Investment Strategy Bulletin

Gold: safe-haven role firmly established

Investment Solutions

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Historically, government bonds have been the safe-haven or risk-free asset of choice to diversify the risk in a portfolio.

However, negative government bond yields in Europe and Japan have fundamentally changed the relative merit of government bonds versus gold as safe havens, for two reasons: 1/ in these economies, government bonds no longer have an income advantage over gold; 2/ there is a limit to how low negative bond yields can go and still attract investors.

We believe the negative yield environment will remain in place for euro and Swiss franc government bonds for the near future. This has profound implications for long-term portfolio construction: the expected returns of government bonds in case of a stress scenario are capped and gold becomes a necessity rather than an optional allocation.

Gold has traditionally been considered as a safe-haven asset, together with government bonds, in an investment portfolio. In other words, when financial markets experience stress or investors become more cautious, both the gold price and government bonds have tended to appreciate. However, the safe-haven or risk-free asset of choice to diversify the risk in a portfolio has always been government bonds. Why?

The answer is that government bonds have three attractive characteristics. First, they exhibit a persistently negative correlation with equities, i.e. government bonds appreciate when equities depreciate. Second, government bonds present lower risk metrics than equities, which means replacing equities with government bonds will systematically reduce portfolio risk. Finally, government bonds offer a recurring income component in the form of bond coupons.

Gold, on the other hand, has:

1. an unstable correlation with equities – although it tends to be negative in severe periods of stress (chart 1)
2. comparable volatility to equities, which means replacing equities with gold does not automatically reduce portfolio risk (chart 2)
3. no cash flow generation – and even instead a cost when it comes to physically holding gold, which requires storage in a safe.

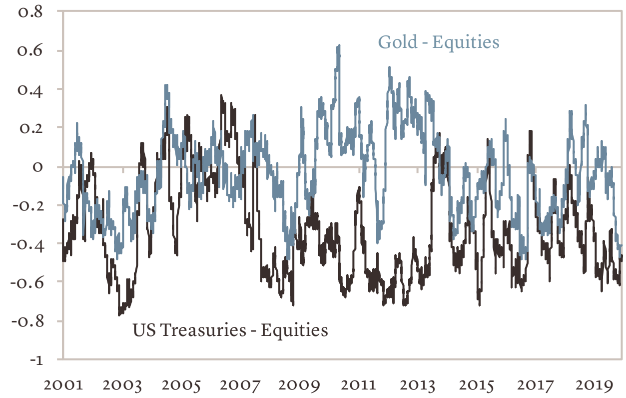
In addition, there have been striking moments where gold did not protect portfolios against equity drawdowns, notably in the financial crisis of October 2008 where both gold and US equities dropped by around 20% due to global portfolio de-risking and forced sales by funds stuck with their illiquid credit positions. Nevertheless, gold quickly attracted flows again shortly afterwards, recovering its losses and gaining almost 35% when equity markets fell another 30% in Q1 2009.

The comparison illustrates why we have been reluctant for some time to consider gold as a strategic safe-haven asset, preferring instead to use government bonds or the Japanese yen as hedges to dampen losses during volatility episodes.

However, negative government bond yields in Europe and Japan have fundamentally changed the relative merit of government bonds versus gold as safe havens, for two reasons. First, **government bonds no longer have an income advantage over gold**. More importantly, **there is a limit to how negative bond yields can go and still attract investors**. This fact was highlighted this year in the global bond market

1. Correlation between gold and equities is close to 0 over time (vs -0.3 for US Treasuries)

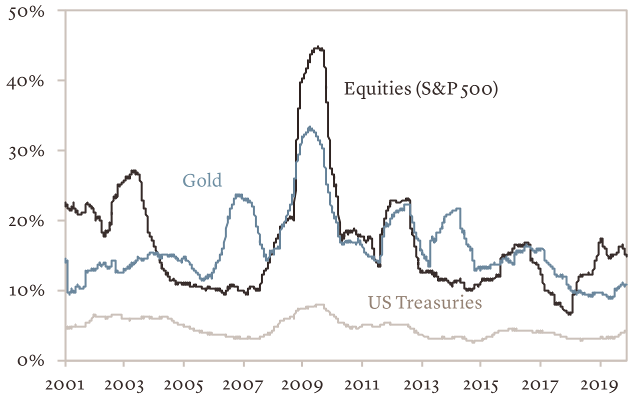
3-month correlations with equities



Sources: Datastream, Lombard Odier calculations

2. Gold volatility is much closer to equity than bond volatility

1-year realised volatilities



Sources: Datastream, Lombard Odier calculations

rally that occurred between June and August: US 10-year yields collapsed by more than 130 basis points (bps), from 2.8% to less than 1.50%. Meanwhile, the German and Swiss benchmarks were down by only 100 bps, with historical lows of respectively -0.71% and -1.12% reached in August. Interestingly, Japanese bonds underperformed their peers due to yield curve targeting implemented by the Bank of Japan, aimed at anchoring the 10-year yields at around 0%.

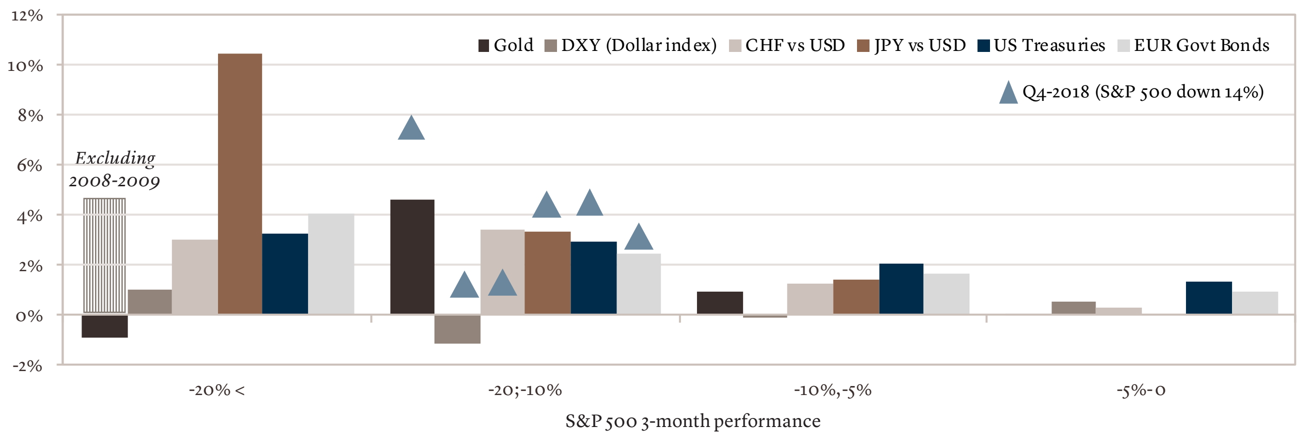
Clearly, the low/negative level of yields discourages investors from holding government bonds, which limits bonds' ability to react and offset equity drawdowns – the bond price appreciation is capped by the floor on negative yields. In fact, last year during the Q4 equity market sell-off, EUR bonds underperformed US bonds markedly – which was not the case historically (chart 3).

Chart 3 also analyses the performance in periods of equity drawdowns of other traditional safe-haven assets: the Swiss franc (CHF) and the Japanese yen (JPY). Here again, the impact of negative rates on the performance of safe havens is remarkable: the JPY, where short-term rates are mildly negative, outperforms CHF, where short-term rates are materially negative.

Given the persistent low-yield environment – e.g. a 10-year US treasury yield at 1.75% vs 3% on average in Q4 18 – we believe the relative effectiveness of safe-haven assets would follow the Q4 18 playbook in case of a material equity market drawdown. We simulated expected returns of different asset classes consistently with a 10% fall in equity markets. We assume -1% as a floor for European government bond yields. The Swiss 10-year yield in fact traded below this threshold for a week in August, but rapidly retreated from this uncharted territory as investors' demand in our view cannot be sustained at this level. As such, the expected total return of European government bonds in a stress scenario would be capped between 2% and 3%,

3. "Safe-haven" returns in various equity market environments

1980-2018, 3-month performance (for EUR government bonds since 1998)



Sources: Bloomberg, Lombard Odier calculations while US yields, which have more room to fall to new historical but still positive lows of 1%, should return more than 5%. As gold has no limit on the upside and benefits from the rising share of negative-yielding bonds (chart 4), we see scope for the yellow metal to outperform significantly (we see almost 14% upside) in an adverse environment, consistently with US real rates falling significantly in negative territory (chart 5). In our baseline scenario, we maintain our 12-month target unchanged at USD 1450/oz, as we expect the Fed to remain on hold for the quarters to come.

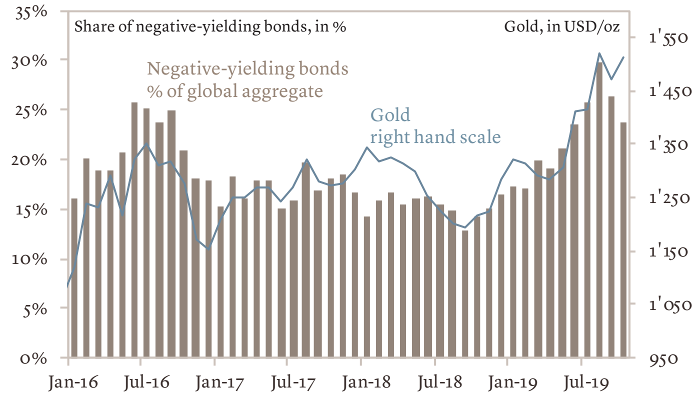
We believe the negative yield environment will remain in place for euro and Swiss franc government bonds for the near future. This has profound implications for long-term portfolio construction: **gold becomes a necessity rather than an optional allocation**. Specifically **for CHF- or EUR-denominated portfolios**, where the yield environment is particularly low, **gold will have an important structural role to play as a portfolio diversifier and a hedge against equity drawdowns**.

With negative rates a clear driver of additional financial demand for gold as an alternative to traditional safe havens, the downside risk for the gold price is limited.

Carolina Moura Alves, Head of Asset Allocation
Sophie Chardon, Senior Cross Asset Strategist

4. Gold is now used as a substitute for negative-yielding government bonds

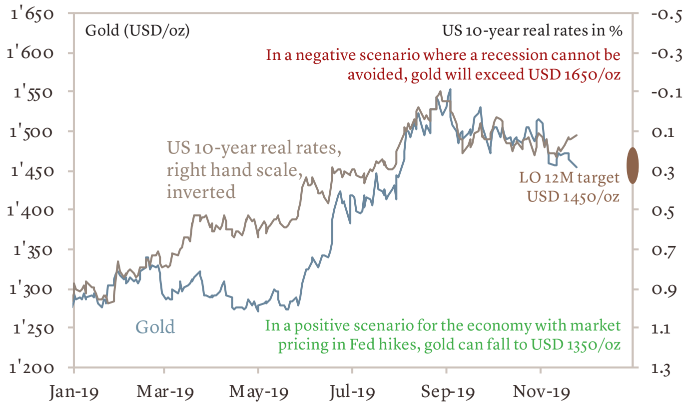
Financial demand for gold is here to stay



Sources: Bloomberg, Lombard Odier calculations

5. Gold in our multi-scenario analysis

We see more upside than downside potential



Sources: Bloomberg, Lombard Odier estimates

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