Investment Strategy Update

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Turkey's travails may weigh on gold, but it still has support

♦ **Gold was in retreat today, together with the Turkish lira, after the central bank in Ankara failed to hike rates.**

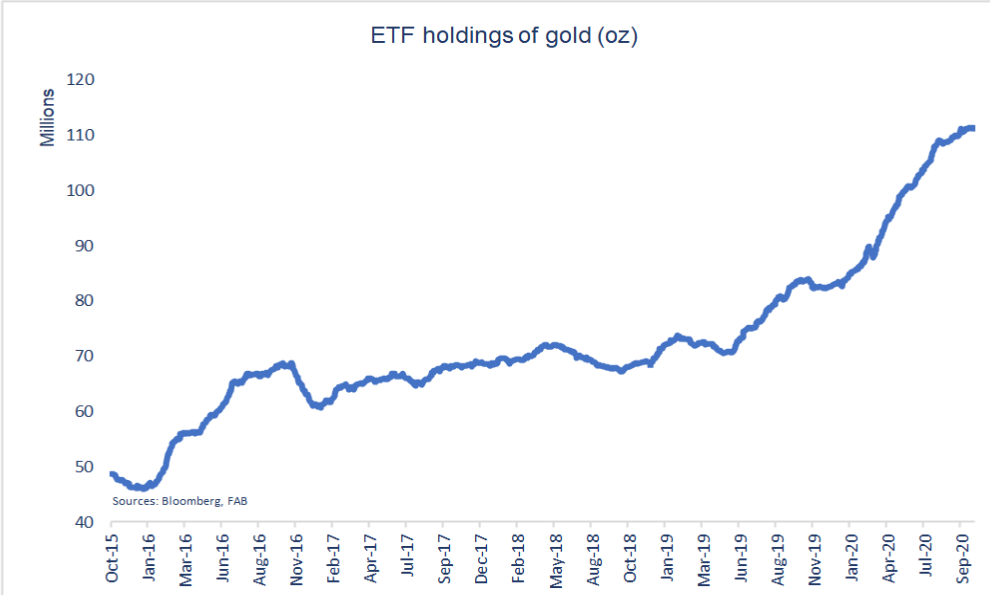
♦ **Almost all of Turkey's foreign currency reserves are in gold.**

♦ **The lira and the yellow metal have shown a higher positive correlation in the past couple of months.**

♦ **Despite potential selling pressure from Turkey and other nations that use gold for reserves, investor interest remains strong.**

♦ **Potentially higher inflation and a weaker dollar in the future may also continue to support the case for gold.**

♦ **The FAB AAC remains slightly underweight in equities, and overweight in IG bonds and gold**



Normally, gold prices and volatility tend to move in opposite directions, barring moments of extreme sell-offs, when some investors unload their yellow metal to meet margin calls and urgent liquidity needs. Today, markets were unsettled and volatility was rising, but it was not one of these climactic moments. Yet, gold prices were in retreat.

The reason could be more mundane than a general risk-off mood. The Turkish lira hit the lowest in its recent history against the US dollar after the country's central bank surprised global markets by not hiking interest rates. In recent months, the lira has shown an increased correlation with gold prices, as Turkey holds almost all of its reserves in the yellow metal, and these have to be sold whenever the currency depreciates too fast.

There is no clear evidence, aside from the correlation, that Turkey is indeed selling gold in large amounts on days when the lira is under pressure like today. Turkey's central bank is also not the only one among developing nations which has converted its reserves to gold. Russia and Jamaica have also done that, while China has reduced increased its holdings, too.

Of these, however, the country with the biggest current account deficit and which is most likely to resort to shedding reserves to defend the currency is Turkey. So the theory makes sense at least. Besides, there are plenty of people buying gold instead, and Ankara is an obvious potential seller.

The Diwali festival in India, in three weeks, is also usually a seasonal factor that increases the demand for jewelry, the main commercial use for gold. Holdings of gold in exchange-traded-funds, a good proxy for retail interest in investing in the yellow metal, are also at an all-time high.

ETFs are holding a record 111 million ounces of gold as retail investors hope for more gains

The wisdom of crowds may have a solid rationale. With fiscal stimulus set to rise in the US, the dollar could continue to weaken and inflation may accelerate. Both of these factors would normally be supportive of gold investments, but now there is an additional one in the form of negative-yielding bonds.

With a record US$17 trillion of debt around the world offering negative returns, gold has become a better store of value than government bonds or cash.

All of these factors suggest that gold demand will remain strong enough to support prices. However, there could be some hiccups along the way, especially when a big holder, such as Turkey, has to sell some of its stash.

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