18 January 2013

Gold: Repatriation

The importance of gold takes a step higher

The aphorism 'actions speak louder than words' refers to actions being thought to reflect more accurately the true intent of the observed. Furthermore while the motive of a speaker can be quite convoluted and contrary, the implication is that he motives of his/her actions are likely to be more direct or forthright.

We have noted previously the shift in central bank behavior over the past several years, from net sellers of gold to net buyers. This includes the significant deceleration of sales by Western Central Bankers. Implicit in this is that most of them are now buyers of gold (in so much as logic suggests that, if one holds an asset one is a buyer of that asset otherwise one would sell and hold something else). The relatively recent actions by central banks however to not only buy gold but also repatriate and upgrade owned bars, further demonstrates in our view an implicit acknowledgement of its monetary importance.

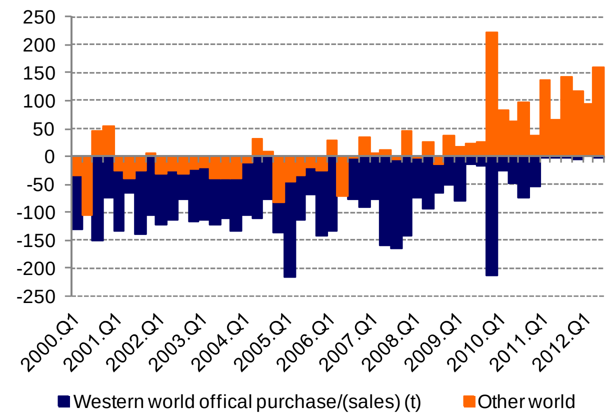
For various historical/liquidity reasons many central banks have in the past held their gold reserves in multiple jurisdictions. These reasons are, in many cases, no longer valid. This and the increased value of gold holdings combined with heightened budgetary pressures that many governments are now facing is, not surprisingly, resulting in a greater call to track assets more closely. On this basis, we believe the timing of the high profile German repatriation process is not altogether unexpected.

Bundesbank Actions

Following on from a request by Germany's Federal Court of Auditors last year to review its overseas gold holdings, the Bundesbank has indicated that it will begin a process to rebalance the distribution of its gold reserves. The intent is to increase the amount of gold held domestically. In this process some of its gold will be repatriated (drawing down on stocks held in the US and in France). The Bundesbank wishes to increase its domestic gold holdings to 50% from 31% currently over the next six years or so.

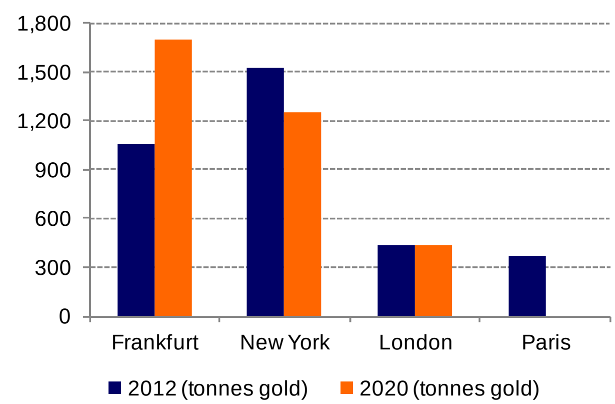
The Bundesbank has stated that its objectives in expediting this new storage plan are: 1) to build trust and confidence domestically, and 2) to ensure liquidity in an emergency.

Figure 1: Central bank gold purchases



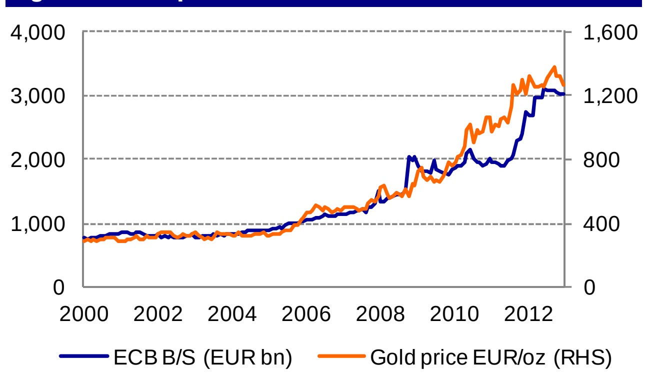
Source: Deutsche Bank, WGC

Figure 2: German gold re-allocation



Source: Bundesbank, Deutsche Bank

Figure 3: Gold price (EUR/oz) and ECB balance sheet



Source: Deutsche Bank

Not only will incoming bars be stored domestically however: these bars will, if necessary, also be upgraded to London Good Delivery (LGD) standards, thereby ensuring compliance with the request of the Court to 'spot check' their quality. We believe much of the gold held in NY is old, known as 'Fed Melts' or 'Deep Storage' bars and may not be acceptable as is for transaction without additional processing.

Furthermore we note that the Bundesbank has indicated that it will continue discussions to expand its rights to conduct audits in NY, London and Paris.

Given the highly 'charged' or politicised nature of the gold market as it pertains to central bank actions, particularly in the Western World, central bankers are generally highly sensitive to public perception and to perceptions of trust. In our view the Bundesbank is responding in large part to the Court of Auditors, who themselves have no doubt observed the increase in value of German gold reserves and may wish to raise the standard by which gold is treated on their books. Furthermore, we believe that the slow transfer of gold from the US Fed in NY back to Frankfurt, at 50t/year, is partly a reflection of its wish to avoid any perception of a change in confidence in the US Fed. A secondary factor could perhaps be the reluctance to put undue strain on the gold refining sector.

Impact

Many central banks have already gone through the process of rebalancing gold holdings and upgrading where necessary; Germany happens to be a high profile example.

As we indicated previously, we view the repatriation and upgrade of old gold by the Western World's central banks as a further positive in gold's evolution as a legitimate form of money. While this is unlikely to have any impact on the near-term price performance of the metal, it could have important longer-term implications.

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Appendix 1

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