GLD ETF and Performance During Market Downturns

GLD ETF is one of the most popular exchange-traded funds that tracks the price of spot gold. It is, in fact, the largest exchange-traded fund that investors use. GLD ETF serves multiple purposes from being able to invest directly in gold to gaining exposure.

Gold is one of the oldest precious metal that has been in use for commerce from time immemorial. Investors have always flocked to gold due to its store of value. During economic downturns and geopolitical turmoil, gold often becomes the preferred asset of choice.

Numerous studies have been done on the significance of gold among the investing community. Academicians, independent researchers agree that when it comes to asset allocation, gold finds a significant place.

Dubbed as a safe haven asset, one can invest in gold in some ways. From the GLD ETF fund to Gold futures contracts or even purchasing physical gold bars or coins.

The importance of gold as a safe haven spans the globe. It is not just investors in the United States but all over the world who view gold as a safe haven asset.

This study takes a look at whether gold is merely a hedge or a safe haven asset, from the perspective of the Malaysian stocks for example. Many such research articles and papers can be seen when it comes to gold.

The overall view globally is that investors anywhere in the world find gold to be a safe haven asset. During times when the markets are in a distress, investors find it easy to switch from the risky assets into gold.

But of course, there is a downside to this. Although gold investments through GLD ETF can be useful, the returns one can expect from such investments are not as high. The markets work on the basic premise that investors get rewards for the risk they take.

But with gold, this is not entirely the case. In this article, we take a look at how gold performs during market downturns. We also look into how the exchange-traded fund, GLD ETF performs when the markets are down.

And finally, we see how GLD ETF behaves when interest rates are rising. But first, we need to define that a safe haven and a hedge is.

GLD ETF – A Safe Haven Asset or a Hedge?

GLD ETF can be a safe haven and a hedge. Depending on the context, the words are interchanged. But this begs the question as to whether there is a difference between these two.

Interestingly, both hedge and safe haven have the same meaning. A hedge or a safe haven asset is one which has a negative correlation to another asset. The primary difference between the safe haven and the hedge is the duration.

Investors use hedge in average terms. For example, when someone has a direct exposure to gold, such as gold bars, they can hedge this using GLD ETF for example. Another example is when investors can use the gold futures contracts to go long or short and hedge against the underlying asset.

A safe haven is a term that is used for longer duration and the main aspect being that s safe haven asset performs during specific conditions.

Besides the GLD ETF and other gold contracts, other safe haven assets are sovereign bonds. The United States bonds are one of the safest assets when it comes to managing risk.

What's unique about gold and as a result the GLD ETF is the fact that gold tends to act more like a safe haven than a hedge. Investors tend to mix the terms but there is a big distinction.

The GLD ETF has an extremely close relationship with spot gold prices. The chart below shows a comparison between GLD ETF and Spot gold, XAUUSD.

GLD ETF v/s Spot Gold

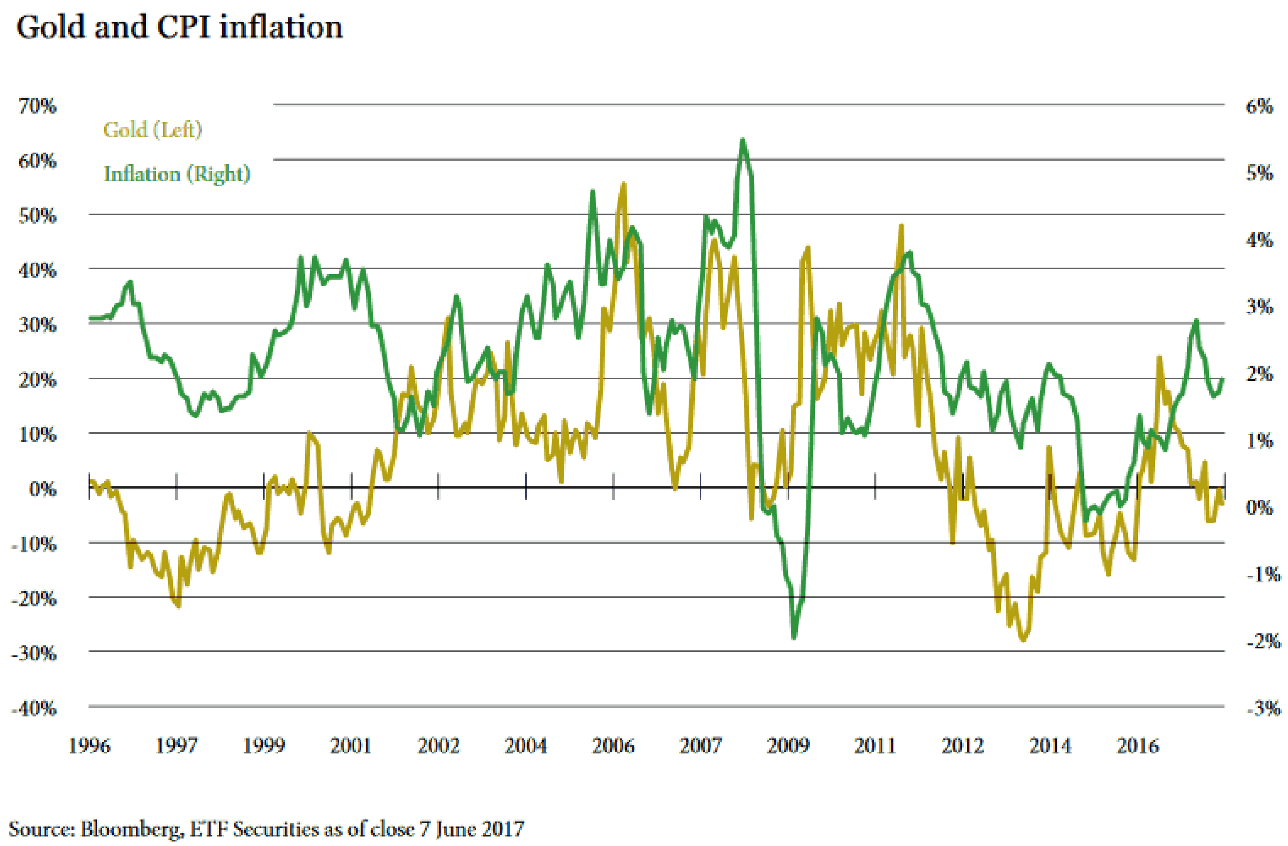
The above chart shows how closely the GLD ETF tracks the price of the underlying spot gold price. Investors find it easier to purchase GLD for a number of reasons. From low expense ratios to the liquidity that the GLD ETF offers.

GLD ETF Performance During Market Downturn

When talking about the GLD ETF's performance during market downturns, there are two things to bear in mind. Gold prices act as a safe haven and also a hedge. When the market's risk appetite wanes, you can see an inflow into GLD.

When there are times of economic uncertainty or political turmoil, investors once again flock to gold assets such as the GLD ETF. It is important to note that gold prices, therefore, behave differently. If one expects gold to rise every time the market is down or when inflation rises, they are comparing apples and oranges.

The next chart below shows gold's behavior compared to inflation.



Gold price comparison to inflation

The central banks in the current environment have been moving towards hiking interest rates. This comes as inflation starts to gradually rise. While inflation is forecast to be contained, the increase in consumer prices tends to push gold prices higher.

The basic premise comes from the fact that inflation tends to erode the dollar value. Under such circumstances, investors find gold to be a better store of value. While gold doesn't give any return, it is the expectation that gold prices

tend to store their value as the value of the fiat currency falls. In the above chart, however, you will see that gold behaves differently. For example, in the period starting from 2008, gold prices have been falling and tracking inflation.

As inflation rises, gold prices also start to rising and vice versa.

The main takeaway from this chart is the investors need to focus not just on the market turns but also the economy. As we head towards a tighter monetary policy which is a result of higher inflation, the question is whether gold prices will also rise?

GLD ETF and equities

One of the most visible features of GLD ETF or gold is its relationship with the stock markets. Various studies show that there is no strong correlation with gold. Before going into the details, it is important to understand the characteristics of gold.

Gold is a highly liquid asset. It is unique because it possesses the characteristics of being a commodity and a currency as well. Gold has come a long way as it still retains its value as a medium of exchange and it is also a unit of value.

The International Review of Economics and Finance takes a closer look at the dynamic correlation between gold and stocks.

Let's start by taking a look at the S&P500 index and the GLD ETF.

GLD ETF and the S&P500 Index

The above chart shows the S&P500 index on the right and the GLD ETF on the left side of the chart. The peaks and troughs in the S&P500 index show only a small amount of correlation between the two.

For example, during the peak in the S&P500 index around 2011 and 2012, the GLD ETF is also seen to be gradually increasing.

Various studies pertaining to portfolio management indicate that investors need to allocate five to ten percent in gold. This paper takes a deep look into the returns between gold and the S&P500 index.

The research paper looks at the time variation and the conditional correlations and how these two unique assets (gold and stocks) act as a hedge against each other.

GLD ETF and the monetary policy

If you look over a longer horizon, GLD ETF has in fact been steadily rising. For the period of 2009 and 2012, both GLD ETF and the S&P500 index were steadily rising.

But since 2012, GLD ETF was in a steady decline. Meanwhile, the equity markets continued to post a steady rise. The reason for this is due to the Fed’s quantitative easing policy. As the central bank injects liquidity, the excess money helps fuel the equity markets.

This, in turn, pushes investors to put money into the equity markets. As a result, with rising risk appetite, GLD ETF and other gold-backed securities decline.

An important point to note is that one cannot simply make a blanket statement that gold prices have an inverse correlation to stocks. Investors need to consider a lot more aspects than merely looking at correlation.

In the United States for example, monetary policy plays a big role. As seen in the above example, you can notice how monetary policy plays a big role. Of course, in the absence of policies such as quantitative easing, gold has a stronger negative correlation to the stock markets.

The correlation can be seen to be stronger on a day to day basis. For example, when we look at the daily chart, you can see the negative correlation more strongly.

GLD ETF and S&P500 daily chart

The above chart covers the period from May 2017 to date. You can see how the GLD ETF behaves on a day to day basis. There are some periods in the chart where the GLD ETF and the S&P500 index tend to rise at the same time.

On the extreme right of the chart, you can start to see the extreme negative correlation.

GLD ETF and Stocks – Should you care?

So far, the article gives a brief overview of the GLD ETF. We learn how GLD ETF tracks the spot price of gold. We also cover the other aspects of how monetary policy and the risk sentiment plays a role.

Many investment advisors suggest that you should allocate a certain portion of your portfolio into gold. While one might brush aside the wisdom, in the longer term, diversification among assets is a big help. While bonds also compete with gold as a safe haven asset, the uniqueness of gold makes it stand out.

During times of turmoil where the fiat currency can fluctuate (i.e: rise or fall in value), exposure to gold can help you maintain some value. Some might argue that investing in bonds would be a better option. True as it may seem, the bonds are also valued in fiat currency.

This is where gold can help you to diversify. For short-term speculation or hedging, GLD ETF is ideal. Due to the liquidity and the low expense ratio, GLD ETF can help you to hedge against the fluctuations in the stock market.

However, it is important to recognize when the market is in a bear territory or just a correction. This brings us to timing. Timing is essential if you want to really see the correlation between stocks and gold assets.

Therefore, GLD ETF, which is also priced in U.S. dollars can act as a temporary hedge against market corrections. Those who have a direct exposure to gold, such as the gold bars will find the commodity to act as a safe haven.

GLD ETF – Conclusion

By some estimates, gold is known to outperform stocks and bonds. However, if you shorten this time frame, in a 30 year period, stocks and bonds outperform gold. Narrow this down further and gold once again emerges on the top, outperforming stocks and bonds.

In conclusion, gold has held its own ground. It is one of the rare metals that is naturally found. Gold has always been the preferred medium of exchange. Until a few decades ago, even the U.S. dollar was pegged to the price of gold.

While there are successful investors such as Warren Buffett who dismiss gold, the fact remains that gold is unique. For investors who focus on diversifying their portfolio, diversifying across different assets can help in terms of economic downturns.

The GLD ETF is certainly an investment that you can find easy to buy into or sell with ease.