MARKET VIEW

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Bretton Woods, 50 years on: Gold, inflation and diversification

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On August 15th, 1971, exactly 50 years ago, US president Richard Nixon went before the assembled press to announce that he was ending the US dollar's convertibility into gold and introducing wage and price controls. Nixon thus laid the foundation for the end of the Bretton Woods international financial system, which dated back to 1944, with the US dollar convertible into gold at a fixed rate of USD 35 price per ounce since 1958. In Milton Friedman's view, the "Nixon shock" paved the way to irredeemable fiat currencies[1] 50 years ago.

While monetary policy can quickly expand the supply of fiat money, the supply of gold is less flexible, as gold deposits are limited and goldmining is time-consuming and costly. Market watchers often argue that gold is a good hedge against inflation, as goldmining costs should rise with inflation over the long term. Campbell Harvey and Claude Erb, two prominent gold researchers, have calculated that a centurion in ancient Rome earned 38.6 ounces of gold per year and that this was roughly equivalent to the wages of a US army captain nowadays. They also found that the price of a loaf of bread in gold terms under the Babylonian king Nebuchadnezzar in 562 B.C. was the same as today. Gold could therefore have been a very good inflation hedge over periods of several centuries.

However, over shorter time periods (a few years), gold is a poor hedge against inflation. The chart shows, according to Harvey and Erb, the real price of gold over the past 50 years. It shows that gold, as measured in real units, is too volatile to provide reliable protection against inflation. In three periods – 1980/1981 at the end of the "great inflation", 2011/2012 driven by euro crisis-driven uncertainties, and in summer 2020 as a result of the low-interest-rate policy – the real price of gold rose by more than 7.5-fold. Gold shines when people doubt the stability of fiat currencies such as in 1980/1981 and 2011/2012.

During times of market panic and uncertainty, gold is often an attractive asset class.

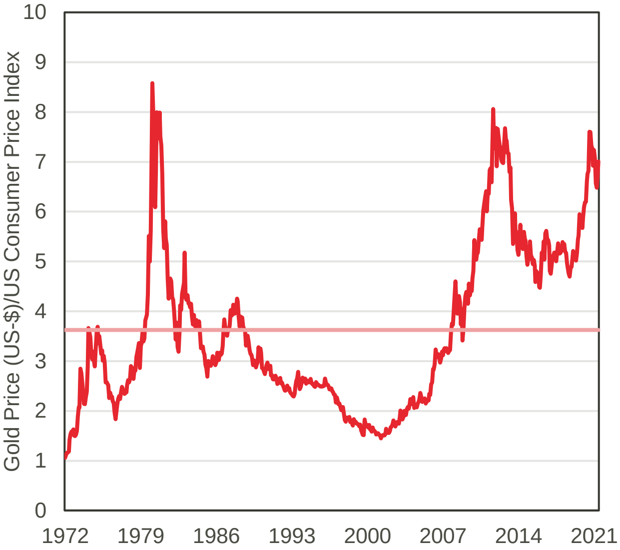

***Chart 1:** Real price of gold calculated as the price of gold divided by the US Consumer Price Index for All Urban Consumers. The CPI is published monthly by the U.S. Bureau of Labor Statistics.*

Like other asset classes, gold sometimes experiences phases of overshooting. Chart 1 shows that the real price of gold is currently high. Like many other asset classes, gold is no longer cheap, due to central banks' expansive monetary policy. What is now new is that gold is in competition with crypto-currencies. Amidst heavy government debt and unprecedented monetary expansion, those seeking a hedge against weakness in fiat currencies can now turn to cryptocurrencies instead of gold (however, it is not our recommendation).

[1]Fiat currencies: money without intrinsic value, such as commodity money has

Gold earns no interest. So bond yields may be understood as the opportunity cost of holding gold – i.e., the returns that one foregoes by holding gold instead of bonds. When bond yields rise, the opportunity cost of gold rises with them, and gold prices typically fall. As we have been forecasting a significant economic recovery for several months, due mainly to the American Rescue Plan and the post-Covid reopening of economies, we believe that equities, as well as oil, copper and other commodities, which will be in greater demand because of economic expansion, are currently more attractive than gold.

The US dollar is another key factor that influences the price of gold. Gold and the USD are negatively correlated. As gold is usually denominated in USD, a depreciation of the USD makes gold look more expensive to buyers outside the dollar zone, who therefore demand more gold, with heavier demand leading to higher gold prices. Volatility is now low on currency markets, and the USD has even posted some gains vs. the euro since ending 2020 at 1.2216. Gold is not seeing any tailwinds in 2021 from other currencies.

According to the World Gold Council, demand for gold from exchange-traded funds (ETFs) has cooled considerably. Global assets under management (AuM) in Gold ETFs were 7% lower in July 2021 than in October 2020.

So, are these all reasons not to hold gold in a diversified international portfolio? Absolutely not according to us. One advantage of gold is that it is more loosely correlated to equities, which makes gold a good way to diversify an equities portfolio. Jaffe (1989) recommends keeping 10% in gold, while Draper / Faff / Hillier (2006) believe 9.5% is the optimum gold weighting to enhance the diversification of an international equity portfolio. There is also much evidence to suggest that gold is better than goldmining shares for diversifying an equities portfolio, as goldmining shares are typically more closely correlated to equity indices than gold. Gold was not one of the most attractive asset classes in 2020, owing to a positive economic outlook, its already historically high price, and shrinking demand from gold ETFs. Should one give up on gold completely? Not a good idea in our opinion. For the last 50 years have taught us that the next crisis is just around the corner.

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