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Re-Examining the Case for Gold in Multi-Asset Portfolios

Our weekly view on asset allocation.

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The Current Appeal of Gold

Gold is often characterised as a store of value (primarily against inflation) as well as an investment portfolio hedge against a range of other portfolio risks such as general financial market instability, geopolitical tensions, and currency weakness.

Gold tends to have a low, and at times, negative correlation to other asset classes, particularly in times of acute stress or in macroeconomic environments that are unfriendly to more traditional financial assets e.g. high inflation regimes.

Gold's low or negative correlation is potentially attractive from a diversification standpoint, helping to dampen overall portfolio volatility. Therefore, gold can potentially complement other portfolio hedges such as high-grade fixed interest.

Gold is a higher volatility asset class, so we place it within the alternatives segment of diversified multi-asset portfolios. Physical gold holdings can, of course, be complemented or even replaced with an allocation to gold equities. Our current position in gold is fairly moderate. We have a 2% allocation in our multi-asset balanced fund and a 3% gold stock allocation within our Australia equity portfolio.

At present, we believe gold holds a degree of appeal in a portfolio context as cash and fixed interest offer very low yields. While our base case is that inflation ebbs on a 12-month view, we see a somewhat asymmetric risk profile for inflation, particularly relative to current market pricing in fixed interest markets. So, we think a moderate gold allocation is currently reasonable given the prevailing backdrop of very low interest rates, elevated equity markets, and asymmetric inflation risk.

Exhibit 1: Gold price over the long run

Source: Refinitiv, Wilsons.

Exhibit 2: The early 1980s marked the highest "real" price for gold

Source: Refinitiv, Wilsons.

Examining the Drivers of the Gold Price

There are a few rules of thumb around how gold should behave. These relationships are not iron clad but are undoubtedly worth recognising when we think about the outlook for the gold price and its role in portfolios. We would summarise these influences as follows.

Gold and (real) interest rates

Gold is typically characterised as being negatively correlated with interest rates (most particularly real interest rates).

In short, low or negative real rates are typically good for gold. This is likely to be a function that the cost of holding gold falls with low (real) rates and that unexpected surges in inflation tend to coincide with negative real rates e.g. 1970 and 80s. This relationship has tended to hold over the long-term but is not ironclad. For example, gold did very well in the five years from 2003-2007, despite the Fed raising rates from 1% to 5%.

Gold as an inflation hedge

Gold tends to be positively correlated with inflation. Gold has proven itself to be a reasonably effective store of value. While gold's real value can vary significantly from year-to-year and indeed decade-to-decade, gold has tended to hold its relative value over very long timeframes e.g. the past 50 years.

Gold has also proven itself to be a highly effective hedge in high inflation regimes, most notably the high inflation 1970s and early 80s when the gold price appreciated more than ten-fold over the course of less than a decade.

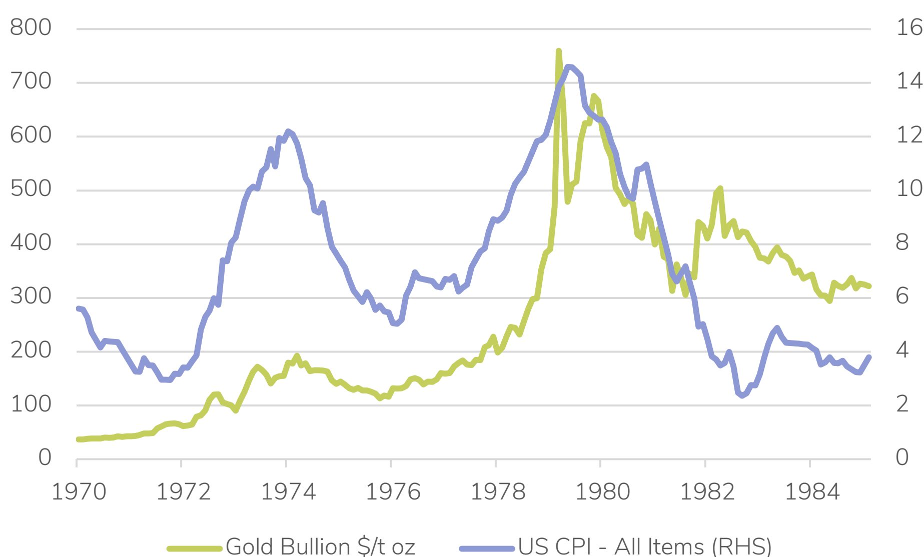
Gold (mostly) negatively correlated with the US$

Historically, gold has shown a long-run tendency to rise in weak US$ "regimes" such as the 1970s, the second half of the 1980s, and the first decade of the 2000s. Once again, gold's month-to-month and indeed year-to-year correlation with the US$ is less reliable, but gold has performed well in multi-year periods of US$ weakness. In short-term phases, gold has shown a tendency to strengthen in concert with bursts of US$ strength in "risk-off" financial market periods. Both assets tend to be seen as safe havens in times of stress and uncertainty.

Gold acts as a hedge in times of equity market weakness

As a safe-haven asset, gold's tendency to protect against equity market downside is reasonably good. Gold has shown some brief vulnerability in the epicentre of market dislocations. Still, gold performance is relatively consistent when measured against the peak to trough performance of equities in major corrections.

Exhibit 3: Gold performed very well in the high inflation 1970s and 1980s



Source: Refinitiv, Wilsons.

Exhibit 4: Gold has performed well in major global equity corrections

	US S&P500 Performance	A$ Gold Price Performance
2007-2009	-56%	72%
2011	-18%	20%
2018	-18%	9%
2020	-34%	16%

Source: Refinitiv, Wilsons.

Physical Gold More of a Hedge than an "Investment"

Our 12-month core macro view is arguably not overly positive for the physical gold price. We expect above-trend economic growth, a fall in inflation, a moderate increase in real rates, and decent returns from risk assets.

While this core view arguably suggests the potential for a retracement in the gold price, our position in gold is meant to act as a hedge against our core view being wrong. Specifically, the risk that we see more inflation than under our core view or some other unanticipated risk-off event impacts financial markets, e.g. a spike in US-China geopolitical tensions.

Once again, the lack of appeal of fixed interest or cash as a hedge, particularly against what we see as asymmetric risk on inflation, increases the current appeal of gold in our view. Interestingly, gold did react positively to the pick-up in US inflation earlier this month.

Physical Gold or Gold Equities?

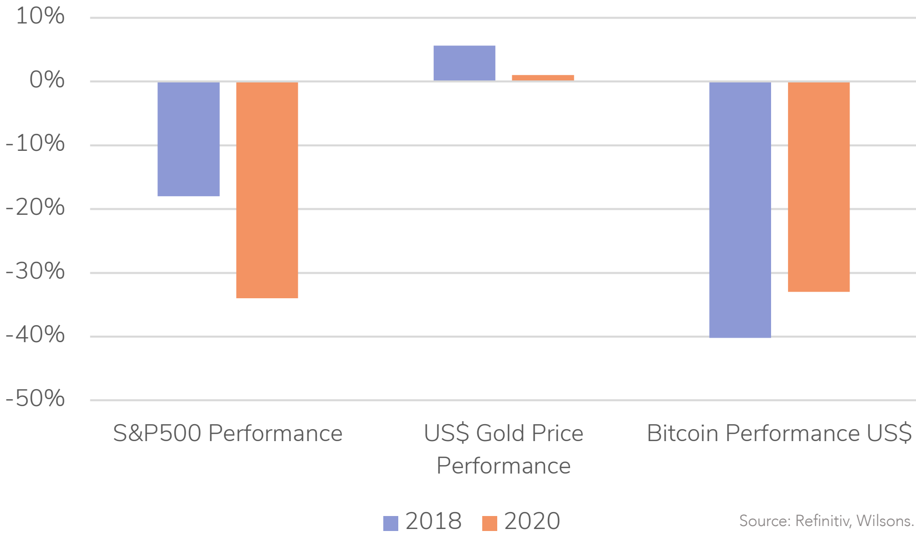
We have a moderate allocation to both physical gold and gold equities at present. We note that gold equities have been unusually weak in the face of a range-trading gold price over the past 12 months. Gold equities look to be discounting a fairly significant fall in the gold price (they look very attractive at spot A$ gold prices), so from that perspective gold equities may have the edge over physical gold at present.

Exhibit 5: Australian Gold Equities have underperformed gold over the past 12 months

Are Cryptocurrencies the New Gold?

The performance of gold is perhaps disappointing over the past year given falling real rates and the significant spike in inflation to 30-year highs. In part, this is likely because investors still view the inflation spike as transitory. However, the rise in interest in cryptocurrencies is likely to be a contributing factor to gold's somewhat lacklustre performance. While Bitcoin and many other cryptos have had an impressive run, we still view them as unreliable portfolio hedges. In the brief history of market leader Bitcoin, we note that it has proved to be a poor hedge against periods of significant equity market instability. On the evidence to date, cryptocurrencies look more like a "risk-on" excess liquidity play than a portfolio hedge. Recent comments from the RBA around heightened crypto regulation are also cautionary, hence we still prefer gold over cryptocurrencies as part of our portfolio hedging toolkit.

Exhibit 6: Gold has proved a better portfolio hedge than Bitcoin in the past two major equity market corrections



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Definitions at www.wilsonsadvisory.com.au/disclosures.

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