ETFS Investment Research

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The Case for Gold Keeps Growing

Key Points:

- Gold has been on a run in 2019 reaching a new all time high in AUD terms of over A$2000/ounce.
- Gold price is influenced by economic uncertainty and momentum
- Demand is high, driven by central bank and ETF purchasing

Gold has been on a great run in 2019. US$ spot gold is up 9.1% since the start of the year and has recently been trading above US $1,400 for the first time since 2013 (as at 8th July 2019). In Australian dollar terms gold is hitting new all-time highs above A$2,000 an ounce.

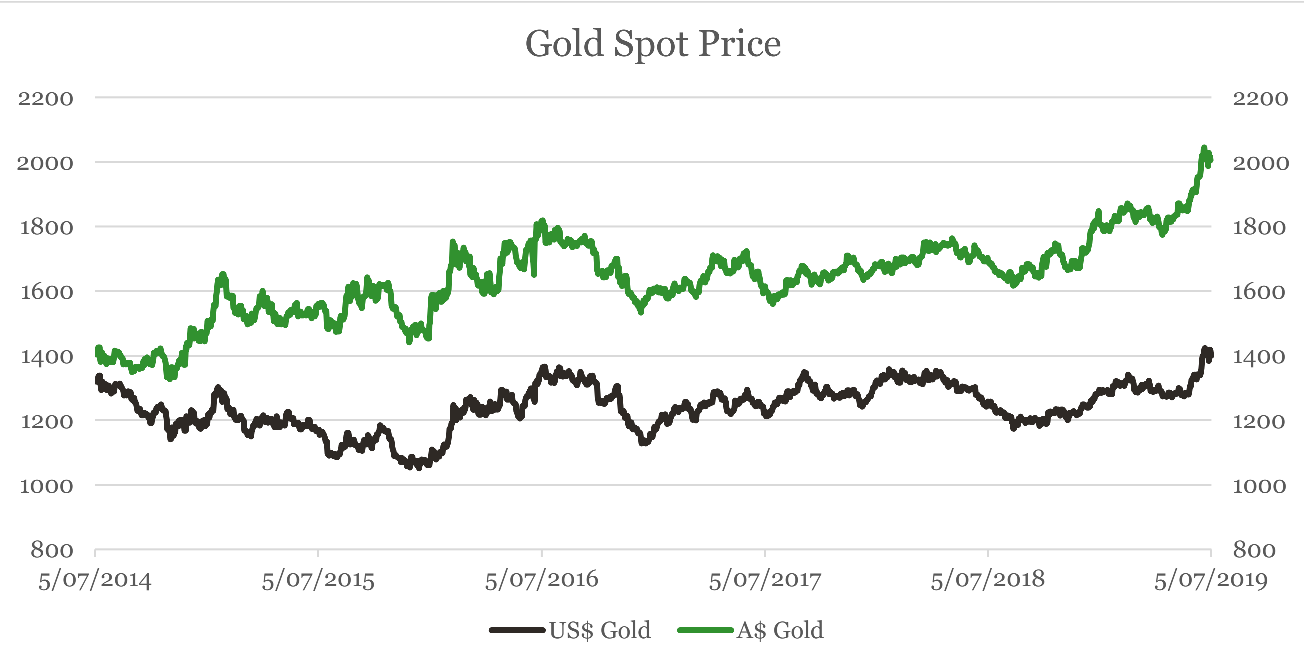


Figure 1: Spot price of Gold in US$ and AU$ terms, source: Bloomberg data as 8 July 2019

Fuelled by equity market volatility in late 2018 and recent heightened expectations of easing monetary policy, gold has performed precisely as would have been predicated by anyone anticipating the broader macro forces at work over the past year. Equity market volatility in early 2018 triggered a rally, which subsided as markets regrouped and set sail for new highs in the third quarter. Volatility returned the fourth quarter of 2018, driving gold higher again. All of this occurred with the backdrop of an abrupt shift in monetary policy from major central banks.

To put gold's price activity into context, it is worth looking at the historic drivers of the gold price. Research by the World Gold Council highlights the four broad categories of factors that influence the price of gold;

Table 1. Investment Update – The impact of monetary policy on gold, source: World Gold Council, March 2019

Economic expansion	as wealth grows demand for gold as an investment asset, for jewellery and for industrial uses grows
Risk and uncertainty	gold's role as a safe haven asset and risk diversifier is well-known and is used across many segments of investor types
Opportunity cost	because gold is not directly yield-producing and is not free to store, there is always an opportunity cost associated with holding gold. When yields available on bonds are high the opportunity cost of holding gold is also high
Momentum	like most investment assets gold is subject to persistent price trends over time

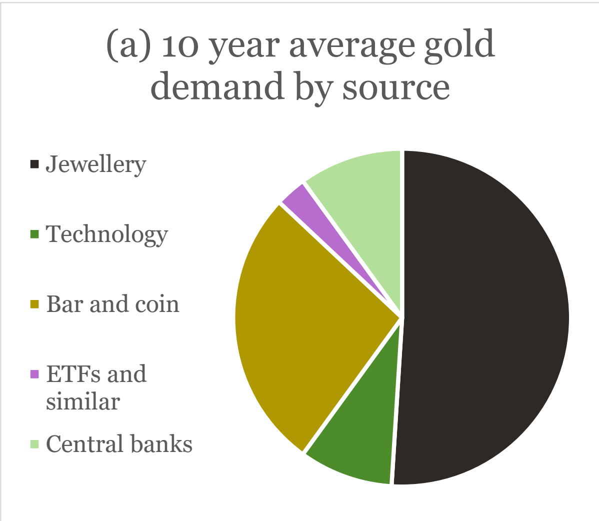
This article looks at these four key factors in the context of the current market from a global perspective.

Factor 1: Economic Expansion

Despite much talk about the uncorrelated and counter-cyclical aspects of gold, like most assets, demand for gold is at least somewhat driven by the overall level activity and wealth in the global economy. Where savings and investment levels are high, demand for gold is high.

Recent years have seen growing demand for gold from both India and China as levels of disposable wealth have grown. These two countries now account for more than 50% of global demand for gold. Conversely, a slowdown in the technology sector in late 2018 saw industrial demand fall by 3% in Q1 2019.

While a broader economic slowdown seems to be in progress, the diversity of demand for gold and its traditional role as a strategic investment asset makes it unlikely that a reduction in economic activity will have a significant negative price impact on gold in the short-term.



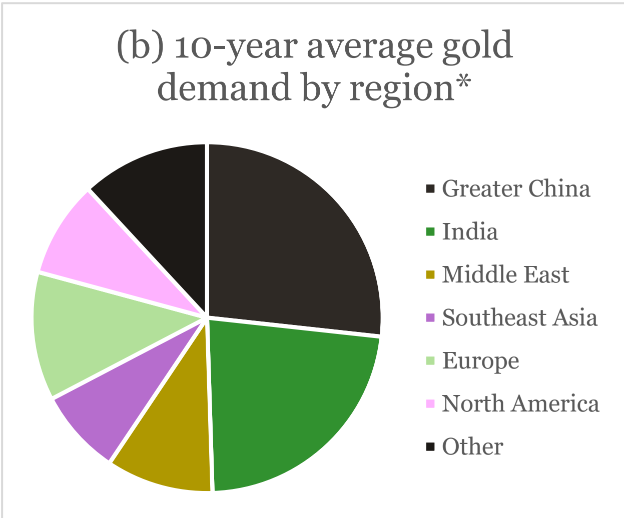


*Figure 2: Gold demand by source and region; source: World Gold Council: The relevance of gold as a strategic asset in the UK, June 2019; * Computed using annual demand from 2009 to 2018, regional breakdown excludes central bank demand due to data availability*

Factor 2: Risk and Uncertainty

As an investment asset gold is commonly deployed as a portfolio diversifier, inflation hedge and quasi-insurance policy.

Gold has shown persistently low levels of correlation with stocks and bonds over the long term, which means that the addition of gold to a portfolio is often able to improve risk-adjusted returns by adding diversification. Figure 3, below, shows the impact of adding gold to a typical balanced portfolio invested across Australian and international equities and fixed income (as represented by Vanguard's LifeStrategy Balanced Fund).

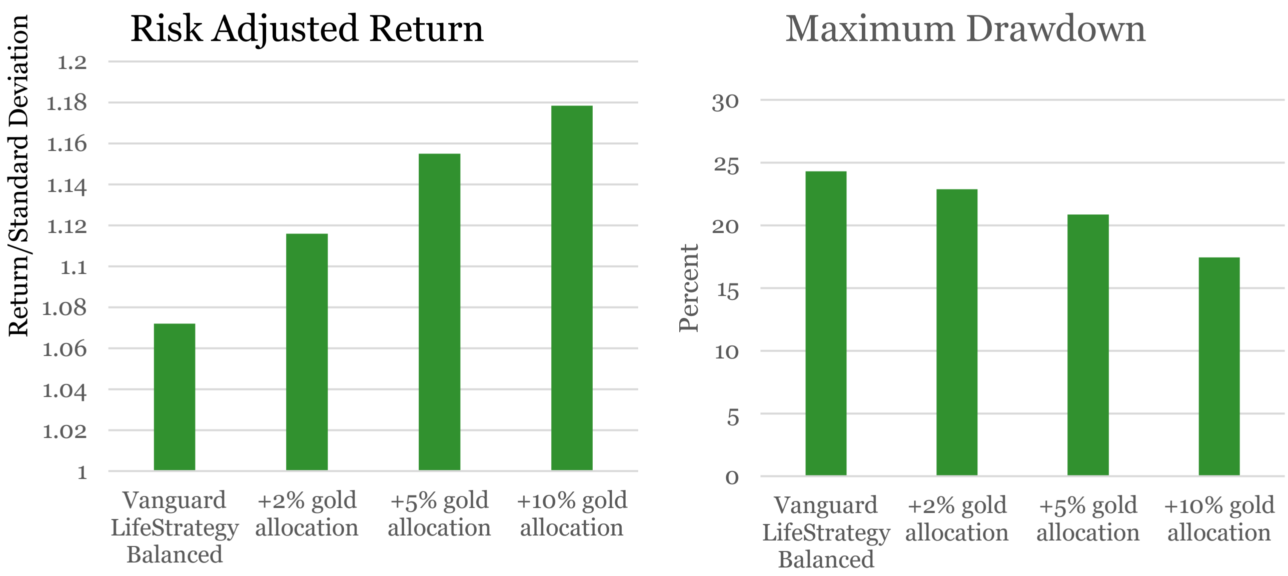


Figure 3: (a) Risk adjusted return (return divided by standard deviation) and (b) maximum drawdown of a portfolio consisting of the Vanguard LifeStrategy Balanced Fund with ETFS Physical Gold added in varying proportions. Data is from 1 April 2003 to 30 June 2019. Source: ETF Securities, Morningstar Direct data as at 8 July 2019.

The conclusion here is that over the long-run a relatively small allocation to gold in a portfolio can have a consistent impact on the risk/return profile of the portfolio. In addition, gold can also have a substantial impact when other asset returns are stressed. This is evidenced in Figure 3(b) by the lower drawdowns, or losses experienced during the largest negative events.

This leads us to gold's commonly cited role as an "event risk" hedge. When major, unexpected events occur gold has, time and again, had a better outcome than equity markets. Figure 4, below, shows how gold fared versus the S&P 500 and ASX 200 through a selection of major financial events over the past four decades.

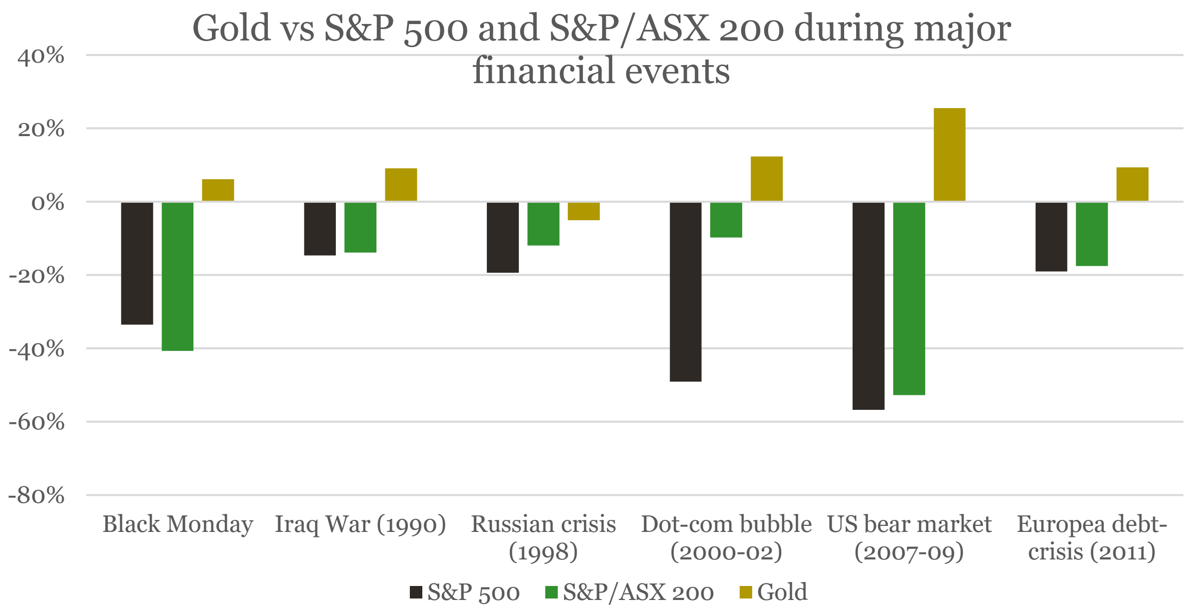


Figure 4: Gold vs S&P 500 and S&P/ASX 200 during major financial events, source: Bloomberg, data as at 8 July 2019

When negative market events occur, gold's correlation with mainstream asset classes tends to reduce and even become negative. This is in stark contrast to many other "alternative" assets, such as hedge fund strategies. During the global financial crisis, these were seen to be highly correlated to equity markets as investors simultaneously rushed to the exit of anything but the safest stores of value.

Not only is gold highly liquid, its other important feature is that it has no credit risk. Unlike other asset classes, during times of financial stress when risk premiums are raised correlations between other assets rise as investors simultaneously look to sell, while gold often moves the other way on safe-haven buying.

While such major events are unpredictable by nature, there is a growing case to be made that equity market valuations are currently stretched and that the volatility seen in early and late 2018 could well return in the near-term. Even if the monetary authorities are ahead of the curve and manage to engineer a soft landing, late-phase bull-markets are synonymous with bouts of volatility. As with any insurance policy, premiums are paid in the hope you never need to make a claim.

Factor 3: Opportunity Cost

The most common argument made against investing in gold is that gold has no intrinsic value because it produces no income and in fact produces negative income if you account for storage and security costs. This is certainly true in a literal sense. As has already been demonstrated, however, this should not detract from the role gold can play in a portfolio and the potential value it adds.

The opportunity cost associated with holding gold is driven by the income and gains forgone by investing in gold over other asset classes. This is clearest in relation to bonds - when interest rates are high the relative cost of owning gold is high. Bonds may provide the necessary diversification, while also providing attractive levels of income. When yields are low, however, that cost of owning gold is reduced, making gold a more attractive play. In cases where yields are negative, as we currently see across Japan and the eurozone, gold effectively provides a positive yield.

In the current market, not only are interest rates at the low end of the historic range, but monetary authorities, most importantly in the U.S., but also in Australia and Europe, have recently shifted from a normalisation/tightening bias, to a stimulatory/easing bias. Figure 5, below, demonstrates the very close relationship between gold and the U.S. 2-year Treasury yield over the past 18 months. Furthermore, over the past two easing cycles in the U.S. between 2001-03 and between 2007-08 gold appreciated by 31% and 17% respectively.

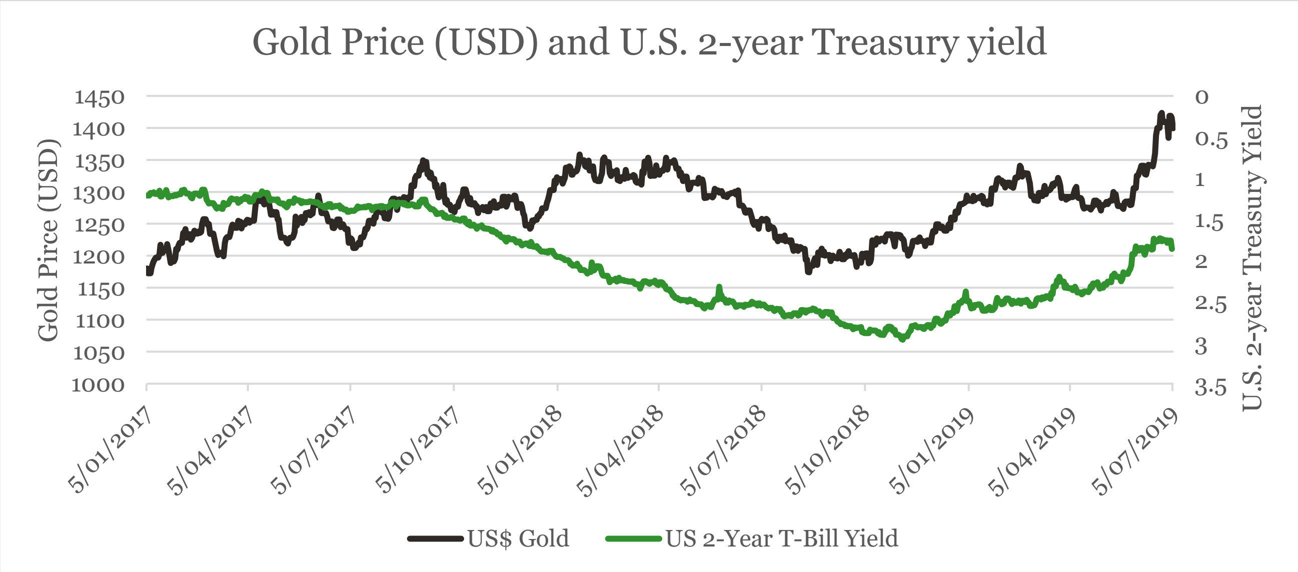


Figure 5: Relationship between the Gold spot price in USD and the U.S. 2-year Treasury yield; Source: Bloomberg data as 8 July 2019

Research by the World Gold Council also suggests that not only do lower interest rates raise demand for gold, but that interest rates have a greater impact on gold in periods where there is a shift in stance, which is exactly what we have seen over the past few months. Markets are now pricing a 100% probability of a Fed cut at the end of July. The likelihood of this was less than 20% as recently as late-May.

Factor 4: Momentum

Like most assets, gold is susceptible to trends and changes in momentum as it moves in and out of favour and the current trend is overwhelmingly positive.

A key area of investment demand is from exchange traded funds (ETFs). Figure 6 shows that global ETF holdings have been steadily rising since early 2016. There are now over 74 million troy ounces of gold supporting physically-backed ETFs, which provide investors with access to gold on most global stock exchanges. ETF users range from larger institutional to small retail investors.

Central bank demand is also growing and has been doing so since 2010. Net purchases are at historic highs and diversified across a wide range of nations. According to the World Gold Council 9 central banks added more than a tonne of gold to their reserves in Q1 2019.

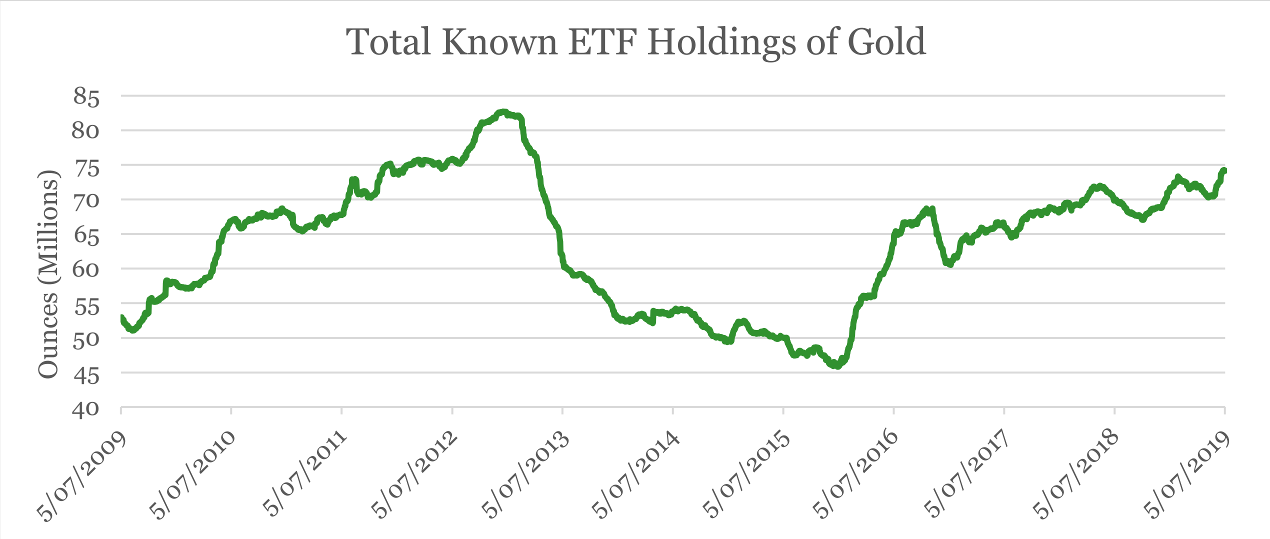


Figure 6: Total known ETF holdings of gold in million of ounces; Source: Bloomberg data as 8 July 2019

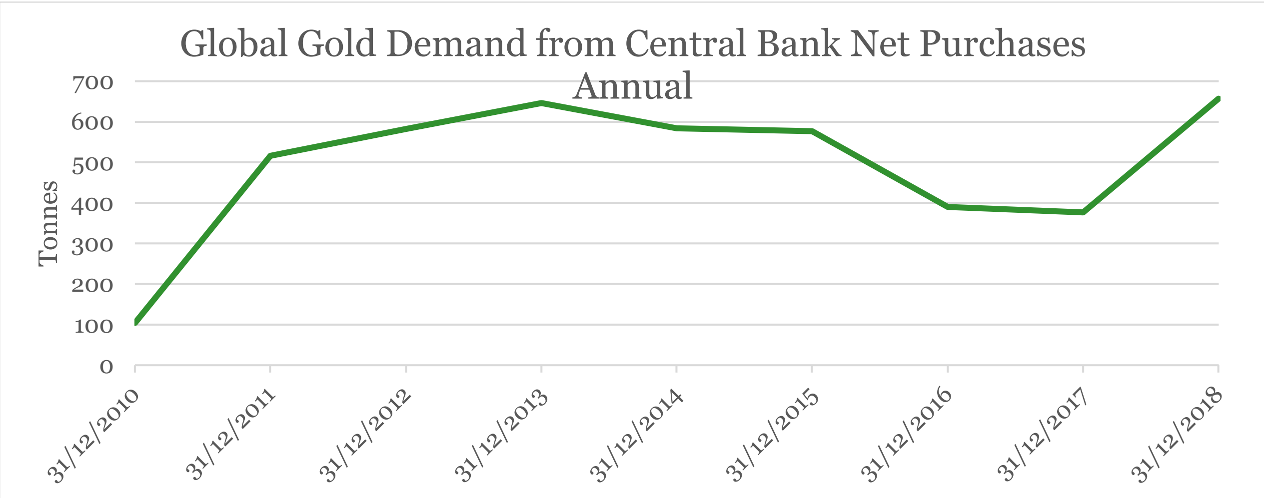


Figure 7: Global Gold demand from central bank net purchases annual; Source: Bloomberg as at 8 July 2019

Conclusion

In summary, gold has picked-up a strong tail-wind in recent months. Demand for gold continues to grow on multiple fronts. The case for using gold as a portfolio diversifier is also becoming clearer as interest rates decline and future growth prospects of global economies are questioned. For investors who are concerned with the risk of drastic, unexpected events it is hard to go past the track record of gold in helping to reduce losses in such scenarios.

How to invest?

Investors looking to add gold exposure to their portfolios can do so via ETFS Physical Gold (ASX: GOLD). GOLD is the oldest and largest gold ETF traded on the ASX. It is fully-backed by physical gold bullion vaulted on behalf of investors in the fund. GOLD charges a management fee of 0.40% per annum.

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