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Personal Finance

Why gold has been falling when it should be rising, and should you buy it?

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- Gold prices tend to inversely correlated to the US dollar.
- With the coronavirus-induced economic crisis deepening, investors are flocking to the US dollar first.

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Gold has long been considered as a highly-sought-after investment destination because of its reputation as a store of value.

The value that it contains can be said to be drawn from various things – its history as a currency, and later, as the material (gold reserve) backing the currency – but today, many believe that it is drawn from value (or lack thereof) of other asset classes.

Put simply, if people are chasing other asset classes such as stocks, gold tends to take a backseat. If there is nervousness in the economy, they flock back to gold.

But recently, the price of gold has been acting weird.

In US dollar terms, gold rose about 20 percent in 2019 to $1,523 per ounce. It rose further this year, topping out at about $1,750 before retracing to $1,480 levels now, just as the coronavirus crisis threatens to sink the world into recession.

What's happening?

To understand the behavior of gold, one needs to take into account another asset class that competes with gold for “safe haven” status: the US dollar.

The world's reserve currency, meaning the currency in which a majority of global trade takes places (on account of its perceived stability), the US dollar also tends to rise when economic uncertainty picks up.

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What this means is a rise in the US dollar makes gold expensive for others who purchase gold in other currencies. This negatively impacts the gold price.

In sum, besides acting on each other, both gold and dollar get driven by a host of other factors.

For instance, take the example of 2008.

Just as the global financial crisis started deepening in the middle of that year, investors rushed to the safety of US treasuries, which -- because of being denominated in the dollar offers protection from currency risk -- also high enjoy liquidity and are backed by the US government.

The rise in the US dollar in 2008 meant gold took an immediate tumble.

However, as central banks unveiled a mammoth a money-printing exercise to shore up the global economy, the dollar was expected to go down and gold up.

Then the inverse correlation broke.

Gold prices are driven by Comex and is generally part of a managed portfolio.

“We saw the negative correlation break off in past in 2008 because there was broad-based selling,” says Arvind Sahay, Chairperson, India Gold Policy Centre at IIM Ahmedabad.

For a few months, investors flocked into both the dollar and gold.

But this time, there seems to be a crucial difference. With the effects of the grand monetary experiment that started in 2008 still kicking around, bond yields are trading at historic lows.

The Federal Reserve has already unveiled a fresh quantitative easing package that should ideally put pressure on the dollar and shore up gold prices.

“But how far can the 10-year yields drop to? This is not a situation like 2008 when there was room for bond prices to go up. In other words, financial markets are short of liquidity,” adds Sahay.

With nowhere to go, investors may be selling whatever they can lay their hands on.

Ragvendra Nath, Managing Director, LadderUp, agrees with this view.

“Speculators are one of the reasons for the gold downtrend. They could be in losses in other asset classes and therefore want to offset some of them by selling gold which has seen major upside [last year],” he says.

The second reason is the consumption angle.

“With half the world locked down, most of the population is busy stocking up key supplies. Nobody is going to spend money on buying gold jewelry," adds Nath.

China and India are large consumers of gold jewellery and if the demand for gold is going down, prices will reflect it.

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So, should you buy or sell gold now?

Most financial advisors say that gold should form a small but crucial part of your portfolio, anywhere between 5-15 percent.

But the current correction in gold prices could be used a correction to add some gold to the portfolio, says Navneet Damani, VP– Commodities Research, Motilal Oswal Financial Services.

Prathamesh Mallya, Chief Analyst Non-Agri Commodities and Currencies, Angel Broking, adds that gold could exhibit volatility going forward, but with economic uncertainties rising because of the coronavirus outbreak, “gold will perform”.

Agrees Sahay of IIM Ahmedabad’s India Gold Policy Centre.

“Gold price in rupees has declined by 12% from its recent peak. But the dust hasn't settled yet considering the factors driving the volatility. A year down we expect gold in rupees to reach new record high levels,” he says.

How should you invest in gold (in case you do)?

While traditionally gold was exchanged or bought in a physical form and it still is, there are certain problems attached to handling physical gold such as storage or chances of theft, purity concerns, etc. Given the problems associated with physical gold, one could invest in gold ETFs, digital gold, or sovereign gold bonds instead.

“Gold ETFs are easy to trade on exchanges and come in dematerialised form. Sovereign gold bonds, which are issued by RBI, accompanies an assured interest of 2.5 percent per annum while gold deposit schemes can be considered as a fixed deposit in gold,” says Harsh Jain, Co-founder, and COO, Groww.