

CIO Viewpoint

Going for gold

Investment Solutions

25 July 2019

Gold's traditional role in a portfolio has been as a hedge against inflation and equity market volatility, and as a diversification tool. This year, a combination of factors have driven gold to six-year highs. These include expectations of lower interest rates in the US, a weakening US dollar and rising geopolitical risk in the form of US-China trade and tensions with Iran in the Gulf. In addition, uncertainties around the late economic cycle and widespread negative yields have all pushed investors to look for alternative havens.

It is worth reminding ourselves that gold trades for the most part on financial demand, rather than on fundamentals (physical market). A big driver of financial demand is fear in financial markets (see Chart 1), which is why gold often acts as an effective hedge against volatility. And today, while the effectiveness of government bonds as a hedge decreases with the level of yields (the potential for lower yields is more limited when bonds are trading in negative territory), holding gold in multi-asset portfolios is necessary. In fact, the additional financial demand induced by the lack of safe haven assets is likely to limit downside risk, and given the already exceptional length of the cycle, we can expect recession fears will periodically re-emerge.

Still, a negative correlation between gold and equity should not be taken for granted. Furthermore, gold's annualised volatility has historically been comparable to equity volatility (see Chart 2). As such, adding gold to a multi-asset portfolio usually means adding to the overall portfolio risk, which is why it's key that this allocation is tactically managed. In fact, there have been striking moments where gold did not protect portfolios against equity drawdowns, notably in the financial crisis in October 2008 where both gold and US equities dropped around 20% (on global de-risking of portfolios and forced sales by funds stuck with their illiquid credit positions). Nevertheless, gold quickly attracted flows again and recovered losses, gaining almost 35% when equity markets fell another 30%.

Indeed, gold has always been thought of as the ultimate hedge against financial instability and any loss of confidence in financial and monetary institutions. Since the financial crisis, accommodative central bank monetary policies have bailed out the financial system with two negative consequences. First, they have exacerbated social inequalities by benefiting most those able to invest and take advantage of the lower cost of money and rising asset prices. That disparity, in turn, has led to an increase in populist politics, undermining political stability.

Secondly, the global economy's greater dependence on unconventional monetary policy and inflated central bank balance sheets threatens confidence in the financial system itself. If the next stage in monetary policy fails to improve economies sustainably, investors may turn away from cash and towards gold.



Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- A series of factors have pushed gold to six-year highs, with market fears still a key driver
- Gold is an effective volatility hedge, but must be managed tactically
- Limited safe-haven alternatives should limit downside risk
- Low-to-negative sovereign yields and geopolitical tensions are likely to continue support for gold

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Weekly publication of Lombard Odier – Contacts: Investment Solutions, investment-solutions@lombardodier.com

Data as of 25 July 2019 unless otherwise stated.

Lombard Odier · CIO Viewpoint · 25 July 2019

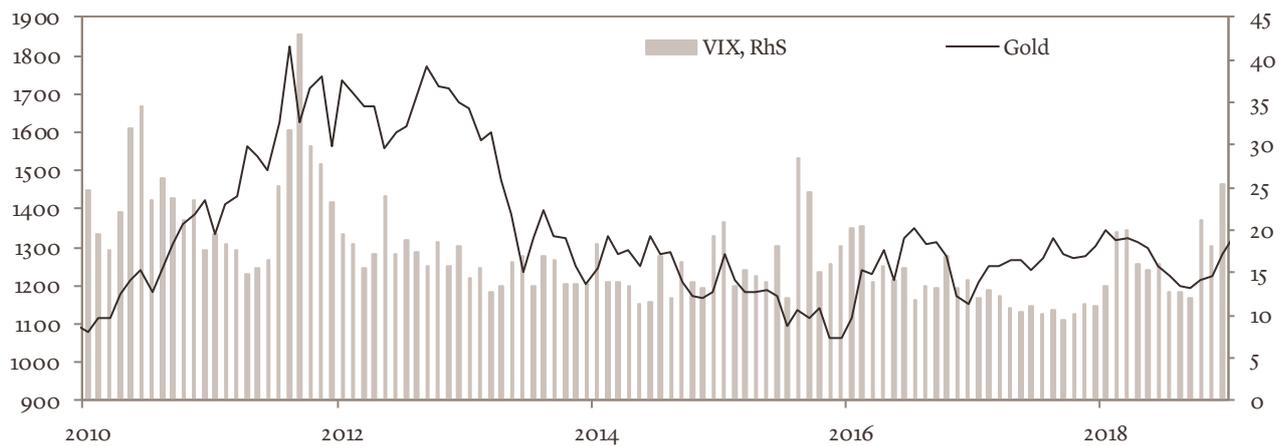
We believe the current environment justifies an allocation to gold in our client portfolios. We expect the combination of low government bond yields, uncertainty around US-China trade relations and a weakening US dollar to stay with us in the months to come. This is an environment supportive for both gold prices and gold's effectiveness as a hedge.

Recent performance and our tactical positioning

After trading around USD 1,300/oz over the first five months of this year, gold rallied 8% in June and finished the month at USD 1,410/oz. The precious metal is now trading at USD 1,426/oz. While we may see some profit taking at these levels (prices have now exceeded our 12-month price target of USD 1,400/oz and any repricing of market expectations for the Federal Reserve would push gold prices closer to our target), the case for a gold allocation in a multi-asset portfolio remains strong.

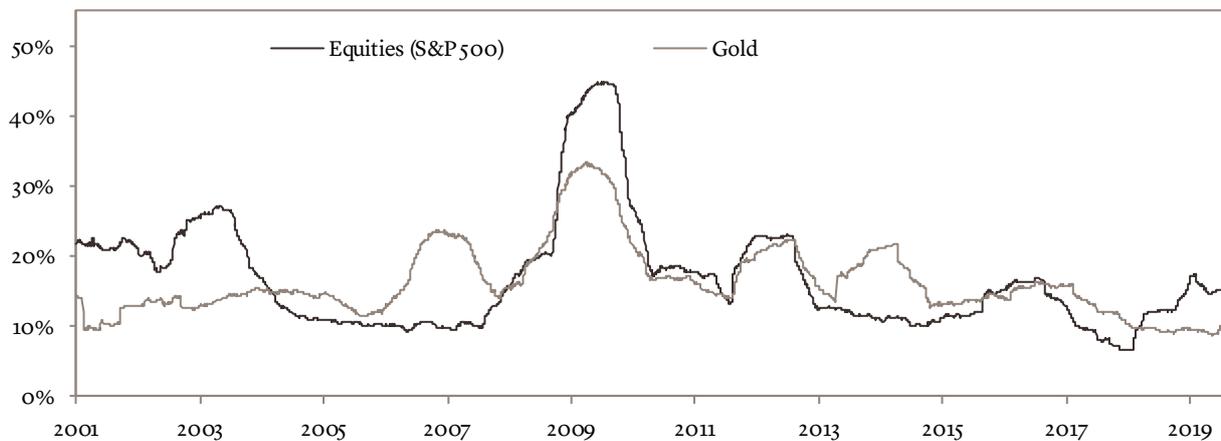
As mentioned earlier, we believe in the importance of managing gold allocations tactically, and in January we started by switching a diversified commodities exposure into gold. We bought the metal at USD 1,282/oz and built a 3% overweight position compared with our strategic benchmark. We then reinforced our position in April, adding another 2% to portfolios. More recently, we reduced the allocation by 2% and are now holding an allocation of 3% across all portfolios.

Chart 1: Gold is trading in line with our 12-month target at USD 1,400/oz



Sources: Bloomberg; LO Calculations

Chart 2: Gold volatility can be close to equity markets volatility
12-month realised volatility



Sources: Datastream, LO calculations

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