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market notes - All Weather Assets and Inflation Waves

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Figure 1: All-Weather Portfolios? Recent Equity Drawdowns

Start	End	S&P 500	Stocks-Bonds-Commodities (60%-38%-2%)	Stocks-Bonds-Crypto (60%-38%-2%)
12/31/21	9/30/22	-24.77%	-19.61%	-21.03%
7/31/23	10/31/23	-8.61%	-6.71%	-6.51%
3/31/24	4/30/24	-4.16%	-3.34%	-3.74%
2023-2024 Average		-6.39%	-5.03%	-5.12%

Source: Bloomberg LP. CBAM Calculations. Performance is measured from January, 2021, to September, 2024. Stocks are represented by the S&P 500 Index, bond performance is measured by US Total Return Government Bonds, the Bloomberg Commodity Index is employed for commodity returns, and Crypto is based on Coinbase Indices. Returns cited in the text are hypothetical portfolios based on the same composition of data in the table with monthly rebalancing.

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10/25/24 – Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. In a world driven by waves of information, market sentiment, and shifting power, investors find themselves less at the helm and more at the mercy of the tides. Gold is glittering in turbulent waters, bitcoin's surge mirrors the frenzy of a storm, and the US election is like a crest on the horizon. The best investors manage to find "all-weather" portfolios. It isn't coasting calmly; it's about learning to embrace market nonlinearity. After decades of bonds playing that role, commodities are now on the all-weather board.

2. Central bankers get the joke—and not because they are humorists, but because it's ironic. Central bank balance sheets used to be the anchor tenant for gold. More than two-thirds of central bank reserve assets were held in gold in the early 1950s, and it dropped to less than 10% by the mid-2000s. Discretionary trust-based policy replaced rules to maximize flexibility. After all, nobody wanted to repeat the rules-driven monetary tightening behind the 1930s economic depression.

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3. How things have changed. The BRIC nations met this week with a nuanced message: they still love the US dollar, but US dollar policy isn't showing them much in return. So there's a need to build just-in-case alternatives. Not surprising, countries like China, Russia and India are dominant buyers of gold—not as an alternative currency, but as a hedge. The price of gold has nearly doubled in the past six years, and central banks are responsible for 2.4 times the overall increase in demand.

4. How can central banks be responsible for more than the overall rise in gold demand? It's a staggering outcome. Central banks are crowding demand from other places. Even though 99.6% of gold reserves are profitable to mine at current prices, supply has been stagnant in the past decade. Instead, central banks are buying gold away from jewelry owners who melt and sell, as well as exchange-traded products where demand has declined this year. The central bank supertanker has set course—buy gold.

5. Gold has an uneasy rival—bitcoin is also vying to become the next all-weather asset. The demand profiles are the extreme opposite of one another. The slowest-moving of institutions are backing gold and its long monetary history, shunning bitcoin at almost every turn. A rise in the value of bitcoin is bad because it's perceived as an unproductive economic asset, the latest argument marking a socialist economic revival. Bitcoin ETF buying, on the other hand, demonstrates demand as a reserve asset for the people.

6. Both are structural trends. Gold and bitcoin are both riding through the cycles of interest rates, credit spreads, US dollar valuations, global equity markets, and geopolitical frictions. True, structural trends always turn cyclical—just like any wave. The continuation of trends invites more and more investors. And when returns are sapped, leveraged trading marks the tipping point where the structural turns cyclical. That can take years or even decades. Don't be fooled—there's always an end. But it's not now.

7. What is the market telling us? They need a new all-weather asset. And it is not government bonds. During the secular decline in global inflation from the 1980s, bonds' fear of an inflation return led to higher real interest rates and higher inflation expectations than were realized. Adding bonds to a portfolio cushioned against economic and equity downturns without detracting from portfolio performance in a growth environment. It was a win-win—until the return of inflation.

8. On hypothetical portfolio analytics, crypto has the edge over commodities to replace bonds. Since 2021, a 60%-38%-2% stock-bond-crypto mix has outperformed a 2% commodity inclusion by 394 basis points per year, with stronger risk-adjusted results. Yet, opposite of gold, institutions have still been cautious in crypto adoption. Investors may be over-indexing to the most recent bad memory: the 2021-2022 downturn. Since then, crypto and commodities have added balance during equity selloffs (Figure 1).

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9. Old habits die hard, and it often takes brutal market adjustments. Investors are holding cash-equivalent assets like never before. US money-market assets are sitting near all-time highs at $6.5 trillion, nearly double past cycle highs. It's 5.3% of household financial assets, on par with peaks of the past five recessions. The "everything bubble" of housing, stocks, bonds, gold and bitcoin near all-time highs have investors hiding in cash, waiting for the deflationary shock to buy. It's a shock that may never arrive.

10. We will learn more from central bank balance sheets than press releases. Inherently cautious, central banks are built to take the punchbowl away from the party. But now, central banks are riding the liquidity wave they created. For all of the focus on rate hikes and cuts, the quagmire of high government debt and excess liquidity in the banking system of advanced economies leads to one macro conclusion—inflation. It's the early stages of a megatrend, its structural phase.

11. Central banks are investing in gold. Private investors are inching toward bitcoin. Both sense the structural change. And neither are moving fast enough. 2% is dipping toes in the water when the economics argue for a cold plunge. Investors are searching for a new all-weather asset. Choose wisely. In an inflationary world, cash isn't protection, it's a tax. After all, no one rides a tsunami—the only choice is to brace for its impact.

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