Watch

Opinion: Gold is 33% overpriced, by this measure

By Mark Hulbert
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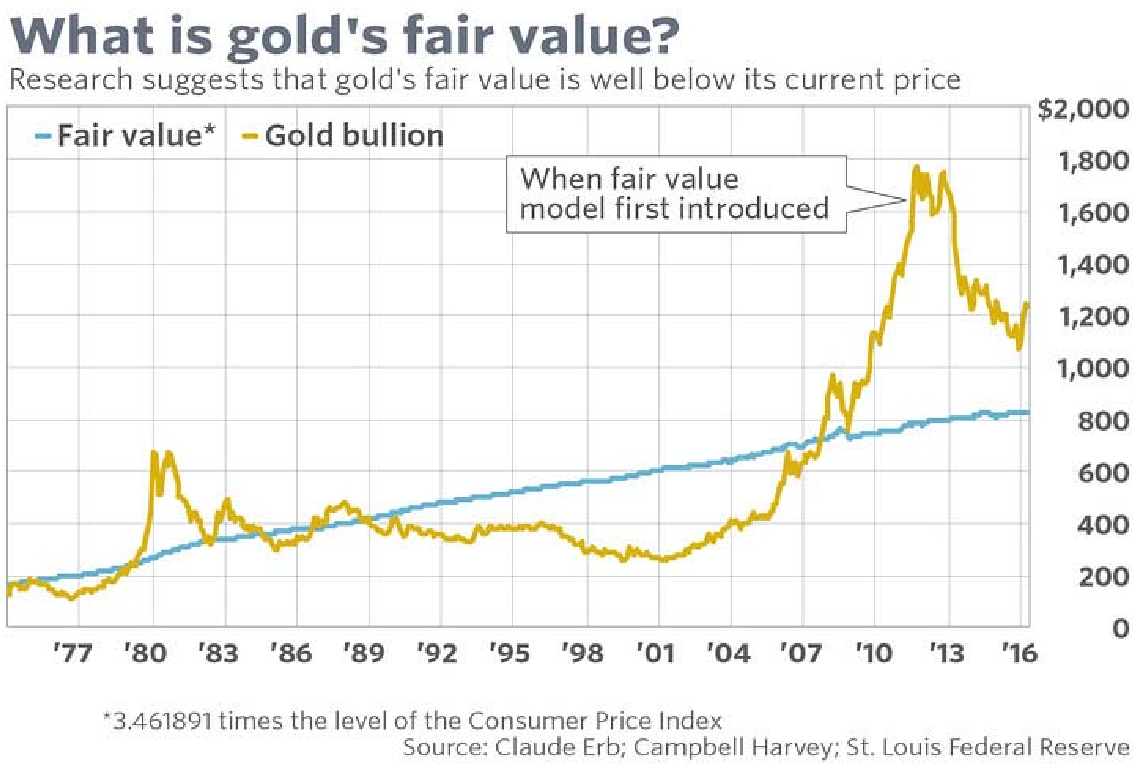
That’s according to two researchers who say the yellow metal is an inflation hedge only in the very long run



CHAPEL HILL, N.C. (MarketWatch) — Gold’s fair value is a third less than where it’s trading today: $824 an ounce, to be exact, not the market price of $1,235.

The notion that gold might trade for that low might seem ludicrous to some. Bullion is already nearly $700 below its all-time high set in 2011. You might even consider such a forecast as evidence of the excessive pessimism that is more characteristic of market bottoms than tops.

But don't be too hasty to dismiss the forecast. It is the result of serious academic research, conducted by analysts who are not predisposed to be anti-gold. Even more compelling is that their fair-value model wasn't just recently introduced and retrofitted to the historical data; it was first introduced in late 2011, not far from when gold was trading at a record of over $1,900 an ounce.

The researchers were laughed at then, too. But they've so far had the last laugh.

The study, "A Golden Dilemma," was conducted by Campbell Harvey, a finance professor at Duke University, and Claude Erb, a former commodities portfolio manager at TCW Group. Their key finding is that gold is a decent inflation hedge only when viewed over the *very* long term — measured over many decades, even centuries — rather than a few years.

For those who think gold does a good job hedging inflation over the shorter term, consider this: If so, then gold's inflation-adjusted price would never vary. But, in fact, gold's GCM6, +0.15% real price is quite volatile over the short and intermediate terms: In the past five decades, the ratio of gold to the Consumer Price Index (CPI) has been as low as 1.5 and as high as 8.7.

Many have tried to wriggle out from underneath the force of this observation by arguing that the CPI is not an accurate gauge of true inflation. But the researchers point out that they would have reached the same conclusion had they focused on alternate inflation measures, such as those championed on websites such as ShadowStats.com.

The average gold-CPI ratio since the early 1970s is 3.46-to-1, and the researchers propose that average is a good estimate of gold's fair value. Currently, that ratio translates into a gold price of $824 an ounce.

How much gold should you own?

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Note carefully that the researchers are not forecasting that gold will immediately fall to $824. Like other fundamental measures of value, theirs is not a short-term market-timing tool. It would not be inconsistent with their analysis for gold to enter into a one- or two-year bull market.

Indeed, gold has risen over $100 an ounce since early February, when I last wrote about Harvey and Erb's research. But that has no impact on their analysis. In an email earlier this week, Erb insisted that, per the model, inflation would have to rise at a 9.4% annualized rate over the next five years for gold's fair value to merely rise to where bullion currently trades.

Anything is possible, of course. But we shouldn't forget that the collective judgment of investors in the bond market — a market that is many orders of magnitude larger than gold's — is that inflation will be far lower: 1.42% annualized, to be exact, as measured by the five-year break-even inflation rate.

Unless inflation is a lot higher than what the bond market is discounting, and assuming Harvey and Erb's model is right, gold's fair value will exert a gravitational pull on gold's price that eventually will bring its price down a lot lower than where it stands today.

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