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# Does Gold Protect Your Investment Portfolio? Think Again...

*By* James Mackintosh Oct. 13, 2020

After falling alongside stocks amid March's market panic and again last month, the metal might continue to move with shares for some time.

There is no asset that prompts more emotional reactions than gold, so I really shouldn't have dismissed its role in a modern investment portfolio with a mere throwaway line [in a recent column](#).

I pointed out that gold had been a hopeless hedge last month and warned that it was likely to continue moving in the same direction as stocks, making it ineffective as a way to protect against share-price losses.

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As several readers said, the full story needs more than just a line. Gold's role as a hedge depends on the risk you are trying to protect against, and it has its uses. The metal has been the last word in insurance against the collapse of the state for millennia, being near-universally exchangeable and easy to hide away or carry across borders. A rich family can reasonably hold a small portion of their portfolio in physical gold abroad and know they will be able to flee and restart their lives elsewhere, albeit much reduced, if society falls apart.

But gold isn't a good replacement for Treasurys in a standard 60% stock, 40% bond portfolio. When stocks fall, investors want a diversifier that rises in value to cushion the loss. But gold fell alongside stocks during the market panic in March and again last month, and might continue to move with stocks for some time. That doesn't make it a bad investment on its own, and the scale of the loss (and gain) will be different to stocks, but it is of little extra use for investors looking for an alternative to bonds in their portfolios.

**Markets**

We're in an environment where stocks like inflation, and gold likes inflation. The outlook for inflation is closely tied to the economy, with a stronger economy (perhaps due to an agreement on stimulus) meaning more inflation and vice versa. An improving economy should help stock prices, so stocks rise with gold. A worsening economy would mean less inflation, so stocks fall and so does gold.

In the past, gold has sometimes been a better hedge against stocks. To understand why it works sometimes, and doesn't others, we need to consider gold's main price drivers. Thinner CushionGold and stocks moved in opposite directionsin the 2011 market panic...but its win was brief in 2020, doing well inthe first two weeks of the pandemic selloffbefore moving similarly to stock prices.

Prime among these are real rates, best shown by Treasury inflation-protected securities, or TIPS, whose yields already account for inflation. Like TIPS, gold tends to rise when real yields fall and fall when real yields rise—and gold peaked this year on Aug. 6, when 10-year TIPS yields reached a new low.

With the Federal Reserve committed to keeping interest rates at zero for the foreseeable future, higher inflation would mean lower real rates and lower TIPS yields, helping gold. But higher inflation also suggests a stronger economy, helping stocks.

This is different to the summer of 2011. Back then, stocks suffered as Congress fought over the debt ceiling. But inflation was roaring ahead and investors thought commodity demand from a fast-growing China would keep prices rising. Gold soared as 10-year TIPS yields turned negative for the first time, reaching a high that wasn't surpassed until this summer when TIPS yields again plunged.

Gold shines when inflation fears are rising in a weak economy. Inflation then makes Treasurys unattractive, while a weak economy both makes stocks unappealing and encourages the Fed to cut rates or keep them low. The 1970s stagflation illustrated this perfectly, with gold reaching a high in January 1980 that still hasn't been passed when adjusted for inflation.

Speculation also has a big influence on gold. Because so much gold is held by speculators, often bought using debt, the metal suffers as well when markets seize up and speculators dump everything. This makes gold a particularly bad hedge when the finance industry is in trouble, which is exactly the moment when many expect it to shine. From its early-March high this year gold fell 12% before bottoming, while it lost more than a quarter of its value at its worst point in the chaos of 2008's financial crisis.

There isn't a neat formula for converting the TIPS yield and expected inflation into a gold price. What is clear, however, is that the best time to use gold to hedge stocks (societal collapse aside) is when we are worrying about the wrong sort of inflation, driven by supply issues such as commodity and labor costs, while the Fed is trying to help the economy.

Gold is a good way to protect against such stagflationary problems. That's not the case when, as now, [inflation is more the virtuous type, driven by underlying demand]. Unless you think that's about to change, expect gold and stocks to move in tandem.

The price of gold is going haywire, driving a frenzy of investment that's calling into question the metal's reputation as a safe haven during times of economic uncertainty.

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Don Wilson / CEO

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