Publication	WEALTH (The Economic Times): Ahmedabad | Chennai | New Delhi
Date	5.12.16
Description	Quote: Jayant Manglik, Religare Securities

What you can do if there is a limit on gold

The Sovereign Gold Bonds could be a good alternative to the metal but people might not opt for the Gold Monetisation Scheme.

SANKET DHANORKAR

The market is rife with rumours that the government might take radical measures to unearth unaccounted wealth in the form of gold. This has made consumers uncomfortable about buying physical gold. A portion of the demand is expected to shift to Sovereign Gold Bonds issued by the RBI. These bonds offer 2.5% interest per annum (payable half-yearly) and their price is linked to the prevailing market price of gold. The bonds are listed on the exchange, facilitating early exit for investors. They mature in eight years, with an exit option at the end of five years from the date of issue. Sovereign Gold Bonds are a superior option to physical gold because while investors are assured of the market value of gold at the time of maturity, they also get periodical interest income. What's more, the capital gains are fully tax exempt if the bonds are held till maturity and the investor can claim indexation benefits if he exits after one year.

The Sovereign Gold Bonds have evoked good response. Investors have bought bonds worth 14,071 kg of gold amounting to ₹4,027 crore till now. The latest tranche, which was issued at a ₹50 per gram discount on the prevailing market price of gold, saw investors buy bonds worth roughly ₹915 crore. Anil Chopra, Group CEO and Director, Bajaj Capital, asserts gold bonds are a better alternative to physical gold. "Gold bonds not only provide better tax efficiency if held till maturity, they also do not have problems regarding safety and purity as is the case with physical gold." Tanwir Alam, Managing Director of Fincart, reckons gold bonds will be a good alternative to fixed deposits as interest rates are likely to dip.

However, if the government cuts the interest rate on gold bonds, they will lose some of their charm. Since these bonds are linked to gold prices, a sustained disinflationary environment globally would also impact their returns, says Alam.

Investors may be deterred by some niggling issues as well. The latest issue concluded on 2 November but customers have not yet received the bonds. This could put off some investors, feels Manoj Nagpal, CEO, Outlook Asia Capital. "A better mechanism needs to be put in place by the RBI for the credit of these instruments in a defined timeframe." There are other issues as well. While these gold bonds can be used as collateral for loans, several banks are refusing to sanction loans against them, says Vikram Dalal, Managing Director, Synergee Capital.

Meanwhile, the government's Gold Monetisation Scheme has evoked lukewarm response, with a total of 5,730 kg of gold mobilised under the scheme as on 14 November. The scheme allows individuals to earn interest on idle, unused stock of physical gold in the form of jewellery, bars or coins. Depositors can get back the gold in physical form or in Indian rupees at prevailing market value at time of redemption. There is no capital gains tax on the appreciation in the value of gold deposited, or on the interest earned from it. Yet, investors have kept away from the scheme. "There are only limited number of branches for assaying the gold and investors have no control on the purification and no clarity on grammage of gold they will get in return for the gold they deposit," says Amol Joshi, Founder, PlanRupee Investment Services. Most individuals hold physical gold in the form of jewellery, where the purity of the gold is often suspect and there is a high incidence of making charges. This deters people from submitting their gold lest it is valued far lesser than they expect. Also, the emotional attachment to jewellery and its snob value prevents most from parting with it. Even if a limit is put on gold holdings, people are likely to stay away from this scheme.

GOLD BONDS HAVE GIVEN MIXED RETURNS

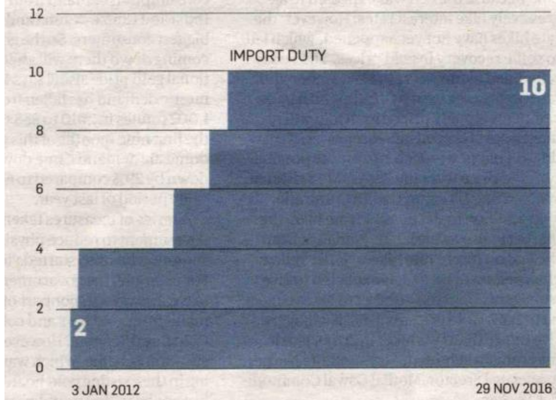
Returns of the six Sovereign Gold Bond issues.

	Issue date	Issue price (₹)	Market price (₹)	Gain (%)
Tranche 1	Nov 2015	2,684	2,930	9%
Tranche 2	Feb 2016	2,600	2,880	11%
Tranche 3	Mar 2016	2,916	3,000	3%
Tranche 4	Jul 2016	3,119	2,910	-7%
Tranche 5	Sep 2016	3,150	2,920	-7%
Tranche 6	NA	2,957	NA	NA

Price data from NSE. Data as on 29 Nov 2016.

IMPORT DUTY HELPS GOLD

The 10% duty on imports buoys the domestic price of gold.



Since the government's focus is to rein in gold demand, the import duty may not be cut.

Compiled by ETIG Database

"Local gold demand has come down drastically after demonetisation. People are using the available cash for other purposes," says Krishnan. "There is almost a standstill in the market and gold sales from wholesalers to retail jewellers have come down by around 90%. The situation is expected to remain like this till 31 December," says Hasmukh Bafna, President, Gold Chains & Jewellery Wholesalers Welfare Association.

Despite the glum tidings for the gold trade, the World Gold Council is putting up a brave face about the Indian demand in the fourth quarter. "Diwali was already over before demonetisation. Though some pockets like casual purchases (non wedding purchase) may get affected, people are still buying jewellery for marriages. Since most jewellers have long-term relationship with their customers, these transactions are happening through cheques or cards. So we are not revising the forecast for the year," says Somasundaram P.R., Managing Director-India, World Gold Council.

Outlook for gold

What will happen if the price of gold falls in the international market? "We are generally bearish on gold for the next three months," says Krishnan. Others agree that gold is headed for lower levels. "International gold prices may come down to around $1,100 by the first quarter of 2017," says Rao.

But the decline in the global gold price may not be mirrored in India. "Domestic gold prices are expected to remain range bound with a weaker bias in the next quarter," says Narne. This is because the dollar is strengthening against the Indian rupee. This depreciation in rupee will act as a cushion and prevent the domestic price of gold from falling too much. Also, the depreciation of the rupee may not be as pronounced as the decline in other currencies. "FCNR redemption is already over. Current account situation usually improve during January-March quarter also, so the rupee weakness will not be as much as the currencies from other emerging markets," says Upasna Bhardwaj, Senior Economist, Kotak Mahindra Bank.

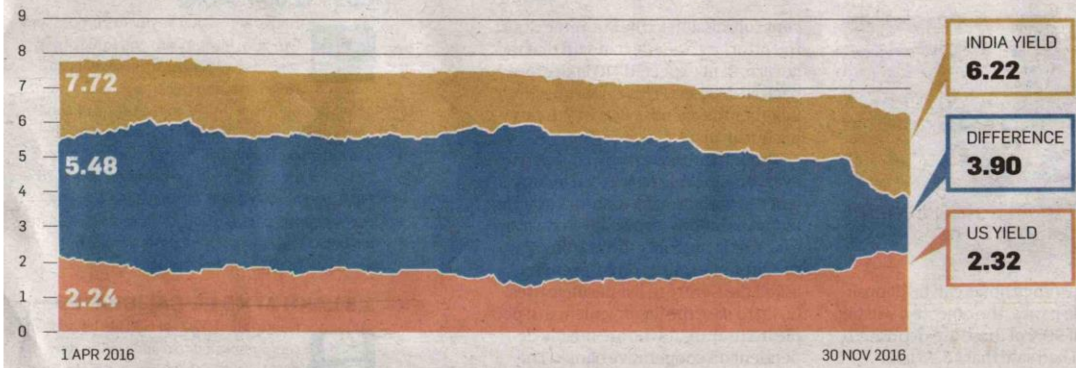
Rising yields are a worry

However, the sudden spurt in government bond prices (or fall in yield) due to increased liquidity from demonetisation may be a factor to watch out for. This sharp fall in the yield is happening at a time when the bond yields are going up in other markets. For example, the 10-year bond yield in the US has risen by 47 bps in the past one month, while it came down by 57 bps in India. The difference between the US and Indian yield has gone below 4%, the normal forward premium for a year (*see chart*). "Narrowing interest rate differential is a worry and this may cause FII outflows from debt and that could be another source for further weakness in rupee," says Bhardwaj.

High import duty on gold, placed at 10% now, is another factor to be considered. Any reduction in the import duty can bring the domestic gold prices down by that extent. However, the government's focus now is to bring down domestic consumption, so no one is expecting an immediate cut in the import duty. "The import duty will come down only if this high import duty results in large-scale smuggling. Since there is no proof that this is happening, the government may

RISING US BOND YIELDS ARE A WORRY

Bond yields are rising in the US while they are falling in India.



The narrowing of the difference in yields may trigger FII outflow from debt market.

Source: Bloomberg

not cut import duty soon," says Jayant Manglik, President, Religare Securities.

What should investors do

Though most experts are bearish in the short-term, it still makes sense to have a part of your total portfolio in gold. But financial planners say this should not be more than 5-10% of your total investment portfolio. "Gold is no more a safe haven, so limit the exposure to 5% of your portfolio," says Gurgaon-based financial planner Taresh Bhatia. The rupee is expected to continue weakening against the dollar, which could benefit gold. "Our foreign exchange reserves are increasing along with a weakening rupee. That means the RBI and the entire economic system prefers a weak rupee. This trend is expected to continue in the coming years as well," says Manglik. This weakening gold has protected Indian gold investors in the past also. "Historically, Indian gold investors have never lost money in any five-year holding period, mostly because of this rupee depreciation," he points out.

Also, the uncertainty in the global economy is not yet over. Though one major event (the US election) is out of the way, several such events are expected in the coming months. "It is always better to have some small allocation (say 10-15% of the portfolio) to gold because global uncertainty will always be there. Once the Italian referendum is over, some other event will come," says Rao.

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