Gold-just another commodity or a unique asset class?

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I. Introduction

Periods of financial turmoil are generally associated with reduced financial liquidity and an erosion of risk appetite of investors. The emergence and rapid spread of Coronavirus (COVID-19) globally in 2020, triggering a health crisis worldwide, brought back the memories of the global financial crisis of 2007-08. Uncertainties surrounding its progression, severity and impact engendered significant volatility in the global financial and macroeconomic conditions. Financial and commodity markets witnessed major disruptions while global trade and supply chains suffered major challenges and setback on account of the pandemic. A majority of the commodity prices fell year-on-year, with crude oil prices witnessing an unprecedented contraction since 1960s. Prices of industrial metals moderated owing to a weakening of industrial activities. However, gold glittered with its prices surging as investors rushed for flight to safety and liquidity through safe-haven assets amid heightened uncertainty. In other words, this implies that the pandemic weighed on the risk appetite of investors, leading them to switch from risky assets (equities) to risk-free assets (gold; treasury bills). Thus, equity markets tumbled all over the world. Under such a global scenario, there has been a renewed interest among researchers and practitioners to study the linkages among gold and other precious metals, commodities and asset classes like equity and debt.

Gold is often regarded as the leader among the precious metals largely because an increase in its price generally leads the prices of other precious metals like silver and platinum to rise. Importantly, the yellow metal is considered to be a safe haven asset for investment purposes, all the more in times of economic turbulence and uncertainty. Historically, investment in gold is generally linked with fears of rising inflation and/or political tensions (Levin and Wright 2006). Apparently, the value of gold does not depend on the interest rate decisions, thus, limiting exposure to losses in times of financial market downturns and adverse economic events. Therefore, in such situations, demand for gold from investors goes up, which pushes up its price. Theoretically, the demand for gold consists of two components – short-run and long-run. While the short-run component comprises 'use' demand (depends primarily on the price of gold) and 'asset' demand (depends on a set of factors like exchange rate changes and expectations, inflation expectations, return on other assets), the long-run demand for gold is primarily linked to its inflation hedging properties, i.e., a reliable store of value against purchasing power risk (Levin and Wright 2006). During the past two decades, the price of gold has increased from as low as $260/troy ounce in April 2001 to as high as $1969/troy ounce in August 2020, which is around 8 times. In terms of a year-on-year rise, in the year 2020 gold prices surged remarkably, the highest rate of growth being 34 per cent in May. Interestingly, during the previous two decades, gold prices recorded the highest

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gain of 60 per cent year-on-year, just preceding the global financial crisis, in May 2006. During 2007-09, the asset demand for gold had increased significantly, while the other assets witnessed a fall in their value. However, gold prices declined significantly in the post-crisis period when stock prices started recording considerable increase.

Set against the above background, the primary focus of this paper would be first to develop an index for investors' risk appetite in the case of India and then analyse the effects of changing risk appetite

on commodity prices and various asset classes. Using this index, the paper would attempt to check the impact of the pandemic on the risk appetite of investors and how the risk appetite in turn impacts liquidity of the assets. This is crucial in the Indian context as there are limited studies in this area of research. The paper would then move on to study the linkages between gold price and the mainstream asset classes, specifically equity and debt, in the Indian context. Theoretically, gold shows no correlation with the mainstream asset classes. However, in times of financial volatility, when the conventional assets are under stress, an inverse correlation may develop between gold and such assets, highlighting the role of gold as a safe-haven for investors. Literature suggests that gold behaves as a safe haven only during certain times and against certain assets, primarily equities. The paper would investigate that in the Indian scenario and also place a special emphasis to study the behaviour of gold and the other assets during the period of the pandemic. It would answer the question as to whether the situation has been any different than such episodes of financial and economic turmoil in the past. Some of the other aspects of the paper would be to look at the relationship between gold and other commodity prices as well.

The paper has been structured as follows. Section II presents a brief review of the related literature on linkages between gold, other commodities and assets. This section also provides evidence on the role of uncertainty on gold price dynamics. Section III covers the stylised facts used in the study describing the behaviour of various commodity prices and asset returns during episodes of financial and economic turmoil. Section IV presents the investors' risk appetite index for India providing the various steps that went into its construction. This section also analyses the effects of changing risk appetite on the behaviour of commodity prices and various asset returns. Section V discusses the methodology and empirical results on the linkages between gold, other commodities and assets. Section VI concludes the paper.