



Testing Its Mettle During Covid-19: Gold as a Potential Hedge in Crisis Environments

The Covid-19 pandemic and policy responses to it laid bare many of the risks that had been accumulating during the 10-year-plus equity bull market, including massive levels of sovereign debt, the ongoing debasement of fiat money, excessive risk asset valuations, and simmering political and geopolitical tensions. For investors, the sharp selloff and heightened volatility across asset classes that emerged in early 2020 underscored the benefits of owning a potential hedge that can perform satisfactorily under a wide variety of circumstances disruptive to financial markets.

At First Eagle, we take the humble view that while disruptive episodes are inevitable, they also are impossible to predict. Because of this, many of our diversified portfolios maintain a strategic allocation to gold as a long-duration potential hedge; we also manage a standalone gold portfolio for external investors. Of all the available potential hedging options, both real and financial, we believe gold's unique risk-return characteristics enable it to serve as a source of potential resilience in the widest variety of adverse circumstances—including both inflationary and deflationary environments as well as equity bear markets—while also supporting real purchasing power across market cycles.

Key Takeaways

- Gold's unique risk-return characteristics have given it the rare ability to maintain its real value in both inflationary and deflationary environments, while also serving as a potential hedge against extreme equity market drawdowns and thus a source of resilience for stock portfolios.
- Movements in the price of gold in response to the Covid-19 pandemic are reminiscent of its behavior during the global financial crisis in 2008–09, a period during which gold's real purchasing power increased amid significant volatility in both real and financial assets.
- While there can be short-term aberrations in their negative correlation, we believe movements in real interest rates are the most important driver of the gold price.
- At First Eagle, gold serves as a potential hedge, and thus an additional source of resilience in diversified portfolios that seek to avoid the permanent impairment of capital. While we don't presume to forecast movements in the price of gold, we believe its long-term historical performance makes a strong case for gold's continued value as a potential hedge.

Comparing Crises: 2008-09 vs. 2020

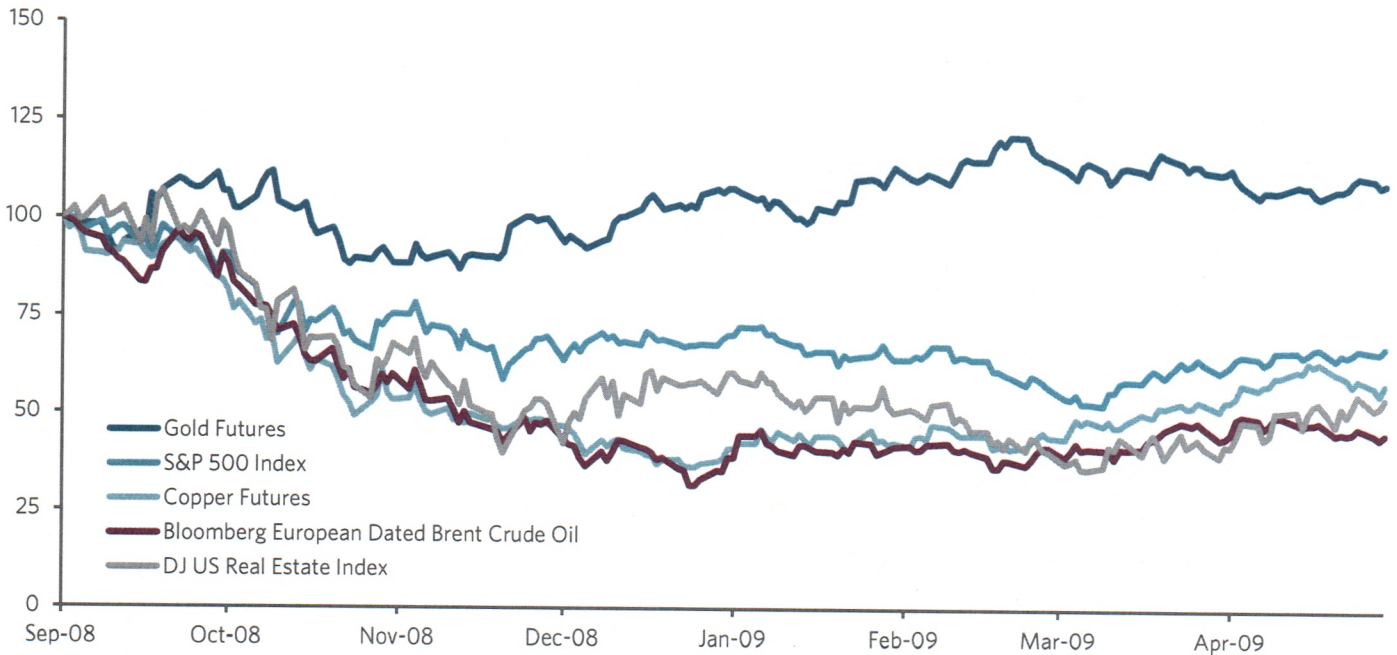
While there were an array of indicators suggesting that the decade-long US business cycle was in a mature state, the economic disruptions of the Covid-19 outbreak brought an unexpectedly swift end to the record-setting expansion in February.¹ Although the rapid and forceful response of central banks and governments appear to have arrested the financial markets' freefall at the time of writing, allowing risk assets in general to claw back much of their early-year losses, the pandemic's economic impact is likely to be massive.

Recessions historically have been favorable for the gold price in the medium to long term, but they have often led to short-term price corrections. In this regard, movements in the price of gold in early 2020 were reminiscent of its behavior in fourth quarter 2008, another extremely challenging investment environment during which gold increased its relative purchasing power despite intra-quarter volatility. Exhibit 1 begins on September 15, 2008, the day Lehman Brothers declared bankruptcy, perhaps the defining moment of the global financial crisis. As shown, gold initially spiked higher on Lehman's news before collapsing alongside equities, oil, real estate, copper and most other risk assets as liquidity breakdowns across markets paradoxically pushed real yields higher. While gold ultimately shed more than 20% to reach its mid-November trough, the potential hedge value of gold reasserted itself as central bank actions eased liquidity fears, as it traditionally has; rebounding into year-end as other risk assets remained distressed, gold posted a gain of nearly 6% in calendar 2008. By the time risk assets reached their cyclical nadir in March 2009, gold was more than 20% higher than its pre-Lehman price; two years later it had about doubled that price (although past performance does not guarantee future results).

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Exhibit 1. Despite Short-Term Volatility, Gold Has Weathered Recent Crises

September 15, 2008, through April 30, 2009; September 15, 2008 = 100



Source: Bloomberg; as of December 31, 2019.

Past performance does not guarantee future results.

1. Source: National Bureau of Economic Research; as of June 8, 2020.

The arithmetic of compounding suggests that consistently mitigating losses may be as important to long-term portfolio returns as generating outsized gains.

The emergence of liquidity issues is not unusual in the late phase of an economic cycle, and several events over the course of 2019 led us to believe that investors in general were underestimating liquidity risk in the financial system heading into 2020.

Of course, our interest in gold is not based on expectations for increases in its price, but rather for its value as a potential hedge; from this perspective, there are a couple of important takeaways we can draw from the experiences of 2008–09. First, even though the price of gold declined in nominal terms in the immediate aftermath of the Lehman bankruptcy, its real purchasing power increased as it outperformed most other real and financial assets. Second, the decline in the gold price was not only smaller in magnitude than the fall of these other assets, it was shorter in duration; the arithmetic of compounding suggests that consistently mitigating losses may be as important to long-term portfolio returns as generating outsized gains. In the pandemic-related dislocation of 2020, we have observed gold demonstrate similar resilience.

At this point, it is unclear whether the rebound in risk assets that began in late March 2020 reflects a definitive change in market direction or merely a pause in what will prove to be a longer-term decline. That said, it's not hard to imagine a re-emergence of risk-off sentiment. The pandemic seems likely to result in an economic contraction greater than any we've seen since World War II, if not longer. Further, the novel coronavirus responsible for Covid-19 remains poorly understood even as universities, government research centers and pharmaceutical companies across the globe work toward tests, vaccines and cures; a return to "normalcy" appears to be some time away.

If there is another shoe to drop in connection with the pandemic's financial dislocations, an even more apt parallel for first quarter 2020 perhaps may be found a bit earlier in 2008. Before Lehman Brothers brought the financial system to its knees in September, the March collapse of Bear Stearns sparked a global scramble for liquidity, sending gold—which had climbed higher through much of the 2000s on the back of easing real interest rates—into a volatile but lower-trending phase that lasted well into autumn. Gold, as mentioned, ultimately proved to be among the most resilient assets as the events surrounding the Lehman bankruptcy unfolded in late 2008, delivering positive nominal returns in a calendar year that was brutal for almost all other investments.

The emergence of liquidity issues is not unusual in the late phase of an economic cycle. Several events over the course of 2019, amid the backdrop of a steadily shrinking Fed balance sheet, led us to believe that investors in general were underestimating liquidity risk in the financial system heading into 2020. Notably, the market for repurchase agreements—or "repos," collateralized short-term loans that have become the primary source of overnight financing for financial institutions—seized up in September 2019, forcing the Fed to provide the market with daily liquidity to ensure this vital source of funding remained readily accessible to banks, a commitment it has increased massively post-Covid.

Banks have been challenged by very low interest rates in the years following the financial crisis, and the likelihood of ongoing low rates as a result of pandemic-related stimulus actions will further pressure bank profits—and thus threaten financial stability—in the years to come. While US banks generally appeared to be much healthier heading into this crisis than the last, some regions in the world appear quite vulnerable. A number of banks based in Europe, for example, seem particularly susceptible, especially those in Italy, which was hit hard by Covid-19 fatalities. We are keeping a close eye on financial, monetary and political developments in continental Europe.

With the debasement of fiat currency likely to continue, we are more confident in gold as a long-term source of “dry powder” in our diversified portfolios than cash and cash equivalents.

In addition to mitigating macro risk, gold also historically has served as a diversifying complement to equity portfolios under most circumstances and as a potential hedge against periods of extreme equity market distress.

Gold as an All-Weather Potential Hedge

Gold’s performance as a potential “safe haven” during challenging times has been driven in part by the relative stability of its supply. Its supply growth has tended to be steady at levels well below that of fiat currency and, thus, the nominal demand for gold. Gold production from 1900 to 2019 has compounded at a rate of less than 2% per year, for example, while M2 money supply in the US has posted a compound annual growth rate of nearly 7% over the past 60 years. In fact, with cash likely to be further debased by global central banks committed to double-digit expansions of the monetary base to combat pandemic-related economic dislocations—M2 expanded about 23% over the 12 months ended May 2020, with the bulk of that growth occurring this year²—we are more confident in gold as a long-term source of deferred purchasing power (aka “dry powder”) in our diversified portfolios than cash and cash equivalents, despite the potential for short-term volatility in the price of the metal.

Gold doesn’t rot, rust, tarnish or otherwise debase, and as a result virtually all the gold ever mined remains as aboveground inventory today; a longer-duration asset would be hard, if not impossible, to find. And with a global market value in excess of \$10 trillion and significant aggregate daily trading volume, gold is also extremely liquid, a highly desirable feature in a potential hedge.³

Moreover, gold—chemically inert and with few industrial applications—has virtually no beta to business activity and thus has tended to be a broader source of portfolio stability compared with other, more economically sensitive real assets such as copper, oil, silver and platinum. Gold’s qualities are also differentiated from those financial assets often considered as potential hedges. Take government bonds, for example. Massive and still-growing levels of sovereign debt in the developed world have significantly increased the risk these bonds now carry, even as nominal yields remain negligible at best. Meanwhile, structural factors affecting both nominal and inflation-linked issues further limit the suitability of these bonds as a long-duration potential hedge, in our view. While derivatives strategies like options can be structured to hedge against a variety of scenarios, their liquidity generally is far more constrained than that of gold and their high costs inhibit their long-term strategic utility as potential hedges.

In addition to mitigating macro risk, gold also historically has served as a diversifying complement to equity portfolios under most circumstances and as a potential hedge against periods of extreme equity market distress. Gold’s long-term correlation to the S&P 500 Index is close to zero since 1971—when it began to trade freely following the collapse of the Bretton Woods system⁴—and Exhibit 2 captures gold’s countercyclical tendencies when equity markets sell off. As shown, gold outperformed the S&P 500 in 14 of the index’s 16 10%-plus drawdowns since 1971, and it did so by a margin of nearly 30 percentage points.

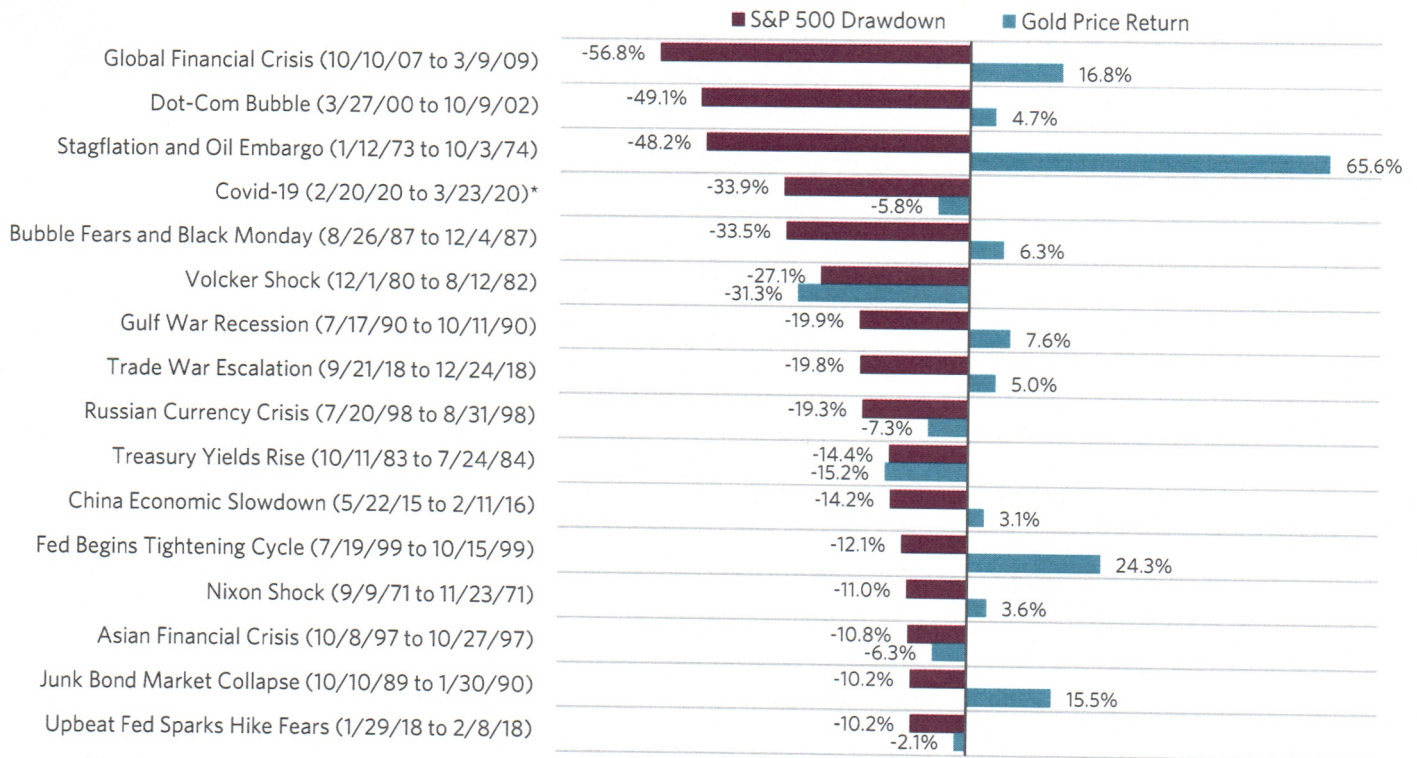
2. Source: US Geological Survey, World Gold Council, Federal Reserve.

3. Source: Bloomberg, World Gold Council; as of August 9, 2019.

4. Source: Bloomberg, World Gold Council; as of May 31, 2019.

Exhibit 2. Gold Has Mitigated the Impact of Recent Market Corrections

Change in Gold Price During All 10%-Plus Drawdowns in the S&P 500 Index Since August 1971



S&P 500 Index Average	-24.4%	Gold Average	5.3%
S&P 500 Index CAGR	-26.2%	Gold CAGR	3.5%

* Given that the S&P 500 has failed to recapture its peak at the time this exhibit was produced, these figures may not necessarily represent the full extent of the Covid-19 drawdown.

Note: Gold returns are represented by the Bloomberg gold spot price in US dollars per troy ounce. All returns calculated daily.

Source: Bloomberg, FactSet; as of June 8, 2020.

Past performance does not guarantee future results.

The two exceptions to gold's outperformance are notable in their timing: Both occurred in the early 1980s amid the largest move in real interest rates in recent history, a shift that served as a transition between the end of a decade-long gold bull market and the beginning of a two-decade-long gold bear market. Untethered from the US dollar in 1971, gold staged a fierce rally to reach its inflation-adjusted peak in January 1980, posting a cumulative return of more than 2,000% across years marked by inflation, oil shocks and geopolitical turmoil.⁵ Extreme tightening by the Federal Reserve in the early 1980s sent real interest rates up sharply, however, toppling gold from highs it was unable to reclaim in the years that followed despite occasional periods of strength. Though equity markets weren't immune from the sting of Fed policy in this period, the S&P 500 was able to establish new record highs between its two early-1980s corrections and ultimately entered a secular bull market that persisted through the end of the century.

5. Source: Bloomberg.

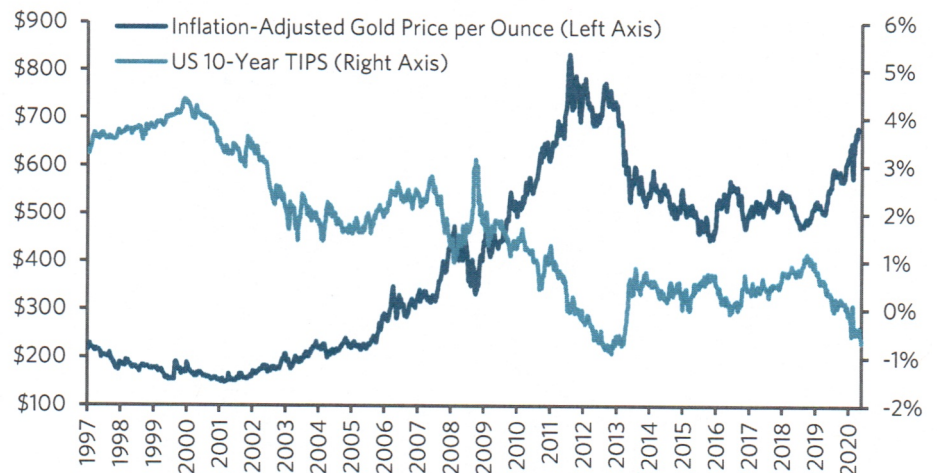
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The Shrinking Opportunity Cost of Gold Ownership

Though there can be short-term aberrations in the relationship, we believe real interest rates are the most important driver of the gold price over the medium and long term. Real interest rates—i.e., the difference between nominal interest rates and inflation—represent the opportunity cost of owning gold; since it pays neither dividends nor interest, gold is relatively expensive to hold when real interest rates are high and relatively inexpensive when real rates are low. As such, real interest rates and the price of gold historically have been negatively correlated; as shown in Exhibit 3, when real interest rates have moved lower, the gold price, despite some lead/lag effects, has generally moved higher and vice versa.

Exhibit 3. Real Interest Rates Historically Have Been the Key Driver of the Gold Price

January 1, 1997, through June 26, 2020; Consumer Price Index, 1982-84 = 100



Source: Bloomberg; as of July 8, 2020.

Note: Per standard Bureau of Labor Statistics practice, the consumer price index data incorporated into the above use 1982-84 = 100 as a reference base. Treasury inflation-protected securities (TIPS) were first introduced by the US Treasury in 1997.

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On the basis of real interest rates, gold, in our view, has perhaps never been more attractive than it is today.

Notably, gold prices have tended to be at their highest—and real interest rates at their lowest—when the economy is weak and/or experiencing inflation, periods that have tended to coincide with low levels of confidence in the economy and government and thus a greater inclination among investors to hold a universal currency like gold rather than its man-made substitute. For example, gold's inflation-adjusted peak (at more than \$2,800 in May 2020 dollars⁶) occurred in January 1980, when the US inflation rate was well into double-digits and the economy was in recession. Conditions changed for gold in the early 1980s, however, as extreme Fed tightening sent real interest rates sharply higher to bring an end to gold's post-Bretton Woods rally. In fact, the inflation-adjusted spot price of gold remained depressed even after rates normalized, as cheap credit, strong equity markets and the re-emergence of confidence in the monetary regime left both investors and many central banks with little interest in a potential "safe haven" like gold for the rest of the century.

On the basis of real interest rates, gold, in our view, has perhaps never been more attractive than it is today. With sovereign yields broadly negative across the curve

6. Bloomberg, Bureau of Labor Statistics; as of June 5, 2020.

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on an inflation-adjusted basis—and on a nominal basis as well many cases, notably Europe and Japan—the opportunity cost of gold ownership is minimal. In fact, the level of interest rates suggests certain sovereign bond investors may lose purchasing power over the term of the security, even as record levels of government debt imply that sovereign risk has become a greater concern for even the “safest” government issuers, especially should deflation emerge and put upward pressure on the real cost of servicing this debt. We believe sovereigns in general may represent a significant systemic risk in the coming years.

Uncertain Conditions Demand a Flexible Source of Potential Resilience

Whether or not they are successful in reinvigorating the global economy, the stimulus measures introduced over the first several months of 2020—ranging from interest rate cuts and asset purchases to broad-based fiscal packages—are likely to promote further deterioration in the quality of man-made money and sovereign balance sheets. It's hard to imagine that actions of this magnitude will not have some sort of deflationary or inflationary consequences down the road, either of which would highlight the possible benefits of a strategic allocation to gold as a potential hedge.

At First Eagle, we don't maintain a directional view on the price of gold, but its long-term historical performance makes a strong case for its continued value as a potential hedge. To prepare for both upward and downward movements in the gold price—and, thus, pursue solid, risk-adjusted real returns through the cycle—we seek to build resilience into our diversified portfolios. Though volatile, our positions in gold bullion and gold stocks, for example, have enabled us to benefit in a variety of market environments over the years; this includes periods like 2019, when gold appreciated in value alongside equities, as well as during periods like first quarter 2020, when high levels of volatility battered risk assets in general. The cash and cash equivalents we maintain in our diversified portfolios have enabled us to buy gold and gold stocks when we believed valuations pointed to attractive opportunities; similarly, our gold holdings serve as another form of portfolio liquidity to be deployed into equities more broadly should relative valuations dictate.

In the current uncertain environment, we believe gold's proven ability to maintain its purchasing power over the long term combined with its historical countercyclical price dynamics, versatility, resilience and long duration make it the most compelling form of potential hedge against both the seen and unseen risks facing equity portfolios.

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