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WEALTH MANAGEMENT

THE BIG PICTURE

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All that glitters

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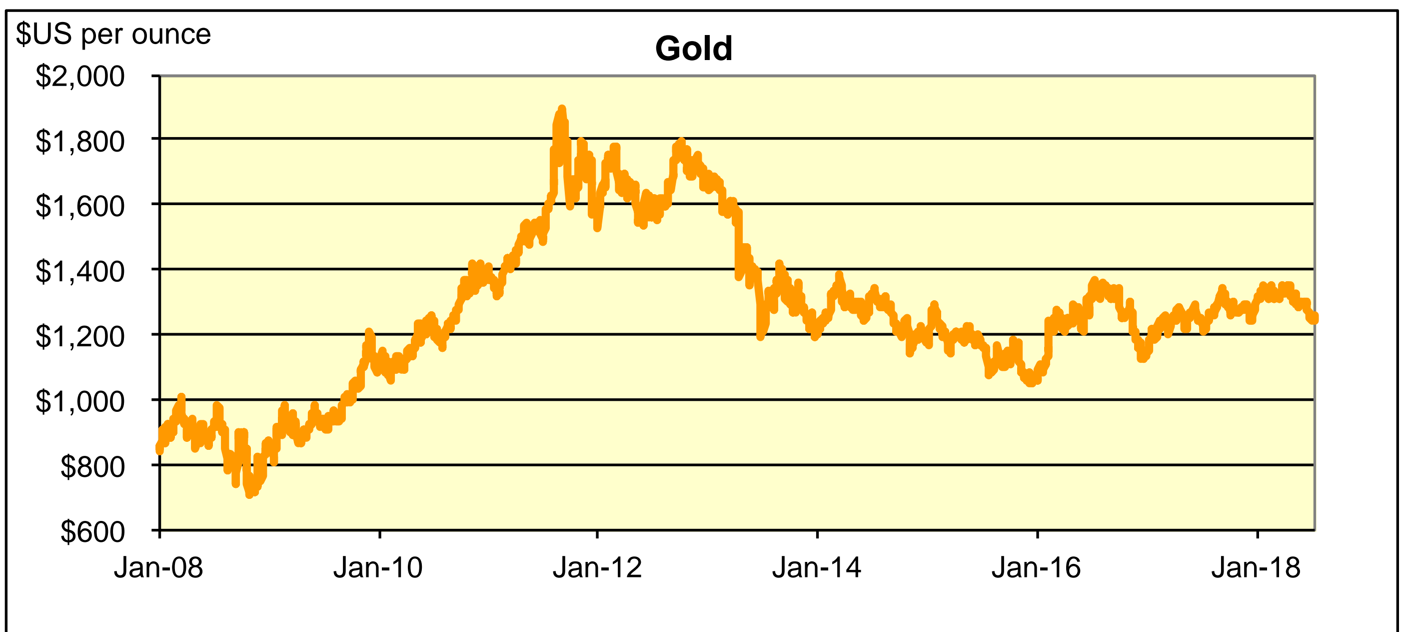
Investors, even well-seasoned market veterans, can be forgiven for the unease that they may be currently experiencing. The business cycle in the United States has pushed through the nine-year mark and pundits are regularly suggesting that a material pullback in financial markets is overdue. In addition, unprecedented changes to international relations generally and international trade specifically have supplied shocks to equity, fixed-income and currency markets. In a speech in South Africa on July 17, 2018, even former U.S. President Barack Obama underscored this sense of uncertainty, stating that each day's news cycle was bringing more "head-spinning and disturbing headlines." At times of heightened uncertainty, investors have sought the refuge of lower-risk investments. One of these so-called safe-haven investments, gold, has a particularly long history of attracting attention during periods of political and social upheaval. Gold exhibits some traditional diversification properties and can help in the construction of a well-diversified portfolio. However, shifting large weightings to gold, or cash for that matter, comes with its own type of risks. Taking advantage of professional advice offers the best defence against market uncertainty and can ensure a portfolio is well diversified.

Figure 1



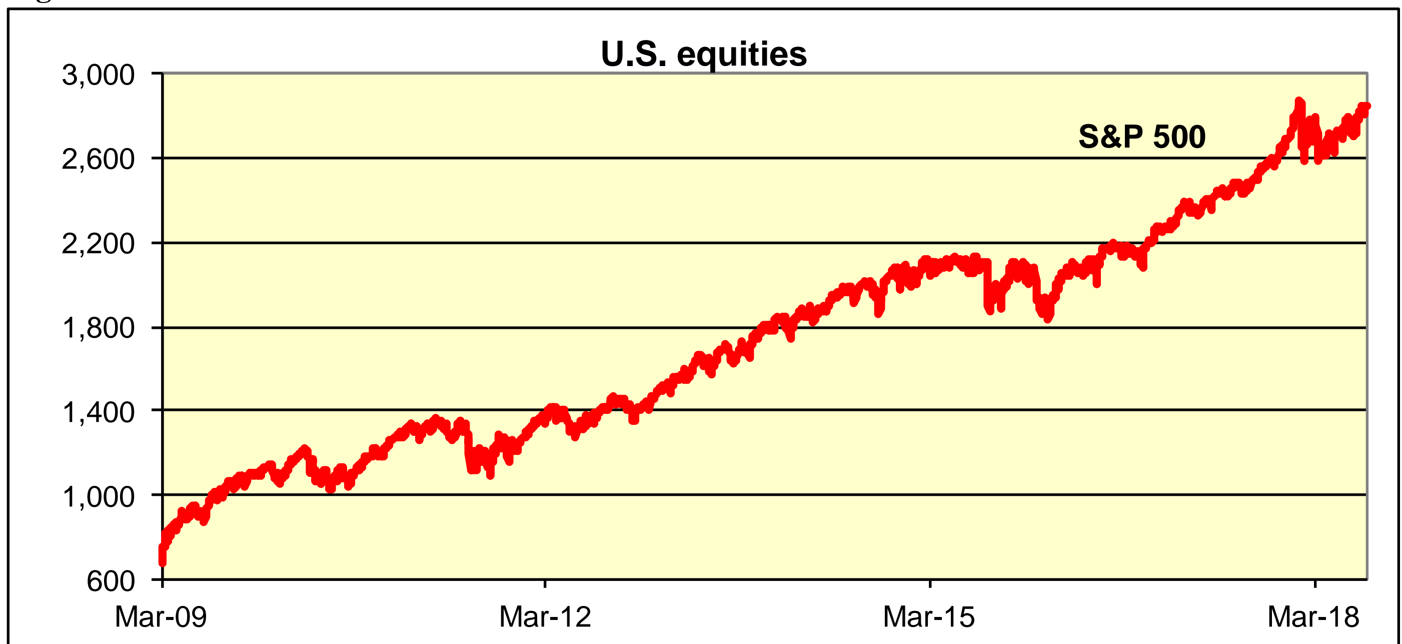
Source: London Bullion Market Association

Gold is unique as it has almost always been associated with wealth as a tangible asset. Gold has been highly sought after and "gold rushes" have punctuated much of history. It appeals to the deeply embedded emotions of fear and greed far more than would a dollar bill, a bond or a stock certificate. Gold often represents a store of wealth, serving as protection from political or social upheaval. One would have predicted that the onset of the financial crisis in 2008-09 would have prompted heavy buying of gold. As can be seen in Figure 1, the pricing pattern of that period reveals an anomaly, at least initially. When the U.S. equity market (represented by the S&P 500 Index) peaked at 1,576.1 on October 9, 2007, gold stood at $736.00 per ounce. Over the next 12 months, world gold prices fell 6.9%, reaching a relative low of $684.90 on October 24, 2008. At that juncture, however, gold bulls switched gears and pushed prices up by 180%. On September 6, 2011, the price of gold hit an all-time high of US$1,921.15 per ounce.

Equity market

As the extent of the sub-prime mortgage problem and all of the other interconnected issues blossomed into the financial crisis, the equity market tumbled. The S&P 500 Index eventually dropped 57.1% to close at a 12.5-year low on March 9, 2009. Since then, the story has been different.

Figure 2



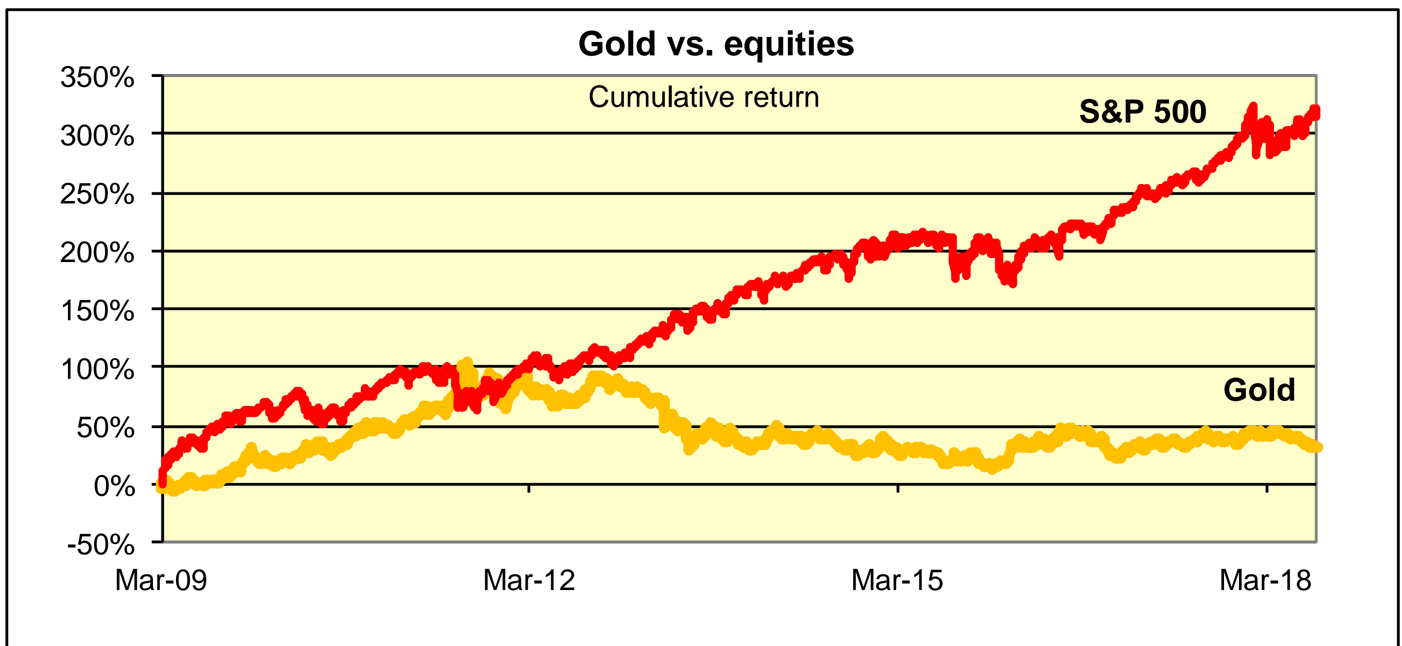
Source: Bloomberg

The fear and volatility that characterized this period did not dissipate quickly, but fear for some investors was viewed as opportunity by others. Various shocks and financial calamities continued even though they appear muted in Figure 2. In fact, while the U.S. market has thus far been able to avoid encountering a bear market (a decline of 20% or greater from a recent high), it has experienced four market corrections.[1] However, the S&P 500 Index rose from its March 2009 low, eventually recovering its losses on March 28,

[1] A market correction is traditionally viewed as a decline of between 10% and 20% from a recent high. These occurred in the second quarter of 2010, the fourth quarter of 2011, the first quarter of 2016 and the first quarter of 2018.

2013 when it closed at 1,569.2, the first new high since October 9, 2007. During the five years that have followed, more uncertainty has accompanied the move higher. After an eight-month break, the record high of 2,872.9 established on January 26, 2018 has now been topped as the S&P 500 Index closed trading at 2914.0 on August 29, 2018. All told, this index has gained a cumulative 330% from its bottom in 2009. As can be seen in Figure 3, the advance in world gold prices has been shorter lived and less robust. Once again, the daily price movement is muted by the time length of the graph. Nevertheless, gold prices have generally tracked horizontally since the second quarter of 2013.

Figure 3



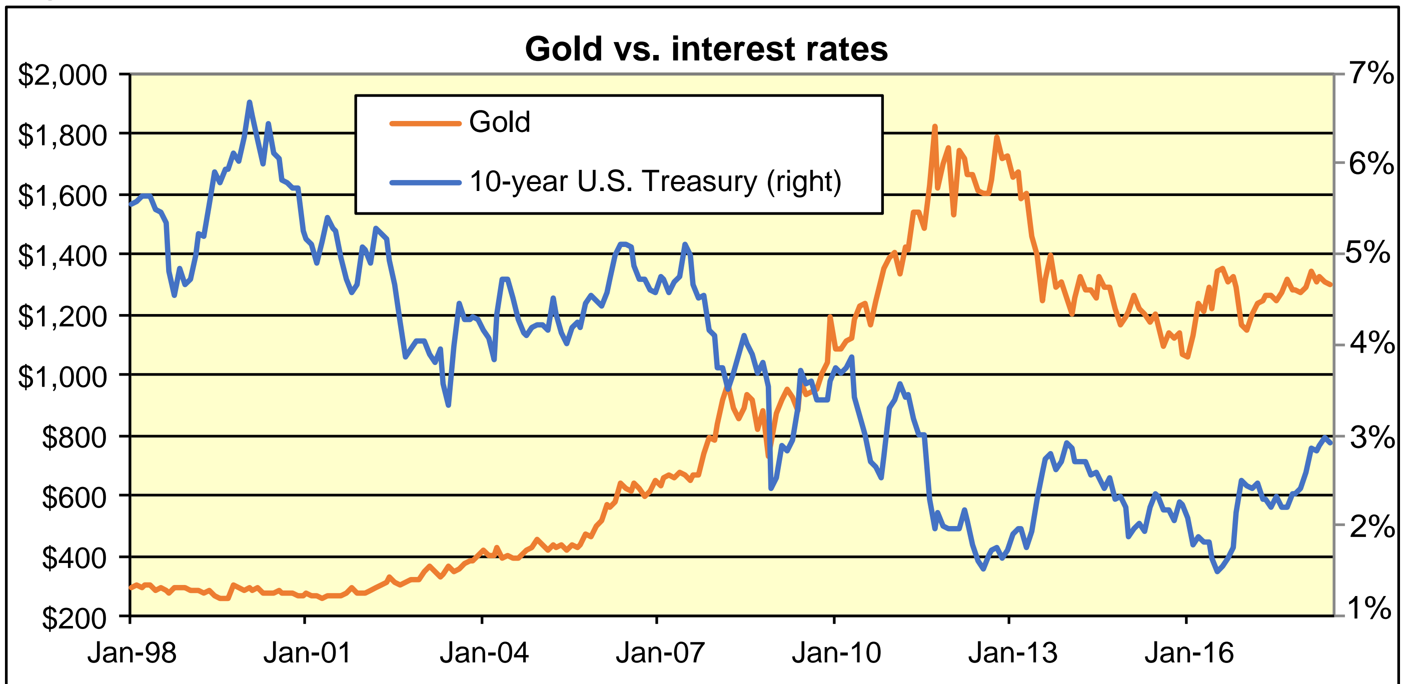
Source: London Bullion Market Association; Bloomberg

Interest rates and inflation

More recently, some of the decline in investor interest in gold has been related to the increase in interest rates. This change makes gold more expensive to hold. Even though some forms of gold investing do not have a direct tie to physical bullion, those that do are in some way eventually responsible for its safe-keeping. Gold has to be locked up and guarded. This is reminiscent of a famous Warren Buffett quote, "Gold gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head." In addition, unlike traditional bonds that provide regular coupon payments or stocks that pay regular dividends, gold offers no stream of income. Even stocks that do not provide regular dividends represent a claim on the issuing company's future cash flows. Gold's only prospect for a return is the willingness of someone else to pay more for it in the future. Clearly, this is a guessing game and timing the gold market is the difference between success and failure. As a result, there is an opportunity cost associated with holding gold that varies over time. During periods where corporate profits are weak and dividends may be suspended or when bonds are issued with zero or even negative yields, the relative costs

of holding gold are diminished. In particular, extremely low interest rates on high-quality government debt can provide little incentive as a competitive "safe-haven" asset. Now that the U.S. Federal Reserve's tightening cycle is well underway, these costs are rising. As can be seen in Figure 4, from historically low yields of less than 1.5% in July 2016, interest rates on the benchmark 10-year U.S. Treasury bond have now doubled to the 3.0% range.

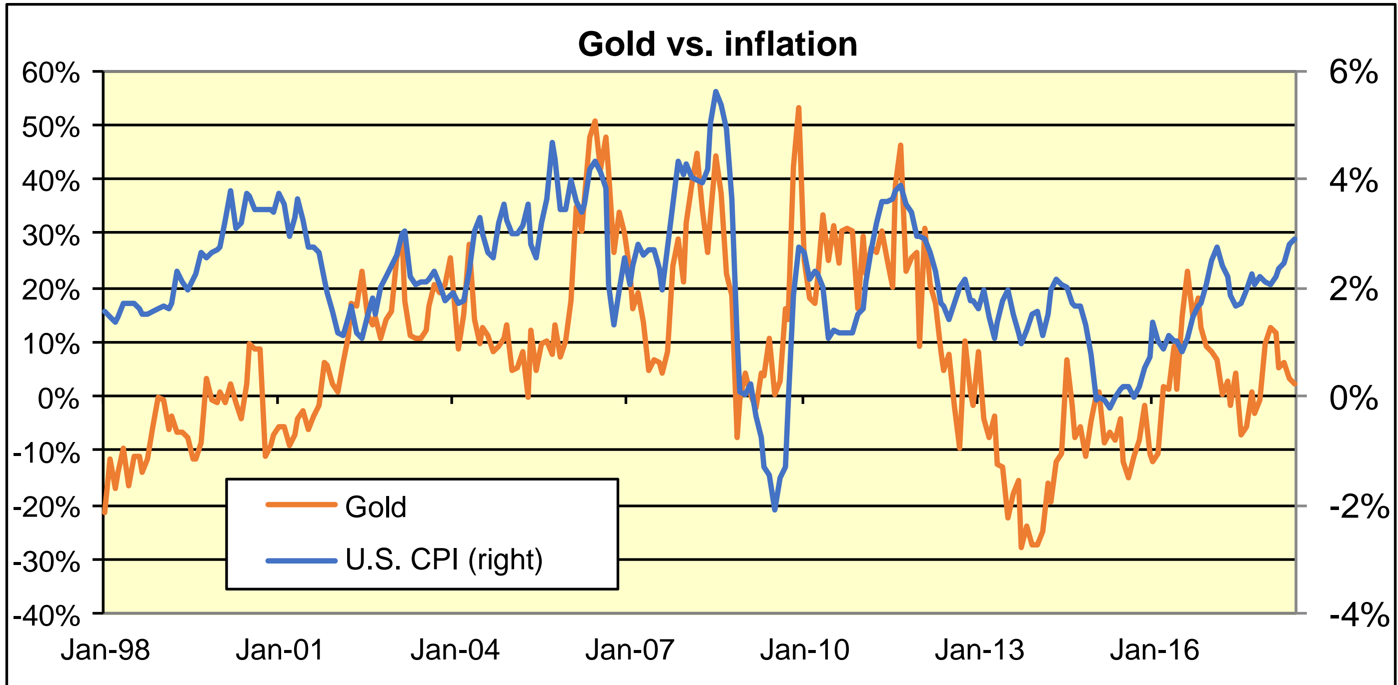
Figure 4



Source: London Bullion Market Association; U.S. Federal Reserve

While gold's relationship with inflation may have been reliable at some points in history, it seems to have broken down more recently. As can be seen in Figure 5, there have been wide swings in the price of gold over the past 20 years, while movements in inflation have been more muted. More importantly, these movements were not synchronized. Over this period, the price of gold has risen as inflation was falling or even turning negative. Conversely, gold prices weakened as inflationary pressures increased. These movements run counter to gold's notional use as an efficient hedge. The sharp appreciation in world gold prices to over $1,900 per ounce in September 2011 attracted plenty of press coverage. However, when adjusted for inflation, the high of $850 on January 21, 1980 translates to $2300 per ounce and remains the all-time high.

Figure 5



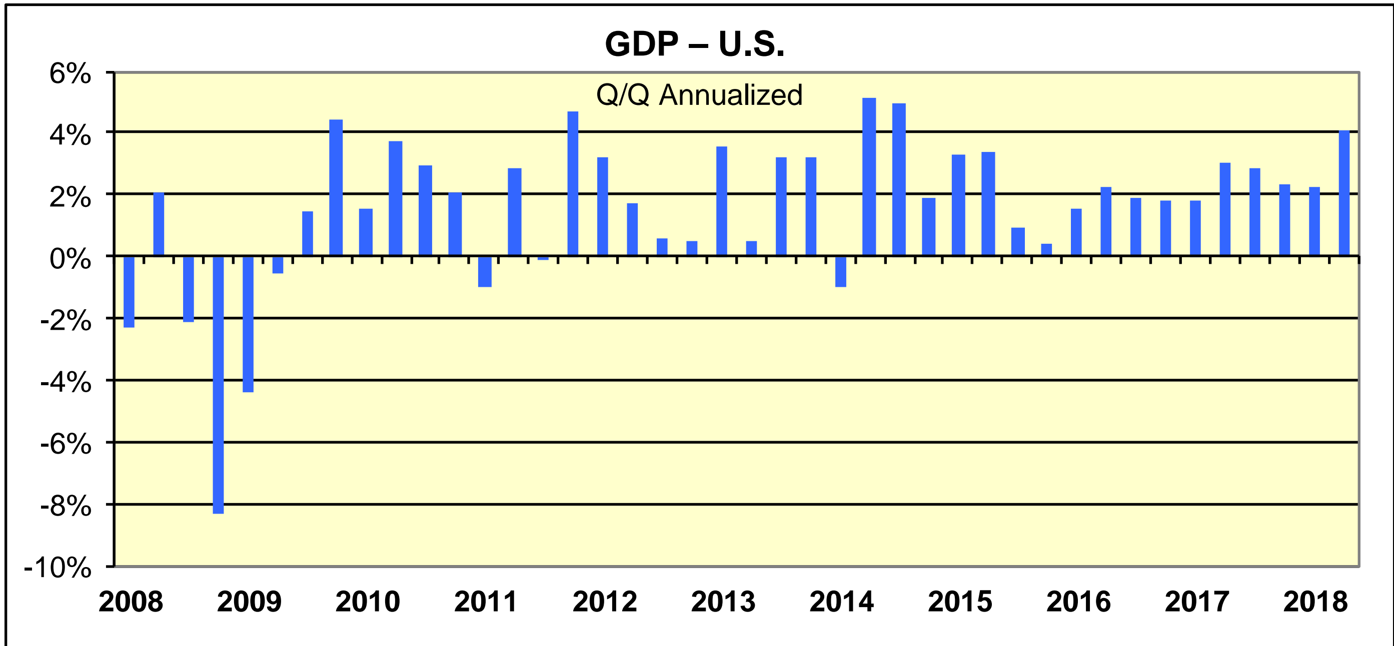
Source: London Bullion Market Association; U.S. Bureau of Labor Statistics

Economic growth

An old Wall Street proverb stating that the stock market "climbs a wall of worry" has rarely been more appropriate than during the current business cycle. The "Great Recession" of 2008-09 has been frequently compared to the Great Depression of 1929-1933, particularly in the United States. Not surprisingly, then market participants look not just at the aging bull run in stocks, but at the current economic recovery and wonder if it too is a little long in the tooth. According to the U.S. National Bureau of Economic Research, the business cycle in the U.S. began in June 2009, as can be seen in Figure 6. As of this writing, this means that the business cycle is now 98 months old, making it the third-longest economic expansion on record.[2] In fact, the current cycle will take sole possession of the second spot if it persists through May 2019. Even though business cycles do not die of old age, every one of them has come to an end.

[2] U.S. National Bureau of Economic Research business cycle dating begins from 1854. The longest recorded expansion began in March 1991 and ended in March 2001.

Figure 6



Source: U.S. Bureau of Economic Analysis

Still, this should not be used as an excuse for panic selling and shifting to gold or cash. Timing the market has been shown to be impossible and defensive posture can be assumed without eliminating exposure to important asset classes. The fact that gold has historically had low correlation with other assets suggests that its inclusion as a small component within a well-diversified portfolio would produce improved risk-adjusted returns.[3] For Canadian investors in particular, the materials sub-sector of the S&P/TSX Composite Index represents 11.4% of the index. Additionally, 30 of the 53 constituents of the materials sub-index are companies that engage in exploration for, or development of, gold properties. As a result, it is likely that most Canadian investors already have at least some exposure to gold. Investors are best served by taking the time to discuss their portfolio composition with their financial advisor to determine if a position in gold should be added, increased or reduced.

[3] Forbes, “Gold’s low correlation to other asset classes” Juan Carlos Artigas, March 2010.

Conclusions

- Gold tends to exhibit low correlations with other traditional assets within investors' portfolios. However, unlike those other assets, it does not provide a stream of income and costs money to hold.
- Gold is often viewed as a store of wealth, representing protection from inflation. Despite this reputation, the relationship between the price of gold and inflation is poorly correlated.
- Moving out of traditional assets and into gold during periods of economic or political upheaval carries an emotional appeal. However, guessing when and who will pay more for that gold in the future is an exercise in timing the market. Taking advantage of professional advice helps to remove the emotion. Working with a financial advisor can create a defensive portfolio.

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