WEEKLY CLIENT COMMENTARY | DECEMBER 5, 2023

Mitch on the Markets

Portfolio Manager Investing Insights

Investors are Again Eyeing Gold. Is it a Good Investment?

Gold is back in the headlines, as prices have jumped to record highs. As of last Friday, the front-month futures contracts for gold closed at $2,071 a troy ounce, which meant gold prices exceeded their peak reached in August 2020 (at the height of Covid-19 uncertainty).

This move has gold enthusiasts clamoring over the investment benefits of the precious metal, particularly at a time when fears over rising deficits and ballooning interest payments have many concerned about the U.S.'s fiscal situation. It's also true that markets are starting to price in interest rate cuts sometime in 2024, with inflation-adjusted bond yields in decline as a result. Since no-yield gold would arguably have less competition in a falling rate environment, many investors see this factor as giving gold a bit more 'shine.'[1]

My message here is to think twice.

For one, if we strip out the impact of inflation on gold's rising price, i.e., we find that gold is still about 13% below its 2020 peak (as of the end of November) in real terms. Second, if we are to believe that falling rates are good for gold looking forward, then we should expect that the historical correlation between gold and interest rates – as measured by the 10-year U.S. Treasury bond – should be close to -1.00. In fact, since 1973 when gold started trading freely in the open market, the correlation is less than -0.10.

When considering gold as an investment, there's simply no comparison to stocks' performance over the long term. Not only has gold been highly volatile over time, but U.S. stocks' outperformance of gold since the early 1970s is nowhere near a close race. From 1973 – 2022, the geometric average historical return for gold was 6.91%, compared to the risk-free return of 6.12% for 10-year U.S. Treasury bonds. For stocks, it was 10.24%.

For investors seeking to generate solid positive returns from investment in gold, it's all about precision timing – a very difficult feat to achieve. Getting gold decisions right in the mid-70s and mid-80s would have paid off, and going long in 2005 but getting out in 2012 would have generated strong returns, too.

ABOUT MITCH ZACKS

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Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

But many other periods over this long-time span would have generated lackluster or negative returns often with volatile rides, a less than desirable outcome for investors. For instance, over the last 10 years, the geometric average historical return for gold was a paltry 0.96%, while for stocks it was 12.44% over the same time frame.

As for gold's new all-time high, it's important to point out that in all the time it took gold to surpass its August 2020 high mark, stocks as measured by the S&P 500 are up over +40%. In that time, we know corporate profits have risen strongly and that a tremendous amount of new value has been created in the economy. Buying stocks gives investors a share in that earnings growth while buying gold does not. Gold does not generate earnings, pay investors a yield, or even have many industrial applications. I'd make a similar argument about cryptocurrencies.

A person could certainly choose to try and time investment decisions on when to get in and out of gold, but history suggests this is not an optimal approach.

CONCLUSION

Over time, gold's performance simply does not hold up relative to stocks, and I would argue that bonds offer far better risk-adjusted returns given gold's historical volatility. This is not to say that gold cannot outperform going forward – it certainly could. But a few realities remain that might inhibit gold from becoming a better investment than stocks:

- Gold doesn't generate earnings;
- It doesn't pay dividends;
- It doesn't create new products or services that add value to the economy; and,
- It hasn't consistently, over time, delivered long-term attractive returns to investors.

At the end of the day, gold might be a useful asset in small allocations for diversifying a portfolio – maybe. But investors should use caution if or when considering it as a major investment holding, in my view. Gold is an asset with historically high volatility and relatively weak returns.

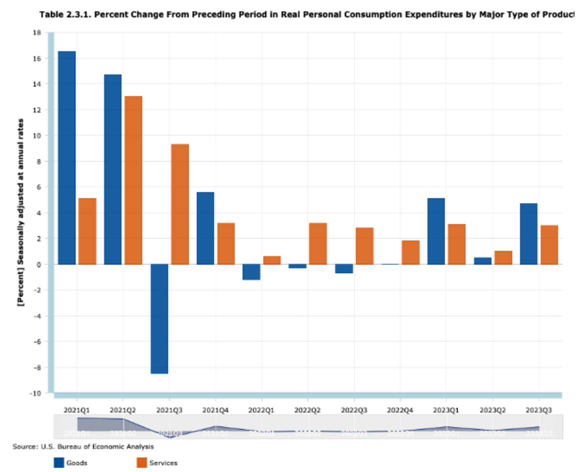
[1] Wall Street Journal. December 5, 2023. https://www.wsj.com/livecoverage/stock-market-today-dow-jones-12-05-2023/card/gold-prices-looked-brighter-in-2011-and-1980-5ZbluD61VnmVwua9nRpl?mod=lctimeline_finance

STEADY INVESTOR WEEK

- **Current inflation ease**
- **OPEC+ cuts production**
- **Earnings estimates are falling**

Slower Spending, Softer Inflation

U.S. economic trends in consumer spending and inflation might be best summarized with a single word: downshifting. On the spending front, Americans bought less furniture, clothes, and vehicles in October, with consumer spending rising 0.2% in October compared to September's stout 0.7% month-over-month increase, according to the Commerce Department. October's pace of increased spending was the slowest since May, as consumers saw personal incomes rise 0.2% in October compared to September's 0.4% increase. While spending softened a bit in October, inflation also continued in a downtrend. The Federal Reserve's preferred inflation gauge, the personal consumption expenditures (PCE) price index, rose 3% year-over-year in October, a meaningful decline from the previous month and below the long-term average for inflation. Core prices rose at a 2.5% six-month annualized rate, which is a significant step down from the 4.5% rate for the six months through April. All told, it's clear to see below that inflation-adjusted consumer spending has moderated in recent quarters[1]:



BEA[2]

In our view, investors should not read too much into the soft consumer spending reading. For one, it still marked growth from the previous month. But second, consumers still showed robust spending patterns in areas like travel, where spending on trips abroad rose by 5.8%. Americans also spent more on concerts, museums, healthcare, and other areas. It's also true that many Americans may have just been waiting for deals to arrive in November. Consumers spent $38 billion in the five-day Thanksgiving period through 'Cyber Monday,' up 7.8% from 2022 levels.

OPEC+ Cuts Production Again, But Oil Prices Aren't Rising

Saudi Arabia and other OPEC+ nations have continued to pursue production cuts throughout 2023, with the latest round calling for cuts of an additional million barrels a day. Oil prices barely budged. Since late September, the global price of a barrel of oil is down around -20%, despite Saudi and Russian attempts to curb global supply. The latest announcement has a few features that have not – at least to date – had the intended effect of putting upward pressure on oil prices.

For one, the cuts are voluntary, and traders do not seem to be convinced that major oil-producing nations like the United Arab Emirates, Nigeria, and Angola are going to sign on. Another factor to consider is that the U.S. is the world's largest oil producer, and other nations can also step in to add supply to the market to replace lost OPEC+ production. The final factor is global economic demand, which is expected to slow in 2024 as global growth downshifts in response to higher interest rates.[3]

How Two Companies are Largely to Blame for Falling Earnings Estimates

With Q3 earnings season drawing to a close, investors like to scrutinize how companies adjust their forecasts for Q4. In any given year, the expectation is that companies will lower earnings forecasts, usually as a means to lower the bar. Over the last 10 years, for instance, companies have lowered earnings estimates by 1.8%, on average. In Q3 2023, however, S&P 500 companies have cut projections by 3.9%, more than double the 10-year average. Two companies are largely to blame – pharmaceutical giants Pfizer and Merck. Pfizer made a major adjustment to earnings with revenues from the Covid-19 vaccine expected to bring in $9 billion less than anticipated, and Merck reduced forecasts due to a $5.5 billion charge related to a deal with Japanese drugmaker Daiichi Sankyo. The good news here is that if Pfizer and Merck's estimates are removed from the S&P 500 totals, earnings expectations essentially fall back to the 10-year average.[4]

[1] Wall Street Journal. November 30, 2023. https://www.wsj.com/economy/consumers/inflation-consumer-spending-personal-income-october-2023-6a1ecb1d?mod=djemRTE_h

[2] BEA. 2023.
https://apps.bea.gov/iTable/?reqid=19&step=2&isuri=1&categories=survey&_gl=1*q8w689*_ga*MjQ0ODg0OTgyLjE3MDE3MjMzNjA.*_ga_J4698JNNFT*MTcwMTcyMzM2MC4xLjEuMTcwMTcyNTAwOC4wLjAuMA..#eyJhcHBpZCI6MTksInN0ZXBzIjpbMSwyLDNdLCJkYXRhIjpbWyJjYXRlZ29yaWVzIiwiU3VydmV5Il0sWyJOSVBBX1RhYmxlX0xpc3QiLCI2MSJdXX0=

[3] Wall Street Journal. November 30, 2023. https://www.wsj.com/business/energy-oil/opec-agrees-to-significant-oil-production-cut-c8c6c131?mod=djemRTE_h

[4] Wall Street Journal. November 30, 2023. https://www.wsj.com/finance/stocks/earnings-estimates-are-falling-these-two-companies-are-shouldering-the-blame-4bcb68f1?mod=djemMoneyBeat_us

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