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Gold's defensive appeal shines as market risks mount

The policy response to the COVID-19 pandemic has been nothing short of extraordinary. Central banks have responded on an unprecedented level both in terms of speed and scale. Governments too, despite some execution fumbles, appear to have appreciated the enormity of the challenge and have responded with fiscal alacrity.

Indeed, fiscal policy is increasingly being deployed as the primary line of defence. Conventional monetary policy mechanisms appear exhausted and at worst inappropriate, or at best lacking the requisite potency.

For example, there are serious questions concerning the breakdown in the traditional monetary policy transmission mechanism attaching to central bank policy rates. That is, lower policy rates seem to inflate financial asset prices without any significant increase in spending. Economists refer to this as a decline in the velocity of money.

There may be perverse influences at work via income effects, with workers saving more (and spending less) as interest rates fall, in order to hit a target level of retirement savings.

The build-up in non-financial private leverage has been the clearest area of financial imbalance, so there are obvious limitations to what monetary policy can achieve.

In this context, the current extremely accommodating monetary conditions imply significant and multi-faceted medium-term challenges for investors, ranging from inflation to addressing moral hazard concerns.

Once the initial deflationary shock from the sizeable pandemic distress dissipates, inflation pressures might well build. There is a process of deglobalisation and reregulation that has accompanied the rise of left/right populism in the developed world.

With central banks possessing a strong disposition to tolerate temporary overshoots above inflation targets, and with governments not exhibiting the same alacrity in winding back budget deficits, inflation can much more easily take root.

While not yet commonplace, the idea of monetary financing of fiscal policy is gaining some acceptance, albeit with varying interpretations on the precise form that such monetary financing might assume. Although it is not axiomatic, the political economy of monetary financing suggests it is also inflation prone.

This calls into question the diversifying qualities of nominal government bonds in a multi-asset portfolio. It may be that investors need to seek alternatives should the diversifying properties of government bonds decrease as yields near perceived lower bounds. The underperformance of German and Japanese bonds in recent equity sell-offs may well be a harbinger of things to come.

Inflation-linked bonds are an obvious alternative.

Despite recently hitting a nine-year high, so is gold. Investors have always appreciated gold's safe-haven or defensive attributes but in contrast to nominal bonds, gold is also good hedge against inflation.

Even in the event that bond yields stay low then the opportunity cost of holding gold remains diminished, increasing its attraction.

Gold is not adversely influenced by the complexities and attendant challenges for central banks that attach to exit strategies from the current extraordinarily accommodating global monetary policy settings.

And it provides safety in the event of any escalation of geopolitical concerns, of which there is no shortage.

It is not that any of the canvassed scenarios might unfold quickly, but movements in the gold price indicate that investors are thinking about the defensive qualities of gold in a multi-asset portfolio.

Unlike government bonds, investor interest in gold may have some way yet to run.

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