News

Gold is not a safe haven

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Gold prices have risen five-fold in the past decade. Recent surveys have shown that proportion of investors who consider gold as the best long-term investment when compared to real estate, stocks and bonds. But is it really a good hedge against inflation, currency fluctuation and economic uncertainties?

Claude B. Erb and Campbell R. Harvey through their amazingly comprehensive research paper on gold titled - `The Golden Dilemma` try to answer these questions.

Gold as an inflation hedge: One of the most widely held belief about gold is that it is an inflation hedge. It means that if inflation rises by 4% a year for the next 50 years then the price of gold should also rise by 4% a year.

Authors compare the gold price (in US dollar terms) versus the monthly reading for the US consumer price index (CPI).

The price of gold swings widely around the CPI. In fact, the price of gold adjusted for inflation (real price) and the actual price of gold (nominal) have rarely been equal. Given the most recent value of the CPI index, the price of the gold should be currently around USD780 an ounce.

It was found that real price of gold has been quite volatile and it converges to its mean price over a period of ten years. The variability of the real price of the gold suggests that gold has been a poor short-term inflation hedge.

It was also found that gold is not a very effective long-term inflation hedge when the long term is defined as ten years. However, authors do agree that gold may be a very long run inflation hedge, but this long run may be longer than an investor`s investment time horizon or life span.

Gold as a currency hedge: Gold as a currency hedge means that if Indian rupee declines 10% against the dollar, then the price of gold should rise by 10% in rupee terms. The net result of this hedge should be a return of Zero (Gold return + currency return = 0).

Above argument is just another version of the ``gold as an inflation hedge`` argument considering currency declined because of inflation.

Authors studied the real price of gold in local currencies since 1975 in the following countries: Australia, Canada, Germany, Japan, New Zealand, Switzerland, the UK and the US. Since the real price of gold seems to move in unison across the above countries, it is not convenient to label gold as currency hedge.

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Gold as a safe haven: There is a common perception that in times of financial stress, gold prices increase as funds move to the safer gold investment. So, when there are negative equity returns, gold should be giving positive returns. But, 17% of the time when there was a negative equity return (monthly returns of US stocks) there was a negative gold return too.

Authors do note that in the extraordinarily remote event of hyperinflation, gold prices can also move up and hence provide protection to investors.

Gold as an under owned asset: Authors calculated the price elasticity of demand for gold (from 2001 to 2011) for jewellery, investment and technology. Price elasticity measures the percentage change in demand for gold in response to a one% change in the price of gold.

The result was quite interesting. A 10% increase in price of gold leads to 0.8% decrease in demand for gold, 6.7% increase in investment demand. Demand from technology sector is not affected by the price of gold. Interestingly, both the production as well as the supply of scrap gold also is insensitive to the price of gold.

According to authors, if the gold market is taken to be the non-central bank investment amount then this would represent about 2% of the total market capitalization of a stock/bond/ gold market.

However, there are few pension funds, institutional investors and other high net worth individuals who don`t have two% allocation to gold. Given the small size of the gold market

relative to the stock and bond markets, this 2% portfolio allocation to gold would represent 19% of the gold market, or about 30,000 metric tonnes of gold.

Given the illiquid of the gold market indicated by the existence of the Central Bank Gold Agreements and a seemingly positive elasticity of investment demand, a broad-based move to a two% portfolio allocation to gold would probably result in much higher gold prices. If a two% allocation were pursued by buying no more than 400 tonnes of gold a year, it would take in excess of 70 years to complete the 2% allocation.

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