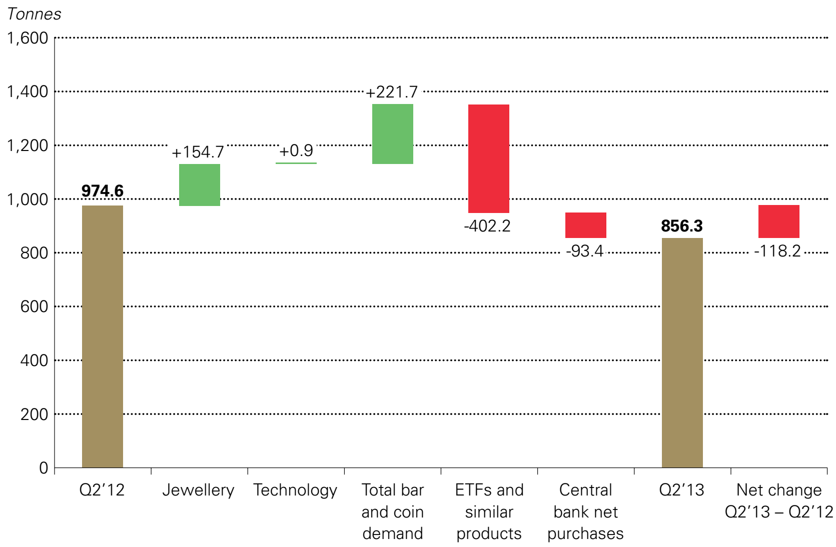
Gold Demand Trends

Second quarter 2013

August 2013 www.gold.org

Q2 gold demand totalled 856.3 tonnes, worth US$39bn. Lower prices generated another surge in quarterly jewellery demand, most notably in India and China. Record quarterly investment in gold bars and coins was countered by sizeable outflows from ETFs as western investors reacted to a seemingly more positive outlook for the US economy and an eventual tapering of quantitative easing. Read more...

Overall demand changes (Q2'13 vs Q2'12, tonnes)



Source: Thomson Reuters GFMS, World Gold Council

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Executive summary

In a turbulent quarter, demand fell by 12% to 856.3 tonnes (t). A wave of outflows from ETFs was the principal cause of the decline, although this was mitigated by record demand for gold bars and coins. Continuing the theme of the previous quarter, demand for jewellery grew significantly to reach multi-year highs. Supply declined by 6%, the primary reason being a marked contraction in recycling.

Table 1: Q2 2013 gold demand overview

	Tonnes				US$mn			
	Q2'12	Q2'13	5-year average	Year on Year % change	Q2'12	Q2'13	5-year average	Year on Year % change
Jewellery	420.8	575.5	503.9	37	21,775	26,179	20,854	20
Technology	103.3	104.3	108.8	1	5,348	4,743	4,528	-11
Investment	285.9	105.4	374.5	-63	14,794	4,794	15,779	-68
Total bar and coin demand	285.9	507.6	297.7	78	14,795	23,091	12,968	56
ETFs and similar products	0.0	-402.2	76.8	-	-1	-18,297	2,809	-
Central bank net purchases	164.5	71.1	49.9	-57	8,514	3,236	2,776	-62
Gold demand	974.6	856.3	1,037.1	-12	50,430	38,952	43,936	-23

Source: Thomson Reuters GFMS, World Gold Council

The 12% decline in tonnage demand translated into a 23% drop in value to US$39bn – its lowest level for more than three years (**Table 1**). Q2 saw an absolute drop in the gold price of more than US$400/oz – a double-digit decline in the average quarterly price compared with both Q1 2013 and Q2 2012 (**Table 2**). In the context of this price move, the decline in value terms is unsurprising. That total bar and coin demand was able to reach a record value of US$23.1bn in spite of such a sizeable price move is testament to the strength of demand in that sector.

The price action also had an impact on the supply side of the gold market resulting in a sharp contraction in recycling. In what is a normal reaction to sharply weaker prices, recycling activity shrank – primarily due to consumers in developing markets holding onto their stocks of old gold as the profit motive waned along with the gold price. Please see the section on supply for a more in depth discussion of recycling.

The second quarter saw: 1) a continuation of the strong recovery in consumer demand for jewellery; 2) the prominent role of India and China on the global stage; 3) a divergence between different elements of investment; and 4) a shift in focus from West to East – all of which were amplified compared to last quarter.

Table 2: Average gold prices in various currencies

	2011	2012	Q2'12	Q3'12	Q4'12	Q1'13	Q2'13	Q2'13 vs Q2'12 % chg
US$/oz	1,571.5	1,669.0	1,609.5	1,652.0	1,721.8	1,631.8	1,414.8	-12
€/oz	1,129.9	1,298.7	1,254.7	1,320.2	1,328.8	1,235.6	1,083.2	-14
£/oz	980.8	1,053.0	1,016.6	1,045.3	1,072.6	1,051.6	921.4	-9
CHF/kg	44,649.6	50,323.7	48,464.7	51,088.5	51,603.7	48,792.5	42,865.7	-12
¥/g	4,015.8	4,278.2	4,144.4	4,174.8	4,478.6	4,834.7	4,492.5	8
Rs/10g	23,624.1	28,639.4	28,004.8	29,302.1	29,964.7	28,420.8	25,381.0	-9
RMB/g	326.3	338.5	327.6	337.3	345.7	326.5	280.0	-15
TL/g	85.4	96.6	93.5	95.8	99.3	93.6	83.6	-11

Source: LBMA, Thomson Reuters Datastream, World Gold Council

The great gold jewellery rush

Having flexed their muscles in the first quarter, jewellery consumers were out in force again in Q2, pushing the value of demand to near-record levels. Tonnage surged to such an extent – far outweighing the decline in the average gold price – that demand in value terms was up 20%.

Although jewellery demand is influenced by a wide set of factors, including economic growth, consumer sentiment and disposable income, to name a few, all were eclipsed by the effect of the drop in the gold price. The resultant buying frenzy caused a huge rise in regional premiums on gold, as supply chain bottlenecks caused delays in meeting demand.

The upward trend was almost universal, with the most notable year-on-year improvements occurring in India, China, the Middle East and smaller Asian countries. The focus in most markets was on higher carat jewellery with its connotations as an investment proxy. Europe was the only region not to see an improvement in jewellery demand, unsurprisingly in light of continued concerns over the region's economic wellbeing.

As we had expected, the US delivered a second consecutive quarter of growth, with lower jewellery price points well received. Although demand was again healthiest at the high end of the US market, there was also evidence of a slowdown in the shift to lower carat items in the middle segment. Demand was augmented by growth at the wholesale level, with lower prices presenting a favourable opportunity to embark on early stock building in preparation for the seasonally strong fourth-quarter.

India and China still lead the field

The consumer market for gold was once again dominated by global leaders India and China, which together accounted for almost 60% of the global jewellery sector and around half of total bar and coin demand. On a year-to-date basis, total consumer demand (for jewellery, bars and coins) in each country is almost 50% ahead of the same period in 2012.

In both markets, the strength in second quarter demand was indicative of opportunistic buying not only at the consumer level but also by the trade, which used the opportunity to bolster stocks. This attitude among consumers is perhaps a more surprising result for China, where the historical tendency has been to buy into a rising trend, and is more remarkable for the fact that the second quarter is traditionally a seasonal low point for gold, coming as it does after the Q1 peak of Chinese New Year-related purchases. However, the response in part reflects the strength of positive price expectations in the market, a view that was replicated in India and which is borne out by World Gold Council survey results, as discussed overleaf.

Chart 1 depicts an increasing conviction among Indian and Chinese consumers that gold prices will be stable or higher in the future, with particular positivity around longer-term expectations for the gold price. What is notable is that positive price expectations appeared to have increased with subsequent drops in the price, illustrating extremely resilient sentiment around the future trajectory of gold.

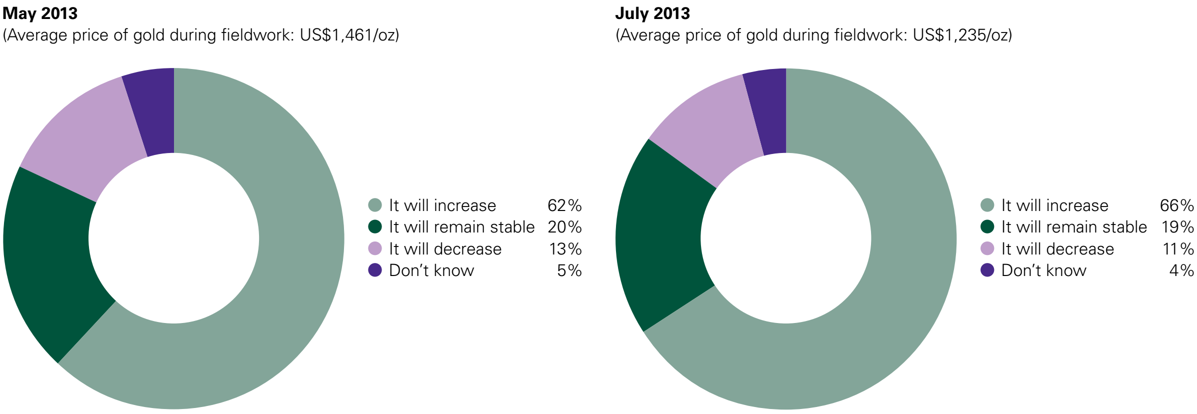
The strength of growth confirms that gold jewellery remains highly desirable, with consumers committed to spending their allocated budget rather than taking advantage of lower prices to spend less: indeed, both markets saw an increase in the value of jewellery demand (in local currency terms) in excess of 30%, suggesting that budgets were increased to make the most of the opportunity. The positive response to the price drop was enhanced by supportive conditions in both countries: a growing middle class and relatively high inflation/inflation expectations, combined with the ingrained cultural significance of gold.

The Q2 data also confirms that the investment case for gold in China remains compelling: the poorly performing stock market is not an attractive alternative investment; concern lingers over the possibility of a domestic credit crisis and economic slowdown; inflation, although much less of an issue than in previous years, is creeping higher; and gold investment products are increasingly available and easily accessible to a captive domestic audience.

The second quarter in India, where bar and coin demand reached a record high, clearly needs to be considered in the context of domestic developments, given government efforts to curb gold imports and their contribution to the current account deficit. The introduction of restrictions on payment terms for gold imports in May and an increase in import duties in early June created uncertainty in the market but had a limited impact on end-user demand, which was met by stocks that had been built up to healthy levels following the April price drop. Nevertheless, imports tailed off in June with demand slowing sharply as the market entered its seasonal quiet period and as the government extended the restrictions on gold imports as well as further raising import duties to 8%.

In more recent weeks, the change in emphasis from restricting payment terms to linking import quotas to exports is likely to create further confusion and exaggerate the normal Q3 lull in Indian demand ahead of the Q4 festival and wedding season. However, it is interesting to note that price premiums in India have recently spiked higher again, suggesting that demand is healthy. A good monsoon season so far also bodes well for demand later in the year, with the assumption that the market will by then have had time to digest and acclimatise to the recent restrictions imposed by the Reserve Bank of India (RBI).

Chart 1: Survey of Indian and Chinese consumers: Over the next five years, what do you think will happen to the gold price?



- Survey results reveal positive future price expectations among Indian and Chinese consumers following the April price pullback.
- These results help to explain the strength of the demand response.

Note: Survey of 1,000 Indian and 1,000 Chinese consumers and their attitudes towards gold conducted by the World Gold Council during May – July 2013.

Source: World Gold Council

Investment forces counterbalance

As we discussed in the previous issue of *Gold Demand Trends*, ETF outflows accelerated during the second quarter as a number of hedge funds and speculative investors exited their positions in reaction to predictions of US economic recovery. The prospect of the US government tapering quantitative easing by the end of 2013 had a disproportionate downward impact on the gold price as some investors in ETFs saw their key rationale for seeking a safe haven in gold fade (for a fuller discussion on the factors that affect gold's performance, please see *Gold Investor, Volume 3*).[1] The net result was a more-than 400-tonne reduction in ETF holdings in Q2.

Conversely, the precipitous price drop elicited an unprecedented response from 'retail' buyers of gold bars and coins – a phenomenon examined in our recent *Market Update*.[2] Demand in this sector of the market mushroomed as strategic investors – focused on gold's core qualities as an inflation-hedge and store of wealth – took advantage of lower prices to add to their long-term holdings.

These two sectors deviated more widely in the second quarter, with record demand for gold bars and coins moderately exceeding record ETF outflows (**Chart 2**). However, while ETFs may continue to contract, we expect the pace to slow as the holder base becomes stickier. Bar and coin demand may struggle to maintain the exceptional levels of the past quarter, however it has solid underpinnings – most notably in the Asian markets.

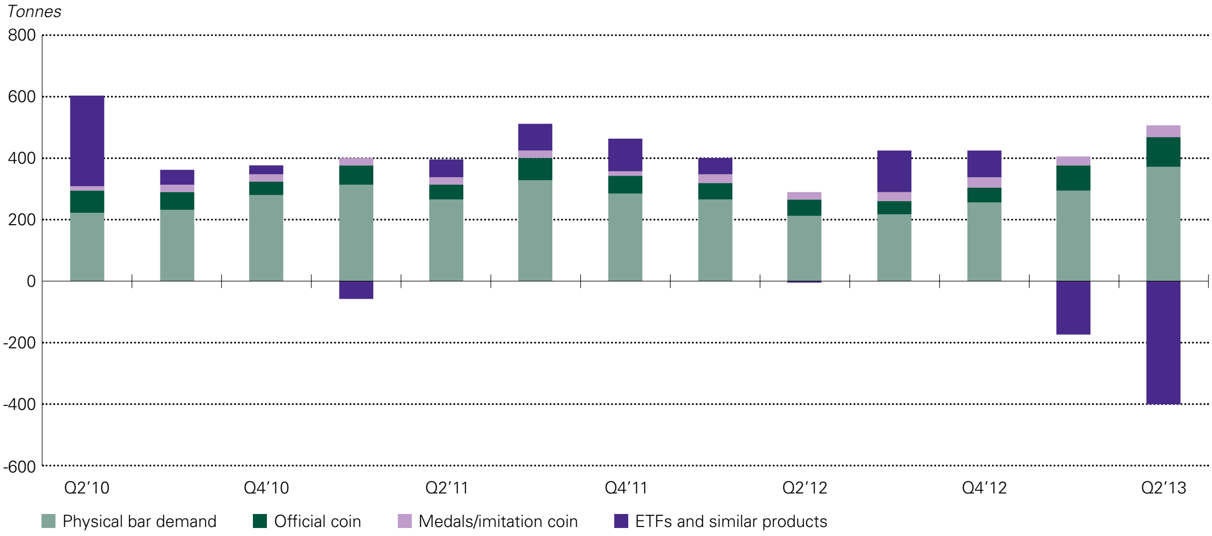
Focus shifts Eastwards

The divergence between ETF demand and bar/coin demand is illustrative of another shift within the investment segment: a geographical swing from West to East.

The 2008 crisis caused a shift in the investment pendulum towards western markets: gold investment in Europe and the US was reinvigorated as the crisis unfolded. A reversal of this shift will be a likely feature in the coming quarters, with the focus for demand moving from the west back to the east, particularly as India and China cement their dominant position.

There is evidence to suggest that this is an increasingly widely held view: Australia and New Zealand Banking Group (ANZ) is the latest bank to have opened gold vaulting facilities in Singapore – a market that is on its way to becoming a trading hub for the Asia-Pacific region – in order to satisfy growing demand from the region. That Japanese gold ETFs saw a counter-trend rise in holdings during the second quarter, albeit representing a fraction of global holdings, underscores the geographical flow.

Chart 2: Investment demand by category



- Record demand for gold bars and coins compensates for ETF outflows in the second quarter.

Source: Thomson Reuters GFMS, World Gold Council

1 World Gold Council, *Gold Investor, Volume 3, What drives gold? Factors that influence gold and its role in a portfolio,* July 2013

2 World Gold Council, *Market Update, Second quarter 2013.*

Global gold market – second quarter 2013 review

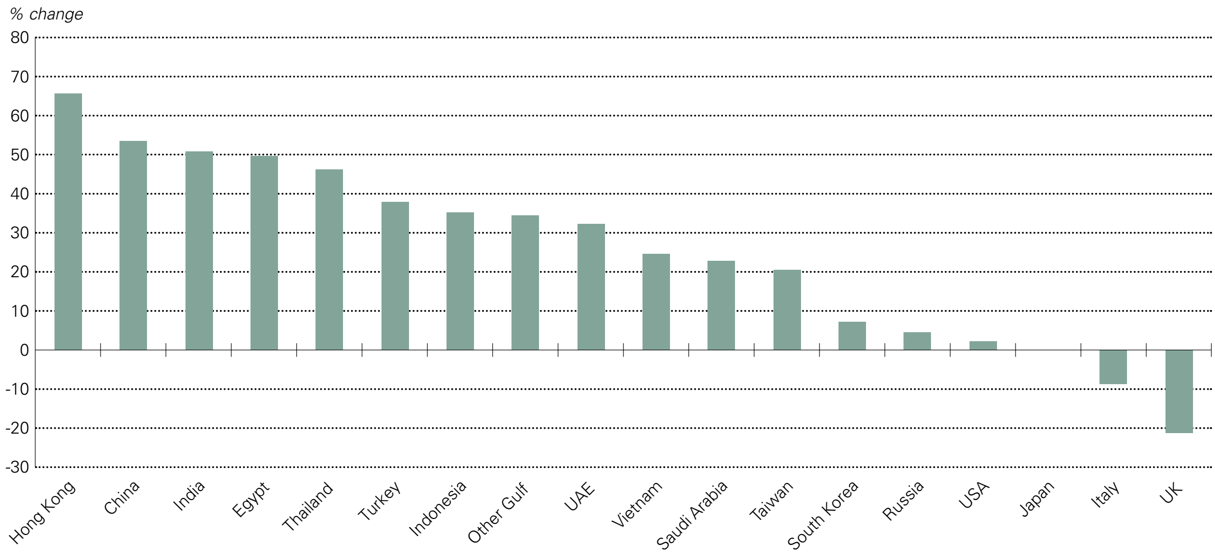
Jewellery

Quarterly jewellery volume rose to its highest level for five years as the sharp drop in prices met with a very positive reception across the globe. Despite the lower prices, demand in value terms was the fourth highest on record.

India and China generated the largest volume increase – almost 120t of the 155t increase in demand was from the two Asian giants. We see a notable dampening of Indian demand over the coming months, more than would normally be expected during the usual Q3 slowdown, as the market digests import regulation changes. Indications for the fourth quarter so far remain positive. In China, continued expansion of the domestic jewellery retail network and growth in production capacity has positive longer-term implications for jewellery demand, but the market faces possible shorter-term headwinds from a more material economic slowdown. Please refer to the *Executive Summary* for a more detailed look at these markets.

Hong Kong generated the strongest percentage growth in demand, surging to a record 12.1t (Chart 3). Similar conditions to those in mainland China were experienced: jewellery retailers were swarmed and stocks were exhausted with notable time delays in replenishing showrooms. Mainland consumers accounted for much of the growth in demand as tourist numbers swelled. Domestic consumers focused their attention on wedding jewellery, taking advantage of the favourable price environment.

Chart 3: Jewellery demand by country in volume (Q2'13 vs Q2'12, % change)



- Lower prices saw consumers across Asia and the Middle East clamouring to buy.
- The double-digit growth in jewellery demand seen in most markets was bolstered by replenishment of stocks at the trade level.

Source: Thomson Reuters GFMS, World Gold Council

Double-digit growth was commonplace among the smaller Asian markets, although Japan was a notable outlier, being unchanged from the previous year as consumers focused instead on investment products. In Indonesia, demand of 7.8t was the strongest second quarter since Q2 2009. Domestic demand was particularly responsive to the April price drop. Demand was more subdued in June, however there were signs of a renewed pick-up in July. Stock replenishment at the trade level also contributed to growth.

Turkish jewellery demand hit a record high in terms of local currency value at TL2.2bn, well above its 21t five-year quarterly average. As well as the expected bargain hunting among consumers (which was concentrated in 22-carat due to the investment overlap of that segment), trade demand was also a key feature of this market. The opportunity to build inventories at lower prices ahead of the summer sales peak proved attractive to the trade.

Growth across the Middle Eastern region was almost purely price-related and we have commented previously on the extreme impact on price premiums in Dubai. Demand in the UAE was heavily buttressed by the substantial ex-pat Indian community, which favours 22-carat items.

Western consumers did not respond with quite the same relish to the lower price environment. As discussed in the *Executive Summary,* the US market saw an improvement that was not replicated in the western European markets, where negative economic conditions overwhelmed the positive impact of lower prices. Italian consumers expressed an increasing interest in silver and non-precious alternatives. In the UK, the 9-carat segment was one of the worst hit, losing out to the high-volume fashion market. UK hallmarking statistics also reveal a relatively healthy quarter for the high-end 22-carat segment, indicating a relative increase in the gold content of each piece being hallmarked.

Jewellery demand in Russia continued to normalise towards pre-crisis levels. Reports suggest a growing divergence in the market, with demand being concentrated in both the high and low ends of the market. While the prospects for 2013 as a whole are good, the softening of domestic economic conditions suggests a tempering of growth in this segment further out.

Investment

As discussed in the *Executive Summary,* the notable decline in demand for gold investment products in Q2 conceals a less clear-cut picture: one of professional investors liquidating ETFs, while investors in Asian and Middle Eastern markets eagerly absorbed the gold coming onto the market in the form of bars and coins. This divergent picture highlights the unique balance in the gold market, which sees demand from one sector compensating for declines elsewhere.

Total investment demand (which includes OTC investment and stock flows – the element of investment capturing less visible investment flows and possible stock changes, as well as any statistical residual) also showed a notable year-on-year decline. In value terms, total investment was at a two-year low.

The 151.5t of OTC investment and stock flows demand was made up of inflows from a number of different sources, including investment in gold deposit accounts (not captured in total bar and coin demand): growing interest in such investment vehicles was notable in China, Turkey and Japan. The numbers are also thought to reflect a continued shift into allocated accounts by some investors who sold out of their ETF positions.

During the first half of the year, bar and coin demand has reached 913.2t, around three-quarters of the 2012 annual total (Chart 4). The extent of demand is supported by recent statistics released by the LBMA, showing a second consecutive 12-year high in the monthly volume of gold transferred between accounts held by bullion clearers in June. Transactions averaged 29.0 million ounces per day during the month '*buoyed by strong physical demand, particularly from China and India*' according to the LBMA.[3]

The global response to the price decline was almost universally positive – France being the sole exception among the individual countries that we monitor. Excluding India and China (which are discussed in detail in the *Executive summary*), the 262.7t of demand from the rest of the world has been exceeded on only two previous occasions: in Q4 2008, the aftermath of the financial crisis; and Q3 2011 as Europe was engulfed by the sovereign debt crisis.

Chart 4: Total bar and coin demand

- Total bar and coin demand for the first half year is running at 76% of the average annual total from 2009 – 2012.

Source: Thomson Reuters GFMS, World Gold Council

3 http://www.lbma.org.uk/pages/index.cfm?page_id=51&title=clearing_-_most_recent_figures

For the most part, investors were encouraged by the price fall, viewing it as an opportunity to add to their holdings more cheaply. The resultant increase in net investment was magnified as lower prices also discouraged profit-taking on existing investment; Japan was a prime example of this. **Gross new investment outweighed selling by 4.5t in Japan,** a market that has seen virtually continuous disinvestment since 2006 (with the exception of the somewhat anomalous Q4 2008, when volatile currency and stock markets generated a temporary surge in investment). The younger generation in Japan was the main source of demand, representing a source of new investment in the market. At the same time, profit taking among the older generation, which had been triggered by the almost ¥5,000/g peak early in the quarter, dropped markedly in line with the price.

We have previously commented on the possibility of Asian investors absorbing the gold flowing out of ETFs in recent months and this would seem to be the case. The high - in some cases record - gold price premiums that were reached during the second quarter in a number of markets were the result of bottle-necks in the supply chain as refiners, even working at full capacity, struggled to convert larger gold bars (London Good Delivery bars and 100-oz bars) into smaller bars fast enough to meet the needs of Asian consumers. **Growth in the smaller markets – Thailand, Vietnam and Indonesia – underscores this theme.** Year-to-date, the combined demand from these three markets is up 46% with premiums on gold sold by Vietnam's central bank at times exceeding US$200/oz.

The jump in investment across the European region was dominated by Germany and other German-speaking countries. Demand was heavily concentrated in bars rather than coins; 250g bars in particular were reported as being the most popular. Switzerland's healthy investment number masked a decent amount of selling as well as robust net new investment.

US investors were similarly inspired by the opportunity to add to their bar and coin holdings at lower prices. American eagle coins flew off the shelves, to such an extent that stocks of the one-tenth ounce coins – which had been built up prior to mid-April – sold out and sales of that denomination were briefly halted.

Investment in Turkey hit new quarterly records for both volume (37.9t) and Lira value (TL3.2bn). Advanced purchasing of coins for gifting during the summer wedding season made a notable contribution to the numbers, which largely reflected strategic investment purchases. The opening weeks of the third quarter saw a strike at the Turkish mint, which may have generated a spike in unofficial flows during the current quarter.

Turkey's strong quarter was mirrored in the regional total for the Middle East, which was a record 11.6t. Demand in the UAE was again heavily influenced by the non-resident Indian population.

While the April price correction generated a strong surge in demand, the initial response to the June price fall was somewhat more cautious in a number of markets. However, anecdotal evidence suggests that interest subsequently revived during the opening weeks of July as price volatility subsided. While indications are that some of the recent surge in demand was tactical in nature – and therefore could result in a degree of profit-taking should higher prices materialise during the remainder of the year – the bulk was from long-term investors adding to their physical holdings of gold.

Central banks

The rate at which central banks added gold to their reserves stayed within the broad 70-160t range we have previously cited (Chart 5). Although the pace of demand slowed, the year-on-year comparison is made with a record quarter in Q2 2012. The lower rate of purchasing is likely a result of a number of factors: the volatile price moves during the quarter; weakness in emerging market currencies; and the declining rate of growth in foreign exchange reserves among some banks.

Purchases were concentrated among countries in the CIS region, the largest being Russia with 15 tonnes over the quarter. Year-to-date, Russian gold reserves have grown by almost 39t. Germany's small sale in June (of less than 1 tonne) was the latest in a series of regular sales to the finance ministry for the purpose of minting coins.

We expect central banks to remain net buyers of gold, although there may be a slight drop-off in annual demand to between 300-350t. This is still roughly in line with the average for the last three years. The fundamental arguments for central bank buying remain in place; allocations to gold are still largely far below 'optimal' in many emerging markets; and the desire to diversify away from an over-dependence on the US dollar continues to inform asset allocation strategy at many central banks.

Technology

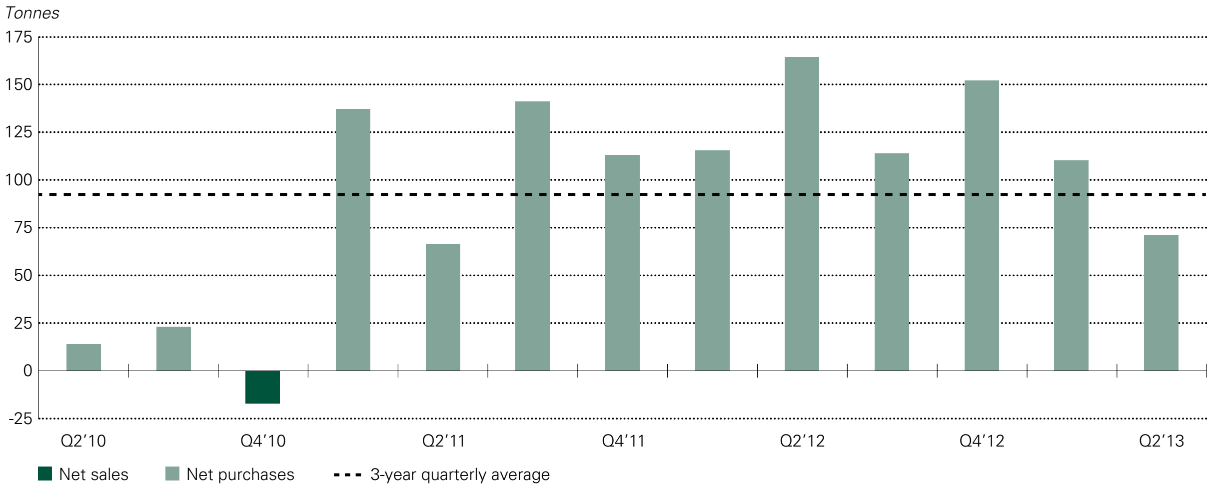
The use of gold in technological applications was marginally higher in Q2, the first – albeit modest – quarter of year-on-year growth for two years. Marginal growth in electronics and 'other industrial and decorative' was partially eroded by continued decline in dental demand.

Inventory build in the electronics supply chain contributed to growth in the sector. The gold price correction provided a much needed boost to the sector as manufacturers took advantage of lower prices to replenish previously liquidated assets. Growth was concentrated in the semi-conductor space (dominated by mobile phones and tablets as well automotive-specific applications). Migration from gold to copper in the production of bonding wire remains a significant threat to demand in this area.

Other industrial and decorative demand for gold also benefited from the lower price environment. India as usual dominated the segment (primarily through demand for *jari* – gold thread used in the weaving of saris) as the price sensitive market rushed to replenish stocks.

Dental demand was unable to reverse its long term decline, slipped to a new all-time low. Increasing use of ceramics, base metals and palladium further eroded gold's share of this market.

Chart 5: Central bank contributions to demand in tonnes



- Central banks complete their tenth consecutive quarter of net purchases.
- Purchases were concentrated among central banks in the CIS region.

Source: Thomson Reuters GFMS, World Gold Council

Supply

A 62.4t decrease in the supply of gold during the second quarter was almost solely due to reduced quantities of recycling coming onto the market (Chart 6).

As briefly discussed earlier, a fall in the supply of recycling was heavily influenced by the developing world, where well-informed consumers are able to respond at speed to changes in the gold price. Recycling in those markets dropped 25% compared with Q2 2012 and, given price expectations among consumers in China and India (**Chart 1**), a resurgence in supply would likely require a significant recovery in the price.

The 672.1t of recycling supply in the first six months of the year was the lowest first-half total since 2007.
The fact that this element has subsided to pre-crisis levels is a function not just of lower prices but of a lower need for 'distress selling' among consumers in developed markets, particularly the US. Recycled gold supplied by industrialised countries was 14% below the same period a year earlier and there is little scope for any material growth from this quarter, given further signs of economic recovery in a number of markets and the severe depletion of stocks of old gold available for sale.

Recycling has generated, on average, 40% of total supply over the last five years. Supply from this sector, particularly in the developing markets, is highly price sensitive; as such, the immediate and notable contraction in the second quarter – to 30% of total supply – was to be expected.

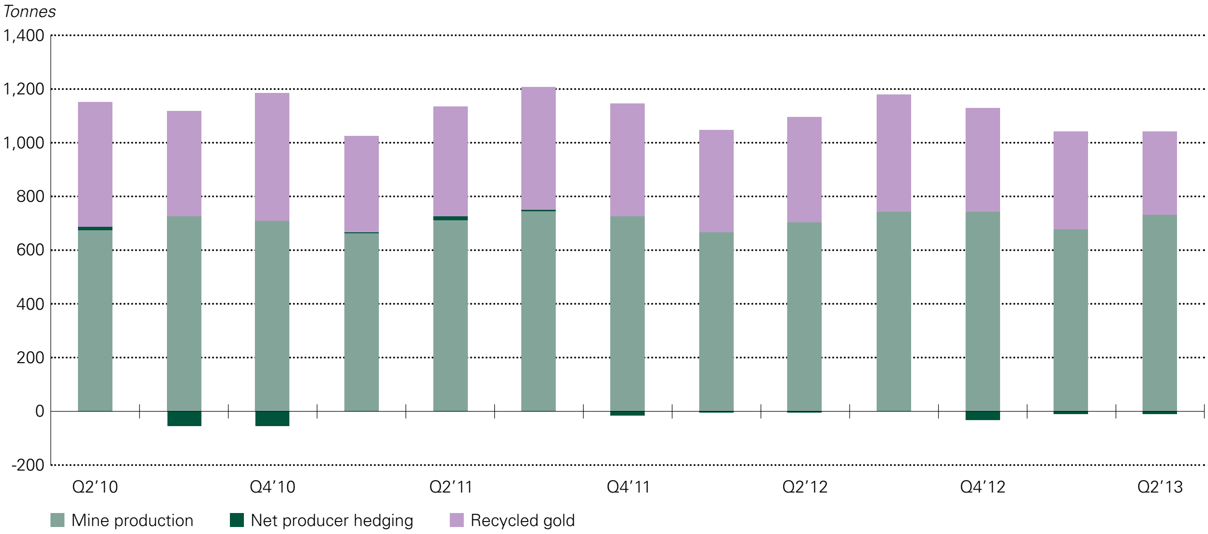
This is broadly borne out by historical precedent: **Table 3** summarises a simple analysis between gold prices and recycling. It highlights the change in recycling (in US$ value terms) during previous periods in which the annual average gold price declined in at least two consecutive years, with a cumulative decline of at least 10%.

The data shows a correlation between recycling activity and the gold price, with a 10% decline in price on average corresponding with a 14% decline in the value of recycled gold when periods of substantial and sustained price pullbacks occur. It is worth noting, however, that gold prices are not the only driver of recycling. Economic and income growth as well as price volatility can also have an effect.

Table 3: Value of recycling during prolonged price declines

	Cumulative decline in annual average gold price (London PM fix) Q2'12	Cumulative reduction in of recycling (US$ value)
1980 – 1982	-38.9%	-69.8%
1983 – 1985	-25.1%	-15.5%
1987 – 1989	-14.7%	-27.4%
1990 – 1992	-10.3%	-17.6%
1996 – 1999	-28.2%	-30.8%
Average	-23.4%	-32.2%

Chart 6: Quarterly supply in tonnes



- Recycling activity subsided to pre-crisis levels largely in reaction to the price pullback.
- Mine production expanded modestly, with largest contribution to year-on-year growth coming from China.

Source: Thomson Reuters GFMS, World Gold Council

There are a number of reasons for this relationship between recycling and the gold price: not only are consumers less likely to part with their old gold at lower prices (the profit motive being less appealing), but improving economic sentiment also makes recycling less necessary for consumers in need of funds. Add in the fact that the process of recycling gold becomes less economically viable at lower prices and you have the makings of a smaller contribution from this sector of the market as the price declines.

The second quarter saw an extension of the upward drift in mine production, which has been relatively stable with a moderate upward bias since Q1 2008. Main contributors to growth in the sector were little changed from last quarter, with China generating the bulk of the increase thanks to expansion among a number of small- to medium-sized operations. Production at Pueblo Viejo in the Dominican Republic continued to ramp up and in Brazil, three new operations have come on stream since Q2 2012, boosting the year-on-year comparison. Peru and Ghana were joined by Indonesia on the list of regions that saw a year-on-year decline in mine production.

While mine production historically has been slow to react to changes in the price, the extent of the fall in the second quarter has elicited a swift response from gold producers. Recent spending cuts and the closure of costly operations across the industry may start to have an impact on the supply pipeline by the end of this year.

De-hedging of 15t was indicative of a continued desire among producers to reduce further their outstanding hedge positions. Interest in taking out fresh hedging positions was virtually non-existent and any such activity was confined largely to guarding against price volatility rather than insuring against an extended down trend in the price.