TO HAVE YOUR CAKE AND EAT IT: A CASE FOR CURRENCY HEDGING GOLD EXPOSURE

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Summary

- The US dollar is in for a period of protracted weakening
- A European investor holding unhedged gold could lose out on gold's full potential. A currency-hedged gold product would allow them to pick up all of gold's gains.
- In the coming year, our forecasts for gold indicate that an unhedged gold investor could lose out on US$52/oz of the US$545/oz gain between Q3 2020 and Q3 2021.
- Historically, when gold has risen more than 5% in a month, hedged gold has outperformed unhedged.
- Hedging costs have fallen close to a five-year low, making hedging even more attractive.

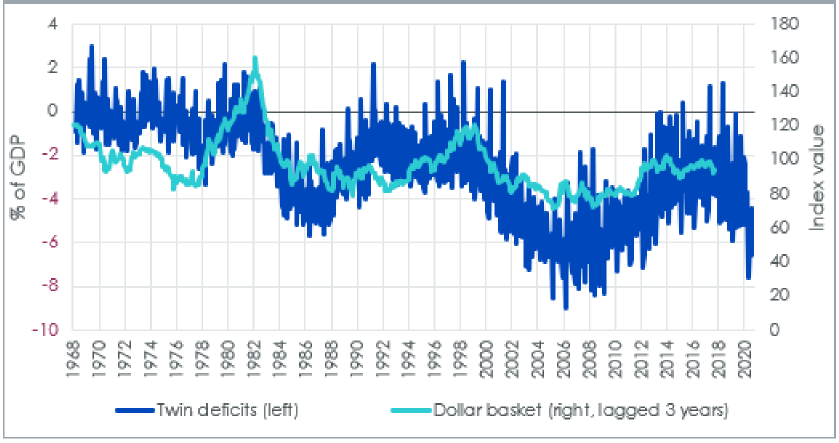
Why could US dollar be set up for a period of extended weakness?

Historically, periods where you see a current account deficit widening and government budget deficit widening (often termed a twin deficit), we have seen the US dollar enter a period of extended weakness.

A current account deficit indicates that the country is importing more goods and services than it is exporting, in effect (in possibly over-simplified terms) borrowing from the rest of the world. A government budget deficit means that the government is spending more than its earning i.e. borrowing. The combination of a rise in both of these types of borrowing has historically raised concerns, expressed in US dollar weakness.

Figure 1 below highlights the US dollar basket goes through long cycles of strength and weakness and historically big movements in the twin deficit have been a trigger for the turning point in the cycle. The chart plots the twin deficit against the US dollar basket with a three years lag. So, if history is any guide to the future, a period of dollar weakness may have already been set in motion. The size of the twin deficit could depend on who is sitting in the White House and Congress, but under all four scenarios we have explored, the trend is likely to be in one direction. Obviously, these relationships are not identity equations and there are many other influences on currency direction, but currently many investors are worried about history repeating itself and hence investor speculative positioning on the dollar is very negative.[1]

Figure 1: US Dollar and US Twin deficits



Source: WisdomTree, Bloomberg, data from January 1968 to September 2020

Twin deficit is defined as a current account deficit and a government budget deficit. The wider the deficit, the more negative the number. Dollar basket is the US Dollar against a basket of six currencies. Index value increases with Dollar appreciation.

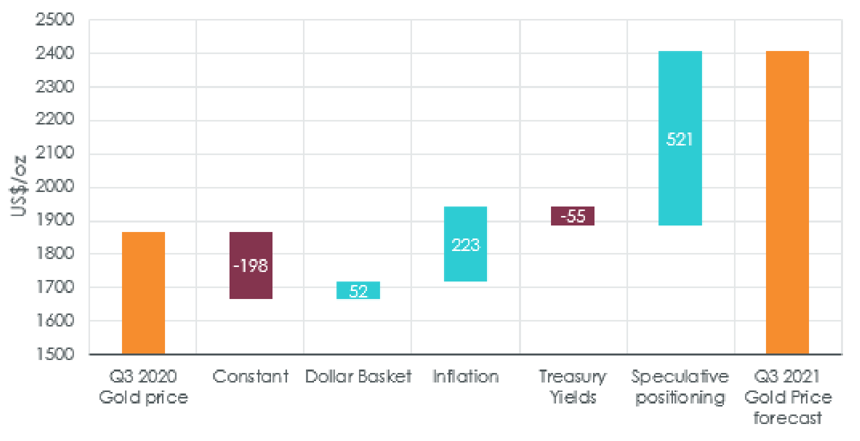
Historical performance is not an indication of future performance and any investments may go down in value.

If we are in for a period of structural weakness for the US dollar, a European (Euro or Sterling) investor in gold may miss out on potential gains if their gold holding is unhedged. Gold in US dollar terms gains from US dollar weakness, but holders in other currencies (unhedged) don't benefit. Hedging could give the European investor a similar return to the US investor.

US dollar weakness has already started and will influence gold prices in 2021

We recently published our outlook for gold prices for Q3 2021 (see Gold Outlook to Q3 2021: To regain lost ground and reach fresh highs). Part of the gains in gold prices in US dollar terms over the coming year will come from US dollar depreciation (Figure 2). However, a European or UK investor managing a portfolio in local currency and holding a US dollar-based gold product may miss out on a part of the gold gains that come from US dollar weakness. Numerically, out of the US$545/oz increase in gold price between Q3 2020 and Q3 2021, an unhedged investor could miss out on US$52/oz i.e. 9.5% of the increase compared to a hedged investor just in the next 12 months.

Figure 2: Decomposing Q3 2021 gold price forecast



Source: WisdomTree Model Forecasts: [Gold Outlook to Q3 2021: To regain lost ground and reach fresh highs].

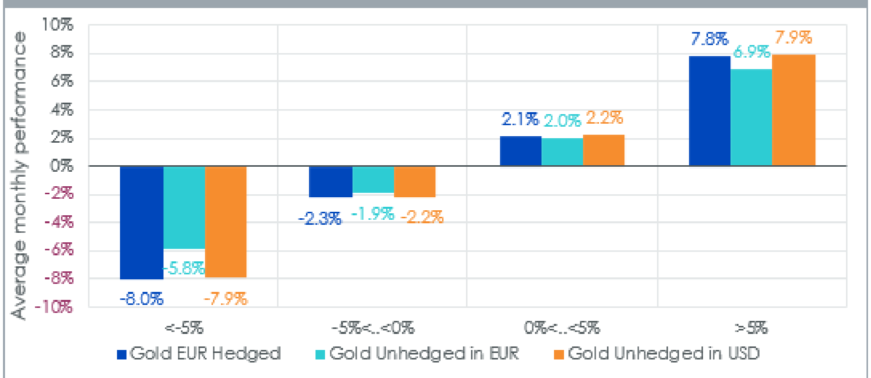
Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.

The US dollar: a drag for unhedged foreign gold investors

Looking at the historical relationship between gold and the US dollar, we have noted in our Model that they correlate negatively in most periods. What that means is that when gold goes up, the US dollar tends to move down. From the perspective of an unhedged foreign investor (i.e. a Euro or British pound-based investor) this means that when gold goes up, part of that increase is wiped down by the currency moving the other way. It is worth mentioning though that in financial crises the negative correlation between the US dollar and gold tends to break down due to the fact that both acts as safe-haven assets. In those scenarios, the unhedged version does benefit from both gold and US dollar going up.

In Figure 3, we look at the performance of a hedged and unhedged investment in Gold from the perspective of a Euro-based investor.

Figure 3: Historic performance of gold, hedged and unhedged



Source: WisdomTree, Bloomberg, data from December 2003 to September 2020. Performance buckets based on gold in US Dollar on monthly basis.

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What we observe is that when the price of one ounce of gold in US$ is up, on average the currency-hedged investment captures more of that increase. Looking at all the months where the price of one ounce of gold in US$ increase by more than 5%, on average the hedged investment captured 7.8% i.e. 0.9% more of the upside than the unhedged version which is quite a substantial difference. Coming back to our macro analysis, in a period of US dollar weaknesses, unhedged exposure to gold could suffer from such weaknesses and fail to benefit fully from the gold appreciation.

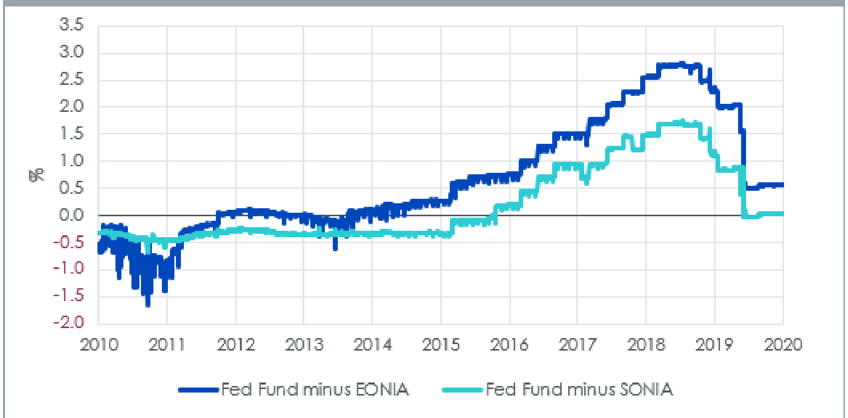
Taking a numerical example, starting from an ounce of Gold at US$2000 (i.e. €1666 with a EURUSD exchange rate at 1.2), if the US dollar depreciates against by 5%, everything else being equal, the expectation is that the intrinsic value of gold would not have changed and therefore the price in Euro would remain €1666 per ounce. However, because of the currency move, the price in US$ is now 5% higher 2100$. In such a scenario, the euro investor unhedged would not benefit at all, the price of gold in euro is unchanged after all. However, the hedged investor would benefit from the 5% increase in dollar term.

Getting cheaper to hedge currency

One last point to consider for a gold investor aiming to benefit from the US dollar potential weakness in the near future is the cost of hedging, i.e. the cost of carry. Currency hedging is not costless and is subject to a carry (that can be positive or negative) and that can be approximated using the interest rate differential between the respective domestic interest rates of the two currencies in the pair.

What is really interesting is that after a period where the cost of carry to hedge US asset back in Euro (or in GBP for that matter) was really high due to the difference in monetary policy in the US and Europe, the cost of carry has now significantly diminished. This is quite clear looking at Figure 4. Furthermore, with the policy framework change at the Federal Reserve, where the central bank now focuses on average inflation, expectations are that the monetary policy between the two economic blocs could continue to converge for an extended period of time contrary to what happened in 2015/2016 with the early hiking of US rates.

Figure 4: Interest rate differentials



Source: WisdomTree, Bloomberg, data from December 2003 to September 2020.
EONIA: Euro Overnight Index Average, SONIA: Sterling Overnight Index Average.

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Conclusions

With the US dollar potentially entering into a multi-year bearish cycle and the cost of hedging falling close to a 5-year low, it is extremely compelling for European (Euro or Sterling) based investors to hedge their gold exposures. We have a constructive view on gold over the coming year and a proportion of that could be lost if holding a position unhedged. In gold bull cases (i.e. when the price of gold rises more than 5% a month), hedged gold exposure outperforms unhedged. With our constructive view for gold over the coming years (in an environment of monetary and fiscal expansion), we believe hedged exposure will capture gold's full potential.

[1] In September 2020, net speculative positioning on the US Dollar were the most short since December 2017 (The Commitments of Traders report by the Commodity Futures Trading Commission).

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