Market Commentary

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Is Now a Good Time to Hold Gold?

As of August 5, gold has rallied 35% this year, far eclipsing most other asset classes and its own previous high from 2011. While we may not know the exact reasons for the surge in gold's popularity, there are several factors supporting its record-setting rally.

First, as a safe-haven asset, gold tends to do well when there is increased uncertainty, and there is no shortage of potential risks now. Currently, the coronavirus (COVID-19) pandemic is the greatest source of uncertainty. The spread of the virus, scope of government containment measures, and the development of therapies and vaccines will have a profound impact on the economic environment. At the same time, we face other domestic and international risks. In the U.S., social and political conflict has been escalating since the death of George Floyd. Tensions have also been mounting between the U.S. and China on issues such as unfair trade practices, cyber espionage, and human rights violations.

Second, the current opportunity cost of owning gold is low. Investing in gold means investing less in other assets, such as stocks and bonds. Unlike other assets, gold does not produce an income stream so it "costs" investors to hold gold instead of other assets (in terms of lost yield). At present, the yield being given up is exceptionally low. For example, the S&P 500's forward earnings yield is around the lowest it's been in the last 25 years, and U.S. treasury yields—of all maturities—are below expected inflation.

Finally, because gold has been used as a form of currency for thousands of years, it has benefited from recent actions taken by the U.S. government which risk devaluing the dollar. However, because of the dollar's current status as a globally accepted currency, the U.S. can borrow, print, and spend a lot more money than it could otherwise, and that's exactly what the U.S. has done to stem this economic crisis. There's no doubt that increased government spending is helpful in times like these when the private sector is suffering from a steep drop in income. By filling the spending and income holes caused by the current recession, the government can reduce the risk of a downward spiral caused by defaults and deflation.

The downside is that government debt is exploding higher, and if there isn't a corresponding increase in productivity, the central bank (Fed) will have to continue lending to the federal government with newly printed money. This process is called debt monetization, and it devalues the currency that is printed. The risk of economic stagnation (a prolonged period of little or no growth in the economy) continuing is material. After cutting interest rates to zero and purchasing massive amounts of debt with newly printed money, the Fed is left with few policy options to stimulate economic growth. If this scenario persists, there is an increased risk of the dollar devaluing against foreign currencies, domestic goods and services (through inflation), financial assets (e.g., stocks), and/or real assets (e.g., gold).

The key thing to keep in mind is that the future is highly uncertain. So, when constructing portfolios, we always emphasize diversification across asset classes. We evaluate the opportunity set by testing asset classes' valuations across a range of economic scenarios, giving assets that produce income streams (stocks and bonds) preferential treatment. But to the extent that stocks and bonds risk not meeting your portfolio's future real return goals due to stretched valuations, we look to real assets and absolute return strategies as alternative return sources. Currently, we believe gold is attractive enough that it makes sense for some investors to consider holding it in their portfolios. Gold by itself is extremely volatile due to its lack of cash flows and can deviate substantially from stocks and bonds, but given the current economic and market landscape, we believe gold is an important component of well-diversified portfolios for investors who can tolerate its large swings. Nevertheless, given a long enough time horizon, stocks are still preferred over all other assets including gold.
