The original article is in German. This is a generic translation.

Why gold fails as inflation protection

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Gold has many fans. Especially among small investors, the yellow precious metal enjoys great popularity - also as a protection against inflation. But gold does not live up to its good reputation.

By Angela Göpfert, tagesschau.de

A widespread belief among private investors is that gold is an excellent inflation hedge. The reason is obvious: "Unlike paper currencies, gold has no central bank that can expand the supply at will by 'printing money' and thus dilute the value ," explains Commerzbank commodities expert Carsten Fritsch.

Rapidly rising inflation

Consumer prices have recently risen massively, with the inflation rate in Germany soaring by 5.3 percent year-on-year in December. The last time there was such a rapid increase was 30 years ago. In the USA, consumer prices rose by 6.8 percent in November - the sharpest increase since June 1982.

One might expect the gold price to be a natural profiteer in such an environment. But far from it: the gold price fell by around four percent in 2021. Gold was thus the commodity with the fourth lowest return - only palladium, silver and platinum performed worse.

"Gold does not pay interest"

"Gold is definitely no good as a hedge against inflation," emphasizes Mojmir Hlinka, investment expert at Swiss asset manager AGFIF International, in an interview with *tagesschau.de.* "As is well known, the best protection against inflation is cash flow - and gold has no cash flow. Gold pays no dividends, no coupons, no interest."

There has never been a better fundamental environment for gold than in recent years with all the crises from Lehman to the euro crisis to Corona, Hlinka emphasizes. "If the gold price doesn't explode in this environment, when will it?!"

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Advises stocks rather than gold:

Mojmir Hlinka, investment expert at Swiss asset manager AGFIF International.
Image: Musto Studios

Side effect of the Fed's tighter monetary policy

The image of gold as a "perfect inflation hedge" has definitely cracked. In the search for explanations for the miserable performance of the precious metal in the inflation year 2021, the strengthening dollar and rising interest rate expectations are cited above all.

The background to rising interest rate expectations is the ongoing tightening of monetary policy in the USA. This is likely to continue to weigh on the gold price in the newly started year. "The Fed minutes published in midweek signal that the Fed could become even more restrictive than assumed," says market expert Robert Rethfeld of Wellenreiter-Invest.

First US interest rate hike as early as March?

The path of interest rate hikes speculated on by the market now looks much more aggressive than it did just a few weeks ago. According to the CME's Fed Watch tool, the probability of a first rate hike as early as March 16 has risen to over 70 percent. The yield on ten-year US government bonds is rising to over 1.7 percent.

Relevant for the gold price is the so-called real interest rate, i.e. the nominal interest rate minus the inflation rate. According to the expectations of analysts and economists, the currently high inflation rates are likely to decline in the course of the year. The logical consequence is that the real interest rate will rise. However, a rising real interest rate makes gold less attractive for investors.

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Strong dollar as additional burdening factor

"The real interest rate becoming more positive again will weigh on gold in the first half of 2022," market expert Robert Rethfeld of Wellenreiter-Invest is convinced. "Because if our assumption is correct that the U.S. inflation rate will decline from six to three percent within the first six months of 2022, then the real interest rate can only move back toward the zero line."

Speculation on tighter U.S. monetary policy is also causing the dollar to appreciate - another factor weighing on the price of gold. A strong dollar makes the dollar-traded commodity more expensive and thus dampens demand for the precious metal from the non-dollar region. Investors who invest in gold are thus trading themselves into a foreign currency risk, AGFIF expert Hlinka warns.

Bars and coins popular, outflows in gold ETFs

Despite its recent weak performance, gold is more popular than ever with many investors. This is evidenced by investors' gold holdings at Deutsche Börse, which increased by 20.7 tons last year to a record 237.6 tons.

However, this is also shown by a look at the significantly increased demand for coins and bars in 2021. This form of gold investment is particularly popular with private investors. The large professional investors, on the other hand, tend to rely on gold ETFs; these suffered the largest outflows in eight years last year with 287 tons.

Media arouse interest in gold

AGFIF expert Hlinka explains why private investors in particular are investing in gold despite its poor performance as follows: "Investors make their decisions based on information that is most easily available. This is also called the availability bias."

Gold is very present in the media, no other commodity is reported on more. This suggests to people that this asset class is worth investing in. "Investors usually make their investment decisions psycho-logically rather than fundamentally and logically," says Hlinka.

Experts remain skeptical

Currently, the gold price is oscillating around the round mark of 1800 dollars. Experts do not have too much confidence in the gold price for the coming months. "The gold price should tend weaker in an environment of initially falling inflation rates. The mark of 1700 U.S. dollars is an important support," says market expert Rethfeld.

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BayernLB Chief Economist Jürgen Michels is similarly pessimistic about the prospects for the yellow metal. He expects the gold price to slide to 1650 dollars. Investment expert Hlinka is also cautious: "The gold price is likely to fluctuate between 1700 and 2100 dollars for the next few years."

Shares better than gold for returns

Things could be better for stocks: "Even if the Fed successively raises interest rates to 0.75 or 1.0 percent, that's still nothing in historical terms," Hlinka emphasizes. Investors who want to protect themselves against high inflation rates should therefore continue to turn to equities. There is no alternative to equities.

"There is no asset class that has had such success since the inception of the major indexes," Hlinka points out, also referring to the Dow Jones, which celebrated its 125th anniversary last year.

The US leading index has almost tripled in value in the past ten years alone. By way of comparison, the price of gold rose by around ten percent over the same period. Consumer prices in Germany have risen by over 15 percent since then. Those who invested their money in gold were therefore not even able to compensate for the loss in value due to inflation.

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