FROM THE CAPITAL

Too many gaps in gold data

Not helpful in resolving a mystery critical to an understanding of the state of the gold market

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There is no point looking to the World Gold Council (WGC) to understand what is happening in the gold market. Its data for the March quarter beg too many important analytical questions about why gold prices rise.

The WGC reported that "gold demand grew 21% to 1,289.8 tonnes" in the first quarter of 2016.

The gold price appreciated by 17% "on the strength of investor conviction", according to the gold industry mouthpiece as it reported breathlessly that "the enthusiasm with which investors renewed their appetite for gold ETFs in Q1 was palpable".

One needs to understand the contrived nature of the council's reporting framework to avoid drawing a hopelessly inaccurate conclusion from its commentary.

The stock of gold held did not increase by 21%. Nor was the amount of new gold acquired in the March quarter 21% higher than the amount taken up a year earlier.

Either of these inferences may have been validly drawn from similar statements by other industry associations less intent on proselytising than analysing. But not the WGC.

The WGC can misleadingly assert such a large increase only because there are gaps in its reporting. It keeps tabs on some holders of gold, but not others.

In this instance, the statistics published by the council show that the amount of gold purchased by exchange traded funds in the March quarter increased more than tenfold to 338.1t.

The council weaves a storyline around "swirling uncertainty" to justify a supposed increase in demand by investors concerned about a loss of confidence in traditional asset classes. Their flight to safety, on this reasoning, propelled prices higher.

There are pieces missing from the gold market puzzle

The only source of new gold over the past year, as always, was from mine supplies. They were 56.3t higher in the quarter than in the previous corresponding period, on the reckoning of the WGC.

Without any other feasible source of new gold, the WGC statistics imply that the bulk of the gold newly acquired by exchange traded funds must have come from sources liquidating previously held positions or transferring gold from alternative investment structures.

The March-quarter outcome may just as validly warrant a headline along the lines of "slump in demand for gold". Unless the WGC can identify the source of the gold being taken up by the ETFs, its statistics are going to be of little value to an investor trying to interpret what may be happening.

There is also a flaw in the way the WGC tries to portray the price impact of the physical gold movements it is describing. The WGC compares physical movements in the first quarter of 2016 with the equivalent changes in the first quarter of 2015. In contrast, it compares the gold price in the first quarter of 2016 with the price at the end of the December quarter of 2015.

The average London gold price of US$1,182.6/oz in the most recent quarter compares with US$1,218.5/oz a year earlier. Perversely, the allegedly one fifth increase in demand appears to have coincided with a lower price.

In contrast to the first quarter of this year, the WGC had estimated that ETF holdings of physical gold had fallen by 312t during 2014 and 2015.

Over a period of 27 months, the actual net change has been quite modest.

The WGC seems unable to account for either the source of the ETF gold accumulation this year or the destination of gold resulting from ETF liquidation in the prior two years.

Controversy abounds among gold market analysts about the accuracy of bullion market data.

Some have argued cogently that the amount of freely tradeable gold has been sharply reduced through unreported or surreptitious transactions resulting in gold being shifted into the vaults of the Chinese government, for example.

> **"A large body of investors thinks of gold as a monetary instrument or currency. For them, physical movements are less important than changes in financial market relative prices"**

Any material rundown in the amount of gold available to investors trading in response to near term changes in macroeconomic conditions, such as if gold is being secreted by unidentified buyers, would make gold prices increasingly sensitive to relatively small changes in macro conditions.

The WGC statistics, by leaving so many gaps, are not helpful in resolving a mystery critical to an understanding of the state of the gold market and its price prospects.

The WGC pretends gold is a commodity like copper or coal and dresses up its analysis accordingly. However, the typical commodity market physical balance analysis is focused on what happens to current-year production.

Inferences are drawn about prices from an assessment of how much is left unused by industry at the end of the period.

The WGC analysis, on the other hand, confusingly mixes current production and transactions arising from the historical stock of metal even when those latter transactions do not involve any net change in the stock on hand.

Meanwhile, a large body of investors thinks of gold as a monetary instrument or currency. For them, physical movements are less important than changes in financial market relative prices.

The gold price change in the March quarter coincided with a reappraisal of the extent to which the US Federal Reserve would normalise interest rates during 2016. Connected to that, a fall in the US dollar took the exchange rate to its lowest level in over two years.

These financial price changes would have warranted an increase in US dollar denominated gold prices.

No doubt the full extent of the upward move was reinforced by traders attracted to a rising price, but the end result was a gold price that remained within the range it had occupied for the best part of three years.

Whether gold prices rise in response to more aggressive buying of physical gold, or whether buying is a reaction to the expectation of a positive investment return from changing financial-market relative prices, remains unclear from anything reported by the WGC. ■

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