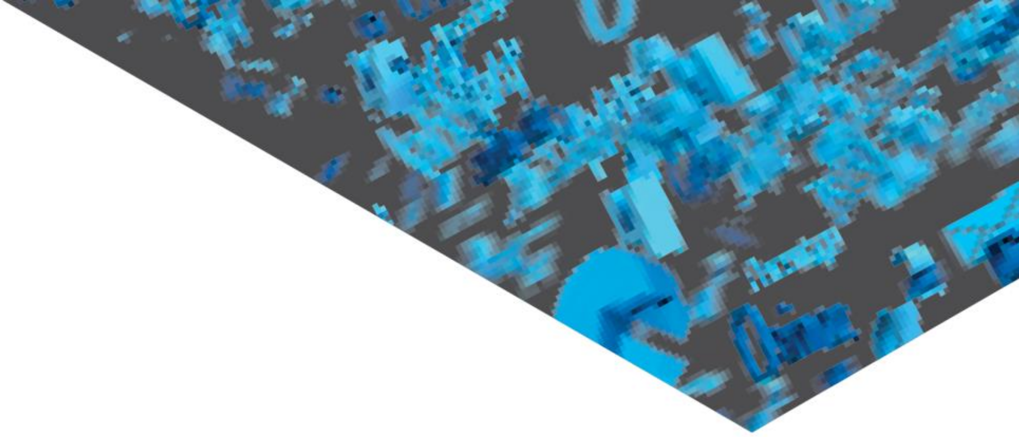

AA View

As good as gold?

Summary

- Gold’s unique character as a parallel currency and store of value makes it difficult to bracket with other asset classes.
- Price cycles have come in long and deep waves. Even the 80% plus price increase in the latest upswing falls well short of earlier runs.
- We look back at key gold price drivers: inflation uncertainty, the US dollar and interest rates are key, but their importance has varied over time.
- Gold does best as an ‘uncertainty hedge’, which appears to be protective during periods of risk-asset market turbulence. Most periods of stock market weakness have seen gold behave defensively.
- Gold’s key price drivers are supportive today. Inflation uncertainty is higher, the US dollar likely to weaken further, interest rates are locked by central banks at well below inflation, and current economic and market extremes suggest strong investment demand for defensive assets.
- Gold’s high volatility needs to be allowed for when putting into portfolios.

Gold – an asset like no other

Which asset has no cash flow or yield, has a volatility that is as high as equities even though its long-term performance has been well behind equities, and which has also had long periods of negative returns? Gold. We tracked a half century of gold and compared this to US stocks, in inflation-adjusted terms (see chart below). Over the long-term, gold has more than held its value against inflation, clear from the chart, but it pales in comparative terms versus US equities. In other words, gold is not obviously appealing as an ‘asset class’ on its long-term return and risk attributes.

The comparison between gold and other assets is not straightforward at all, however. Gold’s centuries-long and intimate connection with the global financial system, unlike stocks or bonds, means that it is not an asset like any other. Nearly three centuries of an informal or formal gold standard for many currencies (from the late 17th century to 1971), a growing

Market data source FactSet and Bloomberg
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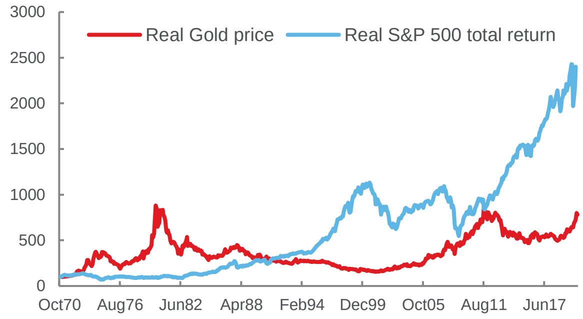
component of central bank reserves around the world today and a preferred store of value of hundreds of millions of households around the world, all tell us that gold is different to other assets.

Reflecting its history and its unique character, gold is better regarded as a 'currency', not an asset class, let alone a commodity. Since 1971, when convertibility with gold was finally broken, it has been possible to create ordinary currency limitlessly. Gold, by contrast, is finite, though not fixed, in supply. That very break with convertibility half a century ago, bolstered gold's claim as a parallel currency, which comes into its own when, as now, confidence in conventional currencies is weak due to the scale of money creation in the wake of the pandemic.

Gold and S&P 500 returns compared
(after inflation, October 1970=100)



Source: Aon, Robert Shiller, FactSet

Gold's long cycles – where are we today?

Even a cursory look at gold's behaviour over the past half century shows that cycles have been *long* and *deep.* The table below highlights these attributes. The 'up' cycles have been much larger in magnitude than the downcycles. Unlike other risky assets, a rising market has not been the norm, so the 'up to down' markets ratio over time is lower. When gold has really got going, the magnitude of the move higher has been spectacular.

Gold has moved in long and deep cycles

Dates	Market move (Total)	Market move (Annualised)
1/1970-9/1980	1795%	31.5%
9/1980-3/2001	-60%	-4.5%
3/2001-8/2011	583%	16.9%
8/2011-12/2015	-42%	-6.1%
12/2015-ongoing	86%	14.5%

Source: Bloomberg

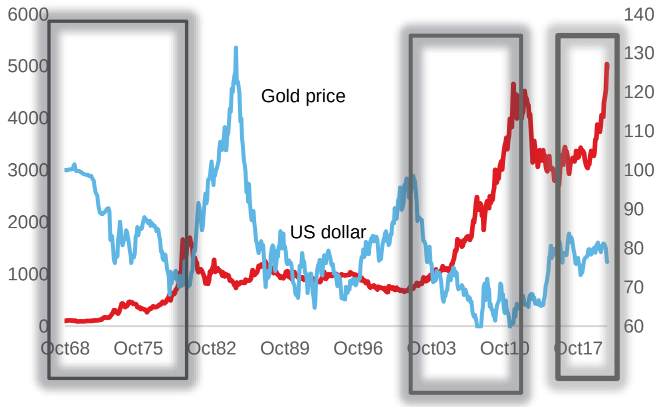
This matters now. What can we say from past behaviour? On the face of it, the run up since 2015 looks modest by past comparison. Of course, previous market moves may not be appropriate comparators for the very different economic situation we find ourselves in. However, to those who say the run up leaves little room for further gains, past cycles suggest that the upswing could have much further to go in both length and size.

Gold, inflation and the US dollar

Gold's behaviour in the 1970's is the main evidence for it working well not just as an inflation hedge, but as beneficiary. Gold rose 8x in inflation-adjusted terms in the inflationary 1970s (see chart above) massively outdoing equities and bonds. This period was gold's heyday. US inflation went from under 3% in 1968 to peak at some 15% in 1980 before the arrival of the low inflation era we are familiar with.

A closer look shows that the linkage has been stronger with the US dollar than inflation, even though the 1970s did see both. In the next run in gold from 2001, higher inflation was nowhere in the picture, but the dollar's weakness was similar. The shaded areas showing gold's periods of strength in the chart below shows that weakness in the US dollar and gold price strength went together in both the 1970s and the early 2000's. The US dollar's break with gold convertibility gave it stronger currency status, so that dollar weakness from 2001 helped gold prices.

Gold and the US dollar
US dollar index (right axis), gold (left axis), October 1968=100



Source: Bloomberg

Neither inflation or the US dollar explain the more recent run-up in gold that started in 2015. The dollar's summer 2020 weakness probably helped, but much of the run up in gold prices came before this. This feeds our suspicion that this time is different.

Gold and interest rates

What is different about this time? The spur for gold may be more related to the collapse in real yields around the world, which has been gathering momentum since 2018. Gold and real interest rates are linked because higher rates tend to increase the opportunity costs of holding gold as a zero-yielding asset – and vice versa. Gold and real interest rates have been inversely correlated (i.e. moving in opposite directions) for this reason. As our data in the table imply, this linkage may have strengthened in the past few decades. Real US interest rates (Fed funds rate less consumer price inflation) have fallen from about +1% at the start of 2018 to -1% recently, a big move. This is gold supportive and goes a long way in explaining why a weaker dollar or higher inflation has not been needed to spur prices this time around.

Market data source FactSet and Bloomberg
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Real interest rates have been an important gold driver

(Correlation coefficients, Gold and US real policy interest rates)

50 years	-0.40
30 years	-0.79
20 years	-0.77

Source: Aon, Bloomberg

Gold's credentials as 'defensive hedge'

Gold has worked well as a defensive hedge in weak market conditions quite a lot of the time. The best claim for its defensive credentials came during the latter stages of the dotcom bust (2002-3) and the financial crisis (2007-9) - see table below. Gold did well during much of the 1970s' market troubles (though this may be more to do with its inflation and currency linkages noted above). It performed very poorly in the early 1980s' recessionary market falls, though, because interest rates went very high, which is unsupportive for gold as it makes bonds more attractive. Thereafter, gold's record is good. All in all, its moves in most market corrections lays reasonable claim as a defensive hedging asset. Its correlation with equities has tended to be consistently negative in times of market stress. This is a reason why gold has featured in the asset allocation team's ideas for hedging assets in the choppier market conditions seen from 2018 onwards.

Gold's performance during S&P 500 falls (monthly data)

Periods	S&P 500 drop (%)	Gold price (%)
10/'73-9/'74	-41%	+58%
12/'76-2/'78	-19%	+35%
11/'80-7/'82	-24%	-31%
8/'87-11/'87	-30%	+9%
5/'90-10/'90	-16%	+8%
8/'00-9/'02	-46%	+18%
10/'07-2/'09	-52%	+18%
4/'11-9/'11	-17%	+4%
9/'18-12/'18	-14%	+8%
2/'20-3/'20	-20%	+6%

Source: Bloomberg

Supports for gold prices today

Where does that leave us today? We have already had a period of considerable gold price strength in the past few years. As we noted, however, this does not look like a big move versus past upswings so that is not a particularly big deterrent for investors. There are five major supports for gold to continue doing well.

- *First, there is more inflation uncertainty after the pandemic* – money printing with very large fiscal stimulus ('fiscal QE') is creating fears of higher inflation, which boosts gold's credentials. As we know, however, higher inflation is not that easy to bring about. Japan's example shows that a long period of fiscal stimulus and money creation does not necessarily bring inflation in its wake. However, if central banks' attempts to raise inflation fail and economies go into deflation instead, gold's case is not weakened very much because a deflationary environment is bad for risky assets, which would increase the defensive attractions of gold.

- *Second, we continue to see the outlook for the US dollar as weak* over the medium-term. This stems from the loss of its interest rate advantage and high valuations to name two factors. The combination of high levels of money creation and dollar weakness is supportive of gold seen as currency.

- *Third, gold is continuing to benefit from very low interest rates*. As we noted, low interest rates, especially in real terms, lowers the attraction of bonds as a hedging asset. This big driver of gold price appreciation since 2018 continues to remain supportive on our expectation that central banks will keep interest rates below inflation to help manage growing debt burdens. If inflation was to come back, the argument is that gold would do a lot better given the 'lockdown' in interest rates.

- *Fourth, the defensive attributes of gold are attractive*. Yes, we have had a bear market already in 2020, but with a dramatic recovery soon after, taking the market back to levels which no longer provide assurance of an upward trending market to come from here on. Economic, financial and market risks are high. The 'extremes' we see – deeply negative real interest rates, record highs in government and corporate debt, unprecedented levels of central bank intervention in markets, high levels of geopolitical risk, all point to large speed bumps and downside risks in markets. For those wanting to build portfolio defences, gold's attractions are good and the opportunity costs for holding it are surprisingly low currently thanks to ultra-low yields.

- *Finally, the supply-demand fundamentals for gold are supportive.* Though physical demand for gold jewellery has waned with high prices recently, investment demand has more than offset this weakness. Our data show that investment demand has been rising consistently since 2017. Additionally, central banks have been raising their share of reserves held in gold over the last decade, and there are few indications that this trend will slow or end. Against this demand, gold supply is growing, but slowly.

Key Implications

The key takeaway here is that gold has an important part to play in today's portfolios as an asset that fits well in today's very uncertain environment. Post pandemic, broader market risks from trends in inflation, currency and ordinary asset classes have increased, which will keep gold's popularity high.

Higher investor demand brings potential for further appreciation. The appreciation potential is hard to put numbers to, but gold's defensive qualities mean that outright return potential is less important for this asset.

Weighing against all this to some degree is that gold remains a more volatile asset to hold than most. This needs to be allowed for when comparing against other defensive portfolio strategies.

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