Jane Young: Gold is not the magic bullet to fight inflation

JANE YOUNG Special to The Gazette
Feb 20, 2022

As prices continue to soar, inflation has become the primary concern for investors.

As demonstrated by numerous television commercials, gold dealers are quick to espouse gold as the magic elixir to guard against inflation and any other economic crisis that may threaten your portfolio. But while a small percentage of gold may be appropriate for your portfolio, it lacks the luster that is often promised.

After being delinked with the U.S. dollar in 1971, gold is just a commodity. It does not produce anything and does not generate earnings, dividends, cash flow or interest. When you buy gold, you are betting on the value that someone will pay for it in the future — unlike investing in stock where you invest in a business and the economy, which tends to provide growth and income.
Gold is generally held with the goal of preserving wealth. Most investors buy gold to hedge against stock market volatility, rising inflation and a catastrophic economic disaster. Historically, gold has not been closely correlated with the stock market. Gold, along with investment-grade bonds, can provide a buffer against stock market fluctuations.

However, the benefit of gold has been diminished by poor returns in comparison to the stock market over the last 50 years. Gold performs best during times of economic and social turmoil, giving the impression it is safer than the stock market. Over time this has not been true; since 1974, the S&P 500 returned about 12% annually compared to about 4.8% for gold.

Gold has also demonstrated mixed results as a hedge against inflation. A study by the National Bureau of Economic Research, authored by Duke University professor Campbell Harvey and Claude Erb, a former fixed-income and commodities manager at the TCW group, explored this concept. They found that gold is a decent inflation hedge only over extremely long periods — measured in many decades if not centuries. Over shorter investment time horizons, of concern to most investors, gold’s relationship to inflation...
An investment that provides an effective hedge against inflation would be expected to rise when the Consumer Price Index increases. However, gold has experienced negative returns during some of the highest inflationary periods. For example, gold decreased 10% in 1980-84 with inflation of 6.5%, and gold decreased 7.6% in 1988-91, when inflation was 4.6%. However, in 1973-79, when inflation raged to 8.8%, gold returned 35%.

Gold can dampen volatility during extreme swings in the market but does not necessarily work well as a hedge against inflation. A better hedge may be stock, TIPS (treasury inflation protected bonds), real estate, I-Bonds and commodities such as oil and timber. If you decide to invest in gold, limit your allocation to around 5% of your portfolio.

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