

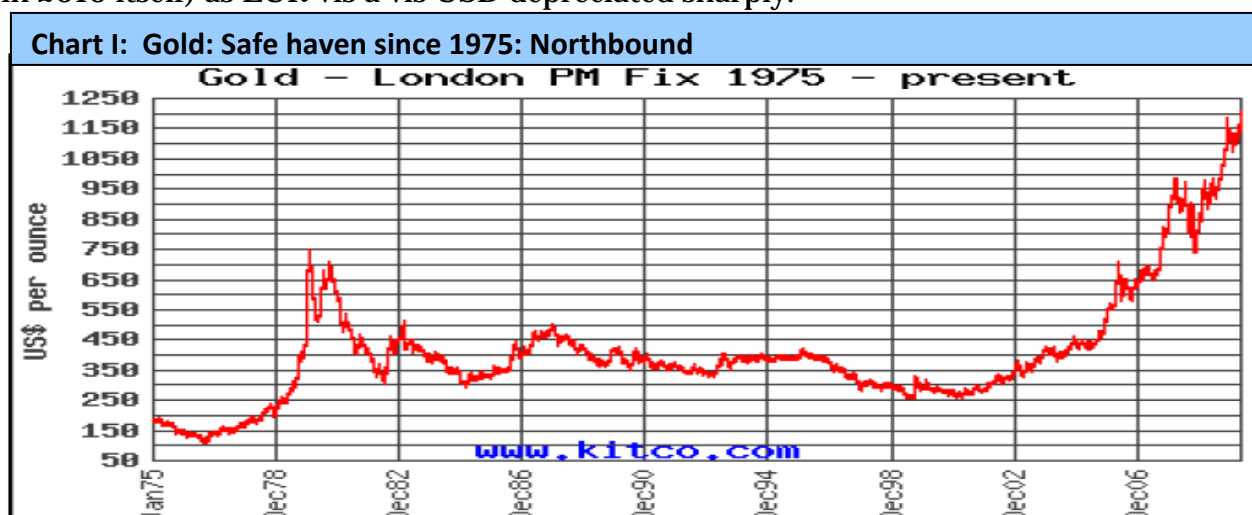
Title: GOLD: The Breakdown of Historical Co relations

Region: Global

Date: 14th May 2010

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The Gold Prices in international markets rallied to an all time highs of around USD 1240/oz. Gold prices in Indian Rupees would have been much higher than the current of about Rs 18,200 per 10 gms, if the Indian Rupee has appreciated in last one year and jewelry demand had not been a little lower. Gold in US Dollars has returned around 30% in last one year (Chart I). And Gold in EUR has returned much higher (around 28% in 2010 itself) as EUR vis a vis USD depreciated sharply.



Source : www.kitco.com

The Gold's rise is mainly attributed to the ongoing sovereign crisis in Europe and the adverse implications of the same on the global economy. As the clouds of uncertainty appear over the global skies, demand for Gold as a safe haven rises sharply.

Let's understand traditionally what role Gold plays in an investment portfolio and how its returns are historically co related to returns from other asset classes such as stocks.

- Gold is regarded as a traditional safe haven during turbulent times such as financial crisis or wars, due to its inherent attributes such as easy liquidity, unaffected by air, moisture etc.
- Gold acts as a hedge to inflation. Due to its unique characteristic of store of value, it preserves its purchasing power, which normally gets eroded due to inflation.
- Historically Gold is negatively co related with US Dollar. As USD falls gold rises and vice versa. Gold acts as a proxy currency and is often used as a hedge against the paper currency, the US Dollar. Gold is limited in supply whereas the USD can be theoretically printed (debased) in unlimited quantities by the Federal Reserve.
- Gold also acts as portfolio insurance or shock absorber, since its returns are negatively co related with returns from other traditional risky assets in the portfolio such as stocks. Risk appetite and Gold usually are negatively co related. So a risk aversion is good for Gold and higher risk appetite is negative for it.

In recent times, as the demon of sovereign risk rose in Europe, some of historical co relations of Gold with other economic variables and asset classes have broken down.

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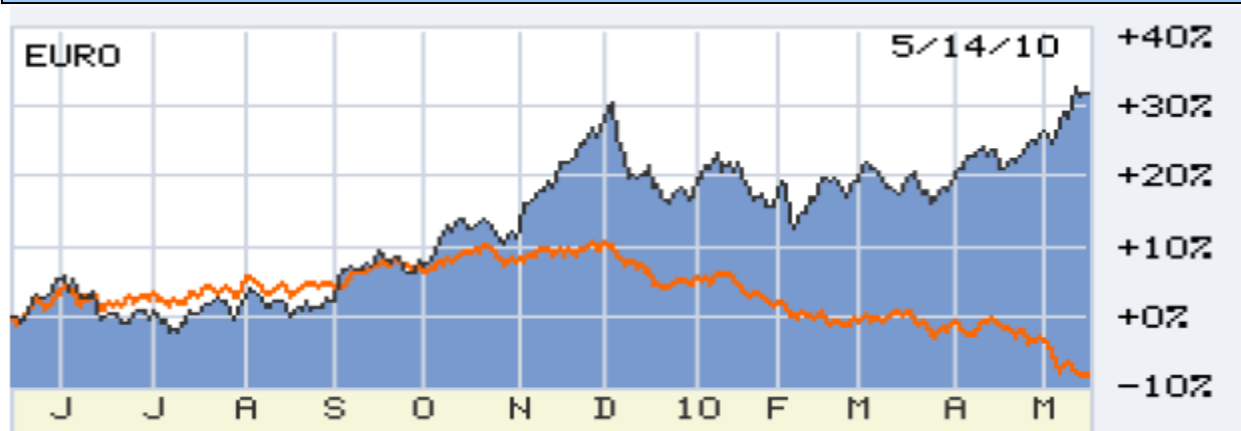
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The rise in risky assets accompanied by a rise in Gold prices have been sending contradictory signals, on the state of global economy and the global risk appetite. *Someone has to be on the wrong side.*

The USD vis a vis EUR has appreciated by almost 10% in last one year (Chart II), again a safe haven bid. Traditionally due to its negative co relation with USD, Gold should have depreciated. But in fact Gold has appreciated by more than 30% in that period. *How can both Gold and USD be safe havens at the same time?* May be a “New Normal”. Clearly the rising European sovereign risk and safe haven demand is playing an important role in driving EUR lower and Gold higher.

Chart II: The Divorce of USD and Gold Co relation.



Source : www.wsj.com. Chart Normalized. Euro-Orange line

Similarly rise in risky assets such as stocks (say US DJIA) indicates that risk aversion is low and there is no uncertainty in the US/Global economic growth or markets. And when there is no uncertainty, traditionally Gold should fall. But in last one year US DJIA index as well as Gold is higher in almost the same proportion around 30%. (Chart III).

Chart III: The Dow and Gold rising together



Source : www.wsj.com. Chart Normalized. Dow-Orange line

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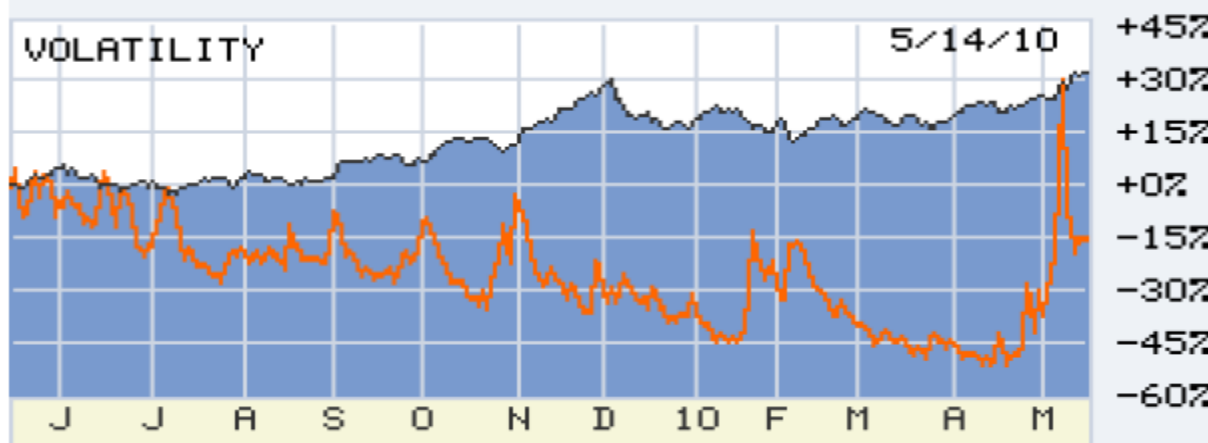
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The CBOE VIX index which is a gauge of the risk or fear in US equity markets (derived from Index Options) has fallen dramatically in last one year (except in May 2010) indicating falling or lower risk and higher risk appetite, but Gold in the same period has appreciated by around 30% (Chart IV).

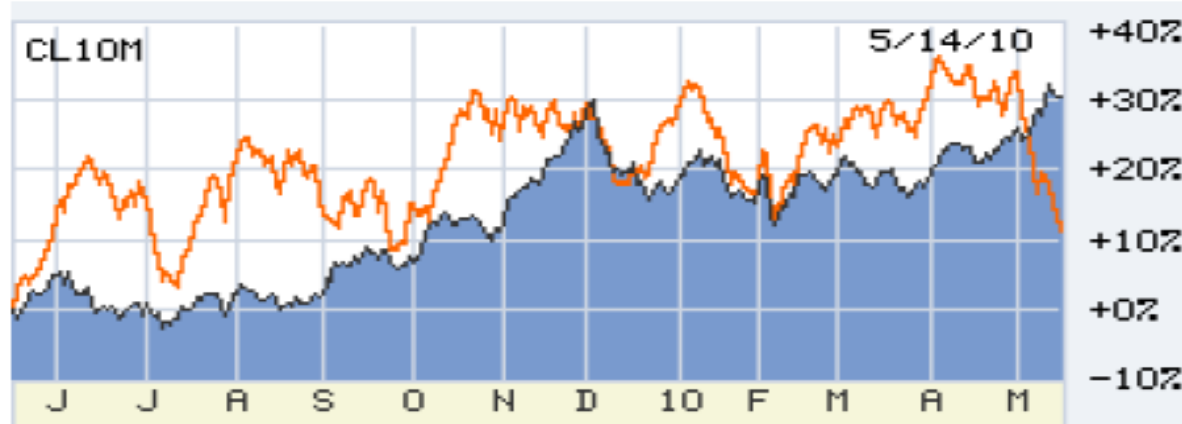
Chart IV: The VIX and GOLD : Falling Risk and Rising Gold



Source : www.wsj.com. Chart Normalized. VIX-Orange line

Similarly Gold is positively co related to inflation in US. The US inflation has not gone significantly higher in the last one year; in fact it's around 2%. Nor the inflationary expectations are rising. But Gold has rallied by 30%. Talking about inflation, it's the positive link between price of Crude oil and Gold. Rising crude oil prices are usually inflationary and Gold is an inflation hedge. Till April 2010, for the last one year, Gold and oil almost had equal returns. But as the sovereign crisis struck, crude and gold prices moved in opposite direction. (Chart IV)

Chart V: Crude Oil and Gold: Recent Divergence



Source : www.wsj.com. Chart Normalized. Crude Oil (NYMEX)-Orange line

Very often in abnormal situations like the current ongoing sovereign crisis, traditional co relations between assets break down in short term. Investors should take cognizance of it while rebalancing or hedging your portfolio. At times any one factor tends to

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become a dominant one in driving Gold prices in short term, which is now the fear of contagion and the ensuing safe haven demand. And the biggest headache for Central Banks around the world is the rise in Gold prices, since Gold competes with fiat currency issued by them. And higher Gold prices indicate that something is wrong somewhere in the financial system which is expected to be regulated by Central Banks.

But hold on to Gold to the tune of 7-10% of your portfolio, irrespective of current highs, just in case the tail risk of a full blown sovereign crisis materializes resulting in say an *EU break up or debt monetization or hyperinflation*. Gold will then prove as effective portfolio insurance. The year of 2008 is an evidence of the same. And in event of such a crisis, Indian Rupee will depreciate and add to the shine of Gold price in Rupees.

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