Gold:

The Silk Road Redux

Many investors use gold in diversifying their commodity asset allocation strategies, as well as for outright 'safe haven' investments. But this market is changing and gold investments (of whatever kind) should be carefully re-evaluated. This article looks at gold flows and their implications for the price.

By Ross Norman

THE WEST DOES not have much to thank Marco Polo for. In his chronicles about trade along the Silk Road in 1271, he reported gold flowing East, while exotic luxury goods such as spices and silks flowed West. He also brought from the palace of Kublai Khan the concept of fiat currencies. 750 years later and gold is once again flowing eastwards – and with a vengeance – with paper money partly to blame.

The Silk Road is one of the oldest and most significant historical trade routes linking both cultures and centres of commerce. Arguably, the story is repeating itself, but this time for different reasons. The parallel theme is the accumulation of gold in the East, in contrast to disposals in the West (think 'cash-for-gold' and specs shorting the gold futures market); in a modern twist, buying in the East is for physical bars and coins while selling in the West is 'paper' – which involves a 'translation' from one form to another. In short, the gold market is in transition, which has ramifications for the future structure of the market as well as the price outlook.

In his book *The Structures of Everyday Life* Professor Fernand Braudel stated, "*Precious metals had been leaving the Western circuits, primarily for the Indies and China, since the far-off times of the Roman Empire. Silk, pepper, spices, drugs and pearls from the Far East had to be paid for either in silver or gold to force them westwards. As a result, Europe's balance remained in deficit in this respect – until as late as the 1820s in the case of China. This perennial flight became part of the economic structure of the world; precious metals flowed to the Far East ...*"

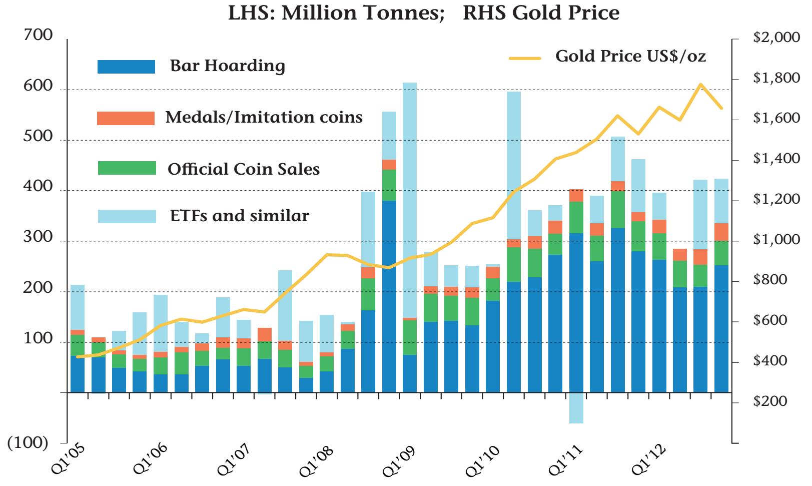
The divergent attitudes towards gold between East and West is manifest at many levels. Among emerging nation central banks there is an accumulation of gold to build official reserves, hot on the heals of selling by developed nations under the *Washington Accord* during the 2000s. If these developing nations increased their gold reserves from the current average of 2.6% to 15%, they would need to acquire an additional 17,359 tonnes, or seven years of global mine production. Being already 'long dollars' this trend has legs to run.

> ... the gold market is in transition, which has ramifications for the future structure of the market as well as the price outlook

Central bank buying is mirrored by activity in the futures markets with speculators on COMEX in New York holding record short positions while 'specs' in Shanghai continue to build long positions. At the investor level we have also seen massive redemptions of gold ETFs by western financial institutions with the sold physical being converted into Asian size and quality bars.

Gold Investment Demand, 2005-2012

LHS: Million Tonnes; RHS Gold Price



Sources: WGC, GFMS, Morgan Stanley Commodity Research

Meanwhile, registered stocks on COMEX have nose-dived this year as traders grab the arbitrage opportunities embedded within the high premiums for gold in Asian markets. COMEX registered stocks are now at the lowest levels since 2005, while speculative longs are the lowest for over a decade.

Even at the retail level we see a similar divide. Cash-for-gold is omnipresent on the high street in the West as consumers have sold old jewellery and coins in an effort to maintain the consumption binge of the 2000s. In contrast, rural Indian and Chinese 'aunties' buy. For every buyer there needs to be a seller and while western consumers queue at cash-for-gold outlets, there are corresponding queues for 'gold-for-cash' in the East.

At the nexus of this switch stand the Swiss refineries which are awash with jewellery scrap and Western gold of 99.5% purity large bars which are being converted into 'Eastern' 99.99% purity kilobars. In August 2013 the UK reported a twenty-fold increase in gold exports to Switzerland (at a massive 800 tonnes in H1 2013). This underscores the role of London as a conduit – *entrepôt* – in global flows and gives the clearest indication which way the tide is travelling.

> ... the divergence is not just East against West, it is also physical versus paper

But the divergence is not just East against West; it is also physical versus paper. Eastern markets remain predominantly physical while western markets are more faith-based and involve paper and leverage (think futures and options). Arguably, the decline of paper markets and the growth of physical ones are being driven by the same motivation; concerns about counterparty risk and bank solvency as well as a growing desire to own investments outright and in material form. Both point to fading confidence for economy recovery.

The *West*

Stepping back from well-rehearsed causes and effects of the economic crisis, it is clear that some macro-trends over the last generation very much favour ongoing growth in the East at the expense of the West – and gold is reflecting this. By this we do not simply mean demographics. In the 1990s we had the knowledge transfer as western companies sought competitive advantage by building factories in the East to take advantage of lower labour costs and more benign tax environments. This knowledge transfer was immediately followed by the jobs transfer. Western economies were largely shielded from this phase by the bloating of their public sectors as governments sought to maintain full employment.

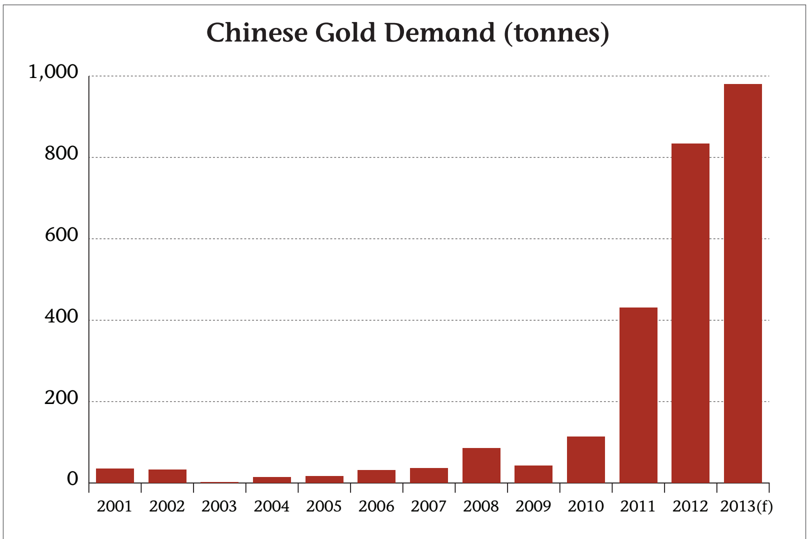
The third phase – the wealth transfer – is only just beginning. The effect of it has again been less apparent because some emerging nation currencies such as the Chinese yuan are held artificially low so as to give competitive advantage in growing their export markets. Meanwhile, the West continues to haemorrhage jobs and manufacturing in economies propped-up by unaffordable and unsustainable entitlements and benefits programmes to keep the show going.

Germany and London stand out as two key exceptions for good reason. For Germans of a certain age, they know from first hand experience that families have lost their entire wealth 3 times in the last 100 years through the effects of hyperinflation and gold remains the only reliable antidote to such an event in the future. It has become part of their DNA. Meanwhile, London has the largest concentration of expatriate millionaires and billionaires from countries with a strong cultural affinity for gold and a tax regime which makes it attractive to locate there. In these two locations physical demand remains robust and has the potential to grow further.

Chinese Gold Demand

China's physical gold buyers have largely replaced western ETF investors as the primary underpinning of demand. They are, of course, different from each other from a number of perspectives – including different motivations for buying, different tenure for holding the investment, and different forms and specifications of gold held.

The one-third fall in the gold price (from its all time high in September 2011) can be ascribed to the exit of the western ETF investor (aided and accelerated by speculators shorting the market) with the current bounce in prices to the re-awakening of eastern physical demand. In the media it is not uncommon to see so-called 'Chinese aunties' being pitted against hardened Wall Street traders.



Source: Sharps Pixley

But if gold has simply migrated from western to eastern hands this might ordinarily be thought of as price neutral. Not so. One needs to consider who are the so-called 'strong hands'. In other words, who is most likely to hold gold for the long term and who might be considered a short term holder.

> ... the Chinese market is a lobster pot for gold – easy in, difficult out

Typically, Asian buyers tend to purchase physical gold as a form of long-term savings – unlike most western investors. As such, they do not sell when the price goes up, nor do they sell in a panic when the price drops. More importantly, the Chinese market is a lobster pot for gold – easy in, difficult out – as the country has a strictly enforced non-export policy for gold. Ever seen a Chinese gold bar in the West?

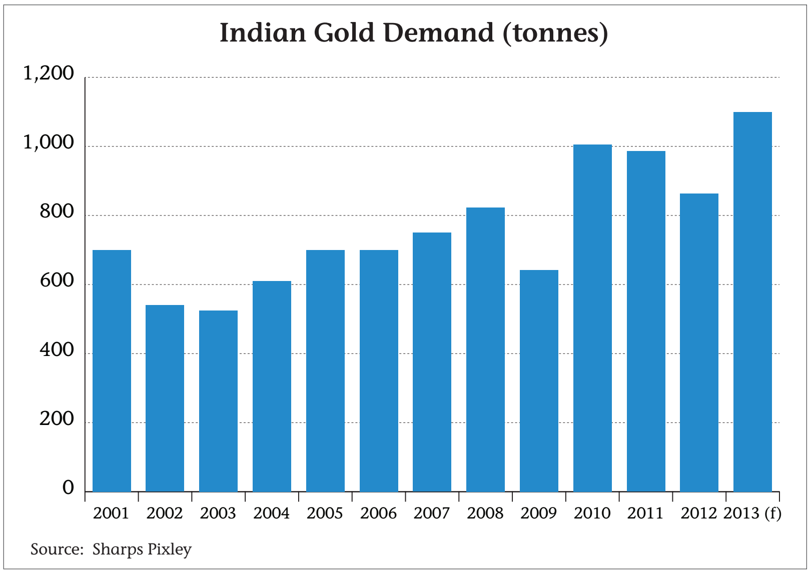
Gold imports into China via Hong Kong reached 165 tonnes in April 2013 alone, and show no sign of abating. Chinese gold imports are expected to gather momentum after more than doubling to an all-time high in March 2013. There is also ample scope for growth in the Chinese gold consumer market given that per capita gold holdings in China are about 5 grams compared to a 20-gram average in developed nations.

India's Gold Tax Timeline (2012 to August 31st, 2013)	
Gold Import Duty Doubled from 1% to 2%	Jan 17, 2012
Gold Import Duty Doubled from 2% to 4%	Mar 16, 2012
Gold Import Duty Increased from 4% to 6%	Jan 21, 2013
Duty on Raw Gold Doubled from 2.5% to 5%	Jan 22, 2013
Transaction Tax on Gold Futures Contracts Introduced	Feb 28, 2013
RBI Launches Tax Investigations on gold coin sellers	Mar 18, 2013
Bank Gold Consignments Restricted	May 13, 2013
Traders Gold Consignments Restricted	Jun 04, 2013
Gold Imports Only By Outright Cash Payments	Jun 04, 2013
Gold Import Duty Increased from 6% to 8%	Jun 05, 2013
Gold Imports for Consignments ONLY for Jewellery Exporters	Jun 27, 2013
20% of Imports To Be Held in Warehouse Available for Export with 75% of withheld metal exported before fresh imports	Jul 22, 2013
Gold Import Duty Increased from 8% to 10%	Aug 13, 2013
Gold Excise Duty Increased from 7% to 9%	Aug 13, 2013
RBI bans gold coin imports and domestic buyers must pay cash	Aug 14, 2013

Indian Gold Demand

India soaks up roughly one third of world's gold supply every year and domestic purchases are a major contributor to the net outflow of hard currency from the country. In January 2013 the Indian Finance Ministry set out in earnest to resolve the countries $20b/quarter current account deficit by throttling domestic gold demand. The world's largest gold buyer was using a $1,010b hammer (domestic gold holdings) to crack a $20b/qtr nut (or problem; the current account deficit).

In doing so, the Finance Ministry has inflicted collateral damage upon the value of the worlds largest private holdings. This – it could be argued – is the price for manifest failure in economic policy.



Source: Sharps Pixley

The damage was wrought upon an estimated 18,557 tonnes held by Indians (18,000 tonnes privately held plus 557 tonnes of official reserves), to the 3.5 million workers involved in the bullion sector. Worse still, they have fired a cluster of torpedoes into India's nascent financial markets and exchanges, sinking its aspiration to become a potential global gold trading hub.

Sharps Pixley estimate that the value of Indian gold holdings have suffered a $294 billion decline as a result of the anti-gold campaign by the Finance Minister Mr. Chidambaram ... and for no discernible effect. This is to say that this policy has manifestly failed for one good reason; it is self-defeating. With inflation remaining high, economic growth stalling, and with the domestic currency in free-fall, it follows that when the government tries to dissuade you from buying gold, it is surely a pretty good time to do just that. Indians know this instinctively. After all, gold was designed as a safeguard against precisely the difficult economic environment that India now faces. The more stringent the rules, the more keenly they will be circumvented.

> Sharps Pixley estimate that the value of Indian gold holdings have suffered a $294 billion decline as a result of the anti-gold campaign ...

Despite the best efforts of the government to wean rural India off gold, demand continues to rise. For Indian farmers gold is the medium for holding savings between harvests, with rupees less useful – not least because there are just 36,000 bank branches to cater for 650,000 villages. For Indian farmers (and for the 10 million weddings held each year) gold retains both its close cultural and financial link going back to the early days of the old Silk Road.

What may be India's loss is often Dubai's gain – indeed many would suggest that Dubai is only 'offshore India' anyway. The collapse of the Indian National Spot Exchange and the squeeze on Indian gold futures exchange MCX has seen a corresponding doubling in gold trading in Dubai on DGCX in H1 2013. Meanwhile, physical demand through Dubai saw a 40% increase in Q2 2013 reflecting higher demand from ex-pat Indians plus good demand from across the Middle East on geopolitical tensions in the region.

The fog of confusion that the Indian government has wrapped around gold is giving market participants a real headache. But for Indian consumers the game remains unchanged. Unhappily for them, the falling rupee has propelled gold to all time record prices in local currency terms, on top of which they are paying ever higher taxes, coupled with higher spot premiums to reflect the scarcity of physical supply over loco London gold. Despite all this, Indian imports are expected to reach 350-400 tonnes in the April to June 2013 period, 200% higher than a year earlier, nearly half of last year's total. For 2013 we forecast Indian gold demand will achieve a record 1,000 tonnes.

Conclusion

Gold has within living memory remained very much a London-centric market. That may not remain the case forever. Not only is the epicentre of gold trading moving East, so is the vaulting. The current hubs are London, Zurich and New York but new custodianship centres are opening in Dubai, Hong Kong, Singapore and Shanghai. The emerging nations are making it ever easier and cheaper to buy and store ... their regulations and taxes are infinitely less onerous. It is presently only a slow migration but a tipping point will be reached where all things bullion will have their epicentre in Asia. Its less of an 'if' than a 'when'.

As we later discovered, the Silk Road not only brought good things; it was also the conduit down which the bubonic plague travelled. This may resonate with those who take the view that the over-expansion of fiat currencies have in the end undermined western economies. Interestingly enough, while making the hazardous journey back to Europe during difficult geopolitical times, Marco Polo did not himself carry paper money from Kublai Khan's kingdom, but took with him 4,000 Byzantine gold coins – which just goes to show you ...

... all things bullion will have their epicentre in Asia. Its less of an 'if' than a 'when'

Ross Norman is CEO at Sharps Pixley Ltd, a physical bullion-broking firm based in London.
www.SharpsPixley.com
Platinum Group Metals are served at:
www.PGM.net