UBS ETF Market Matters

Investing in Gold

Key highlights:

- The gold price has surged 25% in H1 2016, supported by strong ETF inflows, amidst challenging and volatile markets. The H1 rally constituted gold's best performance since 2007.
- Gold has experienced strong investment demand year-to-date. In Q1, inflows into gold ETFs were near record-levels (330 tonnes) and this trend continues.
- We outline key factors influencing gold price developments. Market uncertainty associated with the unfolding Brexit process appears to be the main short-term driver, together with monetary decisions of major central banks.
- For investors considering gold exposure in these uncertain times, we demonstrate that gold has historically played a hedging role against equity market downside.

Recent developments

Gold has experienced its second best half-year since 2007, outperforming major stock and bond indices, as shown in Figures 1 and 2. The vote for Brexit resulted in a gold price jump of 5% over two days, which together with the preceding Q1 rally adds up to a 25% appreciation year-to-date. Gold has thus recouped some of the ground lost in previous years although the current price remains well below the highs of USD 1900/oz seen during August-September 2011 (around the EMU and Greek sovereign crisis).

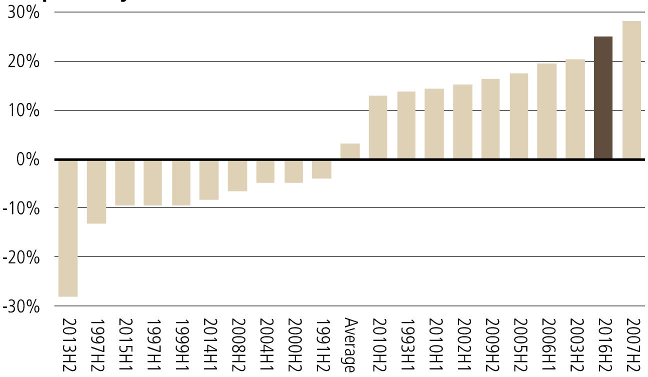
The figures on supply and demand in the gold market published by Thomson Reuters[1] demonstrate that much of the year-to-date appreciation is due to strong investment demand. Gold ETF inflows amounted to 330 tonnes in Q1 2016 compared to an average quarterly outflow of 35 tonnes over the previous two years. These inflows constituted almost 30% of global demand, whilst physical gold demand (for jewellery and industrial applications) was at its lowest level since 2009. In particular, year-on-year jewellery demand contracted by 31%, from 558 to 385 tonnes, due to a weaker appetite from China and India.

Drivers of performance

Gold has been supported in H1 2016 by financial market uncertainty as it is an asset considered to provide insurance against market turmoil (downside). Moreover, the opportunity cost of such insurance, given by real-interest rates, has been at very low levels. This can be seen in Figure 3 depicting a clear inverse relationship between the gold price and the rate on Treasury Inflation Protected Securities (TIPS).

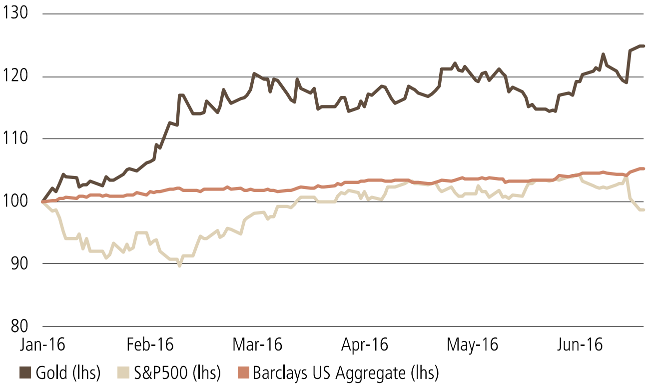
1 Similar conclusions can be reached based on statistics from the World Gold Council. While the reports refer to Q1 2016, UBS internal analysis confirms that this trend holds year-to-date as of June 28, in particular after the Brexit vote. "GFMS Gold Survey 2016", Thomson Reuters, April 2016; "Gold Demand Trends: First quarter 2016", World Gold Council, May 2016.

Figure 1: Top 10 highest and lowest quarterly gold returns over the past 25 years



Source: Bloomberg, UBS Asset Management, data as of June 28, 2016.

Figure 2: Performance of gold, equity and bond markets
Daily data in USD, total return net, rescaled to 100 on Jan 1, 2016



Source: Bloomberg, UBS Asset Management, data as of June 28, 2016.

Figure 3: Gold price vs 10 year TIPS rate
Daily data in USD, TIPS rate rescaled to 100 on June 1, 2006

Source: Bloomberg, UBS Asset Management, data as of June 28, 2016.

The economic developments driving the gold rally year-to-date include the following[2]:

- The vote for Brexit resulting in substantial short-term market volatility and longer-term uncertainty about the UK-EU exit negotiations
- Dovish Federal Reserve
- Deepening expectations of negative real interest rates in the US
- Indications of further quantitative easing commitments in Europe and Japan
- Stock market selloff and increased volatility in January and February, together with the tightening of credit markets
- Heightened concerns of a hard landing and credit crunch in China

As of end-June, markets have just been rattled by the British vote to exit the EU, further boosting demand for and price of gold. Looking forward, the bullion's performance will largely depend on how the UK-EU negotiations unfold and their impact on Europe's economic and political stability. Supportive of gold, the US and Euro real interest rates remain at historical lows, and central banks have indicated readiness to ease more if necessary.[3] Monetary policy thus continues to be an important driver of the gold price. Following the UK referendum and poor US labour data, the UBS view on Fed decisions has been updated to expect one rate hike this year.[4]

2 For a UBS publication on the topic, see e.g. "Precious metals: Gold awaits the next trigger", UBS Chief Investment Office WM, May 17, 2016
3 "Risk Radar Special: UK referendum & related investment ideas", UBS Chief Investment Office WM; "UBS House View", Monthly Extended May 2016, UBS Chief Investment Office WM, April 28, 2016
4 "Precious Metals: Watching gold closely", UBS Chief Investment Office WM, June 16, 2016; "Precious Metals: Gold's insurance qualities pay off", UBS Chief Investment Office WM, June 27, 2016

Gold as a portfolio diversifier?

With a substantial increase in market volatility year-to-date, many investors are looking for protection against the downside by adding portfolio diversifiers. Since gold is often claimed to be a good diversifier, we analyse what value it can bring to a portfolio along this dimension.

Figure 4 illustrates the performance of gold as well as several equity and bond benchmarks in the return-volatility space. Gold has provided an annual return of 9.0% with a volatility of 19.5% over the last decade. Such a volatility level is only marginally lower compared to S&P500 and at a similar level to the Swiss SMI Index. Some argue that it implies gold is no longer a safe-haven asset and might add risk to a portfolio. However, Figure 5 illustrates a strong inverse relationship between the realized 5-year Sharpe ratio on a gold investment vs. S&P500 based on long-term historical data. This is evidence that gold has indeed historically been a robust hedge against market downside, despite having exhibited substantial volatility.

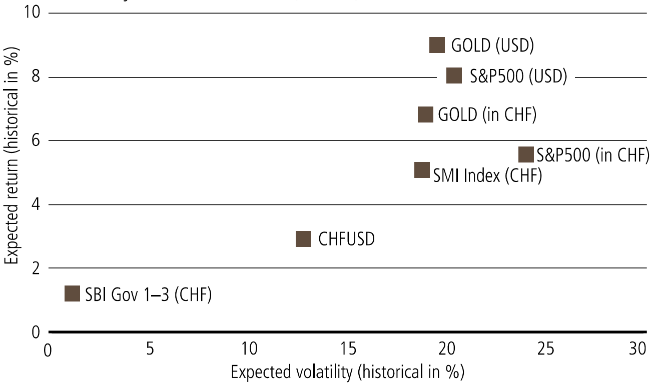
Table 1 sheds more light on properties of gold as a hedging instrument for a stylized portfolio. We consider a simple allocation maintaining constant proportions in the S&P 500 and gold from a 40 year perspective. We can see that a gold allocation of between 10 to 40% reduces portfolio risk even though gold itself has higher volatility than the S&P 500 over this period (respectively 19.3% vs 14.9%). The reduced risk of the combined equity and gold portfolio results from the negative correlation, i.e. in cases of market stress, gold typically appreciates, while equity prices decline.

What about currency hedging?

Figure 4 also shows that Gold (USD) had the highest returns of the assets considered, including the S&P500, over the past decade. As expected, short-term bond indices offer the lowest returns at 1.2%, while the SMI index (CHF) has experienced only moderate annualized returns in the range of 5.1%.

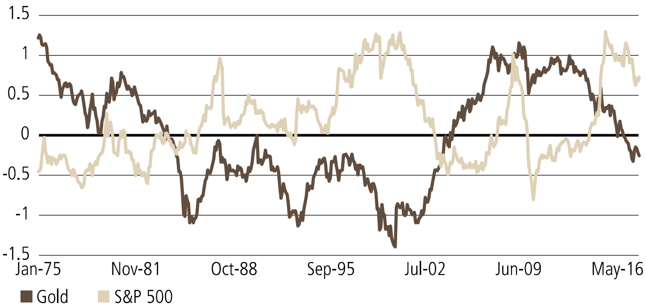
To illustrate the importance of currency hedging, we present gold and S&P500 performance in both USD and CHF (unhedged). Returns in the USD are higher due to pronounced movements of the CHF-USD currency pair: a 2.9% return with a standard deviation of 12.8%. CHF investors may therefore want to consider embedded currency hedging when buying gold exposure. Currency hedging for gold is has been more important than for S&P 500, since both gold and Swiss franc are safe haven assets exhibiting positive correlation.

Figure 4: Historical average returns and volatilities of gold and major equity and bond indices
Based on daily data since June 1, 2006, total return net



Source: Bloomberg, UBS Asset Management, data as of June 28, 2016.

Figure 5: 5-year rolling Sharpe ratios: gold and S&P 500
Monthly data in USD since January 1975



Source: Bloomberg, UBS Asset Management, data as of June 28, 2016.

Table 1. Historical average returns and standard deviations on portfolios invested in S&P500 and gold in constant proportions with monthly rebalancing.
Monthly USD returns in percentages since January 1975

		100/0 EQ/Gold	90/10 EQ/Gold	80/20 EQ/Gold	70/30 EQ/Gold	60/40 EQ/Gold	50/50 EQ/Gold	0/100 EQ/Gold
1975–	Ann. Ret.	9.14	8.88	8.62	8.35	8.09	7.83	6.51
2016	Ann. Vol.	14.91	13.57	12.56	11.97	11.86	12.24	19.29
1996–	Ann. Ret.	7.65	7.50	7.35	7.20	7.05	6.90	6.16
2006	Ann. Vol.	15.63	14.08	12.71	11.59	10.79	10.39	14.41
2006–	Ann. Ret.	6.20	6.39	6.58	6.77	6.96	7.16	8.11
2016	Ann. Vol.	15.25	13.92	12.93	12.34	12.22	12.59	19.56

Source: Bloomberg, UBS Asset Management, data as of June 28, 2016.

Past performance is not indicative of possible future returns.

Interested in gold?

Expand your portfolio with UBS ETFs:

Fund name	Fee	AuM (CHFm)	NAV Ccy	Replication	Distribution	ISIN	Bloomberg
UBS ETF (CH) Gold	0.23%	448	USD	Physical	No	CH0106027193	AUUSI SW
UBS ETF (CH) Gold hedged CHF	0.23%	928	CHF	Physical	No	CH0106027128	AUCHAH SW
UBS ETF (CH) Gold hedged EUR	0.23%	128	EUR	Physical	No	CH0106027144	AUEUAH SW

Source: UBS Asset Management, data as of 29 June 2016

About UBS ETFs

Index-tracking investment solutions have been a core competence of UBS Asset Management for over 30 years. As a leading fund house in Europe, UBS launched its first ETF in Europe in 2001 and is currently both one of Europe´s foremost providers as well as a dominant force in currency hedged ETFs in the region. The range comprises more than 200 ETFs and offers investors a transparent and flexible opportunity to diversify their investments across key markets and all asset classes, including equities, bonds, real estate, commodities and alternative investments. UBS ETFs are listed on the following stock exchanges around the world – SIX Swiss Exchange, Borsa Italiana, London Stock Exchange, Deutsche Börse XETRA, Euronext Amsterdam, Australian Securities Exchange ASX, KRX Korea Exchange and Tokyo Stock Exchange.

For more information on UBS ETFs: **www.ubs.com/etf**

Hotline: 044-234 34 99

Bloomberg: UETF <Go>

E-mail: ubs-etf@ubs.com

Website: www.ubs.com/etf

UBS