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The Case Against Dumping Bonds for Gold in '60/40' Portfolios

- **Bonds questioned as a hedge with yields at rock-bottom levels**
- **Gold's rise alongside stocks makes it an imperfect substitute**

By Katherine Greifeld

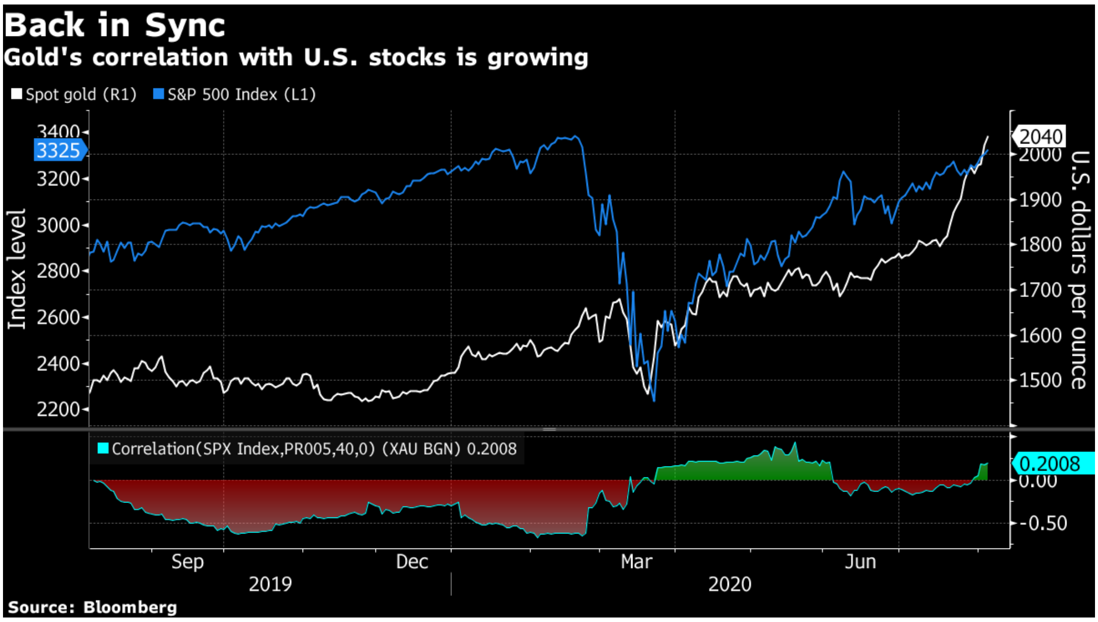
(Bloomberg) -- Gold's growing popularity as a bond substitute in the world's most prevalent investment strategies may be the metal's undoing, at least as far as using it as a hedge is concerned.

With Treasury yields at historic lows, Goldman Sachs Asset Management and Morgan Stanley are among the ranks openly questioning whether bonds still serve as an effective hedge for equities. In the traditional portfolio mix of 60% stocks and 40% fixed-income -- a bedrock principle of investing for decades -- bonds now have less room to rally and thus can't cushion equity losses as well as in years past, the argument goes.

That's shone a light on gold, which has rocketed to record highs as yields plummet. Bridgewater Associates LP -- which helped popularize risk-parity strategies -- said in a report last week that the hedge-fund firm is increasingly using bullion and inflation-linked debt to balance equity risk in place of nominal bonds.

But a significant push to use gold as portfolio insurance may create a self-reinforcing spiral that upends the metal's appeal as a hedge. Treasury yields are chiefly driven by expectations for Federal Reserve policy changes and the inflation outlook. Gold doesn't have a similar anchor, according to EIA All Weather Alpha Partners' Naufal Sanaullah. Bullion prices are much more sensitive to investor positioning than Treasuries, which means that gold may move in closer lockstep with stocks should it be adopted in a big way -- defeating the purpose of using it as a hedge, he warned.

"If enough portfolios are attempting the 'financial alchemy' of replacing government bonds with gold for risk parity, gold and stocks become increasingly correlated," said Sanaullah, the firm's chief macro strategist. "On risk-off episodes, gold can actually fall."



The relentless drive into gold-backed exchange-traded funds illustrates the impact of positioning on the metal's price. Over the last decade, the quarterly correlation between gold ETF flows and bullion prices is roughly 0.8. As a result, record amounts of cash flowing into gold ETFs has become a bigger driver of the metal's price than positioning in the futures market, where traders haven't been as enthusiastic.

Long-term Treasuries have soared nearly 28% this year after the coronavirus roiled global markets, forcing the Fed to slash interest rates to near-zero levels and pump liquidity into the economy. That's also fueled a rebound in stocks, with the S&P 500 up over 3% year-to-date after plunging into a bear market in March. All told, a portfolio of 60% U.S. equities and 40% bonds is up nearly 7% so far this year after posting 22% gains in 2019.

Those types of returns might be difficult to replicate: With benchmark 10-year Treasury note yields below 0.5%, there's not much further to fall. And with Treasuries yielding next-to-nothing, the income advantage over gold shrinks.

"One of the knocks on gold has always been its lack of income," said Dan Suzuki, the deputy chief investment officer at Richard Bernstein Advisors. "But with interest rates so low, and a significant portion of fixed income securities with negative yields, that argument is less meaningful today."

But the fact that gold has ripped higher alongside equities over the past several months is proof that the two assets are too correlated to hedge each other, according to BNY Mellon Investment Management's Liz Young. Gold has surged a stunning 114% since March 23, while the S&P 500 is 49% higher over that period.

"You still need bonds in the portfolio. Are Treasuries going to be the best juice for the squeeze? Probably not," said Young, director of market strategy. "You could use things like investment-grade corporates -- I think there's a lot of options in that space."

Of course, Treasuries weren't the perfect hedge during the throes of March's turmoil, when U.S. equities fell into the swiftest bear market on record. The cash crunch that ensued saw yields climb as investors sold even their high-quality holdings in an effort to raise funds. At one point, Treasuries and stocks suffered their worst combined losses since 2008.

But the unprecedented nature of the virus and the magnitude of the Fed's response means that such an episode isn't likely to be repeated, according to JPMorgan Chase & Co.

"For Treasuries to lose their hedging properties more broadly, such a market impairment would be need to be a regular occurrence during equity-market corrections," analysts including Nikolaos Panigirtzoglou wrote July 31. "Given the Fed's emerging role as market maker of last resort, it is unlikely in our mind that such a breakdown in Treasury market functioning would become the norm during equity corrections."

--With assistance from Eddie van der Walt.

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