ANDBANK RESEARCH

Global Economics & Markets

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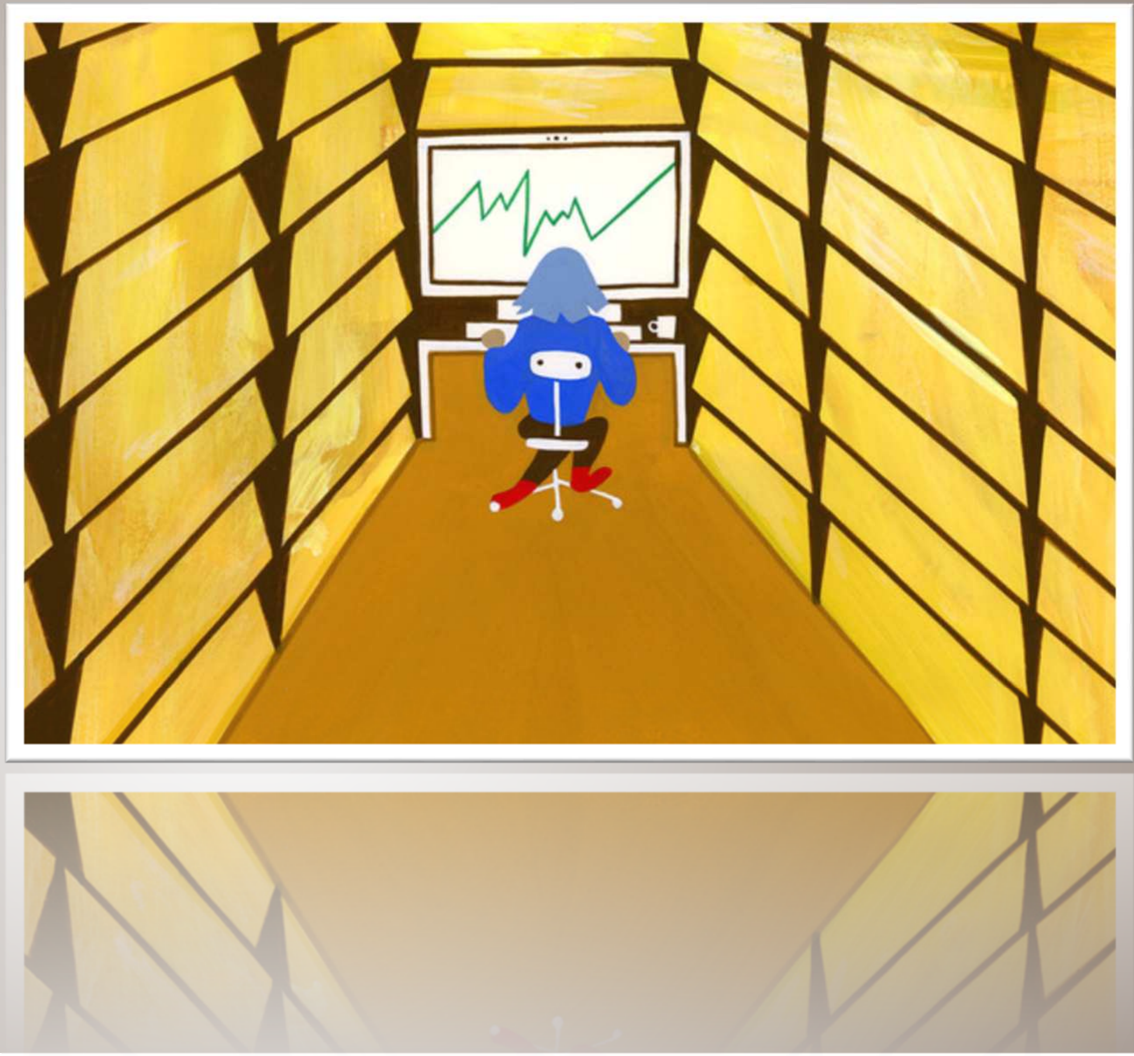


Working paper - 64

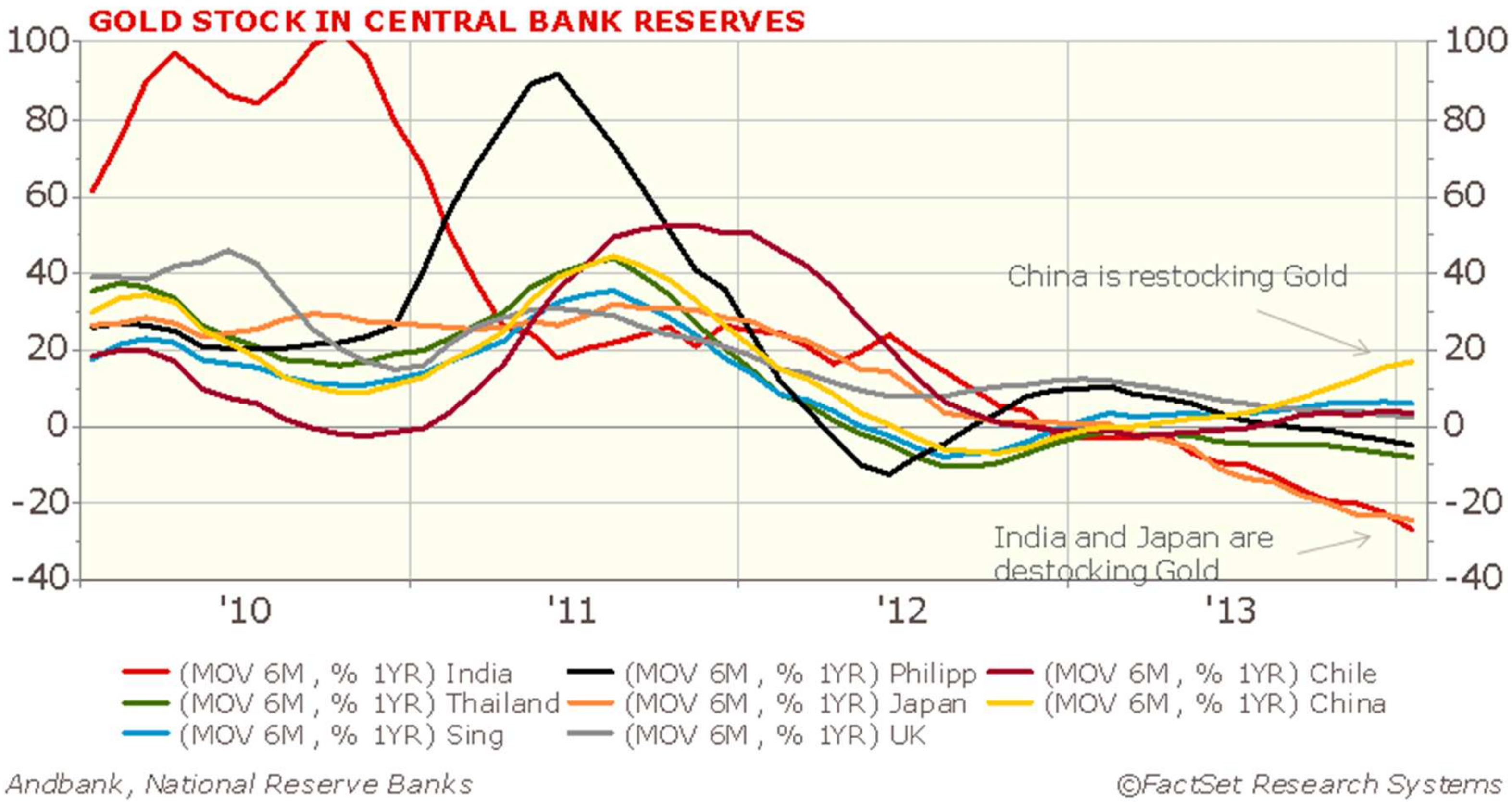
Investing in gold is like going to the casino, only with no bar service *(Ted Allen)*

January 31st , 2014

ANDBANK
Private Bankers

Have you asked yourself why is Gold so stable in these turbulent days with EM in panic mode?

- ✓ Because within the Reserve banks' activity in Asia, we are witnessing two offsetting forces.
  - On the one hand we have India and Japan that are firmly reducing their stocks of gold.
  - On the other hand we have China showing an evening appetite to increase its gold reserves (see the chart)



Which of these two forces will prevail? Is it gold price to remain range bound? or Is Gold going to head North again?

- In my very limited degree of wisdom, I identify today three major themes that could dominate gold prices in the foreseeable future.

(Ok. This is just one more of the many opinions you receive every day but … just hope it helps)

1. The Indian Factor.

- ✓ India, like China, accounts for 25% of global demand for Gold.
- ✓ As you already know (because I've been specially persistent in remind it to you), Indian Fx & government bonds have been specially hit hard by market participants for belonging to that group of countries experiencing current account deficits. (India's CA deficit was 5.5% in 2012, and although lower, it is going to be still high in 2013).
- ✓ In that regard, India will likely continue destocking Gold (in order reduce imports or raise exports, improve CA, and finally to abandon the "group" just to stop receiving blows.
- ✓ This factor will presumably continue to put pressure on Gold price
- ✓ Representing therefore **NEGATIVE IMPLICATIONS FOR GOLD**

… The other themes.

2. The Japanese Factor.

- ✓ The sale of gold by the monetary authorities in Japan is part of the BoJ's asset purchase program
- ✓ In the one hand, the BoJ expands monetary base to get fresh money and buy bonds. In the other hand, the BoJ sells gold in order to get money from the market and buy bonds as well
- ✓ The million dollar question is whether Japan will continue doing it. And … you also know perfectly my view in this regard. Yes.
- ✓ Until when? Many are projecting the limits of this policy through the prism of the USD/JPY exchange rate. They said "the BoJ will continue doing it until the USD/JPY reaches the 130 or maybe the 140 level, as it did in 1998 or 2002". They forget that Japan has now Europe's export champions in its crosshairs and that Germany is a major trade competitor. As a result, the prism should be better the EUR/JPY exchange rate. If so, the aggressiveness of gold sale could be much higher than previously considered since gold sale could continue until the EUR/JPY exchange rate reaches the 160 or 170 level (as it did in the 1998 and 2008).
- ✓ In summary, this factor will presumably continue to put also pressure on Gold price
- ✓ Representing therefore **NEGATIVE IMPLICATIONS FOR GOLD**

… The other themes.

3. The Chinese factor.

✓ Do you have some slight idea of why is China buying now Gold again? Let me give you a visual hint

✓ Yes, the Yuan is now at 20 year record high because of two reasons:

1. PBOC's Governor (Zhou Xiachouan) reported three weeks ago that the Bank would end regular Fx intervention. This drew the attention of investors who, for a long time, were eager to enter long the Yuan but remained out due to the CNY's status of "intervened currency".

2. Chinese authorities have been progressively tightening (raising) reference rates in order to control loan and shadow banking dynamics. The result of these two actions has been a strong flow of capital into the country.

… The other themes.

… The Chinese factor.

- ✓ Well. At this point one should know that the PBOC does not like such an intense appreciations of the Yuan (CNY) …

- ✓ … What are then the instruments the PBOC has in order to respond to this sharp rise of the currency? A rise that, on the other hand, has been driven by "speculative inflows"? **Indeed. Sell Yuans in the market and buy Fx reserves (US$ or Gold).**

- ✓ In fact, we know that the PBOC purchased $73bn of Fx in October and another $70bn in November (according to CEIC). THE MOST IN THREE YEARS.

- ✓ **What from now on?** Please note that China is doing nothing more than "sacrificing growth" in order to ensure the necessary credibility of the CNY (as a potential new currency reserve in the region). Remember the expression? "China must sacrifice growth". *If you say the Working Paper, I promise a reward)*

- ✓ In this process, market participants may think of two ways:
    1. Think just like us that sacrifice will entail sustainability. In this regard investors will probably decide to go long the CNY. In such a case, the PBOC will continue selling Yuans and buying Gold => POSITIVE IMPLICATIONS.

    2. Nevertheless, if investors fears about a sharp slowdown in China spread, they could decide to go short the Yuan, allowing the PBOC to buy the local currency while selling Fx reserves in the form of USD or gold => NEGATIVE IMPLICATIONS.

- ✓ My bet on this specific issue / factor? **I do not know. Let me say it a "Neutral Factor"**

Our conclussions

1. Gold remains stable (despite the turbulent moments seen in EM) because within the Reserve banks' activity in Asia, we are witnessing two offsetting forces.

2. While India and Japan are firmly reducing their stocks of gold, China is accelerating its purchases of gold (by selling CNY) in order to respond to the sharp rise of the CNY. A rise that has been driven by "speculative inflows" powered by recent decisions of the PBOC (the announcement of the end of the regular intervention and the raise in the reference rates)

3. I identify today three "major themes" that could dominate gold prices in the foreseeable future. Here you have the implications that, in my humble opinion, will arise from each factor:
   I. The Indian Factor => NEGATIVE IMPLICATIONS FOR GOLD
   II. The Japanese Factor => NEGATIVE IMPLICATIONS FOR GOLD
   III. The Chinese Factor => NEUTRAL IMPLICATIONS FOR GOLD

4. In summary, and according to these considerations, I maintain a **negative long-term vision for the Gold with a** fundamental target US$ 900 ozt*.

* For those interested in the calculus of our target price for gold, please look at the Monthly Corporate Review document

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