GM ADVISORY GROUP
WEALTH MANAGEMENT

Paradigm Shifts – Gold's Time to Shine

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"Identify the paradigm you're in, examine if and how it is unsustainable, and visualize how the paradigm shift will transpire when that which is unsustainable stops." – Ray Dalio

Investors have been rewarded handsomely for buying and holding stocks since the 2008 global financial crisis; however, ten years into the longest US economic expansion on record, we may be on the precipice of a regime change that could cause the baton to be passed from stocks to hard assets like gold.

Executive Summary

- **We have started to favor gold at the expense of equities**
  History has demonstrated that there is a time to own stocks and a time to own gold. Fortunately, these periods have not coincided with one another, which has provided investors with an opportunity to generate robust returns in a variety of different environments. We believe client portfolios will benefit from reallocating exposure from equities toward gold as the US economy transitions into and through the next recession.

- **Gold's role in your portfolio? *Think currency instead of commodity***
  The price of gold has increased by 39x over the past half-century as governments and central banks have steadily increased the supply of fiat currencies to combat economic downturns. This devaluation of fiat currencies relative to gold—which can be perceived as a superior form of currency—is likely to continue as the primary monetary policy tool, interest rate reduction, is now largely exhausted across major global economies.

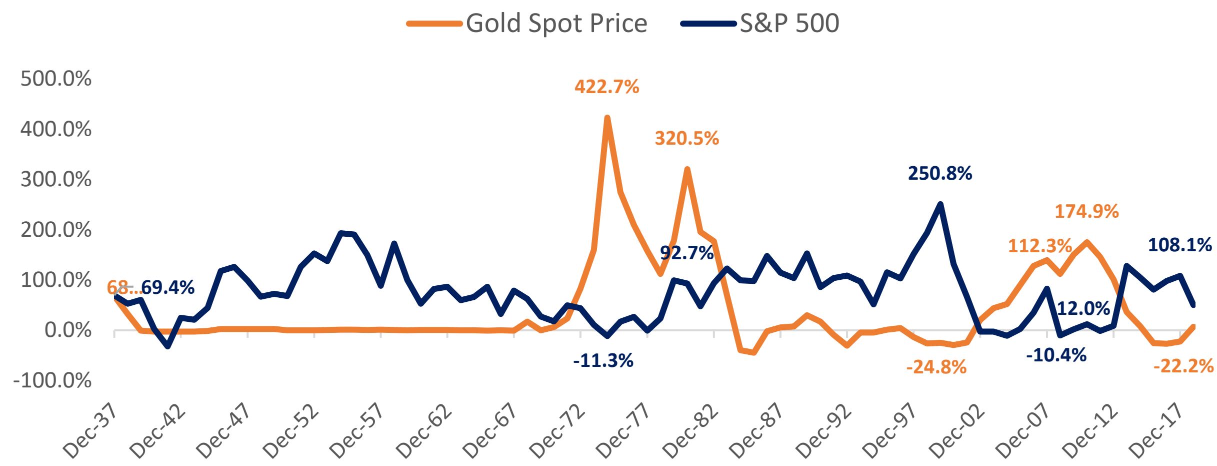
- **Gold is the ultimate store of value**
  Gold's utility as a store of value is what separates it from other fiat currencies and precious metals. The fact that only 2 to 3% of the existing stockpile can be mined in any given year makes it a superior store of value relative to other commodities and currencies.

- **Our outlook for an allocation to gold**
  Although gold is in a bullish trend, it remains a volatile asset. That volatility may present more attractive entry points to allocate to gold in the future. Therefore, we believe it is prudent for purchases of gold to be made incrementally as the business cycle matures, as opposed to allocating all at once.

We have started to favor gold at the expense of equities

History has demonstrated that there is a time to own stocks and a time to own gold, as illustrated by the rolling returns in Figure 1.

Figure 1: Rolling five-year returns of gold spot price vs. the S&P 500.

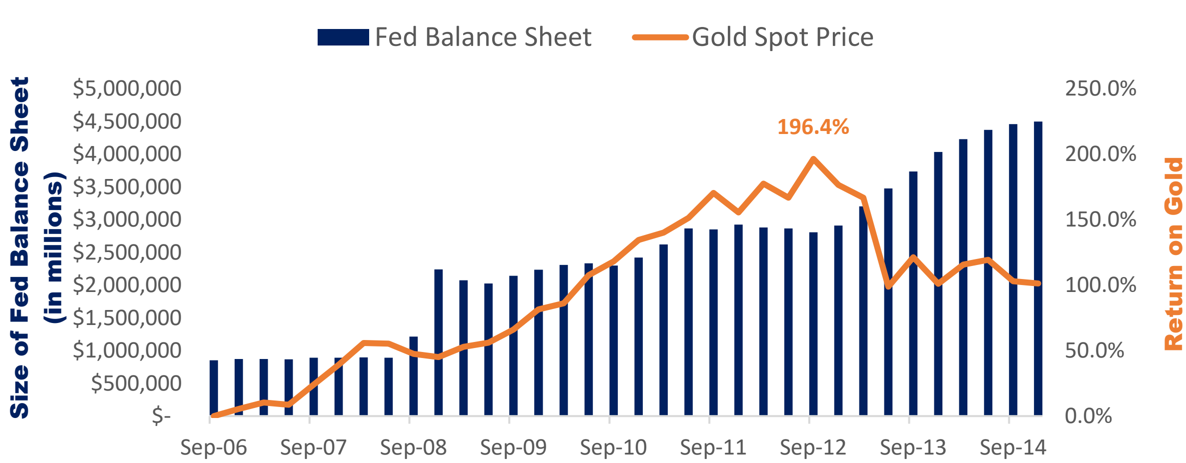


Source: Bloomberg, GMAG Research

Fortunately, these time periods have not coincided with each other, which has provided investors with an opportunity to generate strong returns in a variety of different environments.

Equities have been in favor over the past decade as the global economy has expanded. Over the past ten years, the MSCI ACWI Index and S&P 500 Index returned **+134%** and **+261%**, respectively, whereas gold is up **+54%**. However, now may be a good time to start reallocating from equities to gold because the US economy is late in the economic cycle, which means that the risk of recession is elevated. Furthermore, given that interest rates are near, at, or below zero across most major economies, the magnitude of the fiscal and monetary response that will be required to stem the next economic downturn is likely to be unprecedented. Figure 2 highlights how gold prices increased throughout the wave of stimulus unleashed by the Federal Reserve—and other central banks—during the financial crisis. What will happen to gold prices if even more inflationary policies are deployed? It's certainly feasible that more inflationary policies will be implemented given that traditional monetary policy tools have largely been exhausted across most major economies.

Figure 2: Gold rallied ~200% due to stimulus implemented to combat the financial crisis.



Source: Bloomberg, GMAG Research

Our assessment is that there is currently significantly more downside than upside in equity markets. This is because (1) we do not see a clear path for growth to reaccelerate persistently in the coming quarters, and (2) the risk that we enter a recession within the next six to eighteen months is material. The past two economic downturns brought with them **–49%** and **–58%** drawdowns in global equity markets, and we do not expect that the next one will be any less severe given that equity prices are just as extended, and private-sector leverage (corporate debt-to-GDP) has only increased.

It is difficult to forecast when the next recession will occur; however, a plethora of historically reliable late-cycle indicators, most notably the yield curve, suggest that the risk of entering a recession within the next year has risen substantially over the past few months. The yield curve is inverted, and as of August 31, the 10-year Treasury Bond yielded **–26 bps** less than a 1-year Treasury Bond. Recession has often ensued six to eighteen months following an inversion of this magnitude.

Even if the Fed can engineer the proverbial soft-landing and thereby extend this business cycle, there is doubt that the economy has much productive capacity available as we are likely at or past full employment. If true, it will be difficult for companies to continue to expand profit growth, and history would suggest that equity market upside is limited from this point forward.

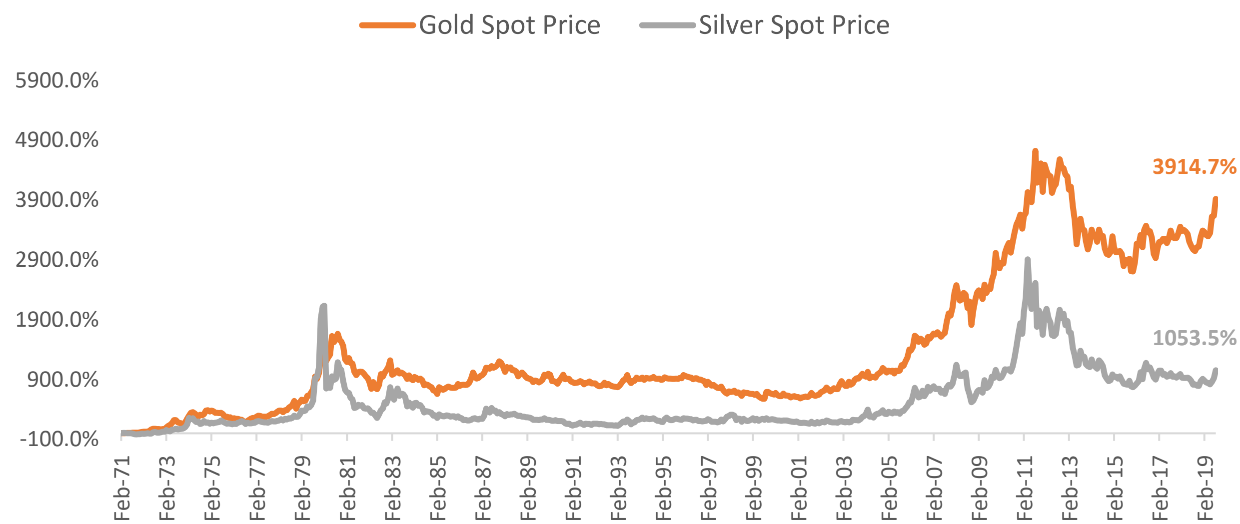
Gold's role in your portfolio? *Think currency instead of commodity*

We submit that understanding the role that gold can play in investment portfolios may require recalibrating how the asset is commonly viewed.

Gold is up **+26%** over the past year, outpacing the MSCI ACWI and S&P 500 indices by **+22%** and **+20%** respectively, during that time. Consequently, gold is making headlines as high-profile investors have come out to vouch for bullion.

But what causes an asset like gold that generates no revenues and distributes no cash flows to see such demand? As famed investor Warren Buffet highlights, gold does not do anything but *"sit there and look at you."* In fact, Buffet says that gold's usefulness as a production input is substantially inferior to that of other commodities such as silver. But if this is true, then why is gold up 39x over the past fifty years, whereas silver is only up 11x (see Figure 3)?

Figure 3: Gold has outperformed silver by ~2,800% since its peg to the dollar broke in 1971.



Source: Bloomberg, GMAG Research

Although gold's utility as a production input may be limited versus other commodities, note that paper dollars have *zero* productive value yet we know that dollars are not worthless. In our opinion, what Mr. Buffet fails to consider—or at least value—is gold's utility as a currency, as opposed to a consumable commodity or resource for production.

Gold is the ultimate store of value

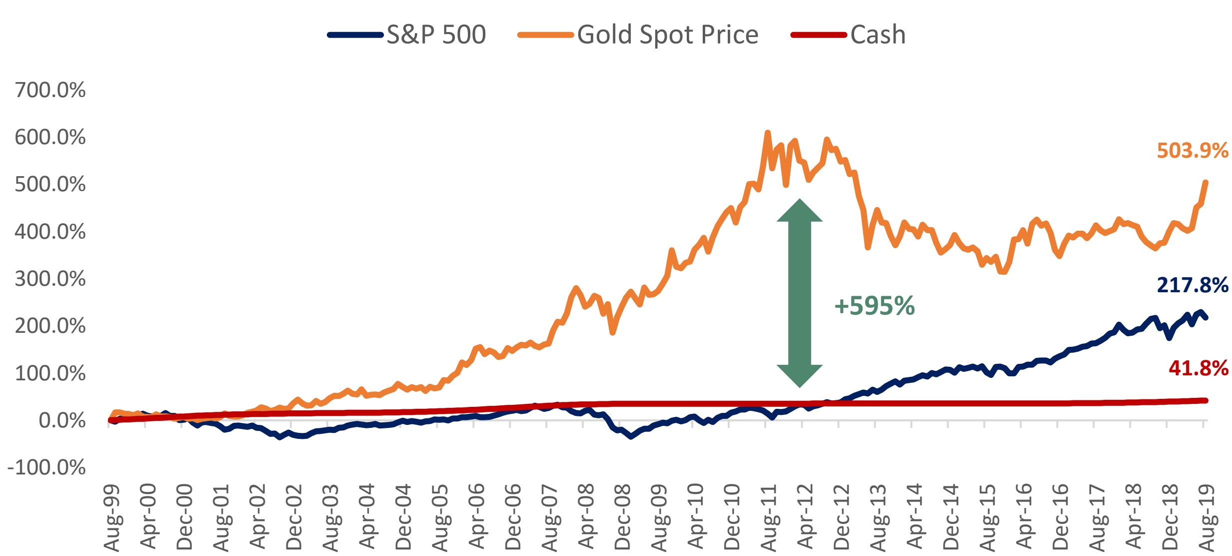
Gold has served the role as a sound form of currency for millennia, and the reason that its purpose has not wavered throughout this time is because it satisfies all three properties of sound money: it is (1) a medium of exchange, (2) a store of value, and (3) a unit of account.

Gold's inertness (it doesn't weather) and malleability (it can be reduced into smaller denominations) long made it popular as a medium of exchange and unit of account, and paper (aka fiat) currencies share these properties for the most part. But what separates gold from other forms of currency—and commodities for that matter—is its superiority as a store of value.

Gold is a good store of value because only 2% to 3% of the existing gold stockpile can be mined in any given year. As a result, gold has a high stock-to-flow ratio that dwarfs its peers, which makes it less vulnerable to the supply gluts that can devalue commodities and currencies over time. In other words, the Fed can't print gold bars.

Instead of perceiving gold as an asset that we purchase with the hope that it will appreciate over time, we should think of it as a vehicle for preserving our purchasing power. In other words, when gold appreciates, reframe it as everything else depreciating against it. As shown in Figure 4, gold is up **+504%** over the past twenty years, significantly outperforming the S&P 500 Index and T-Bills which have returned **+218%** and **+42%**, respectively, over that time.

Figure 4: Gold has significantly outperformed stocks and cash over the past twenty years.

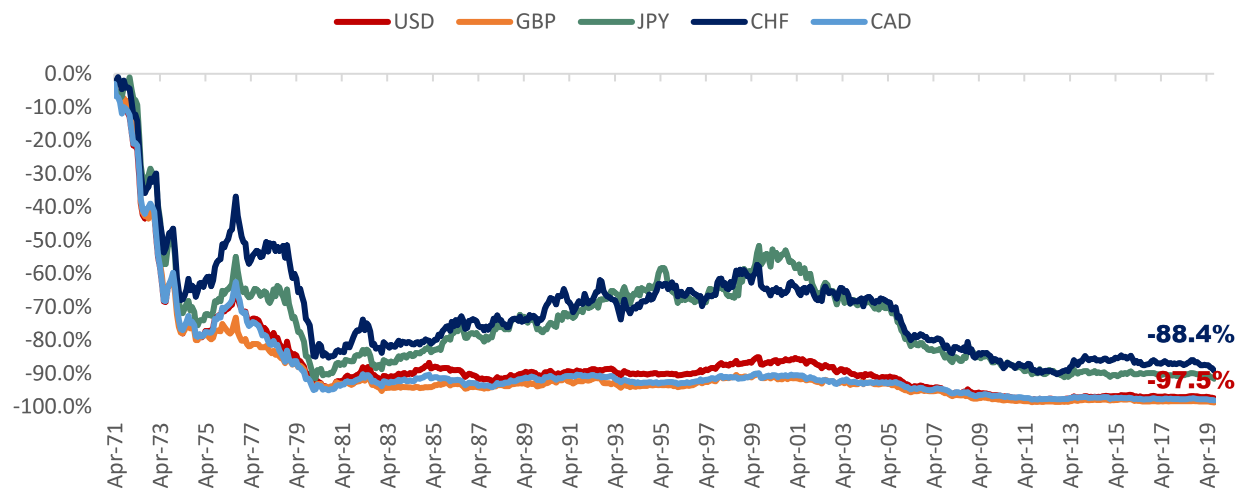


Source: Bloomberg, GMAG Research

Another way of looking at it is that dollars and stocks have actually decreased in real value during the past twenty years. This devaluation is a product of (1) a continuous increase in the supply of money perpetuated by global central banks and (2) the marketplace's reduced preference for fiat currencies and assets denominated in them as a result of that supply increase.

To be clear, we are not knocking the US dollar specifically. In fact, the US dollar has been the world's reserve currency since WWII, and therefore it has been extremely stable relative to most other fiat currencies. The point instead is that a fiat currency's ability to maintain its value is inferior to gold because its supply can, has, and likely will continue to be manipulated in the future. To illustrate this, Figure 5 shows that since the suspension of the [Bretton Woods Agreement]() in 1971—when the peg between the US dollar and gold was removed to prevent the public from converting their US dollars into gold—all major global currencies have depreciated **–88%** to **–99%** against gold.

Figure 5: Major currencies have depreciated by 88% to 99% since breaking from the dollar-gold peg in 1971.



Source: Bloomberg, GMAG Research

The bottom line is that gold is valuable because it serves as a hedge against continued devaluation of fiat currency. It has much less to do with jewelry demand or its utility as a meaningful production input and much more to do with the fact that gold upholds the properties of sound money better than any other alternative.

Our outlook for an allocation to gold

We believe that a 10 to 15% position in gold is prudent heading into and through the next recession. However, gold remains a volatile asset, and although it is [currently in a bullish trend](), there are likely to be material pullbacks along the way that will provide attractive entry points relative to those that exist at current prices. As the business cycle continues to mature, we will likely recommend increasing the allocation to gold in 2 to 3% increments, much like we have been recommending since the beginning of 2018.

Please do not hesitate to reach out to us if you have any questions, comments, or concerns about our investment outlook, or how we are managing your individual portfolio. We will keep you apprised of any important developments.

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