ICICI direct Research

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Gold: Outlook remains positive, SGBs best way to take exposure

Recently, gold prices have been globally on an uptrend since November 2022 amid moderating US retail inflation numbers and anticipation of a less aggressive US Federal Reserve. Further, the US dollar as well as US bond yields have begun to cool off, which has been supporting gold. Buying by global central banks and the potential positive impact on gold demand given the opening up of Chinese markets have also boosted prices.

Gold prices are up 13% in the last four months, both globally as well as in India). Domestically, it is up 28% in the last two years (13% CAGR) and 78% in the last four years (15.5% CAGR). The historical long term return of Indian gold is around 10% per annum. Recent return in gold is higher than long term average and, therefore, mean reversion may lead to moderation (lower than long term average return of 10% per annum) in return in the near term.

Allocation Strategy

While the future outlook matters the most, historical return also gives 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 future outlook.

Currently it is time to be equal weight in 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 US. While inflation concern globally has moderated, it still remains 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 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.

So far, the Government of India through Reserve Bank of India (RBI) has issued 62 tranches and raised around ₹ 43000 crore. The popularity of Sovereign Gold Bond has gained significance prominence in 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.

Thematic Report

Latest SGB Scheme:

- *March 6-10 2023*
- *Issue Price: ₹ 5561/gm (₹ 5611/gm plus ₹ 50/gm online discount)*

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*

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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.

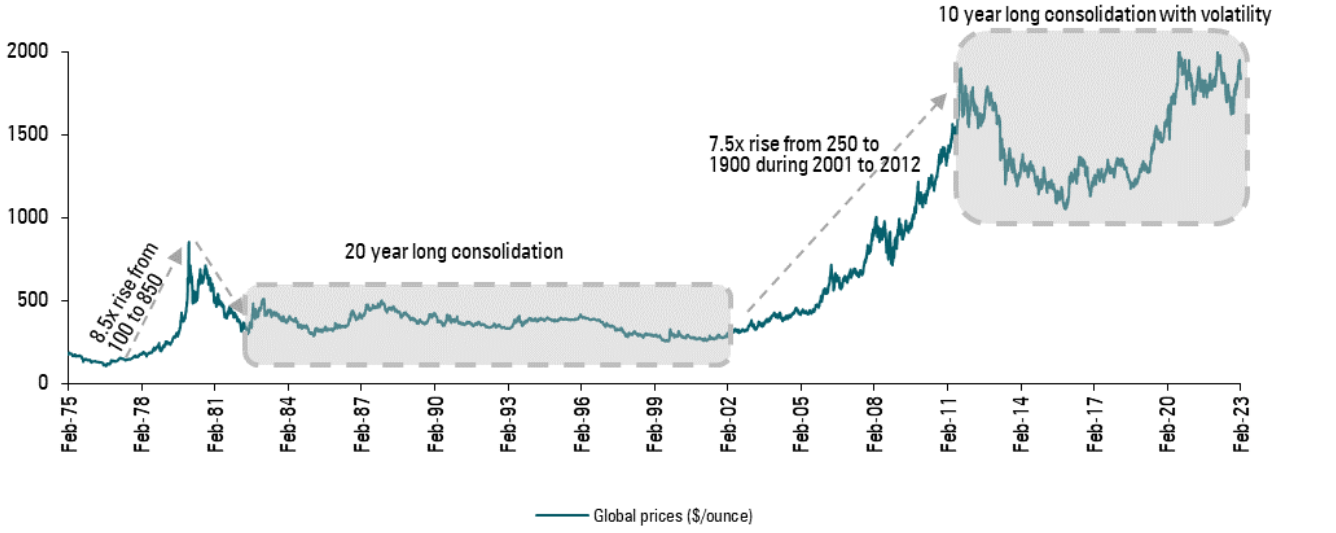
Indian gold prices, on the other hand, have been more structural and stable. Gold has not just seen higher buying interest during uncertain periods like recent Covid-19 related concerns or any geopolitical tension, it has been a long term performing asset class, especially in the Indian context.

Annualised long term returns since 1970s in US$ terms are ~3.3%. However, during similar periods, the return in rupee terms is around 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

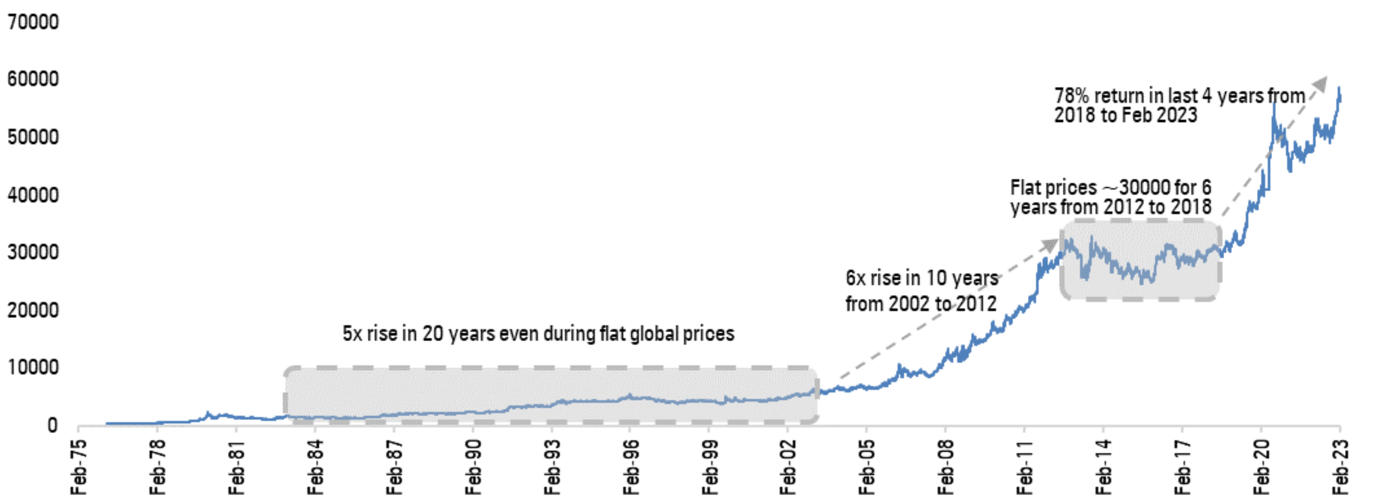
Going ahead, global price movement will be the major determinant of prices in India as currency depreciation tailwind may not be as significant as it was in the last few years

Exhibit 1: Global gold prices 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. The fall during 2012 to 2018 was largely due to rally in US dollar trigger by taper tantrum (first rate hike indication by US Fed)



Source: Bloomberg, prices in US$ per ounce

Exhibit 2: Domestically, gold has been a stable performer over longer term. Recent rally of 78% in last four years is largely on the back of rally in global gold prices



Source: Bloomberg. Prices in ₹ per 10 gram

Global recession, elevated inflation to outdo US Fed rate hike concerns

While safe haven demand has been accentuated by the Covid-19 pandemic, gold prices started rising from October 2018. Recently, moderating US retail inflation and anticipation of a less aggressive US Federal Reserve has led to rise in global gold prices. Gold prices are up 13% in the last four months, both globally as well as in India). Domestically, it is up 28% in the last two years (13% CAGR) and 78% in last four years (15.5% CAGR).

Further, the US dollar as well as US bond yields have begun to cool off, which has been supporting gold. Buying by global central banks and the potential positive impact on gold demand given the opening up of Chinese markets have also boosted prices.

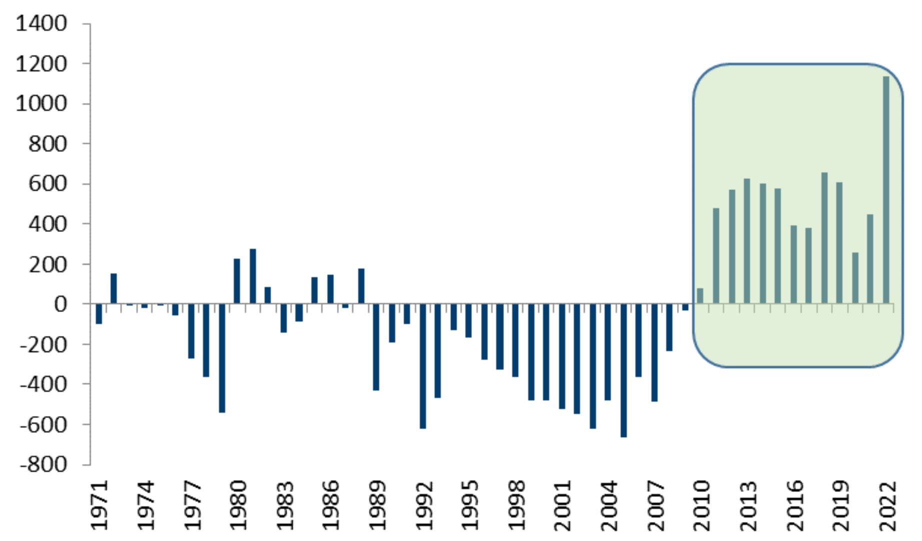
Historically, gold has been a good hedge against inflation with prices rising in a higher inflation environment. Higher inflation would also keep the real interest rates at the very low or negative, which should also support gold prices. Accordingly, gold may remain an attractive and more effective diversification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

Outlook remains positive given we are at the fag-end of the interest rate hike cycle particularly in the US. While inflation concern globally has moderated, it still remains far above desired levels (US average inflation for CY23 is expected at 3% while US Fed target is 2%)

Central bank buys record gold in 2022

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 1136 tonnes in gold purchases in CY22, highest ever in any calendar year. 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.

Exhibit 3: Global central banks make record purchases in 2022



Source: World Gold Council

The year 2022 saw the highest ever buying by global central bankers at 1136 tonnes. Within 2022, Q3 saw buying of 445 tonnes while Q4 saw 417 tonnes of buying. These institutions hold nearly 35,500 tonnes of gold, 20% of all gold ever mind.

Gold poised to extend rally towards ₹ 68000

The structural up trend in gold prices remain intact as it is seen resolving past its lifetime highs of September 2020 (56018). The prices in the process have generated a breakout above the last two year's broader consolidation (56000-44000) signalling extension of the up move.

International gold prices are also in secular up trend. Historically, we have observed 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 the rhythm and continue uptrend for another couple of years.

The robust price structure on long term charts makes us believe prices have significant upsides towards ₹ 68000 levels over two to three years being the confluence of the last two year's broad range breakout (56000-44000) and also the value of the rising supply line joining major yearly high of CY12 & CY20. Hence, investors should continue investing to benefit from multiyear uptrend

Structurally, gold prices have witnessed a shallow retracement in the last two years retracing just 50% of its preceding two year's rally (31220-56018) signalling strength.

Gold prices, after last four month's strong up move, some consolidation cannot be ruled out in the short term. However, we expect it to hold above last quarter's low (49353) and extend its structural up trend in the coming quarters.

Exhibit 4: : Gold price uptrend to get bolstered as breaking above last two year's consolidation

Source: Bloomberg, Gold monthly candlestick chart

Some 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.

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

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