MKS PAMP GROUP

**Metals Strategy | Sanctions, de-dollarization & CB flows Part 2**

**March 22, 2022**

A follow-up from yesterday's note with further thoughts around CB Gold and exploring some “what-if” scenarios that are both fun but also informative. It is well known that CB flows are historically very opaque (besides the monthly stats as reported by the IMF/WGC), but there have a been a few questions around how/what can be done by this sector that’s worth considering.

- **CBs collectively hold 1.1bn (yes bn!) oz of Gold. That is roughly 10x more than what's sitting in global ETFs (~105mn oz) or annual gold supply (~113mn oz).** Graph 1. That stat makes one think twice about hyper focusing on relatively smaller daily ETF/OI flows, when holdings of this size (and associated flows) pass through the OTC market arguably on a daily basis.

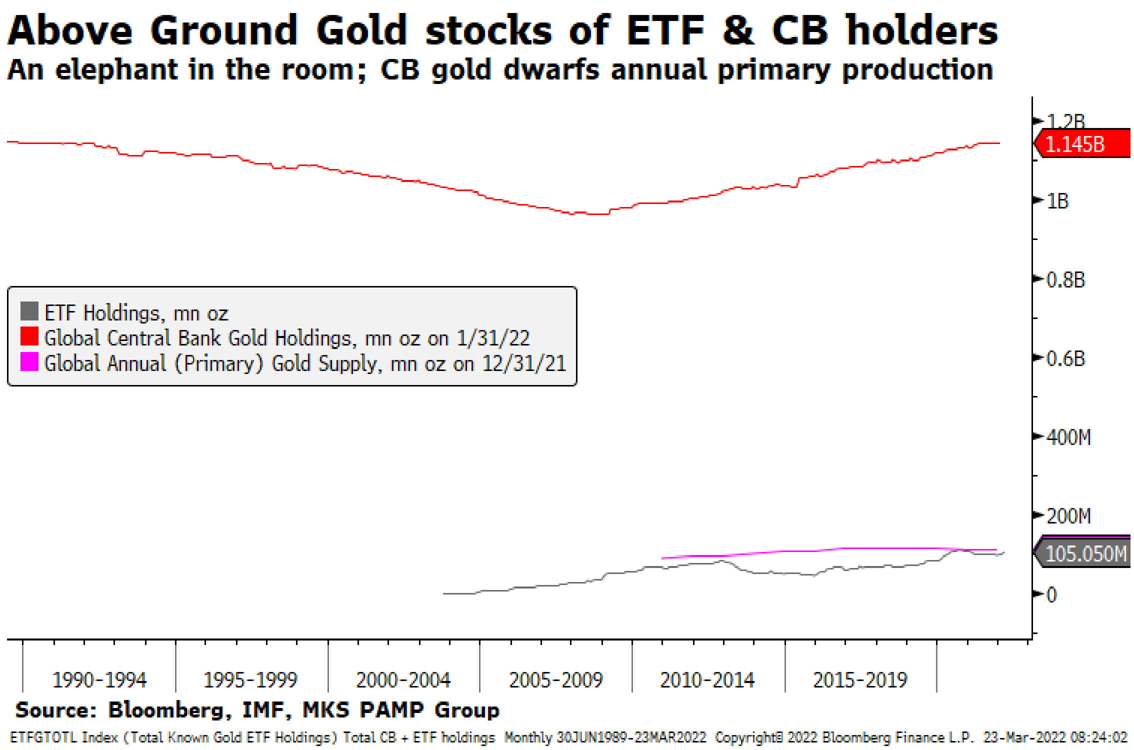
- The relatively larger size of holdings also perhaps help explain the unexplained price action – at the very least it’s a scapegoat. The recent large $170 pullback in a straight line from $2070 should not have been so deep & painful; bull markets in other asset classes don't put in moves like that! One can’t confirm nor deny any direct CB participation, and price action and context is all we have. However **markets should respect that CBs are the largest player, larger than investors or physical flows, at a time when the US$ is being weaponized and prices are very appealing (not only in US$ terms but local currencies as well).**

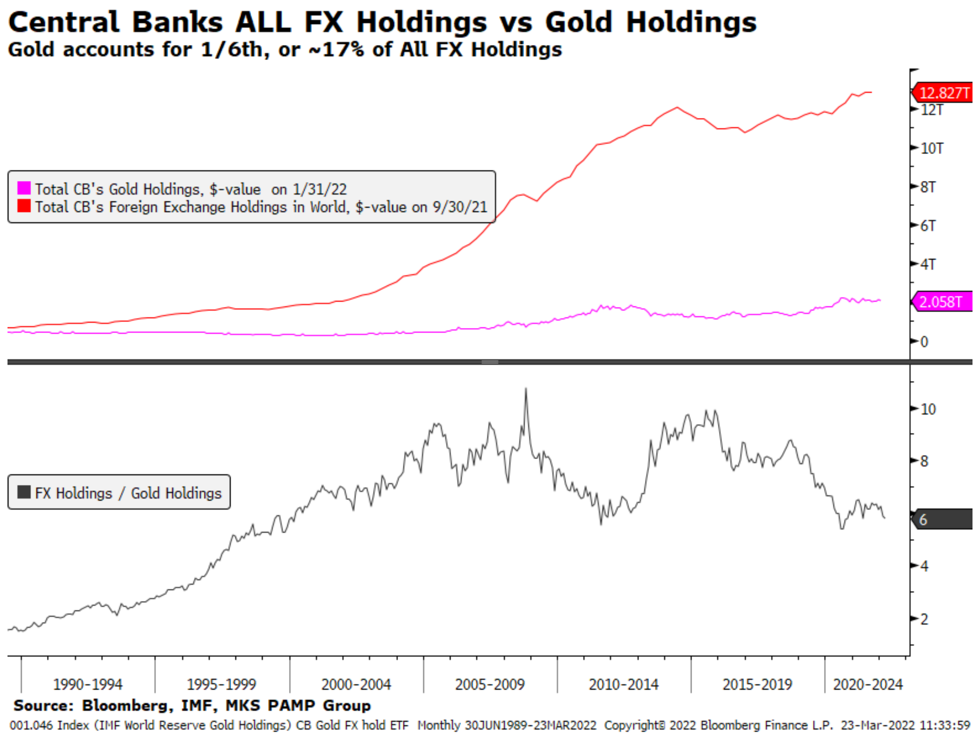
- **The worlds Central Banks own 1.145bn oz of Gold. Thats currently worth >$2.1tn, which is 1/6th or 17% the value of all Central Bank FX holdings as estimated by the IMF (graph 2).** Collective Gold holdings have been as small as 1/10th (10%) of all FX reserves (2009 – post GFC and 2015 –European financial crisis), and as high as 18% of FX reserves (in 2011 and 2020, which is largely due to the higher notional gold prices seen in these periods).

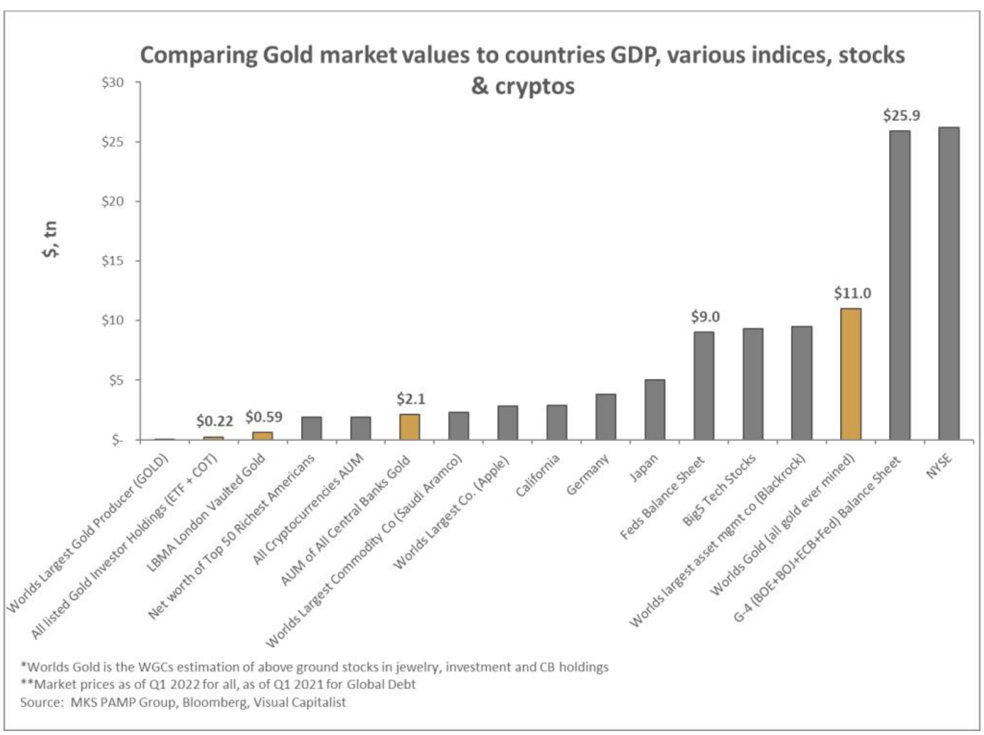
- A global Gold share of 17% of All FX reserves, is just that; it doesn’t underscore the fact that Emerging Market CBs largely tend to have a low gold exposure (typically <10% of all FX reserve) while the G-10/Developed Markets CBS are Gold-heavy (typically >50% of FX reserves). **So IF those countries deemed Russian friends *(email below highlighting they together own 193mn oz of Gold)* were to alter their Gold reserves and bring them in line with the current threshold of 17%, collectively they would need to buy an additional ~290mn oz of Gold**. That’s a whopping 2.6x the size of all ETF holdings. Specifically, China would need to buy ~260mn oz (alone), given the size of its reserves, India +33mn oz and Bangladesh would need to buy 3.9mn oz (the top 3 largest buyers). Kazakhstan would need to sell 9.2mn oz to bring down its gold exposure from 66% of FX reserves to 17%.

- **The all-important question of whether CBs now ramp up holdings to de-dollarize further or monetize and sell, is complicated by a few factors.** 1) Prices. Arguably Gold is expensive and has put in a US$ (and local currency for most) peak, 2) inflation and the Feds upcoming rate hiking cycle in which expected higher rates make lending/monetizing Gold more appealing, 3) Sanctions and or threat of (Western) sanctions directly impacting CB Gold holdings; the uncertainty stalls any buying activity not accelerates it. 4) Food inflation and high energy costs / imports. Certainly, diversifying into Gold is de-prioritized at a time when food inflation/scarcity is rampant and a large concern especially for EM nations like India, South East Asian or African countries. Theres less political will to be seen to be buying Gold at these prices when the population simply can't buy bread. Typically, food crises and the associated surging inflation is bullish gold, from an investment standpoint, but only to a point. **If it severely impacts discretionary income from poorer gold consuming nations (India, South East Asia), not only is consumer demand crimped but Gold holdings/savings could potentially be be unlocked.**

- Graph 3 is an update providing some perspective around the value of all CB Gold vs assets and other relevant measures. **CB Gold currently valued at $2.1tn has just pipped the AUM sitting in all cryptocurrencies ($1.9tn) and is almost as large as the size of the largest commodity company (Saudi Aramco). CB Gold also accounts for over 1/5th of all Gold ever mined.**




Central Banks ALL FX Holdings vs Gold Holdings
Gold accounts for 1/6th, or ~17% of All FX Holdings
Total CB's Gold Holdings, $-value on 1/31/22
Total CB's Foreign Exchange Holdings in World, $-value on 9/30/21
12.827T
12T
10T
8T
6T
4T
2.058T
0
FX Holdings / Gold Holdings
10
8
6
4
2
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014
2015-2019
2020-2024
Source: Bloomberg, IMF, MKS PAMP Group
001.046 Index (IMF World Reserve Gold Holdings) CB Gold FX hold ETF Monthly 30JUN1989-23MAR2022 Copyright© 2022 Bloomberg Finance L.P. 23-Mar-2022 11:33:59


Comparing Gold market values to countries GDP, various indices, stocks & cryptos
$, tn
$30
$25
$20
$15
$10
$5
$-
$0.22
$0.59
$2.1
$9.0
$11.0
$25.9
Worlds Largest Gold Producer (GOLD)
All listed Gold Investor Holdings (ETF + COT)
LBMA London Vaulted Gold
Net worth of Top 50 Richest Americans
All Cryptocurrencies AUM
AUM of All Central Banks Gold
Worlds Largest Commodity Co (Saudi Aramco)
Worlds Largest Co. (Apple)
California
Germany
Japan
Feds Balance Sheet
Big5 Tech Stocks
Worlds largest asset mgmt co (Blackrock)
Worlds Gold (all gold ever mined)
G-4 (BOE+BOJ+ECB+Fed) Balance Sheet
NYSE
*Worlds Gold is the WGCs estimation of above ground stocks in jewelry, investment and CB holdings
**Market prices as of Q1 2022 for all, as of Q1 2021 for Global Debt
Source: MKS PAMP Group, Bloomberg, Visual Capitalist

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Part 1:

The Global economy has entered a new age of economic conflict – using devastating, arguably to some “indiscriminate” (as Xi called them) financial sanctions, will have far reaching effects. It’s economic war in which the US$ has been weaponized; its upending financial and commodities markets, while raising structural questions around the greenbacks supremacy. Depending whether the West are successful or not, the more they are use or the longer sanctions are imposed, the more other countries will try avoid relying on Western finance, will recalculate any geopolitical costs to war (e: g China invading Taiwan) but more importantly, autocracies are now increasingly nervous over Western pressure to ‘fall in line’ when they together own $20tn of reserves and sovereign wealth assets. Put another way, in relevant Gold terms, the countries who either abstained or voted against the recent UN resolution (i.e.: China, India, Belarus etc), collectively own 193mn oz of Gold, or ~$370bn worth (graph 1). Some broad-based thoughts below as the global monetary order is being reconsidered as investors worry that the non-West may unshackle themselves from the Petro-$/Western financial system, now that large swathes of reserves (US$, Gold and other assets) are no longer risk-free assets.

**More support than the Western media portrays**: The UN General Assembly’s resolution earlier this month (demanding that Russia stop its offensive & immediately withdraw all troops) reflects influence and world opinion. The vote saw 141 countries back the motion, with 35 abstaining (China, India, South Africa to name a few) and 5 against (Belarus, North Korea, Syria etc).

- Almost 30% of the world (proxied by these votes), either implicitly or explicitly support Russia; that’s 1) far too high, 2) far more than what the media portrays or Id argue markets believe. *(yes, the war has been ongoing for 1 month+ with more atrocities on a daily basis, so opinions/votes may have changed)*

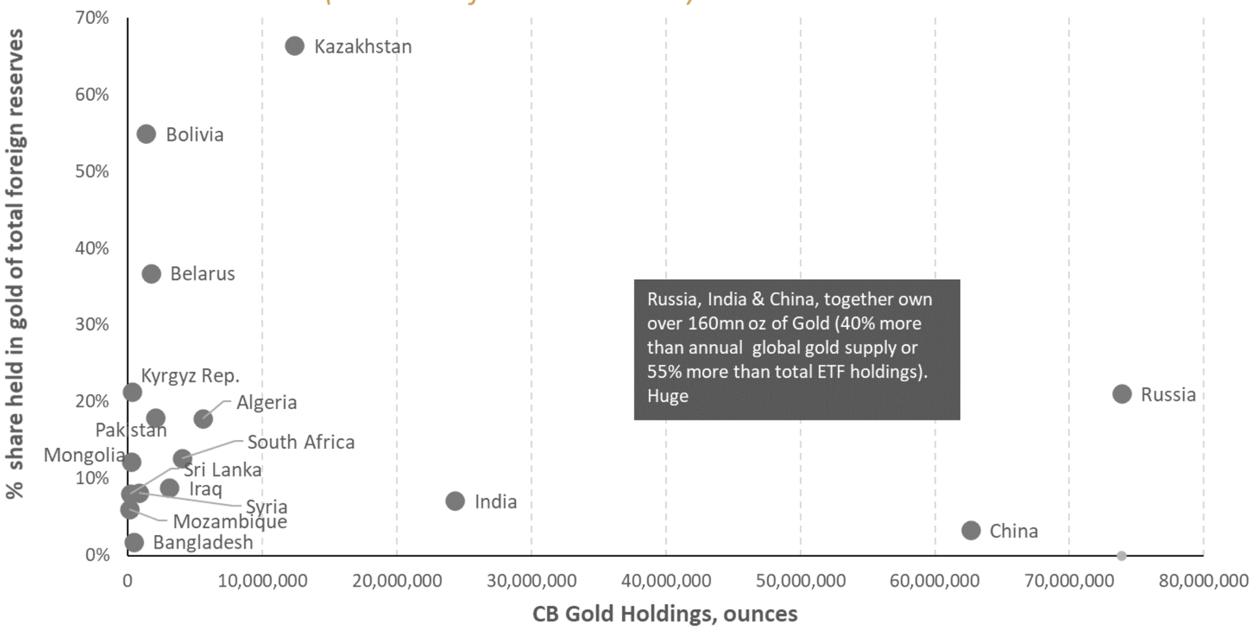
- **Russias “friends” (the 40 abstaining or voting against the UN resolution) collectively own 193mn oz of Gold, that can be monetized and sold off-market (bearish) or ramped up in order to further de-dollarize (bullish) in an effort to reduce reliance on the US$ and thus the Western banking system.**

- In the event of a war over Taiwan (or perhaps simply if China doesn’t utilize its influence and take a harder stance against Russia?) the West could freeze China’s $3.3tn reserve pile, the largest in the world. Even India, South Africa and other democracies, who have avoided outright condemning Russia *(for various reasons – look at history)* may worry they are more vulnerable to Western pressure.

- Thus a huge amount of US$ and Central Bank Gold “lies in the balance" with Russia a top 6 gold holder, India a top 10 & China the 7th largest holder of Gold. Together they own over 160mn oz of Gold (40% more than annual global gold supply or 55% more than total ETF holdings). All 3 countries own large amounts of Gold, but they are also not Gold-heavy; Gold reserves only make up between 3.3% (China) and 21% (Russia) of FX reserves, with the rest sitting in US$, EUR, SDRS and other currencies, implying there is room for Gold exposure to ramp up as the expense of other fiat currencies.

- Note, of the 40 countries that either abstained or voted against the US resolution, only 38% of them have reported their gold holdings in the last 6 months.  So over 60% (some of whom are known to hold gold) do not report their holdings publicly to the IMF, just underscoring how difficult it is in understanding official sectors flows and/or unexplained Gold price action.

**Gold holdings of Russias friends** *(those who voted against the UN motion)* **and "friends"** *(abstained from UN motion)*** ***- 193mn oz in the balance***




** Note, the following countries who abstained or voted against from the UN resolution, either have not reported their gold holdings to the IMF in the last 6 months , or are known to hold gold but they do not report their holdings publicly to either the IMF (and thus the the WGC) --> Angola, Armenia, Burundi, CAR, Congo, Cuba, El Salvadore, Eritrea, Iran, Kyrgyzstan, Lao PDR, Madagascar, Mali, Namibia, Nicaragua, North Korea, Senegal, South Sudan, Sudan, Tajikistan, Tanzania, Uganda, Vietnam, Zimbabwe.

**Source: MKS PAMP Group, World Gold Council, IMF**

**Graph 2: US$ dominance; there are growing threats to the dollars supremacy, but still no viable option/alternative.**

- The US dollars share of currency reserves has been rather steady at ~60% and still remains the largest held currency reserve by Central Banks. Its closest rival is the Euro, (~20% of reserves), with the JPY at ~6% and yuan at almost 3%. **Obviously theres been a re-think around the security/risk of holding US$s especially for**

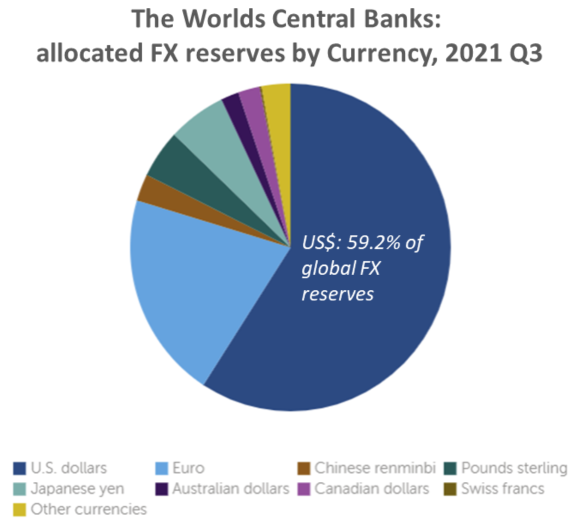
**nonWestern countries given the US' heavy-handed approach in weaponizing its currency when it froze the Russian CBs holdings.**

- Talk of the US$ demise has been ongoing for decades; it ramped up after the GFC in 2008, especially after QE, but its remained dominant, a reserve currency and strong (its share did fall from ~65% of global reserves in 2009 to currently 59.2%). In addition to the US$ making up around 60% of Central Bank foreign-exchange reserves, nearly 90% of trades in the daily $6.6tn FX market still involve the greenback (BIS).

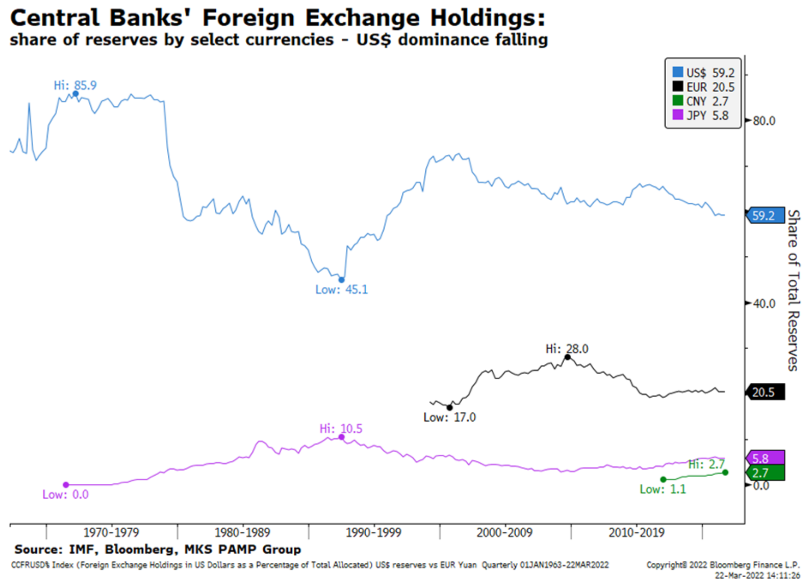
- There are non-stop efforts to create challengers or alternatives to the dollar, especially from the East. Technological changes could create a new payments network bypassing the Western banking system (China's digital-currency trial has over 260m user compared to today where the yuan's share of payments over SWIFT is only 3% vs 40% for the US$ and 37% for the EUR).

- There are current alternatives, but none *currently* match the US$ in size, depth and respect. 1) China continues its efforts to internationalize the yuan, but the issue is its an emerging market with capital controls that has yet to build the infrastructure to become a financial powerhouse, 2) The EUR remains a viable choice but its more a concept than a traditional government back currency, is too close to the fire/war, and is damaged from the Eurozone crisis which showed up bureaucracy/cracks in the system, 3) Cryptocurrencies, are outside of system/government and fiat shackles, but are too new, niche, underdeveloped and volatile. 4) Gold is impractical and too small of a market.

- Increasing more money will be parked outside Western financial markets and away from the US$ as countries seek to diversify their reserves by investing more elsewhere. Its just not the demise of the US$ now but a slow de-dollarization; superpowers aren't built in a day and don't collapse in 1 war.




Source: IMF (latest data available, as of 12/2021)




**Graph 3: Western sanctions have been weak up until now; its a new economic weapon effective but one that should be used smartly**

- **The world is fragmenting; theres trade de-globalization and now financial de-globalization as even more sanctions are being applied than the past two decades, pushing more countries to sever from the Western-led financial system.** If that continues then the threat of being sanctioned/'excluded' is simply less powerful in future crises.

- Graph 3 shows American sanctions affect around ~10,000 firms or people, covering 50 countries and accounting for roughly 27% of world GDP. The trend has been steadily higher the past 2 decades. However, very few thought the West would ever apply max force on such a large and natural resource rich economy (at a time of commodity inflation); past measures (Iran, Venezuela) were crippling for the local, but not international economies.

- We've been here before. The trade embargoes, isolationism in the 1930s led to autocracies and dictatorships. But there are more relevant, near-term threats: economic (food security, or lack therefore, energy crises, global inflation), humanitarian (refugees) before political ones are considered. Nevertheless, these devastating and wide reaching sanctions should be reserved for the worst acts of war; it's a new economic weapon the West has deployed and if its not used smartly, it can put the global economy on a path to economic calamity.


The Economist