Lincoln Private
Investment Office

London

June 2020

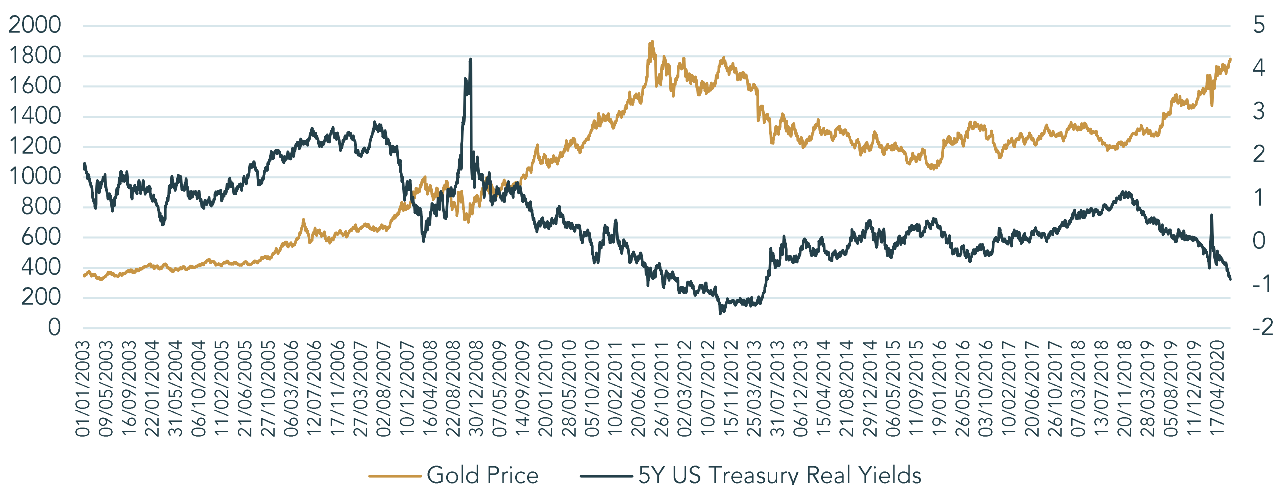
Safe Havens

Safe haven investments are typically defined as assets that should keep or even increase their value when markets are turbulent. Investors often flock to these assets during market downturns to try and insulate themselves from potential losses in conventional risk assets, such as equities. However, it is vital to understand that these perceived safe investments usually come with their own set of risks. Investments that are often considered safe havens during periods of market volatility include gold and government bonds, as well as currencies such as the US dollar and Japanese yen. We will discuss how these assets have fared during the Covid-19 crisis, focusing specifically on the assets we have exposure to in client portfolios.

Gold is seen as the original safe haven. Investors have traditionally liked gold because its value is not backed by any institution, corporate or sovereign. Therefore, it does not carry any credit risk in the same way that a bond does. Bonds, also regarded as relatively 'safe' investments, rely on the issuer paying back your investment at the end of the bond's term which may be called into question during times of profound crisis. Gold, by contrast, is a tangible asset that has played an integral part in the monetary system for thousands of years. As such, it is regarded as a reliable store of value, much like a currency. However, unlike currency, its supply is limited, and the government cannot print more of it at will. Gold not only has usage in jewellery and manufacturing, it is also a significant component of central bank reserves, meaning its price is supported by demand from multiple sources.

These properties have given gold the ability to protect investors' capital by providing a hedge against high inflation and currency devaluation. We also like gold because of its appeal in a negative real interest rate environment. As government bond yields trend to zero around the world, investors can no longer achieve returns ahead of inflation from the conventionally lower-risk portion of their portfolios, resulting in capital erosion. This is an established theme in client portfolios which we have written about previously so will not go into detail here, other than to say that we believe government bonds currently offer very little long-term upside and are one of the best examples of the risks inherent in perceived safe havens.

In order to avoid capital erosion of this kind, we believe investors will buy gold as a means of preserving capital, creating an attractive long-term outlook for the asset. Moreover, if one believes, as we do, that the unprecedented fiscal and monetary stimulus we have seen in 2020 will create inflation in the medium-to-long term, negative real interest rates will become further entrenched, giving the gold story a considerable amount of runway. The chart below shows the relationship between real interest rates (right hand axis) and the price of gold (left hand axis).



Source: Bloomberg, 2020

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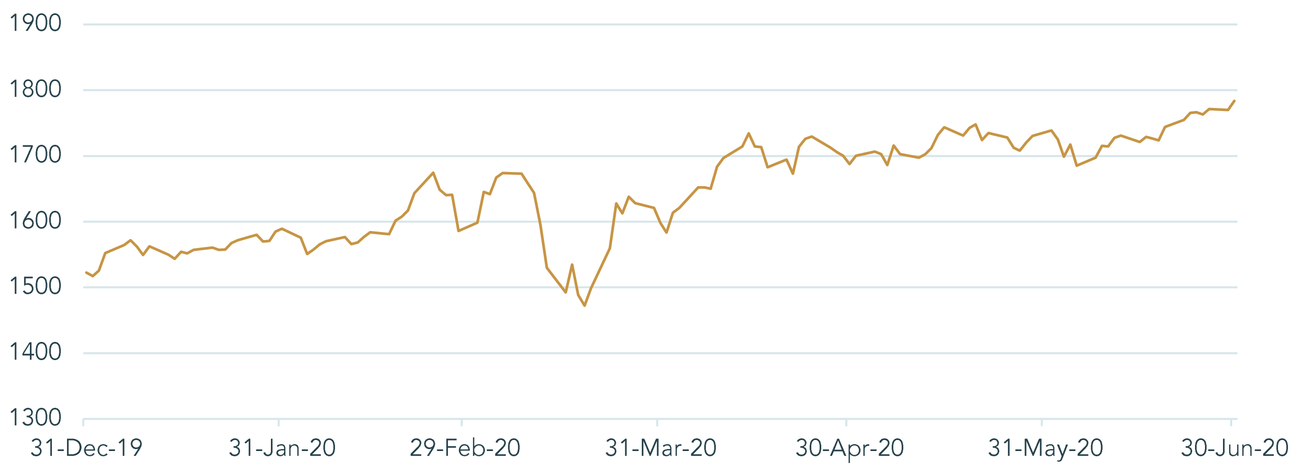
As we write at the end of June, gold has gained 17% over the year to date. Taking the gold price at the start of the year ($1523) and comparing with its current price of ($1784), you might reasonably be led to believe that gold has delivered a textbook safe haven performance during the most volatile few months for equity markets on record. However, the chart below illustrates that the journey has been far from smooth, with a particularly sharp drawdown in March, just when investors most needed protection from their gold holding.



Source: Bloomberg, 2020

As equity markets collapsed in March, many investors who were investing with borrowed money were 'margin-called' by brokers. This means investors were required to deposit currency or securities into their account to bring it up to a minimum value or 'maintenance margin'. Given the deep and liquid market for gold, investors sold their gold holdings as a source of funding to meet their margin calls. The consequence was a 12% drawdown in the gold price. This served as a reminder to many that gold is not immune to shocks of its own, albeit that these are rarely a direct result of equity market behaviour. It is partly for this reason that we do not own a higher percentage of gold, despite our belief in the long-term investment case.

Another source of protection during times of crisis is the Japanese yen. The mechanics of this phenomenon are twofold. Firstly, Japan was and remains an exporting powerhouse, consistently exporting significantly more goods and services than it imports. Consequently, it has run decades of current account surpluses that have positioned Japan as a net creditor to the world, with the substantial savings of Japanese citizens allocated abroad. The upshot of this situation is that when markets become risk-averse, that money tends to move back home. The repatriation of capital requires flows out of other currencies and into the Japanese yen, causing it to strengthen.

Secondly, Japan has a 20-year record of ultra-low interest rates, having adopted the practice well before major economies followed suit after the Financial Crisis of 2007-08. The yen has therefore served as an attractive 'carry trade' whereby investors will borrow money in a low interest rate jurisdiction and invest that money in higher yielding assets in a different economy, profiting from the difference. When volatility hits global markets, investors may choose to unwind these trades, which then results in additional demand for the yen. As always with investor sentiment, there is also an element of self-fulfilling prophecy. Once a safe haven has been established, it tends to perform as such because investors gravitate towards it in difficult times.

We gain exposure to the yen's defensive properties by holding Japanese equity funds in Japanese yen, as opposed to hedging our exposure to the local currency. The yen has proven stable during benign market periods, whilst offering a source of protection during times of market stress. Indeed, the currency gained 10% during the equity market sell off in March against sterling, providing some welcome protection during the worst of the market turbulence in the first half of 2020.

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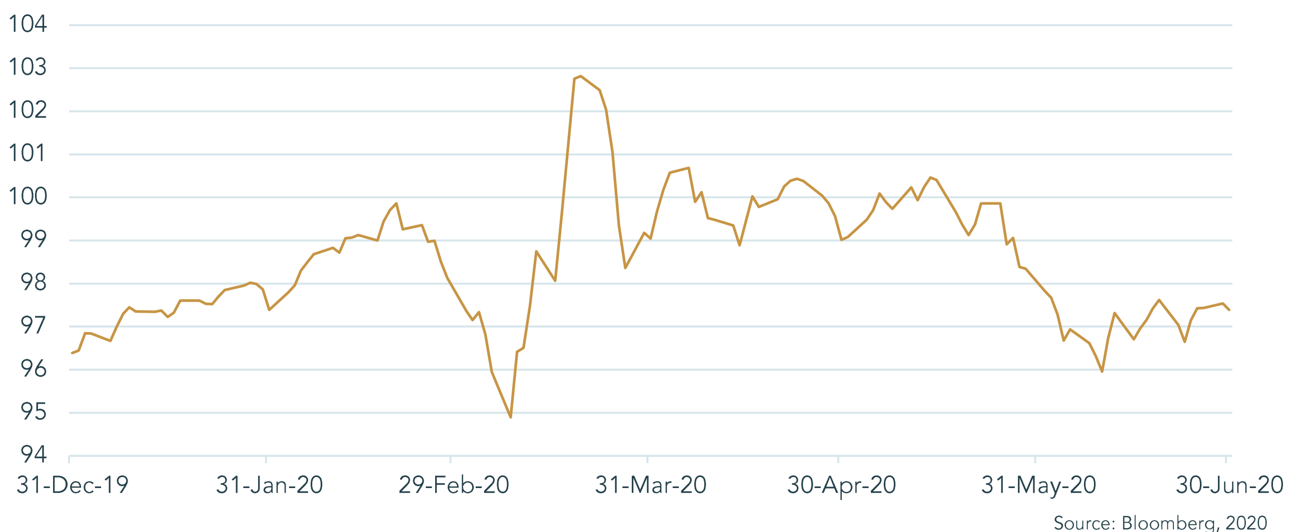
Another currency that fared well in March was the US dollar. Whilst it may not have the same aura surrounding it as other safe haven currencies like the Japanese yen, it is the undisputed reserve currency of the world. The implications of this status were made abundantly clear during the Covid-19 crisis. Between 9th – 20th March the US dollar index gained a staggering 8.4%. The move was caused by a dollar shortage, created by international institutions and governments rushing for US dollars in order to meet their funding needs during the crisis. This coincided with a natural gravitation/rotation by investors to dollar denominated assets during risk-averse times, creating a shortage that required the Federal Reserve to intervene by expanding currency swap lines with international counterparts. Rumoured G7 intervention in currency markets to weaken the dollar, caused additional speculative upward pressure on the dollar. As a result, investors experienced a degree of protection from their US dollar denominated holdings, benefitting from the significant spike in the dollar index highlighted in the chart below.



Source: Bloomberg, 2020

The chart above also shows a near-total unwind of these gains from the index's peak in March to today. As risk sentiment improved through April and May, investors felt less inclined to hoard US assets such as Treasuries which softened demand for the currency. The price action in the dollar and gold this year serve as useful reminders of the virtues of a portfolio approach when investing in safe haven assets. Ultimately, you are taking a risk with an allocation to any of these assets, albeit they may be less correlated with equity markets.

All of the above feeds neatly into our own portfolio management decisions during the Covid-19 crisis. We have demonstrated the virtues of a handful of popular safe haven trades, particularly gold where we run an especially active allocation. But many of these assets have proven themselves problematic at various points this year. In the short run, we strongly believe that the only truly risk-free option is to hold assets in cash in your home currency. As such, we elected to raise the cash levels in client portfolios during the periods of maximum uncertainty this year, keeping this cash on the side lines rather than immediately redeploying it all into safe haven instruments. We have since put some of this cash back to work in stages, reflecting improvements in the outlook, whilst selectively allocating to our preferred safe haven investments as part of a balanced portfolio. In each case, we see an attractive long-term story, rather than a speculative opportunity.

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