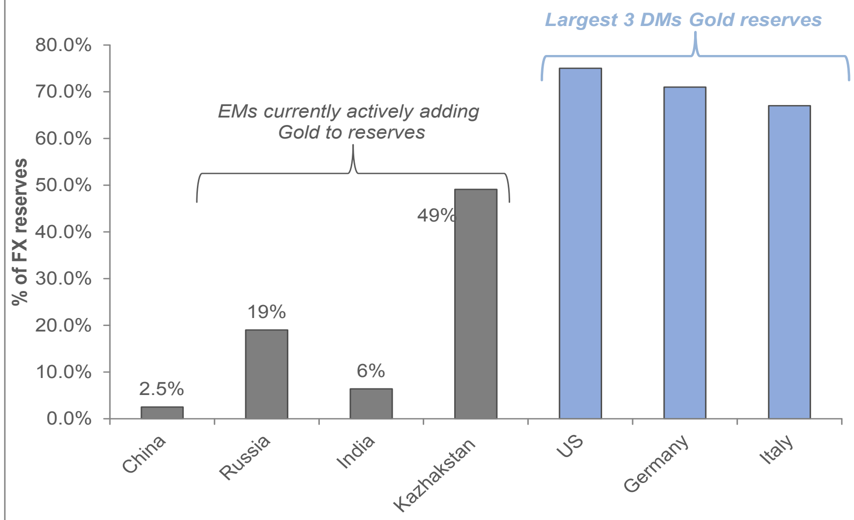
*Reuters News data showing the net annual aggregate of 37 Emerging Market Central Banks cuts & hikes

Source: Scotiabank Commodities Strategy, Bloomberg, Reuters

Focus —> Chinas important but baby steps

- **The PBOC** bought about 32 tonnes of Gold the past three months (December through February); if it keeps purchasing at that rate, they would surpass Russia and Kazakhstan (who led buying in 2018) as the most aggressive CB gold buyer.
- Its tough to know exactly when these purchases were actually made (or when they were sourced internally from local production). **However, the timely (during ongoing fraught trade tensions) and consistent release of data (3 consecutive months after spending long periods without revealing gold holdings) is important & telling—it signals a commitment to de-dollarizing policies.** This subtle statement matters more than the fact that the total *amount* accumulated the past 3months is ~1/6th of the persistent buying seen over 2015-2016 (of a total of ~6m oz).
- China would generally be persistent buyers of Gold (sourced internally & externally) when FX reserves were consistently climbing during the 2008-2014 era, in order for them to just *maintain* ~2-3% of overall Gold holdings. Thus **the Gold additions when FX reserves were flat-lower post 2015 (due to trade tensions, a cooling economy, capital outflows and the CB intervening more frequently to support faltering currency) implies a higher allocation to Gold.**
- SAFE—Chinas FX regulator— expects FX reserves to remain stable in 2019. **If theres less of a need for them to intervene to support the yuan on expectations of improved sentiment around US tariffs/trade deal, then technically, theres more flexibility allowing the PBOC to diversify away from the $ / USA / protectionist policies, with Gold**

Chinas Gold holdings (a small share of of FX reserves) vs large & active (EM) and large & inactive (DM) Central Bank Gold holdings



Source: Scotiabank Commodities Strategy, Bloomberg, IFS

China boosts gold holdings for three consecutive months

Source: PBOC, Bloomberg
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