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Fragile improvement

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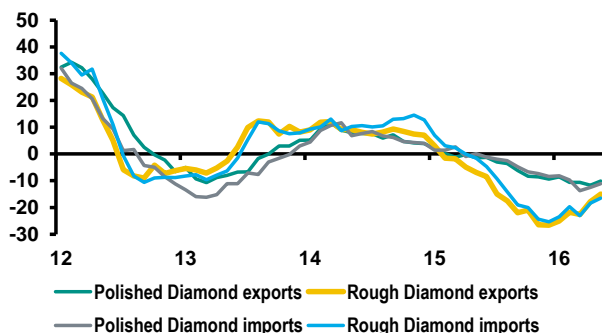
- Diamond trade data signal a fragile improvement
- Household net worth of main consumers could improve...
- ...and there are signs of stabilisation in the marriage rate
- This implies somewhat higher jewellery demand going forward...
- ...but as the recovery is fragile, pricing power will likely be limited
- Fragile end-demand and structural factors continue to weigh on prices
- We expect polished diamond prices to stabilise at best...
- ...and rough prices likely to decline for the remainder of 2016

Introduction

On 19 January 2016 we released our [Diamond Sector Outlook: Nothing is forever...](#) From now onwards, we will release an outlook for the diamond sector twice a year. This publication will take into account the latest developments, the outlook for demand and supply, and our outlook for polished and rough diamond prices.

Some bottoming out of diamond trade in Antwerp...

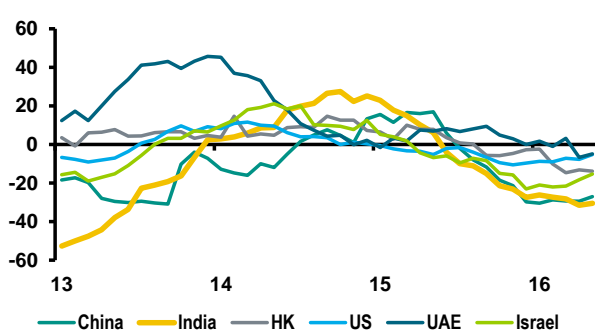
12m sum % yoy



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

...also exports to main centres

12m sum % yoy



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

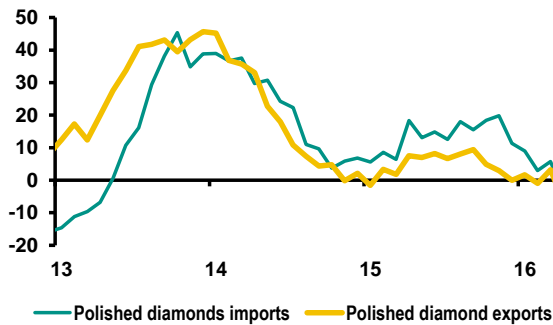
Diamond trade data point into the direction of a fragile improvement

To feel the pulse of the diamond trade, import and export data of main trading (Belgium, India, Dubai and Israel) and manufacturing centres (India, Southern African countries and China) provide important signals.

The latest diamond trade data show that diamond trade via Antwerp is bottoming out. Exports of polished diamonds to other main centres including the US (the largest consumer of diamonds) also show this improvement. Trade data from the two other main trading centres UAE and Israel provide a mixed picture. Diamond trade to and from the UAE appears to be stabilising while that of Israel remains very weak and there is no bottom in sight yet.

UAE polished diamond trade stabilising...

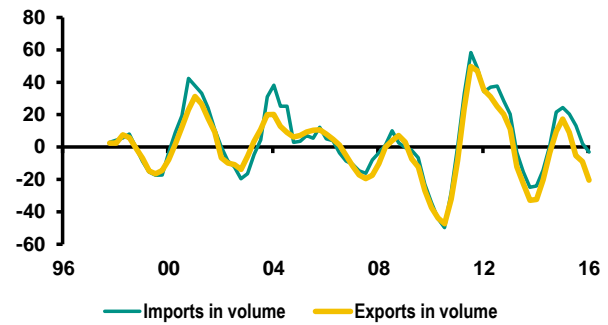
12m sum % yoy



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

...but Israel diamond trade still weak

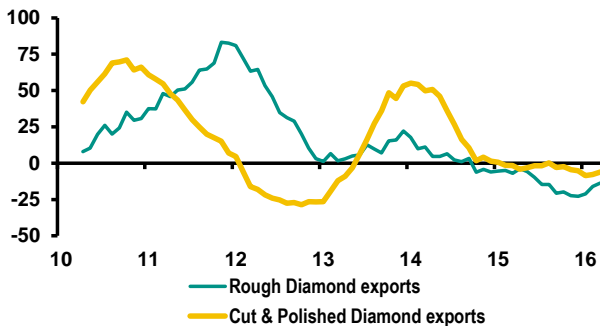
12m sum % yoy



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

India's exports showing signs of improvements...

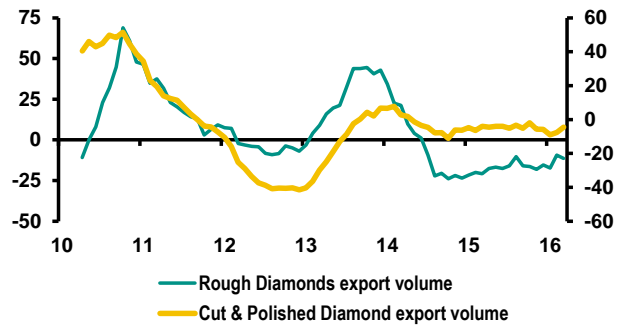
12m sum % yoy



Source: Thomson Reuters Datastream, GJEPC, ABN AMRO Group Economics

... and volumes stabilising

12m sum % yoy



Source: Thomson Reuters Datastream, GJEPC, ABN AMRO Group Economics

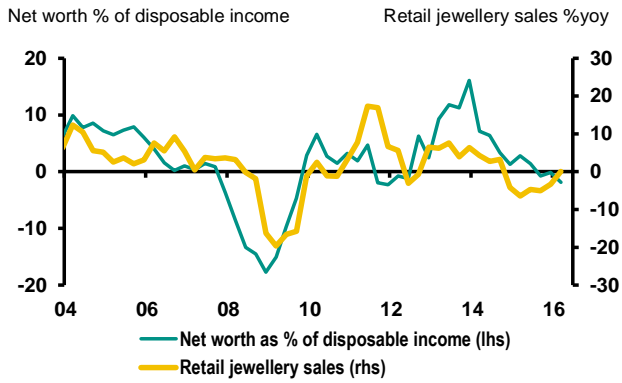
India is the main cutting, polishing and manufacturing centre (90%) of diamonds world-wide. The diamond trade data for India are hopeful. They also point into the direction of a bottoming out. If we take all the above into account, there are some signs that diamond trade is slightly improving but this improvement is very fragile.

Household net worth crucial for demand outlook...

The main markets for diamond jewellery are the US, China, India, Japan and Europe. The US is by far the largest market for diamond jewellery accounting for 30-40% of the market. Both China and India account separately for a little more than 10% of the market. What drives (diamond) jewellery demand? Jewellery is a luxury product and therefore it has its own specific drivers. Demand for jewellery highly depends on households' net worth (the value of households' assets minus their liabilities). Home equity, stocks and savings are important components of household net worth and the changes in value of these

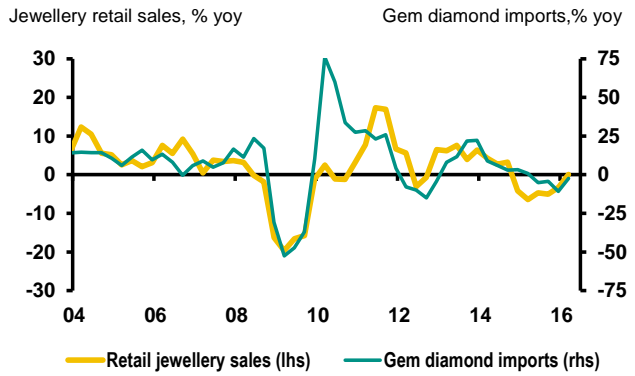
components affect an individual's financial capability to purchase jewellery. Next to this, the outlook for employment and the economy in general also plays a role. In the US there is a very clear relationship between net worth and jewellery retail sales. An increase in a household net worth fuels demand for jewellery.

US net worth and jewellery retail sales



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

US jewellery sales drive gem diamond imports...

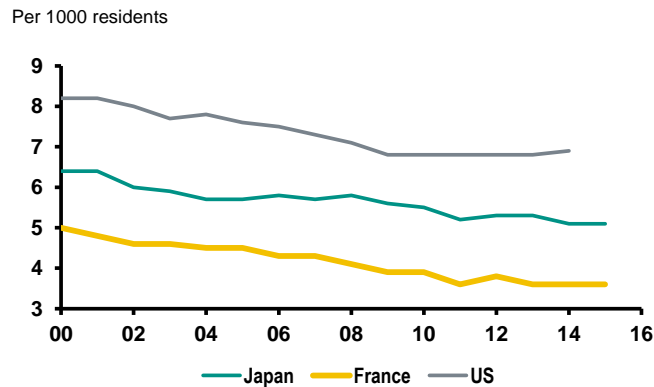


Source: Thomson Reuters Datastream, ABN AMRO Group Economics

...and a stabilisation in marriage rate should help diamond jewellery demand

Another important variable for diamond jewellery demand is the number of marriages. US diamond jewellery demand is to a large extent driven by people getting married. Since 2000, the marriage rate per 1000 residents has declined in the US but also in other countries such as Japan and France. This seems to be a general tendency. In recent years, the marriage rate has stabilised. A bottoming out and a modest increase in the marriage rate would be a positive development. It is too early to draw conclusions from these data yet.

Marriage rate



Source: Thomson Reuters Datastream, US CDC, NCHS

We expect some improvement in US jewellery demand...

The US savings rate is relatively high and our US economist expects this to decline modestly, reflecting that consumers will spend more and save a little less. Part of these funds could spur the purchase of jewellery (also diamonds). In addition, we expect the US housing market to remain healthy. House prices have been on an upward trend for several years. Moreover, we expect the Fed to keep interest rates unchanged this year. This

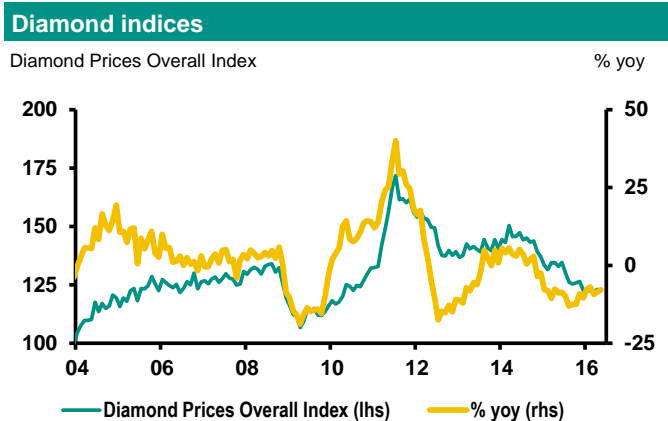
should nurture US growth and support sentiment on financial markets. We expect equity markets to be relatively resilient. However, uncertainty has increased because of Brexit. So we expect the main sources of net worth to remain supportive. Therefore, US household net worth will likely increase further and this will result in somewhat higher jewellery consumption leading to slightly higher demand for gem diamonds.

...as well as improvement in demand in China and India

For China and India, we expect GDP per capita to increase as the middle class grows. The resulting gains in disposable income should result in support for jewellery demand (also diamonds). It is likely that the trend in jewellery consumption will strengthen further over time. In the near term the monsoon in India will play a crucial role for jewellery demand, as the amount of water during the monsoon strongly affects agricultural incomes. This, in turn, will affect demand for jewellery. The government recently announced that it rolled back its budget decision to apply 1% tax collection at source for cash purchase of gold jewellery of Rs 200,000 and above and raised the threshold to the earlier Rs 500,000. The decision took effect from 1 June. This will likely support India jewellery consumption this year.

Polished diamond prices to be stable at best...

Between August 2011 and February 2016, the overall diamond index dropped by close to 30%. Since March of this year, the index has stabilised (see graph below). The most sustainable situation for diamond prices is if end-demand picks up strongly. This would result in higher polished diamond prices. As mentioned earlier in this report, there are some signs that end-demand is improving somewhat. However, it is far too early to conclude that this trend will continue. In fact, we think that this improvement in end-demand is still fragile and might not be able to withstand higher prices. Since the start of this year, prices of precious metals used in jewellery (gold, silver, platinum) have risen substantially and this could already result in lower margins and/or higher prices for end-consumers. If diamond prices would also rise, this could have a serious negative effect on jewellery demand. So substantially higher polished prices will only materialise if there is a strong upward shift in end-demand. This is unlikely to happen in the coming six months or so. Therefore, we expect polished prices to remain stable at best for the remainder of this year.

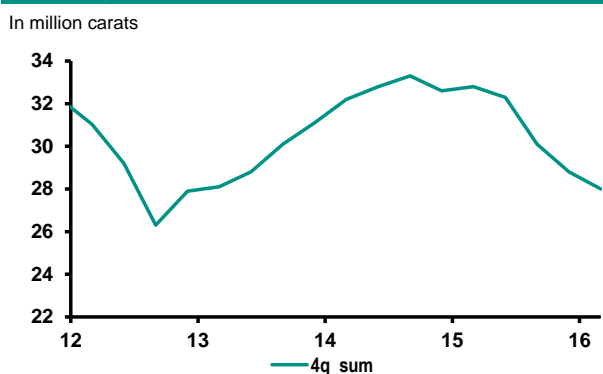


Source: Bloomberg, PolishedPrices.com, ABN AMRO Group Economics

...while producers' cut-back of production had its effect on rough prices

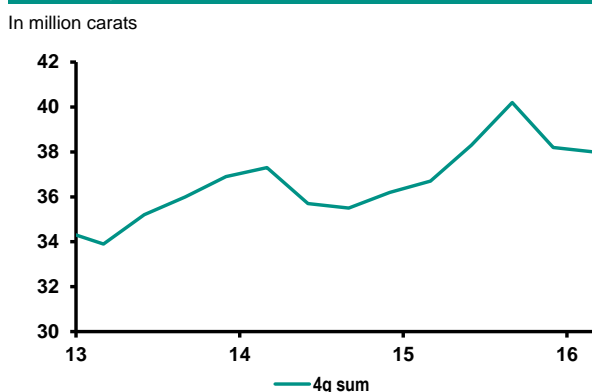
Since 2014, De Beers has decided to reduce production in carats. Meanwhile, Alrosa increased production in 2015 despite weak market conditions. This dampened the impact of production cut of De Beers. Since Q3 2015, both miners together have reduced production and this has helped rough diamond prices. Without the lower production, rough prices could have been substantially lower. They also adjusted the production target for 2016 in order to avoid further price reductions. The new annual production targets in carats are below that of 2015. Lower production will work initially, but, eventually stronger price competition and more transparency appears inevitable.

Quarterly diamond production De Beers



Source: Company reports, ABN AMRO Group Economics

Quarterly diamond production Alrosa



Source: Company reports, ABN AMRO Group Economics

Meanwhile, higher demand for rough diamonds has also supported rough diamond prices. Estimated sales at De Beers sight holders has picked up since the start of 2016 (data based on news items on www.diamonds.net).

Tentative sales of De Beers sights are up strongly...

Sales in million US dollar



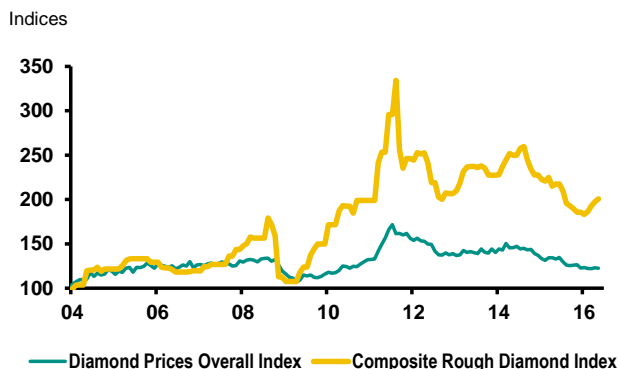
Source: www.diamonds.net, estimate

A new rally in rough diamond prices or just a temporary recovery?

Between 2004 and August 2011 the Composite Rough Diamond Index more than tripled – almost twice as much as the Diamond Prices Overall Index. Subsequently, between August 2011 and the start of 2016, the Composite Rough Diamond Index dropped by more than 45%. This was in percentage terms more substantial than the drop in polished

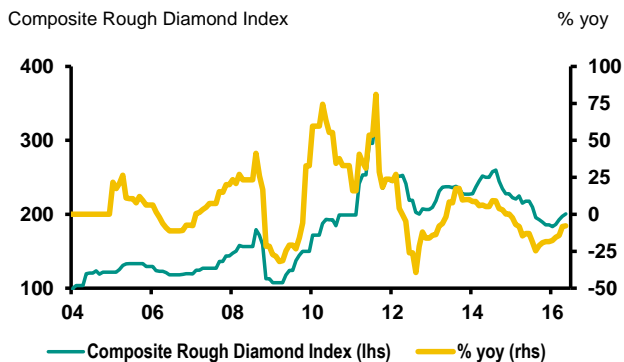
prices. The graph below on the left clearly shows the divergence between both indices. Also since the start of this year, rough diamond prices have done better than the overall index.

Composite Rough Index outperforms Overall Index ytd



Source: Company reports, ABN AMRO Group Economics

Start of a new rally or just a temporary recovery?



Source: Company reports, ABN AMRO Group Economics

De Beers and Alrosa are price setters (for rough diamonds) in the industry. They compete on quality and perception (advertisement) to achieve and keep a substantial market share. The diamond industry is confronted with major challenges (see our [Diamond Sector Outlook: Nothing is forever...](#)). One of the challenges is the profitability of the middle segment. De Beers and Alrosa have acknowledged this and in 2015 gave the manufacturers and dealers the opportunity to defer allocations of the supply to the next supply offer (sight). In addition, they have cut prices for their preferred customers by around 15% in 2015. This has supported demand for rough diamonds at the start of this year and resulted in a higher Composite Rough Diamond Index so far this year (see graph above on the right).

The main question is if the rise in the Composite Rough Diamond Index is sustainable or not? We don't think it is sustainable. First, the higher take-up of the rough diamonds at the sights may have been motivated by the opportunistic behaviour that some money could have been made temporarily from a trading perspective. Second, higher rough demand may also have been the result of hopes that end-demand may improve and result in a drawdown of inventories. As shown above, the improvement in end-demand remains fragile and this doesn't justify higher polished and rough diamond prices. Moreover, history and market dynamics have shown that inventory levels/positions first need to be cleared before a new uptrend in prices can materialise. We think we are not there yet. The fact that the trend in demand for rough diamonds at the sights may already have lost momentum could be an important signal. As soon as demand for rough diamonds starts to falter again, despite the cut-back in production, producers may need to cut prices in order to support demand going forward. Last but not least, structural changes in the industry such as more buyers' power could also weigh on rough prices. Overall, we think rough diamond prices will struggle and lower prices are likely in the current environment.

Find out more about Group Economics at: <https://insights.abnamro.nl/en/>

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