What’s driving the new gold rush?

BY SHAWN TULLY
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The new gold rush is on. Suddenly, the precious metal has regained its long-lost glitter, jumping to over $2,000 an ounce during the first full week of August, its highest inflation-adjusted level in a decade. That new peak roughly matched its all-time record in 1980 when the Hunt brothers of Texas notoriously cornered the silver market and gold joined the ride. Then gold collapsed from what everyone in retrospect recognizes as delirious heights. Now, the goldbugs are claiming that it’s the safest port in these stormy seas, while history warns that a rerun of 1980 could be looming. Who’s right?

Over the past few days, the shiny metal has retreated a bit, closing 5% off its summit at $1,946 on Aug. 12. Still, the 24% liftoff this year easily bests stocks and bonds, beating the S&P 500’s modest bump 5 to 1.

On the surface, the story that gold’s fans are advancing to justify its comeback seems to make sense. Banking on this classic store of value, they argue, provides the best insurance against the threat of rampant inflation raised by the U.S. government’s unprecedented fiscal stimulus and the Fed’s money-creation binge. Ruchir Sharma, chief global strategist for Morgan Stanley, recently expressed the widespread view that gold’s resurgence has legs, because stocking bullion furnishes a safe haven in these dangerous times. On Aug. 8, as its price hovered over $2,000, Sharma wrote in a New York Times editorial that “Gold appears relatively cheap,” adding that “unless a vaccine emerges quickly, central banks stop printing money frantically, and real interest rates start rising again, it’s difficult not to be a goldbug right now.”

If gold’s advocates are right, the metal should have a long history of first, predicting when inflation is about to take off, and second, providing protection when it happens, in periods when consumer and producer prices are rapidly rising. Over many decades and cycles, gold has failed on both counts. In fact, fear of looming inflation probably isn’t the main motive behind today’s mania. The puny yields on 10- and 30-year Treasuries are forecasting the opposite scenario of prices rising at an unusually slow pace in the years ahead. Even if Treasuries way underestimate the risks of heavy inflation, and that’s highly possible, gold has reached such excessive highs that it’s unlikely to keep rising substantially from here, which is what’s needed to keep you even with a galloping consumer price index (CPI). Catching gold fever is far more likely to saddle you with a big loss.

Rather, what’s driving the spike in gold is what usually brings forth its golden interludes: a speculative frenzy. In the past few years, it has evolved from a favorite of traders at banks and hedge funds, and die-hard “goldbugs,” into a popular, mainstream vehicle. The rise in gold ETFs has made it much easier for the retail crowd to buy. The folks and funds piling into those “massive passives” seem sold that a train chugging with this head of steam, getting buzz this favorable, is bound to keep rolling.

“It’s what Warren Buffett calls ‘the bandwagon effect,’” says Campbell Harvey, an economist at Duke University and adviser to Research Affiliates, a firm that oversees investment strategies for $145 billion. “As Buffett says, ‘People create their own truth.’ In this case, they buy more and more gold, and the price goes up, validating their investment thesis. The momentum builds until a shock to the markets or economy gets people to stop believing, and they rush to get out.”

The silver boom

The silver boom of 1980 and its aftermath offer a warning for what may follow from the current craze in its pricier sibling. This writer had an upfront view of the thinking and personalities behind the storied silver debacle. As a young reporter for Fortune, I spent a weekend interviewing the Hunt brothers of Dallas just after the silver bubble exploded in one of the biggest commodity meltdowns in history. Famed oilmen Nelson Bunker and William Herbert Hunt had spent billions accumulating the shiny stuff at below $10 an ounce and watched their holdings multiply to around $13 billion when prices soared to $50. But over a few weeks in March of 1980, silver plummeted 80%, forcing the heavily-leveraged Hunts to mortgage assets from wells for black gold to mansions to Rolex watches as security for the lenders. From the early 1980s to 2016 silver never broke $10. Investors who had suffered heavy losses in the rout charged the Hunts with cornering the market, and the courts agreed, awarding big penalties that forced the brothers into bankruptcy.

When I interviewed the Hunts in June of 1980, their multibillion windfall had collapsed. But for the brothers, it wasn’t a drop in silver’s enduring bedrock value, but the maneuvers of short sellers and regulators that had caused the crash, and
they wanted to tell the world in what was their first major interview. I was then a researcher accompanying legendary Fortune writer Roy Rowan, and frankly, despite their travails, the Hunts were delightful company.

The heavyset Bunker dropped some great lines. He even had a witty way of conveying that inflation was a scourge not just for the man on the street, but Texas tycoons. When Roy asked whether he was still a billionaire after his losses on silver, Bunker quipped, “I don’t know. But I do know a billion dollars isn’t what it used to be.” Since he’d just returned from a vacation in Paris, I asked how he’d enjoyed the City of Light. Declared the famously frugal Bunker, “Sure is tough to get a bad meal over in Paris. Sure is tough to get a cheap one, too.”

His luxurious lodgings in a landmark overlooking the Place Vendôme impressed Bunker more for their expense than aesthetics: “When I paid my bill at the Ritz Hotel, I thought I bought the place!” he joked. Bunker was intrigued by what my name suggested about my ancestry: “Shawn, you wouldn’t be an Irishman?” intoned Bunker from an armchair at home, sipping Coca-Cola from a big bottle. Brother Herbert was a relatively quiet foil who confessed to purchasing paintings more for their baroque frames than the artwork itself.

Many years later, Herbert Hunt proved that although his foresight had failed in silver, he retained a knack for charting the future in the oil patch. Herbert staged an amazing comeback as a pioneer in shale fracking. In late 2012, he sold his assets in the Bakken region for $1.45 billion, putting his net worth at an estimated $4.2 billion.

The Hunts told us that it was the Fed’s easy money policies, marshaled to rescue the economy from the deep recession caused by an explosion in oil prices, that drew them to silver. Along with many other gold and silver bulls at the time, the brothers predicted years of heavy inflation that would boost the value of hard assets that, unlike dollars, would stay in short supply. Bunker, a Texas-size Christian, even quoted praise for the safety of silver in times of strife from the Bible. It was clear that Bunker and Herbert were wildcatters at heart and didn’t see silver mainly as a hedge but a ticket to a new gusher of billions.

As it turned out, silver was a lot more plentiful than the Hunts thought. The jump in prices itself punctured the boom. Stores sprang up advertising super-high prices for household silver, and people rushed to sell their jewelry and teapots. Smelters turned the heirlooms into bullion, swelling the supply and sending prices back to where the sprint began.

The outlook for gold

It’s unlikely that a collapse anything like the selloff that hammered the Hunts is looming for gold. Still, the yellow metal’s resurgence recalls the herd mindset that drove the stampede 40 years ago. In an excellent new paper, Gold, the Golden Constant, COVID-19, “Massive Passives,” and Déjà Vu, Duke’s Harvey and coauthors—retired portfolio manager Claude Erb and Tadas Viskanta, editor of the website Abnormal Returns—chronicle the trends in gold prices over the past decades and explore its trajectory in times of fast-rising prices when, in theory, gold is supposed to provide a reliable hedge. The following analysis comes both from the paper, and my conversations with coauthor Harvey, the Duke University economist.

For Harvey, the big picture is that gold prices do track inflation—but only over periods so long—we’re often talking a century—that in effect, they don’t provide protection in times the cost of living soars. “The Romans kept detailed records, so you can measure the buying power of gold, which they used as a currency, at the time of the centurions 2,000 years ago,” he tells me. Harvey found that the emperors paid those officers in coins whose weight in gold roughly translates into the dollar salary for a U.S. Army captain today. “So the same amount of gold had the same value relative to household expenses in the Roman Empire as it does now,” says Harvey. “That means over all those centuries, the rise in the price of gold has equaled the rise in overall prices.”

As further proof, Harvey takes us back another century to the time of Babylonian king Nebuchadnezzar (d. 562 BC). He notes that in those days the gold coins that bought a loaf of bread equate to $5.50 today, what the economist spends at his boutique bakery. “Over long periods, gold doesn’t give a return over and above inflation,” he says. But he adds that simply keeping up with prices is a pretty good performance. Its record over millennia of matching inflation proves that gold indeed has strong intrinsic value because of its scarcity and use in jewelry. In fact, Harvey believes that small holdings of “hard” rather than paper assets are essential to any diversified portfolio because those holdings overall will
perform a lot better than stocks and bonds in times of crisis. Small amounts of gold, he says, should be part of that group.

Gold does sometimes outperform equities and fixed income in turbulent times such as in the mid- to late 1970s when the OPEC oil shock pummeled the world economy. In those years, it also temporarily fulfilled the role that fans praise it for, as an inflation hedge. But gold fails in that role more often than it succeeds. It shows no consistency either in anticipating periods of fast-rising prices or in keeping investors whole when inflation takes charge.

“Gold goes through periods where it’s way overpriced or way underpriced for a lot longer than assets like stocks,” says Harvey. “The lifetime of the average person isn’t long enough to ensure that it will protect you from inflation.” The report focuses on what happened in the two previous periods after gold reached peaks, in 1980 and 2011.

In 1980, the metal hit a “real” price (in 2020 dollars) of $2,200, a touch above the current summit. Gold prices had tripled since 1973, a period where stocks and bonds cratered. For that period, gold had proved a great refuge in a world reeling from inflation.

But gold wasn’t just keeping investors even with racing prices, it was soaring in a speculative bubble. That precedent harbors lessons for today. Indeed, the CPI did run hot for the next five years, advancing at a 6.3% annual clip from 1980 to 1985. But gold failed to keep shielding investors for a simple reason—its price so outstripped its fundamentals that a sharp fall was inevitable. Over those five years, its price dropped a total of 55%. The protector from 1970s inflation flopped as the scourge kept running in the 1980s.

In 2011, gold surged past $1,700 equaling the recent peak of $2,000 in today’s dollars. At the time, many investors fretted that the Fed’s quantitative easing program, marshaled as relief in the Great Recession, would ignite inflation. If that explains the spike, then the gold enthusiasts made a bad bet. From mid-2011 to mid-2016, the CPI rose at just 1.2% a year, while the price of gold dropped 28%.

By comparison, in 2011, the bond market was anticipating minimal inflation following the prolonged downturn. If gold boomed because its backers disagreed and went rogue, they were wrong. The CPI rose at two-thirds of the historical pace for those five years, and gold not only didn’t keep up, it dropped by one-third.

Harvey and his coauthors chose those two periods because, in both cases, prices soared far above their historical norms. They draw two main conclusions on what sent gold to these peaks. First, it’s far more likely that a speculative rush, not fear of inflation, propelled the moonshots. Second, when gold gets this pricey, it’s just too expensive compared with its fundamentals.

**What is gold really worth now?**

So what’s the fundamental force that does govern gold prices? For the authors, it’s the value of goods and services—clothes, groceries, rent, and everything else we consume in our daily lives—that an ounce of gold buys, on average, over long periods. Let’s call it “the gold standard.” When prices rise far above the standard, they eventually trend back toward it, as if driven by a kind of gravity; when prices fall far below the standard, the fundamentals inevitably take hold, and they catch up.

The authors point out that the gold price over the past 45 years has oscillated around a fixed multiple of the CPI. That’s our “gold standard.” It resembles the price/earnings ratio for stocks. When the P/E reaches unusually high levels, it typically shifts back toward historical norms, because investors refuse to keep paying more and more for each dollar of earnings, and instead dump stocks and take profits.

For gold, hitting an outsize multiple of the CPI means that each ounce of the metal buys far more steaks, cars, and semiconductors than at most times in the past. Eventually, the price of gold to the CPI trends back to the long-term benchmark or our gold standard. The rub is that it can languish way below that benchmark for extended periods, and what’s really dangerous, bubble way over that baseline, and stay there, for years.
“The long-term price is its average, inflation-adjusted price,” says Harvey. “That’s the benchmark. Sometimes gold is way above that benchmark, sometimes way below. When it’s way above, prices will eventually fall. You just don’t know when.”

So what’s the P/E-like ratio that for gold, in the long run, is the lodestar that always guides gold back home? We’ll call it the price-to-CPI multiple or the P/C. The authors show that since 1975, the P/C has averaged around 3.5, meaning that the gold price careens over and above a straight line denoting three and a half times the cost-of-living index for goods and services. That 3.5 multiple is our gold standard, the norm the metal historically trends back to.

Today, with the CPI at 257, the P/C stands at 7.6, well over twice the long-term benchmark. The P/C reached about the same levels at the previous tops in 1980 and 2011. It can also fall far below and stay there for a long time: For much of gold’s 14 years in the desert from 1987 to 2001, its P/C languished at around 2.

The bulls want you to believe that today’s towering P/C is the new normal. For Harvey, gold’s ascension threatens the same fate as the last two big spikes: a downward spiral that five years hence would not just fail to match inflation, but saddle investors with sharp losses. “High gold prices now suggest negative returns in the future,” he says. “Gold isn’t a reliable inflation hedge, it’s a risk asset that’s driven often by speculation.” He points to what happened in the big stock selloff in March. “People saw a crisis building, so they dumped gold just like stocks and Bitcoin, even though the outlook for inflation didn’t change. Then when people began to believe in a V-shaped recovery, gold bounced like the other risk assets.”

But, as Harvey points out, gold is extremely vulnerable to bad news at these prices: If the metal retreats to its long-term multiple, the price would drop to $900, under half its recent high of $2,000.

Hence, Harvey doesn’t buy that a group of investors who disagree with the bond market and predict rampant inflation are the force pushing gold ever higher. “I rule out that it’s a special set of investors,” he says. “There are goldbugs who think that it’s the only safe asset, but they’re a very small part of the market.” He rejects the view that the people fearing catastrophic inflation are only in gold when, he says, they could be buying safety in the bond market by acquiring the likes of Treasury Inflation-Protected Securities or TIPS that provide an extra return when the CPI rises.

So why is gold on a tear? Harvey observes that ETFs now account for most of the investment in gold, and that the holdings in the two largest ETFs have jumped from under 5 million ounces in 2004 to 50 million in July. “The price of gold has been rising right in line with buying in gold ETFs,” he says. “And it’s that buying that’s likely driving the price.”

But Harvey says that gold’s new pop status doesn’t change its underlying dynamics. “Now, it’s too much money chasing too little gold in the ETFs,” he says. “It’s when the people in those ‘massive passives’ sell en masse that prices will fall.” That could happen if we have another shock like the one in March, or another signal that the world is getting riskier. Or folks could decide that prices are so high they can’t resist cashing out. When loyalists see the first wave dumping gold, they’ll join the rush for the exits.