TRENDS

PRECIOUS METALS AND DIAMONDS MARKET UPDATES

APRIL 2019

Foreword

As your longstanding banking partner, we understand the importance of being aware of your specific industry's trends and the constantly changing market pattern. With this in mind, I am pleased to introduce our 'industry specific research series'. The first of these covers precious metals and diamonds where we will share various insights so you are informed of the challenges and opportunities while planning your next business move.

Over the years we have learned that investment in precious metals and minerals and specifically diamonds is intensely challenging and volatile. It demonstrates better than many other areas of investment how deeply intertwined and interconnected today's world has become. In this report, prepared in partnership with Refinitiv (formerly the Financial and Risk business of Thomson Reuters), we share with you findings and insights into how investment in these commodities has performed in recent years, and what has been some of the primary influencers of their behavior.

In this inaugural issue we explore how silver should logically be a beneficiary of any move against gold, and again India is relevant with imports up 35% in 2018. But its performance has been affected by a drop in its industrial use. Palladium and platinum have become opposite sides of the same coin, interestingly both with applications in the automotive industry. And then there are diamonds demand has been impacted by slower economic growth in China (the world's second-largest market for them after the US) and elsewhere. But over the past 10 years Dubai an early adopter of the Kimberly Process to ban trading in conflict or "blood" diamonds has benefited from the shifting of production to India as well as De Beers moving their HQ from London to Botswana. Dubai's geographical proximity to centres of both supply and demand has made it a logical fit within the global diamond trading market.

It is clear that the precious metals and diamond business will remain a volatile one, and one which also offers significant opportunity despite everything that our world's instability throws at it.

I hope you find this report interesting and insightful. Please let us have your feedback and any suggestions of topics for future issues.

Vince Cook
Chief Executive Officer
National Bank of Fujairah

Volatile Precious Metals & Diamonds Markets Present Significant Opportunities

Volatility in the global precious metals and diamonds markets looks set to continue through 2019 as political, economic and equity market factors push demand and supply in opposing directions, but there are still significant opportunities for investors.

Global precious metals, particularly gold, remained under pressure during most of 2018 despite a significant rise in political, geopolitical, equity market and economic risks. By the end of the third quarter, the price of gold had declined 12% from the start of the year to under $1,200 per oz. The main driver through the first three quarters was the U.S. Federal Reserve interest rate policy, which was continued regular tightening (the Fed ended up raising rates by 100 basis points across 2018 to 2.375%).

One of the primary drivers of investor demand for gold is as a hedge against inflation, which erodes the value of bonds. However, as monetary policy rates rise with central bank tightening, the value of gold as a hedge is eroded by the lack of cash distributions when interest rates on new bonds deliver higher and higher cash returns. U.S. inflation at the end of November 2018 was running at 2.4% on-year, down 0.1 percentage points from the start of 2018.

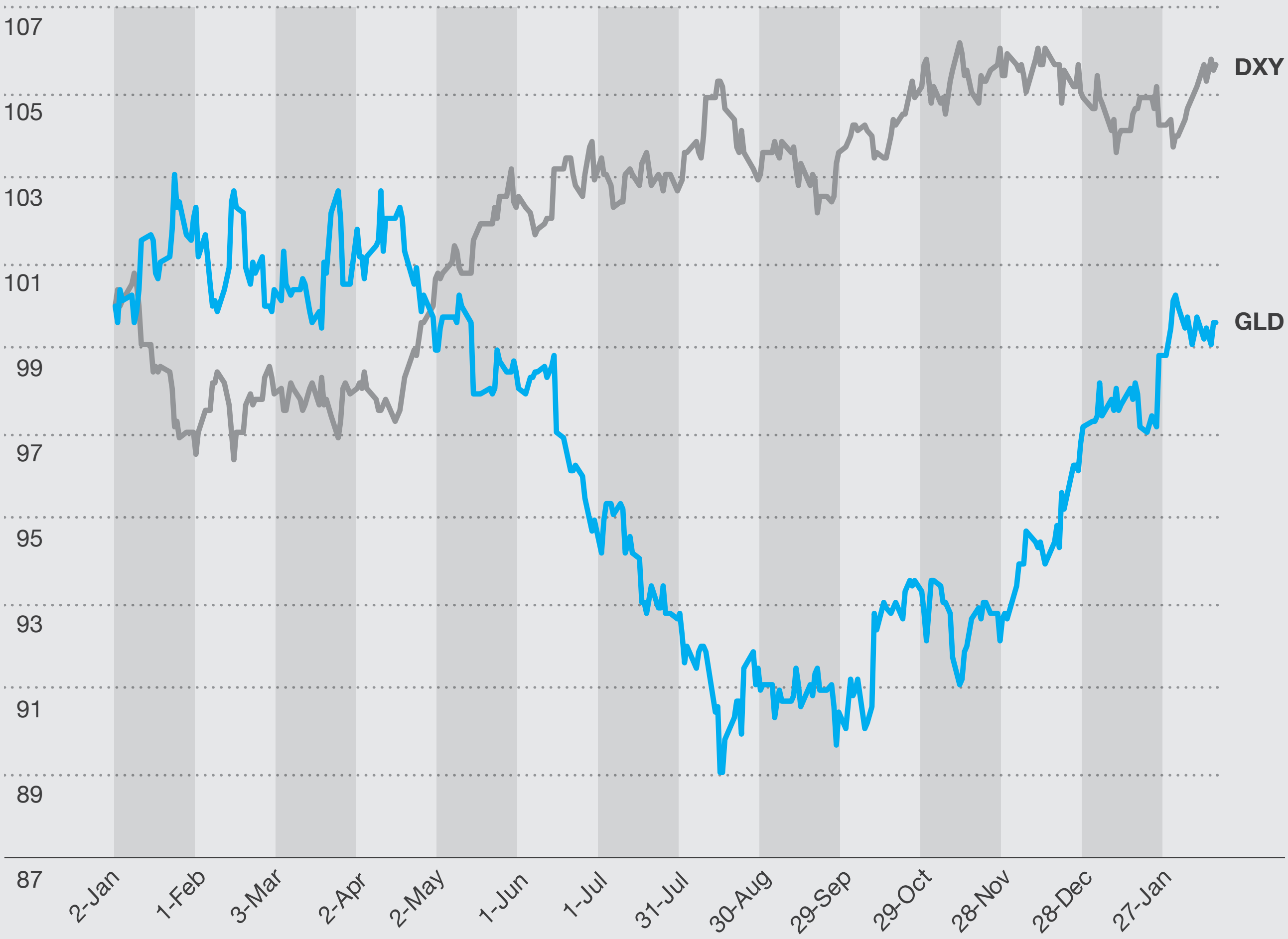
As 2018 wrapped up, however, a few factors combined to spark a rally in the price of gold including the trade war between the U.S. and China where the two sides remain apart on several key issues, the record long U.S. government shutdown, equity market corrections and the failure of the UK Parliament to reach agreement on a Brexit deal beyond the new 12 April deadline. At the same time as developed markets are seeing political worries rise, China has continued to show slower growth, at 6.6% for 2018, the lowest rate in 30 years.

These political and economic developments coincided with a strongly negative short position in the paper market for gold to create a short covering rally that buoyed gold prices 6.7% in the 4th quarter, and has continued to rise, over 2% more through the first half of February. The economic uncertainty and stock market tumble into year-end 2018 has led the U.S. Fed to pause its rate hikes and if other incoming data such as U.S. retail sales come in weaker than expected, markets will begin to price in a longer pause than currently expected, potentially weakening the dollar and strengthening gold and other precious metals.

Physical supply of gold was flat on-year in the fourth quarter, falling about 1% to 1,082 tonnes, while demand rose 8.6% to 1,162 tonnes, leaving a supply shortfall which has led to continued increases so far in 2019. The underlying drivers for gold prices the supply-demand imbalance, global economic developments, and a shift in interest rate policy at least from tightening to neutral is on the healthy side to support further price increases, although some risks remain.

One major risk has emerged from India, where retail gold demand for coins, bullion and jewelry is a significant driver of global prices. India's imports of gold in 2018 fell 20% compared to 2017. In addition, imports of silver totaled 7,000 tonnes, which is a 35% rise in imports from 2017. These extra imports were drawn in largely because of an arbitrage opportunity between local and global spot prices.

Gold & US Dollar Index (Normalized based on level at beginning of Jan 2018)



Source: Refinitiv

Supply-demand Balance of Major Precious Metals (2018 Q4, Tonnes)

	Supply	Investment Demand	Physical Demand	Balance (Supply –Demand)
Gold	1081.6	492.1	669.5	-80
Year-on-Year Change (%)	-1%	26%	-1%	-451%
Silver	990	52.5	970	-32.5
Year-on-Year Change (%)	-1%	-3%	-2%	-33%

Source: Refinitiv

As a result, both Indian gold and silver imports are likely to fall in 2019 because of the likely substitution effect caused by a weak rupee and excess supply of silver in the market. The rupee depreciation makes gold relatively more expensive, which could push some buyers towards silver instead, a trend which would be accentuated by lower silver prices which make silver relatively more affordable than gold in rupee prices (regardless of the value of the rupee against the dollar). The supply of gold within India may be further increased as people in rural areas facing low commodity prices are forced to sell jewelry to unlock their savings.

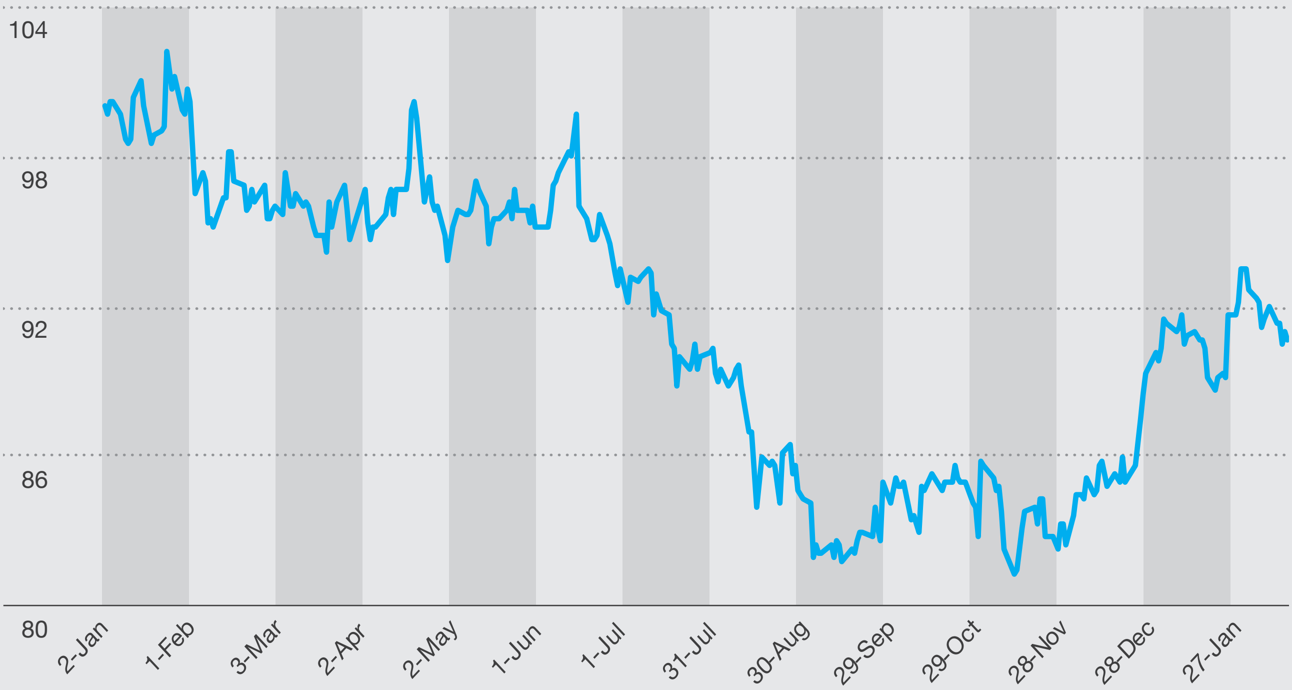
As mentioned before, the rising price of gold is likely to deter some retail buyers and those buying jewelry and they are likely to turn to silver, which saw a sharper drop of almost 15% in 2018. Silver has also been more volatile than gold, which may raise the appeal for investors who believe the current slight excess of supply could be absorbed by rising demand. This rising demand could have an outsized impact if the mergers and acquisitions that have occurred in the silver industry lead to supply reductions. Merger volumes were up 79% to $637 billion, according to Refinitiv GFMS, and may lead miners to a focus on increasing profitability by scaling back more marginal mine production.

Countering the bullish case are the risks to demand for silver from the weakening economy. A significant share of the industrial demand for silver comes from the automotive industry, railways and HVAC installations that accompany increased urbanization. If China's economy slows further, for example, if ongoing trade talks break down with the United States, this could lessen demand for silver.

The trade war has significantly affected China's economy already and the effect increases the longer it goes on. A slower pace of new construction would lower demand, as would fewer purchases of cars. In addition to the China risk, the U.S. presents a risk with its own growth slowdown (auto purchases are highly cyclical) and California's new governor has come out as more skeptical on the prospects for a massive high-speed train connecting Los Angeles with San Francisco.

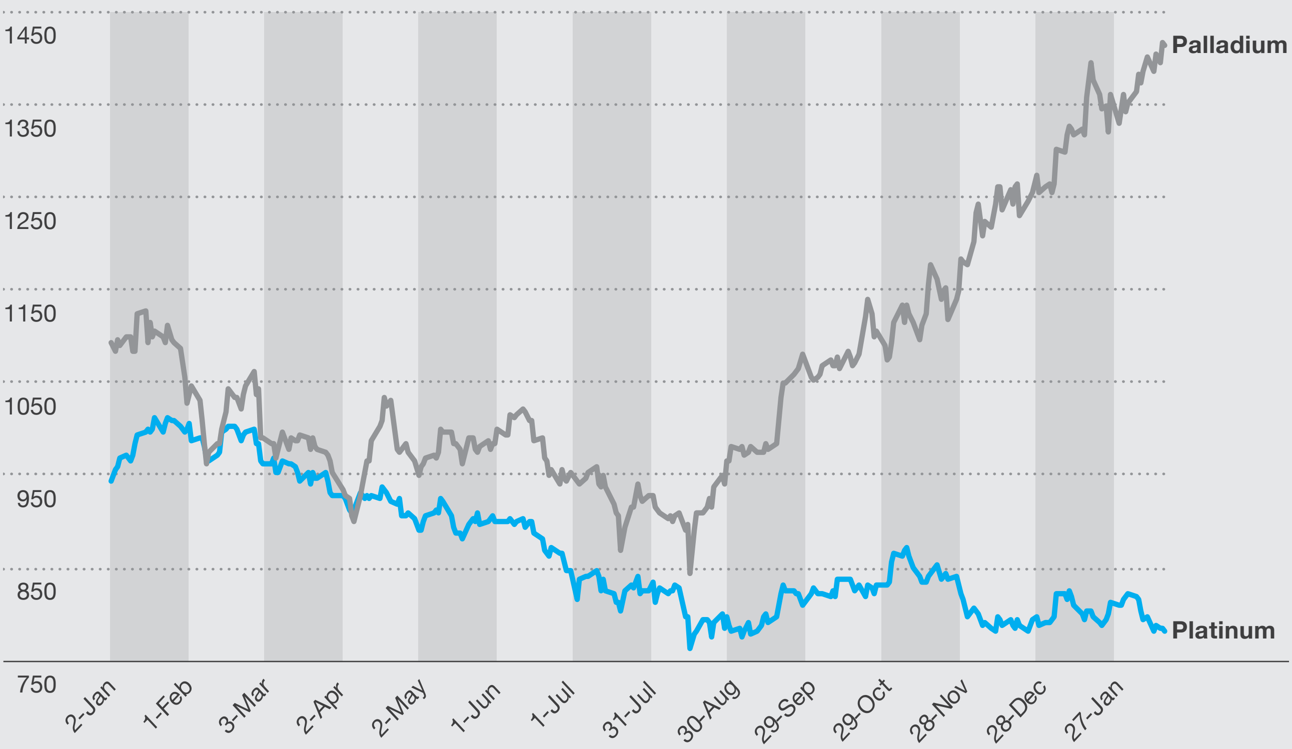
Platinum and palladium are opposite sides of the same coin now. Palladium has been in strong demand. Prices rose 16% in 2018 and have risen almost 10% more in 2019. Palladium has been boosted by a combination of a tight physical market with strong demand driven by gas-powered cars, which have continued to grow strongly in the late cycle of global growth. Platinum, by contrast, has seen excess supply as activity in the automotive sector has slowed, particularly for diesel cars, where it is used to manufacture the drive trains. Lower market share for diesel in Europe is only partially offset by new pollution regulations in emerging markets, which are increasing demand for components that include platinum.

Silver (Normalized based on level at the beginning of Jan 2018)



Source: Refinitiv

Platinum and Palladium Price (Dollars per once)



Source: Refinitiv

Effect of the shift in the rough diamond business to Dubai

Historically, Antwerp was one of the largest centers for rough diamond trading in the world. It has well-developed bourses and a banking system that specializes in the unique financing needs of the diamond industry's supply chain.

At the beginning of the new millennium, Dubai, in contrast with today, had nearly zero market share in the diamond business. There was limited local demand for diamonds and no nearby diamond processing centers. This has changed during the last 10 years after production shifted to India for lower labor costs and as De Beers' shifting of its headquarters from London to Botswana has necessitated sightholders now having to travel to Botswana on a monthly basis.

Products mined in large volumes in Africa bound for processing in India and eventual sale to consumers in Asia (China and India in particular) have less of a need to be traded in bourses in Europe. Dubai's geographical proximity to both the supplying and demanding countries make it a relevant fit within the global diamond trading market. As trading activities in Dubai increased, banks in the United Arab Emirates became more comfortable addressing the financing needs within diamond trading market and are becoming more integrated into the global diamond supply chain. The globalization of finance has also led to more presence by banks operating internationally, rather than an exclusively regional focus. Banks have increasingly focused their presence in the diamond market, both in Antwerp and Dubai, to service the global diamond supply chain.

In addition, increased regulation for banks in Europe in general and especially for those working in the diamond business further raised costs and reduced the relative returns available. These included expansion of efforts to combat 'conflict diamonds' (produced to finance wars against established governments or human rights abuses), which the Kimberley Process is aimed at addressing (see below).

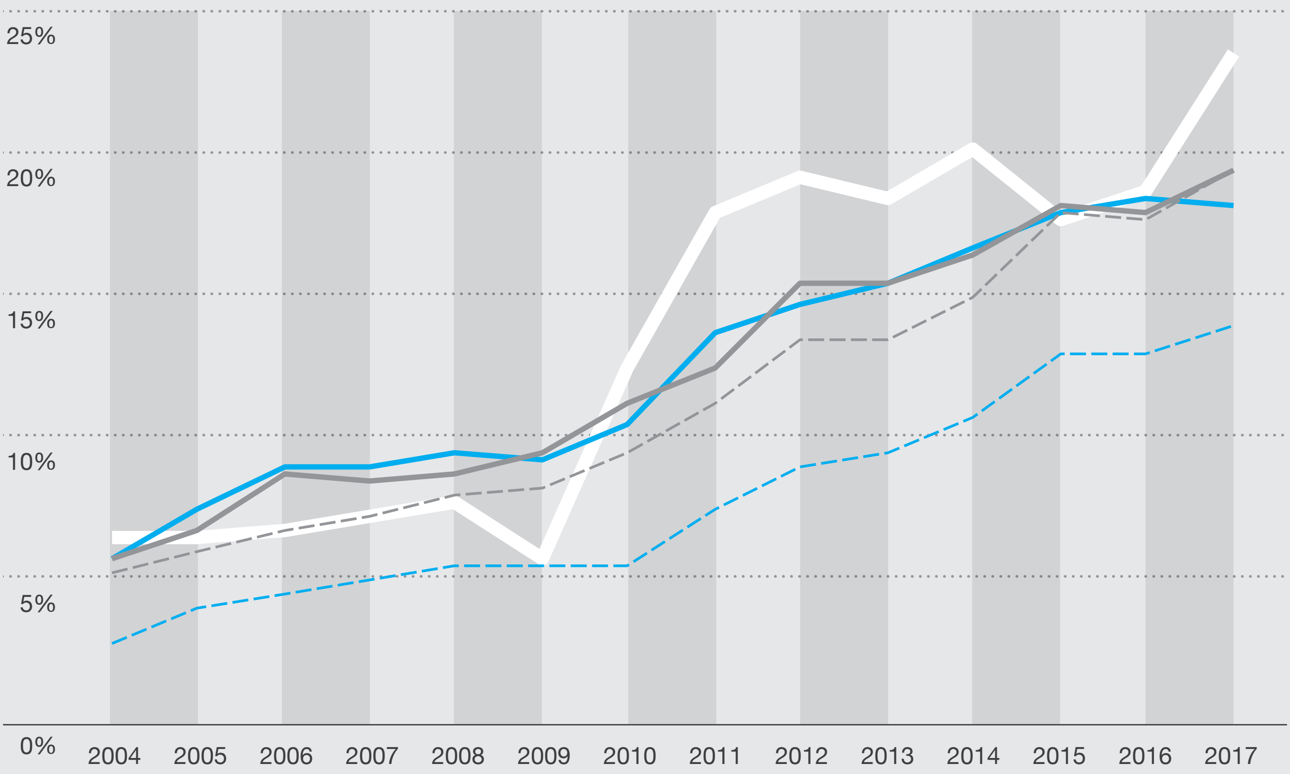
The expansion of the DMCC's activities in this business, and the entry of banks like NBF to fill the gaps in financing, filled the void. As will be discussed in more detail below, the competitive position of the United Arab Emirates in this market has not come with relaxation of standards around the 'conflict diamonds' issue; the UAE has been an active participant in the Kimberley Process since becoming the first Arab country to join in 2003. The UAE promotes supply chain integrity to avoid 'conflict diamonds', by following the strict Kimberley Process rules, and the UAE even chaired the KP initiative in 2016.

Instead, the competitive position came as a result of the ease of doing business in the UAE's free zones and, of course, the tax-friendly business environment, combined with proximity to India, Botswana, South Africa and Russia, which are the biggest producing countries.

After the UAE introduced Value Added Tax on January 1, 2018, which included gold, silver and diamonds, it saw demand shrink and the decision was later repealed to exempt B2B trade of gold and diamonds from VAT beginning in May 2018. As a result of the short period that VAT was in place, there may have been an impact on overall imports for 2018, but it is not likely to have a lasting impact in light of the overall trends in the diamond industry.

These trends have been solidly in favor of the UAE as both a relative and absolute growth market for the diamond trade on a number of metrics. Since joining the Kimberley Process, the UAE has seen its share of global trade in diamonds rise from around 5% in 2004 to almost 20% in 2017. In the process, the potential value that remains in the UAE as a result of the diamond trade, measured by the value of what is exported minus the cost of imports, has risen steadily from under $750 million in 2004 to almost $3 billion in 2017, an annualized growth rate of 10% over a period which included the global financial crisis of 2008-09.

The UAE’s Increasing Role in the Global Diamond Trade



	Import Share		Export Share		Value Capture
	Volume	Value	Volume	Value	Export Value - Import Value ($m, rhs)
2004	6%	3%	6%	5%	785
2005	7%	4%	7%	6%	764
2006	9%	4%	9%	7%	806
2007	9%	5%	8%	7%	871
2008	10%	6%	9%	8%	930
2009	9%	6%	9%	8%	682
2010	11%	5%	11%	9%	1481
2011	14%	7%	12%	11%	2161
2012	15%	9%	15%	13%	2299
2013	16%	9%	16%	13%	2200
2014	17%	11%	16%	15%	2419
2015	18%	13%	18%	18%	2114
2016	18%	13%	18%	18%	2234
2017	18%	14%	19%	19%	2825

Source: Kimberly Process Rough Diamond Statistics

Supply chain integrity tracking/challenges and solutions for businesses

In 2000, the United Nations General Assembly adopted a resolution of support for an international certification scheme for rough diamonds. The resulting Kimberley Process Certification Scheme was launched in 2003. Among the first members, and the first Arab nation to join, was the United Arab Emirates.

The objective of the Kimberley Process is to secure the integrity of the mining, processing and trading in rough diamonds so as to prevent conflict diamonds, also known as 'blood diamonds', entering the supply chain. The Kimberley Process defines 'conflict diamonds' as "rough diamonds used by rebel movements or their allies to finance armed conflicts aimed at undermining legitimate governments".

The 71st session of the United Nations General Assembly in New York. Photo: Drop of Light / Shutterstock.com

The Kimberley Process has been successful at addressing its stated goals and it claims to cover 99.8% of all diamonds mined in the world, from the point when they are mined until processing. Although this has been a major accomplishment, the process has received criticism for not focusing widely enough on human rights abuses caused by those involved in the mining process other than rebel movements and the organization's 55 participants representing 82 countries (the European Union is counted as a single member).

In the final communique from their 2018 meeting, the governments, industry and civil society leaders who support the Kimberley Process agreed to "further strengthening the effectiveness of the Kimberley Process to address challenges posed to the diamond industry and related communities, including from instability and conflict".

The Kimberley Process sets requirements for national governments to create legislation to back a certification process for all shipments of rough diamonds as 'conflict-free' and to prevent conflict diamonds from entering legitimate trade.

As mentioned in the Kimberley Process communiqué, there are developments across the precious metals sector to improve the traceability of the diamonds that are marked as 'conflict-free'. Other industry participants, including De Beers and jewelry retailer Tiffany & Co., have designed pilot programs using blockchain technology to increase the transparency of their supply chains.

De Beers launched a blockchain program as part of a consortium of diamond manufacturers in January 2018 called "Tracr", which was used to trace the first 100 diamonds in May 2018. The blockchain platform assigns to each diamond a unique identification based on its characteristics such as weight and clarity. It shows all the transactions along the supply chain but anonymizes identities and the values paid at various levels of the supply chain.

Financing needs across precious metals/diamonds businesses

Financing is a critical part of the precious metals and diamond business, and worldwide is a multi-billion dollar industry. The financing needs can be broken down across the supply chain from mine to consumer, and different parts of the market have different needs in terms of the type of financing provided. Mining is a capital-intensive business and needs significant equipment in the mine itself, as well as the infrastructure that surrounds it, and requires injection of equity and debt financing, including financing with long tenors to match the payback period of most major mining and infrastructure projects. Under Basel III, there is some crimping of supply of financing but alternative sources of financing have been leveraged to enable banks to finance these deals regardless. For example, guarantees from multilateral institutions and export credit agencies can help reduce risk and deals that reduce the long-term capital commitments have been used to address the impact of Basel III.

After minerals are mined and they are sent through the supply chains to their ultimate buyers, across the process there is a need for trade finance in the tens of billions of dollars. Underpinning banks' involvement in the financing process is a need to ensure adequate transparency of the companies they are financing, especially as regulators focus more attention on banks' ability to demonstrate good anti-money laundering and countering the financing of terrorism (AML/CFT) controls.

Regulatory requirements increase the cost of financing and make diamond and precious metals financing a costly business to engage in, especially with the low margins for traders and capital-intensive nature of the business. In order to maintain relatively low risk profiles, the banks financing the diamond trade in particular avoid asset-based financing structures and instead tend to opt for short-term trade financing (30 to 120 days is common).

Financial institutions can take on more price risk themselves for precious metals besides diamonds since they have access to liquid, well developed futures markets to hedge their price risk. Although, the first diamond contracts were traded on the Indian Commodity Exchange (ICEX) in November 2017, they are not as liquid as the global futures markets for the other precious metals.

The volume of trade finance for the rough diamond business is around $15-16 billion per year, according to a survey of financiers conducted in 2013 by diamond research house Edahn Golan. About half of that financing, $7-8 billion, is provided by 55 to 60 banks within India, where the diamond processing is centered. (80% of all rough diamonds are processed in Surat, India.)

The remaining financing needs are seeing fewer banks engaged because of the risks associated with diamond financing, which have risen without much corresponding rise in available profits. However, with many Western banks retreating and the nexus of diamond trading moving to the UAE, there may be sufficient profits still in the $8 billion global diamond financing business to offer banks a compelling opportunity. With the UAE representing 20% of the global trade in diamonds, this could offer $1.6 billion of financing opportunity.

Trade in precious metals is a larger market, but there has been some exit of global banks that are focused on lower-risk lines of business. In June 2018, Reuters reported that Mocatta (owned by Scotia Bank) was exiting about half of its global precious metals supply chain financing activities, where it had previously financed between 15-20% of the lending to clients across the value chain. Based on the estimated value of its financing that was then outstanding of $8 billion, the global financing opportunity in precious metals is $40 billion to $50 billion. Mocatta's exit followed moves by Barclays, Deutsche Bank and Commerzbank to scale back or exit the market.

A look towards the future

The precious metals and diamond business is subject to considerable volatility, but with significant opportunity as well. In the near future, volatility will be the name of the game as political, economic and equity market instability pushes demand and supply in different directions.

One upcoming trigger that could lead to a rush into safe havens like gold is the ongoing trade negotiations between the United States and China. Although the March 1 deadline for a trade deal has passed without incident, significant raises in tariffs have not fully been taken off the table. The two sides remain far apart on existing tariffs and enforcement mechanisms for a negotiated deal. The most recent rise came in December, when the U.S. and China raised tariffs on one another's goods, with the US imposing 10% tariffs on $200 billion of Chinese imports.

Chinese President Xi and US President Trump have continued their trade war ceasefire as talks continue, which averted the jump in tariffs to 25% that had originally been scheduled to take place on March 1. Currently, the negotiations are ongoing and the failure to reach a comprehensive agreement would likely return the two sides to more aggressive action in raising tariffs.

In terms of precious metals, the easing of tensions leading up to the March 1 deadline led to a sell-off in gold and prices have remained volatile in response to new developments. This could indicate that positioning in precious metals is positioned for the worst-case scenario with sell-offs in gold following after each positive development in the talks.

After whatever resolution comes out of the tension between China and the U.S., the next catalyst for price action is the Brexit date of April 12 that the UK is hurtling towards, seemingly without a plan. The economic shock would be significant to the UK if it went over the cliff's edge, and its trading partners could also face economic slowdown as a result.

Failure to reach a Brexit deal that undermines global economic growth slowing as it already is, especially if the US-China trade war isn't resolved by then could feed through into other precious metals via industrial demand for silver, platinum and palladium. The auto sector, which has boosted demand especially for platinum and palladium, could be hit most by a cyclical shift. Palladium is likely to be the most volatile, with platinum and silver also facing risks from economic worry. Gold would then be best positioned to act as a safe haven, although as mentioned before, it is not clear whether most of these risks are already priced into today's prices.

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