February 20, 2014

China Needs Gold and Silver to Back the Yuan Currency

Deserted in 2013, both gold and silver shine with investors in 2014 and surge by +12% and +15% in six weeks. China's to accumulate gold and silver strategy will pay out.

Key Points:

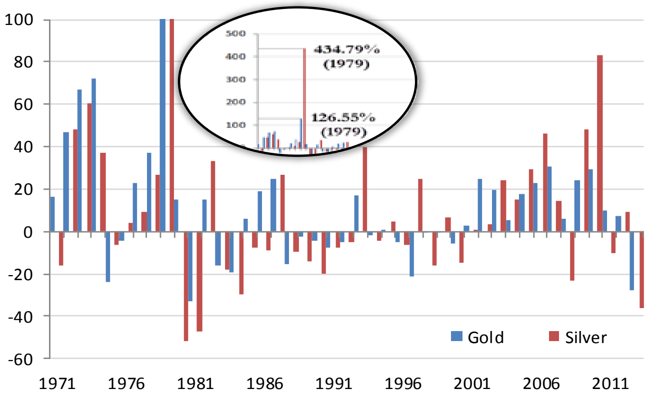
- Historical plunge of gold and silver in 2013
- Massive sales of 900 tonnes in gold ETFs responsible for the supply/demand imbalances
- End of physical gold ETF outflows
- +12% and +15% rebound in six weeks
- Short covering boosts prices
- Global supply stable for 2014
- Resumption of Indian gold imports in 2014
- Return of gold ETFs investment demand
- Increasing demand for jewellery, industry and technology
- China should diversify its reserves beyond U.S. Treasury bonds
- The Yuan is an ever more used exchange currency (bilateral agreements)
- Chinese authorities' discreet move: back the Yuan with the world's largest gold and silver reserves

Gold prices rebound in 2014 following the 2nd largest annual decline since 1971

Gold fell by -28.04% for 2013 as a whole, recording the second fastest price correction since the collapse of the Bretton Woods system in 1971, which put an end to the world gold standard of fixed exchange rates. Gold price had previously recorded a 12-year bull run which saw the precious metal spike from $270 an ounce to almost $2,000 an ounce. Only the 1981 price collapse (-32.6%), which came after a +438% rise in 4 years and a 13x increase in gold prices had been of greater impact.

A similar course was taken by the silver market, whose sharp drop in 2013 (-35.84%) was overcome uniquely by the steep fall of -51.86% and then -47.39% in 1980 and 1981, after the 23x up rise of silver prices between 1971 and 1979.

Gold & Silver Annual Performance (USD)



Sources: Bloomberg, BBGI Group SA

The decline in gold's price peak of $1,921 an ounce in 2011 and the double bottom of $1,180 and $1,182 on June 28 and December 31, 2013 was of -38.5%.

Gold Spot Price (2011-2014)

Sources : Bloomberg, BBGI Group SA

This seems to be quite a coincidence since gold prices hit twice the same level at the end of June and in late December 2013.

Since then gold price recorded a +12.7% increase in six weeks, while silver followed a similar trend, but had to wait until the end of January to gain an upward momentum. Since its top of $50 on April 25, silver melted by -63% before rebounding by +15% in the past two weeks. These recent increases replace the price of the two precious metals above their 200-day moving average for the first time since February 2013.

Silver Spot Price(2011-2014)

Sources : Bloomberg, BBGI Group SA

Fall in gold prices: effects on supply and demand in 2013

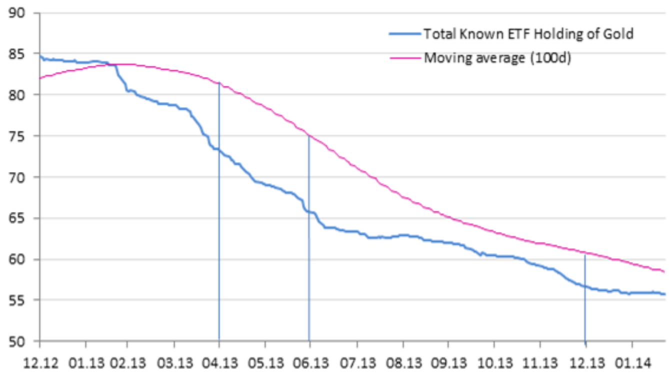
Gold price has been consolidating since 2011, and in April it had finally given in to quite exceptional conditions (see our Weekly Analysis – 18/04/2013), creating the illusion that only one major player was behind the gold's market slump. In the weeks which followed, the U.S. long-term rates jumped from 2.8% to 3.6% following the announcement of the Fed's Chairman of the upcoming taper of the quantitative easing program (QE3). Meanwhile, gold plummeted by -14% in two trading sessions before falling in June by an extra -12% in six other sessions and ended the semester at $1,180 an ounce.

In only eight days the gold paper market was literally overturned, and showed no sign of improvement in 2013 since gold ended the year at almost the same price.

Eight days were enough to shock investors and trigger record outflows of ETFs gold positions since 2003.

Investors' holdings of physical gold ETFs had peaked to 85 million ounces (2,635 tonnes) before collapsing by -22% at the end of June and again to 56 million ounces at the end of December. The total decline was of 33% or approximately 900 tons. If the first wave of sales was accompanied by a price correction (April-June), the second phase corresponding to 300 tons of gold had no further effect on prices.

Total known ETF Holding of Physical Gold

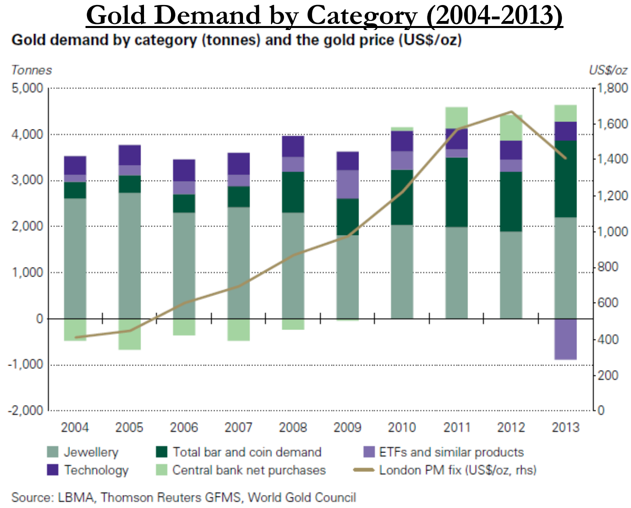


Sources : Bloomberg, BBGI Group SA

For the first time since 2004, investment demand had fallen sharply which effectively allowed aggregate demand to remain relatively stable at approximately 4,330 tons. Without this drop in ETFs investment demand, the market would certainly have been greatly unbalanced.

Yet, the fall in gold prices was not perceived in the same way in the various regions of the world. If ETFs investors' were rather negatively impacted by the drop in the yellow metal, those favouring individual and physical holdings in the form of coins and bars had an opposite reaction. Therefore, the same causes did have not the same effects. The ETFs held by investors in their diversified portfolios experienced the competition of the rising equities in 2013; some investors reallocated their portfolios to equities while abandoning this asset which they considered to be dead money for a time. In most emerging markets, but more specifically in Asia, gold's correction was rather seen as a new opportunity to reap savings through a solid tool.

Gold Demand by Category (2004-2013)



Central banks' net demand was in slight decline (368t compared to 544t in 2012), as that of technology (404t compared to 407t in 2012), while demand for jewelry (2,197t compared to 1,950t in 2012) and direct savings/investments (1,654t compared to 1,289t en 2012) significantly progressed.

Jewellery demand is at its highest since 2009 and has registered the strongest volume growth since 1997. Most of the increase took place in the first half of the year as Indian demand slumped in the second part of the year.

On the supply side, production increased slightly (3,018t against 2,864t), while recycled gold declined for the sixth consecutive year (1,371t against 1,590t) thus explaining a global supply decrease from 4,415t to 4,339t.

Which are the factors which will most likely support a trend reversal in 2014?

First, on the supply side, we see a very unlikely progression in the near future. Production which is an essential element of the supply chain it is expected to stay relatively stable, especially given the major efforts carried out by mining companies since 2013 in order to improve their earnings. The cost reduction process and concentration of production on the most profitable mines should probably improve the earnings but offer **little increase in volume. The scrap gold recycling activity should in turn decrease for the 7th consecutive year. We thus estimate the total gold supply at around 4,500 tonnes for 2014.**

On the demand side, we expect a continuation in all previously observed trends in 2013. Two should be the exceptions which should bring the demand for physical gold beyond 5,000 tonnes, thereby causing a positive imbalance to rising prices.

Jewellery demand is expected to continue its upward trend following the recovery in the economic activity and reach **2,450** tonnes. The import taxes introduced by the Indian government to fight against the fall of the rupee should be lifted and resume Indian imports which were in free fall in the second half of 2013. **Electronic or industrial demand** could also pick up and go beyond **425-450** tonnes. In 2013, the correction of the price of gold elicited a strong and swift response from consumers especially in Asia, a conservative reflex which also extended to the United States. **Savings demand** should remain strong in 2014 and be between **1,600-1,800** tons. Another segment of the global gold demand is identified by the World Gold Council as stock flows and Over the Counter (OTC) investments which will certainly remain relatively stable. That said, **global demand** excluding central bank activity and investments in the form of ETFs could already reach **5,200** tonnes.

The massive sale of ETFs which balanced out the gold market against all odds in 2013 will not take place in 2014. Ergo, we rather expect a return of investors, who will contribute to the rising demand for approximately 200-400 tonnes.

Investment demand for ETFs dropped by -33%, which coupled with the fall in gold prices by -32% has significantly reduced the exposure of physical gold in portfolios and investment strategies, to the point of no longer being considered by many as an actual risk.

A change in the markets' perception of the Federal Reserve's monetary policy was recently enhanced by the comments of the new Fed's chief. Janet Yellen confirmed that she would continue with a loose monetary policy in the wake of that adopted by her predecessor. The Fed Chairman has a notable concern for the job market, and would certainly maintain a loose monetary policy beyond the 6.5% U.S. unemployment threshold.

Furthermore, the Commodity Futures and Trading Commission (CFCT) data as to December 31st, 2013 shows that short positions had once again reached 105,000 contracts. This was close to the level in June (130,000), meaning more than 100% of the 5-year average (40,000). A further rise could cause a situation of short covering which would be positive for gold and should further motivate ETF holders to keep their positions.

Furthermore, we believe that central bank demand will certainly be superior to published statistics, in particular because of the position of China and its likely wish to discreetly increase its physical gold reserves.

Central banks have switched from being gold sellers to net gold buyers in 2010. According to the World Gold Council official statistics, the figures show that central banks made net purchases of **368t** of gold in 2013. Surprisingly, Russia (77t), Kazakhstan (28t), Azerbaijan (20t) and Korea all saw significant increases in official reserves. Surprisingly, China still announced 1,054 tonnes of gold (1% of its total reserves are primarily composed of U.S. Treasury bonds), roughly the equivalent of Swiss (1,040t) and Russian (1,035t) gold reserves. If the net demand is probably underestimated, central banks clearly seem very reluctant in reducing their stocks.

But if central banks all seem to be net buyers, official stocks of the top ten have not varied much. For instance, those of the U.S. Federal Reserve leveled in recent decades to about 8,000 tonnes, the equivalent of 70% of its reserves.

China also announced stable reserves since 2009. But can it really dispose of 1% in gold of its total reserves?

China needs gold and silver to back the Yuan and diversify its reserves

Over the last twelve months, China **imported around 1,000 tonnes of gold** (**850 tonnes in 2012)**. China surely benefited from the massive outflows of ETFs and the absence of the traditional Indian demand, to buy at a good deal almost a quarter of the available 2013 production.

However, China is said to have produced nearly **450** tonnes of gold in 2013 thanks to major investments in the mining industry which in the meantime has forecasted a production growth of +10% per annum.

Are Chinese imports and production exclusively intended for domestic consumption since China does not seem to export its gold?

China has recently emerged as the second largest economy but at present, its reserves are strongly linked to the USD and the U.S. Treasury bonds. At the end of 2013, China had the largest foreign exchange reserves in the world **($3,820 billion)** thanks to its trade surplus which hiked by +13% in 2013 at $260 billion.

The massive flow of gold into the country makes it look as if Chinese authorities are controlling the yuan in an effort to internationalize the currency in the long-term. In recent years the Chinese yuan has gained ground as a global currency. Over the last two years the renminbi went from 20th in world ranking to the 9th most actively traded currency. Moreover, thanks to the trade agreements signed with Russia, Brazil and Australia these countries began direct trading of their currencies for renminbi in international trade. Beijing is stepping up efforts to make the yuan a globally accepted currency. But for it to become even safer in the eyes of all partners and potential investors, the strategy which has been discreetly implemented by the Chinese authorities is certainly to dispose of more substantial gold reserves than those detained so far. China may have the ambition of becoming the world's largest physical gold holder to ensure the yuan's international exchange status.

It certainly does not lack the resources. Diversifying 10% of its reserves would only represent $**380** billion, which would be the equivalent of a little more than two years of global production. At the current price $1,300 an ounce, 1,000 tonnes of gold represent $42 billion. By 2020, China might have the ambition of reaching the U.S. 1st place in the physical gold reserves. It will undoubtedly seek to establish a significant stock, close to **10,000 tonnes** of gold which would account for $**420 billion**, thus probably even less than 10% of its future reserves.

China will diversify its foreign exchange reserves excluding U.S. Treasury holdings through gold and silver purchases.

Hence, it will still accumulate a significant portion of the annual supply in the upcoming years. This strategy must absolutely remain discreet to ensure its success.

Conclusion

Fundamentals are positive for 2014, as supply will be relatively stable while components of demand will strengthen.

Investment demand will be back to positive and Indian imports will be resumed.

China will continue its role as discreet world player, but always on the buyer's side.

Return of an imbalance between supply/demand favorable to higher gold prices in 2014.

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