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By **William Gray**

Gold Bullion: To Have and To Hold

Coining a phrase from another era, the stock market is in another period of irrational exuberance. 18% of all US dollars in circulation were printed in 2020, a staggering increase in money circulating in the system, with the printing presses yet to slow down in 2021. This massive liquidity infusion from the government's fiscal stimuli policies coupled with record household borrowing on the back of the low interest rates, has seen the stock market driven to all-time highs as investors seemingly eschew usual risk considerations and chase returns.

Some tapering of these liquidity measures was expected to have already begun but the continuing pandemic has delayed this by some months and as a result, gold has remained largely range-bound since March 2021. However, signs of inflation are beginning to creep into the system and whilst interest rates will eventually rise, the mountain of debt which has been accumulated may limit the extent to which rate hikes can be used to fight inflation without causing issues for the economic recovery and the debt servicing obligations which both government and individuals have undertaken in record amounts. When interest rates rise, we will also likely see the bursting of the stock bubble and a flight to safety.

Whilst the price of gold may have remained lackluster recently, there are some interesting developments to follow. In the physical gold market, several central banks have been net buyers during 2021, increasing their gold holdings as part of a policy to diversify away from the federal reserve note as the global currency reserve of choice. Their gold purchases in the first half of the year were 39% above the 5-year average for H1. The Thai Central Bank Governor, among others, noting the benefit of increasing gold holdings as part of a policy of managing security, return, diversification and tail-risk hedging. Additionally, the Russian National Wealth Fund, effectively its state pension fund, has now divested all of its US dollar currency holdings and recently allocated 20% of its assets to gold.

September is historically the best month for gold and the factors above, among others, give me confidence that the gold price will begin to rally and continue its trend upward in 2021/22. One potentially significant longer term change for the gold market is the Basel III accord governing the new guidelines which global banking regulators, including in all of the G20 economies, should follow. Implementation of these updated guidelines has been delayed but are now scheduled to be adopted by January 2023.

Following the end of the gold standard in 1971, gold started to be more freely traded and with the advent of futures, derivatives, EFTs and other gold related instruments, it has now become one of the major market trades globally. Although the market is not completely transparent, daily trading volumes have been reported to be in the order of 5,500 tonnes during peak trading periods. On average 3,200 tonnes is mined and 4,000 tonnes is bought and sold annually, so depending which exchange one looks at, between 5% and 0.5% only of all trades are done in physical gold. The vast majority of trades are therefore as paper gold and it is these trades which for the most part, set the price of gold.

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Banks and other institutions have increasingly been adapting fractional reserve gold trading, leveraging their physical gold holdings in the way they do other deposits and assets, and commentators estimate that the value of the paper gold market could already be more than 250 times the physical gold held. However, this growth in the paper gold market also brings an increased potential of third party default risks, which in turn could affect liquidity during a crisis if institutional holdings of physical gold are insufficient to meet settlement obligations.

WILLIAM GRAY IS AN EXPERT IN PRECIOUS METALS WITH OVER TWO DECADES OF ACTIVE MANAGEMENT EXPERIENCE IN THIS FIELD. HIS STERLING-BASED ARC BULLION ACCOUNT, AN ACTIVELY TRADED PHYSICAL BULLION INVESTMENT, HAS RETURNED OVER 116.53% SINCE ITS LAUNCH IN DECEMBER 2014.

The Basel Committee on Banking Supervision designate certain types of investments as safe, or unsafe, for banks to invest in and how they should be treated in terms of capital adequacy requirements and risk management. They are refined from time to time as the financial market becomes more sophisticated and changes in how certain assets and liabilities are treated can have a huge market impact. Indeed, many cite the failure of regulation to keep up with the risks of derivative markets innovation as a key element in the 2008 global financial crisis.

With paper gold trading being largely backed by unallocated gold holdings and fractional trading potentially disassociating the size of the risks from the physical gold holdings, the Basel III accord distinguishes more clearly between physical gold, whether allocated or unallocated, and paper gold holdings. Allocated physical gold is a tier 1 asset which is taken at 100% of value, with no counter party risk, however, the new regulations underline the fact that paper gold carries third party risk. The implications of the Basel III are simple; banks' balance sheets must hold more capital against their "unallocated" gold liabilities. It's too early to tell the effect on the gold trading market of these changes in regulations, ones which LBMA are lobbying against, but it was interesting to note that the amount of physical gold held in London hit record highs in July this year.

To quote Vladamir Lenin, "there are decades when nothing happens, and there are weeks when decades happen." I believe the market change is now a question of when, not if, so for those considering gold holdings as a long term store of wealth and as an asset which carries no counter-party risk to hold, don't wait too long! F

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