Edward Jones

How Precious Are Precious Metals?

MATERIALS SECTOR REPORT

For more information:

If you have any questions, please contact a local Edward Jones financial advisor, or write to: Edward Jones,12555 Manchester Road, St. Louis, MO 63131.

- We recommend long-term investors avoid gold and other precious metals and limit broad-based natural-resource investments to no more than 5% of their portfolios.
- In general, gold is a good barometer for fear. Currently, fear is heightened, with investors worried about the increasing potential of an economic recession due to central banks unwinding their accommodative monetary policy to fight high inflation.
- Gold's performance as an inflation hedge has generally been mixed over the years. If we look historically, gold has done well during periods when inflation increases considerably and is unexpected. Modest or expected inflation has a muted impact on the price of gold.
- For those concerned about potentially higher rates of inflation, we recommend a quality diversified portfolio of companies with pricing power and the ability to raise dividends over time, such as those on the Edward Jones Equity Income Buy List.
- One of our key concerns is related to understanding the true economic value of the commodity itself. The lack of cash flows, dividends and industrial uses make gold a very hard asset to value with any level of precision or confidence. As a result, prices are significantly influenced by changes in investor sentiment, which can result in higher levels of volatility.
- We believe changes in investment demand will be a source of volatility for gold. In 2023, investment demand (ETFs, gold bars, coins) made up roughly 21% of the market, down sharply from 49% of the market in 2020.
- Over time gold and other precious metals have had periods of outperformance, but in our view are not good long-term investments given their volatility, lack of any income stream, and the unpredictability of returns.
- While a small allocation of gold in a broadly diversified portfolio has historically provided a slightly higher return, this excess return was driven by two extended gold up-cycles and thus is very time dependent. A similar allocation to a broad-based commodities index (i.e., the GSCI Index) has provided an even better return and lower standard deviation without taking on the risk of owning a single commodity.

Analyst: Faisal Hersi, CFA

Please see important disclosures and analyst certification on page 4 of the report.

Gold Has Seen Some Exceptional Performance

After reaching a 20-year low of $252.80/oz. in 1999, gold prices have rallied to $2,261/oz. today. We attribute much of this long ascent to an extended period of accommodative monetary policy, global financial instability, central-bank-buying activity, and increased investor participation.

How Did We Get Here?

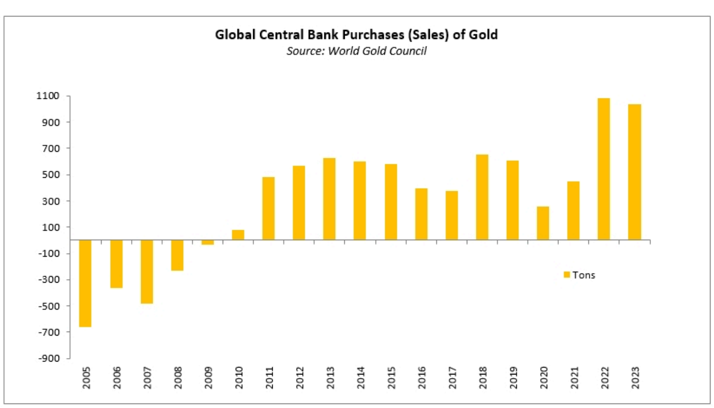
Dovish Monetary Policy Put Upward Pressure on Gold Prices

We believe the start of the gold rally can largely be traced back to dovish (accommodative) monetary policy decisions made in the mid-2000s. In response to the financial crisis of 2008, central banks around the world took unprecedented actions (at the time) to further increase the money supply in order to keep interest rates low and encourage capital investment. Gold prices moderated as central banks began unwinding their accommodative policies, but have since roared back toward their highs following the COVID-19 stimulus that was even more significant than the financial-crisis response.

Central Banks Have Become Net Buyers of Gold

Central banks across the world hold gold as a reserve asset along with other foreign currencies, most notably the dollar and euro. We believe the way central banks look at reserve management has changed considerably over the past couple of years. Prior to 2008/2009, central banks across the world were net sellers of gold, which effectively increased the supply base of gold. However, as the global financial crisis began to take hold in 2008, central banks reversed course and became net buyers of gold in order to reduce exposure to foreign currencies and diversify their holdings (**See Figure 1**).

Figure 1



2023 marked the 13th straight year of net purchases by central banks, and this fundamental shift in central-bank buying patterns has served as a positive catalyst for gold prices. Central-bank purchases can be lumpy and are very difficult to forecast, but we believe central banks will likely diversify their reserve bases.

Investment Demand Driving Prices Higher

Traditionally, the primary source of demand for gold came from consumer purchases of gold jewelry, which represented roughly 80%-90% of demand, while investment and industrial uses made up the rest. Since the financial crisis, gold has become much more of an investor-driven market. Investment demand (exchange-traded funds [ETFs], gold bars, coins) reached a high of 49% of the market in 2020, up from just 15% in 2005.* The popularity of gold ETFs pushed prices higher. We believe the role of investment demand opens the door for increased volatility should gold fundamentals turn less positive and should flows into gold subside.

Where Are We Today?

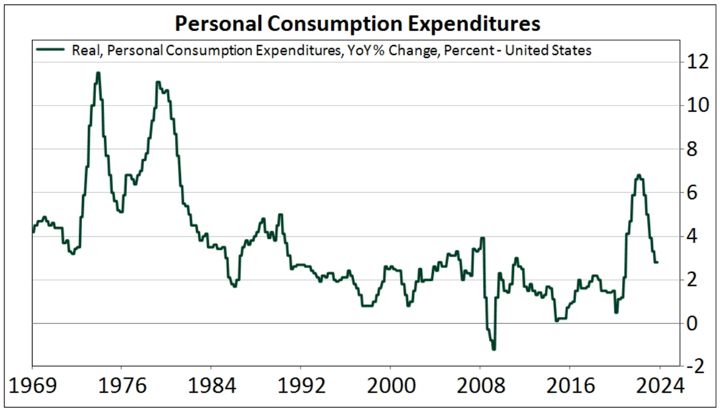
The "Fear Trade" Has Gold Elevated

In general, gold is a good barometer for fear. Currently, fear is heightened, with investors worried about the increasing potential of an economic recession due to central banks unwinding their accommodative monetary policy to fight high inflation. While the environment for gold prices is currently favorable, we see more pro-growth assets, such as equities, as better long-term investments against future uncertainty.

Inflation Heating Up, but Likely to Moderate

If we look at the Personal Consumption Expenditures Index (the Fed's preferred measure of inflation - **Figure 2**), inflation has risen as a result of central bank stimulus and the labor and materials shortages caused by the COVID-19 pandemic. While investors are concerned that higher inflation could persist, central banks are quite aware of this risk and are rapidly unwinding their accommodative policies to cool economic growth and pricing pressures. As a result, inflation has begun to moderate.

Figure 2: Personal Consumption Expenditure Price Change



Source: FactSet. Past performance is no guarantee of future results.

Gold's performance as an inflation hedge has generally been mixed over the years. If we look historically, gold has done well during periods when inflation increases considerably and is unexpected. Modest or expected inflation has a muted impact on the price of gold. For those concerned about potentially higher rates of inflation, we recommend a quality diversified portfolio of companies with pricing power and the ability to raise dividends over time, such as those on the Edward Jones Equity Income Buy List. Over the long term, we see more value creation in owning productive assets as opposed to gold.

What's It Worth?

One of our key concerns is related to understanding the true economic or fundamental value of the commodity itself. Gold doesn't produce cash flow or pay dividends, which makes it very difficult to value. Furthermore, unlike other commodities, gold is driven largely by currency movements, changes in interest rates, and central-bank activity, all of which are very difficult to forecast. Other commodities such as oil, copper and coal are driven off of general levels of supply and demand as well as end-market demand. For example, after oil is discovered and extracted, it is consumed, while all of the gold ever mined remains in circulation today. Gold is accumulated and stored as opposed to being consumed.

At a very fundamental level, an enterprise or asset's value is equal to the discounted value of all future cash flows. Companies that produce a product, sell it and recognize cash flow or profits related to that sale. They expand operations, acquire new businesses, and create new products, all of which, over time, are done with the goal of increasing shareholder value (i.e., a higher stock valuation). The company's theoretical value is the present value of all of those future cash flows. The lack of cash flows and industrial uses make gold a very hard asset to value with any level of precision or confidence. Without fundamental indicators to rely on, gold prices ebb and flow based on currency movements, inflation expectations, and events that cause panic and uncertainty, all of which are difficult to forecast.

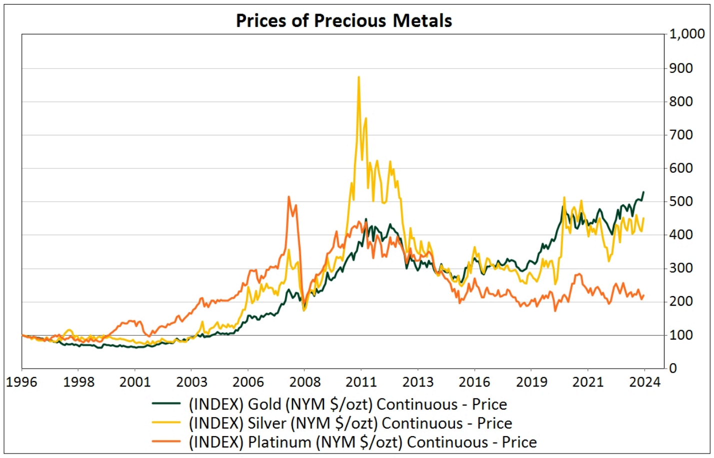
Does Gold Add Value to a Portfolio?

In an effort to answer this question, we created hypothetical portfolios and looked at performance over the past 40 years to better understand the role (if any) gold plays in the context of a diversified portfolio. We examined three main portfolios, one with an allocation of simply stocks and bonds, one with a 5% allocation to gold, and one with a 10% allocation to gold. Over the 40-year time period from 1980 – 2020, we found the portfolios with either a 5% or 10% allocation to gold had slightly lower returns as compared with the stock and bond portfolio, but they also had a lower standard deviation (a measure of volatility). So, looking historically, a small ownership position in gold has provided slightly less volatility in portfolio returns as compared with a portfolio of simply stocks and bonds, but with slightly lower returns.**

Other Precious Metals

While gold is certainly the most familiar of the precious metals, we also took the opportunity to look at silver, platinum and palladium (the other main precious metals). If we look historically, all of the precious metals tend to be fairly correlated with one another **(Figure 3)**. However, we found silver, platinum and palladium prices were significantly more volatile compared with gold prices. In the case of silver and palladium, they were roughly twice as volatile (as measured by standard deviation) as gold going back to 1996. We don't view any of the precious metals as good long-term investments, and we recommend long-term investors avoid gold and precious metals and limit broad-based natural-resource investments to no more than 5% of their portfolios.

Figure 3



Source: FactSet. Past performance is no guarantee of future results.

A Better Alternative

In performing the same exercise as described above, we found that a similar allocation to a basket of broad-based commodities, such as those present in the S&P GSCI (Standard & Poor's Goldman Sachs Commodities Index), yielded a better return than the addition of gold to a portfolio while also lowering the standard deviation of returns, without taking on the risk of owning a single volatile commodity (i.e., gold). The GSCI serves as one of the best benchmarks for investments in commodity markets and as a measure of overall commodity performance. The GSCI is a diversified index with positions in many commodities including energy (oil & gas); agriculture (wheat, corn, soybeans, coffee, sugar, cocoa and cotton); livestock (hogs, cattle); industrial metals (aluminum, copper, lead, nickel, zinc); and precious metals (gold and silver). Commodity and stock market cycles rarely overlap, which allows for additional diversification and the potential for better long-term returns. Diversification is one of the best ways to help reduce risk in a portfolio and help protect against large portfolio swings in the event of weakening economic fundamentals. Given the low correlation with the broader markets and competitive returns, a small allocation to commodities has proven over time to improve portfolio returns and lower standard deviation, especially during inflationary periods.**

Conclusion

We don’t believe gold or other precious metals are good long-term investments, and we recommend investors avoid them. Over time gold has periods of outperformance, but, in our view, it is not a good long-term investment vehicle given the high volatility, lack of any income stream (gold does not pay a dividend), and unpredictability of returns. We think choosing the right time to buy and sell is very difficult, and unless you choose correctly, gold's long-term returns have been poor.

Furthermore, we believe many of the tailwinds gold has enjoyed over the past decade will likely turn into headwinds over the next couple of years, pressuring prices and limiting any potential diversification benefits. As an alternative, we believe owning a diversified basket of commodities has the potential to improve returns and lowers portfolio risk. However, we would limit broad-based natural-resource investments to no more than 5% of your portfolio.

* Source: World Gold Council

** Past performance in not a guarantee of future results.

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