Speculators smash gold as dollar squeeze tightens

News that China's gold reserves are far lower than assumed has rattled investors, but Beijing may not have told the full story

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Powerful speculators have launched an unprecedented attack on **the world gold market, driving prices to a five-year low** as commodities wilt and the US Federal Reserve prepares to tighten monetary policy.

Spot prices slumped by more than 4pc to $1,086 an ounce in overnight trading after anonymous funds sold 57 tonnes of gold in Shanghai and New York, choosing the moment of minimum market liquidity in what appears to have been a synchronized strike intended to smash confidence.

The move came after China’s central bank dismayed "gold bugs" by revealing that the country’s bullion reserves stand at just 1,658 tonnes, far lower than widely assumed. While holdings have risen 60pc since the last update in 2009, they are still a fraction of China’s total $3.7 trillion foreign exchange reserves.

Ross Norman, a veteran gold analyst at brokers Sharps Pixley, said sellers dumped 7,600 contracts covering 24 tonnes on the Globex exchange in New York in a two-minute span after it opened late on Sunday night.

A further 33 tonnes were sold at almost exactly the same time in Shanghai. The combined hit of 57 tonnes in such a short period is an extraordinary event in the world's relatively small gold market.

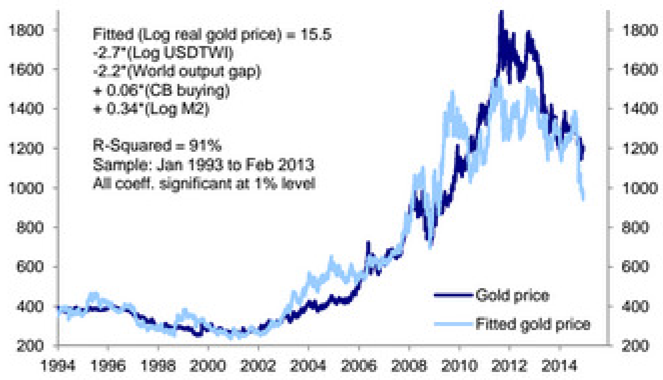
"They choose the optimal moment in the early morning and when Japan was closed for a holiday to get the biggest bang for the buck. It was clearly 'short' traders using leverage to trigger (technical) stops," he said.

The price later regained some of its ground, allegedly as the profiteers cashed in jackpot gains on options that they also had. "It was a trade within a trade," said Mr Norman.

The slide came as the Bloomberg commodity index hit a 13-year low, dragged down by the slump in base metals and energy. Gold has fared better than other commodities over recent months - trading on its safe-haven status during the Greek crisis and China's equity crash - but it now risks being sucked into the vortex as well.

Michael Lewis, commodities chief at Deutsche Bank, said the “fair value” for gold is around $750. This is based on an index of eight indicators, such as oil, copper, income per capita and equity prices, that dates back to the early 1970s. Gold tends to “mean revert” over time.

Figure 7: Gold prices are trading rich relative to fair value



Source: Deutsche Bank

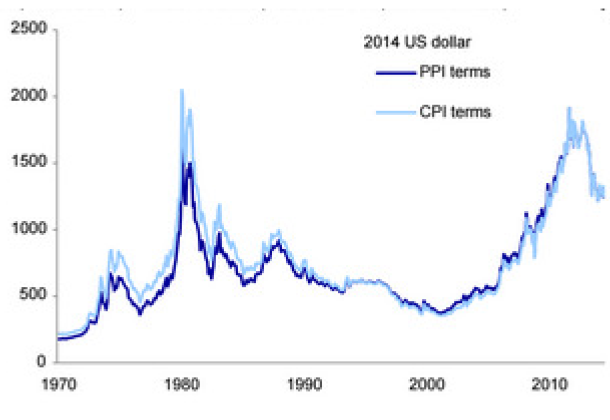
“The prospect of Fed tightening and rising real interest rates in the US is really hazardous for gold,” he said.

Mr Lewis said the markets are finally bracing for the Fed's first rate increase in eight years after a string of warnings from hawks that action is more likely than not in September.

This, in turn, is pushing up the dollar as capital floods into the US in search of higher yield. It is the exact opposite of gold's glory years, when the Fed was deliberately driving down the dollar through quantitative easing to stave off deflation. Excess liquidity pushed prices to an all-time high of $1,921 in 2011.

“All the ducks are now aligned for a gold slide: real interest rates are rising, the dollar is getting stronger and the risk premium on equities is going down,” Mr Lewis said.

This squeeze could go much further. Deutsche Bank expects the dollar to continue rising until 2017, blowing through parity to $0.85 against the euro as the monetary cycle diverges on each side of the Atlantic.



Gold mining shares are already anticipating trouble. **Australia**'s Newcrest Mining fell 8.8pc and Newmont Mining plunged 12pc in the US, while Barrick Gold fell 14pc, touching lows not seen since the late 1980s.

Mr Norman said **the level of gold reserves announced by China massively understates the country's true holdings**. "We think they have at least twice as much, maybe even 4,000 tonnes," he said.

A division of the People's Liberation Army mines gold and transfers the metal to the Chinese finance ministry, acting outside normal commercial channels. The government also buys gold directly from Chinese producers. This is an internal transaction and is therefore not necessarily recorded in China's external reserves.

There is suspicion that China is talking down its true gold holdings as it prepares to join the big league as part of the International Monetary Fund's currency basket (SDR).

David Marsh, from the **monetary forum OMFIF**, said China would risk unsettling the world gold market if it revealed bullion reserves of 2,000 or 3,000 tonnes. This might be interpreted as an unfriendly move against the dollar at a "delicate time", he said.

Sharps Pixley said a "seismic change" is under way in the bullion markets as economic power shifts to the East, boosting gold prices over time.

Central banks were net sellers of 400 tonnes a year in the late 1990s and the early 2000s as developed countries whittled down their holdings and switched to interest-yielding bonds instead.

They are now net buyers, at least in aggregate. The rising nations of Asia and the emerging world are the biggest accumulators of foreign reserves and they own too little gold. Many are targeting a bullion ratio of 10pc in their total holdings in order to limit dollar dependence and to diversify away from paper currencies.

The question is how much these central banks are currently adding. They were buying 300 to 400 tonnes a year at the peak of the commodity boom in 2011. This has dropped sharply and may be nearer 100 tonnes this year. Some are forced sellers as they run down reserves to defend their currencies.

Russia's total reserves have dropped to $361bn, from $524bn 18 months ago, as a result of the Ukraine crisis and the oil price crash.

The risk for the gold market is that the most vulnerable states may have to sell reserves at an accelerating pace once **the Fed tightens in earnest.**Emerging markets have borrowed $4.5 trillion in US dollars. The borrowers are vulnerable to a double squeeze from both higher US rates and a dollar spike.

What threatens to become a "margin call" for dollar debtors could ricochet through gold markets as a secondary effect. It may have begun already.