Opinion: Why gold won’t save your portfolio from inflation’s bite

By Mark Hulbert
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Higher consumer prices don't necessarily boost gold prices

Think gold will be a good inflation hedge in coming months? Think again.

Consider: If gold GCJ9, -0.54% were a good inflation hedge, its inflation-adjusted price would be constant. Yet, while U.S. inflation (as judged by the Consumer Price Index) has declined in each month since last October, gold has risen nearly 12%. In the process, the gold-to-CPI ratio has risen markedly, from below 4.8 to nearly 5.3.

Of course, five months is a short period of time. But even over periods of several years, or even decades, the gold-CPI ratio fluctuates wildly. The ratio got as low as 1.5 in the early aughts, for example, and as high as above 8.0 earlier this decade.

Might it be that gold is instead reacting to expected, rather than realized, inflation? It’s hard to see how that does any better job explaining gold’s recent behavior. Consider 30-year expected inflation, as judged by the 30-year breakeven inflation rate (the difference between the yields on the 30-year Treasury and 30-year TIPS). That rate has declined from 2.13% in October, according to the St. Louis Federal Reserve, to its current 1.85%.

To be sure, inflation is not the only thing that makes gold go up or down. In a recent MarketWatch column, Michael Brush listed several other factors. But inflation is, by far, the leading suspect. And you have to torture the inflation data a lot to generate a forecast that gold should rise significantly over the next several years.

Consider the study “A Golden Dilemma,” which the National Bureau of Economic Research began circulating several years ago. The study was conducted by Campbell Harvey, a finance professor at Duke University, and Claude Erb, a former commodities portfolio manager at TCW Group. The researchers proposed a fair-value model for gold that was based on the average historical ratio of gold to CPI.
That average is 3.57-to-1, based on data since gold began to trade freely in the early 1970s. The researchers’ implied forecast is that, whenever gold trades significantly above or below this level, it eventually will return to trade at that ratio again. Call it reversion to the [golden] mean, if you will.

What does this mean now? For gold to justify its current price in terms of inflation, the CPI either needs to be 47% higher or gold needs to trade for $902.

Many scoffed at the researchers when they first circulated their study in late 2011, when gold was trading above $1,700. Gold’s subsequent decline led many to take their research a lot more seriously. Unfortunately for gold investors, their study continues to imply that gold’s fair value is a lot lower than where the yellow metal stands.

It’s worth noting that the study did find an historical basis for believing gold to be a good inflation hedge. But the yellow metal does this better job only over super-long periods — measured in centuries rather than years. Over shorter periods, including periods as long as an investment lifetime, they showed that gold fluctuates widely relative to inflation.

This in turn means that it’s entirely conceivable that gold could rise markedly over the next several months. But if it were to do so, it would become even less tethered to the inflation data than it already is. Note carefully that, if that is what you’re expecting, you can’t then turn around when the CPI jumps up to argue that gold’s price should respond bullishly.

The researchers’ forecast merely is that, regardless of whether gold rises or falls over the next few months, gold eventually will return to trade at the mean of its historical ratio to the CPI.

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Mark Hulbert
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