Liking Gold’s Ascent? Just Wait for the Plunge, Study Warns

Duke’s Campbell Harvey charts the wacky ups and downs of the precious metal.

record high Thursday of $2,083. At a time
when the stock market is roaring, suggesting optimism about the future, gold is saying the opposite. Namely, that one segment of investors is using it as a refuge against bad times.

The precious metal, an ancient store of value, has a long list of detractors, of course. Economist John Maynard Keynes famously sneered at the stuff as a “barbarous relic.” Add another non-fan: Duke’s celebrated finance professor, Campbell Harvey, who just delivered a paper highlighting its volatility and speculative nature.

Sure, in a fraught century—a tech bust, a terrorist attack, a recession, two wars, a financial crisis, a Great Recession, a trade conflict, and now a pandemic and another deep recession—gold has addressed a lot of anxieties. The yellow metal is up almost nine-fold from 2000 and has doubled since 2015.

Along the way, though, its progress has been as nauseatingly scary as the El Toro roller coaster at New Jersey’s Six Flags Great Adventure. Harvey pointed to gold’s peak in January 1980, after the crazed inflation of the 1970s: Five years later, the substance’s nominal price fell 55% and its real (that is, inflation adjusted) value dropped 67%. Gold’s run-up there from economic recovery and stable inflation.
Gold got very popular again as a result of the 2008-09 financial crisis and the Great Recession. Then, investors viewed gold not as an inflation offset, but as a safe place amid economic collapse. Gold peaked anew in August 2011, and, thanks to resumed economic growth, the price dropped 28% nominally and 33% real.

In his paper, Harvey sounded a warning about the “financialization” of gold leading to even more volatility. Gold has been traditionally traded on commodities markets, known for their madly fluctuating price action. Add another layer of volatility, the stock market’s, to the metal. Example: Exchange-traded funds (ETFs) like SPDR Gold Shares, which is up 18% this year. That’s compared with 36% for physical gold. In general, he wrote, the ETFs and the actual bullion price are tightly correlated.

Owing to the ETFs, the ride for gold investors could get even more nerve-wracking, Harvey predicted. “If stocks can experience ‘irrational exuberance,’” the professor observed, quoting one-time Federal Reserve Chairman Alan Greenspan about giddy mid-1990s stock price, “it is certainly plausible that gold can experience ‘irrational exuberance.”

Pension programs and other institutional gold in their portfolios. The State of New Jersey Common Pension Fund, its latest
filing shows, owns shares in gold mining companies that make up about 0.04% of the program’s assets.

The Alaska Permanent Fund board is eyeing possibly adding gold to its $67 billion portfolio. The state sovereign wealth fund’s staff issued a report favoring the metal as a diversifying asset, calling for it to constitute a 2% portion of the fund’s holdings.

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A surge in liabilities from low discount rates dropped aggregate ratios 1.3 percentage points to 79.9%, Wilshire says.

The aggregate funded ratio for US the first time since the start of the economic recovery.
Last month, funded status fell by 1.3 percentage points to 79.9% for corporate defined benefit (DB) plans, Wilshire Associates said in a report. That's the same funded status corporate plans notched March 31 after the coronavirus crashed markets and the lowest level since October 2016.

A surge in liabilities drove down the funded ratio: Assets in July jumped by 4%, but liabilities climbed higher to 5.6%. A roughly 20 basis point (bp) fall in Treasury yields in July and a 15 basis point drop in corporate bond spreads helped drive up liabilities, according to Wilshire Managing Director Ned McGuire. Discount rates are hovering in the low- to mid-2% range, or the lowest level in more than a decade.

Cumulatively, the aggregate funded ratio has fallen by 7.2 percentage points since the start of the year, when the funded status hovered at 87.1%, as of December 31. Over the past 12 months, funded ratios have tumbled 8.9 percentage points from 88.8% last July.

Historically low discount rates are also continuing to pressure corporate pension plans despite strong investment gains in the equities market. Since March lows, the S&P 500 is up nearly 49% and has nearly pandemic-induced market rout. Year to date, the index is up 3%.
The quick recovery has made some investors nervous that enthusiastic markets will crash in the second half of the year. This week, CNBC Mad Money host Jim Cramer even commented, “I can’t take how stupidly bullish this market can be.”

Other reports from Milliman have found that corporate pension plans had already seen their funded status declining in May. For corporate DB plans, falling discount rates will continue to add pressure to companies looking to de-risk their plans.

The findings are based on a portfolio asset allocation with 22% in US equities, 17% in non-US equities, 25% in core fixed income, 34% in long-duration fixed income, and 2% in real estate.

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