Venezuela is a perfect current test case for those who believe gold is a good hedge against hyperinflation. That's because Venezuela is currently suffering from one of history's most extreme cases of hyperinflation. The country's currency, the bolivar, has become nearly worthless; news reports indicate that the government has had difficulty even paying for the paper needed to print up the currency. The International Monetary Fund projects Venezuelan inflation to reach one million percent this year.

The situation is reminiscent of what historically has been history's paradigmatic examples of hyperinflation, such as Germany after World War I. In 1922 and 1923, the exchange rate between the German mark and the U.S. dollar (which was pegged to gold) rose from 430-to-1 to 433 billion-to-1.

On the surface, it certainly seems as though the yellow metal has passed the test. So far this year, for example, an ounce of gold has skyrocketed to nearly 200 million Venezuelan bolivars from around 13,000 at the beginning of the year.

Believe it or not, however, this huge increase has probably not been enough to keep up with Venezuelan inflation. I say “probably” because reliable economic data is notoriously hard to come by when a currency's value is evaporating so rapidly. For example, some currently are arguing that the IMF estimated inflation rate of one million percent is too low.

Claude Erb isn't surprised that bolivar-denominated gold has failed to keep up with Venezuelan inflation. He is a former commodities and fixed income manager at TCW Group and the author, with Campbell Harvey, a Duke University finance professor, of a study that was circulated a few years ago by the National Bureau of Economic Research. They found that gold typically doesn't maintain its purchasing power during a hyperinflation. In other words, its real price usually declines during such periods.

One case study of hyperinflation that Erb and Harvey examined in detail occurred in Venezuela's neighbor Brazil between 1980 and 2000, during which cumulative inflation totaled nearly 13 trillion percent—equivalent to about 250% on an annualized basis. They report that, over those two decades, the real price of gold in Brazilian currency terms fell by about 70%.

Careful students of history will notice that this 70% decline is quite close to the inflation-adjusted decline suffered by a U.S. dollar-denominated investor in gold over this same period. That is not an accident, Erb explains to Barron's in an email. That's because, once you adjust different countries' exchange rates for their varying inflation rates, gold's price should be the same regardless of the currency in which it's denominated.

As a result, gold's inflation-adjusted return should be roughly the same regardless of the currency in which gold is bought or sold. "Even though countries, such as U.S. or Brazil, may experience very different inflation experiences their real gold return experiences will probably be similar," Erb and Harvey wrote. "There is no reason to expect that the real return will be positive when a specific country experiences hyperinflation."
Gold bugs object to this conclusion, often pointing to a book that has acquired near-Biblical status among gold's true believers: The Golden Constant: The English and American Experience 1560-2007, by the late Roy Jastram, then a professor of business at the University of California, Berkeley, and originally published in the 1970s. Jastram found from his analysis of the historical record that gold is a decent inflation hedge over the long term.

But it's crucial to understand that the long term for Jastram is much longer than any of our investment horizons. Erb's and Harvey's study reached a similar conclusion, since they also found that over very long periods—measured in many, many decades—gold does keep pace with inflation. Erb points out that for both Jastram as well as for his and Harvey's study, "the short run was the next few years, and the long run was perhaps a century."

To be sure, it's always possible that—over the shorter term—gold will produce a positive real return during a period in which a country somewhere in the world experiences hyperinflation. But the crucial takeaway from Erb's and Harvey's study is that you can't count on it.

If you're looking for an investment that is guaranteed to keep pace with inflation, a better alternative to gold might be Treasury inflation-protected securities, or TIPS. These are Treasury notes or bonds whose principal is guaranteed to grow with the U.S. consumer-price index. The exchange-traded fund that invests in TIPS with the most assets under management is iShares TIPS Bond (ticker: TIP), which charges annual expenses of 0.20%.

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Search Summary

<table>
<thead>
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