What's Up with Gold?

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Key Takeaways

- Year-to-date, gold has outperformed many asset classes, including long-term Treasurys.
- The decline in real interest rates is the primary driver behind the upward momentum.
- Institutional investors and flows into gold-related investments have also contributed to the rise.

So far, gold prices are up 27% in 2020, more than long-term Treasurys or the NASDAQ. Tackling the attractiveness of gold or gold-related investments is a challenging endeavor as no other "asset class" invites as much passion or revulsion. Gold is unique in the sense that not much of the metal is consumed. Thus, there is a sizeable above-ground stock, which can make it a useful financial asset (or currency). Some investors view gold as an inflation hedge. Others see it as an alternative to the dollar or a hedge on the entire dollar system.

While we can theorize about the drivers of gold over history, today, we see three main catalysts for its recent rise.

Three Catalysts

1. Decline in Real Interest Rates

Gold competes with "risk-free assets" that generate income, such as Treasurys. As real yields (nominal yields* minus the inflation rate) decline, the opportunity cost of holding an income-free asset declines, and gold becomes more attractive. Since the start of 2020, real yields (measured by the 10-year Treasury Inflation-Protected Security rate) have declined 1.11% to -0.96%, pushing gold prices up. This same relationship developed during gold's last bull market (2008-2011), with declining real yields fueling higher gold prices. With the Fed on hold indefinitely, and inflation expectations rising after the deflationary fears of March, real yields have fallen off a cliff and propelled the price of gold.

Source: FactSet

2. Momentum and Flows

Nothing begets higher prices like higher prices. Since the dawn of investing, speculators have been captivated by high-flying asset prices. Fifty years ago, individual investors read the morning paper to find which stocks were rising. Now quantitative strategists embed price movements or momentum into their algorithms to decide what to buy (or sell). We see this short-term momentum chasing not only in the price of gold but also in the flow data. According to the World Gold Council, $49.1 billion has flowed into gold exchange-traded funds (ETFs) through July, compared to $19.4 billion in 2019.

3. Institutional Asset Allocation Repositioning

Institutional investors are starting to rethink the traditional stock and bond portfolio as they attempt to match their target return assumptions over the next decade. With bonds offering minimal yield, these investors are seeking other diversifying assets, including gold. A similar trend developed after the Global Financial Crisis, with investors looking outside standard assets for portfolio hedges. How much institutional investors will allocate to gold remains to be seen.

The Dominant Factor

While the last two catalysts have played a role in gold's march above $2,000, in our opinion, the dominant factor is the decline in real rates. There are two ways real interest rates can continue to fall. Either nominal rates must decline, or inflation has to rise (or some combination). With the 10-year Treasury rate hovering around 0.70%, there is room to go lower. Earlier in the year, yields broke below 0.50%. But unless the Federal Reserve experiments with negative interest rates, the downside for nominal yields is likely limited.

That leaves inflation. As we embark on $3.7 trillion deficits, the adoption of Modern Monetary Theory, and a Federal Reserve willing to tolerate inflation above its 2% target, inflation could break through. That said, the first go-around of zero interest rate policy and quantitative easing after the Global Financial Crisis couldn't generate sustained inflation above 2%. Since the end of 2009, the inflation rate (CPI) has averaged 1.7%. Despite the enormous fiscal and monetary stimulus, the demand gap created by the COVID-19 crisis may make it difficult for high inflation to emerge in the short term.

Looking Forward

A bet on gold is likely a bet on inflation, with limited short-term impact on yields. Flows and re-allocation may push the precious metal higher than "the fundamentals." But ultimately, in our opinion, your outlook on gold depends on your outlook on real interest rates. While we do see room for real yields to move lower, we believe the downside is curbed. Finally, in most scenarios where real rates trend down absent a significant spike in inflation, other risk assets should benefit.

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* The nominal yield is the stated coupon (interest rate) of a bond.

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