Now you see it, now you don't

Gold statistics need a revamp to make sense

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The World Gold Council (WGC) report on gold demand and supply in 2013 highlighted a rebalancing in demand toward China and away from the rest of the world. Although promoted as a sign of improving market conditions, these are flimsy analytical foundations for conclusions about the direction of the gold market.

In its preliminary report on gold market demand and supply conditions in 2013, the WGC reported mine output of 3,019t, a 5.4% increase over the quantity mined in 2012. An outflow of bullion from exchange-traded funds of 880t was partially offset by central bank purchases of 369t. Fabrication demand, primarily for jewellery, accounted for additional demand of 305t.

In an interview on the CNBC cable business channel following the release of the WGC report, Goldcorp chief executive officer Charles Jeannes cited "the tremendous physical demand we have seen from elsewhere in the world, primarily China" in 2013 as one of the reasons for there to be a floor for the gold price.

According to the WGC statistics, Chinese consumer demand for gold increased 32% in 2013, or 259t out of a worldwide increase in jewellery and bar and coin purchases of 678t. While China accounted for the largest single national tonnage increase, demand in several other countries including Thailand, Egypt and Turkey increased by a larger percentage. Meanwhile, demand fell in Europe.

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At this end of the market, potential purchasers are highly sensitive to price and risk. Unsurprisingly, therefore, weaker prices brought an increase in the WGC assessment of how much gold was demanded. Unsurprisingly, too, the

There's gold in them thar… statistics

numbers went up where political strife seemed to be on the rise.

From an investment standpoint, however, stronger consumer demand is an ambiguous indicator of the state of the gold market. It might simply show that prices are weak and that institutional selling pressures are a dominating influence.

The WGC numbers could also be considered misleading insofar as they measure how new supplies of gold are used and do not quantify demand in the sense in which it is more frequently used in other market and analytical contexts. The WGC numbers do not measure the quantity or value of gold jewellery purchases, for example. They measure the quantity of new supplies of gold transformed into jewellery. Consequently, increasing quantities of existing gold jewellery changing hands would not cause the WGC to record any increase in demand.

Rising demand, in the WGC context, requires rising supplies of new gold or transformations of gold from one form (eg gold bars) into another form (eg jewellery).

A potential buyer of gold could choose between transforming a gold bar into jewellery and purchasing already existing pieces of gold jewellery. If he or she bought existing gold jewellery, there would be no impact on recorded demand. If a gold bar was used, on the other hand, to produce new jewellery, higher consumer demand would be reported.

These are not helpful distinctions with which to analyse the gold market for investment purposes. In reality, by having no regular measure of jewellery turnover, we are none the wiser as to whether consumer interest has risen or fallen. Just as purchases of existing gold jewellery would not be recorded as demand, nor would central bank buying, no matter how aggressive, if the gold came from other central banks.

Since the starting point for its analysis of the gold market is fresh production, demand cannot increase unless mine output is also rising, according to the WGC framework. By defining demand as where new supplies are going, demand will almost certainly keep rising as long as mine supplies are going up.

Some apparently paradoxical analytical conclusions arise when demand for gold must depend on its supply in this way.

Assume, for example, that mine output was falling and no current holder of gold was prepared to sell, no matter how high gold prices rose. The WGC methodology would force a conclusion that gold demand was falling despite these conditions signifying market strength rather than being a sign of weakness.

Conversely, if large numbers of current holders of gold began selling or mine supplies rose rapidly, causing dramatically lower prices, the WGC would conclude that demand for gold was hitting new records.

As long as the framework for analysing the gold market involves a closed system, citing high offtake in one place is rendered analytically meaningless. Any apparent increase in Chinese demand, as measured in this way, is by definition offset by selling elsewhere.

Implicit in the use of China as an indicator of demand is the idea that it is somehow more important than an equivalent level of demand (or lack of it) from anywhere else. The WGC and those companies that use its data need to put forward the evidence to support such a contention, if that is what they mean to say. Without such corroborating evidence, the only meaningful conclusion to be drawn from an increase in Chinese demand, as defined by the WGC, is that there has been selling from other sources, whether they are mines, central banks or investors holding gold in other forms.

Unfortunately, as things stand, the WGC statistics create some headlines but little else. In doing so, those who bankroll the organisation – ultimately the investors in 21 of the world's largest mining companies – could legitimately ask whether this is enough of a benefit to the gold mining industry for the money spent.

Mining companies should perhaps be asking how the flow of these statistics helps create demand for equities. That is where their interests lie. As with the CEO of Goldcorp, they try to use the numbers as best they can to support arguments about their investment cases but, beyond some superficial attractiveness, the numbers do little to buttress the case for investing in companies mining gold. An industry already battling to stop wasted spending should be thinking about the effectiveness of its spending on these efforts, too.▼

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