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Equity-Market Outlook

Can gold immunize an equities portfolio against inflation?

Until the mid-1970s most investors thought equities to be a hedge against inflation. Experience proved otherwise as the worldwide inflation set off by the dismantling of the Bretton Woods monetary system and its dollar-gold fix was followed by "stagflation": higher interest rates, recession and bear markets throughout the world. Even after the decline of the dollar was halted by the personal intervention of Jimmy Carter in 1978, these economic symptoms continued into the Reagan administration.[1] By the time the U.S. equity market finally turned around in 1982, it had produced poor (and cyclically variable) returns for nearly two decades. Now that a long (and mostly prosperous) period of strength in the dollar has come to an end, investors need to get busy looking for escape routes from the probable consequences of the dollar's decline.[2]

Escape routes when inflation surges. *Wainwright* has shown that, over a multi-year time frame, returns from stocks are hurt by inflation as severely as returns from bonds.[3] Equity investors are therefore just as much in need of a refuge when a surge in inflation occurs.

Fixed-income investors who turn to TIPs can hope for decent long-term returns even in the worst inflationary circumstances.[4] But that is not an option for investors who have to stay in equities. To some extent they can protect their portfolios by careful sector selection. Some segments of the equity market have produced favorable returns during periods of inflation. In descending order of performance relative to the S&P 500, they include: gold & precious metals mining, defense electronics, hospital management, oil & gas drilling & equipment, iron & steel, domestic integrated oil, commercial & consumer services, and diversified manufacturing.[5] Of these, gold mining stocks produce returns that are most responsive to inflationary circumstances.

In this report we estimate:

- **the impact of a surge in inflation on the long-term performance of stocks, gold and gold-mining stocks; and**
- **how much gold content it would take to immunize an equity portfolio against inflation.**

The main objection to most of these options is that they protect only the portion of a portfolio that is invested in them. The rest of the portfolio continues to suffer. This is certainly true of TIPs in a bond portfolio. We showed that using gold in some form instead is far more effective than using TIPs, because inflation brings capital gains on the gold component which are sufficient to offset losses due to inflation in the rest of the portfolio. Indeed, it is possible to calculate what fraction of a fixed-income portfolio, when invested in some gold derivative, is sufficient to immunize the entire portfolio against inflation. Based on the historical behavior of gold bullion prices, our estimate was in the neighborhood of 18 percent.[6]

But gold is also effective in a stock portfolio. Figure One on the page following illustrates how the degree to which the CPI inflation rate accelerates or decelerates over five-year periods influences the price appreciation of gold, gold stocks and stocks in general. The data are divided into three categories according to the size of the CPI "inflation surprise". For example, if CPI inflation accelerated from 1.0 percent to 4.9% over a particular five-year time frame that would be an "inflation surprise" of 3.9% pts. The resulting performance data would be included in the bars in the left-hand portion of the graph.

As shown, gold stocks do best when the stock market as a whole is doing worst, and vice versa. Figure One also suggests that they are somewhat less inflation-sensitive than gold bullion itself.

1. As anticipated in "The falling dollar," *Economic and Investment Observations*, H. C. Wainwright & Co., Economics Inc., January 6, 1978. For a historical survey of dollar-cheapening policies and their consequences, see "The dollar: free market or political football?" *The Capitalist Perspective*, December 12, 2003.
2. "Outlook bleak for pension-fund returns," *Strategic Asset Selector*, Wainwright, December 11, 2003. For data on U.S. stock- and bond-market performance during overlapping five-year periods since 1950, see *ibid.*, Table 1.
3. "Inflation is worse for stocks than bonds," *Strategic Asset Selector*, Wainwright, January 26, 2004.
4. "Forecasting the performance of index-linked bonds," *Interest-Rate Outlook*, Wainwright, July 30, 2003.
5. See "How to tilt a portfolio in the event of an uptick in inflation," *Industry Selector*, Wainwright, January 21, 2003, Table 1.
6. "How much gold it takes to immunize a bond portfolio against inflation," *Interest-Rate Outlook*, Wainwright, December 24, 2003.

Using gold stocks to reduce the damage from inflation. Increasing the gold-stock content of a stock portfolio will reduce its sensitivity to inflation. Figure One suggests, in fact, that gold stocks are boosted by a surge in inflation to about the same extent that stocks in general are damaged. This suggests that a portfolio invested roughly equally in gold stocks and in the S&P 500 would be immune to inflation. Figure Two provides a more precise calculation based on least-squares analysis. It illustrates how the inflation sensitivity of overall return varies with changes in the gold-stock content of the portfolio. As shown, a weight of about 47 percent would be sufficient to create total immunity. (A similar calculation indicates that placing 40 percent of an S&P 500 portfolio into gold bullion would do the same job.)

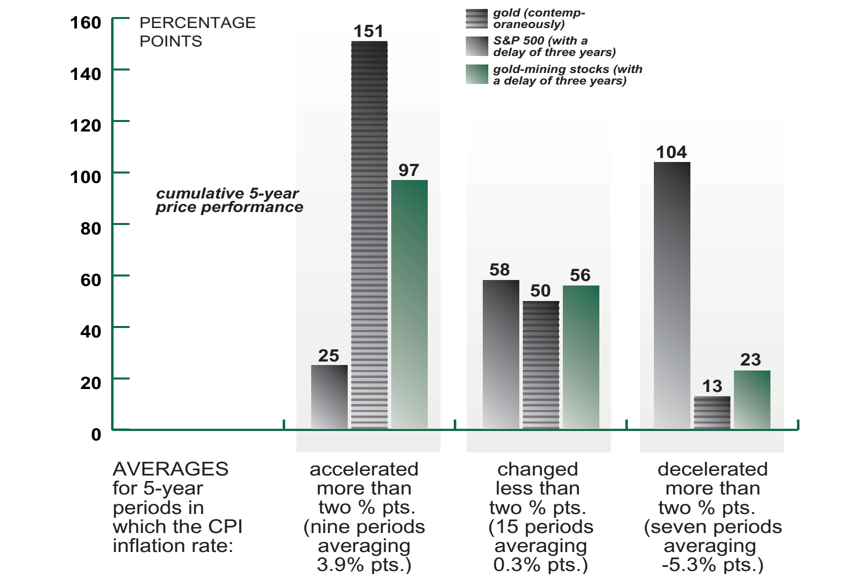
This estimate shows that equity investors would have to make much larger changes to their portfolios than bond investors to get the same degree of protection from inflation.

But equity investors do enjoy a slight advantage over their fixed-income counterparts. Bond investors who use gold to immunize their portfolios have to take evasive action much more quickly than do equity investors who use gold stocks. In fact, when the price of gold escalates and inflation begins to accelerate, bond investors would have to add gold to their portfolios almost immediately or they will be too late to get the full immunizing benefit. But the impact of inflation on equity prices is much slower to show up. As Figure One suggests, markets give equity investors two or three years grace to increase the gold content of their portfolios after the first signs of increasing inflation appear.

Figure One

Five-year Performance of Stocks, Gold and Gold Stocks

Implications of accelerations and decelerations in CPI inflation, 1968 - to date

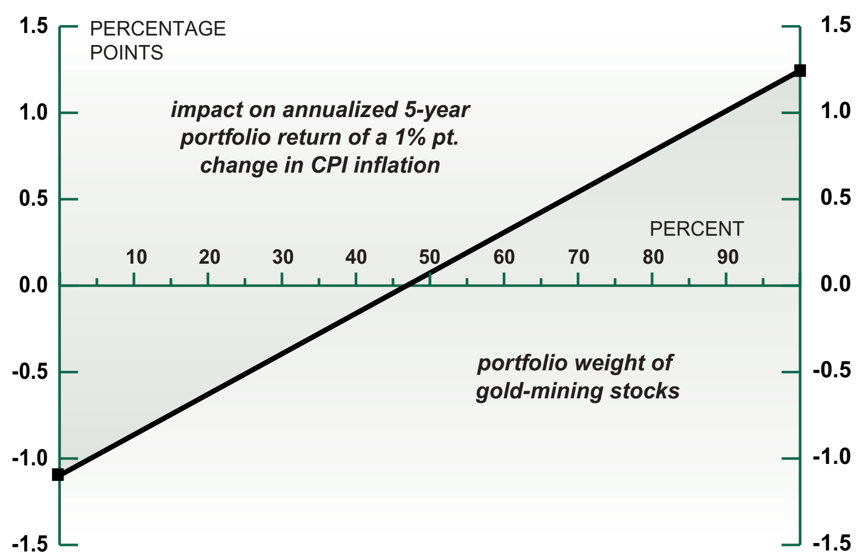


Data: Calendar-year averages of the monthly consumer price index for all urban consumers (Bureau of Labor statistics), month-end prices for gold bullion (*Metals Week/Wall Street Journal*) and last Wednesday prices for the S&P 500 and the S&P index for gold and precious metals mining (Standard & Poors).

Figure Two

Sensitivity of S&P 500/Gold-stocks Mixes to "Inflation Surprises"

1968 to date



Data: As for Figure One.

Investment conclusion. Stock portfolios are adversely affected by inflation, and the damage affects most sectors of the equity market. One clear exception is gold stocks. Equity investors who tilt their portfolios toward gold stocks will reduce the damage proportionately.

The bad news is that it takes a very substantial tilt to do the job. We estimate that, in order to achieve complete immunity from a surge in inflation, the content of a portfolio devoted to gold stocks needs to be raised to about 47 percent.

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