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Markets

FOCUS

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Within *Focus* we comment on extraordinary market events and analyse capital market related special topics.

The golden age continues

“Towards gold throng all, to gold cling all, yes all” – after a rise of 20% in euros, this Goethe quote seems to be proving true again. Gold is one of the best-performing assets this year. In view of the significant economic uncertainty caused by the coronavirus, this is hardly surprising. A look beneath the surface, however, reveals further reasons for this record run. Although stock markets have been recovering rapidly since mid-March, gold continued to surge. But how much more can it rise? Is it still worth adding gold to your portfolio?

Gold continued to appreciate even as stock markets were recovering rapidly

Safe haven without safe loss

Thanks to the unwavering confidence in gold as a universal medium of exchange around the globe, it benefits especially in times of crisis and is generally considered a safe haven. It is also considered to keep its value over the long term and is therefore often used by investors as a hedge against inflation. However, this argument does not sufficiently explain the long-term performance of gold. Looking at the inflation trend, an ounce of gold bought in 1970 would be worth USD240 today. If one starts only ten years later, an ounce would be worth over USD1,700. Determining the fair value of gold on the basis of inflation is therefore highly dependent on the period being considered, and results in an extremely wide range. Yet we are currently at the upper end of this range (see Fig. 1).

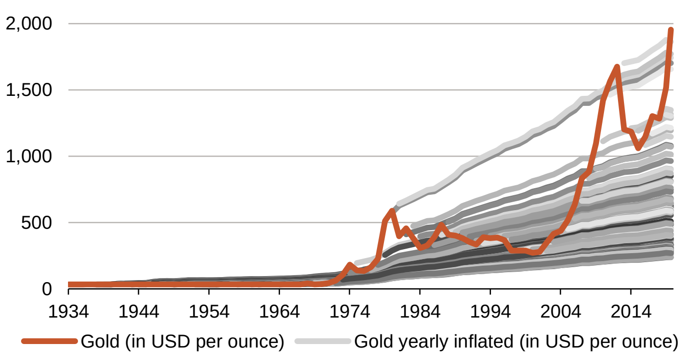
Inflation does not sufficiently explain the performance of gold

Another factor is also crucial for the gold price: the expected performance of other nominal safe havens such as German or US government bonds. While gold, as a real asset, protects investors against inflation but does not generate any regular income, safe government bonds pay coupons but, as nominal assets, suffer depreciation on a real basis. The decisive factor in choosing between gold or safe government bonds is therefore their current yield minus inflation – the real interest rate. The higher the real interest rate, the higher the opportunity cost of gold. This is because, while the future performance of a gold investment is uncertain, the investor foregoes “safe” coupon payments.

Opportunity costs compared with other nominal safe havens are decisive for the gold price

Fig. 1: Inflation alone does not explain the gold price development

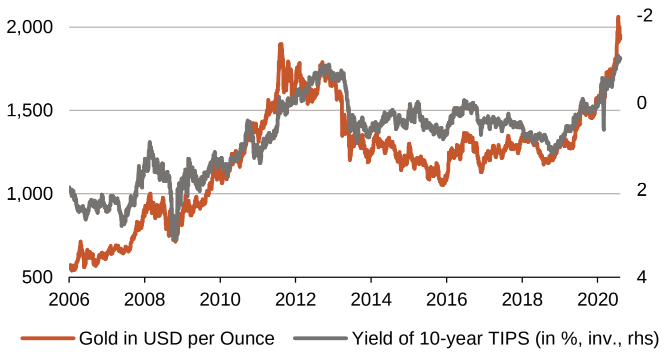
Actual gold price development compared with historical gold prices inflated using US inflation starting in each year from 1934 until today



Time period: 01/01/1934 - 26/08/2020, yearly data
Source: Bloomberg, own calculations

Fig. 2: Gold rises with falling real interest rates (opportunity costs)

Interest rate of 10-year inflation-linked US government bonds versus gold price development



Time period: 01/01/2006 - 26/08/2020
Source: Bloomberg, own calculations

This initially results in two scenarios in which gold gains in relative attractiveness: 1) an environment of financial repression, where central banks deliberately set the level of interest rates below inflation expectations by lowering key interest rates and engaging in bond purchase programmes; and 2) an environment of high and rising inflation expectations, where central banks are not restrictive enough to contain them. In both cases, investors in safe government bonds suddenly incur negative real interest rates and thus losses. At the same time, gold also benefits from the increasing loss of confidence of some investors. In the first case, they accuse central banks of government financing and question their independence. In the second case, they lose confidence in the currency itself due to its dwindling purchasing power. A third scenario in which the precious metal gains in popularity is an environment of unsustainable government debt and thus increasing default risks of supposedly "safe" government bonds. In this case, investors lose confidence in the government as a debtor and instead seek security in gold.

Negative real interest rates and some investors' loss of confidence in their monetary system are driving the gold price

Beneficiary of the globally expansive central bank policy

Currently, we find ourselves in the first scenario. A large part of the central banks' response to the coronavirus crisis consists of launching bond purchase programmes and keeping key interest rates close to 0% in order to maintain financing conditions as low as possible for the purposes of massive economic stimulus programmes, but also for the sake of companies. For example, the ECB is buying bonds worth EUR1.35trn until mid-2021, while the Fed has even granted itself the option of an unlimited purchasing programme. As a result, the yield of 10-year US Treasuries dropped from 1.9% pa at the beginning of the year to 0.7% recently. After deducting inflation expectations of just under 2%, real interest rates are now clearly in negative territory (see Fig. 2). German Bunds have even carried negative nominal interest rates since the beginning of 2019. Consequently, an investor must accept a guaranteed loss for the security of German government bonds when holding them until maturity, regardless of inflation. An investment in gold also entails costs in the form of ETF or safe deposit box fees, for example. There are, however, common ETFs available from 0.15% pa. The fees are therefore usually far below the current negative level of real interest rates. Thus, the opportunity costs for gold are de facto non-existent at present.

In the coronavirus crisis, gold has gained in relative attractiveness thanks to expansionary central bank policies

A departure from the current expansive monetary policy is only likely to come about in the near future if the second scenario materialises, and we see significant inflation rates. Certainly, gold is likely to come under temporary pressure as nominal interest rates rise, but even then it will be supported in the medium term. After all, to avoid jeopardising the bearing capacity of many countries to pay back their mountains of debt, which have risen sharply in the fight against COVID-19, and thus to avoid the third scenario so far as possible, real interest rates are likely to remain negative.

Negative real interest rates should persist in the medium term and thus support gold

Diversifier with potential for increasing performance

Since gold neither pays dividends nor coupons, and is also of little importance in the value chains of the economy, it has been described over the years as "useless" by some investors, including star investor Warren Buffett. In fact, however, gold is proving to be very useful in a portfolio context, as its different characteristics mean that it has a very low correlation with other asset classes. Over the last 30 years, the correlation between equities and gold has been just 0.07. Between bonds and gold, the correlation is 0.39. Adding gold to your portfolio therefore improves the risk-return ratio (see Fig. 3). A global portfolio consisting of 60% equities and 40%

An allocation to gold increases the long-term risk-adjusted return of multi-asset portfolios bonds has achieved an average return of 6.5% pa since 1990, with a volatility of 9.8% pa. This results in a risk-return ratio of 0.66. If we then add 10% gold to this 60/40 portfolio, the return remains the same, but volatility falls to 9.1% and the risk-return ratio finally rises to 0.71. At the same time, the maximum drawdown drops from 35.9% to 31.6%. Especially in phases of higher volatility, gold not only brings more stability to your portfolio, but also improves its absolute return (see Fig. 4 arrow A). In a calmer market, it continues to reduce volatility yet costs an investor very little performance (see Fig. 4 arrow B). In hindsight, the optimal allocation of gold differs depending on the period under review and the general portfolio composition, but in the long run a weighting of at least 5% is useful for adding stability to a portfolio (see Fig. 3).

The majority of global investors are still not sufficiently positioned to benefit significantly from an investment in gold

Given the strong rally since the beginning of the year, new all-time highs and record ETF holdings, one might think that gold is now a "crowded trade", and that the potential for further investment demand might be limited. However, investors are still underinvested in gold on average in order to benefit from its diversification benefits and performance potential. The total capitalisation of global equity markets is approximately USD91trn. The global bond market amounts to approximately USD64trn. Investor gold holdings in the form of bars, coins and ETFs, on the other hand, amount to only USD3trn. When these holdings are compared with the total capitalisation of stock and bond markets, gold accounts for only 1.9% of global portfolios, while gold ETFs account for just 0.1%. So if investors around the world wanted to hold at least 5% gold to make their portfolios more robust, their current allocation would have to almost triple. In addition, with a volume of currently USD14trn of bonds with negative nominal interest rates, even at the current gold price, not even all global gold holdings (including jewellery, central bank gold, etc.) would be sufficient to enable all investors in these securities to avoid a guaranteed loss by switching to gold. In the short term, gold has come a long way, but it is not expensive relative to other asset classes.

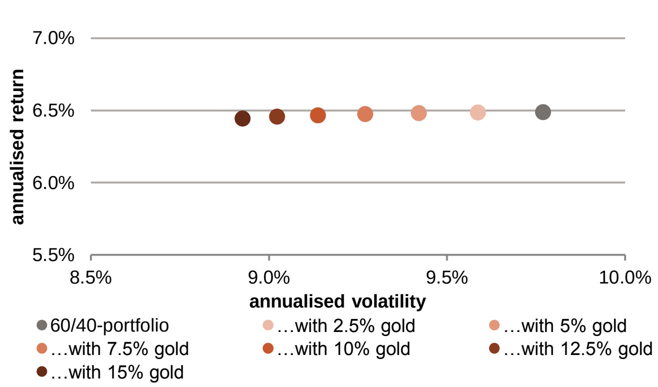
Not every precious metal is a safe haven

Silver, platinum and palladium benefit from the ongoing economic recovery thanks to greater use in industrial applications

Besides gold, other precious metals such as silver, platinum and palladium are also benefiting from the current environment. On one hand, they have gained in relative attractiveness with high and increasing gold prices. On the other hand, they are being used significantly more in industrial applications. Hence, they are benefiting from rising demand in the wake of the ongoing economic recovery.

Fig. 3: Gold increases risk-adjusted returns in the long term

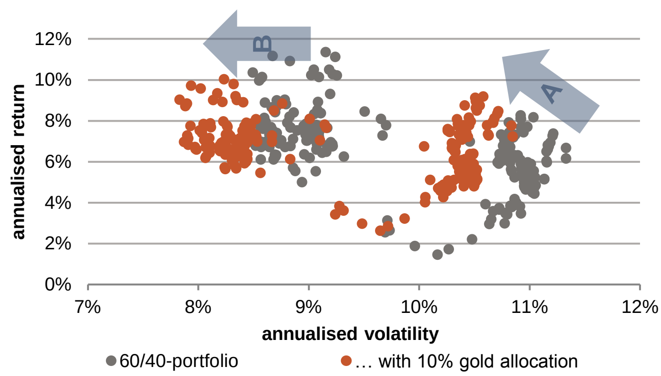
Return and volatility of a portfolio consisting of 60% global equities and 40% global bonds (60/40 portfolio) with an increasing pro rata allocation to gold



Time period: 01/01/1990 – 30/06/2020, monthly data
Sources: Bloomberg, own calculations

Fig. 4: In volatile times, gold also increases the absolute return

10-year rolling yield and volatility of a portfolio consisting of 60% global equities and 40% global bonds (60/40 portfolio) and a 10% pro rata gold allocation



Time period: 01/01/1990 – 30/06/2020, monthly data
Sources: Bloomberg, own calculations

While demand for gold from the manufacturing sector is below 10%, demand for silver is around 50%. Silver is also increasingly used in photovoltaic systems and thus also benefits from the structural trend towards emission-free energy generation. Thanks to growth in demand from industrial applications, a low absolute price and a gold/silver ratio at an all-time high, silver has moved into the focus of many investors in recent months and has already more than doubled since its low in March. As a result, its relative attractiveness to gold has largely disappeared.

In the case of platinum, over 60% of demand is determined by the industrial sector. In the case of palladium it is almost 100%, with investment demand even being negative in recent years. Both precious metals are particularly dependent on the automotive sector, as they are mainly used in diesel and petrol catalysts. They are therefore benefiting from the ongoing economic recovery, while platinum, like silver, could also benefit from the long-term sustainability trend thanks to its increased use in hydrogen fuel cells.

Since the other precious metals besides gold are not safe havens, an allocation only makes sense tactically

Conversely, investors should not be lulled into false security when investing in these precious metals. After all, they are not safe havens, like gold is. On the contrary, due to their high dependence on industrial demand, these metals suffer especially in times of crisis and downturns. All three lost more than 35% in the coronavirus crisis and thus reflected the losses in equity markets. Therefore, an investment only makes sense tactically, especially in phases of rising gold prices during economic upturns and high relative attractiveness.

No multi-asset portfolio without gold

At over USD1,900 an ounce, gold is certainly not cheap. Nevertheless there are good reasons for this price level. In addition to the ongoing uncertainty surrounding the coronavirus, the trade conflict between the US and China and the US presidential elections, the precious metal is benefiting above all from the globally expansive monetary policy and the resulting high relative attractiveness compared with safe government bonds.

Moreover, gold is proving to be particularly useful in a portfolio context. Thanks to its low correlation to other asset classes, the safe haven can bring more stability to a portfolio in bear as well as bull markets, thus improving the risk-return ratio in the long term. Nevertheless, the majority of global investors are still significantly under-invested in gold to take advantage of its positive qualities. Despite its recent popularity, the precious metal is therefore not yet a “crowded trade”. We believe it should form an integral part of any multi-asset portfolio.

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IMPORTANT NOTICES

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