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One more reason to avoid gold

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Is gold really a good hedge against inflation?

That’s the popular impression, or at least one that is drummed into our heads by gold enthusiasts. But gold’ s track record tells a very different story.

Claude Erb and Campbell Harvey, an international business professor at Duke University and a research associate of the National Bureau of Economic Research, have examined gold’s track record in great detail in a new research paper (via Abnormal Returns) entitled “The Golden Dilemma.”

The title is actually a bit misleading, because there isn’t much of a dilemma here at all: They argue that gold offers little value to investors, other than as a speculative play.

As a hedge against inflation, gold’s record certainly appears distorted. The authors found that the price of gold has swung wildly around the U.S. consumer price index since 1975 – and the current level of the CPI index is so far below the price of gold that it implies gold should trade at about $780 (U.S.) an ounce, or about half today’s price.

Another way to look at it is to divide the price of gold by U.S. CPI. Since gold futures trading began, this ratio has averaged 3.2, with a low of 1.46 in 2001. Today, the ratio is a sky-high 7.3, which implies that something is out of whack.

“Since the start of gold futures trading the only other time the real price of gold has been roughly as high as it is today was in 1980,” the authors said in their paper. “Following the real price high in 1980, the real price of gold, as well as the nominal price of gold, fell significantly.”

Gold enthusiasts would respond, “Duh! Gold is telling us that a big spike in inflation is coming.”

Well, Mr. Erb and Mr. Harvey have looked at that too, and have discovered that there has been no correlation between moves in the price of gold and changes in the annual inflation rate, going back to 1975.

Is this time different? The price of gold is already implying an inflation rate of at least 8 per cent a year over the next 10 years, based on the price-to-CPI ratio. That’s at odds with the bond market, which is implying an inflation rate of just 2 per cent a year.

Even if inflation does indeed rise well above the Federal Reserve’s comfort zone, averaging an appalling 5 per cent a year over the next decade, the price of gold would have to slide more than 3 per cent a year to get back in line with the average price-to-CPI ratio.

No doubt about it, gold is a scarce resource – and Mr. Erb and Mr. Harvey note that if everyone devoted, say, 2 per cent of their assets to it, the price would march considerably higher as demand outpaced supply.

But this argument can apply to any asset. If everyone loaded up on shares in Wal-Mart Stores Inc. or baseball cards or Australian shiraz, prices would also soar.

Okay, those assets aren’t going to do you much good if society falls apart – and gold bugs love the fact that gold is gold, no matter what happens.

But Mr. Erb and Mr. Harvey have some bad news for survivalists too: Throughout history, gold owners don’t always get to hold onto their gold when their cities are sacked.

“Gold is viewed as being durable and largely imperishable, characteristics which make gold its own safe haven against the ravages of the world,” they said. “It is not necessarily a safe haven for the owner of gold.”

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