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The Outperformance Of Gold - A Possible Explanation

By August 21, the year to date price of gold had gone up a hefty 27%. While many other asset classes experienced difficult times, the gold price not only showed significant resistance against global concerns on political issues, trade disputes, an oil price crash, Brexit, the Covid-19 pandemic, social unrest in the U.S. and other countries and more, but was able to show a substantial positive outperformance over many other asset classes.

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Gold usually moves upwards if investors fear any form of disruption. To mention only fear regarding the recent performance increase, however, would not do the price development justice, as various reasons lead to this price increase. In August 2018, one ounce of gold would cost slightly over $1,200 USD. Today one ounce of gold costs almost $2,000 USD. Over the same period, interest rates for U.S. government bonds have come down to almost 0%, which means the opportunity cost of holding gold versus U.S. government bonds almost disappeared. Furthermore, the interest differential between the USD currency region and the EUR currency region almost disappeared and resulted in a weakening of the U.S. Dollar in relation to the Euro. A weaker U.S. Dollar, lower interest rates, speculation, a pandemic, political unrest in the U.S. and other countries, trade wars, massive global financial stimulus, fear of inflation, if not hyperinflation and more- all of these are the main drivers for the current outperformance of gold.

ESSENTIAL IN ANY PORTFOLIO

Inflation is probably feared most by investors. Let me elaborate in a very simplified way, how inflation may arise. Inflation may arise in a few ways and is generally defined by a widespread and continuous increase in prices for products and services, resulting in a fall in the purchasing value, i.e. purchasing power of money. Possible ways inflation begins with are expanding money supply and an increasing speed of money circulation, demand-pull inflation, and cost-push inflation. Investors may come across various other terms and definitions, but in essence, this is what inflation is all about, and of course, one may experience any combination of the ways just mentioned. For the last decades, the monetary bases in all (but not only) advanced economies increased massively. The great financial crisis and now the Covid-19 pandemic, were only the most recent and extreme examples, but even before and in between these crises, monetary bases in advanced economies grew steadily.

Nevertheless, there was no spike in what I would call "general "inflation. We saw various forms of asset price inflation, i.e. equities of some listed companies shooting up, prices for real estate going up, pieces of art, collector cars, rare watches, etc. getting more and more expensive. Nevertheless, general inflation with food prices, the cost for cars, TV sets and clothing going up, was not to be seen. How is that possible, one may ask? The reason for it may be found in the slow speed of money circulation. Even if the money was there, it was not used, i.e. spent rapidly enough to create inflationary pressure. There was no demand-pull inflation either. (Demand-pull inflation arises when demand for goods and services exceeds the corresponding supply over a long period), nor was there any cost-push inflation. (Cost-push inflation arises with increasing production costs, primarily increases in personnel costs/incidental wage costs (wage-push infla-tion), energy cost and/or increasing prices of raw materials, or interest rate increases).

> "NEVERTHELESS, GENERAL INFLATION WITH FOOD PRICES, THE COST FOR CARS, TV SETS AND CLOTHING GOING UP, WAS NOT TO BE SEEN. HOW IS THAT POSSIBLE? ONE MAY ASK?"

However, why on earth do we read about all those potentially terrible effects of inflation if over the last decades inflation was by no means excessive? I guess it is because of the fear of a sudden increase in the speed of money circulation. Increasing the speed of money circulation indeed could trigger higher inflation. The question probably is, how likely this is going to happen, and in this respect, it probably makes sense to think in scenarios. If an investor believes in a scenario with a deep recession and increasing unemployment rates, the speed of money circulation will most probably not go up, and private household spending will go down, and as a result higher inflation seems unlikely. However, if an investor believes in a substantial economic recovery, full employment, prosperity for everyone, a de-saving effect may lead to an increase in the speed of money circulation, private household spending will increase, and full employment may lead to a wage-push and inflation, therefore, may go up. I believe mass psychology also plays or will play an essential role in an inflationary scenario. As long as investors, consumers and citizens believe in the value, i.e. purchasing power of their currency, the risk of inflation rests probably tamed. Furthermore, I believe that in a scenario of a sudden spike in inflation; central banks would in a coordinated manner, fight inflation as much as possible.

Today, many investors tend to look at gold as an investment to gain money short-term and are buying into gold and selling out of gold continuously. This is speculation. Investors should always ask themselves why they want to invest in gold. At Incrementum AG, we usually recommend to our private clients to buy gold and keep it in physical form, and in a small denominations in a secure place close to them. I never recommend the selling of it. I instead recommend a 'buy and hold' strategy. I also never recommend adding physical gold in an investor's securities portfolio but rather, as mentioned before, to keep it in physical form, and small denominations in a secure place close to them. Keeping gold in a portfolio may not give investors access to it in a sudden and possible situation of urgent need, due to some sort of disruption and/or sudden spike of inflation.

GO LONG, AND STAY LONG

When investing in physical gold or precious metals, it is essential to understand that the optimal part of physical gold or physical precious metals in relation to an investor's total wealth, may vary. Investors have different and individual needs, concerns and preferences, and thus a potential allocation in precious metals, has to match any investor's individual needs, concerns and preferences. However, we from Incrementum AG regard it as truly valuable to always keep at least a small part of one's wealth in physical gold or precious metals. We see it to some extent, as an insurance policy. Insurance policyholders keep insurance to protect themselves at least financially from the effects of an adverse event. Usually, insurance policyholders do not hope for such an adverse (negative) event to occur, just because they own insurance, i.e. coverage. The same thing is true for us regarding gold. We keep gold, we see some very particular and robust long-term positive features of holding gold, but just because we hold gold, we are not hoping for war, hyperinflation and the like. Since I follow a buy and hold strategy in gold, I do not give the short-term price development too much importance and I regularly recommend to our private clients, not to get too carried away by short-term price movements either. **EG**

For further information, please visit:
www.incrementum.li

Incrementum AG has acted as the manager of the Incrementum Physical Gold Fund for well over ten years www.ifm.li, which again we have published for well over ten years. Our knowledge base in this field of expertise is long-lasting and solid, yet we are humble enough to admit that we cannot foresee the future and thus cannot predict the future price of gold.