By Julian D.W. Phillips 26th October 2016

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Gold's Pricing Power Moving East

How is the gold price made?

When we hear commentary on why the gold price has moved we usually hear of U.S. economic factors and a move in the U.S. Dollar. Most times these do not precipitate buying of physical gold.

What they do do, is to spur the buying or selling of futures or Options on the COMEX gold market. But even this link is tenuous as COMEX does not [except for a maximum of 5% of contracts that disclose they will deal in physical gold, upfront] deal in physical gold].

Price differential between Shanghai and London/New York

U.S. gold prices are driven by demand for physical gold in gold ETFs. But the bulk of physical gold traded in the world now happens on the Shanghai gold exchange. There we see 10 million investors including 10,000 institutions that are able to deal over their cell phones at any time. Such a market dwarfs both London and New York, but with gold exports not permitted from China, there are obstacles to the free flow of gold globally.

But these do not restrict arbitrageurs from working through the Yuan and dollar, increasing or lowering their holdings of gold in London and Shanghai to achieve the same effect as buying and selling between the two markets.

While there are frequent fingers pointing to the 'premium' of Shanghai prices over those of London and New York of around $5 this is not an indication of higher gold prices but equal demand. How so? Shanghai's price of gold is based on the near pure gold they deal in [0.9999 fineness] as opposed to 'London Good Delivery' gold [0.995]. The difference is half a percent or around $6. This accounts for the 'premium' that we usually see.

London and New York and the Gold Price

With London having been the global center of the physical gold world until recently, one would have thought that the influence over the gold price would have resided in London. But this is no longer so, as history over the last few years, has shown that London follows COMEX prices.

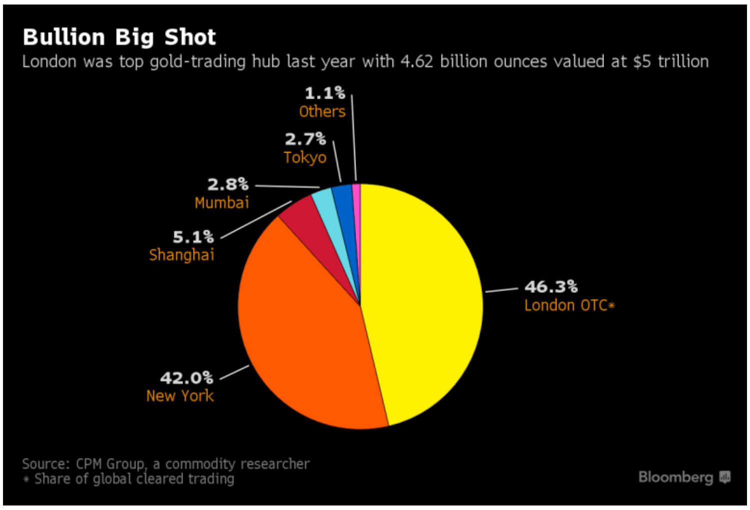
Of course, this would give rise to charges of 'manipulation' from U.S. and other sources. The not uncommon bear-raids by the big U.S. banks and high frequency traders ensured that the gold price bore little resemblance to the real global gold demand and supply factors.

This has allowed both Russia and China to acquire huge tonnages of gold at discount prices. With gold now an integral part of the Chinese financial system, China cannot afford to be at the mercy of the capricious, non-representative, U.S., physically small god market, even though the volumes of paper gold traded are huge as you can see in the pie chart above. This is resulting in China moving to take over gold's pricing power.

De-Globalization, Protectionism and Capital Controls

We are certain that we face a future of de-globalization in which China and the U.S. work for their own separate and conflicting interests. China has and will work at ensuring that it is not under the influence of the U.S., as far as is possible, just as the U.S. will make sure its interests are not vulnerable to outside influences, as far as they can.

We quote a respected billionaire investor, who said, "Demand for gold is often stimulated by the same factors that fan protectionist and populist sentiment" and that "abrupt declines in cross border trade, investment and immigration, the dislocation of global economic policies, and a beggar-thy-neighbor approach to trade is almost tailor-made for higher gold prices.



Events show nations are becoming less willing to cooperate, more willing to contest.

If these de-globalization trends continue, gold will be a good investment. Gold prices tend to rise during periods of contraction in world trade."

He pointed out that the World Trade Organization cut back its expectations for global trade this year to a mere 1.7%, compared with its 2.8% projection in April.

We agree with these views and see an unstoppable trend along this road leading to much higher gold prices in the future and a greater monetary role of gold in the global monetary system. This makes it all the more . In this context gold will be a perhaps the value measure in a declining value world.

China excluded from the global gold price?

China is unhappy that gold prices should be driven by U.S. and dollar concerns. Many state that because there is no free flow of gold in and out of China, China will remain a parochial market not integrated into the global gold market. This ignores the International Shanghai Gold Exchange where gold can be traded by foreigners. Even this is not necessary to allow international trade in gold.

The author has worked with successful arbitrageurs in London in the past, so we can clearly see that through the International Shanghai Gold Exchange arbitrage in gold is not just feasible but practiced. Any overweight London gold stocks can easily be sent to Shanghai from, in particular the ICBC/Standard branch in London that control two warehouses capable of holding 3,500 tonnes of physical gold. With this bank being a ‘market maker’ in London and a member of the LBMA price setting body, such a trading activity would be consistent with its normal functions.

As to gold leaving China it is not permitted, but the export of Yuan is. So a sale in Shanghai of gold receives Yuan which can be exported to buy gold in London. This is in essence giving arbitrageurs the ability to lower prices in Shanghai and raising them in London.

Capital Controls in China do not pose a hurdle for this business. What this could do is to smooth out price differentials between Shanghai and London. With Shanghai’s physical gold prices being more representative of physical gold demand and supply [due to volumes of gold traded] it is inevitable that Shanghai becomes the leading gold Benchmark pricer in the future.

More importantly, will the rest of the gold world ignore prices made in China? After all if it is the biggest physical gold market in the world, how can it possibly be ignored by the rest of the world’s gold markets? The answer is simply that it can’t. And that is now proving to be the case in other gold markets already.

Shanghai gold price to be used by other Exchanges

Shanghai Gold Exchange will collaborate with foreign exchanges and allow them to use its Yuan-denominated gold price in developing derivatives products, its chairman said last week.

The Shanghai twice daily Gold Fix was launched in April. We have followed these fixes twice daily since then and translated them through to the dollar gold price, in our daily, ‘Gold & Silver Market Morning’ [email to ***julian.smaugt1@gmail.com*** to be added to the list receiving it daily]. We saw this as part of China's bid to exert more control over pricing of the metal and increase its influence in the global market.

This established the relationship between gold prices in London and Shanghai gold markets. Until the beginning of this month [October 2016] Shanghai’s Fixes were roughly in line with both London and New York. Since the Yuan became one of the currencies that make up the basket of currencies of the IMF’ SDR on the 1st October 2016, we have noticed that the Yuan price of gold has been higher than both London and New York [even allowing for the different price bases]. Most recently, instead of maintaining this differential, we have seen both London and New York follow Shanghai’s prices higher. This has been at a time when demand in the U.S. for gold ETF shares has been absent from the market.

Now the news is here that supports the credibility of Shanghai’s prices. Shanghai has completed a deal with the Dubai Gold & Commodities Exchange for it to use the Shanghai gold price Fixing in pricing its derivatives markets.

The Shanghai Gold Exchange has also stated, "We would collaborate with various exchanges and authorise these external exchanges to start business outside China to use it as a basis for development of derivatives products." Other exchanges are approaching the SGE to do the same. The SGE stated, "Some of the exchanges are approaching us. Collaboration is a win-win for all. In Latin America and Africa the SGE wish to offer more collaboration with them."

With the Chinese Fixes being used for this purpose it is most likely that producers and users of gold south of Europe and east of Greece will come to favor setting contract prices based on the

Shanghai Fixes. This could account for up to 85% or more of the gold produced in the world. We see Russia favouring the SGE Fixes too.
Both gold producers and fabricators have based their contract prices on the London p.m. fixes to date, so a more stable and representative Shanghai Fix may well persuade them to use Shanghai rather than London in the future.

Is the Yuan a problem in pricing gold?

China has baulked at depending on a dollar price for gold in international transactions and believes its market weight should entitle it to set the price for the precious metal. The Shanghai benchmark gold price is based on clearly defined rules and is transparent, traceable and auditable, backed by 12 price-setting institutions and six reference members.

Bear in mind that Shanghai is the hub of gold trading in China. The SGE has set up 61 designated warehouses across 35 cities in China to expedite deliveries and other services.

As to the Yuan itself being a problem currency, we do not see this as a problem. Since arbitrage in gold markets began when currencies began to float, professional arbitrageurs have run a 'book' in gold and associated currencies, so a Yuan 'book', a dollar book, et al, is the normal operation of such a dealer.
The clipping of small profits, on a daily basis [taking no overnight positions] is a most profitable business and one that has the power to smooth out price differentials between markets and currencies globally.

Consequently, the major steps in shifting gold's pricing power to the east have been completed. It is only a matter of time before we see the influence of COMEX decline considerably and the link between London's physical gold market and the Shanghai Gold Exchange be consolidated with Shanghai dictating daily gold prices.

This will ensure a 24-hour global gold market where prices relate to the gold market and not to the U.S. economic situation.

A word to gold investors - **Simply holding gold overseas will not be enough. We are happy to send you a guide on just how to hold your gold effectively out of the reach of the authorities in your Jurisdiction.**

It will be the gold investor that ensures he is outside the reach of confiscating authorities that will retain his gold and ensure he profits from those rocketing prices.

There are no gold custodians or dealers that are geared to protect their clients with the exception of one we know of – ***www.Stockbridgemgmt.com***.Contact them at ***admin@stockbridgemgmt.com***