Debunking 5 Common Gold Misconceptions

July 2018 | By George Milling-Stanley, *Head of Gold Strategy, SPDR ETFs;* Howard Wen, *Senior Gold Strategist, SPDR ETFs;* and Diego Andrade, *Gold Strategist, SPDR ETFs*

Gold is again attracting investor interest in 2018. This interest isn't surprising — investors tend to flock to gold when uncertainty is heightened and when equity returns may be overstretched.

As we have highlighted in a number of earlier blogs, gold may be able to perform several roles within a balanced investment portfolio, including:

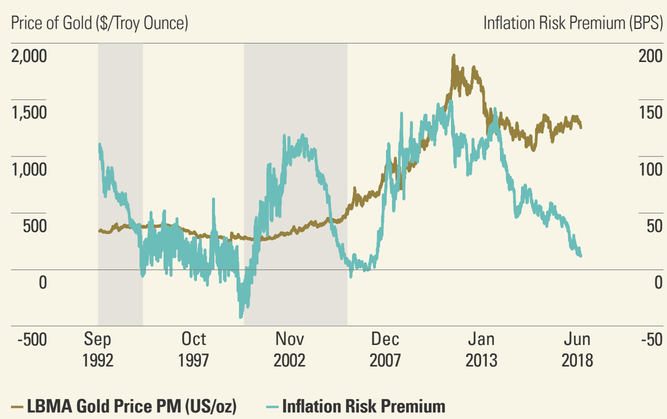
1. **Acting as a diversifier** Gold has the potential to play a diversifying role in a portfolio because it historically has not correlated strongly with other major asset classes held in a typical portfolio.[1]
2. **Reducing total portfolio risk** Including a gold allocation within a balanced portfolio may reduce its overall volatility and improve risk-adjusted returns because gold has relatively low historical correlation to many major asset classes that may help diversify a portfolio.[2] For investors who are already comfortable with a given level of risk, adding a small gold allocation may allow them to move further out along the risk spectrum in some of their other investments, and that may also improve risk-adjusted returns.
3. **Potential hedge against unexpected events** Gold has a long track record of at times holding its value or rising when other assets are falling in a differentiated manner.[3]

The potential for possibly lowering portfolio volatility with an allocation to gold is not the only reason to own gold, and we've found there are a number of outdated notions holding back investors from making a long-term allocation in gold. To tackle this issue, we've put together a list of what we perceive to be five common misconceptions about gold and what we believe to be the reality behind these common misunderstandings.

Misconception 1: Gold's Only Function is as an Inflation Hedge

Reality Although gold has historically tended to perform well during periods of high and sustained inflation that has not always been the case. The blue boxes in the chart below highlight times in the early 1990s and 2000s that gold prices did not surge even though the inflation risk premium, or the amount of extra yield investors require to protect against inflation, did increase. In other words, gold may play an important role in portfolios, but there are other drivers to its return than an increase in prices.

Figure 1: Inflation Risk Premium & Price of Gold Don't Always Move in Lockstep



Source: Bloomberg Finance L.P. & State Street Global Advisors (SSGA) Research, from September 1, 1992 to June 30, 2018.

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Misconception 2: Gold does not Pay any Interest or Produce any Income, so it has no Value

Reality There are many reasons to buy gold beyond its potential value as an investment. For instance, many people purchase gold for cultural and religious purposes.

Jewelry represents the largest source of annual demand for gold, accounting for more than 48 percent of demand for the precious metal in 2017. Within gold jewelry consumption, China and India purchased more than half of the world's gold jewelry last year, and while demand fell in both countries last year, their historical affinity for gold remains strong.[4] So, while investment demand is important for setting the price of gold, it is actually a small portion of overall demand. This highlights how gold demand is different than traditional assets and actually does not respond to business cycle changes in the same way as many other commodities.

Misconception 3: Buying or Selling by Central Banks is the Primary Driver of Gold Prices

Reality While central bank purchases and sales are an important factor in gold prices, central bank activity rarely affects more than 10% of each year's demand or supply. From 1989 to 2009, central bankers were net sellers to the private sector of about 10% of the annual gold supply; since 2010, central banks have been net purchasers of about 10% of annual demand. Meanwhile jewelry regularly accounts for around 50% or more of end-user demand, and the use of gold in industrial and technological applications accounts for up to another 10%. Investment demand has historically ranged from roughly 10% to 30% annually.

Figure 2: Gold Demand By Source

Demand (Tonnes)	2017
Fabrication	
Jewellery	2,122.0
Technology	332.8
Sub-total above fabrication	2454.8
Total bar & coin demand	1029.2
ETFs & similar products	202.8
Central bank & other inst.*	371.4
Gold demand (Fabrication Basis)	4058.2
Surplus/Deficit.**	340.2

Source: World Gold Council, Gold Demand Trends Full Year 2017, as of 2/2018.

* Excluding any delta hedging of central bank options.

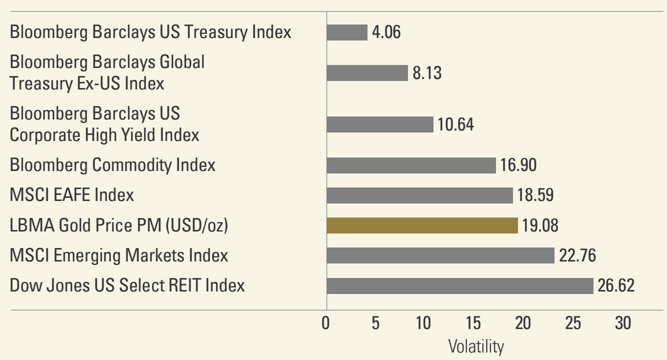
** Surplus/deficit: This is the difference between total supply and gold demand. Partly a statistical residual, this number also captures demand in the OTC market and changes to inventories on commodity exchanges, with an additional contribution from changes to fabrication inventories.

Misconception 4: Gold does not Deserve an Allocation in a Portfolio Because it is Volatile

Reality Gold actually ranks around the midrange in terms of volatility when the precious metal's price is compared with various stock and bond indices.* (See Figure 4). Moreover, if one considers that indices tend to be less volatile than their individual stock or bond components, gold's potential volatility may be less of a concern. In other words, claiming that gold might be overly volatile relative to other investments may be misguided.

* Indices representing gold, stocks and bonds in the above comparison are as follows: Gold = LBMA Gold Price PM (USD/oz); Equities = MSCI EAFE Index, MSCI EAFE Index; Bonds = Bloomberg Barclays US Treasury Index, Bloomberg Barclays US Corporate High Yield Index, Bloomberg Barclays Global Treasury Ex-US Index.

Figure 3: Gold's Volatility Historically Tends to be Lower than Certain Equities



Source: Bloomberg Finance L.P., SSGA. Data from 06/30/2008 to 06/30/2018 reflect annualized monthly averages for 120 months. Past performance is no guarantee of future results.

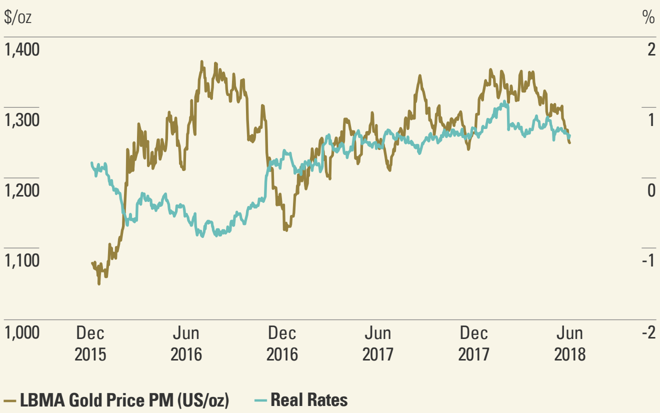
Misconception 5: A Tightening Cycle Leads to Negative Gold Prices

Reality The traditional view is that when the Fed starts raising rates the economy is growing well and countering inflation is starting to be a concern. Interest rates and inflation are often linked together due to their impact on real rates, which has historically affected gold prices. There may be short-term noise, but interest rate hikes are not necessarily negative for gold. The ten interest rate tightening cycles we analyzed since 1971, when gold effectively became free-floating, had resulted in an average increase of 37% in the price of gold[5]. In line with prior tightening cycles, gold is currently up 18% (as of June 30, 2018) from the price level we saw in December 17, 2015 when the current interest rate tightening cycle just began.

Throughout the 1970s, inflation was a huge concern that forced the Fed to raise rates aggressively in early 1980, which helped real rates stretch to 9% and average 4.50% for the entire decade.[6] Those rates along with other variables that affect the gold price played a key role in gold's poor performance during the 1980s. However, we believe the long-term trend of real rates is currently in gold's favor.

Today we are in a different macro environment than we were in the 1970s and 1980s. As figure 5 shows at the start of the current tightening cycle real rates and gold were at 0.13% and $1,049.40, respectively. After 7 rate hikes both have increased to 0.61% and $1,250.45, respectively, as of June 30, 2018. The other variables that drive the price of gold have helped the price appreciate as real rates increased, but we believe the most important thing investors need to keep in mind is that all tightening cycles behave differently and real interest rates remain at levels that have historically benefited gold prices.

Figure 4: Gold's Return has been Higher Under Low and Moderate Real Rate Regimes*



Source: Bloomberg Finance, L.P., State Street Global Advisors, as of June 30, 2018.

Past performance is not a guarantee of future results. Performance above does not reflect charges and expenses associated with the fund or brokerage commissions associated with buying and selling exchange traded funds. Performance above is not meant to represent the performance of any investment product.

** Gold Price represented by LBMA Gold Price; Real Rates represented by 10-year Treasury note yield minus US core Consumer Price Index (excluding food and energy).

The Takeaway for Investors

Today's uncertain market environment may be the ideal time for investors to rethink any of these common misconceptions about gold and the potential role gold can play in an investment portfolio.

1 Since 2000, the correlation of gold to stocks, bonds and other commodities was 0.01, 0.28, and 0.44, respectively. Source: SSGA, Bloomberg, as of 06/30/2018. Computed using monthly return data from January 2000 to June 2018. Correlation measures the degree to which the deviations of one variable from its mean are related to those of a different variable from its respective mean. Stocks represented by S&P 500 Index; Bonds represented by the Bloomberg Barclays US Aggregate Index; Commodities represented by Bloomberg Commodity Index. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income.

2 World Gold Council, An Investors Guide to the Gold Market US Edition, December 2010. As quoted in SSGA. The Case for Gold: A Strategic Asset.

3 FactSet, SSGA, from 12/31/1989 to 12/31/2013.

4 World Gold Council, "Gold Demand Trends Full Year 2017," published 02/06/2018.

5 Source: Bloomberg Financial L.P. & State Street Global Advisors, as of June 30, 2018.

6 Source: Bloomberg Financial L.P. & State Street Global Advisors, as of Date June 30, 2018.

Glossary

Bloomberg Barclays Global Treasury ex-US Index A benchmark designed to track the fixed-rate local currency sovereign debt issued by investment-grade countries outside the US. Bonds must have a remaining maturity of one year or more.

Bloomberg Barclays U.S. Corporate High Yield Bond Index The Barclays U.S. High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. The index includes both corporate and non-corporate sectors.

Bloomberg Barclays US Aggregate Bond Index A benchmark that provides a measure of the performance of the US dollar denominated investment grade bond market, which includes investment grade government bonds, investment grade corporate bonds, mortgage pass through securities, commercial mortgage backed securities and asset backed securities that are publicly for sale in the US.

Bloomberg Barclays US Treasury Index US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

Bloomberg Commodity Index A broadly diversified commodity price index distributed by Bloomberg Indexes that tracks 22 commodity futures and seven sectors. No one commodity can compose less than 2 percent or more than 15 percent of the index, and no sector can represent more than 33 percent of the index.

Consumer Prices (CPI) Consumer Prices (CPI) are a measure of prices paid by consumers for a market basket of consumer goods and services. The yearly (or monthly) growth rates represent the inflation rate.

Dow Jones US Select REIT Index A benchmark of US REITs and REIT-like securities that screens for market capitalization, liquidity and percentage of revenue derived from ownership and operation of real estate securities. It is float market cap weighted and quoted in dollars.

LBMA Gold Price The LBMA Gold Price is determined twice each business day (10:30 a.m. and 3:00 p.m. London time) by the participants in a physically settled, electronic and tradable auction administered by the IBA using a bidding process that determines the price of gold by matching buy and sell orders submitted by the participants for the applicable auction time.

MSCI EAFE Index An equities benchmark that captures large- and mid-cap representation across developed market countries around the world, excluding the US and Canada.

MSCI Emerging Markets Index The MSCI Emerging Markets Index captures large and mid-cap representation across 23 emerging markets countries. With 834 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

Standard Deviation Measures the historical dispersion of a security, fund or index around an average. Investors use standard deviation to measure expected risk or volatility, and a higher standard deviation means the security has tended to show higher volatility or price swings in the past.

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Important risk information

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Howard Wen and Diego Andrade through 7/18/2018 and are subject to change based on the market and other conditions.

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