



China Express

MARKETS THAT MOVED & NEWS THAT MATTERS

CONSUMER DEMAND VS. WHOLESALE DEMAND

- OUR DISCUSSION WITH THE WORLD GOLD COUNCIL

- We are pleased to report that we just had an in-depth discussion with the Market Intelligence team of the World Gold Council (WGC). Our discussion focuses on how to explain the significant gap between China's consumer demand of gold, as defined and reported by the WGC to be just over 1,000 tonnes in 2013, and China's wholesale demand, as defined and reported by us to be about 2,200 tonnes based on the Shanghai Gold Exchange (SGE) vault withdrawals during 2013. The following are our takeaways from the discussion:
- First, the WGC has revised up its estimate of China's 2013 consumer demand to 1,275 tonnes, up from their initial estimate of 1,066 tonnes. All aspects of WGC's data set are revised over time. This is not surprising. Revision of complex data sets is standard practice; we just need to look at GDP figures for most economies, which are regularly revised as new information comes to light.
- Second, although official rules prohibit bullion exports, trade data in other countries show that China does export some amount of gold. Therefore, not every ounce of gold withdrawn from the SGE vault stays in the country. Gold leaving the SGE may be exported overseas in various forms and accounted for as demand in other countries.
- Third, gold leasing is an opaque practice that might increase China's wholesales demand, but this is not a part of consumer consumption. Gold leasing has boomed in recent years. In a report earlier, the SGE noted that leasing amounted to 1,103 tonnes in 2013, up from 30 tonnes in 2007.
- Fourth, recycling might also explain a small part of the gap. There are two types of recycling: "gold exchanged for cash", which represents new supply, and "gold exchanged for gold", which leaves the supply and demand balance unchanged. The WGC reports data on "gold exchanged for cash", but excludes "gold exchanged for gold" from their supply and demand model, even though this amount of gold does flow through the SGE. In 2013, there were total 229 tonnes of recycled gold that was withdrawn from SGE, among which "gold sold for cash" amounted to 144.7 tonnes. Therefore, we estimate that about 85 tonnes of gold were flowed through the SGE for "gold exchanged for gold" purposes.
- Fifth, conceptually some amount of gold could be withdrawn from the SGE vaults directly by individual investors. These investors, as long as they do not care about the physical appearance of the bars, might prefer direct purchase from the SGE rather than from gold shops. Currently all the gold contracts on the SGE can be traded by individual investors. Physical withdrawal is for a minimum of either 100g, 1,000g or 3,000g, depending on the contract. That said, the WGC does not believe physical withdrawal by individual investors really occurs, because in WGC's view, "the majority of trading by private investors is not related to taking physical delivery but rather to leveraged speculation on the price".

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For important disclosures please see Appendix A.

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- And last but not least, although we do not have any direct evidence, we cannot rule out institutional purchases of gold. Even though the Chinese central bank does not seem to purchase gold from the Shanghai Gold Exchange, other Chinese institutional investors and commercial banks in China might choose to increase their gold exposure. And not all institutional purchases are captured in WGC’s consumer demand estimate. (In our *China Express* dated April 15, 2014, based on financial reports of China’s listed banks, we calculated that their aggregate gold holdings increased by some 600 tonnes in 2013).

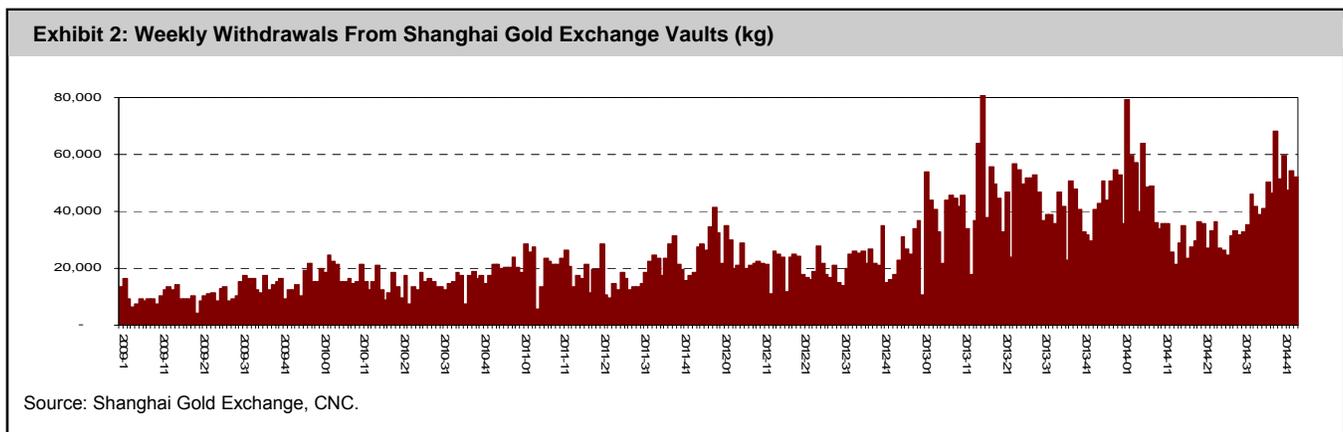
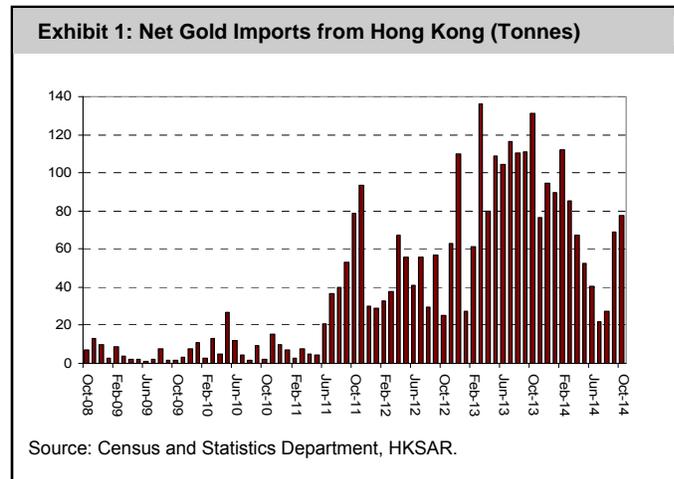
- Both the WGC and we at CNC believe that more work needs to be done to understand China’s actual gold demand. The WGC stresses that the difference between their estimate of China’s consumer demand and our estimate of wholesale demand are captured in WGC’s “OTC Investment and Stock Flows” figure in their “Gold Demand Trend” report. In addition, the WGC suggests investors read their reports “*Understanding China’s Gold Market*” and “*China’s Gold Market: Progress & Prospects*” for a deeper analysis of China’s gold market. Both reports can be easily found on their website.

- Our discussion with the WGC was fruitful and thought-provoking. We greatly appreciated the insights offered by the Market Intelligence Team.

- **In our view, investors should follow both WGC’s estimate of China’s consumer demand and our estimate of China’s wholesale demand. The WGC’s consumer demand figures reflect the organic, and therefore more sustainable, gold consumption trend in China. In contrast, although our wholesale figures are timelier (on a weekly basis) and cover a broader area, investors should note that some part of the wholesale demands, such as direct purchases from the SGE by individual or institutional investors, are more price-driven and/or sentiment-driven in nature.**

- For instance, we observe that Chinese investors have shown a good level of price-sensitivity in recent years. When gold price declines, the SGE premium tends to climb, indicating investors in China tend to take advantage of the lower prices and bottom fish.

- Lastly, we observe that latest trade data and wholesale demand data are both supportive for our positive view on the gold sector. Exhibit 1 shows that China’s net imports from Hong Kong strengthened again in October, and Exhibit 2 shows that China’s wholesales demand, as measured by the SGE withdrawals, remains lofty.



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