Key Questions

October 24, 2022

Has Gold Lost Its Luster?

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

The precious metal has usually been a safe haven during inflationary times; its price is languishing now but it still has a place in your portfolio.

Inflation surged during the past year to levels not seen since the 1970s, a decade when the price of gold appreciated significantly. Yet this time, gold has languished, causing investors to ask: Has gold lost its luster?

Gold prices are primarily a function of real interest rates (interest rates after adjusting for inflation), the US dollar and risk – with rates and the dollar being the most critical long-term secular drivers. As expected, the combined fiscal and monetary response to the disinflationary shock of COVID-19 created an environment where inflation has run hot. In response, the Federal Reserve (the Fed) has raised its policy controlling interest rate at a remarkable pace, tightening financial conditions.

In fact, real interest rate yields as measured by 10-year Treasury inflation-protected securities, known as TIPS, have moved from negative 1.20% in November 2021 to positive 1.65% today, a move of approximately 2.85%. Negative real yields were incredibly positive for gold. Why? Holding the yellow metal does not provide any yield return for investors, so when competing fixed-income investments have negative real yields, there is little opportunity cost for investors to own gold.

The current environment is the opposite scenario. Real yields are not only positive, but persistently rising, creating a tremendous headwind for precious metals because there is a significant opportunity cost to holding them.

Laser-Focused on Inflation

The Fed's work of cooling inflation through interest-rate hikes continues, and market participants expect the tightening to persist well into early 2023. That should keep precious metals under pressure. While financial markets have been volatile, Chair Jerome Powell and the Federal Open Market Committee do not seem to be overly concerned about:

- Financial stability
- The potential consequences of a recession
- The impact of multiyear increases in interest rates despite elevated debt levels
- The knock-on impact of a surging US dollar

They are laser-focused on inflation, and for good reason: Their credibility is at stake!

During the 1970s, the Fed maintained a bias of prioritizing economic growth over inflation. Gold prices rose, even in a rate-hiking environment, as the risk to growth outweighed the impact of higher rates.

During the 1980s, we saw the opposite, when the Fed, led by Paul Volcker, demonstrated that fighting inflation was its top priority. The tightening effect outweighed the impact of economic growth concerns and gold fell during the rate-hiking cycle.

The experience of the 1970s and 1980s demonstrates definitively that if inflation is allowed to become persistent, it is challenging both politically and socially to push the economy into recession with the intention of bringing it back under control. The genie needs to be kept in the bottle!

Arthur Burns, Fed chair during the 1970s, argued that the Fed always knew what had to be done to stop inflation but failed "due to the political and philosophic currents of the time." It took multiple years of high inflation for the Fed to gather political capital to finally end it for good. Given this, we believe that Powell's Fed will err on the side of tightening too much. To do otherwise tempts fate.

With the first rate hike only coming roughly seven months ago, we believe the well-documented lagging negative economic impact of Fed action has yet to fully show up in the data, let alone the impact of further hikes to come. This suggests the economy potentially may see disappointing growth next year, setting the stage for an eventual pause in the tightening cycle. But markets are nowhere close to embracing this view yet, and neither is the Fed.

Key Takeaways

The upside scenario to gold prices is that the Fed changes its tune completely and exhibits an inflationary bias similar to the 1970s. Think of it as a 4% inflation target becoming the new 2% (the Fed's currently stated target). In this setup, US real rates are likely to move materially lower while recession risks remain elevated due to high macroeconomic uncertainty. We see this scenario as unlikely. The Fed now has the experience of undesired past outcomes and will likely act with resolve if it sees signs of inflation expectations accelerating. However, that cannot be ruled out completely.

We are clearly cautious about the Fed's near-term direction with inflation continuing to come in hotter than expected and the Fed in full-tightening mode. It is simply still too early to call the bottom. However, several signs lead us to ponder whether a change in the Fed's inflationary bias might be in the offing, signs such as:

- The unprecedented speed of the tightening cycle
- A 20%-plus surge in the US dollar
- An inverted yield curve
- Historic debt levels
- The potential impact of wealth destruction stemming from one of the worst years for both equity and debt markets on a combined basis

Given all this, we believe that gold maintains its place as a portfolio diversifier, even if it is less shiny.

For more information, please contact your advisor.

About the Author

Stephen Hoedt is responsible for the oversight of our internally-managed strategies, individual equity due diligence, equity trading, and both taxable and municipal fixed income due diligence with an emphasis on credit research. Within the Equity Research team he is responsible for coverage of Energy, Industrials, and Materials.

Prior to joining Key, Steve was the Industrials and Materials Analyst for the National City Corporation's Private Client Group. He began his investment career in 1993 as an equity research analyst with responsibilities for the computer hardware and software industries.

Steve has been quoted in several publications including Barron's and The Wall Street Journal, and has also appeared on CNBC and Bloomberg TV.

Publish Date: October 24, 2022