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Inflation and Gold

Executive Summary

- Inflation has been an issue for countries such as China, Britain and Singapore and is likely to persist on the back of high oil and food prices.
- Possibly higher inflation expectation in US might cause workers to demand higher wages to compensate for the inflation, which could lead to further inflationary pressure.
- Gold can act as a long-term hedge against inflation to a certain extent. Gold outperformed inflation on average in all inflation quartiles from 1970 to 2010.
- There are several gold-related funds on the PhillipCapital platform which offers exposure to gold, gold-related securities, industrial metals or precious metals.

Introduction

Inflation has been appearing on the headlines for many countries and is likely to persist in our view. For investors that are looking to maintain their purchasing power through investment opportunities that hedge against inflation, gold and precious metals can be viable options. In this article we aim to explore gold as a possible investment hedge against inflation and propose unit trusts for investors looking to gain exposure in gold.

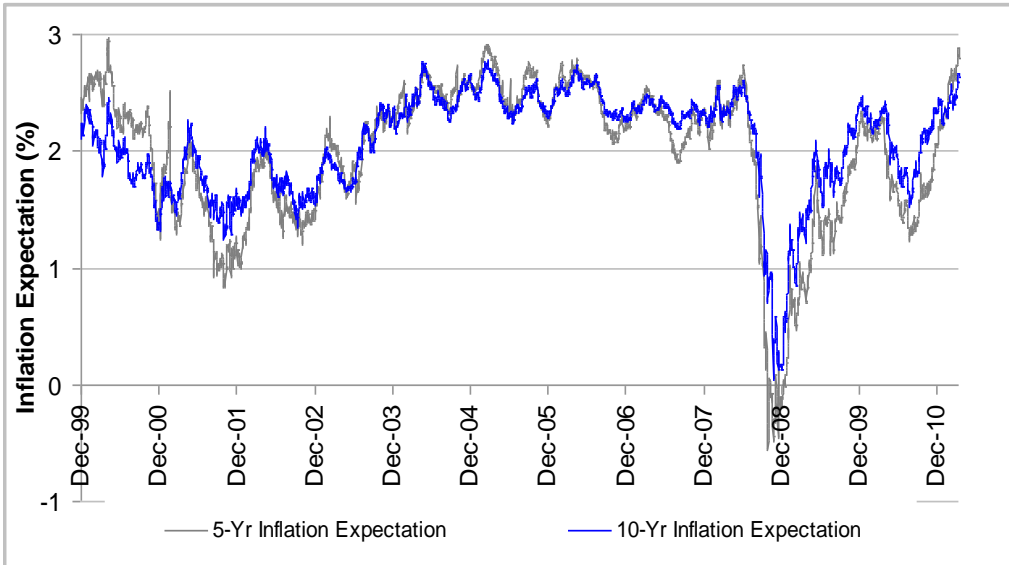
Persisting Inflation

Inflation is increasingly a concern for China, Britain, India and Singapore. Despite government efforts to tame inflation, we expect inflationary pressure to persist due to high oil and food prices. Oil has been trending above US\$100/oz and is likely to stay high on the back of supply-risk from the ongoing Middle East unrests. While the FAO food price index has dropped 2.9 percent in March this year from the all-time high in February, Abdolreza Abbassian, FAO Secretary of the Inter-Governmental Group on Grains, expressed that his outlook for food prices is “very volatile prices, a bit down, a bit up but remaining high”.

Even for US which had lower inflation as compared to the abovementioned countries, the Government Inflation-indexed bond yield signals mounting inflationary concerns. Inflation-indexed bonds are bonds whose principal and coupon adjust with changes in the Consumer Price Index (CPI) to give returns that aim to compensate for the inflation. With everything else constant, the difference between a 5-year US Treasury bond and a 5-year US Government Inflation-indexed bond should reflect investors' inflation expectation. Therefore, we use the 5 and 10-year differences between the two bond yields as proxies for the inflation expectation of investors. As shown in Chart 1, the 5-year and 10-year inflation expectations are approaching a historically high level, signifying mounting concerns on inflation. High inflation expectations might cause workers to demand higher wages to compensate for the inflation, possibly leading to further inflationary pressure and suggesting needs for inflation hedge.



Chart 1: Inflation Expectation since Dec 1999



5-year and 10-year inflation expectations are at a historically high level.

Source: Bloomberg, as of 13 Apr 2011

Note: 5-Year inflation expectation is estimated using 5-Year US Treasury bond yield minus 5-Year US Government Inflation-indexed bonds yield. 10-Year inflation expectation is estimated using 10-Year US Treasury bond yield minus 10-Year US Government Inflation-indexed bond yield.

Gold as an Inflation Hedge – In the long term

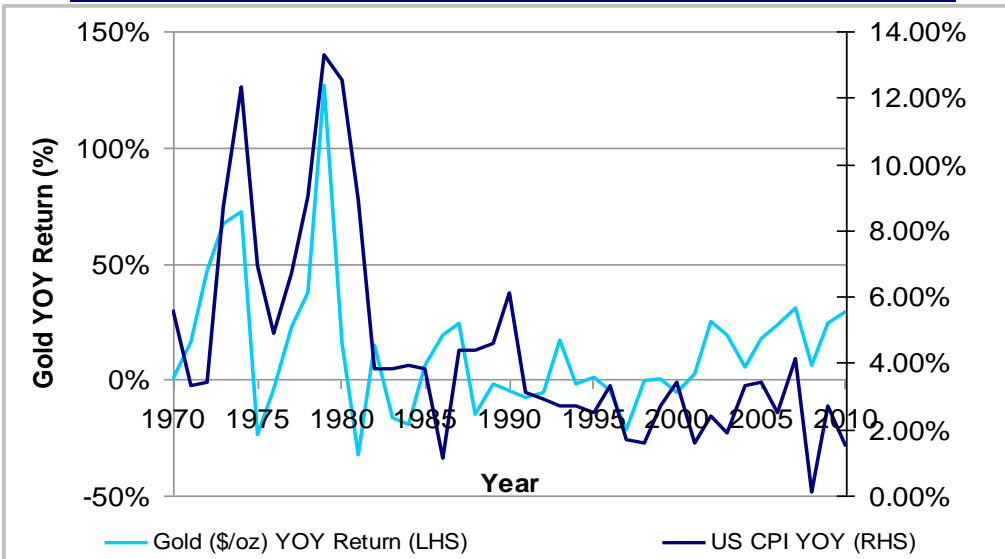
Gold has gained 27 and 58 percent in the past 1-year and 3-year periods respectively and could be caused by a variety of factors including geopolitical instability, natural disaster, increased investment demand and inflation. As gold has been thought of as a good long-term hedge against inflation, we compared the annual performance of gold against the annual percentage change in US CPI since 1970 to explore the relationship between the two. A glance at Chart 2 shows that peaks in annual gold performance are near to peaks in annual US CPI change, signaling a certain level of correlation between the two.

A previous study, 'Short-run and Long-run Determinants of the Price of Gold' (2006), by the World Gold Council which used data from 1968 to 2005 concluded that there is a long-term one-for-one relationship between the price of gold and the general price level in the US. The study also showed that short-run deviations from the long-run relationship could occur but there is a slow reversion towards the long-term relationship which takes about five years. However, one limitation is that the study was focused on US inflation data and gold price denominated in USD, which may differ for overseas investors.

Overall, we are of the view that gold can act as a hedge against US inflation to a certain extent in the long-term period. This could be due to the increased in demand from investors for inflation hedging purposes. Given relatively constant gold mine production, which had been trending between 2400 to 2700 tonnes per year in the past 10 years, the increased demand could be one of the factors that attributed to the gold return during inflationary times.



Chart 2: Annual Percentage Change of Gold Spot (US\$/oz) and US CPI



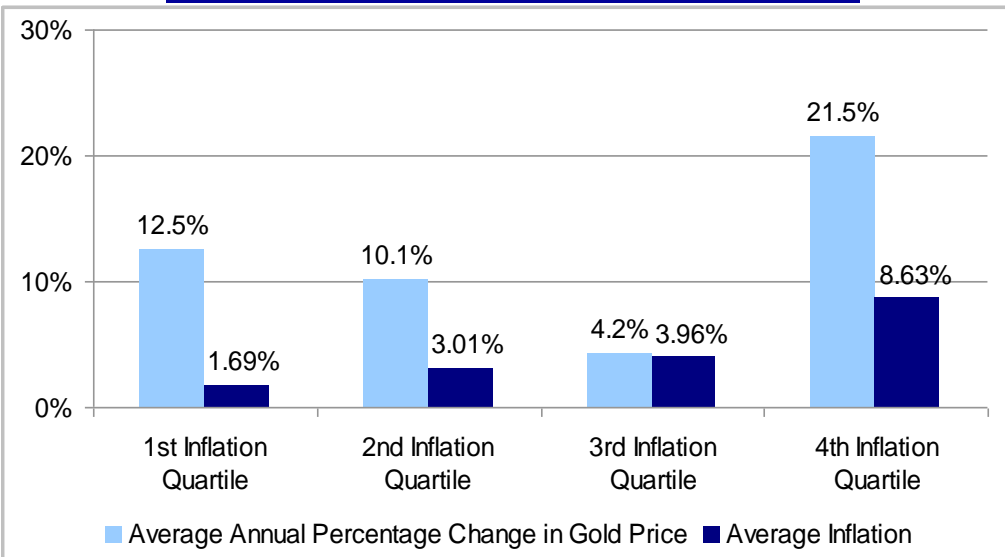
Peaks in annual gold performance tend to coincide or are near to peaks in annual CPI change.

Source: Bloomberg, as of 12 Apr 2011

Gold as an Inflation Hedge – Degree of inflation

Having established gold as a possible inflation hedge over the long term, we next aim to explore the degree of protection that gold offers over different ranges of inflation. We segregated the annual inflation from 1970 to 2010 into quartiles and computed the average US inflation and return of gold spot price (US\$/oz) during each quartile in Chart 3.

Chart 3: Average Gold Return vs Inflation (1970 – 2010)



Gold outperformed inflation on average in all inflation quartiles.

Source: Bloomberg, as of 12 Apr 2011



We notice several interesting issues from the chart. Firstly, the average annual return of gold outperformed average inflation on in all quartiles, reaffirming the previous the point that gold can act as a possible inflation hedge. Secondly, there appears to be no direct relationship between degree of inflation and gold performance as the average annual gold return did not show a steady upward trend against increasing inflation. This probably mean that inflation is not the only factor that can affect gold prices as well. Lastly, the return of gold in the 4th inflation quartile significantly outperformed the lower quartiles. One inference that can be drawn is that investors have greater demand for gold as an inflation hedge during times of significantly higher inflations, therefore contributing to high gold return during high inflationary times.

Gold in Unit Trust

One way of gaining exposure to gold is through unit trusts which invest in either gold-related equities or gold futures. Listed in Table 1 are several funds with exposure in gold futures or gold-related securities on the Phillip Capital platform. With regards to exposure in gold, DWS Noor - Precious Metals Securities (65.9%) and UOB - United Gold & General (67.3%) appear to have greater exposure than Schroder AS - Gold & Metals (32.9%) according to the latest factsheets available.

Table 1: Gold-related Funds on Phillip Capital's Platform

Name	Asset Class	Geography/Sector	Currency
DWS Noor - Precious Metals Securities A USD	Equity	Gold and Precious Metals	USD
Schroder AS - Gold & Metals A Acc NAV USD	Commodity Futures	Precious and Industrial Metals	USD
Schroder AS - Gold & Metals A Hedged SGD	Commodity Futures	Precious and Industrial Metals	SGD
UOB - United Gold & General SGD	Equity	Gold and Precious Metals	SGD
DWS Noor - Precious Metals Securities J SGD	Equity	Gold and Precious Metals	SGD

Source: UT Research

Schroder AS - Gold & Metals is mainly invested into derivatives and outperformed in recent short term periods such as 1-month, 3-month and year-to-date. (Table 2) However, it has a shorter track record than the other funds and charges a performance fee. (Effective on 3 May 2011, the performance fee will be removed and there could be alteration in its allocation between derivatives and equities.)

Among the funds available, we prefer UOB - United Gold & General as it has a longer track record than Schroder AS - Gold & Metals and outperformed DWS Noor - Precious Metals Securities in the longer period (3-year). Its low expense ratio (1.81%) will erodes less of the fund's return, and the low turnover ratio (40.84%) suggests that the investment committee takes a long term approach in investing. However, we note that the investment mandate of Schroder AS – Gold & Metals has changed and will be monitoring its performance and changes in allocation between equity and derivatives moving forward.



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Unit Trust – Market Insights

14 Apr 2011

Table 2: Gold-related Funds Return and Other Ratios

Name	1 Mth % Change	3 Mth % Change	YTD % Change	1 Yr % Change	3 Yr % Change (Ann.)	1 Yr Vol	3 Yr Vol (Ann.)	1 Yr Sharpe Ratio	3 Yr Sharpe Ratio (Ann.)
DWS Noor - Precious Metals Securities A USD	4.88	0.95	-2.4	21.07	2.47	26.95	50.4	0.87	0.06
Schroder AS - Gold & Metals A Acc NAV USD	5.15	4.42	4.6	15.75	---	17.02	---	1.02	---
Schroder AS - Gold & Metals A Hedged SGD	5.05	4.21	4.46	14.9	---	17.01	---	0.97	---
UOB - United Gold & General SGD	5.09	1.27	-2.52	14.31	6.1	23.33	41.27	0.68	0.16
DWS Noor - Precious Metals Securities J SGD	3.45	-1.56	-4.49	9.11	-0.17	23.52	46.6	0.49	0.01

Source: Financial Express, data obtained on 14 April 2011

*Highlighted in bold are the outperforming fund

^Returns expressed are calculated in local currency terms assuming dividends are reinvested.



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