Precious Metals International Context

By Jeremy East, Managing Director Global Head, Metals Trading, Standard Chartered Bank

The following article is the Keynote Speech delivered by Jeremy East at the LBMA Bullion Market Forum in Singapore on 25 June, 2014.

Introduction

Thank you very much, ladies, gentlemen, and Minister. I notice there is no session here called 'East goes east'. I have spent most of my career in London. A year ago, I moved to Hong Kong. The reason for moving out to Asia was really a reflection of what is going on in Asia and the development of Asian markets. One of the key reasons that we are here today is because of what is going on out in Asia.

Today, I am going to talk a bit about what is going on in the Asian markets. I will obviously talk a lot about China because it is now the largest market in gold. We will look at the price trends and the impact of Asia on those, and also at what is happening with the physical flows. Where is the gold going to?

Then, as I said, I will talk about China and what is actually going on in China. Why it is becoming much more important on the global stage and why is it trying to become more international with RMB internationalisation?

Finally, I will talk about how this is going to impact the London and New York markets.

Gold Price Drivers

Three years ago, there was another Jeremy here, Jeremy Charles. He was talking about the growth of the ETFs. Three years ago, the ETF was around 70 million ounces. Later that year, it grew to 85 million ounces. The ETF is one of the main developments in the gold market. At the same time, the gold price rose up to $1,900 per ounce, a key driver was the growth of the expansion of ETF holdings. We all know what happened in the following few years, and if you look at the gold price, clearly the liquidation of the ETF was a main driver of that move down too.

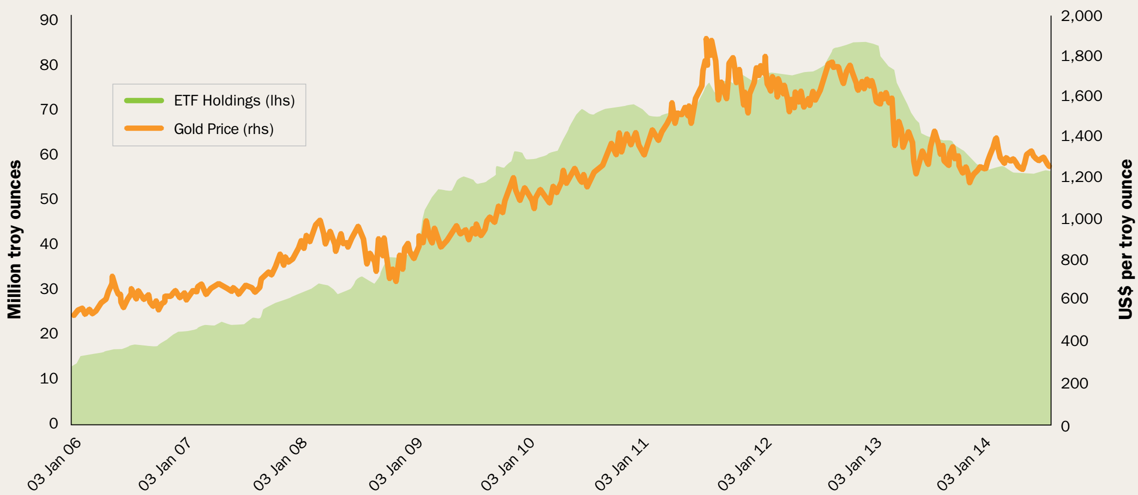
If you look at the key drivers from our colleagues at Goldfield GFMS, they talk about import duties in India, ETFs, quantitative easing, Western budget deficits and US interest rates. These are all the things that we frequently talk about as influencing the gold price. However, there is no mention of the biggest player in the market. There is no mention of China. I think things are changing.

The China Effect

Let us look at this year. When we started this year, everyone was bearish and gold was around $1,200. In the run up to the Chinese New Year, the premium in Shanghai spiked to $1,500. There was a huge flow of physical gold in to China in the first four weeks of the year. Very soon after that, instead of moving lower as everyone expected, the gold price rallied strongly on the back of the demand from China and it moved up to close to $1,400 at $1,390. What happened at that point? I can tell you what happened. The PBOC allowed the Chinese currency to weaken. It had a massive impact on the gold market. Very few people have been talking about it. Within a few days, the premium on the gold exchange had actually turned to a discount. The Chinese demand for gold dried up and within the next two weeks gold dropped $100.

It is important that we now start to see and understand what is going on in China, because it is having an impact on the international prices. Recently, we have seen the gold price bounce back. It came down to around $1,250 and then back up to $1,300. At $1,250, the PBOC allowed the fixing to get slightly stronger in China, and so we suddenly saw a little bit more confidence coming in to the Chinese market, with people more confident in terms of what was going on with their currency and a bit more confident in terms of what they could do with gold. Whether it is a coincidence or not, I think it is important to realise that this is starting to be a major driver.

Chart 1: Total known ETF Gold Holdings and the Gold Price



Source: Bloomberg

Flows of Physical Gold from West to East

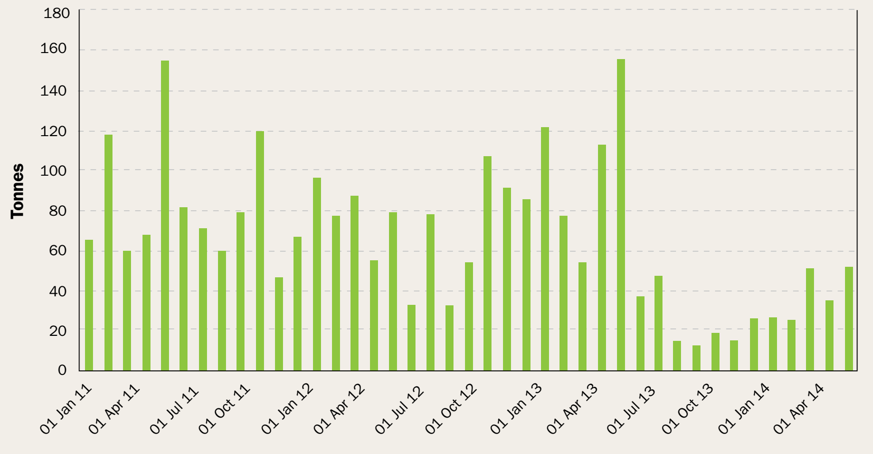
I will now have a look at the physical flows. The ETF built up a stock of around 85 million ounces, but it took many years – a decade or so – to get there. Within one year, approximately 30 million ounces were liquidated, so there was a huge amount of selling. It was not just ETF selling, it was also physical, so there were people with physical holdings liquidating as well. As we saw with the gold price from last year, there was huge selling from investors but also huge selling from people who had held gold as a safe haven, so there was a huge amount of physical selling.

So, where did the gold go?

At least part of it went to India. In the first four months of the year, India imported a huge amount of gold and, thereafter, basically nothing. The imposition of higher import duties and the new 80:20 rule meant that Indian imports were really nothing after May. By September 2013, imports were at their lowest level for 10 years. So, where did the gold go?

Just a few more comments about India: obviously one of the reasons driving India is the current account deficit. I am sure my colleagues will go in to this in more detail this afternoon. Gold was one of the top imported commodities for India. There was a real focus on gold in terms of saying if we can reduce the amount of gold going in to the country that will improve the current account deficit. If you look back to Q4 2012, the current account deficit was almost $32 billion. The government decided to control that and, soon after, as we see in terms of the data, this had an impact, firstly on the gold import volumes and then in the trade data. We saw the current account deficit come down dramatically. In fact, if you look at the first quarter of 2014, it is down to just over $1 billion. Our understanding is that India now believes it is comfortable with a current account deficit which is about 2.5% of its GDP, and current levels are presently below that, at around 1.7%. The expectation is we will start seeing more relaxing of duties or perhaps of the 80:20 rule by the government. I think it is important to understand that potentially the Indian numbers may have overshot on the downside and this may have an impact on the gold market later in the year.

Chart 2: India Gold imports



Source: Standard Chartered Research

China really bought gold last year and it also continued to into this year. My numbers are estimates rather than the exact numbers, but it gives you an idea of what is going on. In the last few years, China has probably imported more than 3,500 tonnes of gold. Last year, it was probably around 1,400 tonnes. You also need to add on 400 tonnes of domestic production, so China is now by far the largest gold market in the world, consuming probably around a third of all gold produced. It has overtaken India; it is now the largest driver in the physical market.

I will say a few words about the physical flows. Obviously, we saw the ETF selling and we have also seen physical selling of gold in the west. The ETF gold selling is 400 ounce loco London bars in vault. These gold bars did not find their way back to London. The majority of this gold found its way out to Asia. The large bars were converted through the Swiss gold refineries and other refineries, and shipped out to Asia and supplied largely to the Chinese market.
There were huge logistical challenges last year, such as taking metal out of storage that had been there for many years. The refineries struggled with the volume, in terms of being able to convert the gold into kilo bars for the Asia market, and we saw an unprecedented squeeze on the premiums for physical gold.

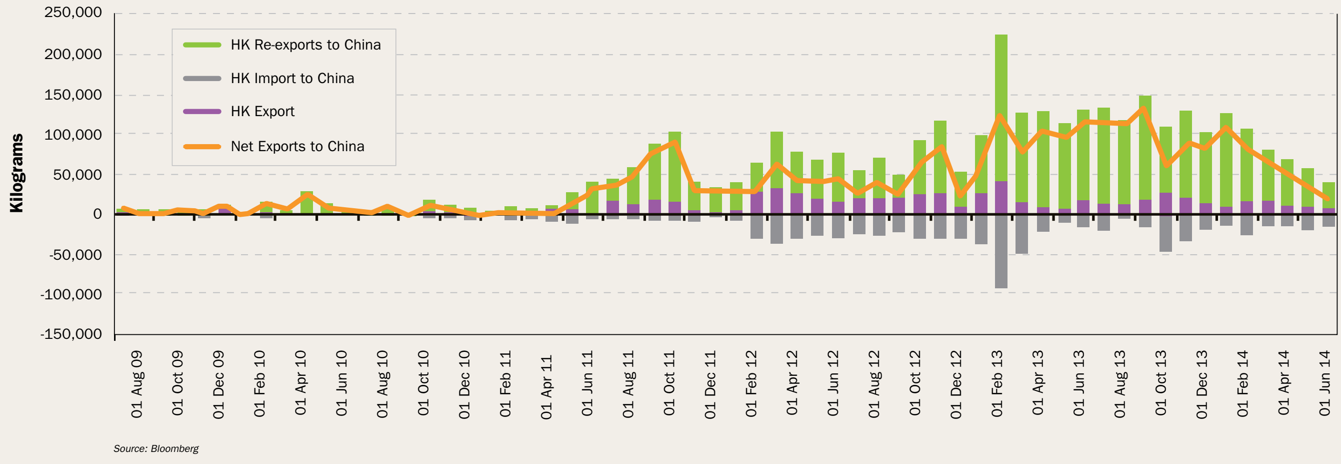
Now, we are actually seeing quite an interesting situation. The Chinese market is still taking gold. This year, we have seen the ETF stabilising and there is no real selling of the ETF. The current level of scrap supplied to the market is low and probably close to non-existent. We are now seeing a growth in supply coming from producers going directly to the Chinese market. We are seeing gold flows circumventing the London market when, historically, gold would typically find its way to London and then out again. So we are seeing a bypass of the London market and, in fact, in times of strong demand from Asia, gold is being drawn out of the London market. From time to time, there is tightness in liquidity and I think this is a trend it is worth keeping an eye on.

Why are the Chinese Buying?

So what is going on in China? Why are the Chinese buying? It only seems to have been happening over the last few years. What is going on?

1. China's Gold Friendly Strategy
I was at the Shanghai Derivatives Forum at the end of May and one of the speakers was a

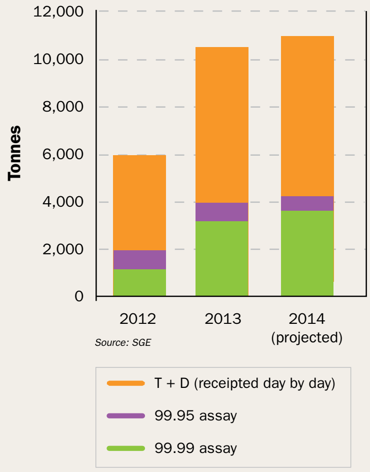
Chart 3: Hong Kong Gold imports



Source: Bloomberg

representative of the Gold Association. He gave us quite an interesting insight into the flavour of what is going on in China from a strategic perspective. Some of the things he talked about included that China planned to change the landscape of world gold markets. He talked about having a strong currency and about having that currency backed by gold, like the US dollar. He also talked about people holding more gold and encouraging more people to hold gold. That is not just individuals, but also the central bank. From that perspective, it is also getting gold into the country in terms of encouraging domestic gold production, but also investing in international mining companies and sourcing the product from them. China has got a very friendly gold strategy.

Chart 4: Shanghai Gold Exchange gold contracts turnover



2. China's Purchasing Power
China is becoming much wealthier. Most economists thought the purchasing power of China would overtake that of the US in 2019. They were five years too soon. It happened this year. The GDP of China is still way below and probably half of that of the US. However, purchasing power is greater. This means that Chinese people have more money to spend. Obviously, we cannot relate it directly to what is happening in the US, but it is a real data reflection on what is actually happening and there is a huge growth going on.

3. Growth of Asia's Regional Markets
In addition to being wealthier, how do you spend that? How do you invest that? China has a very accommodative strategy in terms of promoting gold in the domestic markets. We have seen that in terms of the volumes that have been going through the Shanghai Gold Exchange and also the products that are going through. However, it is not just the Exchange. The government is encouraging the local banks to offer new gold products to their clients. They are building distribution networks for gold investment bars and coins, and pass book accounts. China is now is the largest country for gold processing in terms of jewellery and small bars, and in terms of the jewellery space, there has been a massive expansion of retail space in China in the last year, allowing people to invest in and buy jewellery.

It is not just the physical markets. It is also the futures markets that are expanding. Here, we look at the Shanghai Futures Exchange. Gold from the Futures Exchange is now the second most actively traded contract globally, and silver is the most actively traded contract globally. So the Futures Exchange is also driving the market.

RMB Internationalisation

1. Impact on Dollar Denominated Commodity Markets
China is going through a strategy of internationalising the RMB. This will have a direct impact on international commodity markets. Payments between the US and the rest of the world, and exports from China to the US are seeing a dramatic increase in the use of the RMB rather than US dollars. What we can expect to see is imports into China – for example, commodities – starting to be paid for in local currency. China is probably the largest consumer of commodities globally. It is the largest consumer of copper and iron ore, and we now know it is the largest consumer of gold and oil.

In terms of the strategy for internationalising the RMB, why not encourage the market to pay for these imports in RMB, so when China buys the imports, it will pay for them in RMB? This will help spread the internationalisation of the RMB. Recently, there were some transactions that allowed China to consume iron ore and pay for it in RMB. There was also the recent development of the Shanghai Free-Trade Zone, allowing a corridor for payments from CNY (onshore RMB) to CNH (offshore RMB). It is very important to understand what is going on in the Free-Trade Zone, because that will be, as I said, a corridor for commodity flows, and it will also have an impact on the precious metals market.

2. Benchmarking
How do you get people to use RMB? The way to do it is to use a benchmark denominated in RMB. We are seeing this initiative in the Free-Trade Zone. We have seen the Shanghai Futures Exchange launch a crude oil contract, denominated RMB. This is attracting a huge amount of excitement in China and we expect this to be a very successful contract. This will allow international traders and international companies to supply commodities into China through the Free-Trade Zone and to sell that commodity on an exchange benchmarked in CNH. That means that they are going to be transacting, internationally, in the RMB.

But of course it is not just China that is interesting, a lot is going on in Asia. The Southeast Asian market is a very important market for gold and as we hear today, the launch of the gold contract on the SGX is a key initiative. I would expect the interest in that to be significant, and we are proud to be associated with that initiative.

Lastly, I want to say that when you are using a benchmark, it is important that the benchmark is relevant for you and, importantly here, we are talking about the SGX benchmark for gold and the oil benchmark for China. Why should a country that is importing gold or oil use a benchmark that is set in London or Chicago? Is it not more appropriate that they use a local benchmark for that?

Conclusion

So just to conclude: what does this mean for the market? I talked about China and the impact of prices and flows. The Chinese economy will continue to grow and its pro-gold policy will continue, and I expect that to have much more impact in the future. I picked out a few points today regarding what is going on in China, the huge impact it is having on the global markets, and I think this will become more and more important in the coming years. Also, in relation to the global landscape, the liquidity of China's physical markets and futures markets will continue to grow, and they will overtake the more established Western markets.
Finally, in terms of the internationalisation of benchmarks, I think this will be the biggest challenge for Asia. It is a challenge to be able to change how people use physical contracts against benchmarks. However, I think it is an initiative that will play out in the long term, and in the short term, we are already seeing progress, especially in China. So, I would say, in terms of the benchmarking, watch this space.
Thank you very much.

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Mr Jeremy East has over 25 years of experience in the metals industry and joined SCB in 2006. His responsibility covers metals trading, hedging, financing and investment solutions covering both physical and derivative products. Additionally, he built up SCB's commodity inventory financing business. The metals trading business has presence in Shanghai, Hong Kong, Singapore, Dubai, London and New York serving its franchise client base mainly in Asia, the Middle East and Africa. SCB is Category 2 member of the LME, member of the LBMA and market making member of the LPPM and was the first international member of the Shanghai Gold Exchange. Jeremy recently relocated to be based in HK, to drive the growth of the metals business in Asia.

Before joining SCB, Jeremy was Global Head of Precious Metals at Commerzbank and also board member of Argor Heraeus – the Swiss gold refinery, where he focussed on a physical precious metals franchise in India, Turkey and in Russia and CIS.

Prior to that, Jeremy started his career with Philipp Brothers, then the largest commodity trading company in the world, where he traded base and precious metals. In 1990, he joined Salomon Brothers to run the precious metals business in London.

Jeremy is an International Advisor to the Shanghai Gold Exchange and on the Management Committee and The Membership Committee of the LBMA.