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Why You Should Own (Some) Gold

Gold acts as insurance when bad things happen, from inflation and runaway government debt to war and political instability

By Greg Ip Follow

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Gold stored in a basement depository vault at the New York Fed, circa 1960s. PHOTO: ROLLS PRESS/POPPERFOTO/GETTY IMAGES

Here are some good reasons not to invest in gold. First, it earns no dividends or interest. Second, you can't live in it, like real estate. Third, it has doubled in the past few years, so forget about buying at the bottom.

Nonetheless, this column is going to explain why a prudent, diversified investor should consider owning gold today. This isn't about potential return. It is about insurance. Gold tends to go up when bad things happen, from inflation and runaway government debt to war and political instability. Those things seem more likely now than they have for a long time.

In a new report, Ashwin Thapar, of D.E. Shaw Investment Management, argues that as global wealth grows, so should gold holdings. He estimates that since 1975, gold has ranged from 1.8% to 7.3% of developed market liquid wealth (it has recently broken above that range).

Newly mined gold increases the stock of gold less than 2% a year, according to JPMorgan Chase. The remainder of gold wealth comes from a rising price. Over the long run that is probably enough to keep up with Treasury bills, but not a plain vanilla mix of stocks and bonds. The purpose of gold is to damp the impact when something hammers stocks, bonds, or the dollar. The trick is to figure out what that something is.

Inflation is gold's best friend

Gold does best when fiat currencies (the kind central banks issue) lose purchasing power. Gold soared during the 1970s as stocks and bonds foundered amid double-digit inflation.

U.S. inflation, at around 3%, is hardly a disaster. And the Federal Reserve thinks it will be lower in a year in part because of a weaker labor market, which is why it is likely to trim interest rates on Wednesday.

But the structural forces that kept inflation below the Fed's 2% target before 2020 have switched direction. Globalization, which brought a flood of low-cost goods to American shores, is out; tariffs, protection and reshoring are in. Before, legal and illegal immigration compensated for an aging labor force. That inflow has been cut off even as fertility rates hit new lows.

These structural pressures need not push inflation higher. The Fed can ensure inflation stays low by raising the real interest rate (the nominal rate minus inflation), which weakens demand and pricing power. As D.E. Shaw points out, higher real rates are bad for gold.

But making such tough decisions requires the Fed to remain independent. And before long, it may not be. On Tuesday, President Trump told reporters the Fed should be independent, "but I think they should listen to smart people like me."

He is taking unprecedented steps to ensure the Fed listens. He has just installed the chairman of his Council of Economic Advisers, Stephen Miran, as a Fed governor;

Miran will retain his White House title while on the Fed. Trump is also trying to fire another governor for alleged mortgage fraud. By next May, he can replace Chair Jerome Powell. He is forthright about his goal: get interest rates down faster.

Investors don't seem to think this will lead to higher long-run inflation, and they might be right. But an end to central bank independence is the sort of once-in-a generation risk investors struggle to price, and for which gold is well-suited.

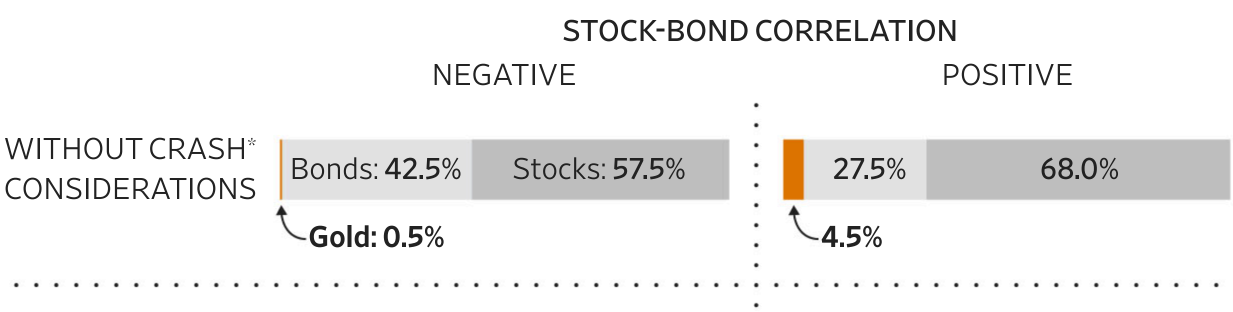
A gold bar for sale at a Costco store in New Jersey. PHOTO: CLARK HODGIN/BLOOMBERG NEWS

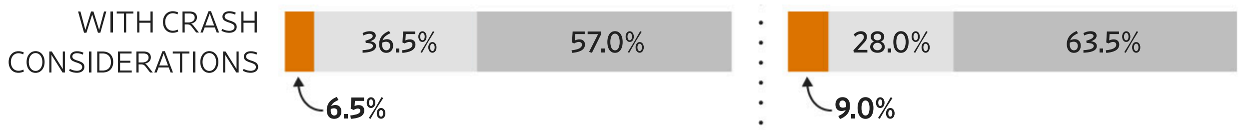
Stocks and bonds

When interest rates go up, bond prices go down, and gold usually rises. So gold can hedge bonds. But that hedging value depends importantly on why interest rates are going up. In low inflation eras, rates rise and bond prices fall because of better economic prospects, and stocks rally. So stock and bond returns are negatively correlated, and hedge each other.

But at times of rising inflation, bond and stock prices rise and fall together. Their returns are positively correlated and no longer hedge each other. This makes gold even more attractive, because it can hedge both. There are signs of this now.

Optimized asset allocations under different scenarios





*Stock market crash or inflation shock. Note: For illustrative purposes; not a recommendation. Allocation amounts are rounded to the nearest 0.5%; totals shown might not sum to 100%.
Source: D.E. Shaw Group
Drew An-Pham/WSJ

You could hedge against inflation with Treasury inflation-protected securities, or TIPS. But last month, Trump fired the commissioner of the Bureau of Labor Statistics after it reported unflattering jobs data, and nominated a partisan supporter to replace her. Investors must now weigh the risk the BLS will change the consumer-price index to lower reported inflation. That would undercut the protection offered by TIPS, which are indexed to the CPI. Gold isn't.

Debt and the dollar

The publicly held federal debt is on track to rise from almost 100% of gross domestic product now to 120% in a decade, exceeding the all-time high during World War II, according to the Committee for a Responsible Federal Budget. Neither political party has a credible plan to stop the rise.

High debt poses two risks, both of which make gold attractive. The more remote is that the government defaults. The other is "fiscal dominance," in which the central bank gives priority to keeping the federal debt burden manageable over inflation. Indeed, Trump regularly cites debt costs as a reason why the Fed should cut rates.

Gold also competes with the dollar as a reserve asset for central banks, sovereign-wealth funds and individuals trapped in kleptocratic regimes. The dollar, however, has lost some of its reserve appeal since early 2022, when Western governments froze Russia's foreign-exchange reserves because of its full-scale invasion of Ukraine. Goldman Sachs estimates central bank buying accounts for most of gold's doubling in price since. Trump's trade war this year further soured investors on the dollar, no doubt helping gold.

If high inflation, fiscal dominance or a loss of reserve status threaten the dollar, you could buy foreign currencies. But other countries also have high debt and political instability. You can't be sure the euro will exist in a decade, given the rise of euroskeptic parties in Germany and France. Gold hedges against a collective loss of trust in fiat currencies.

Gold as insurance

Fear of inflation, fiscal dominance, dollar depreciation, war and political instability are why gold has already risen so much. Since these risks are already reflected in its price, why buy now? This argument sounds like what you hear at the top of a market.

The case for gold doesn't depend on where its price is going, but its role in your total portfolio. According to D.E. Shaw, someone optimizing both return and risk might allocate anywhere from 0.5% to 9% of a portfolio to gold. The share is higher when stocks and bonds are positively correlated, or a financial disaster, such a stock market crash or inflation spike, are a concern. This allocation isn't right for everyone; it depends on personal risk tolerances.

And what if your gold goes down? Think of it as an unused insurance policy. And be glad your house didn't burn down.

Write to Greg Ip at greg.ip@wsj.com

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