Investing Through Inflation

Why Isn't Gold an Inflation Hedge?

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Investing Through Inflation

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Why Isn't Gold an Inflation Hedge?

Summary: *Gold advocates believe that gold provides protection against inflation. Their belief can be supported by anecdotal evidence. An objective view suggests this anecdotal evidence is spotty and used conveniently. Gold has a role in a portfolio but perhaps not as an inflation hedge.*

If gold is an inflation hedge then my life as an investor concerned with inflation would be simple; buy gold. I can't, unfortunately, come to that conclusion. Gold has many virtues but its character does not reliably include inflation protection. This view is contrary to widely held beliefs. Where then do I differ?

Gold advocates generally espouse two points of view to support their position of gold as an inflation hedge;

First Point of View - The value of goods when priced against gold has been constant throughout history, which is to say 'a very long time'. This is commonly referred to as **The Golden Constant**. Anecdotally the price of a gentleman's finery costs the same in gold as the price of a good business suit today. Ergo, gold has held its value.

Second Point of View - The price of **gold is inversely correlated to real[1] interest rates**. A complicated way of saying – 'if an investor can't earn bond income greater than inflation what's the point of owning bonds?'. Further, falling real rates also suggests inflation is rising which could lead to oppressive monetary policies. In both cases capital flows to gold for its protection against the decline in real income and possible monetary debasement.

Don't get me wrong – both notions have some merit but they are misapplied to the current exercise of protecting against inflation.

The Golden Constant

Intuitively and anecdotally I believe in gold as a constant. I like the notion that something costs the same today as it did historically if paid in gold. And, if I was trying to hedge for the next century there could be an application of this thesis. Unfortunately, over short periods of

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[1] Real is underlined throughout the paper to bring focus to the discussion of "real" rates vs "nominal" rates. "Real" rates are a more powerful driver than "nominal" rates.

time it is not a reliable hedge and ties up capital long term that could be better used elsewhere more opportunistically.

Worse still, true believers in The Golden Constant have to come to grips with the fact that the current real price of gold is historically high. The basis of the golden constant is that the long-term real return on gold is zero, i.e., the price of gold rises exactly as inflation rises. The 2021 year end real price of gold was $6.4 whereas the average real price of gold since 1978, i.e. the constant, has been $3.8. If the return on gold is to be constant over time the price of gold would need to drop 40% or the CPI index would need to rise 69%. The former alternative is disconcerting and the latter is hard to grasp even for an inflationist.

Inverse Correlation to Declining Real Interest Rates

There is strong quantitative evidence that there exists a negative relationship between the price of gold and declining real interest rates. At first blush one might hope this relationship would be useful in hedging against inflation. And it would have been if one had bought gold when real rates had begun to decline. For example, real 10-year yields declined from approximately 2% in 2009 to -1% on 2013 coincident with gold rallying from $870 to $1,204, i.e., 38%. Or again in 2019 when real 10-year rates declined from 1% to -1% over 18 months vs. gold rallying from $1,279 to $1,880, i.e., 47%. Here's the problem though. Since August 2020 the price of gold has been steady whereas real rates continued to stay in negative territory. The implication being that my assets continued to be debased by negative real rates but gold has not provided any further protection. My overarching investment thesis is that the oversized debt load requires fiscal and monetary authorities to promote a long period of low if not negative real yields. There may be evidence that gold offers protection while real rates are moving lower but there is a lack of evidence that gold can protect a portfolio thereafter through long periods of negative real rates.

If gold's role in a portfolio is to protect against a decline in real interest rates, then its job may be done. Otherwise, there is not enough evidence to support gold's role to provide gains offsetting a continued decline in real income from sustained negative real rates. Gold has been a constructive portfolio asset since the Great Financial Crisis. Going forward the strategic value of holding gold in a portfolio comes from its other characteristics – to be discussed in **Why Isn't Gold a Currency?**

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