Gold mid-year outlook 2020
Recovery paths and impact on performance

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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Investors have embraced gold in 2020 as a key portfolio hedging strategy. Looking ahead, expectations for a faster recovery (V-shaped) from COVID-19 are shifting towards slower recovery (U-shaped), or potential setbacks from additional waves of infections (W-shaped). Regardless of the recovery type, the pandemic will likely have a lasting effect on asset allocation. It will also continue to reinforce the role of gold as a strategic asset. And we believe that the combination of high risk, low opportunity cost and positive price momentum looks set to support gold investment and offset weakness in consumption from an economic contraction.

Gold outperformed in H1 as equities recovered

Gold had a remarkable performance in the first half of 2020, increasing by 16.8% in US-dollar terms and significantly outperforming all other major asset classes (**Chart 1**). By the end of June, the LBMA Gold Price PM was trading close to US$1,770/oz, a level not seen since 2012, and reaching record or near-record highs in all other major currencies (**Table 1**). Though equity markets around the world rebounded sharply from their Q1 lows, the high level of uncertainty surrounding the COVID-19 pandemic and the ultra-low interest rate environment supported strong flight-to-quality flows. Like money market and high-quality bond funds, gold benefited from investors' need to reduce risk, with the recognition of gold as a hedge further underscored by the record inflows seen in gold-backed ETFs.

Economic recovery may come in various shapes

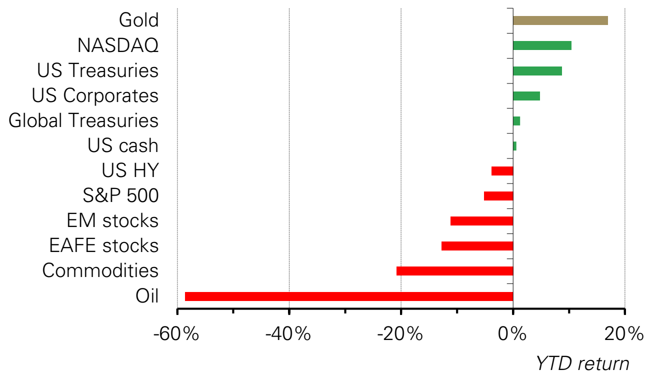
The COVID-19 pandemic is having a devastating effect on the global economy. The IMF is currently projecting a 4.9% contraction in global growth in 2020, with high levels of unemployment and wealth destruction.

There is a growing consensus that a swift V-shaped recovery is morphing into a slower U-shape recovery or, more likely, the possibility that a recovery in H2 is short lived as recurring waves of infections set the global economy back, resulting in W-shaped recovery.

For investors, this is not only keeping uncertainty levels high, but may also have a long-lasting impact on their portfolio performance. Against this backdrop, we believe that gold can be a valuable asset: it can help investors diversify risks and may positively contribute to improving risk-adjusted returns.

Chart 1: Gold outperformed all major assets in H1

Y-t-d performance of major global assets*



*As of 30 June 2020. Returns based on the LBMA Gold Price PM, Nasdaq Composite, Bloomberg Barclays US Treasury Index and Global Treasury Index ex US, ICE BAML US 3-month T-bill Index, Bloomberg Barclays US Corporate and High Yield Indices, MSCI EM Index, Bloomberg Commodity TR Index, MSCI EAFE Index, S&P 500 Indices, and Bloomberg Oil TR Index.

Source: Bloomberg, ICE Benchmark Administration, World Gold Council

Table 1: The gold price is near or above record high across key currencies

Gold price and y-t-d return in key currencies*

	USD (oz)	EUR (oz)	JPY (g)	GBP (oz)	CAD (oz)	CHF (oz)	INR (10g)	RMB (g)	TRY (oz)	RUB (g)	ZAR (g)	AUD (oz)
Y-t-d return	16.7%	16.7%	15.9%	25.1%	22.6%	14.2%	23.5%	18.5%	34.5%	33.9%	45.0%	19.2%
Current price	1,768	1,574	6,133	1,431	2,408	1,675	42,921	402	12,120	4,051	988	2,568
Record high†	1,895	**1,604**	6,538	**1,444**	**2,443**	**1,688**	**43,069**	**403**	**12,178**	**4,184**	**1,060**	**2,741**
Date†	9/5/11	**5/15/20**	1/21/80	**6/29/20**	**4/16/20**	**5/19/20**	**6/22/20**	**6/29/20**	**5/7/20**	**4/22/20**	**4/23/20**	**4/16/20**

*As of 30 June 2020. Based on the LBMA Gold Price PM in local currencies: US dollar (USD), euro (EUR), Japanese yen (JPY), Pound sterling (GBP), Canadian dollar (CAD), Swiss franc (CHF), Indian rupee (INR), Chinese yuan (RMB), Turkish lira (TRY), Russian ruble (RUB), South African rand (ZAR), and Australian dollar (AUD).

†Prices and dates in bold correspond to record highs occurring during H1 2020.

Source: Bloomberg, ICE Benchmark Administration, World Gold Council

COVID-19 is upending asset allocation

In response to the pandemic, central banks around the world have aggressively cut rates and/or expanded asset purchasing programmes to stabilise and stimulate their economies. However, these actions are leading to several unintended consequences on asset performance:

- soaring equity market valuations are not always backed by fundamentals, increasing the chance of pullbacks
- corporate bond prices are also increasing, pushing investors further down the credit-quality curve.
- short-term and high-quality bonds have limited – if any – upside, reducing their effectiveness as hedges.

In addition, widespread fiscal stimuli and ballooning government debt levels are raising concerns about a long-term run up of inflation, or significant erosion of the value of fiat currencies. Deflation, however, is seen by some as the more likely risk in the near term.

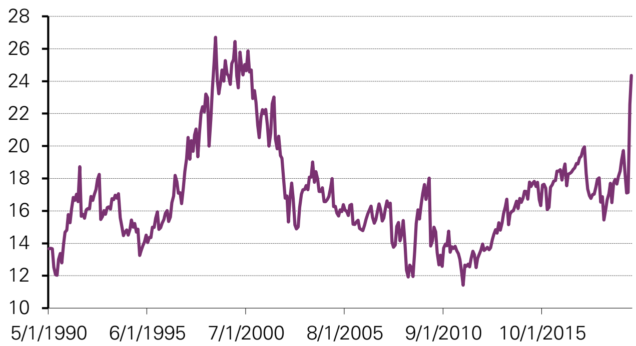
As these dynamics heighten risk and lead to the possibility of ever lower returns than expected, we believe that gold can play an increasingly relevant role in investor portfolios.

Equities are getting (very) expensive and could see sharp pullbacks

Global equities were on a virtually uninterrupted one-way trend for more than a decade. The COVID-19 pandemic changed that, resulting in a significant pullback, with all major equity indices dropping by more than 30% during the first quarter. However, equities have recovered sharply since – especially tech stocks. But stock prices do not appear fully supported by company fundamentals or the overall state of the economy.

This has often been referred to as the Wall Street vs. Main Street divide. In the US, for example, price-to-earnings ratios have jumped to levels not seen since the dot-com bubble in the span of a few months (**Chart 2**).

Chart 2: Valuations are near dot-com bubble levels*



*As of 30 June 2020. Based on S&P 500 price to earnings ratio.

Source: Bloomberg, World Gold Council

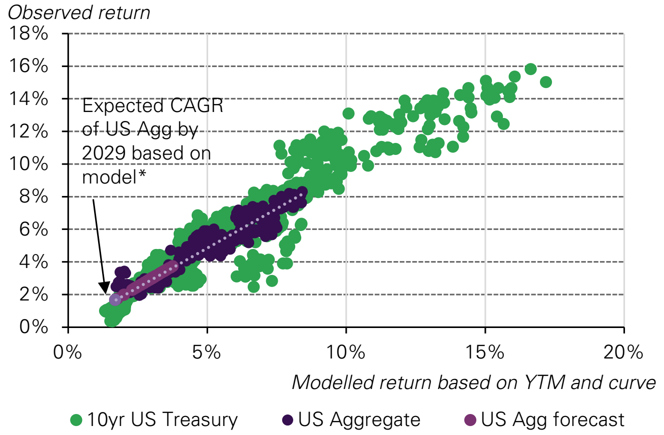
And while many investors are looking to take advantage of the positive price trend, there is growing concern that such frothy valuations may result in a significant pullback, especially if the economy experiences a setback from a second wave of infections. Gold's effectiveness as a hedge may help mitigate risks associated with equity volatility.

Bonds may offer only limited protection

The low rate environment has also pushed investors to increase the level of risk in their portfolios via buying longer-term bonds, lower-quality bonds, or simply replacing bonds with even riskier assets, such as stocks or alternative investments.

Going forward, we do not believe investors will achieve the same bond returns they have seen over the past few decades. Our analysis suggests that investors may see an average compounded annual return of less than 2% (±1%) in US bonds over the next decade (**Chart 3**). This could prove particularly challenging for pension funds, as many are still required to deliver annual returns between 7% and 9%. Lower rates increase pressure on the ability to match their liabilities and limit the effectiveness of bonds in reducing risk. In this context, investors may consider gold as a viable substitute for part of their bond exposure.

Chart 3: Current yields and the steepness of the bond curve are good indicators of future returns*



*10-year US Treasury data from January 1920 to June 2020; Bloomberg Barclays US Aggregate (US Agg) data from January 1992 and June 2020 due to availability. Expected hypothetical returns are based on a log-linear regression using monthly data for the US Agg. The explanatory variables are yield to maturity (y-t-m) of the US Agg and the steepness of curve (based on the difference in yields between the 7-10 year and 1-3 year US Agg sub-indices), while the response variable is the observed compounded return *m* years forward, where *m* represents the corresponding maturity of the US Agg at the time where the y-t-m is measured. The model's R-squared is 82% and has a standard error of ~0.6%.

Source: Barclays Capital, Bloomberg, Federal Reserve, World Gold Council

Stagflation, disinflation, deflation?

While it is fairly evident that lower interest rates and asset purchasing programs are impacting asset price valuations, it is less clear what effect expansionary monetary and fiscal policies will have on inflation. Some believe that quantitative easing and increasing debt levels are inherently inflationary and that, sooner or later, consumer prices will spiral out of control even if economic growth remains subdued (ie, stagflation). Others, however, point out that previous – albeit not as aggressive – quantitative easing measures have not resulted in rampant inflation (at least not yet).

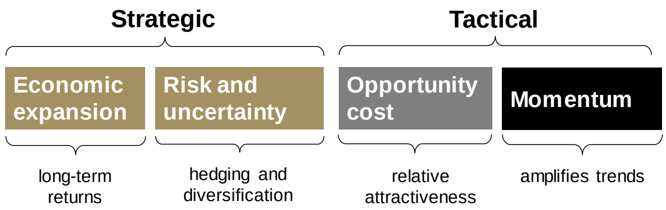
An additional camp points to the Japanese experience and predicts that deflation may happen first. In fact, there are some indications that this is starting to happen already. For example, while the price of necessities spiked during the lockdown in China, consumer price inflation has fallen from 5.2% in February to 2.5% in June. And some economists predict outright deflation by the end of the year.

Gold has historically protected investors against extreme inflation. In years when inflation was higher than 3% gold's price increased 15% on average. Notably too, research by Oxford Economics shows that gold should do well in periods of deflation. Such periods are characterised by low interest rates and high financial stress, all of which tend to foster demand for gold.

Gold investment will likely offset weak consumption

Gold's behaviour can be explained by four broad sets of drivers:

- **Economic expansion:** periods of growth are very supportive of jewellery, technology and long-term savings
- **Risk and uncertainty:** market downturns often boost investment demand for gold as a safe haven
- **Opportunity cost:** interest rates and relative currency strength influence investor attitudes towards gold
- **Momentum:** capital flows, positioning and price trends can ignite or dampen gold's performance.



In the current global economic environment, three of the four drivers are supportive of investment demand for gold, namely:

- high risk and uncertainty
- low opportunity cost
- positive price momentum.

Conversely, an economic contraction will likely result in lower demand for gold in the form of jewellery, technology or long-term savings. This is particularly evident in key gold markets such as China or India (**Focus 1**).

Historically, investment demand during periods of financial stress has offset weakness in consumer demand and we believe that 2020 will be no exception. However, gold's performance may depend on the speed and shape of the recovery, which investors can analyse using Qaurum[SM] (**Focus 2**).

Focus 1: Regional insights

China

The Chinese economy has witnessed a gradual rebound over the past few months. With COVID-19 cases dropping, 90% of companies have resumed operations; industrial output picked up steam, after reaching historical lows in February, as fiscal and monetary policies underpinned the recovery.

For the second half of the year, China is aiming to accelerate the growth in money supply (M2) and aggregate financing through a variety of tools including cuts to the reserve requirement ratio and benchmark policy rate. Historically, gold's investment demand has benefited from a low rate environment as the opportunity cost to hold gold has been significantly reduced. With the money supply rapidly rising, gold's role as a hedge against currency depreciation could be more relevant for investors. And while cautious discretionary consumption may continue to hinder gold jewellery sales, especially if combined with higher prices, an economic recovery may alleviate some of these headwinds.

India

The Indian economy slowed to an 11-year low of 3.1% in Q1 2020. In order to stimulate the economy amid the COVID-19 outbreak, the Reserve Bank of India (RBI) cut interest rates by a cumulative 115bps in H1 2020 and the central government, along with RBI, provided an economic package of Rs 20.97tn (US$278bn).

In H2, we expect consumer demand to remain soft due to reduced economic activity, concerns about increasing unemployment, and income erosion. However, additional economic packages from the government and a forecasted positive monsoon season could help soften the negative impact of an economic deceleration. Additionally, we expect investors to turn to gold as a means of hedging as we have seen in the first half of this year.

Focus 2: Qaurum^{SM} – Your gateway to understanding gold performance

Qaurum is a web-based quantitative tool that helps investors intuitively understand the drivers of gold performance.

Behind its user-friendly interface, Qaurum is powered by the Gold Valuation Framework (GVF). An academically validated methodology, GVF is based on the principle that the price of gold and its performance can be explained by the interaction of demand and supply.

Accessible from Goldhub.com, the World Gold Council's data and research site, Qaurum allows investors to assess how gold might react across different economic environments in three easy steps:

- select a hypothetical macroeconomic scenario provided by Oxford Economics, a leader in global forecasting and quantitative analysis, or customise your own
- generate forecasts of demand and supply, and view the impact of key macro drivers
- calculate and visualise implied returns for gold.

Based on these, investors can use Qaurum to calculate the hypothetical performance of gold over the next five years as well as long-term 30-year returns implied by GVF and the available (or user-constructed) scenarios.

Additional details on GVF methodology can be found at Goldhub.com.

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