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FINMET

Market Update

Volatility in Physical Premiums and GML Rates

A Temporary Disruption or a Structural Shift?

Gold markets are witnessing an unprecedented surge in demand for physical delivery, particularly in New York's COMEX exchange. Unlike the usual practice of rolling futures contracts or settling them in cash, dealers are now 'standing for delivery,' creating a short-term operational bottleneck. The key issue is not a fundamental shortage of gold but rather a logistical constraint—the inability of LBMA refiners to convert 400-ounce bars into the Comex delivery bars (100-ounce bars) required for COMEX delivery at the current demand levels.

Understanding the COMEX Rush

The gold supply chain, which typically moves seamlessly from refiners to financial institutions and eventually to markets like India, has been thrown off balance. Refiners' production capacity is stretched thin, creating an artificial scarcity of COMEX-compliant kilobars. This has increased costs and delays, but the situation is expected to normalise once demand cools down.

Impact on India's Bullion Market

Caught in this turbulence are Indian bullion importers, Jewellery retailers, manufacturers, and exporters. Traditionally reliant on global bullion banks such as HSBC, JP Morgan, and Standard Bank for sourcing 995-kilobar gold, these entities now find themselves in a supply crunch as refiners prioritise 9999-kilobar production for COMEX. This will likely cause disruptions in India's gold supply chain, affecting pricing and availability of gold for businesses dependent on a steady supply of raw materials. However, alternative sourcing from the UAE and other regions remains viable, preventing a full-blown crisis.

For Jewellery retailers, manufacturers, and exporters, the high lease rates and supply chain bottlenecks mean increased costs and potential delays in fulfilling orders. Exporters may face tighter margins due to fluctuating gold prices, while domestic retailers may struggle with erratic supply patterns.

The Surge in Gold Lease Rates

The liquidity squeeze in physical gold markets has had a cascading effect on gold lease rates. Indian bullion banks, which borrow gold from overseas counterparts and lend it to Jewellers, determine lease rates based on several factors:

- Secured Overnight Financing Rate (SOFR): The base benchmark for dollar-denominated borrowing.
- Gold Forward Offered Rate (GOFO): based on the forward price of gold versus USD
- Country/Entity Risk Premium: Adjusted for India-specific risks.
- Bank Margins: Operational costs and risk adjustments made by bullion banks.

Historically, gold lease rates have remained stable, but during crises—such as the 2008 financial meltdown—these rates spiked to as high as 17%. The disruption in the Comex futures prices impacted the gold forward prices. In some instances, it pushed international lease rates from below 1% to over 10%, significantly impacting bullion dealers, jewellers, and gold miners who optimise their working capital by borrowing gold rather than purchasing it outright.

Path to Normalization and Business Adaptation

While this situation has created a ripple effect in global gold markets, it is not a systemic crisis. Central banks may inject liquidity, mine production will continue, and alternative supply chains will adapt. The Indian gold market, one of the largest consumers of gold globally, will see businesses making short-term adjustments to mitigate supply chain risks.

- Supply to exporters and jewellery can be re-organised by sourcing metal from other regions that may have gold refineries which have spare capacity to meet India's requirements
- Jewellery retailers may have to adjust pricing strategies to account for volatile lease rates
- With higher GML rates, inventory financing costs are expected to rise in the short term. Jewellers may explore other working capital methods that may necessitate additional risk management measures.

However, the market seems driven by sentiment and uncertainty around tariffs and macroeconomic developments, which adds to volatility.

The gold market is probably not behaving rationally —it is an evolving, sentiment-driven entity that will self-correct at the right time.

The real question is not whether the market will normalise but when and how that normalisation will unfold. Indian businesses, particularly in the jewellery sector, must remain agile and proactive in responding to these market dynamics.

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