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The China Effect

Newswire headlines overnight from Yi Gang, the head of the State Administration of Foreign Exchange (SAFE), suggest that China will be quite wary about adding to its official gold reserves. Yi suggested that the yellow metal will not be the authorities' main tool in its diversification agenda, and that "it is, in fact, impossible for gold to become a major investment channel for China's foreign exchange reserves" (see Bloomberg News story below).

China is the world's sixth-largest holder of gold, ahead of Switzerland and Japan though significantly behind the official holders that own more than it - the US, the IMF and several European countries. Compared to its mammoth foreign exchange holdings, China's gold reserves are a very minor part of its portfolio: its current 1,054 tonnes are just 1.5% of official reserves. Even if China's gold holdings were to double, they would remain a relatively small element of the overall reserve portfolio. Yet this would also have a very dramatic impact on the market price of gold, as SAFE head Yi acknowledged. While he noted that this would hurt gold consumers, he did not mention that a higher gold price would benefit gold producers, of which China is the world's largest.

That gold is not and will not become China's primary route of diversification does not surprise us in the least. There is no way that gold could perform such a role, as the total market is far too small. This is precisely the reason that China's reserves are mainly held in the most liquid global currencies.

Yi's observation about the potential price impact of Chinese purchases is certainly correct. News in early November of the Reserve Bank of India buying a portion of the IMF's gold sparked a month-long, $170/oz run-up to the all-time dollar price high in early December, and China buying could have much greater price consequences. For some time now there has been a market expectation of additional Chinese official purchases of gold. While to date this is unconfirmed, the fact that the market only learned last April that China's gold reserves had increased by 554 tonnes since 2003 suggests that news of any additional buying will lag well after the buying itself. So while today's comments from SAFE should dampen some of those expectations in the short run, they have certainly not gone away. China has not said that it is suspending further gold purchases.

Considering the negative undertones of Yi's comments, the reaction of the gold price to the news was very muted - negligible at first, then eventually a $3 decline to around $1120, where Asian market participants subsequently emerged to buy the dip. While we would expect more near-term downside for gold once the news sinks in, it is unlikely to entirely quash market expectations that China will indeed move to increase its reserve capacity for gold.

But pay attention to potential for CNY appreciation

Perhaps more important for gold in the short term is the potential for CNY appreciation this year. The UBS house view is for a Q2 2010 move away from China's current effective peg, which has been in place since July 2008. Yuan appreciation would be positive for metals, as it would make them cheaper in local-currency terms. This could lead to increased local demand for both gold and platinum.

- **Precious ETF Update – rolling weekly change to March 8**

Precious Metals Global ETF Holdings - Rolling Weekly Changes				
Date	Gold (in Moz)	Silver (in Moz)	Platinum (in Koz)	Palladium (in Koz)
08-Mar-10	57.25	384.72	927.00	1627.00
01-Mar-10	56.82	385.61	928.00	1594.70
Change	0.43	-0.89	-1.00	32.30

In the week to March 8; Gold ETF holdings have moved to 57.25 moz from 56.82 moz on March 1. An increase of 0.43 moz mainly due to 293 koz of net additions in SPDR Gold Trust, 28 koz in iShares, 62 koz in ZKB, 18 koz in ETFS (London) and Julius Baer just added 71 koz yesterday to boost its total holdings to 324 koz over the week. However Silver ETF holdings dropped over the week to 384.72 moz from 385.61 moz. iShares slipped by 2 moz while ZKB added 868 koz over the week to bring down the net total holdings in silver by 0.89 moz.

For platinum, holdings slipped by 1 koz to touch 927 koz from 928 koz over the week. This drop was lead by New York listed ETFS, 5 koz down from the previous week, while ZKB added 3 koz and ETFS (London) saw 1 koz of inflows bringing the net holdings down by 1 koz in platinum. In contrast, palladium holdings rose to 1627 koz from 1594.7 koz over the week; a net addition of 32.30 koz, split between 13 koz in the London listed ETFS and 19 koz in New York listed ETFS over the week.

- **Technical Precious Metals Focus**

	OTC Market				COMEX	
9-Mar-10	GOLD	SILVER	PLATINUM	PALLADIUM	GCH0	SIH0
Last	1121.57	17.18	1586.60	465.13	1123.10	17.18
50 Days MA	1110.21	16.85	1544.91	432.57	1110.48	16.89
100 Days MA	1113.74	17.27	1478.46	395.09	1110.48	17.29
200 Days MA	1041.21	16.17	1361.76	334.87	1110.48	16.16
Comment	Momentum slowing. 50 & 100 day MA still rising. Outlook Neutral.	Momentum slowing. 100 day MA declining. Outlook Neutral.	Slowing momentum. 50 & 100 day MA still rising. Outlook Neutral.	Momentum positive but slowing. 50 & 100 day MA still rising. Outlook Bullish.		

News Stories of Interest

- **Gold 'Unlikely' to Be Main China Reserve Investment**

Gold is "unlikely" to be China's primary investment to diversify its reserve holdings because of price risks, Yi Gang, head of the State Administration of Foreign Exchange, said today. The "gold price has had handsome gains in recent years," Yi said at a briefing in Beijing today. Still, "if we look at the past 30 years, it had big ups and downs." China is the world's largest producer of gold and the second-biggest consumer after India. China increased its reserves by 454 tons to 1,054 tons since 2003, and has the world's fifth-biggest holding by country, the administration said in April last year. The amount is worth $37.96 billion at current prices. India and Russia added to gold reserves last year as the metal capped its longest winning streak since at least 1948, joining other investors acquiring the metal via exchange-traded funds. "This may have a short-term negative impact on gold prices as one of the key reasons for the rally in the past year has been the expectation of central banks buying," said Li Ning, an analyst at China International Futures (Shanghai) Co. Gold for immediate delivery fell as much as 0.3 percent to $1,119.95 an ounce, before trading at $1,121.44 by 12:15 p.m. Singapore time. "Gold is unlikely to become a primary investment for China's reserve," Yi said. "The size of the world's gold market is small. China's purchase will push up the prices. That will also hurt Chinese gold consumers." Private holdings in China are more than 3,000 tons, Yi said. China isn't a "realistic candidate" to buy bullion from the International Monetary Fund, the World Gold Council said Feb. 22. "We're not surprised to see that China has not" purchased IMF gold, said George Milling-Stanley, the London- based council's managing director for government affairs, said last month. The country is more likely to "buy local gold production" to add to its reserves, Milling-Stanley said. Analysts including Citigroup

Inc.'s Alan Heap have said that the People's Bank of China is likely to buy bullion from the IMF in order to diversify its assets. "Medium to long term, gold continues to be supported by investors looking to hedge against weakness in currencies like the euro and the dollar," said China International's Li. China Investment Corp., the nation's sovereign wealth fund, took a 1.45 million-share stake worth $155.6 million, according to U.S. filings last month. "Regarding people's recommendations on increasing our gold reserves, we'll consider it prudently according to the market conditions," Yi said. (Edited Bloomberg Story)

- **Gold is an 'Under-owned Asset,' World Gold Council's Grubb Says**

Gold is an "under-owned asset," said Marcus Grubb, managing director of investment at the World Gold Council. Grubb spoke today at a conference in London. "Gold will hold its value and do very well against major currencies. "Gold is an under-owned asset class. The idea that gold is a 'crowded trade' we feel is not true. Most institutional investors are only just waking up to gold. "We've seen a strong shift toward increasing investment demand. Jewellery is way below where it used to be" as a percentage of total demand, he said. "Gold is under-owned by Chinese households. If China continues to grow strongly, we believe China will become more and more important as a gold market." (Bloomberg)

- **Deutsche lists physical gold backed commodity funds**

Deutsche Bank's new exchange-traded commodity funds will appeal to investors looking for security because they are backed by physical gold, the German bank told Reuters on Monday. Thorsten Michalik, head of db x-trackers, which houses the exchange traded commodities (ETCs) said four were listed in Frankfurt on Monday and that the plan was to roll them out to Milan and London over the next few weeks. "All our ETCs (in Europe) are collaterised by gold. There are no questions about the quality of the collateral," he said. "It's the highest guarantee you can have for your money. It doesn't matter which ETC, they will all be backed by gold bars ...competitors use baskets of equities and bonds." The new listings included a short gold ETC, a short oil ETC, a long oil ETC and a long industrial metals ETC -- aluminium, copper and zinc. Short refers to expectations of lower prices. The ETCs will be based on Deutsche's own commodity indices and Standard & Poor's commodity index, not on the underlying futures, which some investors view as risky. "The product is targetted at institutions such as pension funds, corporates, insurance companies and also for the retail market, Michalik said. "(Many) cannot invest in futures directly ... The ETCs are very transparent; fees are the lowest in the market." The cost of storing gold will be 20 basis points of the value of the holding and the management fee for the ETCs is 45 basis points. "The ETCs can be used for diversification and Deutsche Bank will be the market maker for the ETCs, so it will be a liquid market, there will always be a price," Michalik said. Deutsche is planning to list 30 ETCs by June and a total of 50 ETCs by the end of the year, making it a direct competitor to UK-based ETF Securities. It estimates assets under management in ETCs at around $20 billion in Europe. "The ETC market is one of the fastest growing investment segments in the exchange traded product (ETP) market," it said. A recent Deutsche Bank research report showed total assets in exchange traded commodity products across Europe grew 145 percent in 2009 compared with 43 percent in equities and 17 percent in fixed income. (Reuters)

- **AngloGold CEO hopes to cut hedge book faster**

AngloGold Ashanti, the world's No. 3 gold producer, said on Monday the company hopes to unwind its hedge book sooner than it's previous target of 2014, and forecast a steady increase in output. AngloGold Ashanti's Chief Executive Officer Mark Cutifani told the Reuters Global Mining and Steel Summit the group, Africa's top gold producer, plans to settle about 800,000 ounces of gold each year for the next five years. Cutifani said gold would trade $1,000 to $1,200 an ounce this year, and anything under $1,100 an ounce presented the company with an opportunity to trim the forward sales, which are among the biggest among its peers. "In the last 2 years we have hit all of our hedge book reduction targets, in fact we've done a bit better," he said. "I would say a reasonable target for this year would be to do 200,000 ounces better -- you will quickly start to erode that hedge book, which would leave you with an opportunity maybe in 18 months, two years time when you could settle it fairly quickly." Cutifani forecast the group's production in 2011 would be 4.8 to 5.0 million ounces from the estimated 4.6 million ounces this year. (Reuters)

- **LME copper up, Shanghai eases ahead of trade numbers**

London copper prices rose on Tuesday, paring the previous session's slide of 1 percent, while Shanghai metal ticked lower, with prices seen range bound ahead of China's trade numbers expected on Thursday. After sharp gains early last week on the back of Chile's 8.8 magnitude earthquake, copper prices have fallen into a trading range bounded by the 10-day moving average on the downside, and recent two-month highs above $7,600 on the upside. "There is a bit of a data vacuum which will be filled on Wednesday and Thursday," David Moore, commodities strategist at Commonwealth Bank of Australia, said. "It will be interesting to see how the market interprets copper imports. If they are down, the market will discount that because of the Lunar New Year holiday. If they are up, it could result in a kick-up in prices." Three-month copper on the London Metal Exchange rose $40 to $7,510 a tonne at 0424 GMT. In the previous session, the market touched $7,629.75, just off a two-month high before closing down 1 percent on the day. "There is not a lot of direction.

People are trading the ranges ahead of the China numbers. The influences are the dollar and stockpiles," a trader in Hong Kong said. "The inventory data looks pretty supportive on the face of it -- there is certainly a downtrend developing and the high level of cancelled warrants makes me think the declines will continue." LME inventories have fallen 9,000 tonnes since March 2 to 541,575 tonnes and cancelled warrants have risen to 5.5 percent of the total inventory. Benchmark third-month Shanghai copper fell 250 yuan to 60,230 yuan and the most active June contract slipped half percent to 60,370 yuan. Nickel fell $25 to $22,275, but remains near last week's 21-month high. "Nickel prices look very strong. The market is taking heart from the fact stocks have stopped rising and have even fallen. The other supportive factor is the dispute at Vale's Canadian operations," Moore said, "But I am sceptical whether nickel can hold these levels," he said adding that while copper was likely to slip into deficit in the medium term, the outlook for nickel was less certain given a slew of projects scheduled to start up in the next few years. Aluminium dipped $3 to $2,228. Aluminium fabricator Novelis Inc said global demand growth for aluminium would rise 4 percent pace in 2010, with the emerging markets driving the growth, and it expects prices to show a slight positive uptrend. Speaking to Reuters Mining and Steel Summit on Monday, Chief Operating Officer Philip Martens said: "We do see the outlook in the global marketplace picking up, but it depends on the region. It's slightly more on the optimistic side than four or five months ago." (Reuters)

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