Key themes

ETF investors rekindle their interest

Inflows into ETFs of 363.7t were the highest since Q1 2009 as sentiment towards gold improved markedly.

Shifts in the global economic and financial landscape have created a positive environment for gold investment in recent months. Uncertainty abounds:

- The Negative Interest Rate Policies (NIRP) implemented by central banks in Japan and Europe represent a shift to '*unconventional policies*' which create *'great uncertainty'*.[1]
- China's devaluation of the yuan fuelled fears over the country's economic health and the potential impact on global growth.
- And the pace of US interest rate rises is now widely expected to slow.

The swirling uncertainty created by this mix of factors undermined confidence in traditional asset classes. Turbulence hit stock markets around the world. The impact of NIRP in particular significantly reduced the appeal of sovereign bonds as a stable, low-risk asset. Enter gold-backed ETFs.

Table 1: Data highlights for Q1 2016 demand (see full details on pages 19–25)

	Tonnes				US$mn			
	Q1'15	Q1'16	5-year average	Year-on-year change	Q1'15	Q1 '16	5-year average	Year-on-year change
Demand								
Gold demand	1,070.4	1,289.8	1,114.7	↑ 21%	41,932.2	49,040.2	51,128.1	↑ 17%
Jewellery	596.9	481.9	589.0	↓ -19%	23,383.0	18,322.3	26,558.5	↓ -22%
Technology	83.3	80.9	92.4	↓ -3%	3,263.0	3,074.1	4,242.5	↓ -6%
Investment	277.9	617.6	292.1	↑ 122%	10,885.7	23,482.7	13,918.3	↑ 116%
Total bar and coin	252.2	253.9	326.2	↑ 1%	9,881.1	9,654.6	15,114.8	↓ -2%
ETFs and similar products	25.6	363.7	-34.1	↑ >300%	1,004.6	13,828.1	-1,196.5	↑ >300%
Central banks and other institutions	112.3	109.4	141.2	↓ -3%	4,400.5	4,161.2	6,408.8	↓ -5%
Consumer demand in selected markets								
India	191.7	116.5	227.6	↓ -39%	7,509.4	4,427.8	10,377.6	↓ -41%
China	275.4	241.3	247.4	↓ -12%	10,788.0	9,174.6	11,210.3	↓ -15%
Middle East	86.9	79.3	79.1	↓ -9%	3,403.5	3,016.4	3,601.0	↓ -11%
United States	33.9	40.9	45.4	↑ 21%	1,326.4	1,555.5	2,062.2	↑ 17%
Europe ex CIS	70.9	71.1	82.4	→ 0%	2,778.5	2,703.4	3,793.5	↓ -3%
Supply								
Total supply	1,081.0	1,134.9	1,108.8	↑ 5%	42,345.5	43,149.5	50,561.9	↑ 2%
Total mine supply	717.7	774.0	762.9	↑ 8%	28,115.8	29,427.0	34,425.1	↑ 5%
Recycled gold	363.2	360.9	345.9	↓ -1%	14,229.7	13,722.5	16,136.8	↓ -4%
Gold price								
LBMA Gold Price (US$/oz)	1,218.5	1,182.6	-	↓ -3%	-	-	-	-

Source: Metals Focus; GFMS, Thomson Reuters; ICE Benchmark Administration; World Gold Council

1 *http://www.bis.org/publ/qtrpdf/r_qt1603e.htm*

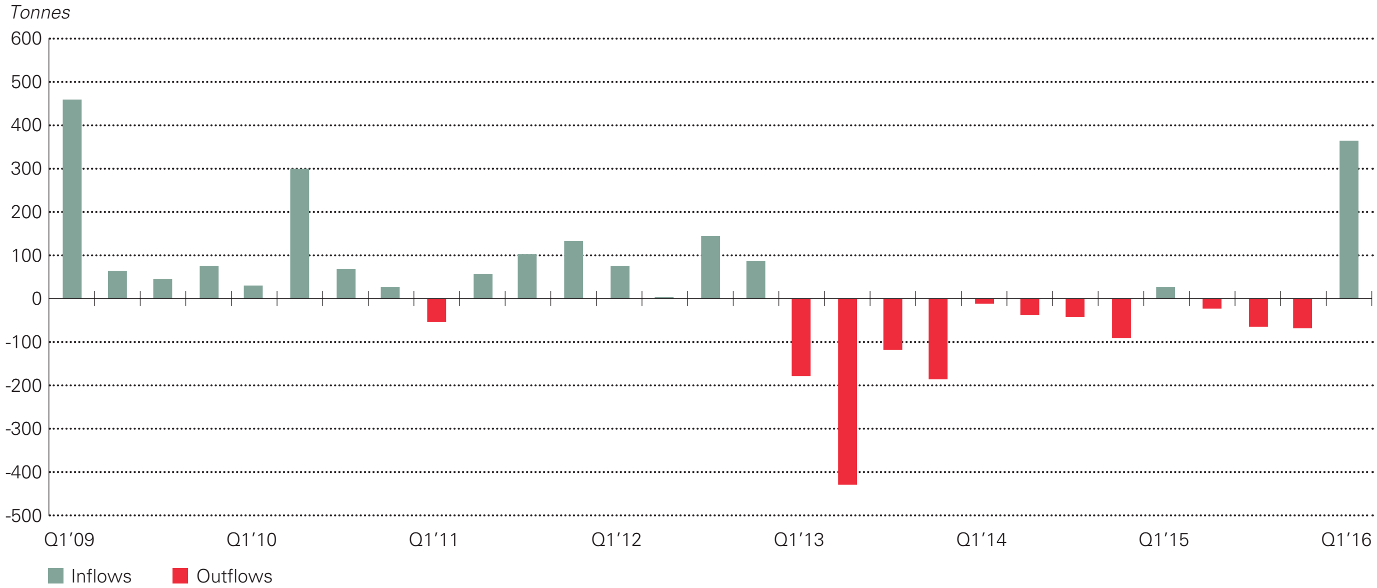
Having seen regular – and at times substantial – outflows over the last three years, ETFs had a stand-out quarter as gold's investment qualities came back into sharp focus (**Chart 1**). Inflows reached a seven-year high, close to levels last seen during the Great Recession when the sovereign debt crisis was also in full swing. Gold found favour for its role as an effective risk diversifier, enhanced by its added benefits of liquidity and relatively low volatility.

Inflows were reportedly from a broad investor base, from institutional to private. Notably, there is anecdotal evidence that many of these inflows are from investors initiating or rebuilding strategic, long-term holdings after the wash-out of positions since early 2013. While a portion of the inflows were driven by price momentum and likely to be more tactical in nature, latent demand among investors who have been looking for an opportunity to re-enter the market was a key factor.

Although largely a Western phenomenon, the appeal of gold ETFs was not limited to these regions. Inflows into gold-backed ETFs in China have risen exponentially in recent months. Although they still only account for a very small proportion of the 1,974t[2] held in these products globally, Chinese gold-backed ETFs on aggregate attracted 11.1t of inflows during the first quarter, more than doubling their holdings in the process. Huaan Yifu Gold ETF surpassed all other funds in Asia: total holdings at quarter-end were 13.5t, up 10.3t from the end of 2015. Although institutional investors were reportedly the driving force behind this flood of inflows, retail investors were also a considerable contributor, looking to gold for diversification and wealth protection.

Chart 1: Investors responded to uncertain economic environment with near-record ETF inflows

- Inflows were global, not restricted to dominant Western markets: volumes of gold held in Chinese products more than doubled during the quarter.
- The trend continued into April, particularly in Europe where investors were plagued by lingering 'Brexit' fears.



Source: Respective ETP providers; Bloomberg; ICE Benchmark Administration; World Gold Council

2 Holdings at end-March 2016, correct as per latest available data.

Investment demand ignites price rally

During the first quarter, the US$ gold price appreciated by 17% on the strength of investor conviction. This was matched by local price gains in markets across the globe.

The enthusiasm with which investors renewed their appetite for gold ETFs in Q1 was palpable – the gold price surged by 17% in response to such large-scale inflows. This was the best performance in almost three decades and gold ranked as one of the best performing assets globally during the quarter.[3] The effect was also felt in the price of gold measured in other currencies, with double digit gains in the euro (+11%), British pound (+20%), Chinese renminbi (+16%), Indian rupee (+17%) and Turkish lira (+13%) (**Chart 2**).

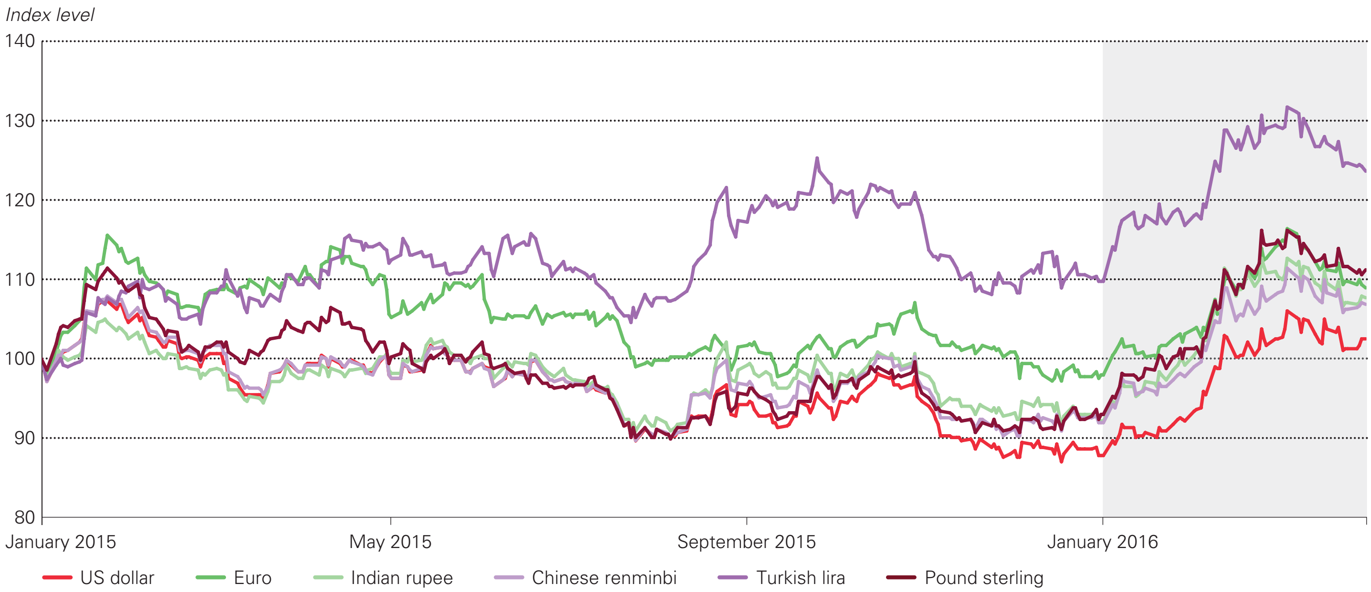
The investment response in the ETF market was echoed in surging physical demand for bars and coins in a handful of markets. US investors in particular were keen to add to their holdings, wanting the security of gold amid economic uncertainty. Demand jumped by 55% to 18.3t, albeit that this was being compared with a particularly weak Q1 2015. Bar and coin demand in the UK grew by a similar magnitude (+61%) although absolute volumes remained low (3.2t). And, powered by a strong German market, European demand remains resolute – at 58.4t it remains one of the largest markets for gold investment. China also increased its demand for bars and coins, encouraged by Chinese New Year festive purchasing and the rising gold price. Demand grew by 5% to 61.9t.

For the most part, however, the sharp price rally suppressed demand for bars and coins in the Middle East and Asia. This was to be expected among these particularly price sensitive markets, where demand typically subsides on a strong price rally before picking up again once the price stabilises.

Chief among these markets was India, where investment demand slumped in response to the price rally. Bar and coin demand fell by 31% to 28t, the lowest quarterly investment total for India in seven years. But it was Indian jewellery demand that garnered all the headlines.

Chart 2: Gold was a top-performing asset in Q1

- Gold closed the quarter at US$1,237/oz, 17% above the end-2015 price of US$1,060/oz. Double-digit gains were seen in a range of currencies, too.
- Sharp price rise had mixed effects on the market: jewellery demand fell, investment grew and recycling in some markets jumped.



Source: ICE Benchmark Administration; Thomson Reuters Datastream; World Gold Council

3 World Gold Council, *Market update, Gold outshines the market in Q1 2016*, April 2016.

Industrial action snuffs Indian jewellery demand

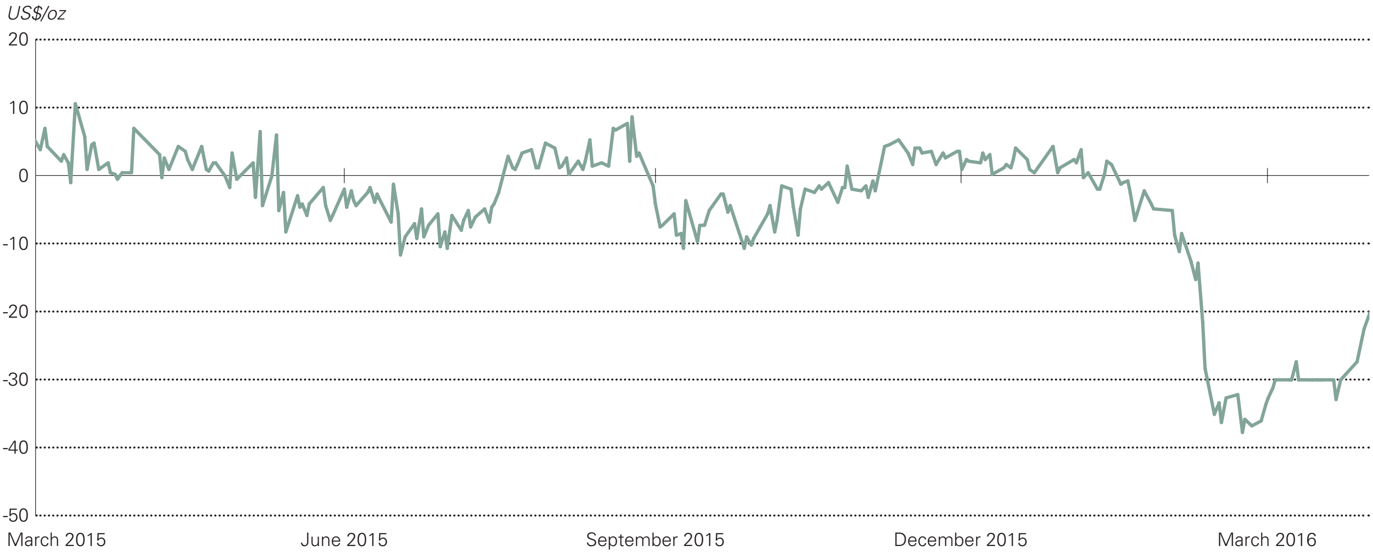
Jewellers respond to government tax rises with country-wide strikes, forcing Indian consumers to postpone Q1 demand.

India's jewellery market virtually ground to a halt in March as a combination of surging prices and industrial action in protest at government policy made for an extremely challenging quarter.

In mid-January, the local gold price breached the key Rs26,000/10g level, reaching Rs28,000/10g by 10 February before surging higher still, getting close to Rs30,000/10g by the end of the quarter. This sent a strong signal to Indian consumers to hold off on buying gold jewellery until prices stabilised. As demand dried up, the local market quickly moved into a discount to the international price. The discount widened sharply, reaching levels close to US$40/oz (**Chart 3**).

Chart 3: Price jump and market disruption push India into steep discount

- The discount widened out to almost US$40/oz on challenging market dynamics.
- This reflected not only a dearth of consumer demand, but also a drying-up of supply as the market effectively shut down in March.



Source: World Gold Council

Then, in the government's budget on 29 February, the Finance Ministry announced plans to impose a 1% excise duty on jewellery manufacturing.[4] The response from the jewellery sector was swift and decisive: a nationwide strike was called from 2 March with the support of national industry associations.[5] While jewellery stores in the south of India re-opened on 19 March, retailers across vast swathes of the country remained shut for the remainder of the quarter and into April. Given the higher penetration of single store retailers in the North, East and West of India, the impact on sales was more prominent for unorganised players, while branded chain stores were relatively resilient.

The widespread media coverage of the strike ensured that customers stayed away, even from those shops that chose not to strike. In its quarterly update to investors, jewellery giant Titan noted that it's premier brand, Tanishq was *"not participating in the strike but many of the stores had to be shut down on many occasions across the country due to agitations by striking jewellery associations. The customer walk-ins in the ensuing period have also been poor due to the customer perception that* [the] *entire industry is on strike due to which the sales performance for the month of March has been affected adversely."*[6]

Taken in this context, demand for gold jewellery was unsurprisingly weak. Quarterly demand of 88.4t was down 41% year-on-year and the lowest quarterly total since Q1 2009. Importantly, though, we believe demand from Q1 is postponed rather than lost. Most stores re-opened in the second half of April, ahead of the Akshaya Tritiya festival in early May and the start of the wedding season. This view is also supported by the sharp narrowing of the local discount as manufacturing activity resumed in April.[7] The pro-rural budget and expectations for an above-average monsoon should further support rural incomes, which has positive implications for gold demand over the coming quarters.

4 An excise duty of 1% on jewellery manufacturing was proposed in the budget. The introduction of this tax is a prelude to the Goods and Services Tax (GST) Bill. Jewellery manufacturers whose turnover exceeded Rs12 crore during the preceding financial year will be liable to pay this additional tax during current financial year.

5 All India Gems and Jewellery Trade Federation *(http://gjf.in/domestic_news.html)* and Indian Bullion and Jewellers Association *(http://ibja.co/ibja-news.aspx)*

6 *http://www.titan.co.in/TitanEcom/corporate/pdflinks/Investor%20Update/Q4%20FY%2015-16.pdf*

7 The local discount immediately narrowed to US$16/oz as soon as the strike ended on 13 April, shrinking further to US$4/oz by the end of the month.