Sovereign Gold Bonds

ICICI direct Research

Thematic Report

ICICI Securities – Retail Research

February 9, 2024

Political uncertainty and rate-cuts to drive gold prices higher

Gold prices rallied sharply in 2023 and moved above $2000 amid correction in dollar and US treasury yields after US FED hit a pause button on its rate hike campaign and signalled rate cuts in 2024. Additionally, prices remained firm due to central bank buying and escalating geopolitical tensions

The structural uptrend in gold prices remains intact as it hit the lifetime highs in December 2023. International gold prices are also in a secular uptrend. Rising geo-political uncertainty and start of a global rate-cut cycle makes Gold appropriately placed for a safe-haven allocation.

Globally, interest rates are near peak levels with the US Federal Reserve likely to start cutting interest rates from the end of the current calendar year. Historically, a decline in interest rates has a positive correlation with gold prices as it lowers the opportunity cost of holding gold.

In the long term, Indian gold prices have witnessed a stable and structural uptrend. Gold has not just seen higher buying interest during uncertain periods like recent Covid-19 related concerns or any geopolitical tension, it has been a long term performing asset class, especially in the Indian context.

Investment in gold should always be considered from an asset allocation perspective as long period of sub-optimal returns and returns in a non-linear pattern are an inherent feature of gold price movement.

Allocation Strategy

While the future outlook matters the most, historical returns also give an idea whether to be overweight or underweight on any asset class. Whenever any asset class had done well (higher return than long term average), it is generally not a time to be overweight. Investors could be either underweight or equal weight based on the future outlook.

Currently, it is time to be equal weight on the overall asset allocation as while historical return is higher, the outlook stays positive given we are at the fag-end of the interest rate hike cycle particularly in the US. While inflation concerns globally have moderated, they still remain far above desired levels (US average inflation for CY23 is expected at 3% while US Fed target is 2%).

Generally, we recommend 5-15% as the normal range of allocation to gold. Hence, investors may maintain around 5-10% allocation to gold.

SGBs: Superior alternative to take exposure to gold

Sovereign gold bonds (SGBs) remain the best way to take exposure to gold due to additional 2.5% per annum interest and no capital gains tax. There are no annual recurring expenses while capital gains arising on redemption of the sovereign gold bond scheme would be exempt from tax. If these bonds are sold in the secondary market before maturity, capital gains arising on such transaction will taxed @ 20% with indexation if sold on or after three years and would be subject to marginal tax rate if sold before three years.

The popularity of Sovereign Gold Bond has gained significant prominence in the last few years as investors gained confidence on the ease of investing and additional interest, which SGBs offer.

The discount of | 50/gram will be available for investors applying online and making payment using digital modes. Investors will get additional interest at the rate of 2.50% per annum on the nominal amount. They will continue to have full exposure to gold prices to the extent of amount deposited.

Advantages of SGBs over other modes:

- *Additional interest of 2.5%*
- *No capital gains tax*
- *No management expenses*
- *Issued by RBI on behalf of Government of India*

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Long term performer, with or without events

Global gold prices movement historically have been non-linear with prices remaining in a range for multiple years and then delivering significant return in the following years as can be seen in the below mentioned chart.

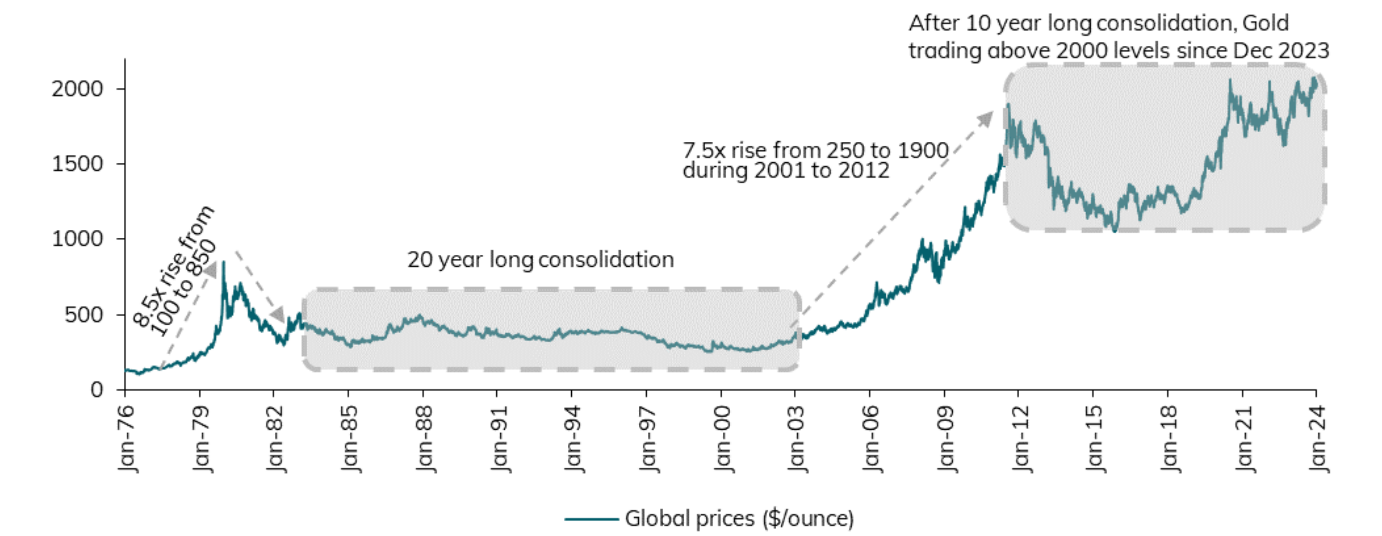
Indian gold prices, on the other hand, have been more structural and stable. Gold has not just seen higher buying interest during uncertain periods like recent Covid-19 related concerns or any geopolitical tension, it has been a long term performing asset class, especially in the Indian context.

Annualised long term returns since 1970s in US$ terms are ~3.3%. However, during similar periods, the return in rupee terms is ~8.8%. The return difference can be explained through rupee depreciation against the US dollar, which is at around 4.0% during the same period in the last 40-50 years. Even the inflation differential between the US and India is around similar levels of around 4.0%.

Global prices are more volatile than domestic prices. In last few years, US dollar index has witnessed heightened volatility leading volatile global prices. Indian gold prices are relatively far more stable

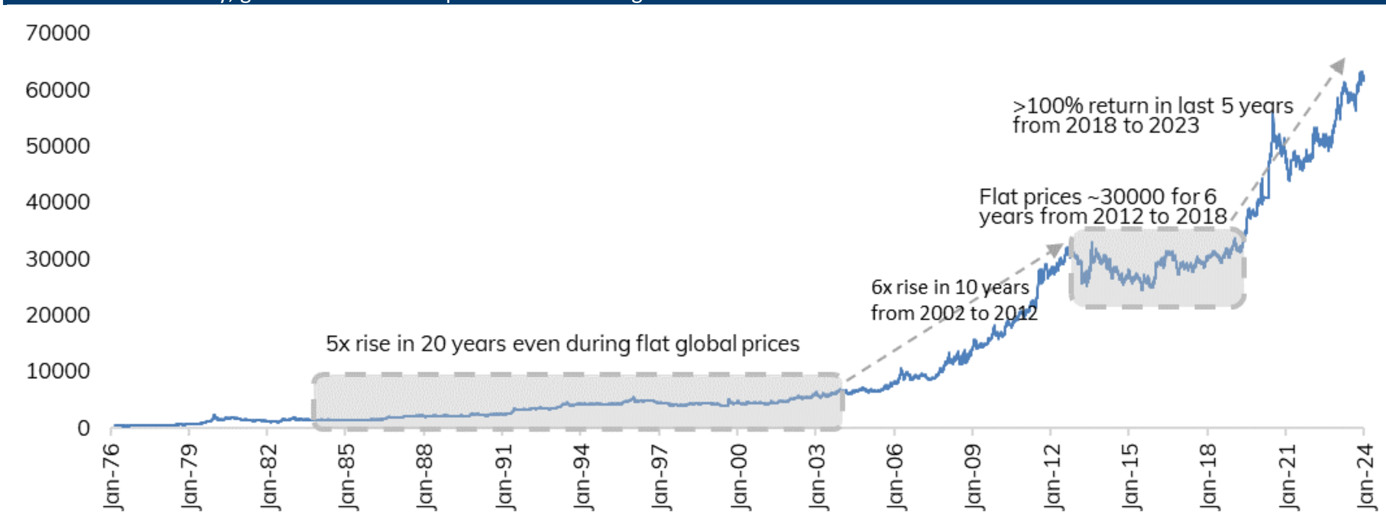
Going ahead, global price movement will be the major determinant of prices in India as currency depreciation tailwind may not be as significant as it was in the last few years

Exhibit 1: Global gold price rise is non-liner. Long consolidation period followed by sharp multi-year rally. It has been consolidating in last 10 years amid higher US dollar index volatility. Fall during 2012 to 2018 largely due to rally in US dollar triggered by taper tantrum (first rate hike indication by US Fed)



Source: Bloomberg, prices in US$ per ounce

Exhibit 2: Domestically, gold has been stable performer over longer term



Source: Bloomberg. Prices in | per 10 gram

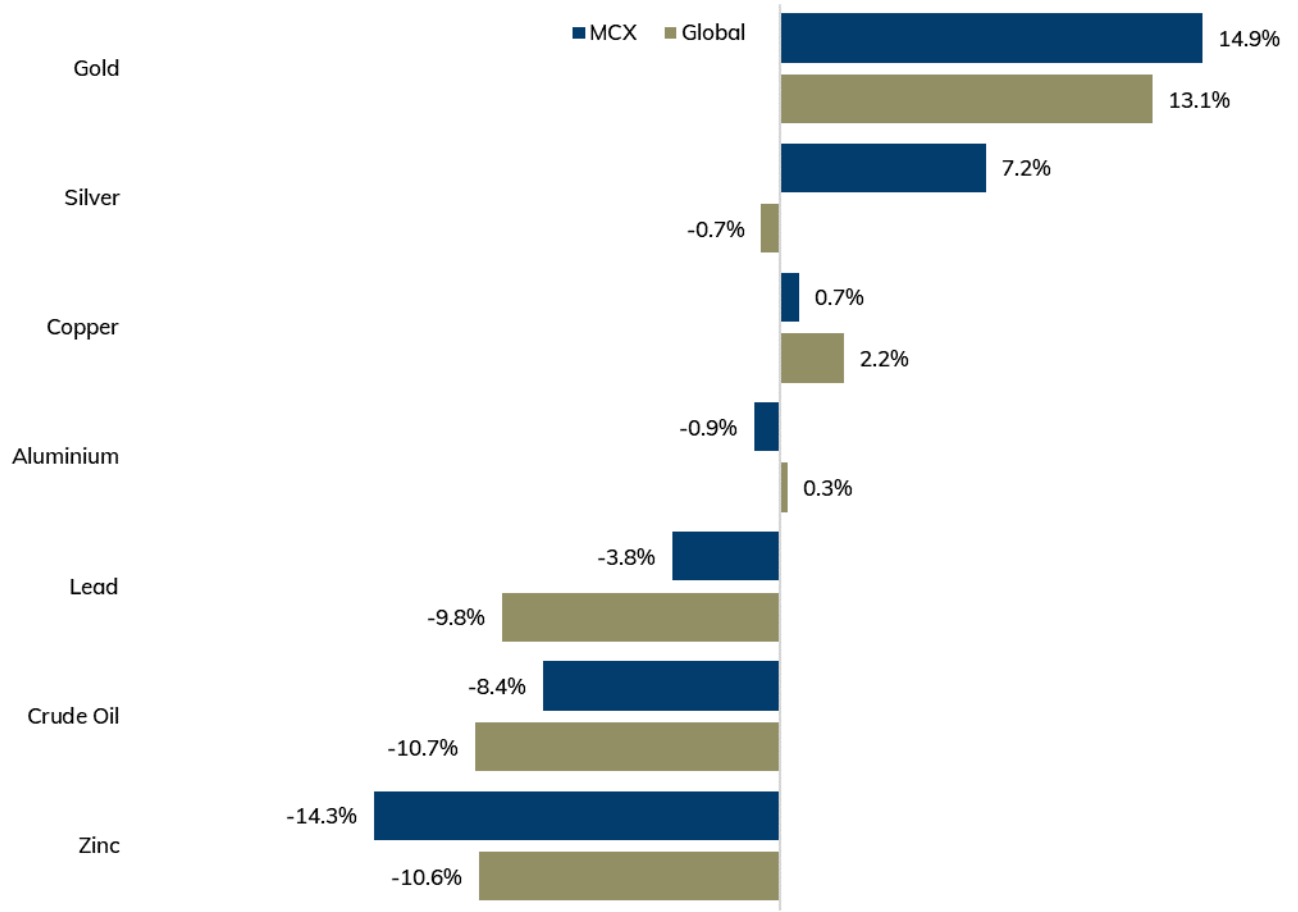
Gold best performing commodity during the year 2023

Gold prices rallied sharply in 2023 and moved above $2000 amid correction in dollar and US treasury yields after US FED hit a pause button on its rate hike campaign and signalled rate cuts in 2024. Additionally, prices remained firm due to central bank buying and escalating geopolitical tensions.

Base metals have underperformed despite of stimulus packages from China to support economic recovery and hopes of rate cuts across major economies.

Crude Oil prices slipped in 2023 by more than 10% amid slowing demand growth and increasing crude oil supplies from Non-OPEC countries.

Exhibit 3: Global gold price rise is non-liner. Long consolidation period followed by sharp multi-year rally. It has been consolidating in last 10 years amid higher US dollar index volatility. Fall during 2012 to 2018 largely due to rally in US dollar triggered by taper tantrum (first rate hike indication by US Fed)



Source: Bloomberg, prices in US$ per ounce

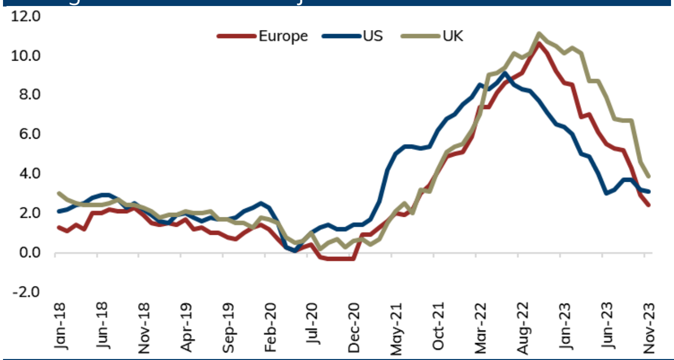
Global rate cut cycle ahead; inflation falling off the cliff

In the coming year, inflation is likely to moderate further and progress towards central banks targets.

Major central banks across globe are expected to cut rates this year. Fed is likely to start cutting rates from first half, while ECB and BOE are likely to cut rates in the second half.

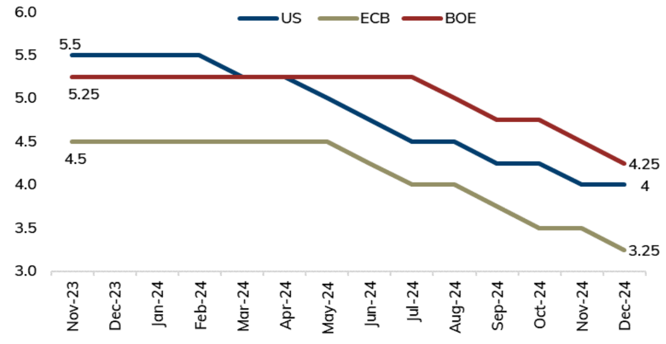
The dollar has started losing its steam and will continue to move south as US Fed is likely to ease monetary policy early and more aggressively than other major central banks.

Easing inflation across major countries



Source: Bloomberg

Rut cut expectations across major economies

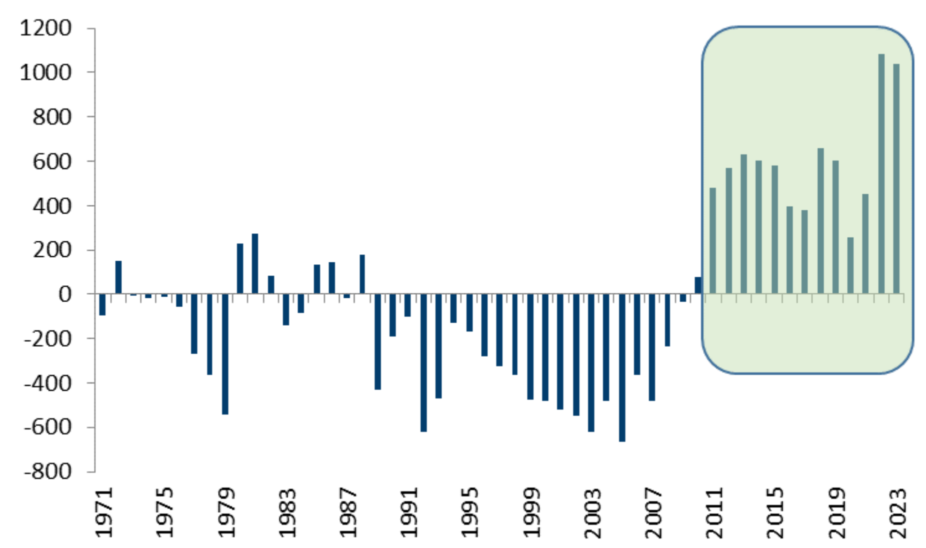


Source: Bloomberg

Record buying by central banks for second consecutive year

Annual net purchases of 1037 tonnes almost matched the 2022 record, falling just 45 tonnes short. Global central banks are looking to diversify their holdings by adding gold to their corpus. Predominantly, US treasuries are believed to be a larger proportion of their holdings. Central banks accumulated over 1037 tonnes of gold in the calendar year 2023 after they purchased highest ever 1082 tonnes in gold in the year 2022. Majority of the buying in CY22 came in Q3 and Q4 indicating recent buying interest. Heightened geopolitical and economic uncertainty throughout the year increasingly drove central banks to diversify their reserves and re-focus their attention on the principal objective of investing in safe and liquid assets.

Net purchase of 1037 tonnes in 2023 almost matched the 2022 record buying



Source: World Gold Council

The year 2023 witnessed the second year of record purchases of more than 1000 tonnes of Gold. These institutions hold nearly 37,000 tonnes of gold, 20% of all gold ever mind.

Gold poised to extend rally towards ₹ 70000

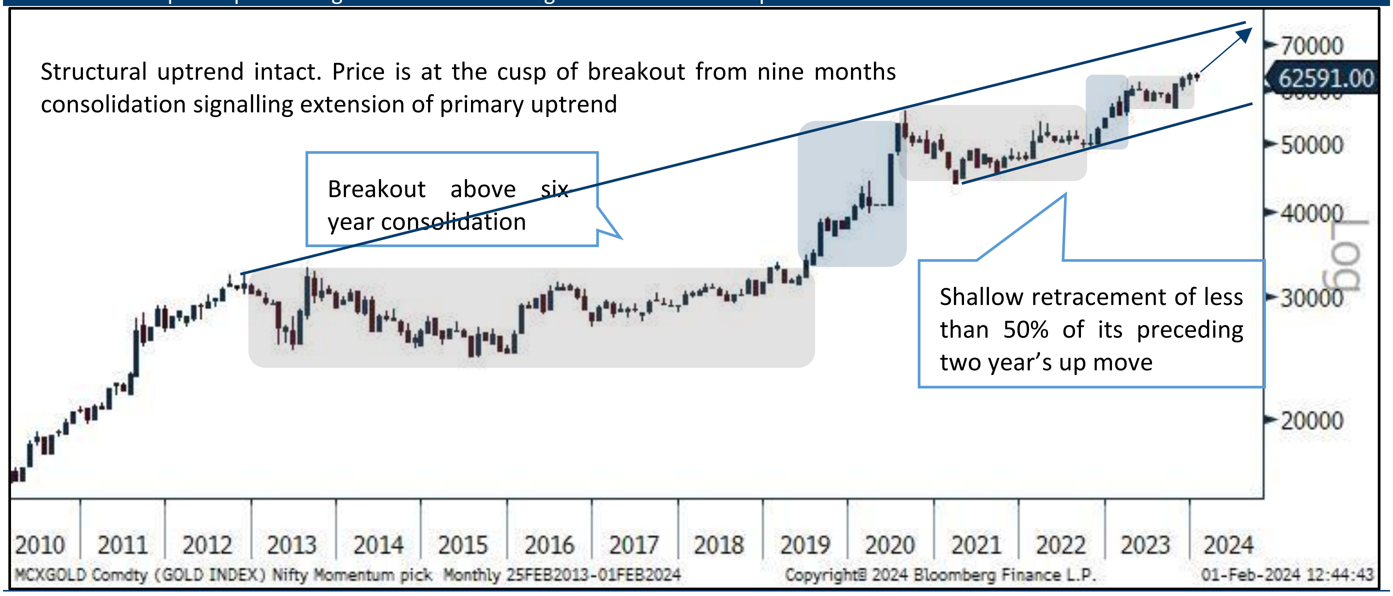
The structural uptrend in gold prices remains intact as it is forming higher base after 6 months consolidation breakout, highlighting robust price structure.

International gold prices are also in a secular uptrend. Historically, we have observed that Gold has inverse correlation with the falling interest rates. In the coming months, possibility of peaking out of interest rates would lead to resumption of uptrend in safe heave Gold. We expect markets to maintain the rhythm and continue the uptrend for another couple of years.

The robust price structure on long term charts makes us believe prices have significant upsides towards | 70000 levels over one to two year as it is confluence of price parity of Spet-22 to Apr-23 rally (48951-61845) projected from Oct-23 low of 56421 coincided with the rising supply line joining major yearly high of CY12 and CY20. Hence, investors should continue investing to benefit from multiyear uptrend.

We believe, Gold has undergone healthy consolidation and it has set the stage to resolve higher in coming quarters. In the process, we expect it to hold Oct-23 lows (56421) and extend its structural uptrend in coming quarters.

Exhibit 4: : Gold price uptrend to get bolstered as strong base formation is in place...



Source: Bloomberg, Gold monthly candlestick chart

US dollar exposure vital in overall asset allocation

Gold is the best way to hold US dollar asset in the portfolio. Future US dollar requirement also necessitates gold requirement for an Indian investor's portfolio. US dollar may be required for financial goals like children's study in a global management or other institute, foreign vacation, buying any foreign asset in future, etc. Gold is the best way to own a dollar asset as all other asset classes like overseas funds, gold mining companies, etc, have higher underlying volatility. Sovereign gold offers one of the best way to hold gold if interment liquidity is not in consideration. For Indian investors, gold provides an effective diversification to the overall investment portfolio. Accordingly, investors may consider allocating 5-15% of their overall portfolio in gold.

The US dollar is considered the world's reserve currency. Therefore, some exposure to it is desirable as an asset allocation. Historically, the rupee has depreciated around 4% per annum in the last 50 years and holding US dollar itself provides around 4% per annum

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