



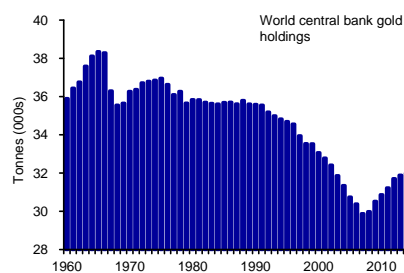
Gold & The Divergent Path Of Global Central Bank Holdings

- While we expect currency, interest rate and equity trends will continue to contaminate the outlook for gold prices heading into next year, central bank gold reserve management is worth watching closely as it may become a more important force in setting the direction of the gold price.
- Of most interest before the end of this year, will be the possibility that next month's referendum in Switzerland will reverse the aggressive programme of gold sales that has been undertaken by the central bank over the past 15 years. Since 1993, the SNB has reduced total gold holdings by 1,550 tonnes, the largest liquidation of gold holdings of any central bank in the world.
- Attention will also remain closely focused on the activity of emerging market central bank gold holdings since their gold to total reserve ratios remain relatively low. For many emerging market central banks, such as Russia, they have stated their intention to increase their gold to total reserve holdings to around 10%.
- Following Russia's programme of gold buying, which has amounted to 795 tonnes since 1993, its gold to total reserve ratio has risen to 9.9%. It has also meant that the country has been the most aggressive builder in gold reserves of any central bank in the world over the past 15 years.
- In Asia, we estimate that if each of the major nine central banks in the region increased the share of gold to total reserves by just 0.1 percentage points it would be equivalent to gold holdings increasing by 140 tonnes. Of the group, the Peoples' Bank of China remains the most important since if it raised its gold to total reserve ratio from 1.1% currently to just 5% it would, all other things equal, be equivalent to the country's gold reserve holdings increasing by just over 3,700 tonnes to just shy of 4,800 tonnes.
- Such an increase in the country's gold reserves would raise China's status as the world's largest holder of gold reserves by volume after the US Federal Reserve. In 1993, China was the world's 14th largest central bank when measured by gold holdings.

In aggregate, global central banks have been increasing their holdings of gold by on average of 300 tonnes per annum since 2008, Figure 1. As a comparison, inflows into gold ETFs between 2004 and 2012 averaged 290 tonnes per annum, Figure 2. Moreover the rise in central bank gold reserves over the past seven years breaks the steady decline in their gold holdings that had been uninterrupted since 1989.

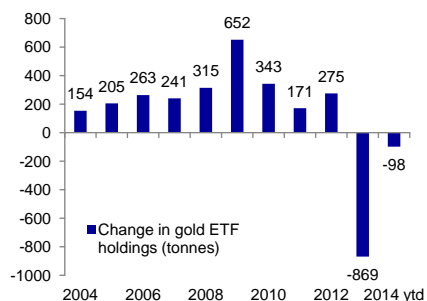
However, the recent rebuilding in global gold reserves since 2008 masks significant divergences in central bank attitudes towards gold. Typically gold reserve management has been split between developed world central bank gold selling and developing world central bank buying. Among the major central banks, Russia has been the most aggressive in building its gold reserves, which have risen just of 800 tonnes since 1993. In contrast, the Swiss National Bank has adopted an aggressive programme of gold sales such that its reserves have fallen by 1,550 tonnes to 1,040 tonnes over the past 20 years.

Figure 1: Global central bank gold reserve holdings



Sources: World Gold Council, IMF

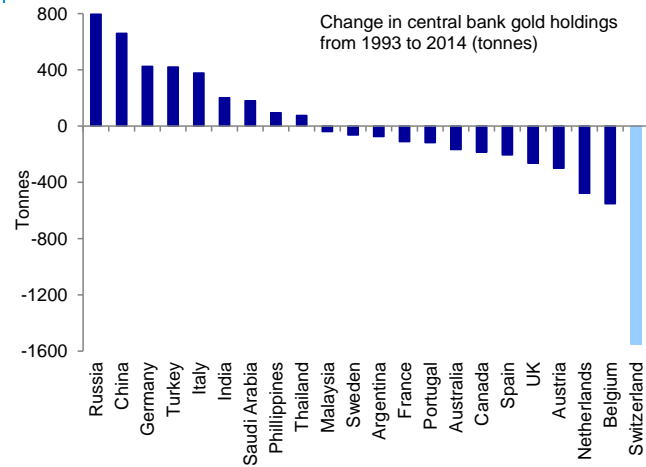
Figure 2: Annual change in gold ETF holdings



Sources: Bloomberg Finance LP (Data as of October 7, 2014)

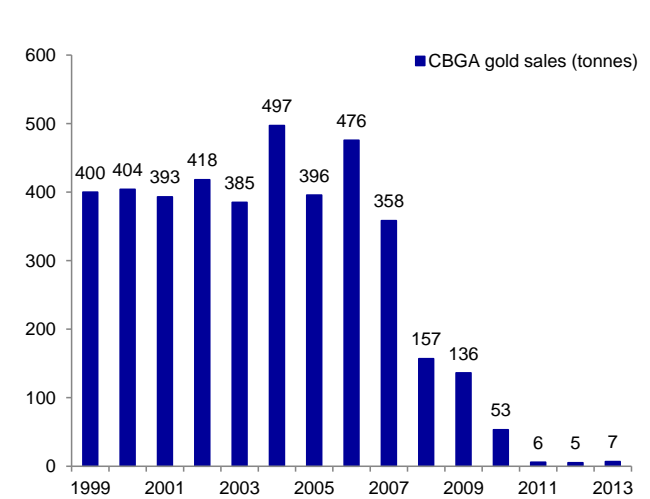


Figure 3: Change in central bank gold reserves by country since 1993



Sources: World Gold Council, IMF

Figure 4: European central bank gold sales

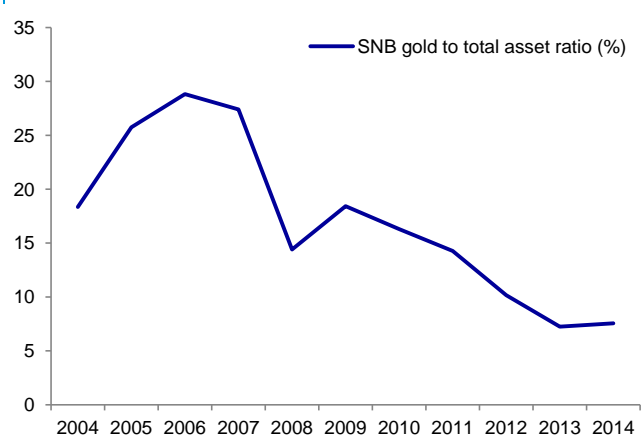


Sources: World Gold Council (Years run from September 27 to September 26)

However, following a petition by the Swiss Peoples Party a referendum will be held on November 30 to decide whether the SNB should reverse its programme of gold selling. If successful, the referendum would commit the SNB to increase the ratio of gold to total assets from just under 10% currently to 20%. In order to bring the ratio back to these levels would mean reversing entirely the gold sales over the past two decades and purchasing around 1,500 tonnes of gold.

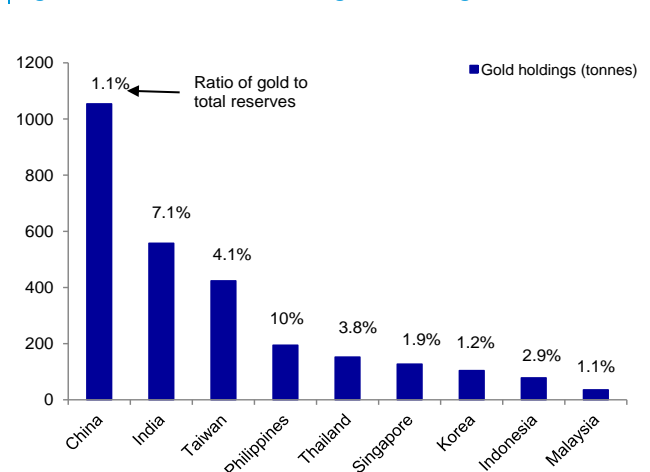
Alongside the liquidation in gold reserves, the decline in the gold to total asset ratio over recent years has been compounded by aggressive FX intervention as part of the SNB's efforts to prevent the CHF strengthening beyond 1.20 against the euro. This has contributed to a significant rise in the country's FX reserves since the end of 2008. Consequently, any steps to rebuild the country's gold reserves would most likely be accompanied by selling part of the SNB's euro asset balance sheet. This may therefore increase the appeal of long gold in euro term trading strategies. While the likelihood of the referendum to reverse the SNB's programme of gold sales is far from certain, the possibility of ongoing gold buying by Asian central banks seems more probable.

Figure 5: The gold to total asset ratio of the Swiss National Bank



Source: SNB

Figure 6: Asian central bank gold holdings



Sources: World Gold Council, IMF



Since the 1990s, China and India have led the pack of Asian countries when it comes to building their gold holdings. We estimate that if the major nine central banks in the region were to increase their gold to total reserve ratios by just 0.1 percentage point it would be equivalent to 140 tonnes. Moreover with many emerging market central banks targeting 10% as the optimal ratio of gold to total reserves this level would imply a relentless programme of Chinese gold buying over the coming decade and beyond. In fact if China raised its total reserve ratio from its current level of 1.1% to just 5%, all other things equal, would mean total gold holdings would have to rise by 3,700 tonnes to 4,800 tonnes. This would propel China to becoming the world's second largest central bank when measured in gold terms behind the US Federal Reserve. In 1993, China was the world's 14th largest central bank when measured by gold holdings.

Conclusion

Central bank reserve data reveals that since 2012 European central bank gold selling has largely drawn to a close, Figure 4. However, the Swiss referendum next month raises the possibility that Switzerland might have to reverse its programme of gold selling that has been underway since the 1990s. While the passing of the referendum is far from certain, central bank activity across Asia would suggest that in aggregate the rise in central bank gold holdings, which has been underway since 2008, will continue.

While we expect interest rates, currency and equity trends will all conspire to push gold prices lower heading into next year, as the process of adjustment in these markets draws to a close we expect a more supportive gold picture may start to emerge as outflows from gold ETFs moderate and central bank flows begin to exert themselves. However, even on our estimates the level of the gold price that can be considered fair value is still somewhere below current levels. Indeed in April 2013, we attempted to estimate the level of the gold price that would bring gold relative to income, in real terms and versus physical and financial assets back to their long run historical averages.

On the metrics we examined, the gold price would need to fall towards USD940/oz to represent close to fair value, Figure 7. However, the still low real interest rate environment, ongoing central bank gold buying, geopolitical risk and the perception that gold will provide a hedge against unexpected inflation may mean that gold may still be able to trade rich relative to our estimate of fair value. As a result, as gold prices move towards USD1,100/oz this may start to introduce a more convincing floor to the gold price which we believe is still absent given our upbeat view towards US growth and an increasingly hawkish Fed heading into 2015.

Figure 7: At what point can gold prices be considered close to fair value

In real terms (PPI)	725
In real terms (CPI)	770
Relative to per capita incomex	800
Relative to the S&P500	900
Versus copper	1050
Versus crude oil	1400
Average	941

Source: Deutsche Bank

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Appendix 1

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