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Which Is the Better Inflation Hedge: Stocks or Gold?

The answer may surprise you, says this columnist

Is gold the best investment to protect your portfolio against an unexpected flare-up of inflation? That’s the conventional wisdom but... PHOTO: ISTOCK

By Mark Hulbert
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The conventional wisdom is that gold is one of the best inflation hedges there is, while stocks are vulnerable when inflation takes off.

But here’s what the data show: Stocks are a better bet than gold to protect your portfolio over the long term against an unexpected flare-up of inflation.

Of course, inflation is at historically low levels and many are more worried about inflation being too low rather than too high. The consumer-price index rose at just a 2% rate over the past 12 months, barely half the 3.94% average over the past five decades. And, as judged by the so-
called break-even inflation rate, the markets are currently betting that inflation over the next 30 years will average just 1.90%. Given that, investors could be excused for not caring at all about which asset classes would provide the best protection against higher inflation.

They may be making a big mistake, however, according to Vincent Deluard, head of global macro strategy at INTL FCStone. In a recent report to clients, Mr. Deluard reviewed a number of arguments for why inflation is likely to heat up in coming years.

One is that the labor market is tighter than we think because government employment data don’t capture the gig economy. Another is that the Federal Reserve’s interest-rate-setting committee may soon come to be dominated by President Trump’s nominees, who are likely to support sharply lower interest rates and other potentially inflationary policies. And yet another is that baby boomers are being usurped as the dominant political force by millennials, who have relatively large debt burdens and therefore will be more likely to support inflationary policies.

Another reason to expect higher inflation in coming years is statistical: The inflation rate tends to be mean-reverting. That is, as shown in the accompanying chart, periods of higher inflation tend to be followed by years of below-average inflation—and vice versa.

There is little historical support for the notion that gold would be a good hedge against a spike in inflation. One relevant statistic: Since gold began to trade freely in the early 1970s, gold’s yearly returns in inflation-adjusted terms have fluctuated just as wildly as they have in nominal terms.

That is telling because if gold were a perfect inflation hedge, its inflation-adjusted returns would never fluctuate. In fact, however, since the early 1970s the ratio of gold’s price to the consumer-price index has ranged from a low of 1.47 to a high of 8.68, according to research conducted by Duke University professor Campbell Harvey and Claude Erb, a former commodities portfolio manager at TCW Group. The two researchers suggest using the average gold-to-CPI ratio as a benchmark of gold’s fair value; on that basis, the CPI would need to be 41% higher than it is today to simply justify gold’s current price.

Messrs. Erb and Harvey suspect that gold’s reputation as a good inflation hedge derives from research that focused on very long periods of a century or more. Over those periods, it does appear that gold historically has done a creditable job of maintaining its inflation-adjusted
purchasing power. But that isn’t the case over shorter periods, even those up to a few decades in length.

The reason stocks are a decent inflation hedge is because corporate earnings grow faster when inflation is higher, and grow more slowly when inflation is lower, according to Richard Warr, a finance professor at North Carolina State University. Consider the growth rate of corporate earnings over all 10-year periods since 1871, according to data compiled by Yale University finance professor (and Nobel laureate) Robert Shiller. The volatility of those growth rates was 21% less on an inflation-adjusted basis than it was on a nominal basis, which Prof. Warr says is a good indication of the extent to which equities are able to hedge inflation.

To be sure, Prof. Warr adds, higher inflation does reduce the present value of the otherwise higher future earnings. But these two effects should more or less cancel each other out over time.

Prof. Warr acknowledges that, over shorter periods of a year or two, stocks often suffer when inflation heats up. His research suggests that is because many investors are guilty of what economists refer to as “inflation illusion.” That is, they focus only on the reduction in the present value of future earnings to which inflation leads, while ignoring the tendency for nominal earnings to grow faster when inflation is higher. So when inflation spikes upward, they sell stocks.

Since the inflation illusion is irrational, it is difficult to predict whether investors will be guilty of it the next time inflation heats up. But Prof. Warr says that if they do and their selling causes the stock market to drop, investors should treat it as a buying opportunity.
Mr. Hulbert was the founder of Hulbert Financial Digest, which closed in 2016. His Hulbert Ratings tracks investment newsletters that pay a flat fee to be audited. He can be reached at reports@wsj.com.

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