China Now Biggest Driver of Gold Prices, HSBC Says

March 3, 2014 (Source: WSJ) — China's buying of gold jewelry, coins and bars is now the biggest driver of prices, not investment demand from the West, according to HSBC Global Research.

"We would argue that physical demand trends in the emerging world will largely define gold's price movements this year," HSBC analysts James Steel and Howard Wen said in a research note.

China alone can take up the equivalent of half of the global gold mine output, while a possible recovery in Indian demand could also act as a boost for the yellow metal as long as the Indian authorities reduce import tariffs on gold.

Investment demand, typically coming from gold exchange-traded funds, had long been considered the sole reason behind the gold's decade-long bull run. Hedge funds and money managers poured money into gold ETFs in anticipation of inflation amid loose global monetary policy.

But a reversal of that trade on expectations of a winding-down of the bond buying program by the Federal Reserve which saw macro hedge-funds and other investors liquidate 881 tons of gold from ETF holdings last year, reducing total holdings by one-third from their peak at end-2012.

Nonetheless, the yellow metal wasn't burned—apart from the tradition of jewelry gift-giving, the young generation in the Asian nation were quietly snapping up gold out of concern of their country's property market and the health of the economy.

And that helped provide a floor to falling gold prices last year (down nearly 30% on year), and make up for the outflows of gold ETFs.

HSBC says it expects China to remain the world's largest importer, consumer and producer of gold this year.

To be sure, headwinds exist – economists have warned about deflation risks globally as economic growth in developed markets, such as the U.S. and Europe, has yet to gather steam. That would imply "lower gold prices than would otherwise be the case, as falling prices removes the need to own gold as an inflation hedge," the house says.

"Gold prices may be influenced based on how well the Fed manages this transition," it adds.

A stronger U.S. dollar against its rivals, such as euro, may also weigh on gold prices as they are denominated in the greenback and will therefore look less appealing for other currency holders.