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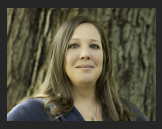
What the Gold Rally Means for Investors



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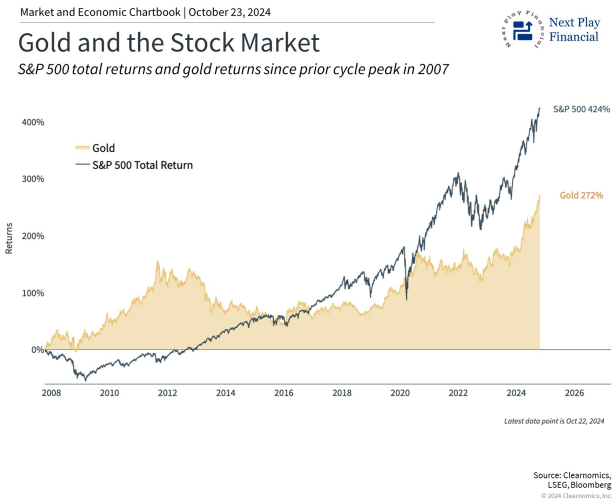
Although markets have performed well this year, some investors may be nervous about upcoming events such as the presidential election, the Fed's next rate decision, and the state of the economy. Along with the uncertainty of the past few years, it's no wonder that gold prices have also risen to record levels above $2,600 per ounce. While gold can serve many important purposes, some investors may focus on it as a standalone investment rather than as a component of a well-constructed portfolio. In today's market environment, what role should gold play in long-term investment and financial plans?

There are many reasons everyday investors are drawn to gold. Many look to it as a store of value, especially in inflationary periods such as the one we just experienced. Others turn to gold in times of political and global uncertainty, particularly as a hedge against fiscal deficits and loose monetary policy. It can also serve as a safeguard against market volatility when geopolitical risk is heightened, as is the case today with tensions in the Middle East.

While gold can play these roles, the stock market has historically outperformed over long periods, and bonds provide attractive characteristics such as yield and income. Understanding the relationship between gold and other asset classes is critical as markets continue to rally.

Gold and stocks can behave differently across market environments



The case for gold really depends on the portfolio objective. Across economic environments, gold can serve at least two investment purposes. First, as a precious metal with consumer and industrial uses, the value of gold can rise over time due to limited supply and steadily increasing demand. This is in addition to demand for gold as a luxury good. As a result, it can serve as a store of value when the world is uncertain and can also protect against inflation as the economy heats up or as central banks increase stimulus, as they have done this year.

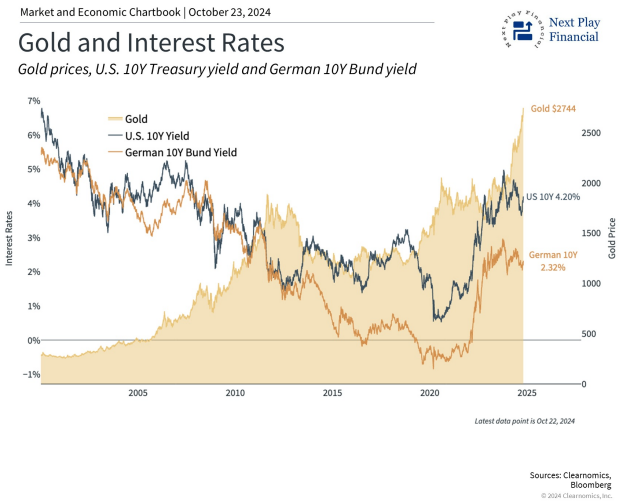
It's also clear that many investors flock to gold for safety when markets get choppy. In many ways, this is no different from how some investors view cash or bonds - as a tool to protect their portfolio from short-term market swings. Unlike cash and other safe-haven assets, however, gold does not generate any portfolio income. Thus, it's important to distinguish between gold as a one-off investment and as a part of a portfolio tailored to achieve financial goals.

The second and more important consideration is whether gold can help diversify portfolios. Much like bonds, gold tends to perform differently to stocks. The relationship between gold and the stock market since 2008, shown in the accompanying chart, makes this clear. Although gold outperformed stocks during the global financial crisis, it fell in value and flat-lined for years while the stock market climbed to new record highs. Gold also jumped in value during the pandemic, and again more recently as the Fed began to cut rates.

What may be surprising is that gold was relatively flat during the recent inflationary period that began in 2021. This is partly because the Fed raised rates rapidly in 2022, increasing the attractiveness of cash and other short-term assets. This shows that understanding the underlying drivers of gold price movements and Fed policy is important when it comes to making portfolio decisions.

It’s also important to note that over this full period, the stock market outperformed gold, just as it has against most other asset classes. Of course, constructing a portfolio is not just about investing in the best performing asset – it’s about diversifying to create a smoother ride and to meet financial objectives. Thus, while gold may be attractive to investors for a variety of reasons, it’s always important to view it with respect to other important asset classes, including stocks and bonds.

Falling interest rates can make gold more attractive

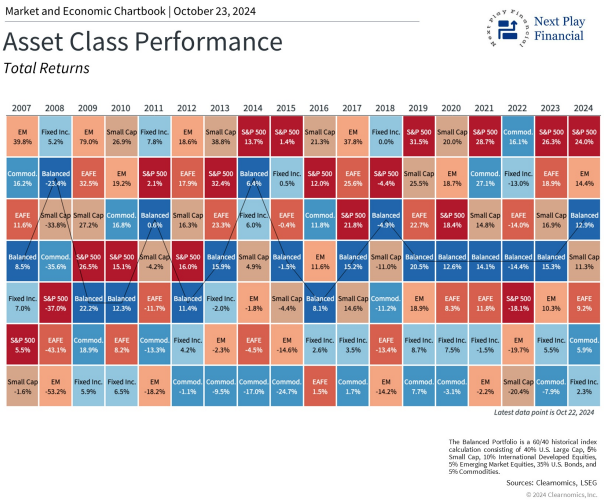


Why have gold prices risen recently? Gold can perform well when interest rates decline, since lower rates on bonds and cash make gold, which provides no yield, more attractive on a relative basis. Specifically, the Fed tends to cut rates to spur economic growth which can be the result of an economic slowdown, and can also be viewed as inflationary. Both scenarios can be positive for gold as a store of value and hedge against rising prices.

However, it's important to keep in mind that ongoing rate cuts tend to also be positive for stocks and bonds. Falling rates, especially if there is a "soft landing" as inflation slows, can create the ideal situation for the stock market, as it has this year. Similarly, falling rates are positive for bonds since existing bonds with higher yields become more valuable. That said, there is still uncertainty around a soft landing and market-based interest rates have actually risen in recent days, with the 10-year Treasury yield climbing back near 4.1%.

While gold has experienced a strong rally and is hovering near all-time highs, it's important to keep its relative performance in perspective. Gold prices are now hovering around record levels, but the choppiness of gold prices over the past few years shows that while it can act as both a hedge during inflationary periods and serve as a store of value, this can reverse quickly as conditions change.

Many other assets have performed well this year



Thus, like all asset classes, gold is perhaps most valuable as part of a diversified portfolio rather than as a standalone investment. The accompanying chart shows that many asset classes, including international stocks, small caps, and more, have contributed to the performance of broad market indices this year.

Geopolitics, the election, and other investor concerns will continue to drive markets. Rather than focus on individual asset classes, it's more important to construct portfolios that can withstand evolving market conditions. Ideally, this should be done with the guidance of a trusted advisor. History shows that while investor worries come and go, the principles of long-term investing remain the same.

The bottom line? Gold’s recent rally can be attributed to Fed rate cuts, geopolitical tension, and fiscal concerns. Investing in gold or any alternative asset should be considered in the context of a well-diversified investment strategy rather than as a standalone investment.

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