Investment Update

Market selloff bolsters case for gold

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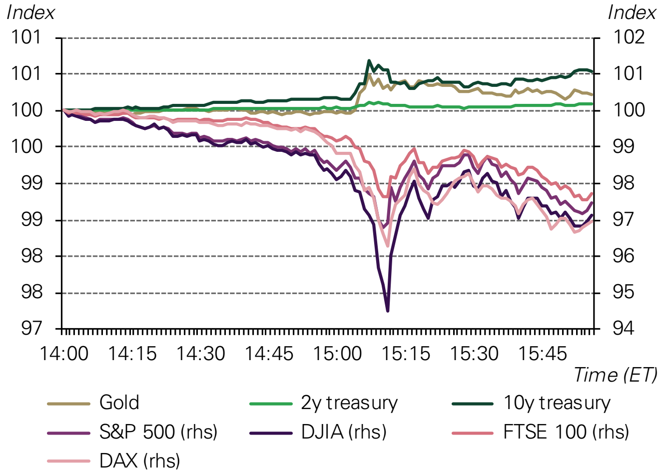
On February 5th, stock markets suffered one of their more precipitous falls in recent years. The gold price rose but, as stocks partly retraced their losses, gold trended lower. Gold has often acted as a portfolio hedge in market downturns and the recent pullback was no exception. But gold's effectiveness improves when market corrections are wider or sustained for longer. In our view, the recent selloff is a good reminder that gold can deliver returns and reduce risk in portfolios.

Gold reacted to the stock selloff

Gold acts as a diversifier and investors often use it to protect portfolios during market downturns. The stock market selloff on February 5th was no exception. Initially, the gold price did not move much as stock indices started to trend lower. But as stocks tumbled, gold rallied strongly – even outperforming short-term treasuries (**Chart 1**).

Chart 1: As stocks tumbled, gold rallied…

Intraday price performance of key assets on February 5th*



*Based on 1-minute intervals. All assets indexed to 100 on February 5th at 14:00 hrs ET

Source: Bloomberg, World Gold Council

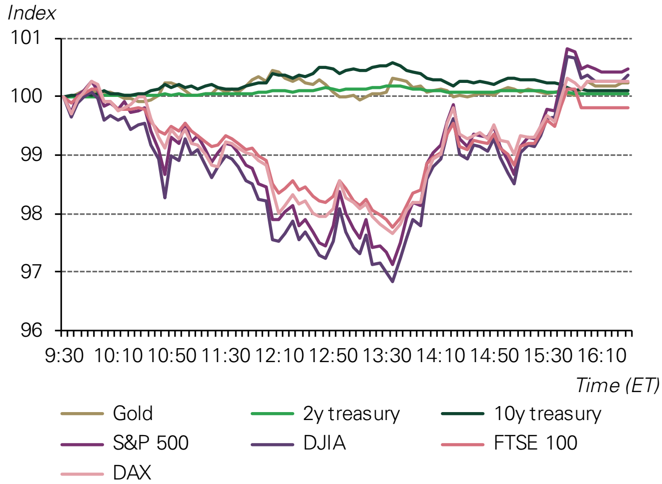
Some investors were somewhat disappointed by gold's performance by the end of the week, as they expected a sustained rally, but gold's performance was quite consistent with its historical behaviour.

The stock market pullback was sharp, but it was short lived. Major western market indices dropped by more than two standard deviations on February 5th (e.g. the Dow Jones Industrial Average fell by 4.6%) but Asian stocks bounced back in the early hours of February 6th and global stock indices retraced some of their losses. Stock markets fell again on February 8th, reaching their weekly lows by mid-Friday February 9th only to start trending higher thereafter (**Chart 2**). By Monday February 12th, the Dow had retraced almost half of its maximum weekly loss and European stocks nearly 30%, while stocks in Asia maintained most of their losses.

Gold lost ground, dropping 0.8% between Friday February 2nd and Monday February 12th. But it still outperformed most assets on the week (other than treasuries) and reduced portfolio losses, providing liquidity to investors as market volatility rose.

Chart 2: …but the market selloff was short lived

Intraday price performance of key assets on February 9th*



*Based on 1-minute intervals. All assets indexed to 100 on February 9th at 09:30 hrs ET

Source: Bloomberg, World Gold Council

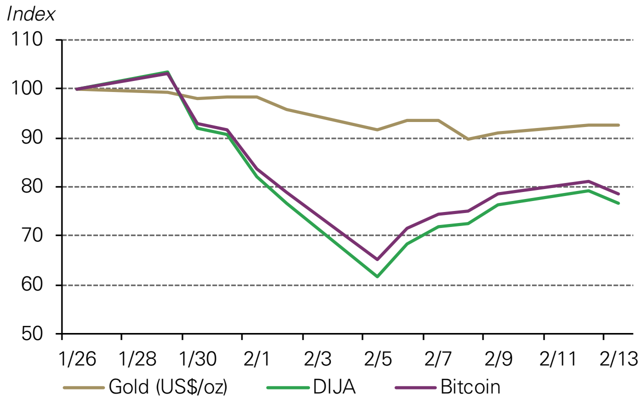
For non-US investors, gold's protection during the selloff and the week was stronger. While gold is often quoted in US dollars, more than 90% of demand comes from outside of the US. For those investors, gold's performance in local currencies is what matters most. For example, European gold investment demand has increased significantly in recent years (see *Germany's golden decade*, October 2017). As European currencies weakened against the US dollar during the week, gold's price in those currencies strengthened. Gold rallied by 0.9% in euros and 1.8% in British pounds between Friday February 2nd and Monday February 12th. US investors can also take advantage of this behaviour by combining a long US dollar position with a long gold position in their portfolios (see *Gold and currencies: looking at gold beyond the US dollar*, Gold Investor, February 2017).

Cryptocurrencies fell alongside stocks

Often, market commentators describe cryptocurrencies as a store of value, but they had yet to be tested in a market downturn (see Cr*yptocurrencies are no substitute for gold*, February 2018). If the behaviour of bitcoin and other existing cryptocurrencies during the recent market selloff is any indication, the expectations may be misplaced. Bitcoin traded on its lows both on Monday and Tuesday in tandem with the stock market selloff (**Chart 3**). It's possible that this may change as the crypto market matures or different offerings based on blockchain address investors' and regulators' concerns. But for now, existing cryptocurrencies remain a highly speculative investment rather than a safe-haven.

Chart 3: Bitcoin sold off as stocks tumbled

Performance of gold, DIJA and bitcoin*



*All assets indexed to 100 on January 26th, 2018.

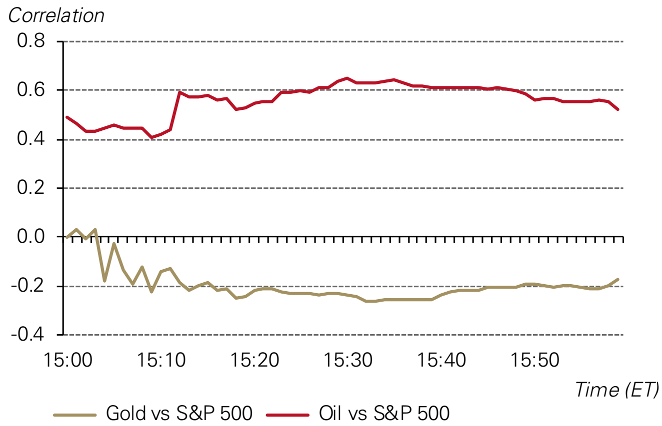
Source: Bloomberg, World Gold Council

Gold's effectiveness as a hedge increases with systemic risks

As a safe-haven, gold typically benefits from flight-to-quality flows. This, in turn, makes stocks and gold inversely correlated in market downturns. The stronger the market pullback, the stronger gold's rally (see *The relevance of gold as a strategic asset*, January 2018). Consistent with its historical performance, gold's correlation to stocks during the February 5th selloff turned more negative as stock prices fell. This behaviour is the opposite to that of risk assets, such as oil (**Chart 4**).

Chart 4: Gold's correlation to stocks typically becomes more negative during market pullbacks

Correlation between S&P 500, gold and oil*



*Computed using a 60-minute rolling window of 1-minute returns.

Source: Bloomberg, World Gold Council

In previous market crises, gold delivered much-needed returns to investors' portfolios. Examples include Black Monday, the 2008–2009 financial crisis and the European sovereign debt crisis (**Chart 5**). But there are exceptions.

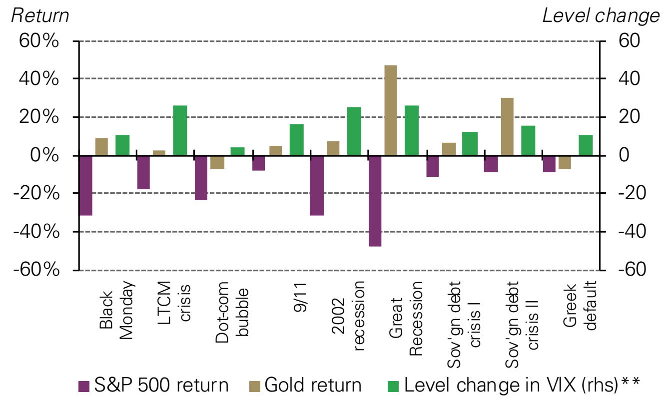
Gold has been more effective as a hedge when a market correction has been broader (i.e. affects more than one sector or region) or lasted longer.

During the 2001 dot-com bubble burst, the risk was mainly centred around tech stocks and was not enough to elicit a strong reaction from gold; it was not until the broader US economy fell into recession that the gold price responded more sharply. Similarly, investors outside of Europe discounted the possibility of a spill-over from the 2015 Greek default. In recent pullback, as stocks quickly rebounded, gold's reaction was more muted.

However, taking a longer, more strategic view, is quite relevant.

Chart 5: Gold prices tend to rise as volatility increases

Performance of gold during stock market corrections*



*Dates used: Black Monday: 9/1987-11/1987; LTCM: 8/1998; Dot-com: 3/2000-3/2001; September 11: 9/2001; 2002 recession: 3/2002-7/2002; Great Recession: 10/2007-2/2009; Sovereign debt crisis I: 1/2010-6/2010; Sovereign debt crisis II: 2/2011-10/2011; Greek default: 6/1/2015-9/30/2015.

** The VIX is available only after January 1990. For events occurring prior to that date, annualised 30-day S&P 500 volatility is used as a proxy.

Source: Bloomberg, World Gold Council

Looking beyond gold's short-term performance

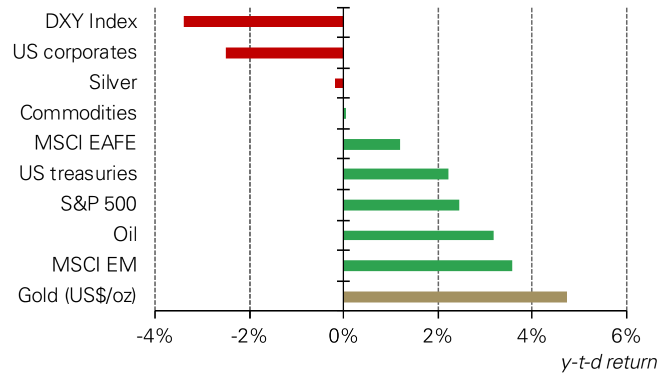
Market corrections may be expected but their timing, length, and magnitude are unpredictable. Many investors and market commentators grew worried over the past few months of frothy stock valuations and over-extended stock prices (see *Outlook 2018*, January 2018). Stocks trended higher for months, until they didn't. Two weeks ago, after continuously reaching record highs, the DJIA had its biggest point-drop in history. This correction was seen by some as a healthy cool-down to an otherwise red-hot stock market. However, as interest rates continue to rise, and the environment of ultra-low interest rates comes to an end, other corrections may follow.

Gold serves four key roles in a portfolio:

- delivering positive long-term returns
- improving diversification
- providing liquidity, especially in downturns
- enhancing portfolio performance through higher risk-adjusted returns

So far, 2018 has been a good case in point of gold's role as a strategic asset. It has been one of the best-performing asset classes year-to-date, besting treasuries and corporate bonds (**Chart 6**). It has served as a diversifier and liquidity source as stock markets tumbled. Thus, gold helped investors improve their portfolios' performance.

Chart 6: Gold has been one of the best-performing asset classes this year*



*As of February 16th, 2018.

Source: Bloomberg, World Gold Council

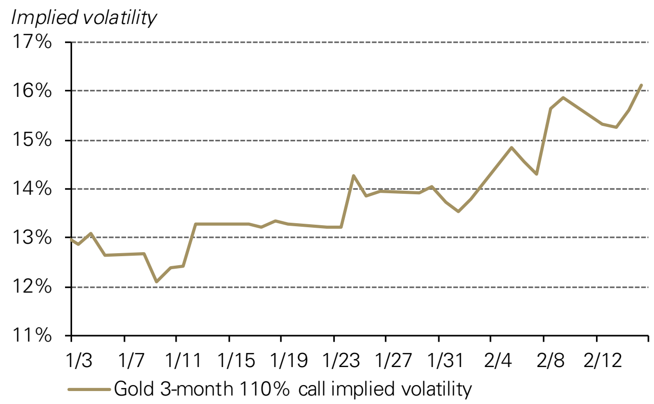
Investors are buying protection via gold options

And many investors seem to agree. Gold call options premia, as seen by their implied volatility, have been increasing since January 26th (**Chart 7**). In addition, the difference in premia between at-the-money and out-of-the-money calls is widening. In our view, this type of bullish positioning suggests that investors may be increasing their portfolio protection against further market downturns.

We also believe that this is as good a time as any for investors to consider including or adding gold as a strategic component to their portfolios.

Chart 7: Investors are buying downside market protection through gold options

Year-to-date 110% call implied volatility



Source: Bloomberg, World Gold Council

About the World Gold Council

The World Gold Council is the market development organisation for the gold industry. Our purpose is to stimulate and sustain demand for gold, provide industry leadership, and be the global authority on the gold market.

We develop gold-backed solutions, services and products, based on authoritative market insight, and we work with a range of partners to put our ideas into action. As a result, we create structural shifts in demand for gold across key market sectors. We provide insights into the international gold markets, helping people to understand the wealth preservation qualities of gold and its role in meeting the social and environmental needs of society.

Based in the UK, with operations in India, the Far East and the US, the World Gold Council is an association whose members comprise the world's leading gold mining companies.

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