Gold: analyzing strong gold inflows (investors & CB) vs physical dishoarding

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Its a known known that both investor and Central Banks have been accumulating Gold at persistently solid pace in 2019, with key stats released by analysts and WGC (see recent Q3 demand trends here). However, the crucial question is, is Golds price action/ response fair in light of these inflows, and given how opaque the physical market/response is. For example, price sensitive gold demand is due to hit 143m oz in 2019* which is the highest in WGC records; why isn't Gold at record highs then? The below will provide a quick summary and analysis around this idea…

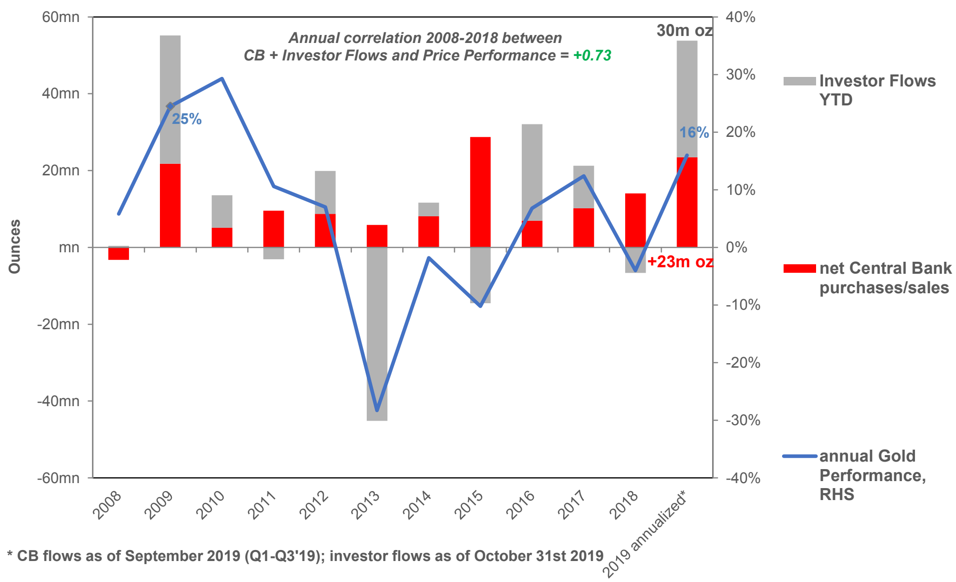
SUMMARY:

- Combined (jewelry + CB + investor) flows and Gold performance only holds a +0.48 correlation highlighting the price sensitivity of jewelry and CB demand. However, CB & investor inflows (the buying highlight for 2019) have a +0.73 correlation against price performance, with investor price performance enjoying the strongest correlation (+0.83) with prices, depicting the momentum quality of investor inflows.

- A simply regression model indicates that, given the strong annualized CB + investor inflows in 2019 (of 54m oz), Gold should've put in 26% gains. Gold is currently up +14% YTD (with max annual gains seen in September of 21%), clearly undershooting what it is capable of / 'supposed to' print. That signals that the unknown / OTC supply response—via recycling, physical dishoarding and/or hedging—has played an important role in capping gains.

- The macro narrative has shifted from "recession or no recession" to "no recession or cyclical upturn" with this is binary thinking contingent on the whether theres a believable phase one trade deal. Thus, given the notable lack of physical support, the critical Gold support into year-end, rests on both structural investor interest recommiting and CB interest re-engaging to offset potentially strong fresh paper shorts (who are underweight).

Known Gold flows -- Annual Central Bank vs investor flows, in 2019 (annualized*) vs previous years



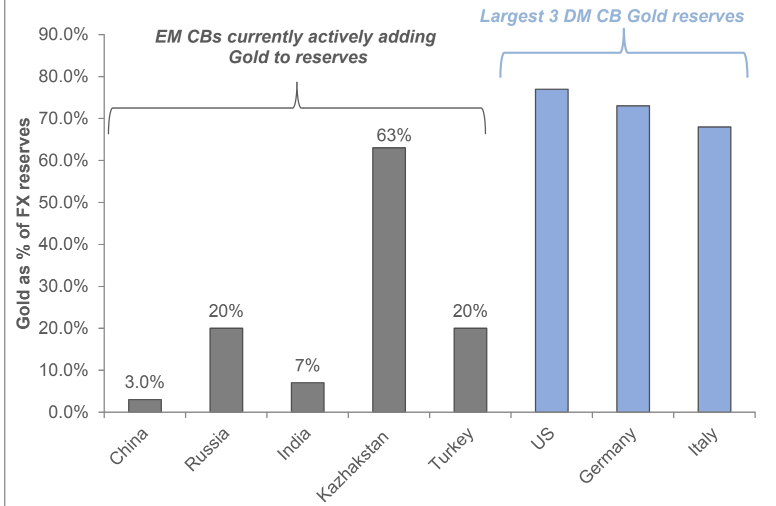
* CB flows as of September 2019 (Q1-Q3'19); investor flows as of October 31st 2019

** Investor Flows defined as net Global ETF flows + net CFTC COT paper flows

Source: IMF, Bloomberg, Scotiabank Commodities Strategy, CFTC

CENTRAL BANK trends:

Gold demand trends in EM vs DM Central Banks: large & active EM purchasers (Gold a small share of FX reserves) vs large but inactive DM CB holdings



Source: Scotiabank Commodities Strategy, Bloomberg, IFS

- Central banks added 17.6m oz to reserves in Q3'19 which is -38% YoY (due to the high base in Q3 2018; the highest quarter of net buying in WGC records). However, on an annualized basis, global CBs have bought 23.4m in 2019, over 2x the average pace of annual buying during the 2009-2018 period, and the most on record (after 2009s stellar 21.8m oz of net accumulation).
- If annualized 2019 CB demand has outpaced 2009 demand trends, a year where gold put in 25% (~$220) gains, then that's one interpretation that Gold should be putting in bull market gains. The counterargument is that 2009s rally was off a much lower nominal $ base (Gold was below $900 then), so todays +-$200 rally is aligned with the $220 rally back then.
- YTD, a total of 14 CBs have reported adding to their Gold holdings, led once again by the usual suspects—Russia, India, Turkey, and China. Other net purchasers of Gold during Q3'19 include the UAE (~160K oz), Qatar (~100K oz), Kazakhstan (~68K oz), Kenya (~61K oz) and the Kyrgyz Republic (~40K oz).

1. Emerging Markets (who traditionally have a much smaller share of FX reserves in Gold) continue to be avid Gold purchasers in 2019, in part helped by lower (global) interest rates —> EM CBs switched into easing mode in Q1'19, after the greenlight from the January FOMC after their 9 month hiking cycle. **With the current Fed pause, buying trends are critically important in providing key support on price dips. The traditional Gold attributes—a safe haven/recession hedge, a liquidity hedge (against pool of negative yielding assets), a reserve asset & a diversification tool for portfolios, a fiat currency hedge, a geopolitical/protectionism/trade war hedge, a $ hedge — are still in tact but upcoming flows will provide insight on how relevant these are in light of trade hopes and current gold prices.**

- Recent CB highlights include:
    1. Turkeys Gold holdings hit their highest level in Q3'19 (at 12.4m oz, representing 20% of total FX reserves) driven by the largest monthly purchase in August 19,
    2. Russias gold buying pace slowed vs 1H'19 but they noted that gold and other currencies like the yuan & EUR are being actively utilized to drive the halving in US$ allocation from 44% to 24%,
    3. The CBGA formally ended in Q3'19; it was once an important cornerstone of the Gold market (in controlling chunky gold sales from CBs), but since the GFC, CBGA sales have declined to trivial levels and CBs have turned net buyers—there is now technically more 'freedom' for CBs to sell Gold, but in practice, in a late cycle with an acknowledgement of sobering growth rates, limited monetary policy tools and trade tensions, that's unlikely.
- **Chinas Gold reserves increased ~700K oz in Q3'19, but the pace also surprisingly slowed (vs beginning of this year); they were actively buying at a pace of 380K oz from December'18 through June 2019, with buying pace slowing to 230K oz in Q3'19, and didn't purchase anything in October 2019**. Q3'19 represented peak trade escalation and the yuan broke the coveted 7-handle during that period, developments, where one would think, would drive the argument for significantly more Gold purchases, not less. Overall, its tough to know when PBOC purchases are actually made (or sourced internally from local production), but their Gold additions in light of flat-to-lower FX reserves (implying a higher allocation to Gold), trade tensions, a cooling economy, capital outflows and a volatile/faltering currency, signals the importance China places on Gold reserves as an principal asset to diversify away from the $ / USA / protectionist policies in the longer-term. **In the short-term, the recent tailwind from PBOC gold buying (whether directly through actual purchases or via a sentiment booster) has been removed.**

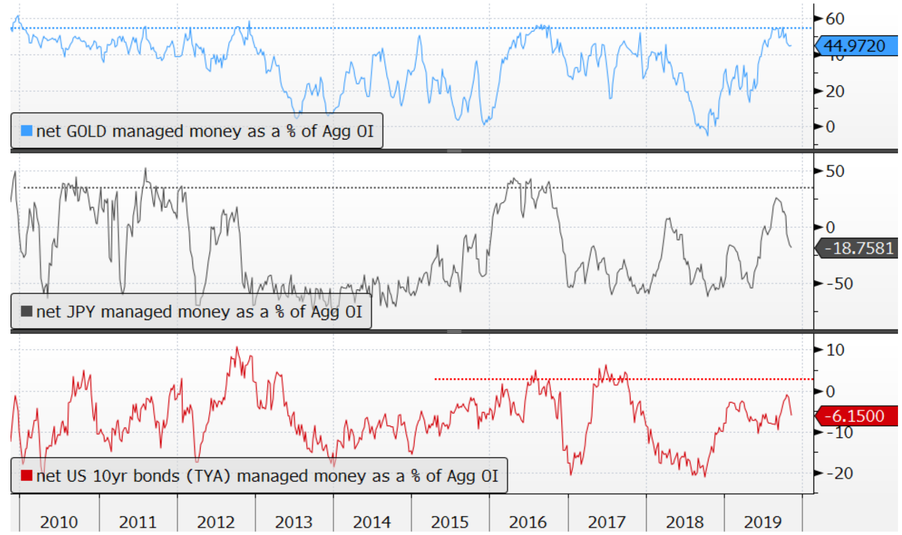
INVESTOR trends:

- **Known investor inflows have accumulated almost over 26m oz of Gold YTD in 2019, taking total investor holdings to a record high of over 100mn oz;** on an annualized basis that's 30m oz of net purchases, and a little shy of the peak investor inflows seen in 2009 (of 33.3m oz).
- Global Gold ETFs hit record holdings in Q3'19 of ~92m oz , unsurprising timed with the (early) shift in Fed policy toward cuts. **The majority of all investor inflows (ETF, COT & coin/bar) in Q3'19 were driven by ETF inflows (+8.3m oz), which were propelled largely by North American investors** (adding ~6m oz), followed by UK ETFs (Brexit fears) adding >900K oz and German ETFs (recession fears) by ~420K oz.
- COT investors added 3/4th of what ETFs accumulated (+6.2m oz) and together with ETF inflows, these '**Western' inflows more than offset softer 'Eastern' coin & bar demand which slumped to 11year low (of 4.8m oz).**
- With annualized inflows of ~30mn oz from ETF & COT investors, and given the strong correlation between annual price performance and investor inflows (+0.83), Gold prices this year should've reach +22%, our model shows. Gold printed in that region for a short period of time before coming under physical related pressure.
- Gold has been actively included in thee 'recession basket' alongside US Treasuries, and other FX havens such as JPY, as both a trade and monetary policy hedge. **These "recession trades" became undeniably overcrowded, aligned with peak 'trade escalation' and recession fears seen in Q3. The narrative has now shifted, given stronger (relative) US data, from "recession or no recession" to "no recession or cyclical upturn". This binary thinking, and whether the second and larger leg of the *tactical* unwind out of havens/recession trades into reflation trades/cyclicals, is contingent on the whether theres a believable phase one trade deal.**
- The key technical pain levels for Gold longs lies well beneath current market prices. The weighted average price both ETF + COT investors are long at, is \$1397*. **However, the key threat for Gold lies with unengaged paper/COT shorts who are underweight**, currently short 3.6m oz, only 1/5th of peak short bets (Aug 2018) or 1/2 of the average size of their positioning over the past 5years. A phase 1 trade deal will determine how aggressive this participant becomes.

**Daily positioning changes since May 2019 (when US/China deal fell apart)*

Positioning in havens - Gold, US 10yrs & JPY

....overcrowded recession hedges but the unwind has already begun

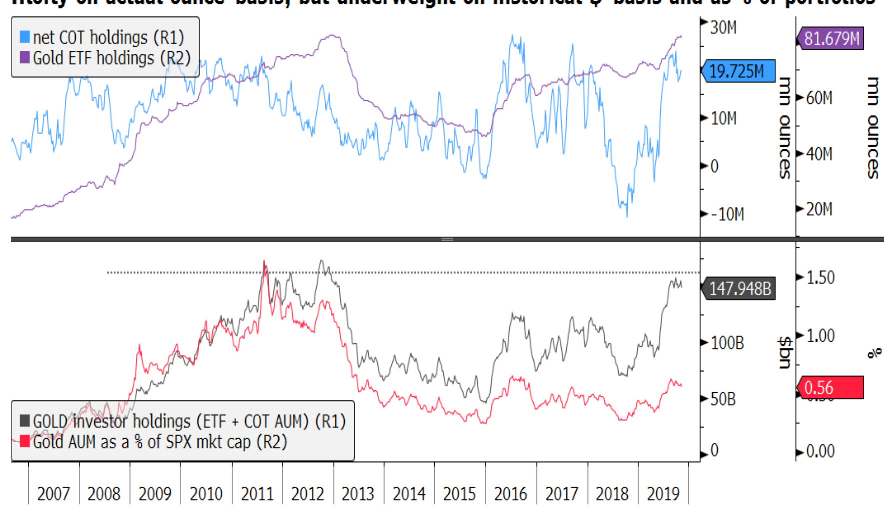


Source: Scotiabank Commodities Strategy, CFTC, Bloomberg

.GCCOT U Index (net length as % of OI) COT%OI GC JPY TSY Weekly 09NOV2009-11NOV Copyright© 2019 Bloomberg Finance L.P. 11-Nov-2019 09:27:55

Investor AUM, ETF & COT holdings in Gold

..lofty on actual ounce-basis, but underweight on historical \$-basis and as % of portfolios



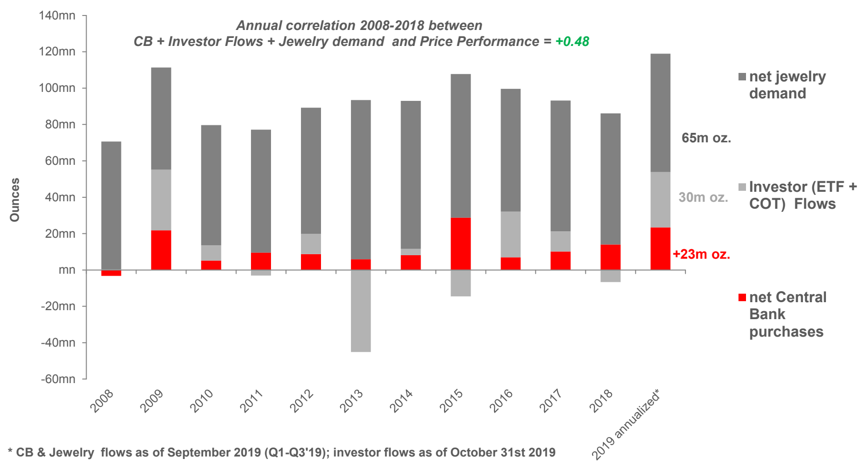
Source: Bloomberg, Scotiabank Commodities Strategy

.GCHOLDIN U Index (ETF + netspec) ETF COT AUM GC Weekly 25AUG2006-08NOV2019 Copyright© 2019 Bloomberg Finance L.P. 11-Nov-2019 09:43:15

PHYSICAL DEMAND trends:

- Combined (jewelry + CB + investor) flows and Gold performance only holds a +0.48 correlation highlighting the price sensitivity of jewelry and CB demand. However, CB & investor inflows (the highlight buying for 2019) have a +0.75 correlation against price performance, with investor price performance enjoying the strongest correlation (+0.83) with prices depicting the momentum quality of investor inflows.
- **Price sensitive gold demand (*i.e.: all demand excluding technology) hit 143m oz in 2019 (annualized basis), the highest in WGC records**; the 2nd largest demand year was 2011 (139m oz), a year of record high Gold prices.
- Primary production has largely been flat in 2019, but recycling on an annualized basis Is up 9% YoY and matches the large recycling response seen in 2016, evidence of some price response.
- **Jewelry demand was pummeled in Q3'19, down 16% to 14.8m oz, the lowest since 2010 driven by large decline in jewelry hubs such as Asia (China –12%, India –32%!) and the Middle East, due to higher gold (in local currency terms) and economic uncertainty.**
- Jewelry demand YoY losses in 2019 (-7m oz) isn't as soft as 2009 and 2016 (-14m & -11m oz respectively). However, what jewelry "lost" in 2019* (-7m oz) vs 2018, investors plugged by over 4x with their 30m oz of annualized accumulation. This investor offset is much larger than what occurred in both soft jewelry demand years of 2009 & 2016 where investor inflows back then were only over double what jewelry lost. **The investor counteracting inflows were huge in 2019, arguing for relatively higher price performance (which has not occurred), again signaling further supply response**.
- Physical premiums across Asian hubs have remained suppressed (the SGE premium has fallen from almost $20 above London gold seen in June'19 to currently $3/oz), with Gold coin premiums also soft reflective of bar /coin demand halving in Q3 to 4.8m oz; retail investors are dishoarding and taking profit, especially as gold prices across many key currencies topped peak levels.

Net annual Central Bank & investor inflows, vs total jewelry demand in 2019 vs previous years



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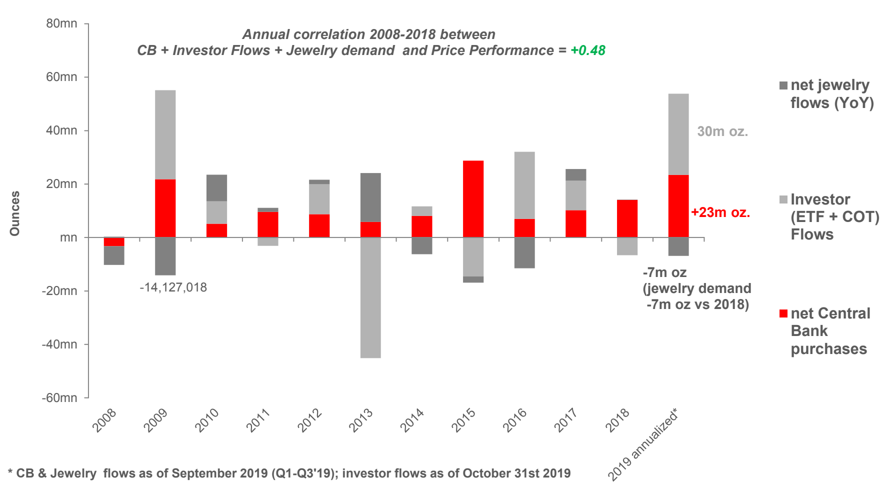
** Investor Flows defined as net Global ETF flows + net CFTC COT paper flows

Source: IMF, Bloomberg, Scotiabank Commodities Strategy, CFTC, World Gold Council

What jewelry loses, investors pickup? - annual Central Bank & investor flows vs YoY changes in jewelry demand



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