IS GOLD BACK?

Key Points

- In 2015, the strong US dollar, driven by an improving US economy, put pressure on gold while the non-US dollar gold price held up.
- Global equity markets took a beating at the start of the year, but gold registered a positive 17% return as of end February as volatility dragged most assets lower.
- We see encouraging signs that may support the gold market this year.
- Adding a strategic allocation to gold within a diversified portfolio can offer a number of potential benefits.

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2015 REVIEW AND 2016 OUTLOOK

Strong Dollar Weighed Down on Gold

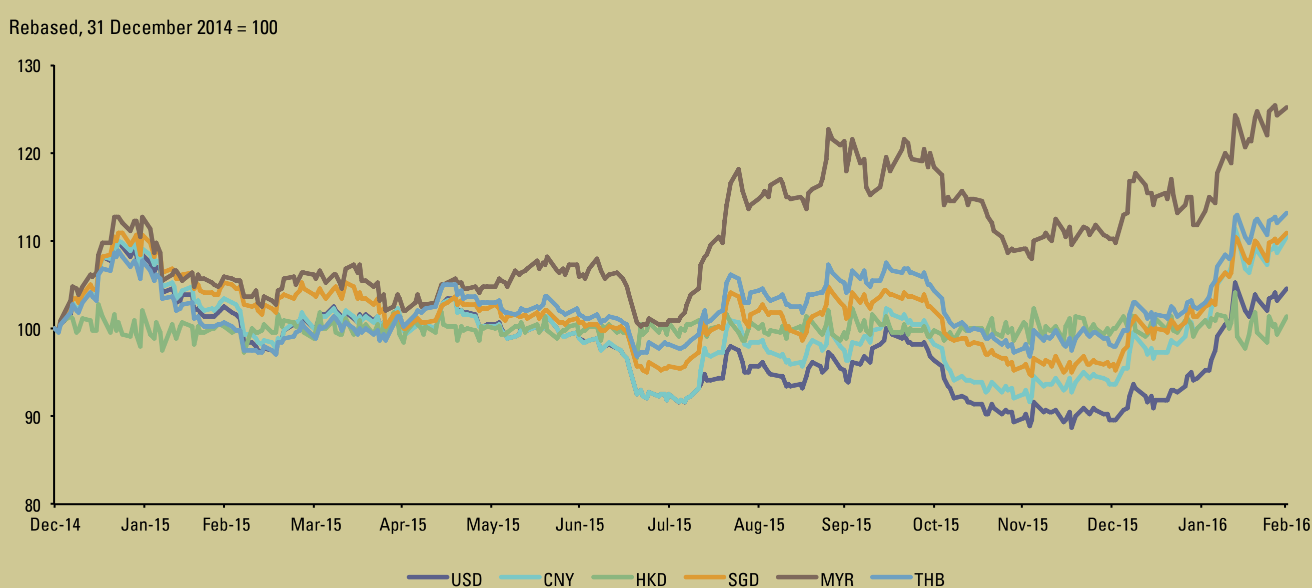
At first glance, 2015 wasn't good for gold. The strong US dollar, driven by an improving US economy, put pressure on gold. By the end of the year, gold's dollar price was down by more than 11%. Investor sentiment was bearish: average net-longs reached their lowest level since 2003 and gold-backed ETFs saw outflows of c. 100 tonnes for the year.

But Local Prices Held Up

While it was a significant driver for gold, the dollar tells only part of the story. In fact, the non-US dollar gold price held up in 2015, even moving up in some currencies. This matters a great deal: More than 90% of physical demand comes from outside the US, primarily from emerging economies, where buyers primarily use local prices for transactions. Moreover, the demand-weighted gold price (the local gold price multiplied by the percentage of annual demand a given country represents) has been, on average, 1% higher annually since the beginning of the century than the dollar gold price.

By the latter part of 2015, more positive trends emerged to set the right tone for gold in 2016. Both Indian and Chinese demand inched up in Q3 2015 from the same period in 2014. Bar and coin demand also grew (including in the US). While gold-backed ETF outflows continued, their pace has markedly slowed. In addition, central banks remained strong net buyers. Recycling continued to fall and mine production was likely to start levelling off.

Figure 1: Gold Prices in Local Currencies (per troy ounce)



Source: SSGA, Bloomberg, data as of 29 February 2016.

A Different 2016

Global equity markets took a beating at the start of the year, but gold registered a positive 17% return as of end February as volatility dragged most assets lower.

We see encouraging signs that may support the gold market this year.

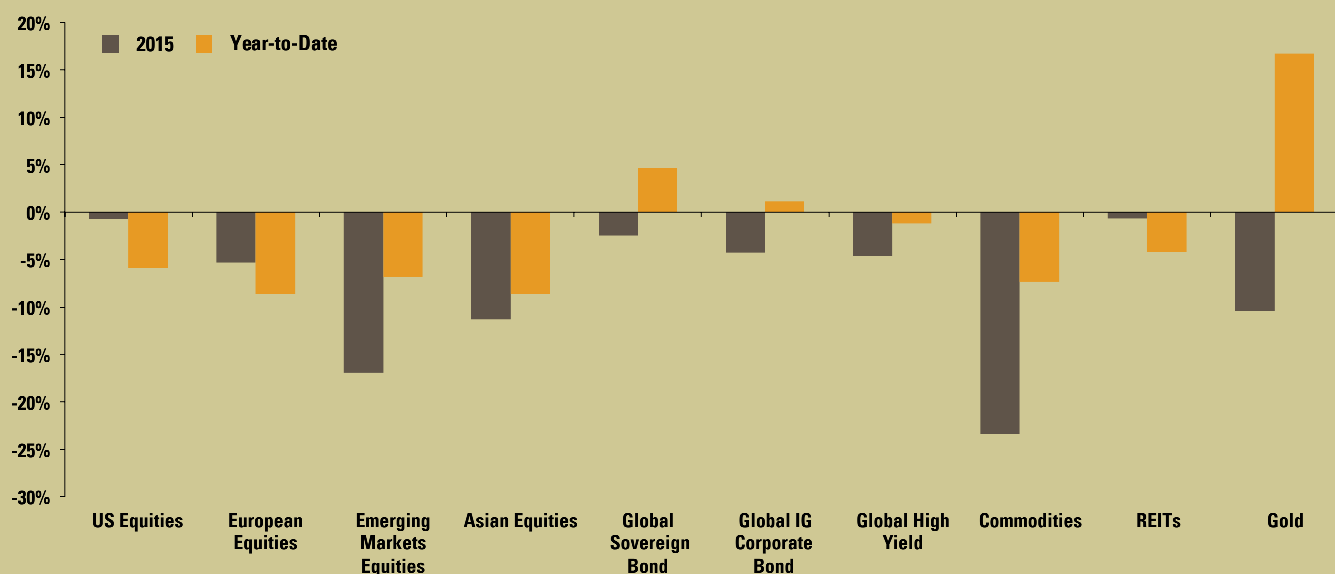
1) Rates may remain low for some time and US dollar appreciation may be slower

Interest rate increases usually hurt gold as bond yields increase and become more attractive to investors.

However, the trajectory of US rates remains uncertain after the first US rate hike in nine years in December 2015. The Fed expects to increase rates by 1% by the end of 2016. Market consensus is more dovish and expects the Fed Funds rate to be below 1% by the end of 2016. Either way, rates may remain low for some time.

Moreover, while we see room for the dollar to strengthen given the current environment and monetary policies, we believe the strength will be likely more muted this year than in 2015. A strong dollar could put the Fed normalization on hold.

Figure 2: Asset Class Performance in 2015 and Year-to-Date (in USD terms)



Source: SSGA, Bloomberg, data as of 29 February 2016.
Asset classes are represented by MSCI US Index, MSCI Europe Index, MSCI Emerging Markets Index, MSCI All Country Asia ex Japan Index, Bloomberg Global Sovereign Bond Index, Bloomberg Global IG Corporate Bond Index, Bloomberg Global High Yield Corporate Bond Index, Thomson Reuters/Core Commodity CRB Commodity Index, FTSE NAREIT Equity REITs Index and Gold Commodity.
Past performance is not a guarantee of future results. The index returns are unmanaged and do not reflect the deduction of any fees or expenses.

2) The Asian gold market continues to grow

In China, the People's Bank of China has continued to add to its gold reserves last year and the Shanghai Gold Exchange plans to introduce a yuan-denominated trading mechanism. In India, the Bombay Stock Exchange and the India Bullion and Jewellers Association have signed an agreement in December 2015 to establish the country's first physical gold exchange. These developments bode well for the gold market in Asia.

3) Market uncertainty fuels flight to safety

Our outlook for the global economy in 2016 is for continued low growth. We continue to see the risks skewed to the downside, likely fueling bouts of investor uncertainty and market volatility. Concerns about a weakening Chinese economy and yuan devaluation have weighed on the market. In such an environment, gold's role as a portfolio diversifier and tail risk hedge cannot be overlooked.

Figure 3: What Drives Gold?

Key factor driving gold		Example	Potential impact on gold price
Systematic and tail risks	↑	Stock market crashes, geopolitical and tensions, war	↑
Interest rates	↑	Higher opportunity cost for holding gold	↓
Inflation	↑	Higher inflation expectations tend to drive gold higher (as a 'store of value')	↑
Consumer spending and income growth	↑	Stronger growth tends to lead to increase in demand for jewelry, tech applications	↑
Currencies	↑	Tends to have a negative correlation to the US dollar and has been a 'store of value'	↓
Short-term investor flows	↑	Short-term flows/demand can drive sentiment towards gold ('momentum trades')	↑
Supply-side drivers	↑	Increase in gold production and recycled gold	↓

Source: World Gold Council.

Through Bulls and Bears: Gold's 45-year Performance

Since the 1970s gold has experienced five bull markets and five subsequent bear markets. Previous bear markets (excluding the current one) have had a median length of 52 months, during which the price of gold declined between 35% and 55%. Each of those declines was generally a fraction of the gains seen in the preceding bull run. The current pullback is not far off the median bear cycle.

Bull market			Bear market		
Dates	Length (months)	Cumulative return	Dates	Length (months)	Cumulative return
Jan 1970 - Jan 1975	61	451.4%	Jan 1975 - Sep 1976	20	-46.4%
Oct 1976 - Feb 1980	41	721.3%	Feb 1980 - Mar 1985	61	-55.9%
Mar 1985 - Dec 1987	33	75.8%	Dec 1987 - Mar 1993	63	-34.7%
Apr 1993 - Feb 1996	35	27.2%	Feb 1996 - Sep 1999	43	-39.1%
Oct 1999 - Sep 2011	144	649.6%	Sep 2011 - Present	52	-44.1%
Average	63	385.1%	Average†	47	-44.0%
Median	41	451.4%	Median†	52	-42.7%

*We are defining a bull market as a period where the US dollar gold prices rose for at least two consecutive years and bear markets as the subsequent periods where the price generally fell for sustained time.

† Excludes the period from September 2011 to date.

Source: Bloomberg, ICE Benchmark Administration Ltd, World Gold Council, data as of 31 December 2015.

HOW GOLD CAN HELP YOUR PORTFOLIO

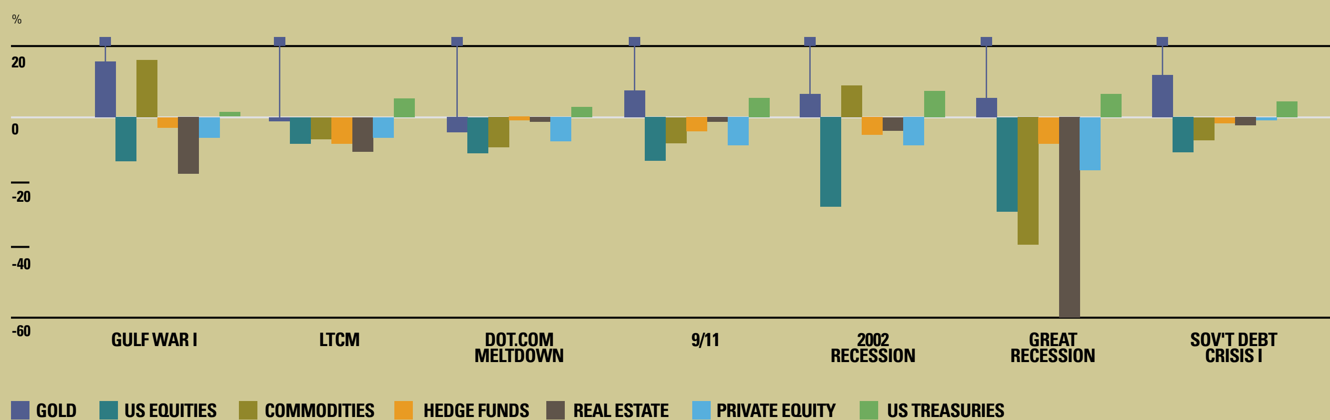
Over the long run, holding 2% to 10% of an investors' portfolio in gold can improve portfolio performance, according to research cited by the World Gold Council.[1] Adding a strategic allocation to gold within a diversified portfolio can offer a number of potential benefits.

Gold as a strategic hedge in tumultuous times

Turbulent and choppy markets present investors with an opportunity to reevaluate the strategic role gold may play in a portfolio. The chart below demonstrates how gold has performed during tumultuous times, including the Gulf War, the demise of the bond-trading hedge fund, Long Term Capital Management (LTCM) in the late 1990s, and the global financial crisis.

In five out of seven of the events captured, gold ranked as either the best performing or second-best performing asset class. By delivering competitive returns during a number of historically challenging times in the market, gold has provided investors with a means of moderating the market's volatility.

Figure 4: Gold as a Strategic Hedge in Tumultuous Times



Source: Factset, SSGA, from 1January 1979 to 31 December 2013. Notes: Persian Gulf War I: Q3 1990, LTCM: Q3 1998, Dot-com meltdown: Q1 2001, 9/11: Q3 2001, 2002 Recession: Q2/Q3 2002, US Credit Crisis: Q4 2008/Q1 2009, European sovereign debt crisis: Q2 2010. Past performance is no guarantee of future results. Gold is represented by the spot price of gold.

[1] Source: J.P. Morgan, Gold in asset allocation, July 2012; Mercer, Gold as an asset class for institutional investors, February 2011, New Frontier Advisors and World Gold Council, Gold as a strategic asset, September 2006; New Frontier Advisors, Gold as a strategic asset for European investors, December 2011; Oxford Economics, The impact of inflation and deflation in the case for gold, July 2011; Matos, P. and R. Evans, Gold as a portfolio diversifier: the World Gold Council and investing in gold, Darden Business Publishing, University of Virginia, September 2012.

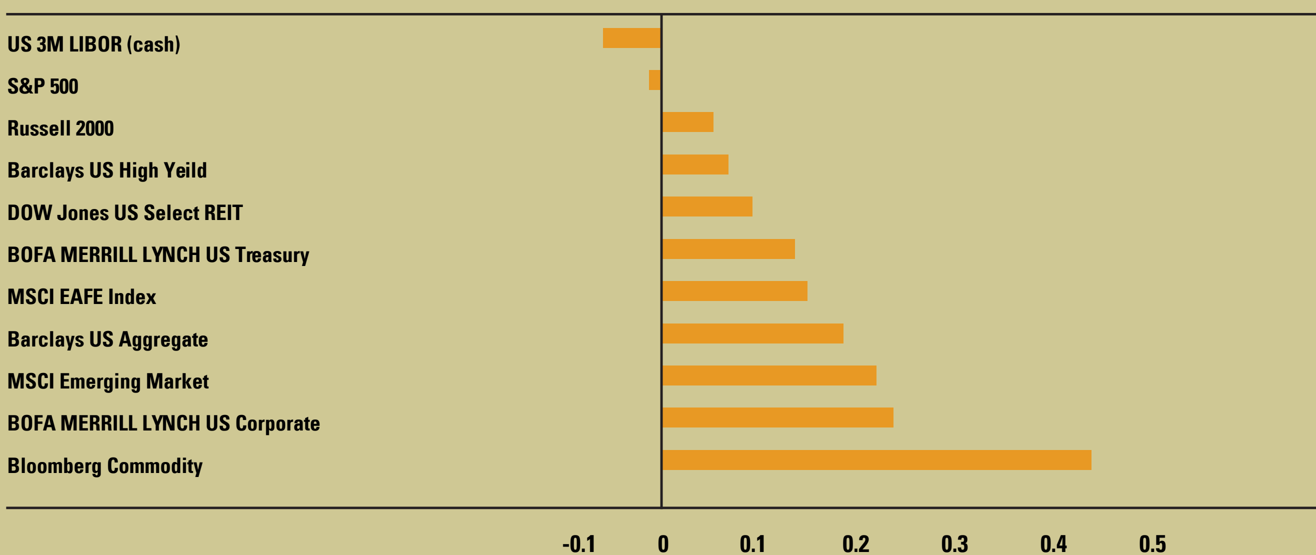
Gold as a portfolio diversifier

The chart below illustrates gold's low correlation to a wide range of asset classes, including other commodities. Adding a separate standalone allocation to gold has the potential to improve the overall diversification of a portfolio.

Gold helps preserve purchasing power

Gold responds to global markets, and consequently global inflation, thus covering a broader set of circumstances than consumer price index (CPI) hedges like Treasury Inflation Protected Securities (TIPS). Gold's negative correlation to the US dollar and many other major currencies protects investors from currency depreciation.

Figure 5: Gold's Low Correlation to Other Asset Classes



Source: SSGA, Bloomberg, as of 31 December 2015. Computed using monthly return data from December 1990 to December 2015. The correlation coefficient measures the strength and direction of a linear relationship between two variables. It 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. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss ans the reinvestment of dividends and other income. Diversification does not ensure a profit or guarantee against loss.

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