Key Questions

How Has Our View on Gold Evolved?

August 10, 2020

Stephen Hoedt, Managing Director of Equity and Fixed Income Research

"When the facts change, I change my mind. What do you do, sir?"
– John Maynard Keynes

In our Key Questions article, "Is All That Glitters Truly Golden?" last October, we expressed our view that gold does not merit inclusion in a strategic asset class framework. We took that position primarily because, unlike stocks and bonds, gold does not offer a stream of cash flows (e.g., dividends and earnings) one would use to estimate its value.

That said, we also put forth three scenarios that would cause us to consider a tactical asset allocation to gold:

1. US interest rates decline to zero or below.
2. Coordination between the Federal Reserve (Fed) and the federal government increases to finance expanding budget deficits.
3. Geopolitical events present an increased risk of a fall in the value of the US dollar.

All three of these have now occurred to one degree or another.

When we wrote the article in October of last year, we favored stocks, bonds, and other diversifying strategies over gold. While we still do so, we have come to believe that the optimal allocation to gold in the current economic environment is no longer zero — a view that is likely to persist for a longer time than the consensus expects. Borrowing from Keynes, the facts have changed, so we have changed our minds.

In the near term, COVID-19 is a disinflationary shock, given that it has produced high spare capacity and high unemployment. Long term, however, it is potentially an inflationary shock in our view. Why? The economic slowdown triggered in response to COVID-19 has resulted in a passing of the torch from global monetary policymakers to fiscal policymakers, a change that we do not see reversed for the foreseeable future. Given this, we believe that fiscal policy will remain highly expansionary until unemployment returns to politically acceptable levels, and spending will be financed by open-ended quantitative easing.

Relative to the Global Financial Crisis in 2008, global central banks in 2020 have expanded their balance sheets at a much faster pace. Within ten weeks of initially launching cash injections, the Federal Reserve, European Central Bank, Bank of Japan, and People's Bank of China have grown their balance sheets astonishingly by a combined $5.4 trillion compared with $1.9 trillion in 2008. On the fiscal side, expansionary policies have also been enacted with surprising speed and force, including direct payments to businesses and families.

In the US, the Fed is now in the business of directly financing the Treasury's potentially unlimited spending. Why do we think spending by the US Treasury will continue? Because fiscal tightening imposed to stabilize government debt would result in deflation and 10%+ unemployment. Neither of these outcomes is acceptable in a credit-based economy. As a result, the most politically, socially, and economically pragmatic solution is to pursue fiscal expansion until unemployment returns to low levels, allowing inflation to rise

and cap bond yields. Bond yields are already behaving as if capped, and real yields have been plummeting. (Real yields are nominal yields after adjusting for inflation.) In this scenario, we could see that real yields decline to -2% or even lower.

As other countries emerge from lockdowns with robust testing and tracing programs for the virus, America faces a growing number of COVID-19 infections. Given this, the US is likely to be at a higher risk than other countries of having to re-enact damaging lockdowns. Renewed disruptions to economic life in the US could hurt GDP growth and potentially lead to lower interest rates for a protracted period. Lower US interest rates could, in turn, result in a structurally weaker US dollar over the next 18-24 months.

What does this mean for equities? Historically, US equities have acted as a good inflation hedge until inflation rises to 3-4%, as the fall in real yields forces market participants to value stocks using an equity risk premium framework instead of the usual price-to-earnings shorthand. Therefore, both US equities and gold can rise together in a moderately inflationary scenario. This is especially likely in a world where bonds increasingly do not diversify risk, which forces asset allocators to switch from bonds to equities or other types of investments.

In short, the US has now come full circle from the initial virus outbreak to the unprecedented monetary and fiscal policy responses to the health policy response and a new and more entrenched viral outbreak. Given this, a weaker US dollar environment could emerge, as it was always somewhat naïve to believe that the Fed can print money to buy assets without global repercussions for the greenback.

In summary, we believe the pandemic will exacerbate some global economic trends, including increased savings, growing inequality, declining productivity, rising public debt levels, the return of bipolarity in global geopolitics, and falling real interest rates. As evidenced by recent data, America has been hit particularly hard by the virus compared with other countries.

These trends are relevant for gold as gold prices are primarily a function of real interest rates, the US dollar, and risk, with rates and the US dollar being the most critical long-term secular drivers. As financial markets come to terms with the prospect of stagnating US and global GDP growth and a declining dollar, real rates could sink further with the dollar following. This combination now creates an environment in which gold may outperform other assets over the next 18-24 months, which argues favorably for a tactical, albeit modestly sized, allocation to gold, which Keynes once called a barbarous relic.

For more information, please contact your Key Private Bank Advisor.

Key Private Bank

Publish Date: August 10, 2020

Any opinions, projections, or recommendations contained herein are subject to change without notice and are not intended as individual investment advice. This material is presented for informational purposes only and should not be construed as individual tax or financial advice. KeyBank does not provide legal advice.
Investment products are:

NOT FDIC INSURED • NOT BANK GUARANTEED • MAY LOSE VALUE • NOT A DEPOSIT • NOT INSURED BY ANY FEDERAL OR STATE GOVERNMENT AGENCY

© 2020 KeyCorp. **Member FDIC.** 200227-751225-1155437815