GITA: Gold Is The Alternative

By Vineer Bhansali| March 20, 2023

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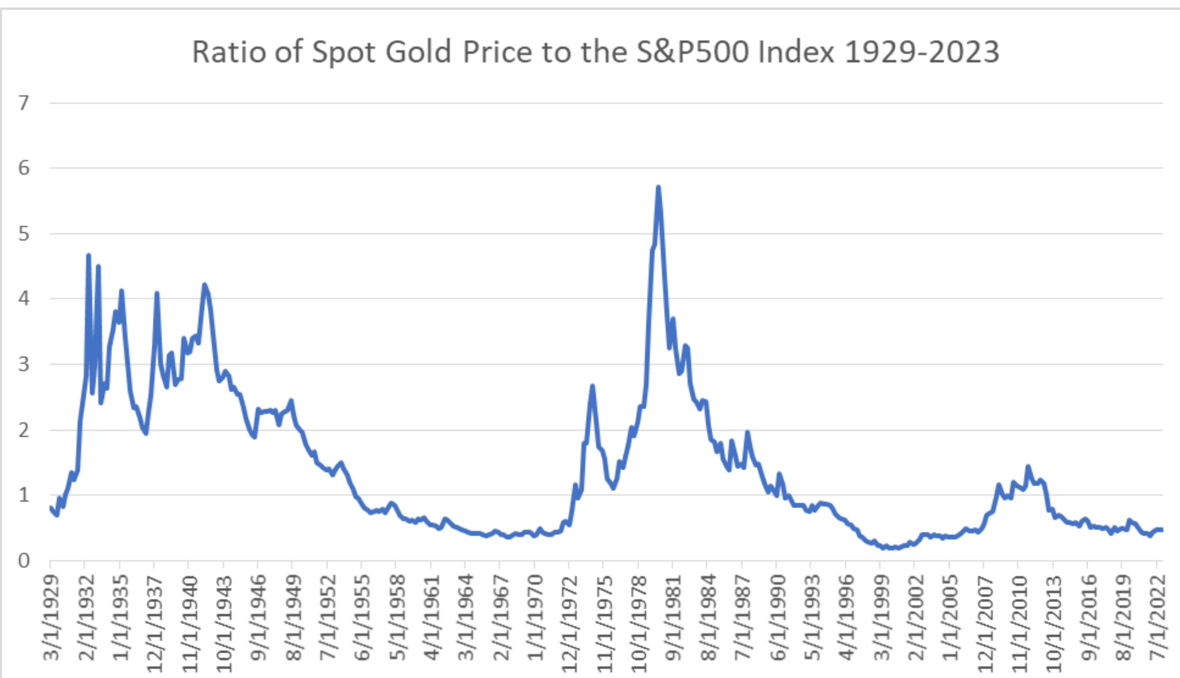
For the decade that preceded 2022, the acronym TINA (There Is No Alternative) applied well to stocks . As central banks used every excuse to flood the system with liquidity, yields were driven to zero, and it seemed that the only way to get any return was to buy stocks. Investors gorged on index funds, and passive ETFs overtook actively managed investments.



Source: LongTail Alpha, Bloomberg

Alas, as central banks realized that inflation, long thought dead, was a real problem, and raised interest rates aggressively, yield curves inverted to historic levels, making short duration Treasury Bills the only safe, viable investment alternative, leading to "TINAC" (There Is No Alternative To Cash). But inverted yield curves are not a stable healthy state of affairs for economies, and as expected, have eventually resulted in financial market breakage which we have been observing for the last two weeks and especially this weekend as Credit Suisse, once my employer, has all but ceased to exist.

In the last two weeks not only have two regional banks failed (Silicon Valley Bank and Signature Bank), another regional bank was temporarily rescued by a government directed consortium (First Republic). This weekend a major international bank (Credit Suisse) was forced to be sold to its competitor for next to nothing. There is probably more to come. As in the financial crisis of 2008, when the sale of Bear Stearns to JP Morgan heralded a year of reckoning, things are likely to get worse before they get better.

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So where does this leave us? Is there an alternative?

I believe that there is an alternative – Gold!

Now I am very definitely not a gold bug. Gold, to me, in general, is one of the worst investment assets one can buy. It is heavy, it has no yield, and its value primarily emanates from its historical record for holding value during economic crises and inflation. Investment in gold does not result in growth from innovation like investment in a startup does. It is a currency of no country, so exchanging it for actual currency is very arduous.

But though it serves no investment purpose, it does serve a purpose to store value when nothing else can be relied upon to do the same. I grew up in India, where gold jewelry has been a core investment for rich and poor alike through the centuries, and where people have had to suffer from the excesses of kings, colonialists and governments for eons, and where history has seen many a boom and bust. Reluctantly, then, I do recognize the value of gold as the asset of last resort.

Here are ten reasons why gold's time might have come again:

1. The Swiss Franc and the Yen are no longer havens: With Credit Suisse going under this weekend, and the Japanese government running massive debts on its way to an all-out implosion, these two "safe-haven" currencies are no longer places to hide out for safety. Especially when banks fail, gold is a haven if fiat currencies are not.

2. Crypto has been tarnished: Not very long ago, bitcoin and its relatives were touted as the "electronic" gold of the future. With the implosion of numerous crypto firms, increasing regulation and scrutiny, and the stigma associated with all things crypto, I will venture to say that for the time being crypto has lost out to gold.

3. Falling real yields make gold competitive against bonds: An inverted yield curve is usually a harbinger of recessions. Recessions mean falling GDP growth, which logically imply falling real yields. As real yields fall, inflation-protected bonds compete with gold for safety since gold has no yield to speak of, but also does not have the risk of the issuer's currency.

4. Gold is probably not much more illiquid than Treasury bonds: I have been a strong proponent of short term Treasury bonds for safety for most of the last two years. In the last few weeks, Treasurys have become so illiquid that holding gold is probably no worse than holding long duration Treasurys, especially if you are a large institutional holder who has to sell them to meet outflows, as many banks who levered the same have recently found out.

5. Inflation is good for gold: Yes, gold is an asset that will usually hold its value when there are defaults and recessions, but it will also hold its value if inflation starts to erode the value of currencies. I believe the Fed is trapped and will have to compromise by letting inflation take its own course (likely much higher than 2%). With the Fed now beginning to ease again through its new credit facilities, much of the recent quantitative tightening has

been reversed, which obviously leads me to the conclusion that inflation control is already playing second fiddle to financial stability concerns.

6. A worsening climate for financial assets is a good climate for gold: Inverted yield curves, widening credit spreads and bank failures are all bad for core financial assets such as stocks and bonds, and investors look for other, safer substitutes. In such an environment, investors will search for “hard” assets. Gold is the ultimate hard asset. The ratio of gold price to the S&P 500 index level has much room to rise after the outperformance of the stock market for the last few decades (see chart at the top of this article depicting the ratio of spot gold price to the S&P 500 index level).

7. Sovereign credit risk of the US makes the case for gold stronger: Investors in credit markets look to the credit default swap market for indications of stress. What might have escaped most investors is that today the credit default swap spread on the US has widened substantially. The 1y maturity default swap spread on the US is currently at close to 1% per annum (Source: Bloomberg), which is a level last seen during the 2008 financial crisis. While the debt ceiling debate might have much to do with this, it is a concern that the credit risk of the US is being priced at such a premium today. Could gold be the natural substitute for holdings of the US dollar? I don’t think there is much chance the US actually defaults, since it has a printing press; but in the markets the perception of risk can create risk.

8. Technicals are supportive of a gold “breakout”: Technical analysts who look at long term charts are focused on gold forming a “coil”. In the financial crisis of 2008, a breakout of gold resulted in a doubling of prices. Could we be setting up for a similar explosive rally for gold that could take its price to around $4,000 per ounce? Such a breakout will bring in “trend-followers” and momentum traders to drive the price of gold higher.

9. Geopolitics make gold more attractive to other nations: I need to hardly remind readers that we are still in the middle of a war where the assets of countries such as Russia have been frozen by the US and others. In such an environment a global economic catastrophe is likely to result in countries not aligned with the US to accumulate gold, which is no single country’s currency.

10. Deficits and impending taxes make gold attractive: for centuries those looking to hide

wealth from the taxman have resorted to buying bricks of gold. With government deficits running at unsustainable levels, and now the increased cost of fiscal bailouts, taxes will have to go up. In such an environment, gold becomes a safe harbor.

To repeat, I am not a gold bug. But whichever direction I look, it appears to me that all roads (finally) lead to gold. As an investor, I have to pay attention to the facts staring at me and take the action that I believe is right for my investment portfolio.

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In the epic poem the Bhagavad Gita, which forms the philosophical foundation of Hinduism, the warrior prince Arjuna is faced with an existential dilemma: he is dismayed to see that he has to go to war against his friends and kin to battle for right against wrong. His charioteer is none other than Lord Krishna, one of the incarnations of India's many deities, who advises him of his duty. Every Indian kid knows the lesson of the Gita: that "a warrior has to fulfill his duty by taking the right action"; i.e. when it comes to taking righteous action the philosophical dilemma is largely irrelevant. For me investing in gold has always been a dilemma. But for now it seems that gold's time might have come again, and whether or not I like it, as an investor the right course of action is to own it. And of course, all investments have risks that each investor has to properly evaluate, and no one investment is right for everyone. For me, today, on balance, an investment in gold seems to be worth the risk.

Important Disclosures

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