The Lustre of Gold

"Gold is money. Everything else is credit."

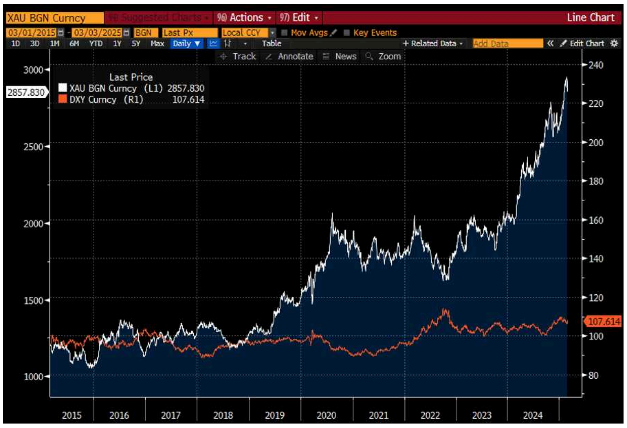
-J.P. Morgan, 1912.

Insights

Whether you agree with his quote or not, let us take a look at some myths and truths about gold, currencies (real money!) and of course Bitcoin.

Is gold really money? It is but a mineral mined out of mother earth with an alluring colour to it that fascinates cultures around the world, from ancient Egyptians to cultures all over the world today. Some people argue that gold has no intrinsic value. They say it is a barbaric relic with no monetary qualities, yet perceived and long-held believed that somehow it is a storer of value in times of economic distress. Gold has seen it's value in US dollar terms appreciate some 2.3x over the last 10 years:

Figure 1 : Gold over the last 10 years vs the US Dollar Index



Source: Bloomberg

Critics of gold contend that in a modern economic environment, paper or indeed digital currency, is the money of choice, and that gold's only worth is as a material for making jewellery. At the other end of the spectrum are those who assert that gold is an asset with various intrinsic qualities that make it unique and necessary for investors to hold in their portfolios. They believe that there are many reasons for investing in gold:

1. **Storer of value** – gold has maintained its value over thousands of years, making it a reliable storer of wealth. Unlike money or fiat currencies, which can lose value due to inflation or economic instability, gold tends to retain its purchasing power over time.

2. **Hedge against inflation** – when the value of currencies declines due to rising prices, gold prices typically rise preserving the real value of an investor's wealth.

3. **Safe haven asset** – during times of economic uncertainty, geopolitical tensions or market volatility, gold is bought as a safe-haven asset. Its value tends to remain stable or even increase during crises, providing a cushion against losses in other investments like stocks or bonds.

4. **Diversification** – Gold has a low correlation with other asset classes, such as equities and bonds. Adding gold to a portfolio can reduce overall risk and improve diversification, as it often performs differently than traditional financial assets.

5. **Limited or Finite Supply** – touted to be a finite resource, gold's supply is relatively constrained. This scarcity contributes to its value, as demand often outstrips supply, especially during periods of economic instability.

6. **Global Acceptance** – universally accepted and recognised as a form of wealth, for its liquidity around the world.
7. **Central Bank Demand** – Central banks around the world hold significant amounts of gold as part of their reserves. This institutional demand underpins gold's value and underscores its importance in the global financial system.
8. **Currency Devaluation** – gold protects against potential devaluations of fiat currencies.
9. **Technological and Industrial Demand** – Beyond its financial uses, gold has practical applications in industries such as electronics, medicine and aerospace. This demand adds another layer of support for its value.
10. **Finally, Cultural and Historical Significance** – gold has deep cultural and historical significance in many societies, often symbolising wealth, power and stability. This enduring perception contributes its lasting appeal.

As investors, we would deep dive into the "myths" surrounding gold as a safe haven asset. Specifically, on gold's supposed role as a storer of value, protector against inflation and diversifier. We refer to these as myths, simply on the grounds that final results sometimes produce the outcome we expect and, sometimes not. Despite its reputation, several myths about gold as a safe haven asset can mislead investors about its true nature and performance. Common misconceptions include the belief that gold ***always increases in value*** during economic uncertainty and serves as a ***guaranteed hedge against inflation***, which can mislead investors about its actual investment horizon. These misunderstandings can distort ***investment strategies*** and ***expectations***, potentially affecting investor confidence.

Myth 1: Gold Always Increases In Value During Economic Uncertainty

One common myth is that ***gold always increases in value*** during economic uncertainty, leading many investors to view it as a foolproof investment, despite potential price fluctuations. However, gold prices can vary significantly due to various factors beyond economic conditions, including speculative demand and central bank policies.

For example, during the 2008 financial crisis, many expected gold prices to rise sharply as markets fell, highlighting the complexities of market conditions. Instead, gold initially dropped along with other assets as investors sold their holdings to cover losses, demonstrating the impact of emotional investing.

This highlighted the complexity of market dynamics, showing that ***investor sentiment*** can drive prices down even in difficult times, affecting overall market trends. Government actions, such as ***interest rate changes***, currency fluctuations, and government spending, also significantly impact gold's value, causing unexpected price drops. Therefore, understanding these market forces is crucial for anyone considering investing in gold and managing investing risks, particularly those jumping in purely on the back of this "myth".

Myth 2: Gold Is A Reliable Hedge Against Inflation

Another common myth is that gold always serves as a reliable hedge against inflation, which can lead investors to have unrealistic expectations regarding their financial analysis. While gold is often viewed as a protective asset, its performance can fluctuate, so it's important for investors to consider market trends and economic conditions within their investment strategies. Inflation can reduce purchasing power, leading many to turn to gold as protection in their investment portfolio. When inflation rises, ***demand for gold*** often does too, as it is perceived as a hedge against inflation. However, gold's ability to protect against inflation has ***not always been reliable***, affected by various market conditions.

For example, in the ***1970s***, gold prices surged as inflation increased, preserving value for investors and influencing capital markets. In contrast, during the ***1980s***, when inflation stabilized, gold lost its appeal, and prices declined, reflecting its speculative demand. Contrastingly, over the last year as inflation trended lower, gold surged. Why?

This shows the importance of analyzing both the ***historical role of gold*** and ***current economic indicators*** to assess its reliability as a hedge and its relevant role in portfolio allocation.

Myth 3: Gold Is A Diversification Tool For Portfolios

The idea that gold is a good diversification tool for investment portfolios is a ***misconception*** that can mislead investors about the broader market conditions and investment horizon.

While gold can help diversify an asset mix, depending only on it without looking at other investments can lead to ***unnecessary risks*** and ***volatility***, affecting overall asset performance and dividends. Understanding the role of gold in a portfolio is important, as diversification is about balancing different asset classes for effective risk management. A well-rounded portfolio typically includes a mix of stocks, bonds, and alternative assets like commodities and precious metals to reduce losses when one area performs poorly.

Empirically, reality says the following:

Reality 1: Gold Can Be Volatile And Subject To Market Forces

Investors often overlook that gold can be quite volatile, influenced by various market factors affecting its price changes. This volatility can result from speculative demand, rebalancing, geopolitical events, and changes in investor sentiment.

Understanding the causes of gold's price movements is essential. For example, during economic uncertainty, many people view gold as a safe haven, increasing demand and raising prices. Similarly, geopolitical tensions can cause sudden price hikes as investors seek security.

Conversely, a stable economy or rising interest rates might reduce interest in gold, leading to lower prices. Large financial players speculating on gold's future can also cause rapid price swings. Examples of significant fluctuations include gold reaching then record highs during the 2008 Financial Crisis and falling sharply in 2012 as confidence in equity markets improved. Recognizing these market influences helps guide better investment strategies.

Reality 2: Gold May Not Always Perform Well During Economic Uncertainty

Contrary to common belief, gold does not always perform well during economic uncertainty, as its value can change due to various external factors.

Historically, investors have looked to this precious metal to protect their wealth. However, there have been times when it did not meet expectations during economic downturns. For instance, during the inflationary crisis of 2022, gold initially rose but later faced significant price drops, showing how market sentiment can affect its value.

- In even earlier recessions, like the dot-com crash of 2000, gold saw limited increases.
- Factors such as geopolitical conditions, inflation rates, and interest changes can influence gold's market behavior.

Investors should understand these complexities and consider a wider range of factors affecting gold prices, beyond the usual idea of it being a constant safe haven.

Reality 3: Gold Should Be Used As A Diversification Tool, Not A Sole Investment

Gold should be used to diversify an investment portfolio, not as a sole investment, due to its inherent risks, volatility and limitations. Including gold in a larger investment strategy helps investors manage risks related to market volatility and economic changes. This method strengthens portfolio resilience, as different asset types often react differently to economic indicators. For instance, during inflation or geopolitical tension, gold has typically held its value when stocks might decline. Therefore, combining gold with:

- Equities
- Bonds and
- Some Real Estate

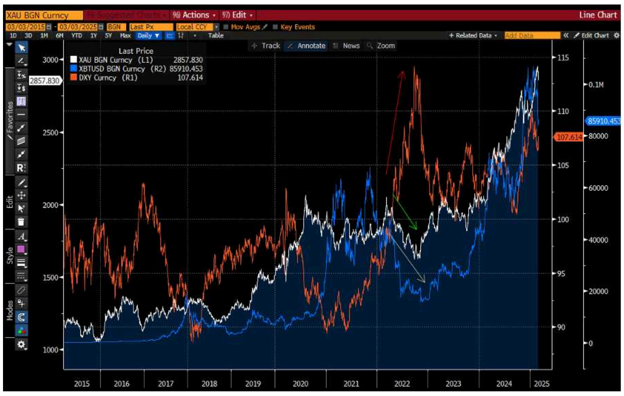
can create a more balanced portfolio. A practical approach might involve allocating a portion of investments to gold, while primarily investing in stocks and bonds. This diversification not only reduces risks but also takes advantage of gold's potential value increase during turbulent times, promoting a more robust financial strategy.

So, there you have it – a sort of a tie-breaker. Gold, whether one believes is money as Mr JP Morgan did in 1912 or otherwise, has its place in one's portfolio. Treat is as yet another asset class but monitor the above mentioned factors, taking into account the above "realities" could serve you well.

And what about bitcoin as a replacement for gold, one might ask.

The late Charles Munger of Berkshire Hathaway said that "Bitcoin is worthless artificial gold". Perhaps, perhaps not. A story for another time.

Figure 2 : Price pattern over the last 10 years for Gold, Bitcoin and the Usd Index.



Source: Bloomberg

The Covid-19 pandemic era of 2020-2021 saw both gold and Bitcoin's "protection". The US Dollar came to the rescue in 2022 as inflation ravaged the world, then Gold and Bitcoin post-2022 outperformed again, albeit at a higher volatility clip for Bitcoin.

Conclusion

For investors, finding a safe haven for their assets, especially during volatile market periods, is a necessity. Is gold the best choice to fulfil that role?

When markets fall into periods of crisis, it is necessary to re-evaluate the hedging and safe-haven properties of traditional assets. In this Monthly Insight, we assessed the safe-haven roles of gold, the mighty US Dollar and to a lesser extent, Bitcoin for risk assets (stocks) over a period including the GFC of 2008, the COVID-19 pandemic, and the inflation spiralled period of 2022-2023. Charts provide evidence of the changing safe-haven properties of assets over differing periods of crisis. Specifically, gold - a traditional asset, loses its role as a safe-haven asset during the COVID-19 pandemic but this role is restored in the Netherlands, US and Germany. Similarly, Bitcoin does not perform as a safe haven during the COVID-19 pandemic but is a strong safe-haven asset for the stock markets of European countries such as the Netherlands, UK, Germany, and Russia, and a weak safe-haven asset for the Chinese markets. In contrast, USD presents a stable safe-haven property through periods of crisis. This role is perceived to be waning in the not-too-distant future as BRICS+ seek to diversify out of the US dollar and replace it with another yet-to-be-decided currency. These results should help investors in choosing the best safe-haven assets, especially during volatile market periods. Additionally, these findings can assist portfolio managers in implementing better hedging strategies to limit the adverse impact of volatility in the market. For policymakers, the role of policy regime changes must be meticulously evaluated because policy shocks can have a significant impact on the future relationship between stocks, foreign exchange currencies, gold, and cryptocurrencies.

In short, there is NO one safe haven for all-weather situations.