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India's Gold market conundrum

Readers please note – the purpose of this piece is to gauge the pressures / supports for the price of gold. Factors mentioned herein are ancillary to the prime objective – trading gold profitably.

Gold occupies a special place in the heart of an average Indian. My family jeweler used to joke with me thus – if I give my wife a 5 Kg bag of vegetables to carry, she will grunt and groan. But gift her 10 Kg gold ornaments and she wont experience fatigue ! This anecdote highlights the average Indian housewife's penchant for Gold. Factually, Indians and Japanese account for a major share of worldwide demand for gold at the individual level, with China racing at a fast clip. Even an average Indian living close to the poverty line aspires to save some money by investing in Gold, especially if a girl child is born into the family. The Gold is expected to secure a better matrimonial match when given away as dowry. These factors seem to indicate that a rising population and a commensurate surge in per capita income for an average Indian MUST result in higher demand for gold.

However, for every bullish trigger there must be a contra trigger and I present a little known fact about how the Indian Gold markets really operate –

The agricultural connection the demand for Gold is quite robust in the heartland of the country. Agricultural income is tax free and literacy levels are low. An average Indian farmer does not understand and / or is unaware of the avenues available to him to deploy his investment surplus. Bank penetration is lower than optimal levels and is only picking up gradually. Wherever bank branches do exist, farmers prefer to use banks as money lenders, rather than deposit their cash and get an electronic statement for their money. They prefer to invest in Gold, which they can touch, see, feel and are comfortable with. Needless to say, a poor monsoon dampens the rural demand for the precious metal. Overseas market players and analysts keenly monitor these aspects of our gold markets. The poor monsoons in 2009 are partly to be blamed for the sluggish Gold prices in 2010.

The "second hand" market if a farmer prefers to save money in physical Gold, he also uses this as collateral to raise funds from banks, private financiers and pawn brokers. The last two lenders are expensive and quite undesirable (from the borrowers point of view) where debt servicing is concerned. Where banks are absent, the borrowing farmer has no real option but to borrow from these private lenders and pawn brokers. The culture of pledging gold is fast spreading to the urban population as well, if the offers of public and private sector banks to lend money against gold jewellery is any indication. Competitive forces have ensured that the buffer (haircut factor) retained by the lender is shrinking. It should also be understood that majority of Indian jewellery is made by family appointed goldsmiths through generations and don't offer hall marking benefits. This leads to lower realization at the time of re-sale. The risk to a lender is therefore higher.

Since private financiers and pawn brokers charge exhorbitant rates of interest, it is critical that Gold prices remain buoyant or the borrower actually stands to benefit if he defaults and forfeits the Gold.

The recurral interest costs add to the original cost of acquisition of the pawned jewellery, and the borrower is interested in redeeming his pledged gold if and only if the ruling prices are higher than his purchase cost + interest accrued. The lenders understand this and are getting increasingly quick on the draw to liquidate the collateral if they sense a threat of forfeiture.

In my opinion, this “second hand” market for gold is sizably bigger this year than the “first hand market” as high bullion prices have deterred buyers and encouraged borrowers to avail of loans to tide over a liquidity crunch, especially in the rural areas. Should the price of Gold decline in the near term or even remain static over the medium term, there is an increasing risk of this “second hand” pledged gold being offered in the street. That will cause a multiplier effect and exert a downward pressure on prices.

The 2010 monsoon will be a critical factor for not only the economic outlook for the Country but also the prospects of this “second hand” market. Bullion traders can ignore this aspect entirely at their peril.

Technical outlook note the price is precariously close to it’s 200 day SMA and should not be violated on a consistent closing basis if the uptrend is to be sustained. A decline below the Rs 16000 / 10 gms levels is unlikely to be a happy situation for the bulls. On the flip side, the price must rally past the Rs 17000 – 17250 band if the bullishness is to remain intact. Watch the coming weeks keenly, especially the MET forecasts of the monsoons.

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