

Financials, Not Fundamentals, Drive Gold

by Joe Foster, Portfolio Manager and Strategist

Gold Continues to Trend Higher in June

Gold and gold stocks clocked another strong month. The monthly low of \$1,670 per ounce came on June 5 as the May U.S. jobs report showed nonfarm payrolls rising by 2.5 million, rather than falling as forecast. However, the good economic news didn't last as the World Bank released a study that expects the U.S. economy to shrink by 6.1% this year, while the Congressional Budget Office (CBO) estimates a budget deficit of \$3.7 trillion. Gold trended higher as the U.S. Federal Reserve (Fed) reaffirmed its dovish policies and forecast a median unemployment rate of 9.7% in the final quarter of this year. Spot gold ended the month with a \$50.69 (2.3%) per ounce gain and new seven-year high of \$1,780.96 per ounce amid new coronavirus outbreaks in Beijing, Latin America and many states in the U.S. It is clear that the pandemic is becoming a persistent impediment to the economic recovery. Gold stocks rose with gold, as the NYSE Arca Gold Miners Index (GDMNTR) gained 6.4% and the MVIS Global Junior Gold Miners Index (MVGDXJTR)² rose 7.0% for the month of June.

A Unique Financial Asset, Not a Commodity

The gold market is unique for a variety of reasons. Gold has been a store of wealth throughout human history. It has functioned as a currency and remains an important component of central bank reserves. It acts as a hedge against systemic financial risks. For these reasons, we don't see gold as a commodity, but as a financial asset.

Gold is hoarded like other financial assets such as stocks, bonds or even art. All of the gold ever mined is available to the market at a price. According to the World Gold Council (WGC), the above-ground stock of gold in 2018 was 194,112 tonnes (6.2 billion ounces). In 2019 there was 3,480 tonnes (112 million ounces) of gold added to the above-ground stock from mining, which translates to a supply increase of 1.8%. This limited supply that has grown at roughly 2% per year throughout history is a key reason that gold has functioned as a currency, store of wealth and inflation hedge.

As a financial asset, the price is driven by currency and interest rate movements, government policies and threats to the financial system. The price is determined in the financial markets centered in London, New York and to a lesser degree, Shanghai/Tokyo where the vast majority of trading volume takes place. A much smaller volume of trading occurs in the physical markets for bars, coins, jewelry, recycled scrap and mined gold. While the physical markets are important, they are secondary to financial markets as a price driver.

COVID's Effect on Physical Demand for Gold

According to the WGC, global physical gold demand totaled 4,384 tonnes in 2019. Jewelry accounted for 49%, bars and coins 20%, central banks 15%, bullion ETF's 9% and industrial uses 7%. These percentages will look radically different in 2020 as the COVID crisis has had a profound effect on nearly every aspect of physical demand for gold. Here is our assessment:

China and India – These two countries are by far the largest consumers of gold, accounting for 1,539 tonnes or 35% of global physical demand in 2019. Lockdowns and shutting of business have decimated demand in both countries. The WGC reported first quarter global jewelry offtake fell to the lowest level on record, mainly due to declines of 41% in India and 65% in China.

The China Gold Association reports total first quarter consumption of 148.6 tonnes, down from 308.3 tonnes a year ago. India imports its gold and Reuters reports April imports fell to 20 tonnes from 93 tonnes in March 2019. Imports were down to 1.4 tonnes in May, compared to 133.6 tonnes a year ago. Bloomberg forecasts Indian jewelry demand will decline by 210 tonnes (30%) in 2020, while local market participants estimate a 50% (350 tonne) decline in total consumption for the year.

Central Banks – The last two years have been two of the strongest on record, as central banks had net purchases of 656 tonnes in 2018 and 648 tonnes in 2019. According to the

WGC, approximately 40% of 2018 and 2019 demand was from Russia and China. First quarter demand remained strong, as the WGC estimates net purchases of 145 tonnes. However, as the pandemic spread, many central banks turned their attention away from gold. The Wall Street Journal reports that in March, emerging markets countries depleted their foreign exchange reserves at the fastest pace since the financial crisis to contain a plunge to their currencies. UBS reckons central banks bought 26% less gold in April than the previous year. Standard Chartered Plc sees net purchases dropping to 360 tonnes in 2020. This is due, in large part, to China, which hasn't increased its official gold reserves since October, along with Russia's decision to suspend gold purchases in April.

Fundamentally, central banks remain positive towards gold, suggesting that once the pandemic clears, many may step-up their purchases. A recent WGC survey finds 20% of central bank respondents plan to add gold this year, compared to just 8% in the 2019 survey. Seventy five percent expect global central bank reserves to increase over the next 12 months, compared to just 54% in 2019.

Swiss Flows/Comex – Switzerland serves as the global crossroad for physical gold. Much of the gold that moves between London and the rest of the world makes a pit stop in Switzerland, where refineries recast the gold into the size, shape and purity needed in the local market of its destination. The overall volume of Swiss flows have been normal so far in 2020. However, the pandemic has radically altered the destinations of Swiss exports. The U.S. overtook China to become the largest destination of Swiss exports this year. According to Metals Focus and Reuters, from 2014 – 2019 the U.S. only accounted for 1% (roughly 15 tonnes/year) of Swiss exports, whereas from March through May the U.S. imported 281 tonnes from Switzerland. Meanwhile, China, Hong Kong and India combined imported just eight tonnes of Swiss gold from March through May.

Skyrocketing Swiss exports to the U.S. was caused mainly by gold flows into Comex warehouses. Because of lockdowns, normal transport and refining of bullion between London and the rest of the world became difficult. Hedging operations of bullion banks could not function normally and prices diverged between the two largest trading centers. Futures on New York's Comex traded at premiums of as much as \$75 per ounce to the London spot OTC market. As a result, according to BMO Capital Markets, Comex inventories have more than tripled since March to 964 tonnes.

Swiss exports to the U.S. and unprecedented Comex demand is related to logistics and trading arbitrage rather than fundamental factors. As such, much of this gold will eventually need a new home. Perhaps as the pandemic fades and other physical demand drivers normalize, Comex warehouse gold will find its way to other parts of the world.

Bars and coins – The economic damage caused by the pandemic along with growing financial risks have created very strong demand for bars and coins. Retail investors dominate the coin market. Global mints have limited capacity and are unable to satisfy periods of heavy demand. As such, coins can trade at a premium to the spot price for physical gold. Premiums have soared to as much as \$135 per ounce this year.

Bullion ETF's are probably the largest force in the market for bars. Most ETF holders are institutional investors, while a lesser portion are retail investors. According to Bloomberg data, ETF's globally have added 622 tonnes to their hoard this year, which is already more than in any full calendar year period since gold ETFs have been in existence.

Outlook

Demand for jewelry, the largest component of physical demand, usually declines when the gold price is rising. Record gold prices in many local currencies combined with pandemic lockdowns have created unprecedented declines in jewelry demand. Central bank demand has also weakened this year. WGC data shows physical supply exceeded demand in 2019, yet the gold price rose 18%. It looks like 2020 might be another year of surplus for physical gold. Prices can rise when physical demand is weak if demand in the financial markets is strong. Strong bullion ETF and coin demand gives us a window into the psychology of the financial markets, which have the most influence on the price of gold.

The above ground stock totals around 198,000 tonnes and the vast majority of owners are happy to keep their gold at current prices. In a bull market when financial markets are buying gold to hedge against risks, differences between supply and demand in the 4,400 tonne per year physical markets amount to an insignificant rounding error.

¹NYSE Arca Gold Miners Index (GDMNTR) is a modified market capitalization-weighted index comprised of publicly traded companies involved primarily in the mining for gold.

²MVIS Global Junior Gold Miners Index (MVGDXJTR) is a rules-based, modified market capitalization-weighted, float-adjusted index comprised of a global universe of publicly traded small- and medium-capitalization companies that generate at least 50% of their revenues from gold and/or silver mining, hold real property that has the potential to produce at least 50% of the company's revenue from gold or silver mining when developed, or primarily invest in gold or silver.

Important Disclosure

For informational and advertising purposes only.

This commentary originates from VanEck Investments Ltd, a UCITS Management Company under Irish law regulated by the Central Bank of Ireland and VanEck Asset Management B.V., a UCITS Management Company under Dutch law regulated by the Netherlands Authority for the Financial Markets. It is intended only to provide general and preliminary information to investors and shall not be construed as investment, legal or tax advice. VanEck Investments Ltd, VanEck Asset Management B.V. and its associated and affiliated companies (together "VanEck") assume no liability with regards to any investment, divestment or retention decision taken by the investor on the basis of this commentary. The views and opinions expressed are those of the author(s) but not necessarily those of VanEck. Opinions are current as of the commentary's publication date and are subject to change with market conditions. Certain statements contained herein may constitute projections, forecasts and other forward looking statements, which do not reflect actual results. Information provided by third party sources are believed to be reliable and have not been independently verified for accuracy or completeness and cannot be guaranteed. All indices mentioned are measures of common market sectors and performance. It is not possible to invest directly in an index.

All performance information is historical and is no guarantee of future results. Investing is subject to risk, including the possible loss of principal. You must read the Prospectus and KIID before investing in a fund.

No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission of VanEck.

© VanEck Investments Ltd / VanEck Asset Management B.V.



33 Sir John Rogerson's Quay
Dublin 2 | Ireland
vaneck.com | international@vaneck.com | +35 31 485 4989