Gold and inflation

Gold is not perfect protection against rising inflation. Investors should hold it for other reasons.

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Inflation is likely to rise this year. Economic forecasters expect CPI inflation to rise from 0.3 per cent in November to 1.9 per cent by year end. Which poses the question: should we hold gold as a hedge against this rise and the risk of a bigger increase? The answer is: not necessarily.

Certainly, gold has been a fantastic protection against inflation over the very long run. Claude Erb and Campbell Harvey point out that a Roman centurion in the time of the Emperor Augustus (who ruled from 27BC to 14 AD) was paid 38.6 ounces (oz) of gold a year. That’s just over £50,000 in today’s money – which is only slightly more than an experienced captain in the British Army gets. Gold, therefore, has kept pace with 2000 years of wage inflation. It’s been a fantastic long-term store of value.

Sadly, however, most of us don’t have time horizons of 2000 years. In the short term it’s much less obvious that gold protects us against inflation. There are two different ways of looking at the numbers here.
One way is to consider the correlation between annual inflation and annual changes in the sterling price of gold. If gold protects us from inflation, this correlation should be high. But it’s not: it’s been just 0.28 since 1971 (when President Nixon broke the link between gold and the US dollar). Yes, gold is more likely than not to do well when inflation is high. But it is not certain to do so. For example in 1975, when inflation was almost 25 per cent, gold actually fell. It also fell in 1981 when inflation was 12 per cent and in 1989 and 1990 when the Lawson boom raised inflation.

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In fact, gold has been poor protection against inflation even over quite long periods. In sterling terms, it was lower in 2005 than in 1980, even though the cost of living tripled in this period.

We can put this another way. If gold were a great short-term hedge against inflation its price in real terms – that is, adjusted for inflation – should never fall. But my chart shows that it can do so, and by a lot. It also tells us that gold rose a lot between 2004 and 2010 and in 2018-20, which were times of quite low inflation, by the standards of the 1970s and 1980s. Which means that gold’s price is driven by much more than inflation.

In all these ways, then, gold doesn’t protect us from inflation.

But there’s another perspective here. Instead of looking at actual inflation we can look at expected inflation, as measured by the gap between conventional five-year gilt yields and their index-linked counterparts. If we look at the 10 biggest annual rises in this measure since data began in 1985, we see that gold rose on nine of these occasions. Which suggests that gold can indeed protect us against fears of inflation.
This is quite consistent with gold being only weakly correlated with actual inflation. Imagine people were to correctly expect inflation to rise. They might then buy gold, thus pushing its price up immediately. As the inflation actually materialised in the following months, however, there’d be no reason for the gold price to change. We would then see little correlation between gold and observed inflation.

In truth, though, the ability of gold to protect us from inflation depends upon why inflation rises.

There are some types of inflation that do see gold do well – such as those caused by rising commodity prices or a fall in the pound.

But there’s another type of inflation which can be bad for gold – that caused by a cyclical upturn. Such upturns can see gold fall for two reasons. First, stronger economic growth can increase investors’ appetite for risk, causing them to dump safe haven assets such as gold. And secondly, economic upturns raise expectations for interest rates. And because gold pays no interest, it becomes less attractive when investors anticipate higher returns on competing assets such as cash.

It was for these reasons that gold did badly during the late 1980s inflationary boom and during the 2010-2015 upturn.

Which is a problem, because if inflation does rise in the next couple of years it is likely to be the result of a stronger economy, in which case gold might not do well.

Now, this does not mean you should dump it. For one thing, the Fed and Bank of England have promised to keep interest rates low until the economic recovery is secure – and if interest rates don’t rise much, gold won’t fall much. And for another, this upturn might be largely already discounted by equities – and if shares don’t rise much the safe haven demand for gold will remain strong.

Instead, we should think of gold as a protection against some types of bear market in equities – such as those caused by investors becoming more risk-averse. This makes the metal worth having, regardless of your opinion about inflation.