May 24, 2021

Recent correction good entry point in gold with SGBs

Indian gold prices, after rising sharply around 75% in a short period of two years and touching all time high levels of around ₹ 56000 per 10 grams in August 2020, have witnessed a sharp correction in the last few months. Prices, however, seem to have stabilised and renewed buying interest is seen as global inflation worries have resurfaced due to sharp rally in almost all global commodity prices. With US Federal Reserve explicitly indicating at not hiking interest rates at least until 2023, reversal in interest rate cycle if any is still far away to have any major negative impact on gold prices. We believe the sharp rise in global inflation expectations, easy global liquidity and no near term concern of rate hike by major global central bankers bodes well for global gold prices. Investors may utilise the recent correction in gold prices as buying opportunity. Sovereign gold bonds issued by RBI offers best investment option to take gold exposure due to no capital gains, additional interest of 2.5% and no management expenses.

Reserve Bank of India (RBI) through its notification on May 14, 2021, announced the launch of Sovereign Gold Bonds Schemes (SGBs) 2021-22. These bonds will be issued in six tranches from May 2021 to September 2021.

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.

SGBs offer a good alternative to take exposure to gold as it offers additional interest. 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 @ of 20% with indexation if sold on or after three years and would be subject to marginal tax rate if sold before three years.

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.

Advantages of SGBs over other modes:

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

Rising inflation expectations to drive gold higher

While safe haven demand has been accentuated by the Covid-19 pandemic, gold prices started rising from October 2018. Indian prices have since then risen from ₹ 30000 per 10 gram to above ₹ 55000 per 10 gram before correcting in last few months. During the same period, global prices after having risen from US$1175 per ounce to US$2000 per ounce, are now trading around US$1900 per ounce.

The reflation trade was stronger in last few months with industrial prices as well as agro commodities rising sharply in the last one year. Prices of raw materials of possibly everything we consume from food items to non-food items have risen sharply. In the last one year, global prices of industrial products like copper, steel, aluminium, zinc has increased between 50% and 90%. Even food prices of corn, meat, coffee, sugar, wheat, etc, have risen sharply.

The global economic recovery post re-opening of the economic activity as vaccination drives gather pace globally is the primary reason for the rise in the prices. The recently announced fiscal stimulus programme by US boosting infrastructure and consumer spending and healthy demand traction in countries like China for various commodities aided the overall prospects of almost all commodities. Crude oil prices have almost doubled

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from the lows of last year and trading neat US$70 per barrel. Food prices are also affected by poor weather in key growing nations like Brazil and France. This widespread rise in input prices is a threat to rise of production across industry in India as well. The WPI inflation has risen sharply and is expected to rise further. The core CPI inflation as already close to 6%. Therefore, further rise may alter market expectation of interest rate and liquidity trajectory even though actual RBI action may not be there.

Gold historically has been a good hedge against inflation with prices rising in a higher inflation environment. Higher inflation would also keep the real interest rates at the very low or negative, which should also support gold prices. Accordingly, gold may become an attractive and more effective diversification, resulting in a higher portfolio allocation.

Historically, long term performer with or without events

Global gold prices movement historically has 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.

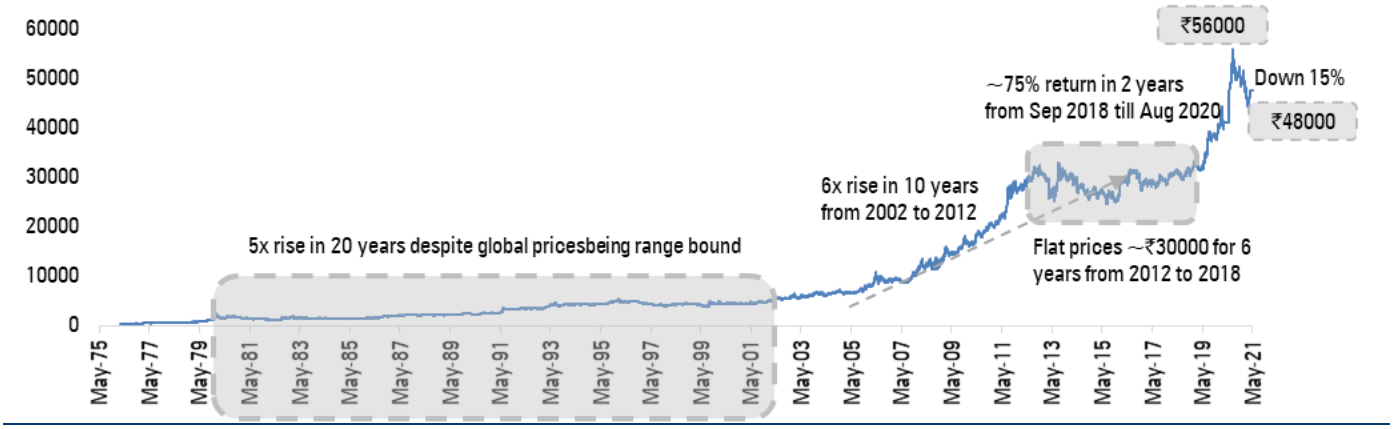
Indian gold prices, on the other hand, have been more structural and stable. Gold has not just seen higher buying interest during uncertain periods like recent Covid-19 related concerns or any geo-political tension, it has been a long term performing asset class, especially in the Indian context.

Annualised long term return since 1970s in US$ terms is ~3.3%. However, during similar periods, the return in Indian rupee terms is around 8.8%. The return difference can be explained through the 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%.

Exhibit 1: Global gold prices rise in non-liner pattern. Long consolidation period followed by sharp multi-year rally. It has been consolidating in last 10 years, likely followed by up-cycle

Source: Bloomberg, prices in US$ per ounce

Exhibit 2: In Indian prices, gold has been stable performer over longer term. After one of the sharpest rallies of ~75% in less than two years, it is down 15% from its all-time high.



Source: Bloomberg. Prices in ₹ per 10 gram

Gold poised for movement towards ₹ 65000

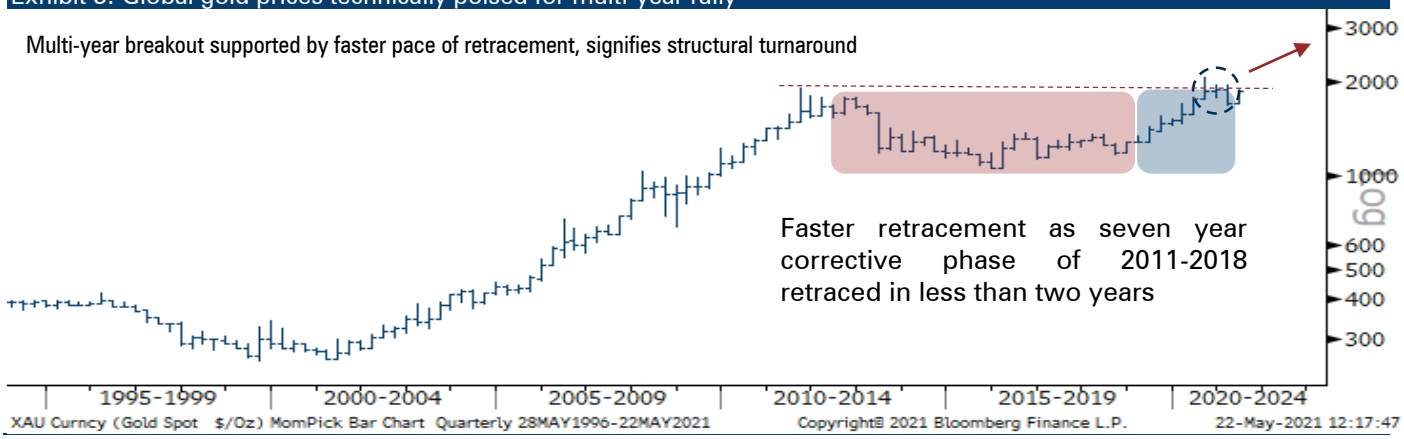
International prices, which have a direct bearing on domestic gold prices (after adjusting rupee movement) resolved past their life time highs of 2011, in July 2020, indicating structural turnaround as prices completed faster retracement of seven-year corrective phase (2011-2018) in less than two years. Technically, such faster retracement bodes well for primary uptrend.

Over the past six to eight months, prices have undergone a healthy retracement of 2019-20 rally and formed a higher base around ₹ 45000 which will act as launchpad for next structural uptrend

Historically, over the past five decades, larger uptrends in international gold prices have lasted usually for four to five years. In the current context, we are in middle of the current uptrend. We expect markets to maintain rhythm and continue uptrend for another couple of years.

The robust price structure on long term charts makes us believe that prices have significant upsides towards ₹ 65000 over a period of time and investors should continue investing to benefit from multiyear uptrend.

Exhibit 3: Global gold prices technically poised for multi-year rally



Source: Bloomberg, Global gold price

Easy global fiscal, monetary policy lower opportunity cost of gold

Global central bankers have cut interest rates aggressively in last few years to counter Covid-19 induced growth impact on the economy. Gold and interest rates traditionally have a negative correlation. In a low interest rate environment, the opportunity cost of holding gold reduces, which supports prices. The higher interest rates mean higher opportunity costs of holding non-interest bearing assets, such as precious metals, making them relatively less attractive. Basically, gold pays neither dividends nor interest. Thus, it is relatively expensive to hold in the portfolio when real interest rates are high and relatively cheap when real interest rates are low. In other words, the higher interest rates are, higher are carrying costs.

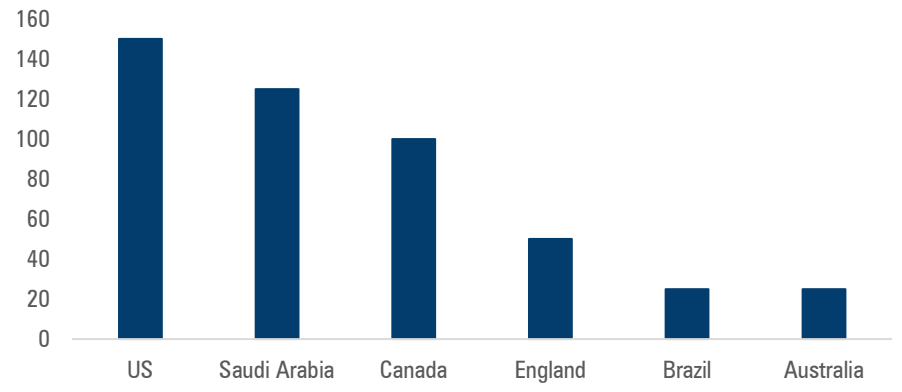
However, the relationship is not linear. Gold prices tend to increase significantly only during periods of negative real interest rates. This is because negative interest rates, i.e. the situation when the inflation rate is higher than the nominal interest rate (the rate which is actually paid), means that creditors are losing money. Therefore, they are more prone to buy gold, even though it does not bear interest or dividends. In other words, gold then reclaims its traditional role as money and a store of wealth, which will at least keep pace with inflation to preserve the purchasing power of the capital while bonds guarantee a real loss at negative real interest rates.

Economic growth is likely to be significantly impacted by the current lockdown due to rising Covid-19 threat on human life. The same is likely to aid the demand for gold in times of weak economic growth

Interest rates are different for every nation, with varying impact upon their economies and the price of gold in those countries. Rates in the US have a greater influence than most and because gold being predominantly traded in US dollars, its interest rates have a significant impact on gold price.

Currently, while there is some rise in global bond yield, overall interest rate environment remain benign.

Exhibit 4: Since start of CY20, almost all major central bankers have cut rates aggressively



Source: Bloomberg

Gold and interest rates traditionally have a negative correlation. Lower interest rates reduces the opportunity cost of holding gold which does not yield anything

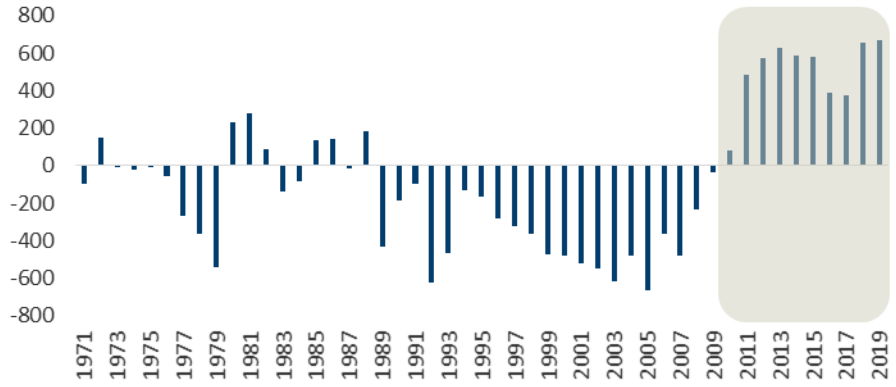
Central bank buying gold to diversify their holdings

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 668 tonnes in gold purchases in CY19, more than 2018's record numbers of 652 tonnes. In Q1CY20, they bought 145 tonnes compared to 108 tonnes in Q4CY19. 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. Central banks have bought significant amount of gold in the last two years. Central bank net purchases crossed 650 tonnes in 2018, 74% higher than 2017. In 2019, gold buying by central banks continued and reached another all-time high of 668 tonnes. The last two years have seen the highest level

The last two years have seen the highest level of annual net purchases by global central bankers. These institutions now hold nearly 35,000 tonnes of gold

of annual net purchases since the suspension of dollar convertibility into gold in 1971. These institutions now hold nearly 35,000 tonnes of gold.

Exhibit 5: Global central banks have increasingly bought gold in last few years



Source: World Gold Council

Similarly, holdings of gold by global exchange-traded funds are at a record high as investors sought safety from recent weakness in equities and worries about the Covid-19 virus hurting the global economy.

The best way to take US dollar exposure

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.

Issue Details

Exhibit 6: Sovereign Gold Bonds details

	Issue Details
Issue Price	Nominal value of the Bonds shall be fixed in Indian Rupees on the basis of simple average of closing price of gold of 999 purity published by the India Bullion and Jewellers Association Limited for the last three business days of the week preceding the subscription period. The issue price of the Gold Bonds will be Rs. 50 per gram less than the nominal value to those investors applying online and the payment against the application is paid through digital mode. The Nominal value and issue price of the current tranche would be notified by RBI on Friday evening.
Maturity	8 years with exit option from 5th year to be exercised on the interest payment dates. These bonds shall be traded on exchanges.
Subscription limit	Minimum 1 grams of gold, Maximum- 4000 grams (4kgs) of gold per person in a fiscal year (April- March). Available in units of one gram of gold & multiples thereof.
Taxation	Capital gain tax arising on redemption of SGBs to an individual has been exempted. If sold in secondary market before maturity, capital gains will taxed of 20% with indexation if sold on or after 3 years and would be subject to marginal tax rate if sold before 3 year.
Interest	2.50% fixed per annum payable semi-annually

Source: RBI

Six tranches from May 2021 to September 2021

Exhibit 7: Sovereign Gold Bonds issue details

Sr. No	Tranche	Date of Subscription	Date of Issuance
1	2021-22 Series I	May 17 to May 21, 2021	25-May-21
2	2021-22 Series II	May 24 to May 28, 2021	1-Jun-21
3	2021-22 Series III	May 31 to June 04, 2021	8-Jun-21
4	2021-22 Series IV	July 12 to July 16, 2021	21-Jul-21
5	2021-22 Series V	August 09 to August 13, 2021	17-Aug-21
6	2021-22 Series VI	August 30 to September 03, 2021	7-Sep-21

Source: RBI

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