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In focus

The tug of war: how we think about gold in Multi-Asset

October 2020

Gold is often thought of as a hedge against everything. For thousands of years, it has been seen as a safe haven, and since the dawn of paper money, it has been seen as the ultimate currency.

In an extreme doomsday scenario, gold may well be an effective store of value, but the nagging reminder that our money is really just paper is closely linked to the fear of inflation. Hence the popular notion that gold is an inflation hedge.

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Multi-Asset Strategist

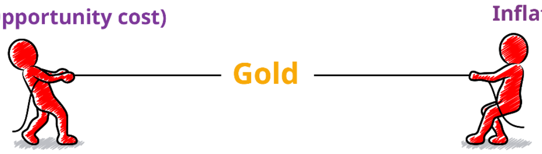
Gold is in the middle of a tug of war

But its not as simple as that. We view gold as being subject to a tug of war between two key variables. Since gold doesn't pay any income, the income available on other 'safe havens' is effectively foregone by owners of gold. The prevailing nominal interest rate available in the market, then, is a measure of the opportunity cost of holding gold.

If nominal interest rates go up, gold is less attractive and its price goes down, all else equal. So nominal interest rates are on one side of the tug of war. On the other side of the tug of war is inflation.

We don't disagree with the notion that paper money is subject to erosion of value over time. So we too expect that as inflation goes up, demand for gold and its price should go up, all else being equal. So the price of gold is subject to a tug of war between nominal interest rates and inflation (Figure 1).

Figure 1: Gold is subject to a tug of war between nominal interest rates and inflation

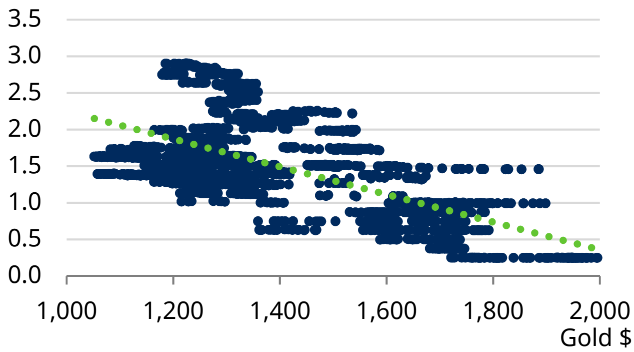


Source: Schroders.

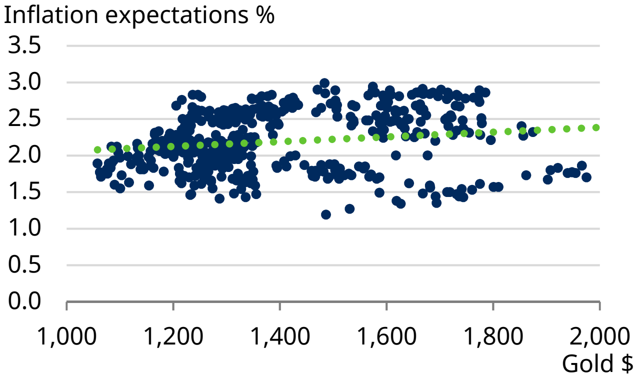
We can see this tug of war in the data. Figure 2 has two panels: one showing the relationship between gold and nominal interest rates, and the other showing the relationship between gold and inflation[1]. A relationship is evident in both charts, but neither one is a strong fit.

Figure 2: Gold is related to both inflation and nominal interest rates, but only weakly

Gold vs. nominal interest rates



Gold vs. inflation



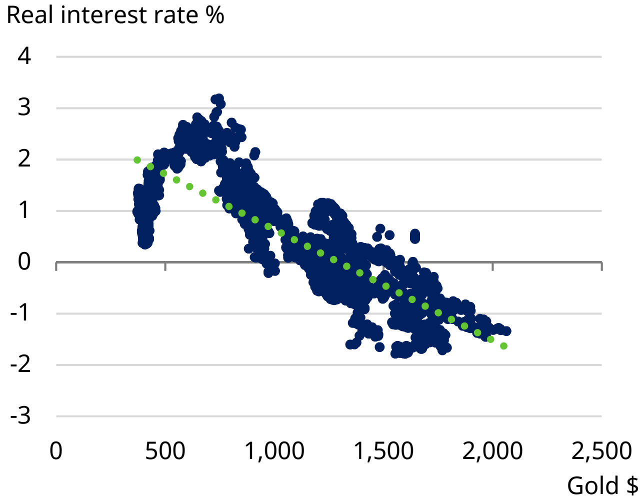
Source: Schroders, Refinitiv, 30 September 2020.

Clearly it is not just one of the above variables driving the gold price, but a combination of the two. Combining nominal interest rates with inflation gives us the real interest rate. Looking at the relationship between real interest rates and gold gives a much better fit (Figure 3).

[1]We use 5-year interest rates and inflation rates so as to smooth out any short term fluctuations.

Schroders

Figure 3: Gold is strongly related to real interest rates



Source: Schroders, Bloomberg, 30 September 2020.

All in all, gold is an effective hedge against inflation when inflation is rising more rapidly than nominal interest rates are rising. If interest rates are rising more sharply, the impact of the increasingly negative opportunity cost of holding gold overwhelms the inflation hedging benefit – hence the tug of war.

Gold is unreliable as a hedge against equity risk

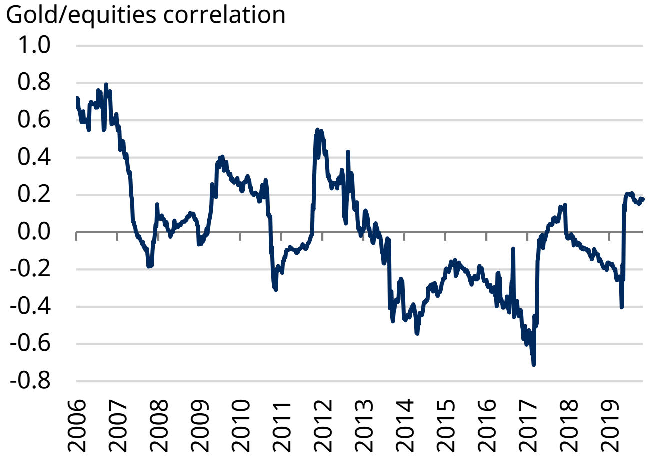
Neither is gold a particularly reliable hedge against equity risk. In some environments, gold actually moves in the same direction as other risky assets such as equities. The environment that prevailed in 2020 is a good example.

The relationship between real interest rates and equities is what drives gold's relationship with the latter, given gold's strong link to the former. Since gold is strongly linked to real interest rates, the link between gold and equities will be driven by the relationship between equities and real interest rates.

Since equity markets reacted favourably to central bank stimulus, which drove interest rates lower and inflation expectations higher, equities have been negatively correlated with real interest rates. This is why gold has been positively correlated with equities.

This is not always the case, as Figure 4 shows. But such behaviour does warn us against relying on gold to hedge us against the next equity market drawdown. The next market fall may well be driven by a rise in real interest rates (either because of a collapse in inflation expectations or a rise in nominal interest rates).

Figure 4: The correlation between gold and global equities increased sharply this year

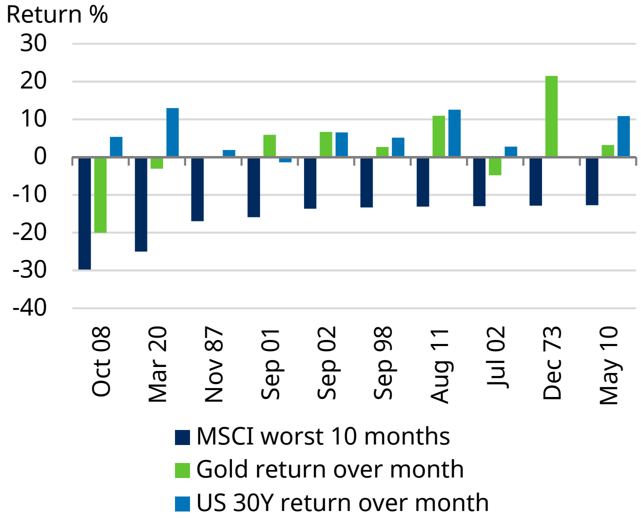


Source: Schroders, Refinitiv, 30 September 2020.

It is tempting to try and explain the behaviour of gold using the economic cycle, but we find a loose relationship at best. Every economic cycle is different; inflation and interest rates at a given stage in one cycle behave differently to the same stage in another cycle. What holds true across cycles, however, is the relationship between gold and real interest rates.

Framing this another way, we look back at history and measure gold returns in the worst months on record for equity markets. Figure 5 shows that gold was not always a reliable hedge, and sometimes a terrible one.

Figure 5: Gold has not always been a reliable hedge against equity risk



Source: Schroders, Refinitiv, 30 September 2020.

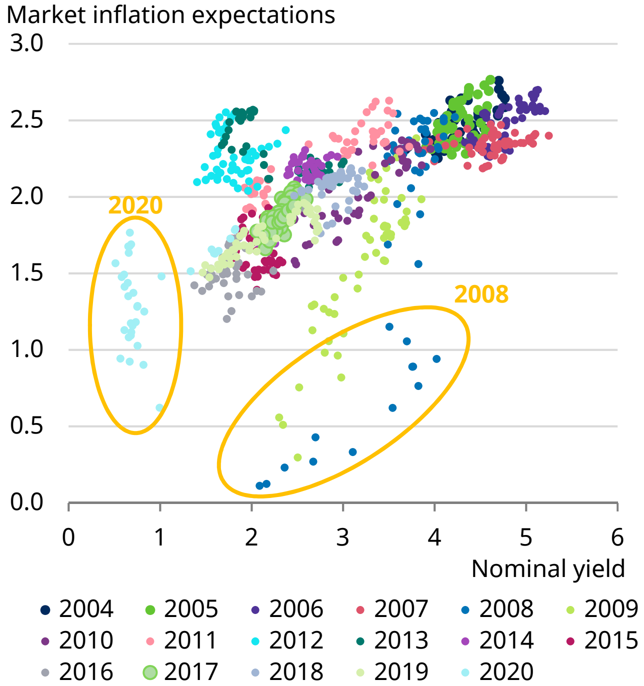
Equities are not the only 'risky' asset, but when a substantial fall in equity markets occurs, it usually sends shockwaves across financial markets. Many readers will recognise the dates in Figure 5 and remember seeking the supposed safety of assets such as gold. Hindsight allows us to see that gold was not so safe after all.

So how do we use gold in our Multi-Asset portfolios?

Like any asset, gold must earn its place in the portfolio. Gold is typically not a strategic position in our Multi-Asset portfolios, owing to the narrow set of economic and market circumstances under which it performs well and the opportunity cost of holding it for any period of time. That makes gold a tactical asset class – one which enters and exits the portfolio for shorter periods of time – forcing it to compete with other asset classes to earn its place in the portfolio.

Given the tug of war that gold is subject to, our outlook on gold will largely be determined by our view on the future path of nominal interest rates and our expectations for inflation. Falling real interest rates are often associated with a loosening of financial conditions, so gold often benefits from the provision of liquidity by central banks. When nominal interest rates are close to the theoretical zero lower bound – as they are now – real interest rates are driven more by expectations of inflation than they are by nominal interest rates. That dynamic is very apparent in the unusual market environment that has prevailed so far in 2020 (Figure 6).

Figure 6: 2020 stands out as an unusual year, where real interest rates have been driven more by inflation expectations than nominal interest rates



Source: Schroders, Refinitiv, 30 September 2020.

The implication of Figure 6 is that central banks can impact the gold price through unconventional policy too (i.e. by influencing inflation expectations), as well as by changing the nominal interest rate.

There are more direct ways of gaining exposure to real interest rates, however. Inflation-linked bonds, such as Treasury Inflation-Protected Securities (TIPS) in the US, pay the buyer the market-determined real interest rate, plus realised inflation later. The real interest rate is market-determined because it is driven by market participants' expectations of inflation, and so their view on whether nominal or real bonds are more attractive at any given time. Outside of the US, we can express views on real interest rates using local inflation-linked bonds, but since gold is priced in dollars, these bonds have less of a connection to gold.

Through our research process, we make our own assessments about the future direction of inflation and nominal interest rates, so we have a view about the attractiveness of inflation-linked bonds. Since gold and inflation-linked bonds are clearly closely related, we will also make a judgement – often based on technical factors such as money flows in the market, price momentum or market sentiment – about which one we find to be more attractive. We could possibly own both in a portfolio at the same time, but we would be mindful of the overlaps and we would require a clear rationale for why they both deserve a place in the portfolio. Since gold pays no income, an assessment of US inflation-linked bonds (TIPS) can be helpful in calculating an estimated value for gold, albeit imprecise. The bottom line is: the price of gold – like that of an inflation-linked bond – is negatively related to real interest rates.

Implementation

In terms of implementation, this paper has discussed our process for forming a view on the yellow metal itself. But for those portfolios that can't gain direct exposure to gold – or other commodities for that matter – other implementation options are available. This is particularly pertinent for sustainably run portfolios. While it is difficult to integrate sustainability criteria into direct commodities investment, integration into equity stock selection processes is now commonplace. Sustainable portfolios seeking to invest in gold might therefore gain exposure via investment in gold miners, for example. It should be noted, however, that the relationships discussed in this note are less likely to hold when exposure to gold is indirect, and a more traditional equity analysis will be warranted.

Conclusion

It is important to avoid complacency when making assumptions about the behaviour of gold. Gold is not a hedge against everything. It is subject to a tug of war between two variables which in combination give us a simple relationship: gold is negatively correlated with real interest rates. Given the difficulty in valuing gold due its lack of cash flows, it can be helpful to keep an eye on the yield of inflation-linked bonds to form a view about the estimated value of gold. After considering market pricing, sentiment, flows and relative value opportunities, Multi-Asset investors should choose whether to buy gold, gain direct exposure to real yields through inflation-linked bonds, or make room for both in their portfolios.

With special thanks to Maurice Hewins.