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Market Ethos

The latest market insights from Richardson Wealth

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Not all that glitters is gold

The usual spin on why you should own some commodity exposure in a diversified portfolio is pretty standard – a little bit of diversification but most importantly, inflation protection. Looking at the past five years, that certainly adds up. We have all lived through one of the highest inflationary environments in decades and just look at how gold and commodities stacked up in the following abbreviated performance quilt. In fact, gold took the #1 spot as often as the mighty S&P 500. Commodities too, as measured by the Bloomberg Commodity Index, certainly saw strong performance in 2021 & 2022, the years in which inflation was rising the fastest.

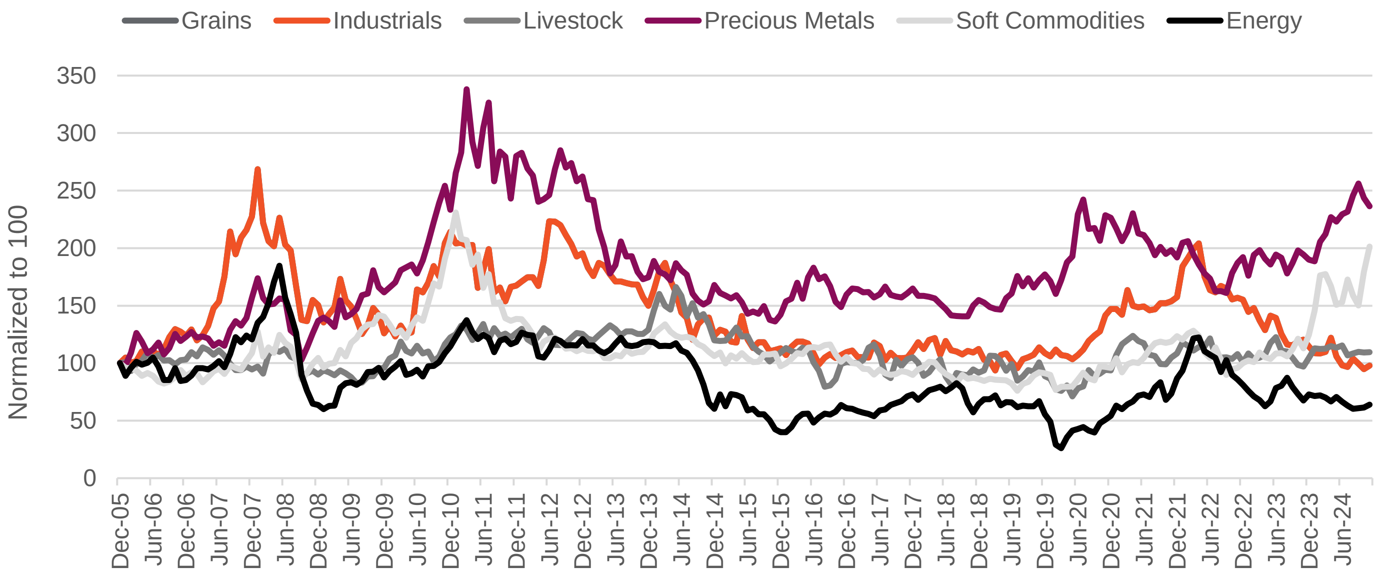
2020	2021	2022	2023	2024
Gold +23	S&P 500 +27	Commodities +22	S&P 500 +23	Gold +39
S&P 500 +16	Commodities +26	Gold +7	TSX +12	S&P 500 +36
World exUS +11	TSX +25	TSX -6	World exUS +12	TSX +22
Cdn Bonds +8	World exUS +7	World exUS -10	Gold +10	World exUS +16
US Bonds +8	US Bonds -2	Cdn Bonds -11	Cdn Bonds +7	Commodities +9
TSX +6	Cdn Bonds -3	S&P 500 -12	US Bonds +6	Cdn Bonds +4
Commodities -5	Gold -5	US Bonds -13	Commodities -15	US Bonds +1

Source: Bloomberg, Purpose Investments

It is still too early to tell if we are out of the current inflationary episode, with inflation remaining a concern both domestically as well as across other international developed countries. Given the current level of macroeconomic uncertainty, tariffs/retaliatory tariffs and renewed nationalism, rising cost pressure remains a key concern for households as well as businesses. Trying to follow the increasingly vocal ‘Buy Canada’ mantra certainly isn’t going to help the wallet. Inflation expectations have been rising, with two-year breakeven rates now back above 3%, up 154 bps since September.

With inflationary pressures back on the rise, inflation ‘proofing’ portfolio remains popular. It’s impossible to talk about inflation protection and not mention real assets. It is an age-old market truism in fact that real assets, in particular commodities are a standout asset class for inflation protection. The only issue with old market sayings, is that they are not always entirely true.

20 Years of Commodity Prices in Real Terms



Source: Bloomberg, Purpose Investments

In the chart above, we have plotted the real price performance of twenty major commodities grouped into key categories. A few insights stand out immediately. One, commodities are cyclical meaning they move in defined cycles. **They are not buy-and-hold forever investments.** Two, **commodities are volatile**. Within a short period of time, commodities surge higher then subsequently crash back down. Finally, not all commodities are good inflation hedges. In fact, over the past twenty years, gold and precious metals appear to be the only commodity that has done an admirable job at protecting purchasing power and increase in real value.

In real terms, Energy, Grains and Industrial metals have all lost value over the past twenty years. Natural gas certainly skews the energy complex with Henry Hub gas prices down 75% in real terms. We all like to complain about the price of gas, however in real terms a barrel of West Texas Intermediary is down nearly 30%. Grains have held onto their value, with the basket only down a couple of percent in real terms. Soft commodities have done well recently but it's not an inflation protection story but a supply driven circumstances driving coffee prices up nearly two-fold in the past year. Each commodity market reacts to its own idiosyncratic supply and demand circumstances.

Gold is up over 10% YTD reaching a new all-time high

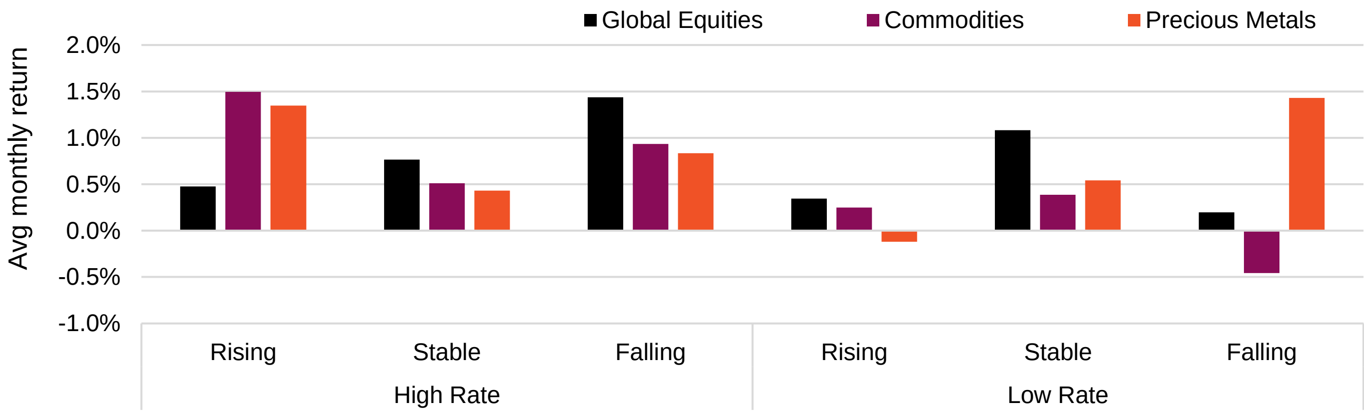
Source: Bloomberg, Purpose Investments

To broadly state commodities are great inflation hedges is not entirely correct. Over the long term, many commodities do not broadly hold up against inflation. Simply holding up to inflation is a very low bar to begin with, and many can't even get past that. Gold and precious metals are an exception. Gold should be the preferred choice when the aim is for longer term inflation protection. You also get the added benefit as one of the defacto safety trades. Despite equity markets showing little regard to surrounding market uncertainty, gold (the original fear index) has been surging, up over 10% so far this year to reach new all-time highs. With few other headlines behind this advance that coincides with a surging U.S. dollar, it does leave us wondering what the gold market is trying to tell us.

Gold very often moves ahead of inflation, so perhaps there is another upward move coming for general prices. Then again, the list of reasons gold has been rising are a plenty from Chinese buying to fear over all the political headlines. Our view has remained consistent, the inflationary spike exacerbated by the pandemic reverberations would fade in 2024. But inflation would not go back down to previous levels due to structural factors and would become a more volatile recurring problem during the coming years. Perhaps it is coming back now.

The good news for commodities today is rates are high. During high rate periods, commodities & gold tend to do better than in low rates environments. And if we get a surprise resurgence of inflation, rates will tick higher, even better for commodities. The chart below slices returns into high and low rate environments, then breaks things down based on the direction of rates.

It is the direction of rates & inflation that matters



Source: Bloomberg, Purpose Investments

Final thoughts

During periods of elevated inflation or higher rates, commodities do tend to perform well, adding value to a portfolio. And that does appear to be the current market environment. However, commodities should not be viewed as a static allocation given long-term inflation protection is limited and cyclicality is high. Gold does appear better, with less economic cyclicality and a safe haven factor. But at $2,850/oz this party has been going on for a while.

One additional consideration, the TSX does carry a good amount of gold exposure (8%) and other commodity exposure (20%). This is one of the reasons the TSX tends to often outperform broader equity markets in higher inflationary environments.

However you get your inflation protection, at this time we continue to believe some is warranted in portfolios.

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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*This report is authored by Craig Basinger, Chief Market Strategist at Purpose Investments Inc. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.

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