Why commodities and gold won't protect you from inflation's punch

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Traditional inflation hedges fail to live up to their reputation

Al Bello/Getty Images

If you're tempted to invest in commodities as a hedge against inflation, beware. Commodities are such a minefield, you can be right and still lose money.

The Labor Department's early-February jobs report showed that inflationary pressures are building. More recently it reported that the Consumer Price Index rose a much-stronger-than-expected 0.5% in the latest month. The argument goes that inflation is a positive for commodities.

Thing is, "commodities" is not a homogenous asset class. Instead, commodities often have little to do with each other. Case in point: Not all commodities historically have been good inflation hedges.

Consider the extent to which various commodities have responded in the past to inflation, according to a study that appeared in the Financial Analysts Journal several years ago by Claude Erb, a former fixed-income and commodities manager at mutual-fund firm TCW Group, and Campbell Harvey, a finance professor at Duke University's Fuqua School of Business. Their research began with results from 1982, since that was the first year that heating oil futures were traded in the U.S. Over the subsequent 20+ years until the date of their study, inflation varied from more than 6% annually to below 2%.

Erb and Harvey found that just three of the 12 commodities for which futures continuously traded over this 20+ year period were positively correlated with inflation at the 95% confidence level that statisticians often use to determine a pattern is genuine. The remaining nine had no statistically significant correlations with inflation, though the researchers note that the correlations for four of these nine, while weak, were actually negative. Clearly, an investor is on shaky ground making the blanket statement that commodities are a good inflation hedge.

It’s also important to be aware of the composition of the commodities funds in which you invest. For many individuals, exchange-traded funds are the vehicle of choice; the two largest such ETFs currently are PowerShares DB Commodity Index Tracking Fund **DBC, +0.18%** and iShares S&P GSCI Commodity-Indexed Trust **GSC, +0.59%**

Yet most investors have little idea of what is in these ETFs. That would be OK if commodities were a homogenous asset class, but this is not the case.

In fact, these ETFs are heavily invested in energy-related commodities — 51% in the case of the PowerShares ETF and 59% for the iShares ETF. Moreover, the composition of the indices that underlie these ETFs has changed dramatically over the years. The S&P GSCI index, for example, to which the iShares ETF is benchmarked, in the early 1970s was more than 50% invested in cattle futures.

This means great care is needed in extrapolating these indices’ historical returns into the future. It also means you shouldn’t automatically assume that ETFs benchmarked to these indices will provide the inflation hedge you think you’re getting.

Why not just invest in energy commodities? To be sure, energy-related commodities are among the few that historically have been correlated with inflation in a statistically significant way. But why dilute the inflation hedge provided by energy with other commodities that historically have not been good inflation hedges?

The answer depends on the set of reasons you have for investing in commodities. If inflation is the primary reason, an alternative might be to invest in energy-related commodities only, such as ETFs benchmarked to the price of oil. The largest such ETFs are United States Oil ETF **USO, +0.41%** and iPath S&P GSCI Crude Oil Total Return Index ETN **OIL, +0.44%**

Note carefully, however, that these ETFs invest in oil futures contracts rather than in physical oil itself, since there are prohibitively high costs to storing oil. And investing in futures comes with significant costs.

Consider the 2017 performance of these two large oil-related ETFs. On the spot market during the calendar year, West Texas Intermediate Crude Oil gained 12.5%. Yet USO produced just a 3.2% return in 2017 while OIL rose 4.6%.

Why the big difference? Because of the losses these products incurred when rolling one futures contract into the subsequent one. This so-called roll return can be either positive or negative, but it was negative for oil for most of 2017 (a condition known as “contango”) — so negative, in fact, that it almost completely offset the gain in crude oil’s price.

Late last year, the roll return for oil turned positive, a condition in the futures market known as “backwardation.” So long as that continues, oil-related futures investments should perform particularly well. But there are no guarantees that it won’t shift back to contango at any time.

The investment implication, Erb told me in a recent email: “Commodity futures are not a ‘set-it-and-forget-it’ investment.” Instead, they “periodically present tactical opportunities” and “this may be one of those times that there is a tactical opportunity.” But, because the commodity markets can quickly shift from backwardation to contango, “it will also be important to correctly time when to sell.”

What about gold **GCJ8, -0.44%** ? No discussion of commodity investing would be complete without mention of gold and precious metals—the sector that has the second-heaviest allocation behind energy in the commodity-focused ETFs.

That is the conclusion of another study conducted by Erb and Harvey, which also appeared a few years ago in the Financial Analysts Journal. They found that the only time horizon over which gold appears to be a decent inflation hedge is measured over a century or longer. "Over practical investment horizons," they found, "gold is an unreliable investment hedge."

In fact, they subjected to critical scrutiny all the major rationales for investing in gold over short- and intermediate-term horizons, and found them all wanting. According to the valuation model they proposed, which is based on the historically average ratio of gold's price to the CPI, gold's fair value right now is below $900 an ounce.

Another way of stating the conclusion of Erb's and Harvey's model: The CPI would need to rise more than 55% to justify gold even remaining steady at its current price. I don't know of anyone who is suggesting that such an increase is in the cards anytime soon.

For more information, including descriptions of the Hulbert Sentiment Indices, go to The Hulbert Financial Digest or email mark@hulbertratings.com .

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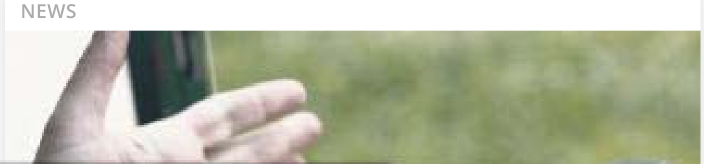

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