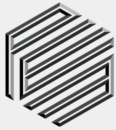

PALUMBO
WEALTH MANAGEMENT
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Weekly Commentary

July 06, 2020

Chief Investment Office PWM | 06 July, 2020
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Gold in Investment Portfolios

Pandemic news has consistently been the top headline producer this year, but at the close of the second quarter, the news turned back to stocks as **the stock market had its best second quarter since 1998**, with SPY, the S&P 500 ETF, gaining 17.1% in the quarter. Meanwhile, gold has been quietly rolling along, with GLD, the physical gold ETF, rising 13% in the quarter, but generating relatively few headlines.
We think gold deserves a little more respect. Afterall, GLD is up 17.1% for the first half of the year while SPY is down 4.2%, despite the big second quarter stock market run. Big declines often beget big rebounds. We thought this was an opportune time to step away from the headlines for a few minutes and talk about gold, it's place in the investment world, and its place in a diversified portfolio.
It has been almost 100 years since John Maynard Keynes, the father of modern economics, called the gold standard, and therefore gold itself, a 'barbarous relic'. In less than 10 years' time from Keynes comment, **FDR was addressing the great depression and taking the first steps off the gold standard when he ordered America to turn in all their gold coins, gold bullion and gold certificates within a months' time**, to be replaced with new Federal Reserve Notes (See the picture below.) The established penalty was a $10,000 fine or 10 years imprisonment! To put that penalty in perspective, $10,000 in 1933 has an equivalent value today of almost $200,000! Make no mistake, FDR was serious about getting that gold. **The problem FDR faced was that the peg of the dollar to gold made it extremely difficult to increase the money supply without having more gold to back it.** Removing the convertibility of dollars into gold solved that problem.

POSTMASTER: PLEASE POST IN A CONSPICUOUS PLACE.—JAMES A. FARLEY, Postmaster General

UNDER EXECUTIVE ORDER OF THE PRESIDENT

Issued April 5, 1933

all persons are required to deliver

ON OR BEFORE MAY 1, 1933

all GOLD COIN, GOLD BULLION, AND GOLD CERTIFICATES now owned by them to a Federal Reserve Bank, branch or agency, or to any member bank of the Federal Reserve System.

Source: History.com

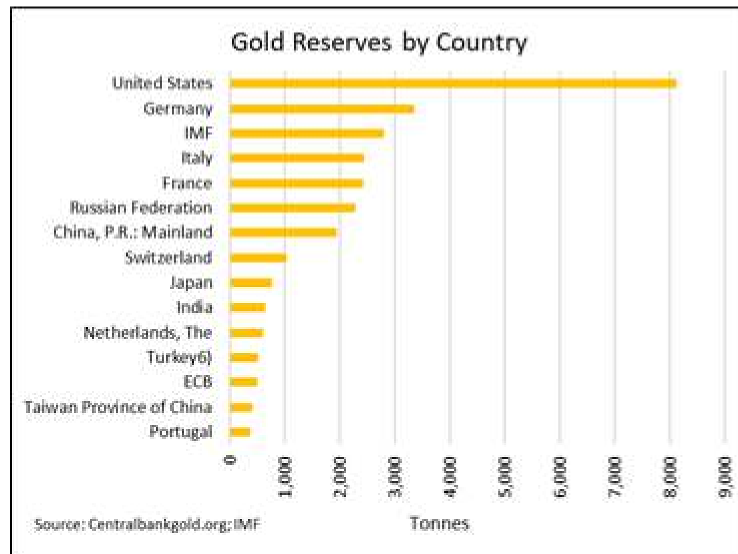
Executive Order

After 1933, dollars were still convertible into gold for central banks only and the dollar was generically 'backed' by the U.S. gold reserves. The gold standard came to a complete end in 1971 when President Nixon cancelled the remaining convertibility of dollars into

gold, making the dollar a true fiat currency, meaning that the dollar was simply deemed legal tender by the government but was not backed by any commodity, such as gold. **The value of fiat currency is based purely on the trust and faith users have in the value of that currency.**
If we have removed the interconnectedness of gold and money, the logical question is then 'why do I have it in my portfolio?' There are actually several answers to that question:

1. Commodities are a part of any truly diversified portfolio and gold is a commodity, therefore it deserves a position in a diversified portfolio. Gold may not be connected to money, but it is used for jewelry and electronics and therefore still has value. **The attraction of gold in a portfolio is that the fluctuations in the value of gold are not correlated with other asset classes, like stocks and bonds. As a result, gold is a very efficient diversifier for portfolios.** Over the 20-year period 1999 through 2019, the correlation of gold and the S&P500 was roughly zero – completely uncorrelated. (Correlation is a value that can range from -1 to 1. Correlation of 1 is perfect positive correlation, i.e. the assets move the same way and -1 is perfect negative correlation, the assets move the opposite way. A correlation of zero means that they move independently of each other.)

2. Although gold has been technically de-coupled from money, in many ways, **gold is still money**. **Consider how central banks support the value of their currency – they own gold!** Central bank gold reserves are tracked and published by the IMF and the amount of gold is considered strong support for that currency. Of course, there are other factors that support currencies, including the overall strength of the economy as well as the debt level, but **if central banks use gold to protect the value of their currencies, then gold is still money.**



3. Because fiat currencies are based on the faith and trust of the public in the value of that currency, anything that happens that shakes that confidence, (like pandemics or financial crisis) either long term or short term, is typically reflected in the price of gold. Thus, **gold is not only a diversifier, but can also provide some protection against a decline in the value of fiat currencies**.

Gold is often mentioned as an inflation hedge and in the short term that has not always been true, but over the long term, because we can't make any more gold, and we can and do make lots of additional dollars gold has generally been an effective hedge. Think of it this way, **in 1930, a kilo of gold could buy you a new Chevy. Today, a kilo of gold can buy you… a new Chevy. You can't say that about the dollar.** Gold plays a small, but very important role in our portfolio models serving as a strong diversifier as well as offering some protection against disaster. We thought you should know.

The Issue of Price Discovery in a 'Managed' Market
We came across some data this week that had us thinking. **Have markets really calmed down, or have we just medicated the markets to the point where they just don't care?** Functioning markets operate in a free exchange of buyers and sellers and in that process, a market price is established. **When governments inject themselves into markets with motivations very different from buyers and sellers, the market price can be lost and we end up with a manufactured price.** We have wondered about this on numerous occasions and that feeling came roaring back this week when the FED disclosed its bond ETF holdings. (Recall that as a way to calm markets from the pandemic scare, the FED has been in the market buying fixed income securities, including ETF's.)

The numbers are rather surprising. **For five ETFs the Fed accounted for over 45% of the net inflows to each of those funds for the period from May 12 to June**

16, acquiring a total of some $2.7 billion of those five funds. In several cases, the FED is now among the five largest owners of these ETF's and owns over 3% of eight different funds, shown in the table below.

Ticker	Fund	Shares Purchased*	Market Value as of June 18, 2020 ($M)	Total Net Flows, as of June 18, 2020 ($M)	% of Net Flows Accounted for by the Fed	Fed Purchases as % of Total AUM
SPIB	SPDR Portfolio Intermediate Term Corporate Bond ETF	11,104,934	404.7	671.4	60.30%	6.50%
VCSH	Vanguard Short-Term Corporate Bond ETF	15,857,256	1307.9	2551.9	51.30%	4.60%
SPSB	SPDR Portfolio Short Term Corporate Bond ETF	7,577,680	237.3	466.3	50.90%	3.60%
IGSB	iShares Short-Term Corporate Bond ETF	11,127,904	607.8	1245.6	48.80%	3.40%
USIG	iShares Broad US Dollar Investment Grade Corporate Bond ETF	2,502,168	150.4	321.1	46.80%	3.20%
SLQD	iShares 0-5 Year Investment Grade Corporate Bond ETF	841,975	43.8	136.3	32.10%	2.00%
LQD	iShares iBoxx US Dollar Investment Grade Corporate Bond ETF	13,316,690	1783.0	5885.7	30.30%	3.30%
VCIT	Vanguard Intermediate-Term Corporate Bond ETF	10,895,898	1037.1	3782.5	27.40%	2.90%
JNK	SPDR Bloomberg Barclays High Yield Bond ETF	3,991,415	411.9	2197.0	18.70%	3.50%
IGIB	iShares Intermediate-Term Corporate Bond ETF	6,606,823	398.0	2297.3	17.30%	3.70%

Sources: Federal Reserve, ETF.com; data from May 12 to June 16

Over the roughly one month, the Fed purchased about $6.8 billion worth of corporate bond ETFs, primarily investment grade, but also dipping into high yield (junk) bond funds. This $6.8 billion is only a small part of the $250 billion the FED is authorized to use. The FED is also buying individual bonds, but it is very clear that the FED still has plenty of dry powder if it desires to keep at it.

The question is like so many others as we attempt to manage our way through each crisis – **does the short-term fix create a more difficult long-term cure?** In this case, we can't help but wonder about two things:

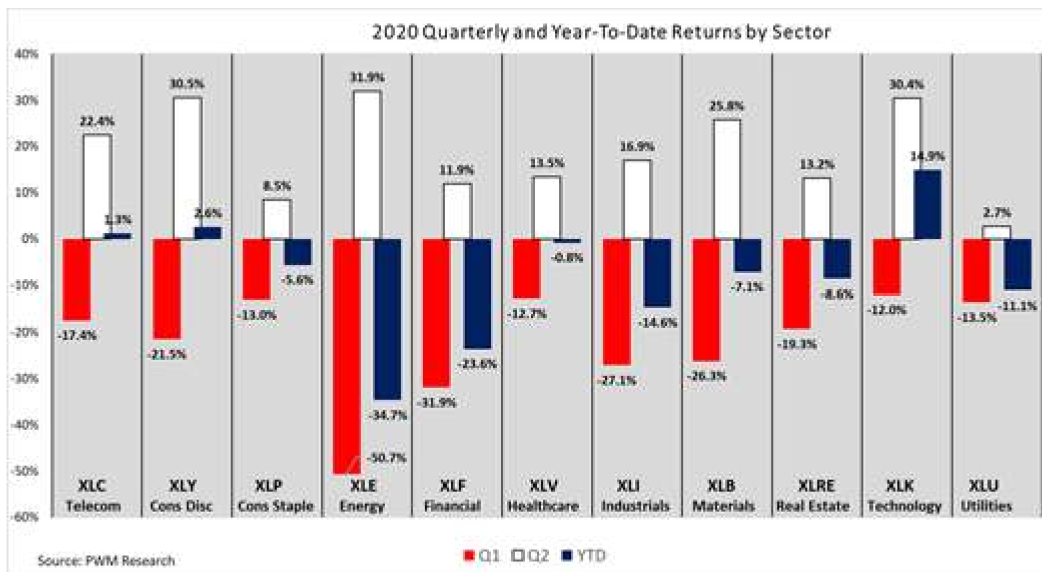
1. **How 'recovered' would markets be without this FED buying activity?**
2. **What happens when the Fed decides to sell these positions?**

It is clear that the FED has been a substantial part of the market activity over the last month and that has to have an impact on prices. How do we know where the real market price is? Have we distorted our perception of value in the process? **Is the current price real or is it an illusion that we will have to confront when the FED exits?**

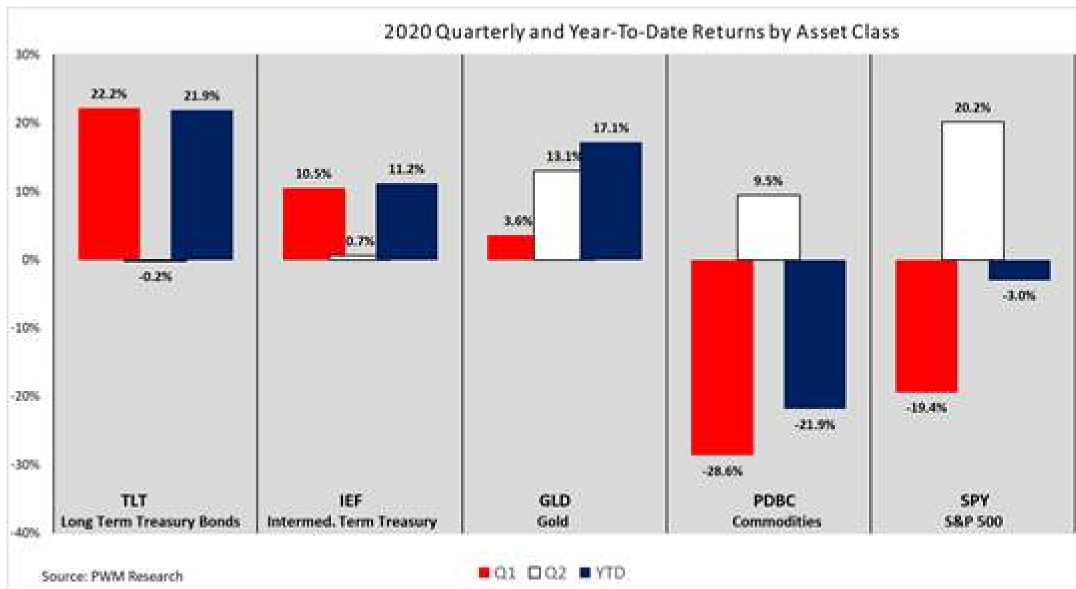
So far, FED buying has not directly impacted equity values, but the recovery of bond market has created the foundation that the equity rally is built on. **To muddy the picture a bit more, there is plenty of speculation that with any additional market disruption, the FED will soon be buying stocks too.** It's not impossible that the rally we are seeing is simply frontrunning that speculation.

A Patriotic Look at First Half Returns

Given the extreme volatility of the first half of this year, we thought we would be remiss if we did not make some commentary. The chart below shows just how dramatic that volatility was. The red bars are first quarter returns, the white bars are second quarter returns and the blue bars are combined numbers for the first half of the year. Energy was absolutely crushed in the first quarter, but actually the best sector performance in the second quarter. This is actually a great lesson on why large losses are so damaging to long term returns. **The energy sector was down just over 50% in the first quarter, then rebounded almost 32% in the second quarter, which leaves them still down almost 35% for the year! Limiting losses as best you can, is critical to long term investment returns.**



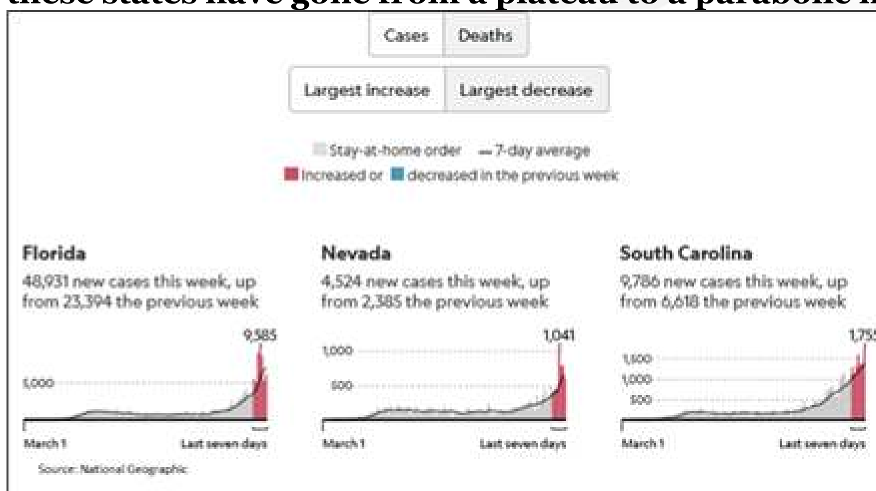
Tech continued to be the star of the show and is the only sector up substantially year-to-date. Which again raises the question of how long can this sector continue to outperform everything else. Tech is again at a level where in the past other sectors have had their comeuppance. It will happen here too; it is just a matter of when. Telecom, Healthcare, and Consumer Discretionary made it all the way back from the first quarter, or came very close.



From the perspective of asset classes, Gold and Treasury bonds were the standouts in the first quarter and the first half. Bond were the buffer in the first quarter and managed to tread water in the second quarter. Commodities were predictably poor in an environment that was becoming increasing deflationary as the pandemic developed. Commodities have managed to rebound with the bounce back of oil, but other industrial commodities remain under pressure. **The benefits of diversification on display!**

COVID Update

The number of cases in the south and west continue to grow exponentially, and that is clearly not a good thing. The weather is getting nicer, school is over and the frustration of this pandemic is getting to everybody. We get it, but this is far from over. We show a few examples below. **Maybe the biggest surprise from these areas is how fast these states have gone from a plateau to a parabolic move upward.**



One of the big changes that we noticed this week came out in a CNBC interview with Houston Methodist CEO Marc Boom, where Mr. Boom stated that the **patients are getting younger**. Whereas at the beginning of the crisis, about 40% of patients were

under 50, that is now up to about 60%. Mr. Boom added that "We are definitely seeing this affect young people, and they're getting quite ill… A**lmost 1 in 3 patients in intensive care units are under 50, compared to about 1 in 5 previously." That is a meaningful change and one that should give everyone pause.**

Meanwhile, **in the economy, these spikes will only slow the recovery process down and add to financial and human cost.** There are already some indications that business is slowing down in these areas, and that would be expected as infection rates rise. Unfortunately, this probably also threatens professional sports. From our perspective right now, it is hard to see how that can work in the near term.

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