Metals Strategy: Gold - Some Thoughts on the Struggle Between Physical & Investors

- Quantifying the struggle between the East (physical/jewelry demand) vs the West (investor inflows): quite recently the World Gold Council published Q1 demand trends, which is helpful in that it quantifies just how weak jewelry and physical was in key regions like China & India. Jewelry sales fell to their lowest on record (-40% YoY), with physical trade imports/flows into China and India mimicking that (down ~65% & 40% YoY respectively). In addition, the pace of CB purchases has fallen off materially (on an annualized basis they have bought +3.7mn oz, the slowest annual pace since 2008). These structural headwinds are well known and been flagged for months -- IF the macro-economic incentive dries up, or worse, paper turns net sellers, the pullback could be sharp & painful. Overall, what is key, and arguably missing, is determining whether the slowdown in physical more or less offsets the ramp up in investor (ETF+ COT) flows, and attempting to model the impact on prices. Graphs 1 simply outlines and compares 3 core demand drivers of the gold price--jewelry (the commodity pillar), CB (and fiat/US$ diversification pillar) and investor demand (the macroeconomic pillar) and puts some historical context on this idea. In summary:

- Jewelry demand is running at an annualized rate of 42m oz.; that's 30m oz. (-41%) less demand vs the average 'jewelry bid' seen from 2009-2019

- CB purchasing power is running at a 3.6m oz. annualized rate in 2020; that is 8.9m oz. (-70%) less vs the average trend seen the past 10 years. The dominant selling culprit is Sri Lanka (sold >400K oz.) while China hasn't reported any purchases since Sept 2019, and Russia has essentially halved its buying pace

- Thus, through this proxy/lens, CBs and jewelry demand together is losing on average ~39 m oz. in 2020. That compares to a ramp up in investor demand (COT+ETF) which is running at 12.3m oz. on an annualized rate, or only 7.6 m oz. larger than the average annual inflows seen the past 10yrs. By this approximation, the loss in physical demand, at this rate, is 5x larger than the increases in investment demand. But gold is up 11% YTD...

- Overall, aggregate jewelry, CB & investor inflows in 2020 is 58m oz. (annualized basis), the lowest in our data series. The correlation between these dominant drivers, and the annual gold price performance is +0.56, which puts the model implied gold* performance, using the past 10yrs of data, at -12%. IE: Gold should be closer to $1350, showcasing a large disconnect between the negative omen from the physical backdrop and price action. Unknown OTC flows, stemming from strategic and/or official sector explains part (not all!) of the difference.

*Simply regression formula: Annual Gold performance (%) = -0.46 + 5.9 (annualized CB + jewelry + Investor inflows)
**Known Gold Flows:** Annual Central Bank vs Investor Flows in 2020 (annualized*) vs Previous Years

- **Annual correlation 2009-2019 between CB + Investor Flows and Price Performance = +0.85**

- **Source:** Scotiabank Commodity (Metals) Strategy Calculations, IMF, Bloomberg, CFTC

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### India: Cumulative Annual Gold Imports

- **Millions of oz**

### China: Cumulative Annual Gold (Non-Monetary) Imports

- **Millions of oz**

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**Note:**
- CB annual net purchases/sales
- Investor Flows
- Jewelry Demand
- Gold Annual Price Change (RS)

**Source:** Scotiabank Commodity (Metals) Strategy, Bloomberg

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Known Gold Flows: Annual Central Bank vs Investor Flows in 2020 (annualized*) vs Previous Years

Source: Scotiabank Commodity (Metals) Strategy Calculations, IMF, Bloomberg, CFTC

Note: *Jewelry and CB flows as of Mar-2020, Investor flows as of Apr-2020. Investor Flows defined as net Global ETF flows + net CFTC COT paper flows.
The bear case: there have been notably more enquiries into gold bears case (to fairly ‘pressure test’ the known bull case) especially as prices deal with predatory-like flows (on Wednesday it was the 8th day out of 9 of consecutive COMEX open selling) attempting to force a break lower. The tactical reversal/bear case includes:

- Long gold is super consensus (in an environment where there’s been a clear rotation into laggards/non-consensus or under owned trades)
- Lackluster price action around $1700 for a full month now and its still under priced vs real rates and some fx pairs
- The pace of peak stimulus (or the fear of peak stimulus) is behind us as health stats improve and global economy shifts to reopening
- Deflation wins, CB policies lose (and those long inflation expectations get burnt, again, as in 2012),
- Horrid physical demand (see above)
- CBs are the largest longs, aren’t accumulating with a threat they monetize holdings
- The last shoe to drop is the US$, which remains resiliently bid and it isn’t clear that trend will reverse since most EM is short USDs
- Technically, it has repriced to a less bullish trajectory on a short-term trend line and seems to be fearful of $1720 resistance region.

Overall, the inflation bid into real assets, arguably got an appeal boost with PTJs support for bitcoin as the “fastest inflation hedge / horse” yesterday. While the unprecedented interventionist monetary AND fiscal response to counter the effects of COVID-19 provides a great case for gold to play an increasingly large part of any portfolio going forward, the lack of physical support does make a case for those overexposed to lighten up…
World Gold Council: Q1 Global Demand Trends

The global pandemic of Covid-19 fueled safe-haven investment demand for gold, offsetting sharp weakness in consumer focused sectors in the market. Gold demand in Q1 2020 increased 1% YoY to 1083.8t. In contrast, Q1 supply fell 4% as lockdown procedures hit mine production and gold recycling.

Demand

- **Investment, ETFs, Bar & Coin:**
  - Investment holdings on a total level grew 80% in Q1 YoY to a four year high of 539.6t.
  - ETF holdings increased by 298t reaching a record high of 3185t by the end of the quarter.
  - Bar and coin investment was down 6% from Q1 2019 at 241.6t.

- **Jewelry**
  - Q1 Jewelry demand fell to a record low of 325.8t, a 39% drop YoY.
  - China’s Q1 jewelry demand fell 65% YoY to 64t. The highest quarterly SGE price ever combined with consumers budgets being constrained by lockdowns both negatively impacted jewelry demand. Consumption stimulating policies by the Chinese government could support demand in Q2 and beyond.
  - India Q1 jewelry demand fell 41% to an eleven year low of 73.9t. The Q1 average price of Rs 41124/10g in Q1 was 26.6% higher YoY.
  - The smaller East Asian markets all sustained double digit losses in Q1, with price-driven weakness due to the coronavirus. Indonesia and Thailand suffered harsh demand losses at –55% and –45% respectively.

- **Technology**
  - Electronic demand fell 7% YoY to 59t. Gold used in other technology application was 13% lower YoY at 11.2t and dental demand continues its decline with a 9% decrease to 3.2t.
  - China’s LED sector was hit the hardest in Q1 with declines of more than 30% YoY as factories were forced to close in February.

- **Central Banks**
  - CB net purchases totaled 145t in Q1 which marks a 8% decline YoY. Only 6 CB increased their gold re-serves by at least a tonne in Q1, compared to 10 a year ago.
  - Russia announced that after Q1 it will suspend its gold purchases having bought more than 1900t since 2005.

Supply

- **Mine Production**
  - Mine production continues its fifth consecutive quarter in YoY declines. In Q1 mine production was 3% lower YoY at 795.8t, the lowest level of Q1 production since 2015.

- **Net Producer Hedging**
  - The global hedge book fell further in Q1 due to net producer de-hedging of 9.7t.

- **Recycled Gold**
  - Recycled gold supply fell 4% YoY to a two-year low of 280.2t. This is 7% below the five-year quarterly average of 302.4t.
Chart 1: World Gold Council—Demand

Coronavirus ignited safe-haven ETF inflows, but undermined consumer demand

Chart 2: World Gold Council—Annotated Indexed Gold Price Chart

Fears over global impact of coronavirus helped drive gold prices up

Note: Index level 100 as 01/01/2020
Source: ICE Benchmark Administration, Dettelstream, World Health Organisation, CNN, World Gold Council
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