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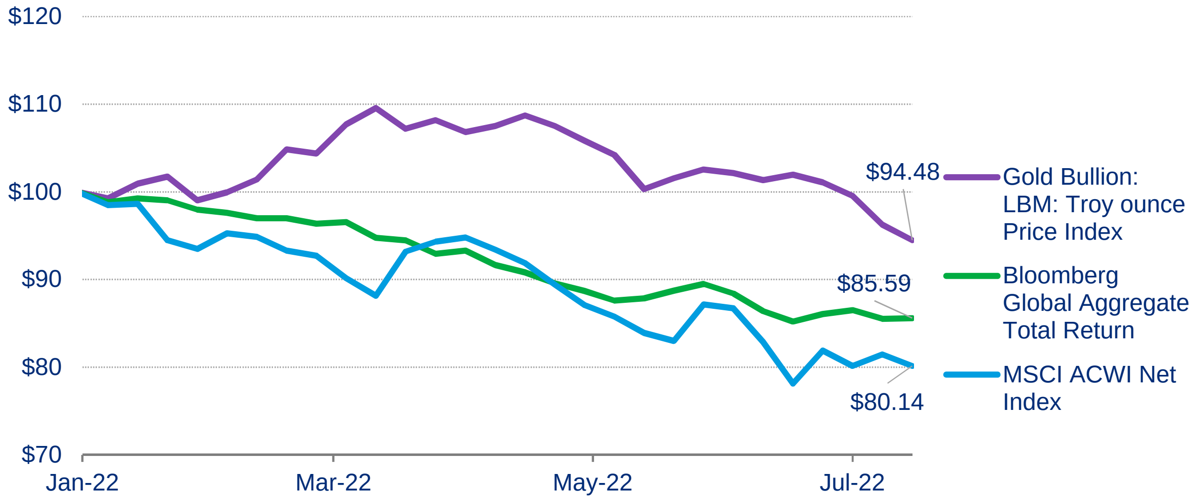
Gold – Surprisingly placid?

A review of gold's performance during the 2022 bear market so far

Introduction

So far, 2022 has been a dramatic year for markets, to say the least, with a 60:40 portfolio returning -15.6% year to date[1] – only the fourth time in a century that stocks and bonds have both fallen over two successive quarters.[2] Gold, by contrast, has had a seemingly placid time of it, significantly up in Q1 but giving back most of those returns more recently (-6.4% year to date[3]), with its realized volatility subdued relative to equities in recent times.[4] However, anyone who has watched the horror movie Lake Placid knows that the lake is far from placid. Beneath the surface, mighty currents have been playing out a tug-of-war with the gold price.

Figure 1. Change in $100 of gold vs equities and bonds in 2022



Source: Refinitiv, all returns in US dollars. Data to July 15, 2022.

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[1] Source: Bloomberg, ticker BMA6040, Bloomberg US Equity: Fixed Income 60:40 Index. US dollar returns, not annualized. Return from December 31, 2021 to July 15, 2022.

[2] https://awealthofcommonsense.com/2022/07/the-worst-6-months-ever-for-financial-markets/

[3] Source: Refinitiv, LBMA, closing prices from December 31, 2021 to July 15, 2022.

[4] H1 volatility was 15.0% for gold and 24.5% for equities as represented by the S&P 500. Source: Refinitiv, annualized sample standard deviations of daily returns.

Recent price drivers

A major conflict in continental Europe, combined with vigorous inflation[5] and a stock market fall could be expected, all else equal, to cause gold prices to sharply rise. All else, however, was not equal. Gold remains sensitive to major geopolitical uncertainty, but it's also priced in dollars. The US dollar, despite all the long-term speculation over some countries and institutions diversifying away from it, has had strong price momentum (see Figure 2), up 12.8% so far this year against a basket of developed market currencies[6] and trading at a 20-year high. Strength in gold this year has therefore mostly been offset by the US Federal Reserve's (the Fed) rate hikes, which in turn has strengthened the dollar.

Gold is typically priced in dollars, but a more balanced picture of gold's performance appears when looking at prices compared with other currencies (up 5.6%, 12.6% and 7.0% versus the euro, yen and sterling).[3] Historically, the Fed has often resorted to quantitative easing after major events, leading to lower real rates (the GFC and COVID-19 are the major examples). It is this response that has supported gold rather than the events themselves *per se*. This time, however, the economic slowdown has coincided with a hawkish Fed that has supported the US dollar and led to rising real yields.

Figure 2. Considerable momentum in the US dollar (against a basket of developed market currencies)

Source: Bloomberg. Closing prices of DXY from June 30, 2021 to July 13, 2022

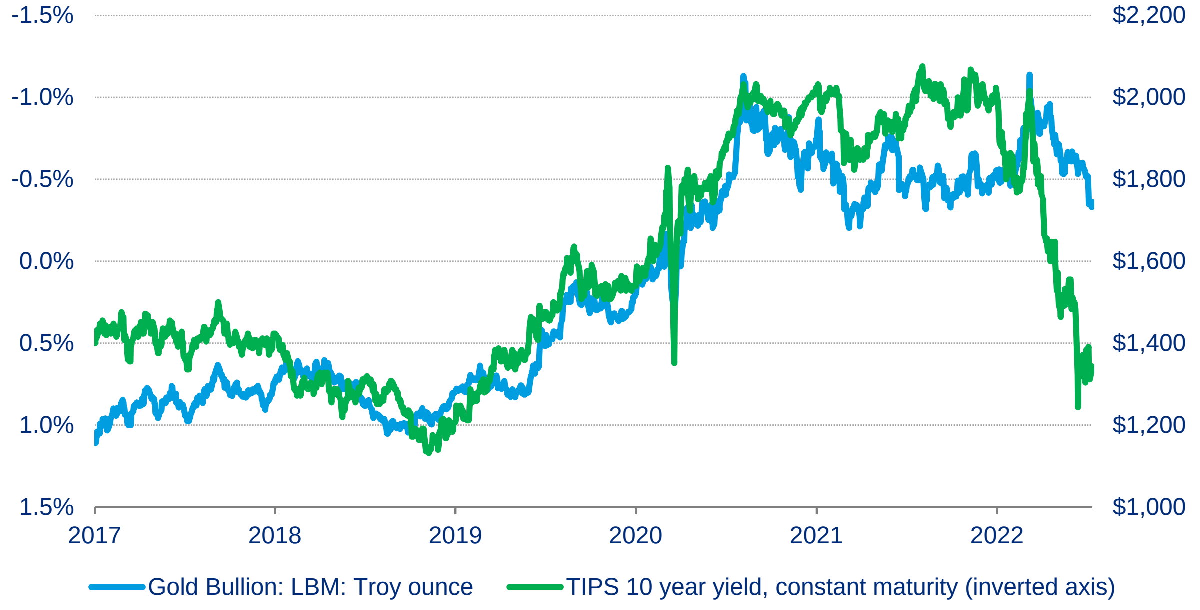
[5] US Inflation at 8.6% as of May 2022, a 40-year high.

[6] Source: ICE. Return against developed market currencies as represented by the US Dollar Index (DXY), to 13 July 2022.

Gold and real yields – this time it's different, for now

Gold has a well-documented relationship with the US real yield, which is to say that, during this century, gold has tended to rise when the US real yield has fallen. The reason for this is that gold has no yield, whereas dollars provide an interest rate. When real interest rates rise, the opportunity cost of holding gold tends to lead to price falls. As can be seen in Figure 3, this relationship suffered a puncture in 2022 as gold prices held up despite real yield rises. The real yield has been inverted in order to more easily visualize the relationship between the two. A short-term tactical concern is that the gap that has opened up between real yields and gold will close, and that is why some asset allocators may prefer TIPS (treasury inflation-protected securities) over gold on a near-term view.

Figure 3. Decoupling from US real yields



Source: FRED (DFII10), Refinitiv. Data to July 13, 2022

The major threat to gold is from a Volcker-style move by the Fed to crush inflation by steeply raising interest rates. That could do away with the current anomaly of gold not reacting to rising real yields. During that period of aggressive rate rises in the 1980s, the gold price fell by 44%.[7] This means there is still plenty of potential downside. Current reluctance to aggressively hike may be linked to a belief that this inflation experience is transient, and the risk of triggering a major recession is high. However, the Fed recently reiterated that it is willing to risk a recession in order to tame inflation.

In summary, gold gave an underwhelming performance in the first half of 2022 in absolute terms because its usual strong performance, which we would expect in a down market, was offset by an exceptionally stronger dollar. In addition, while rising real yields have not been the headwind we might have anticipated, there is a risk that this may change in the short term.

[7] December 1, 1980 – August 6, 1982. Source: Refinitiv, LBM prices.

Still, a variety of factors are positive for gold in the medium to long term:

(1) Gold is one of the few assets that has tended to do well in a stagflationary environment. The risk of experiencing such environments more frequently has increased.[8]

(2) Crypto Winter II is here[9], and Bitcoin, the cryptoasset touted as a "digital gold", spectacularly failed to provide any protection to investors in 2022, neither against inflation nor down markets in general. In 2022 to date, Bitcoin fell by 55% in US dollar terms[10] and traded in a highly correlated manner to technology stocks. Should Bitcoin's troubles continue, it would be good for gold.

(3) The dollar strengthened on the back of conflict in Europe and supply-chain disruption due to recent lockdowns in China. Longer term, the world faces the prospect of becoming less integrated, and the dollar's perch as an international clearing currency could be imperilled if more countries and investors less aligned with the US diversify their foreign currency holdings away from the US dollar. In an era where international tensions resurface, uncertainty is high and monetary indiscipline is tolerated, gold may well benefit from regime change.

For investors who hold gold, some may prefer to tactically reduce their position and "buy the dip" in the equity market. Others may feel there is worse to come and that gold's role in the portfolio is difficult to replace. We believe gold continues to merit a strategic allocation in portfolios: its role as a potential downside protection asset is difficult to replace, especially in stagflationary environments. It may not provide protection in every down market, but even this time around, it was a safer place than both stocks and bonds.

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[8] For more details, see our paper 'Inflation – turning up the heat' (2022)

[9] "Crypto winter" was a phrase invented to cover the decline in cryptocurrency prices in 2018

[10] Marketwatch, to July 14, 2022

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