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Elston Insights

19th May 2023

Financial stress sends gold soaring

- Gold remains a hedge against inflation and fiat money
- Central banks' appetite has supported buying trends
- Gold remains a powerful portfolio diversifier

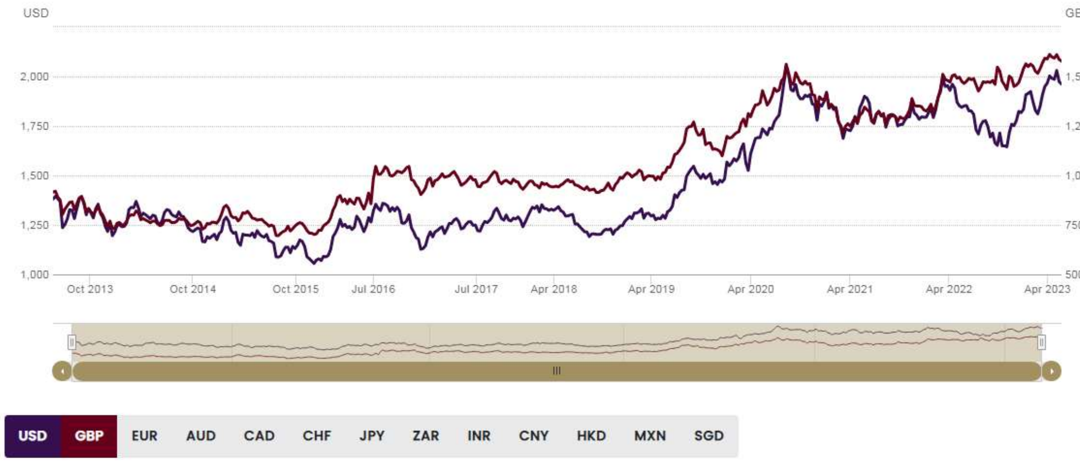
Gold remains a hedge against inflation and fiat money

Gold is under the spotlight again as its price comes close to touching all-time highs, driven by the perfect storm of macro-economic uncertainty, geo-political instability and idiosyncratic shocks. As an insurance policy in times of stress, despite the absence of a yield, gold has tended to deliver over time. Since 2000, the yellow metal has outperformed global equities (using the MSCI All Countries World index as a benchmark) by a factor of 2.4 and in Sterling terms, it has outstripped the FTSE 100's total return by a factor of 3.8. The major recessions of the past century (1929, 1974, 2000 and 2008) have all been followed by a period of high inflation and a gold bull market. While the jury is out as to whether major developed economies will tip into (or indeed are already in) recession, the uncertainty and volatility generated by the Covid-19 pandemic and Russia's invasion of Ukraine has seen the price of the metal soar and sent inflows surging into physically-back Gold ETCs (Exchange Traded Commodities) that own the underlying bullion.

In periods of high inflation and currency devaluation, gold serves to protect investors' purchasing power. And while commodities provide near-term inflation protection particularly when related to supply shocks, gold has typically provided greater inflation protection characteristics during inflationary regimes.

This is why we outlined the case for owning Gold in portfolios in our October 2022 and October 2021 Insights.

Fig.1. Gold price performance in USD and GBP last 10 years



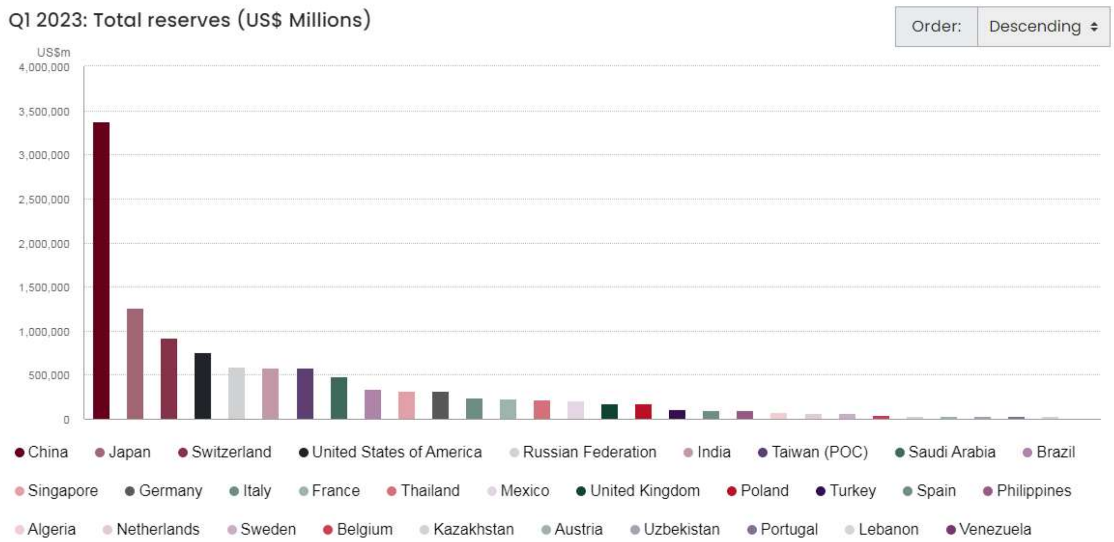
Source: World Gold Council

Central banks' appetite has contributed to recent highs

There are a number of factors that have prompted its recent run-up in price, one of the most significant of which has been increased purchases by central banks. Ultimately, this is a symptom of increasingly fragile international relations and a desire to move away from reliance on the US dollar as a denomination for reserves as well as protection from a weakening dollar and rampant inflation. From November to date, China has added to its gold reserves every month, with a total stockpile currently over 2,000 tonnes. Singapore, Turkey, Iran and Russia have followed the same pattern.

Alongside this, the regional banking crisis in the US in March (which still rumbles on) prompted a flight to safety. More recently, the impasse over the US debt ceiling sowed fear among investors around US Treasury default risks. As with the debt ceiling crisis in 2011, Gold proved the best alternative asset for short-term insurance against that risk.

Fig.2. Central Bank Gold Total Reserves



Gold as a portfolio diversifier

Historically, gold has been an important constituent of any multi-asset portfolio. It is an important diversifier, smoothing risk and return and reducing overall losses when stocks, bonds, real estate and other assets fall. Although it produces no yield, it is not designed to. Instead it provides both liquidity (the gold bullion market is as liquid as the global equity market) and a low correlation with other asset classes that enables portfolio diversification.

Of all the precious metals and broader commodities traded, gold has held its own as the most powerful diversifier, with consistently low correlation with other major asset classes. The diversification effect is not only about adding an additional asset class, it is about its uncorrelated return pattern relative to both equities and bonds.

Widening the scope beyond gold, the fundamentals for silver are also currently strong and improving. The versatile metal is seeing strong demand from the industrial sector but in terms of production, the past two years have seen a structural deficit, constraining supply. Performance may be impacted should a genuine recession materialise, dampening industrial activity, but otherwise its prospects are good.

For gold and precious metals, the physical product tends to outperform the shares of miners and producers in the long run. ETCs enable exposure without corporate governance risk and operating and financial leverage risks associated with buying gold mining companies.

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Summary

With so much uncertainty in the market, the gold price is buoyant. For new allocators, timing is a challenge. But recent events validates our thesis that it makes sense to have an allocation to gold for diversification purposes.

For more on this topic see our October 2021 CISI accredited webinar.

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