Some Perspective on Gold in the New Paradigm

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We've been talking a lot about gold lately—why we think the new paradigm will continue to favor it, and its strategic role in portfolios as a source of diversification in light of the reality that nominal bonds are now more or less dead weight. In this research, we'll share our thoughts on some of the common questions we are getting from clients:

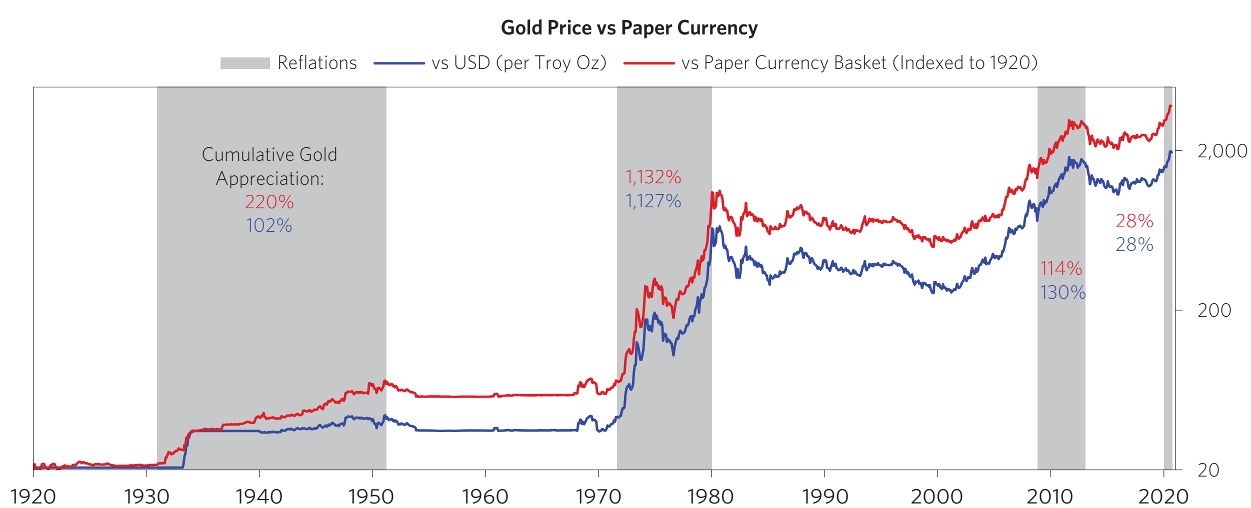
- *Am I too late? Is gold's rally behind us?*
- *Isn't gold currently very expensive?*
- *Why hold an unproductive asset that offers no yield?*
- *Is it prudent to add exposure to an asset with such a small market?*

In brief: in a world of ongoing pressure for policy makers across the globe to print and spend, zero interest rates, tectonic shifts in where global power lies, and conflict, gold has a unique role in protecting portfolios. The move we've seen in gold this year is quite modest relative to what we've seen in past reflationary periods, and given still depressed levels of activity globally, the need to keep reflationary policies in place will persist for some time. While gold offers no known yield, no known yield can be quite attractive when the yields on other assets are known to be terrible. And gold is one of the few assets that can do well in the event that MP3 policies result in stagflation, an outcome likely enough that it has to be considered and planned for. We elaborate below.

Gold's Rally So Far Is Modest Compared to Past Reflations

As the chart below shows, gold has rallied ~30% year-to-date against the dollar and a comparable amount against other developed world currencies, buoyed by fiscal and monetary stimulation of a magnitude unprecedented during peacetime. These are classic reflationary dynamics that more likely than not are still in their early innings. There will be a continuing need to print and spend in order to fill the ongoing income hole produced by the coronavirus crisis, as well as to manage through the historically high overhang of debt that will be left even after the crisis is past.

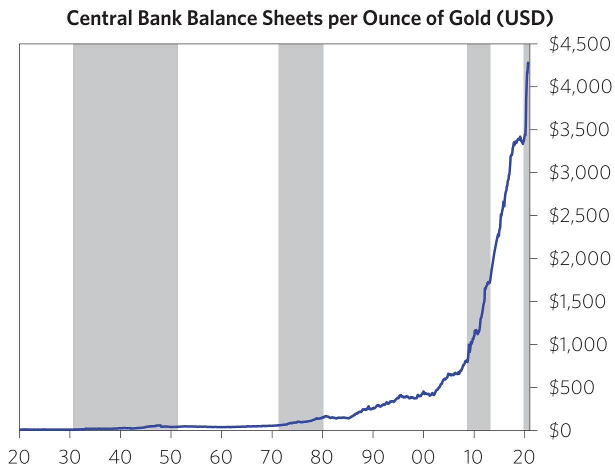
We've had a few such periods of extraordinary stimulus over the past century—all in times of economic depression, conflict, or both—and in all of them, gold saw triple-digit rallies that dwarf its recent run-up. When paper currencies were still tied to gold, policy makers were forced to explicitly devalue in order to do the printing and spending that was needed (e.g., during the Great Depression, WWII and its aftermath, and the dissolution of the Bretton Woods system in 1971). In the era of fiat money, even without the explicit need to devalue against gold, the effect of reflationary policies is to devalue paper currencies relative to storeholds of wealth. These dynamics were manifest in the triple-digit run-up in gold during QE1 and QE2, and we've begun to see them at work today.

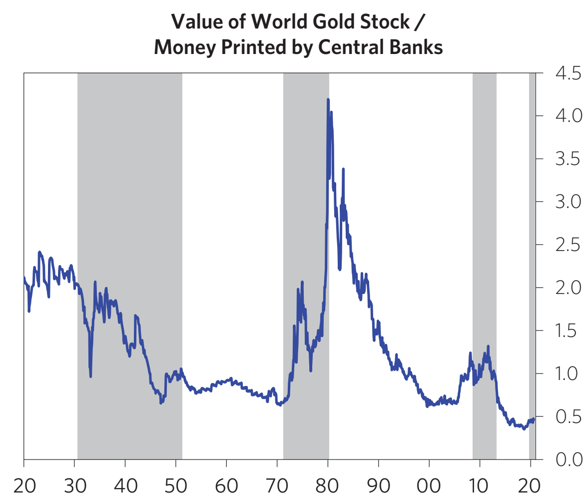


Gold's Price Is Actually Low Compared to Other Storeholds of Wealth

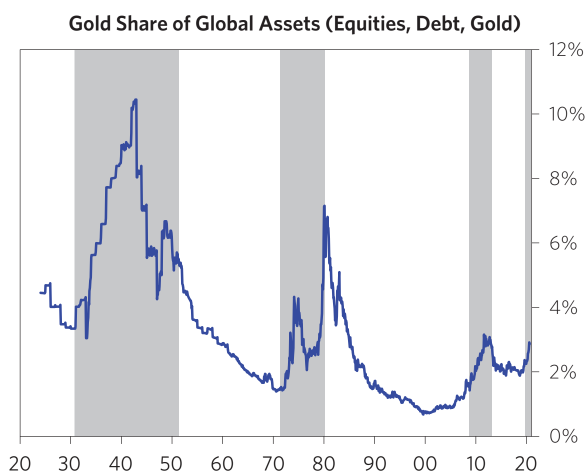
While the price of an ounce of gold in dollars is at historical highs, the price is actually very low relative to history when you compare gold to the competition: paper currency cash and other assets. We show a number of such comparisons below.

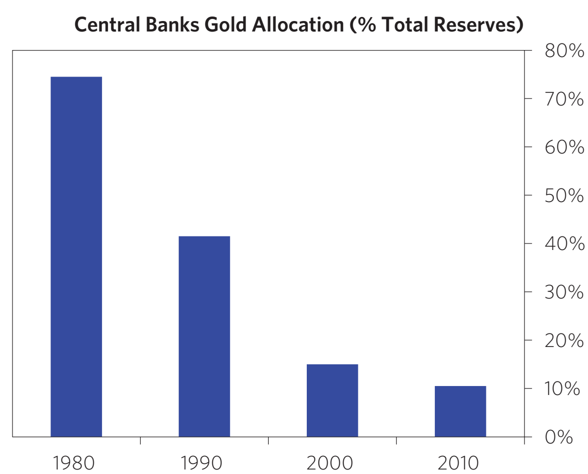
As investors have become more comfortable with the safety of fiat money, and as inflation hasn't been a problem during the lifetimes of so many investors, very little of the enormous piles of paper money that have been printed has made its way into gold.



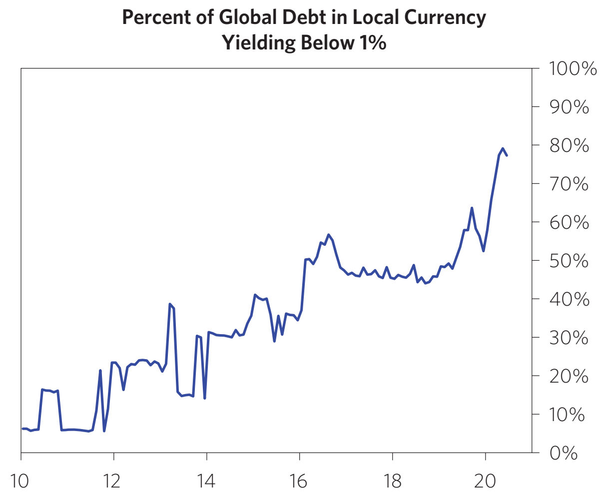


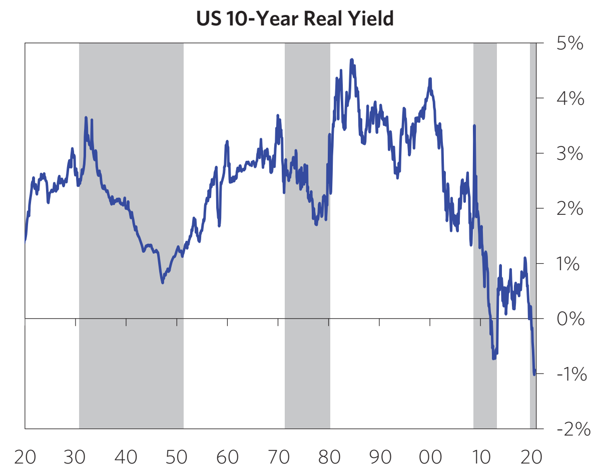
The same holds true when comparing the value of the world's gold stock to the market cap of financial assets (i.e., the total wealth that these assets represent a claim on). Investor allocations to gold are relatively low compared to history, and particularly compared to prior periods of paper currency devaluation that ultimately created inflation. Even governments have secularly reduced their gold exposure.





At least in theory, the yield on paper money is what's required for investors to accept the risk of holding a currency that can be printed away (while gold cannot), and the additional yield on risky financial assets reflects the compensation investors require for their incremental risk relative to cash. Today, the yields financial assets are offering to compete with gold are puny—not just real cash rates but also 10-year real yields are now *negative*, implying that bond returns will not keep up with inflation. This yield compression has affected all financial assets, driving equity multiples up and yields down. It stands to reason that gold, an asset with no yield, is much more attractive when financial assets are offering so little.





Gold Is Very Productive in a Portfolio in That It Provides Necessary Diversification in a World Where There Are Plenty of Risks and Few Assets That Diversify Them

Gold is one of the few effective diversifiers against the depreciation of paper currencies (and assets denominated in paper currency), as they all compete with gold as a storehold of wealth. And with interest rates at zero and the money supply increasing at warp speed, paper currencies are offering the worst deal ever, providing little incentive to hold them relative to gold. So far, this printing hasn't produced too much in the way of inflation that erodes the real value of the currency, and it has succeeded in supporting financial assets. But given how much ongoing printing and spending will be needed, and given that replacing lost incomes is inherently more inflationary than replacing credit (as it doesn't replace the supply those incomes were paying for), we could very well see inflationary pressures mount while the economy remains weak.

A stagflationary outcome would put policy makers in a tough spot and leave paper currency assets vulnerable, while gold would likely be a valuable source of diversification. Stay too easy and risk further inflation (like after WWII, or most famously, the '70s). Tighten too soon and risk plunging the world back into a deflationary downturn, like in 1937. This range of possibilities is illustrated in the table below, which breaks up the major periods of reflation into when the policy response was insufficient, successful, or turned into stagflation.

- In the case of a deflationary downturn without enough stimulus, defaults and bankruptcies lead to terrible returns on equities and corporate credit. Gold fares relatively better as an asset that is no one else's liability that could be defaulted on. And while nominal bonds maintain their value under such circumstances, today there is much less potential upside going forward than there was in past cases when nominal bonds had more room to rally.
- In a successful reflation, financial assets do well as the central bank stays easy and supports a recovery, but gold is generally buoyed as well.
- Stagflation eats away at real returns of paper currency assets, while gold tends to shine as a real storehold of value.

Annualized Real Returns

	Cash	Bonds	Equities	Gold
Insufficient/Ineffective/Depression	**3.7%**	**7.2%**	**-8.6%**	**2.7%**
US 1929–1932	10.6%	13.9%	-22.0%	8.8%
JP 1994–2003	0.6%	3.7%	-3.1%	-0.2%
US 1936–1939	-0.2%	3.9%	-0.7%	-0.4%
Successful Reflation	**-1.4%**	**2.3%**	**11.9%**	**6.5%**
UK 1931–1936	1.8%	7.1%	13.5%	9.5%
US 1933–1936	-1.4%	3.9%	27.1%	14.4%
US 1940–1951	-4.7%	-2.4%	5.8%	-4.2%
UK 1947–1959	-1.6%	-1.5%	8.1%	-2.5%
US 2008–2012	-1.0%	4.6%	4.8%	15.2%
Stagflation	**-1.7%**	**-2.1%**	**-1.6%**	**21.7%**
UK 1970–1979	-2.6%	-2.5%	-1.7%	18.0%
US 1971–1979	-0.8%	-1.7%	-1.4%	25.4%

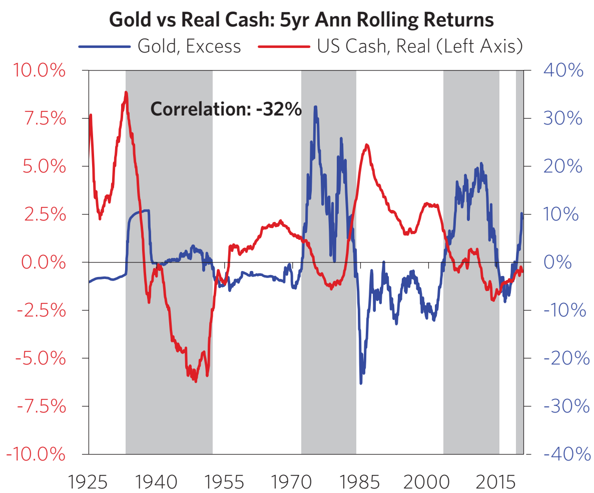
In the context of high and potentially rising levels of external conflict, gold has the added benefit of not being tied to the outcomes of any one country. Past conflicts have led to big paper currency devaluations, as every country involved undertook large-scale deficit spending, and those on the losing side saw the value of their currencies tumble along with their standing in the world. The range of outcomes across countries in WWII illustrates this dynamic. Even in an environment in which 1) there was so much global printing and spending, 2) the civilian economy was "shut down" and transformed into a wartime economy, and 3) inflation eroded the real returns of everything, gold essentially kept pace with cash in the countries that came out on top and did far better at preserving wealth in the countries that lost the war or were occupied during it.

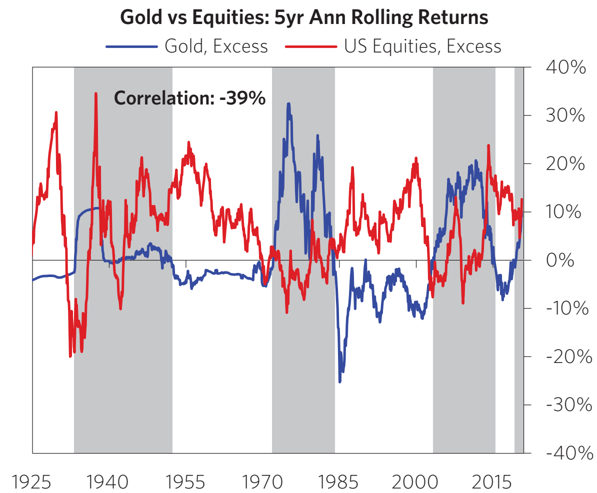
Annualized Real Returns Around WWII and Post-War (1940–1951)

Country	Cash	Gold
Switzerland	-3%	-3%
Canada	-4%	-5%
United States	-5%	-4%
United Kingdom	-5%	-1%
Australia	-6%	-3%
Germany	-19%	-1%
France	-21%	-7%
Italy	-26%	-5%
Japan	-28%	-1%
Average Winner/Neutral	-4%	-3%
Average Loser/Occupied	-24%	-3%

Looking beyond just periods of reflation and printing, over the *very* long run gold has an expected long-term return that is similar to paper cash and less than typical investment assets, as gold (like paper cash) is not part of the capital formation process and offers no structural risk premium. <u>But the periods in which gold does well tend to be the times when cash and financial assets fare badly.</u>

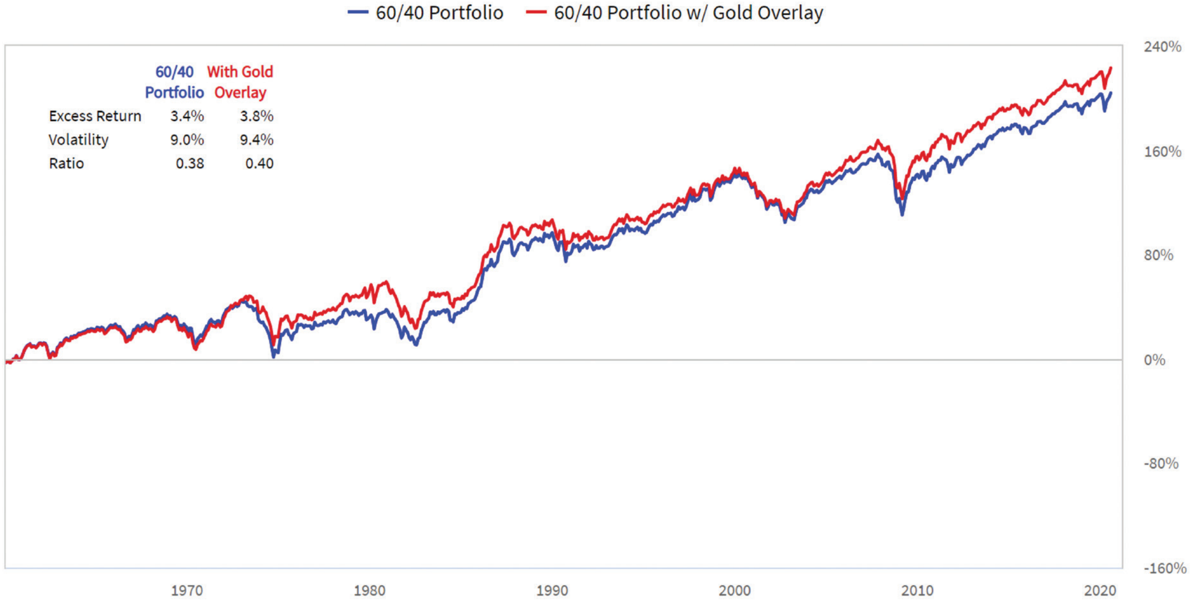
The charts below show this dynamic over the past century, comparing the five-year rolling returns of gold and cash (left) and gold and equities (right). Periods where gold outperforms (shaded) tend to be times of reflation and easy money like we explored above—the real return of cash gets debased, and equities tend to be hurt both by the economic weakness that requires such an extreme stimulative response as well as the eventual emergence of inflationary pressures. Conversely, gold's losing periods (unshaded) tend to be ones where traditional portfolios are not in need of protection—times of strong growth and benign inflation dynamics that don't require extreme stimulus/monetization.





Particularly in environments like the current one, it's wise to hold some of what central banks can't create more of. And through the use of derivatives like futures, an allocation to gold can be structured as an overlay, effectively denominating part of the portfolio in gold as opposed to fiat currencies (rather than diverting it from other risky assets). Below, we show that a modest (10%) gold overlay on top of a traditional 60/40 portfolio would have improved the efficiency of the portfolio over time, and as shown above this would have particularly helped during periods that were bad for equities and therefore the broader portfolio.

Cumulative Excess Return of 60/40 Portfolio with 10% Gold Overlay (In, Simulated)



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Is There Enough Liquidity?

To some investors, the small market value of gold relative to other financial assets is an argument against increasing their own allocations (i.e., gold appears less liquid than other financial assets). But it is worth bearing in mind that given gold's constrained supply (which is what makes it a good storehold of wealth in the first place), liquidity is mostly a function of the price. A key reason the market appears "small" today is precisely that not much liquidity has flowed there yet compared to all the liquidity sloshing around financial markets. At today's valuations, a relatively small number of investors making relatively small shifts in asset allocations can still have a big impact on the gold market. So delaying until liquidity increases essentially means waiting until gold has become more expensive. This, crucially, is a different dynamic from, say, the bond market of a small developing country, where the bigger driver of liquidity growth will be growing supply as the cash flows of the country grow and become more financialized.

In practice, while the gold market is not as deep as equity or treasury markets, there is already ample liquidity for a typical institutional investor to significantly increase their exposure at reasonable transaction costs.

[1] Data shown through July 2020. The 60/40 Portfolio is a mix of 60% world equities and 40% world nominal bonds. The 60/40 Portfolio with Gold Overlay is a mix of 60% world equities, 40% world nominal bonds, and 10% gold. It is expected that the simulated performance will periodically change as a function of both refinements to our simulation methodology and the underlying market data. HYPOTHETICAL OR SIMULATED PERFORMANCE RESULTS HAVE CERTAIN INHERENT LIMITATIONS. UNLIKE AN ACTUAL PERFORMANCE RECORD, SIMULATED RESULTS DO NOT REPRESENT ACTUAL TRADING OR THE COSTS OF MANAGING THE PORTFOLIO. ALSO, SINCE THE TRADES HAVE NOT ACTUALLY BEEN EXECUTED, THE RESULTS MAY HAVE UNDER OR OVER COMPENSATED FOR THE IMPACT, IF ANY, OF CERTAIN MARKET FACTORS, SUCH AS LACK OF LIQUIDITY. SIMULATED TRADING PROGRAMS IN GENERAL ARE ALSO SUBJECT TO THE FACT THAT THEY ARE DESIGNED WITH THE BENEFIT OF HINDSIGHT. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. Past performance is not indicative of future results. Please review the Important Disclosures located at the end of this report.

