Portfolio Characteristics: Gold as Equity Diversifier in Recessions

"The situation is worse than it was in 2007. Our macroeconomic ammunition to fight downturns is essentially all used up. It will become obvious in the next recession that many of these debts will never be serviced or repaid, and this will be uncomfortable for a lot of people who think they own assets that are worth something."

William White

Key Takeaways

- **Our historical analysis shows that both gold and US Treasury bonds have been able to absorb a significant share of stock drawdowns in a portfolio context. Retrospectively, both asset classes are suitable as effective stock diversifiers.**
- **Whether (in particular, US Treasury) bonds can take on that role in the future is in question. Global debt, the zombification of the economy, and the still low yield level cast more than just a shadow of doubt on bonds in this respect. In an environment of this sort, gold presents significantly better future opportunities than bonds.**
- **A detailed analysis of gold in recessions shows that the precious metal has achieved a clearly positive average performance across all recession phases scrutinized, thus effectively offsetting stock price losses.**

Recession Ahead!

“By failing to prepare, you are preparing to fail.”

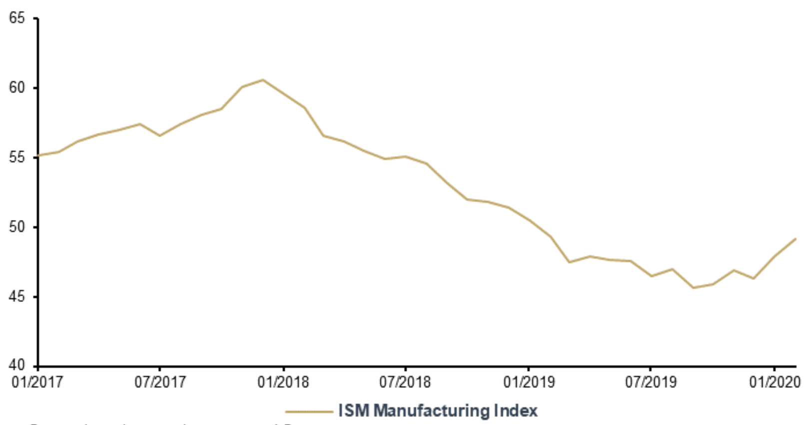
Benjamin Franklin

In the *In Gold We Trust* report 2019, we looked in depth at gold's performance in a recession and explained why gold is an excellent equity diversifier.[1] An important reason for gold's good performance in recessions is that gold discounts the fiscal and monetary policy measures typically implemented to combat recessions. In view of the sometimes dramatic developments surrounding the global outbreak of the coronavirus, the probability of a recession has risen noticeably. Yet one should not forget that the economic outlook had already deteriorated noticeably before the outbreak of the coronavirus.

An impression of what the global economy may be facing in the coming months is provided by the figures for China. The drastic measures to contain the coronavirus have hit the economy hard. Air traffic and property sales each fell by around 80%, while coal consumption fell by 30%.[2] Industrial production fell by 13.5% in January and February, retail trade by 20.5% and fixed capital formation by 24.5% year-on-year.[3] In February 2020, the Chinese Purchasing Managers’ Index (PMI) rattled to a value of only 35.7, compared with 51.8 in January.[4] In this index, the value of 50 is of crucial importance. If the value is above 50, a positive development in industry is expected, while a value below 50 signals a development to the worse.

Let’s have a look at Europe. Optimism in the euro zone has been already on the wane since early 2018, as the Euro Area Manufacturing Purchasing Managers' Index (PMI) shows.

ISM Manufacturing Index, Euro area, 01/2017-02/2020



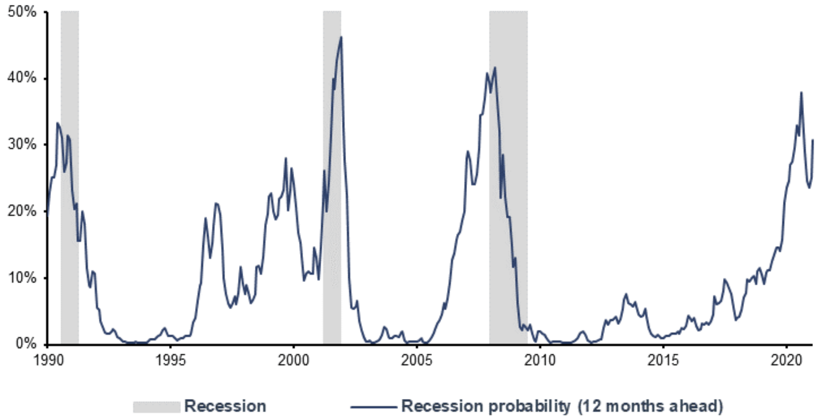
Source: Investing.com, Incrementum AG

[1] This article is an adapted and significantly shortened version of the chapter "Portfolio Characteristics: Gold as an Equity Diversifier in Recessions" from the *In Gold We Trust* report 2019, which you can download free of charge at https://ingoldwetrust.report/igwt/?lang=en.
[2] https://www.capitaleconomics.com/the-economic-effects-of-the-coronavirus
[3] https://www.faz.net/aktuell/wirtschaft/coronavirus-pandemie-laesst-chinas-wirtschaft-einbrechen-16680940.html
[4] https://de.investing.com/economic-calendar/chinese-manufacturing-pmi-594

Since the interim high of 60.6 in December 2017, the PMI has fallen significantly, breaking through the magic threshold of 50 downwards and, after a slight recovery, is at 49.2 in February 2020. However, the February data do not yet take into account the measures adopted in the past few days to combat the coronavirus. As a result, the PMI is expected to fall significantly in March.

And in the US, too, the signs are clearly pointing to a cooling off, even before the coronavirus has hit the USA. The probability of a recession as calculated by the Federal Reserve, which is based on the term spread between 10-year and 3-month Treasury rates, has been on the rise since the low point at the turn of 2014/2015.[5]

Recession probability USA (12 months ahead), USA, 01/1990-02/2020



Source: Federal Reserve NY, Incrementum AG

This interest rate spread has been a reliable US recession indicator in the past. On average, it took 10 months for the recession to actually start after this signal appeared, but the fluctuation range over the past fifty years is between 5 and 16 months. The Federal Reserve assumes a lead time of 12 months for its forecast indicator.

And the first published figures since the coronavirus outbreak in the USA are simply catastrophic. The "Empire State Manufacturing Index of General Business Conditions" published by the New York Federal Reserve collapsed from 12.9 in February to -21.5 in March. This collapse makes the 2008 slump look like a Sunday trip.[6]

The recession that we predicted last year is now just around the corner, will hit large parts of the world with enormous force. The repeated sharp corrections on the stock markets are a harbinger of what will soon happen in the real economy. We therefore want to summarize the main findings of our analysis "Gold as an equity diversifier in recessions", which we carried out in last year's *In Gold We Trust* report.

[5] https://www.newyorkfed.org/medialibrary/media/research/capital_markets/Prob_Rec.pdf
[6] https://www.newyorkfed.org/medialibrary/media/survey/empire/empire2020/esms_2020_3_survey.pdf?la=en

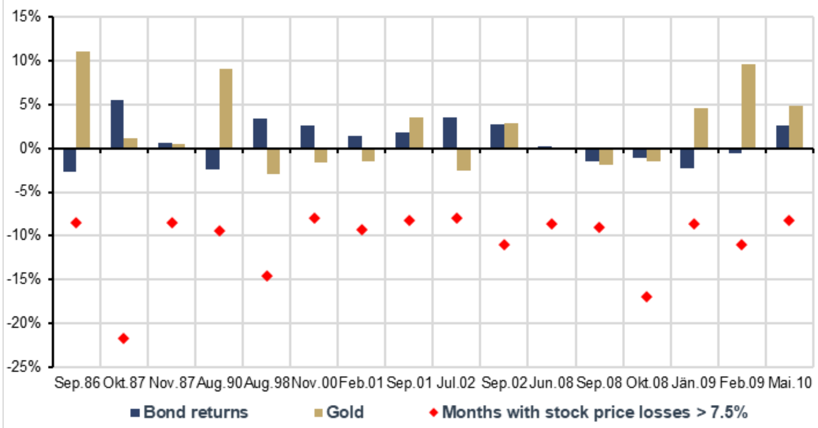
Key Messages

The key messages of last year's analysis are:

1) Gold and bonds are the classic hedge against falling equity prices

First of all, it should be noted that so far gold and 10-year US government bonds have been the perfect hedge against equity bear markets, as the following chart shows:

Performance of bonds & gold at stock market losses > 7,5%, in %, 1982-2019



Source: Federal Reserve St. Louis, Investing.com, Incrementum AG

The chart above prompts a number of conclusions:

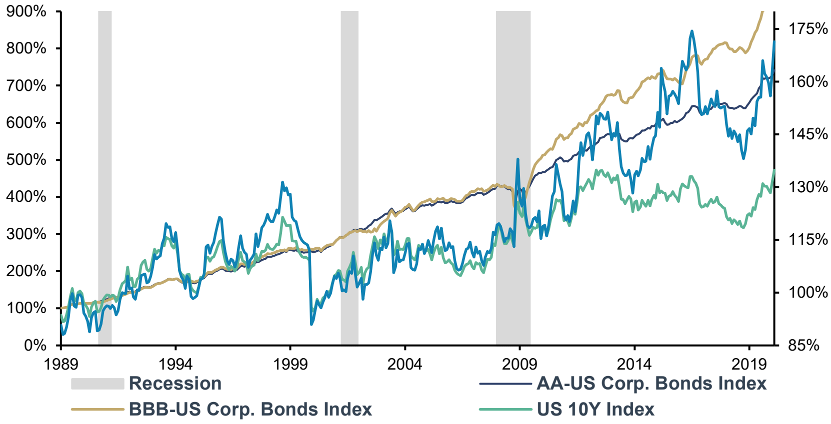
- **Throughout the entire observation period, gold or bond performance during months with clearly negative stock performance was never worse than stock performance.**
- **Gold and US Treasury bonds proved to be valuable portfolio complements, in particular during bear markets in stocks.** As we have already pointed out, there were months where both gold and bonds performed negatively. However, that performance was often offset by other asset classes: When bonds went down (e.g. September 1986, August 1990), gold was clearly up – and vice versa (e.g. August 1998, July 2002).
- **There have been only two months since 1984 (September and October 2008) when both bonds and gold yielded a negative performance.** This means that in 87.5% of observed cases, the gold price and/or bond price gains would have absorbed stock price losses.

Historical analysis shows that gold and 10Y US Treasury bonds have done a good job as stock diversifiers in the past. In particular, both assets have mostly posted gains during bear stock markets and complement each other very well.

2) Gold will in future hedge equity losses better than bonds

As important as historical analysis is for an understanding of the markets, it is only relevant to investors to the extent that fundamental conditions have not changed, or special factors have not occurred. **Yet, in today's market environment, bonds seem to be of limited use as a classic hedge against falling stock prices.** Due to still-low interest rates, bond prices continue to commend valuations close to their all-time-highs. This is true for corporate bonds as well.

US corporate bond indices (ls), and Treasury bond indices (rs), 01/1989-02/2020



Source: Federal Reserve St. Louis, Investing.com, Incrementum AG

We think that in such a scenario, bonds as a hedge against falling stock prices are to be handled with caution. The lower the general level of interest rates, the less suitable bonds are as a hedge.

We have already pointed out that the correlation between 10Y US Treasury bonds and the S&P 500 changed its sign around the year 2000. While they used to be positively correlated, they have been negatively correlated since 2000. Another change in correlation (including a change of sign) cannot be ruled out for the future.[7] This applies not least because of the high global indebtedness and zombification of companies. The structural risks can cause the default risk of bonds to be subject to revaluation in the event of future economic downturns and equity bear markets.

I have confidence in one thing: The Fed will blow it.
Robert Rodriguez

On the other hand, such an environment opens up perspectives for gold, which historically speaking has been suitable as a diversifier against falling stock prices and, in the case of physical investment, has no counterparty risk. As we have discussed in previous years, it is not so much the absolute level but rather the *tendency* of real interest rates (rising or falling) that determines the performance of gold. Our analysis also revealed that negative and slightly positive real interest rates (up to +1.0%) are a good environment for gold.[8] We regard highly positive real interest rates as unrealistic in the long run due to the aforementioned factors of global debt and zombification of companies.

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[7] *See* "Possible Crisis Triggers and Catalysts", *In Gold We Trust* report 2018
[8] *See* "The Extraordinary Portfolio Characteristics of Gold", *In Gold We Trust* report 2014; "Portfolio Characteristics of Gold", *In Gold We Trust* report 2017

Against this background, we think that gold harbors better opportunities than bonds with respect to its future suitability as a stock diversifier. The following simple relationship holds true for bear stock markets: the looser the monetary policy, the better for gold.

3) Gold beats equities in 3 out of 4 recession phases

In this section, we want to focus specifically on the development of gold and stock prices throughout recessions.[9] The analysis of gold and stock markets is an integral part of every *In Gold We Trust* report.[10] Regular readers know that gold as an event hedge and safe haven should experience an upswing during recessions. If one were to use gold for tactical speculation, the exact timing would present difficult decisions. **At what point should one buy or sell? We want to cast a light on this question by analyzing the various phases of past recessions.**

In the following, we will be analyzing all recessions in the US since 1970. To this end, the individual recessions will be subdivided into four phases:

- **1st phase: the run-up** (one quarter before the recession hits)
- **2nd phase: unofficial recession** (the period from the outbreak of the recession to the official release of the GDP growth figures by the statistics office –assumption: one quarter)
- **3rd phase:** official recession
- **4th phase:** last quarter of the recession

The following table shows the performance of gold in USD and EUR and of the S&P 500 in each phase of the recession.

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[9] Based on the data on recessions in the USA, as provided by the National Bureau of Economic Research (NBER).
[10] *See* "Gold in a Portfolio Context", *In Gold We Trust* report 2015; "Gold as Portfolio Insurance", *In Gold We Trust* report 2016; "Portfolio Characteristics of Gold", *In Gold We Trust* report 2017

Overview: performance of the S&P 500 and gold, in USD and EUR, in %, 1970-2018

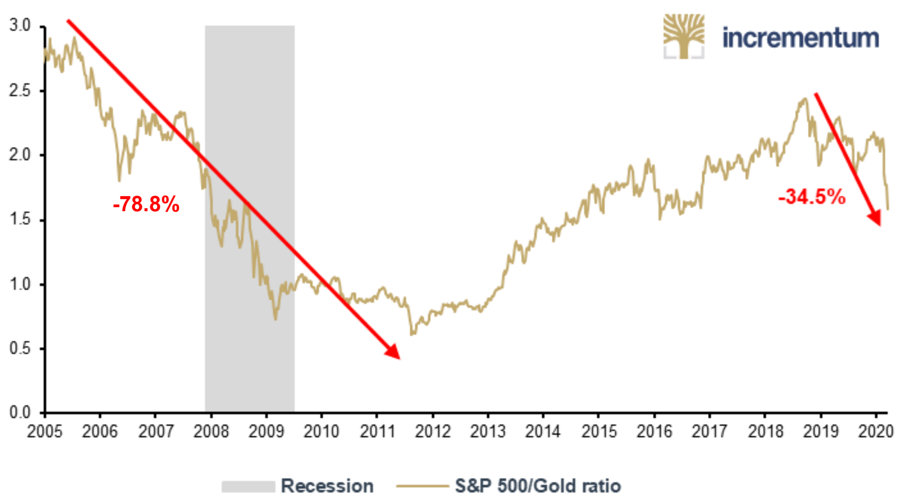
		S&P 500				Gold in USD				Gold in EUR			
	Recession duration	Phase 1	Phase 2	Phase 3	Phase 4	Phase 1	Phase 2	Phase 3	Phase 4	Phase 1	Phase 2	Phase 3	Phase 4
1st Recession	Q1/1970 - Q4/1970	-1.8%	-4.6%	-7.0%	7.0%	-8.9%	-6.6%	0.0%	5.9%	N/A	4.6%	11.1%	3.0%
2nd Recession	Q1/1974 - Q1/1975	-8.0%	0.3%	-15.0%	16.6%	-10.9%	58.5%	89.7%	-1.1%	7.2%	51.8%	51.0%	-6.2%
3rd Recession	Q2/1980 - Q3/1980	7.1%	-2.1%	7.7%	10.0%	70.1%	-22.8%	-5.9%	21.8%	27.5%	0.5%	20.2%	-1.6%
4th Recession	Q4/1981 - Q4/1982	-7.4%	2.9%	12.8%	15.9%	-14.6%	0.8%	1.2%	14.2%	2.6%	-4.8%	21.0%	10.4%
5th Recession	Q4/1990 - Q1/1991	-10.7%	-0.1%	13.8%	13.9%	7.1%	-3.3%	-7.9%	-4.7%	4.6%	-9.3%	-12.2%	-3.6%
6th Recession	Q2/2001 - Q4/2001	-5.7%	1.3%	-8.1%	0.5%	-1.5%	3.8%	5.4%	1.3%	-0.8%	8.3%	5.5%	-4.4%
7th Recession	Q1/2008 - Q2/2009	0.5%	-10.2%	-50.4%	-18.0%	21.6%	14.3%	16.3%	24.0%	2.2%	12.2%	31.4%	19.8%
	Average:	-3.9%	-1.9%	-10.5%	6%	6%	4%	20%	8%	7%	8%	23%	2%

Source: Federal Reserve St. Louis, investing.com, World Gold Council, Incrementum AG

Remarkably, gold posted significant average gains across the entire recessionary cycle both in USD and in EUR in every phase, whereas stocks (as measured by the S&P 500) recorded significant profits only in the final stage of recessions. **Thus, gold managed very well to compensate for the stock losses in phases 1, 2, and 3.** Also, the higher the losses of the S&P 500, the better gold has performed.

An impressive illustration of the high potential of gold in a recession compared to the stock markets is provided by the next chart, which traces the Gold/S&P 500 ratio since 01/2005.

S&P 500/Gold ratio, 01/2005-03/2020



Source: Reuters Eikon, Incrementum AG

With a 34.5% decline in the S&P 500/Gold ratio, the current correction has so far not even reached half the loss in value from 2005 to 2011, when gold gained almost 80% against the S&P 500.

In summary, gold has been excellent at offsetting stock losses during recessions. **Thus, we expect gold to record substantial gains and act as a hedge**

against bear stock markets in the future as well, also in the looming sharp recession – we are about to enter Phase 3, the official recession – massive monetary and fiscal packages have already been put together to combat it. Admittedly, gold has lost ground against cash in recent days. Such absolute setbacks cannot be prevented in view of the current historically unique situation. **Relative to the stock market, however, gold has held up extremely well in recent days, with a plus of almost 11%; since mid-February the increase has been almost 25%.**

About us

Ronald-Peter Stoeferle, CMT

Ronnie is managing partner of Incrementum AG and responsible for Research and Portfolio Management.

He studied business administration and finance in the USA and at the Vienna University of Economics and Business Administration, and also gained work experience at the trading desk of a bank during his studies. Upon graduation he joined the research department of *Erste Group*, where in 2007 he published his first *In Gold We Trust* report. Over the years, the *In Gold We Trust* report has become one of the benchmark publications on gold, money, and inflation.

Since 2013 he has held the position as reader at *scholarium* in Vienna, and he also speaks at *Wiener Börse Akademie* (i.e. the Vienna Stock Exchange Academy). In 2014, he co-authored the international bestseller "*Austrian School for Investors*", and in 2019 "*The Zero Interest Trap*". Moreover, he is an advisor *for Tudor Gold Corp*. (TUD), a significant explorer in British Columbia's Golden Triangle, and a member of the advisory board of *Affinity Metals* (AFF).

Mark J. Valek, CAIA

Mark is a partner of Incrementum AG and responsible for Portfolio Management and Research.

While working full-time, Mark studied business administration at the Vienna University of Business Administration and has continuously worked in financial markets and asset management since 1999. Prior to the establishment of Incrementum AG, he was with Raiffeisen Capital Management for ten years, most recently as fund manager in the area of inflation protection and alternative investments. He gained entrepreneurial experience as co-founder of *philoro Edelmetalle GmbH*.

Since 2013 he has held the position as reader at *scholarium* in Vienna, and he also speaks at *Wiener Börse Akademie* (i.e. the Vienna Stock Exchange Academy). In 2014, he co-authored the book "*Austrian School for Investors*".

Incrementum AG

Incrementum AG is an independent investment and asset management company based in Liechtenstein. Independence and self-reliance are the cornerstones of our philosophy, which is why the four managing partners own 100% of the company. Prior to setting up Incrementum, we all worked in the investment and finance industry for years in places like Frankfurt, Madrid, Toronto, Geneva, Zurich, and Vienna.

We are very concerned about the economic developments in recent years, especially with respect to the global rise in debt and extreme monetary measures taken by central banks. We are reluctant to believe that the basis of today's economy, i.e. the uncovered credit money system, is sustainable. This means that particularly when it comes to investments, acting parties should look beyond the horizon of the current monetary system. Our clients appreciate the unbiased illustration and communication of our publications. **Our goal is to offer solid and innovative investment solutions that do justice to the opportunities and risks of today's prevalent complex and fragile environment.**

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