There’s diversification in them thar hills

By the Real Return team at Newton, part of BNY Mellon Investment Management

Although some professional investors believe gold is an outdated asset and does not keep up with today’s complex investment landscape, history shows that gold can serve as a portfolio diversifier and mitigate risks associated with traditional assets like stocks and bonds due to its lack of correlation.

Investors have generally considered some of the following characteristics of gold when considering it as an investment:

- It is not a promise to pay, and therefore not part of the credit system
- It has historically been viewed as an insurance policy in times of credit stress
- It cannot be printed at will
- The supply of gold is fairly flat
- The fluctuation in quantity is quite different from industrial commodities
- Additionally, it has physical monetary attributes (principally lack of degradation)

While the last bullet point may seem irrelevant in this technologically saturated day and age, with the occurrence of frequent cyber security breaches we believe physical assets still have a place in this world.

Scenarios that may prompt investors to increase gold exposure

In our view, investors might allocate to gold:

- If there is a reasonable risk of monetary inflation or debasement of traditional currencies
- If the credit system becomes stressed
- If the prevailing monetary system is under strain
- If faith in the central banks to provide price stability is not sufficient

While the above could be considered extreme scenarios, there are a few other situations that we feel are more likely, which could cause investors to add exposure to the asset class.

These include: increased efforts by central banks to use monetary finance to reflate real economies, rather than reward asset owners, also known as modern monetary theory. We believe this could occur as soon as the latter part of this credit cycle, particularly since central banks appear short on traditional ammunition to counter the next crisis.

Arguably even more pressing, is the current credit cycle and its accompanying issues, including what we believe to be excessive leverage, lax investor protection (covenants falling away) and dubious accounting, or EBITDA adjustments. We think China is currently a poster child for this issue, as it is relatively unmatched among larger economies for its corporate-debt-to-GDP ratio.¹

Lastly, let us not forget about the Trump administration’s ongoing effort to reduce bilateral trade deficits, which we think clashes with the current monetary system (a de-facto US-dollar standard) that relies on the US having a structural trade deficit in order for the US-dollar to serve as a global reserve currency.

¹ Wolfstreet: The countries with the most monstrous corporate debt pileups. US wimps out in 25th place, 23 March 2019.
**Current thoughts behind money creation**

Gold may get a bad rap as a metal with no intrinsic value, however, people seem to ignore the fact that most other financial assets are merely just paper promises to pay. While it holds true that the global economy has evolved throughout the years into a more sophisticated animal altogether, human nature leads us back to the same pitfalls surrounding money debasement and leverage. At the end of the day, most money is credit created by commercial banks. In our view, this is why they need to be regulated and why, if policy is not well thought out, much of the credit growth can consist of claims on non-productive assets that do not support future global GDP.

We use a theme of financialization, which is when finance dominates economic activity rather than serve it and by doing so, potentially leads to an over-indebted financial system.

Regarding the sheer scale of financialization in the US, some investors have historically chosen to hold gold because it was not anyone’s liability and traditionally not part of the credit system.

While gold may not perform in a conventional manner, in our opinion it has effectively been used as a currency to allocate a portion of assets to for other reasons. It has historically provided ballast, liquidity and value in times of stress for risk assets.
Past performance does not guarantee future results.

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Definitions:

Ballast: To provide balance to a portfolio in an effort to offset equity volatility.
EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization): A financial metric used to measure a company’s overall financial performance.
GDP (Gross Domestic Product): The total value of goods and services produced within a country’s borders in a specific time period.

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