Gold…An Inflation Hedge or Just a Good Story?

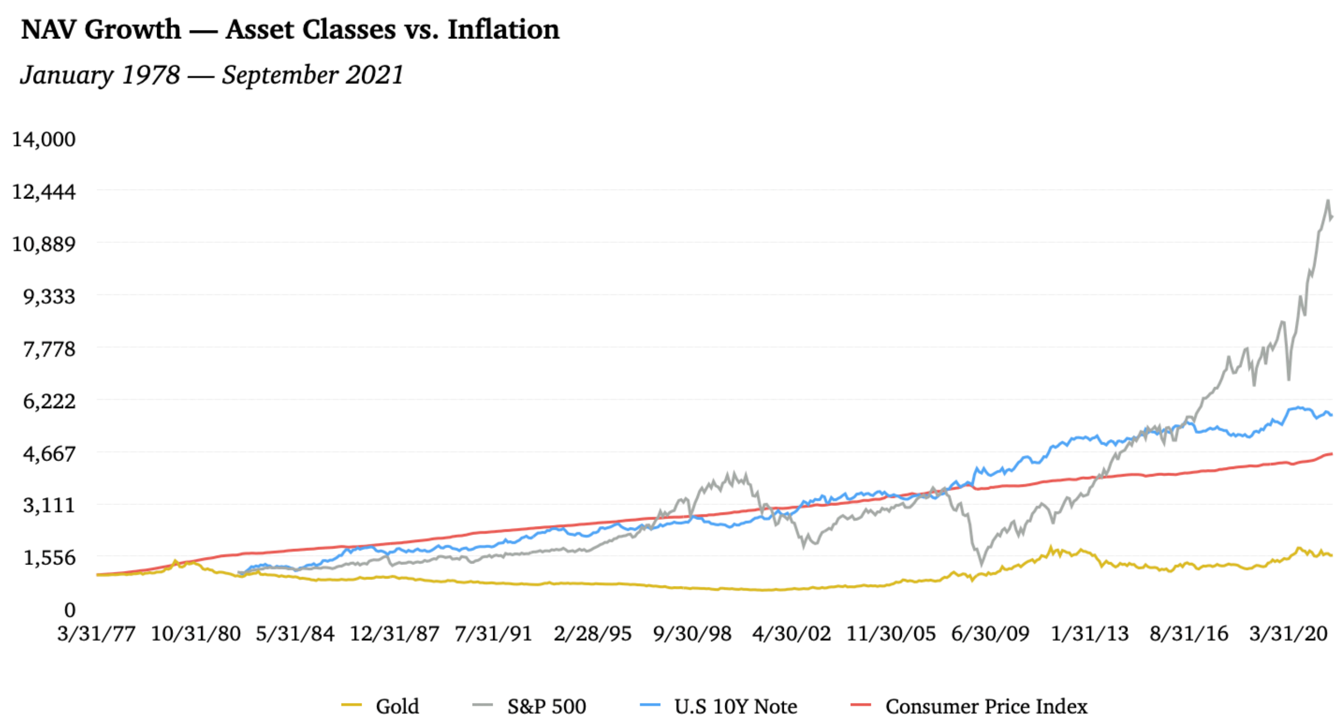
If a higher rate of inflation is indeed here to stay, we need to talk about how to prepare for it. Most people already *know* what to do…buy gold.

A strong narrative that has persisted over time, but has it effectively hedged against inflation? Has it been the best approach? And is buying gold even a robust approach for the future?

If buying gold isn't the answer, what can we do instead? Is there a better way to prepare and proactively address the prospect of higher inflation?

The Buy-and-Hold Approach

From a buy-and-hold perspective, gold has not outpaced inflation over the past 40 years. And, as a comparison, U.S. stocks and bonds have faired much better but as the disclaimer goes — past performance is not necessarily indicative of future results. Not a good start for gold's inflation hedge narrative.



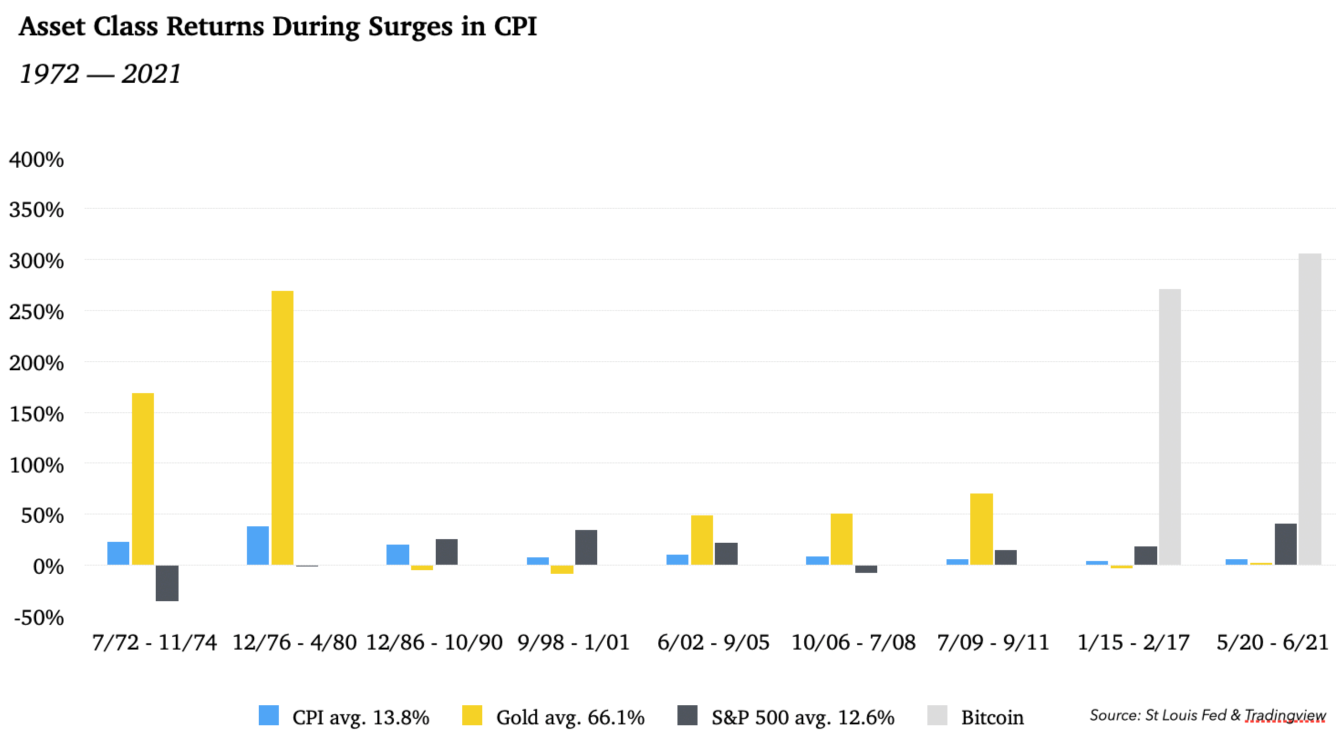
Like equities, buying and holding gold comes with serious risk. It experienced a -65% loss over 20 years following the 1980 top; not making a new high until 2011 (31 years between highs). Not exactly the performance you want from a buy-and-hold investment, much less an underperforming inflation hedge.

To simply buy into the narrative of always assigning a portion of your portfolio to gold no matter what is foolish. Doing this with <u>any</u> investment is foolish. Favoring fundamentals and narrative over the trend is a perilous act in the markets. Despite the trail of blood and tears left by older generations of investors, new ones today still favor this approach.

During Short-Term Surges in Inflation

Gold has indeed performed very well during temporary surges in inflation. I believe gold's performance during these periods, especially in the 1970's, is where the inflation-hedge narrative was born.

Just look at that stellar performance in the mid and late 1970's. It had the wow factor; the kind of performance that sticks in people's minds. So, when the prospect of inflation rears its head in the future, investors remember how well it performed in the past and expect it to deliver the same in the future. Not wise. Overall, though, in a small sample of strong inflationary run-ups gold has easily outpaced inflation.

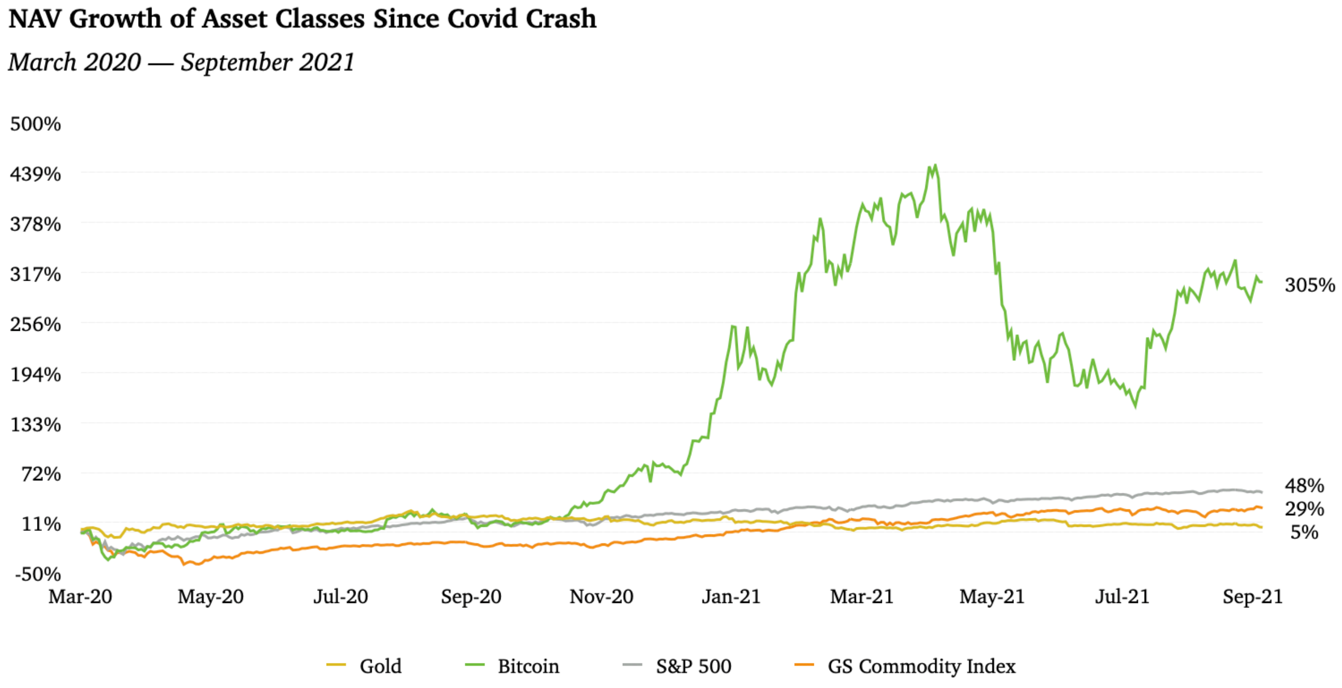


A new wrinkle has emerged however….

Gold has new competition these days — crypto.

Going forward, gold might not attract the same buying demand during short-term inflation shocks that it did in the 70's. In recent years, especially during the inflation surge over the past 18 months, we've seen Bitcoin appreciate multiples more than gold. Hell, we've seen <u>many</u> markets vastly outperform gold over this period.

Chart on next page.



Now, can we rely on Bitcoin to outperform gold during inflationary periods going forward? No, but it's a new development that we must be aware of and adapt to. To us, it presents new opportunity and that's exciting.

<u>Our Approach to Inflation</u>

We don't try to outguess the markets and bet on what we think will be the best hedge during the next short-term inflation flare-up. Instead, we rely on a systematic reactive approach to buy into markets that are moving up well and sell those that moving down. Market performance varies tremendously during inflationary periods, so we think it's futile to try to predict which markets will out/underperform next time.

Global government response to Covid-19 (shutdowns, monetary and fiscal stimulus) set fire to many market trends. In the summer of 2020, markets began breaking out to new highs. Our strategy noticed this and decided to take some risk on the long side, especially in many equity and commodity markets. At the time, we didn't know the extent of the rallies that were going to unfold over the subsequent year-plus but we adapted and that was the key.

During 2020, we held a long position in gold for only a short while. As prices began stagnating in Q4-2020, we exited. When prices weakened further, we initiated a short position in Q1-2021 — a position we still hold today (Oct-2021).

You're short gold during an inflationary period!? Yes. And we will continue to stay short as long as the trend remains down. We don't care what gold has done in the past inflationary periods. Maybe it will go back up at some point. Maybe it'll return to glory. If so, we'll take our small loss and get long again. The current trend is all we care about, not narrative or romanticism.

Conclusion

It's dangerous to let narrative drive your investing decisions. That's not what we do at Melissinos Trading. We go with the trends no matter how ridiculous they are or uncomfortable we feel. Often times, the trends that turn out best make us feel the most discomfort.

As we've seen in limited examples on the page two chart, gold doesn't always come through. Sometimes there are better investment options. Over-investing in gold would've cost us dearly over the past year. We would've put our capital into a market that has actually declined since October 2020 and had much less capital (or none at all) to allocate to much better trends like Bitcoin, soybean oil, cotton, sugar, natural gas, oil, etc.

To wrap up, if there's one thing we can count on, it's that the past will not look like the future. Gold is under no obligation to rally during inflationary periods in the future.

Disclosure

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Sources: 1) https://fred.stlouisfed.org/graph/?g=8dGq 2) https://fred.stlouisfed.org/series/CPIAUCSL

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