

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.



Ben Popatlal
Multi-Asset Strategist

Gold is in the middle of a tug of war

But it's 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

Nominal interest rate
(Opportunity cost)



Gold

Inflation



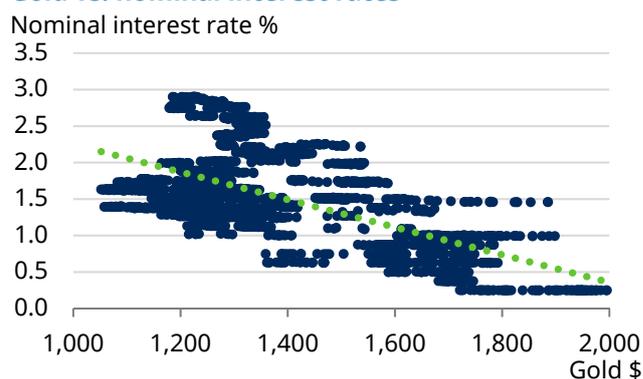
Source: Schroders.

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 inflation¹. A relationship is evident in both charts, but neither one is a strong fit.

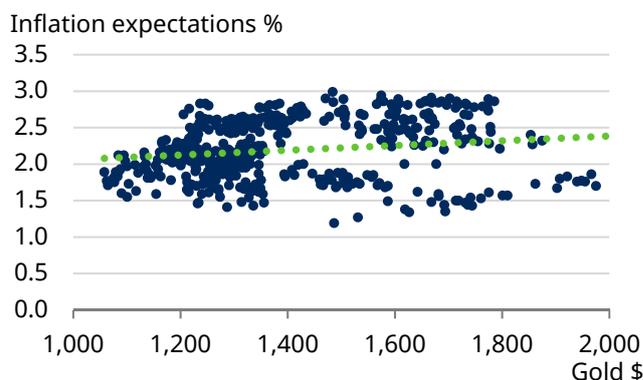
¹We use 5-year interest rates and inflation rates so as to smooth out any short term fluctuations.

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

Gold vs. nominal interest rates



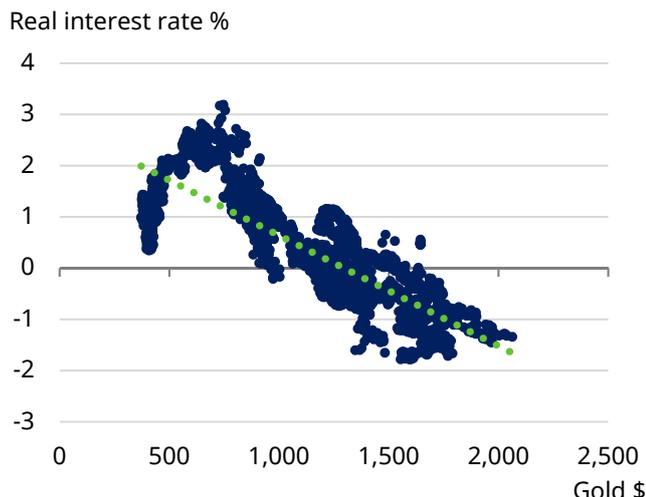
Gold vs. inflation



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).

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

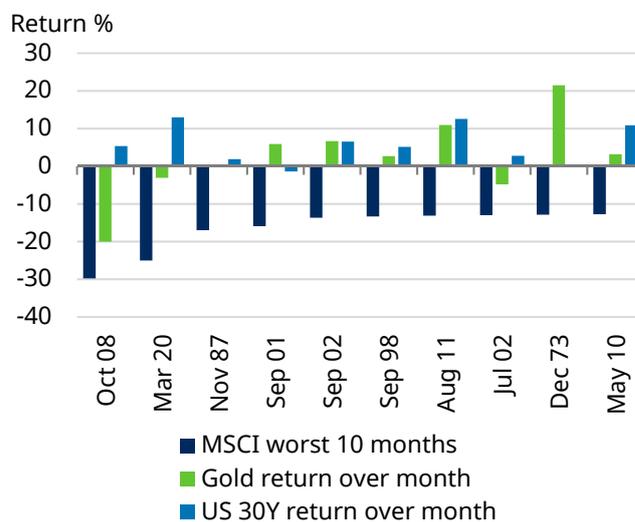


Source: Schroders, Refinitiv, 30 September 2020.

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.

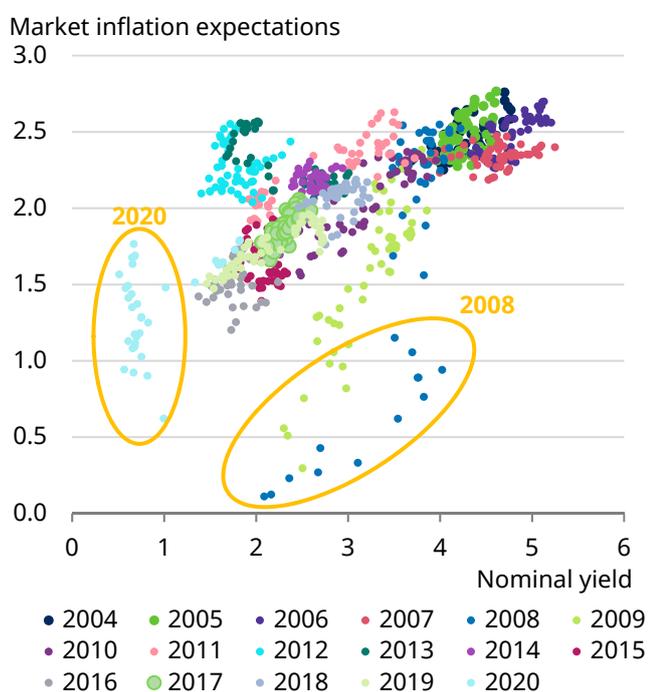
Equities are not the only ‘risky’ asset, but when a substantial fall in equity markets occurs, it usually sends shockwaves across financial markets. Many readers will recognise the dates in Figure 5 and remember seeking the supposed safety of assets such as gold. Hindsight allows us to see that gold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

Important information

The views and opinions contained herein are those of the authors as at the date of publication and are subject to change due to market and other conditions. Such views and opinions may not necessarily represent those expressed or reflected in other Schroders communications, strategies or funds.

This document is intended to be for information purposes only. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument or security or to adopt any investment strategy. The information provided is not intended to constitute investment advice, an investment recommendation or investment research and does not take into account specific circumstances of any recipient. The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice. Any references to securities, sectors, regions and/or countries are for illustrative purposes only.

Information herein is believed to be reliable but Schroders does not represent or warrant its completeness or accuracy. No responsibility or liability is accepted by Schroders, its officers, employees or agents for errors of fact or opinion or for any loss arising from use of all or any part of the information in this document. No reliance should be placed on the views and information in the document when taking individual investment and/or strategic decisions. Schroders has no obligation to notify any recipient should any information contained herein change or subsequently become inaccurate. Unless otherwise authorised by Schroders, any reproduction of all or part of the information in this document is prohibited.

Any data contained in this document have been obtained from sources we consider to be reliable. Schroders has not independently verified or validated such data and they should be independently verified before further publication or use. Schroders does not represent or warrant the accuracy or completeness of any such data.

All investing involves risk including the possible loss of principal. Exchange rate changes may cause the value of any overseas investments to rise or fall. Past Performance is not a guide to future performance and may not be repeated. This document may contain 'forward-looking' information, such as forecasts or projections. Please note that any such information is not a guarantee of any future performance and there is no assurance that any forecast or projection will be realised. For your security, communications may be taped or monitored.

Note to viewers in the European Union/European Economic Area: Schroders will be a data controller in respect of your personal data. For information on how Schroders might process your personal data, please view our Privacy Policy available at www.schroders.com/en/privacy-policy or on request should you not have access to this webpage. Issued by Schroder Investment Management (Europe) S.A., 5, rue Höhenhof, L-1736 Senningerberg, Luxembourg. Registered No. B 37.799

Note to readers in the United Kingdom: Schroders will be a data controller in respect of your personal data. For information on how Schroders might process your personal data, please view our Privacy Policy available at www.schroders.com/en/privacy-policy or on request should you not have access to this webpage. Issued by Schroder Investment Management Limited, 1 London Wall Place, London, EC2Y 5AU. Registered Number 1893220 England. Authorised and regulated by the Financial Conduct Authority.

Note to readers in Argentina: Schroder Investment Management S.A., Ing. Enrique Butty 220, Piso 12, C1001AFB – Buenos Aires, Argentina. Registered/Company Number 15. Registered as Distributor of Investment Funds with the CNV (Comisión Nacional de Valores). **Nota para los televidentes en Argentina:** Schroder Investment Management S.A., Ing. Enrique Butty 220, Piso 12, C1001AFB – Buenos Aires, Argentina. Inscripto en el Registro de Agentes de Colocación y Distribución de PIC de FCI de la Comisión Nacional de Valores con el número 15.

Note to viewers in Brazil: Schroder Investment Management Brasil Ltda., Rua Joaquim Floriano, 100 – cj. 142 Itaim Bibi, São Paulo, 04534-000 Brasil. Registered/Company Number 92.886.662/0001-29. Authorised as an asset manager by the Securities and Exchange Commission of Brazil/Comissão de Valores Mobiliários ('CVM') according to the Declaratory Act number 6816.

Note to viewers in Hong Kong: Schroder Investment Management (Hong Kong) Limited, Level 33, Two Pacific Place 88 Queensway, Hong Kong. Central Entity Number (CE No.) ACJ591. Regulated by the Securities and Futures Commission. In Hong Kong, this material is issued by Schroder Investment Management (Hong Kong) Limited and has not been reviewed by the SFC.

Note to viewers in Indonesia: PT Schroder Investment Management Indonesia, Indonesia Stock Exchange Building Tower 1, 30th Floor, Jalan Jend. Sudirman Kav 52-53 Jakarta 12190 Indonesia.

Registered/Company Number by Bapepam Chairman's Decree No: KEP-04/PM/MI/1997 dated April 25, 1997 on the investment management activities and Regulated by Otoritas Jasa Keuangan ('OJK'), formerly the Capital Market and Financial Institution Supervisory Agency ('Bapepam dan LK'). OJK makes no representation of approving or does not approve this advertisement or publication, nor declare the truth or adequacy of the contents of this advertisement or publication.

Note to viewers in Japan: Schroder Investment Management (Japan) Limited, 21st Floor, Marunouchi Trust Tower Main, 1-8-3 Marunouchi, Chiyoda-Ku, Tokyo 100-0005, Japan. Registered as a Financial Instruments Business Operator regulated by the Financial Services Agency of Japan. Kanto Local Finance Bureau (FIBO) No. 90.

Note to viewers in People's Republic of China: Schroder Investment Management (Shanghai) Co., Ltd., RM1101 11/F Shanghai IFC Phase (HSBC Building) 8 Century Avenue, Pudong, Shanghai, China, AMAC registration NO. P1066560. Regulated by Asset Management Association of China.

Note to viewers in Singapore: Schroder Investment Management (Singapore) Ltd, 138 Market Street #23-01, CapitaGreen, Singapore 048946. Company Registration No. 199201080H. Regulated by the Monetary Authority of Singapore. This advertisement or publication has not been reviewed by the Monetary Authority of Singapore.

Note to viewers in South Korea: Schroders Korea Limited, 26th Floor, 136, Sejong-daero, (Taepyeongno 1-ga, Seoul Finance Center), Jung-gu, Seoul 100-768, South Korea. Registered and regulated by Financial Supervisory Service of Korea.

Note to viewers in Switzerland: Schroder Investment Management (Switzerland) AG, Central 2, CH-8001 Zürich, Postfach 1820, CH-8021 Zürich, Switzerland. Enterprise identification number (UID) CHE-101.447.114. Authorised and regulated by the Swiss Financial Market Supervisory Authority (FINMA).

Note to viewers in Taiwan: Schroder Investment Management (Taiwan) Limited, 9F, 108, Sec.5, Hsin-Yi Road, Hsin-Yi District, Taipei 11047 Taiwan, R.O.C. Registered as a Securities Investment Trust Enterprise regulated by the Securities and Futures Bureau, Financial Supervisory Commission, R.O.C.

Note to viewers in the United Arab Emirates: Schroder Investment Management Limited, located on 1st Floor, Gate Village Six, Dubai International Financial Centre, PO Box 506612 Dubai, United Arab Emirates is regulated by the Dubai Financial Services Authority. 503599.