Bright horizon for miners as gold breaks through to record highs

An update on the precious metals sector

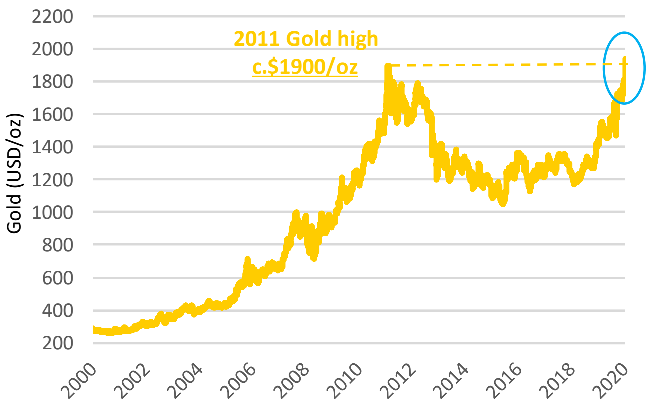
Baker Steel Capital Managers LLP

28 July 2020

The gold price hit record highs this week in US dollar terms, exceeding $1900/oz, against an uncertain and shifting macroeconomic backdrop in the wake of the COVID-19 pandemic. Many economic trends and themes which were in place prior to the pandemic, such as falling real interest rates, rising debt and resurgent protectionist sentiments, have been amplified by the crisis. Drastic action by policymakers to implement unprecedented levels of economic stimulus and money printing have set the stage for a precious metals bull market in the months and years ahead. As momentum builds for gold, the stars are aligning for gold miners, which are already benefitting from margin expansion as the gold price rises, with low energy costs and improving investor sentiment. As one of the few industries where profitability and dividend yields are rising, and where many companies show attractive fundamental value, we consider the gold mining sector to be in its best shape since the early-2000s. As a specialist investment manager with an active management approach, we see a multitude of opportunities ahead as the new precious metals bull market develops.

The gold price has advanced convincingly in recent weeks, exceeding its 2011 high of $1900/oz and building on the metal's recent strong performance as the COVID-19 crisis has engulfed economies worldwide and spread fear and uncertainty throughout financial markets. With the silver price having exhibited similarly strong performance, breaking out to reach a four-year high, momentum is undoubtedly building in the precious metals sector.

The gold price is reaching new highs



Silver is breaking out

Source: Bloomberg. Data at 27 July 2020.

With long-term low and negative real interest rates, a rapid expansion of debt, historic levels of economic stimulus and growing inflation pressures, the core drivers of the new gold bull market are clear. The case for an allocation to gold equities has become increasingly strong in recent months in the face of rising financial sector risk, uncertainty over slowing economic growth, deteriorating public finances and signs that US dollar strength may be fading. When considering the potential magnitude of the new gold bull market, we identify two core themes:

1. **A major macroeconomic shift is underway**, driven by policymakers' post-COVID-19 approach to economic stimulus, money printing and debt.
2. **Gold producers are poised to re-rate**, due to margin expansion based on revenue multiple and the potential for increasing dividends.

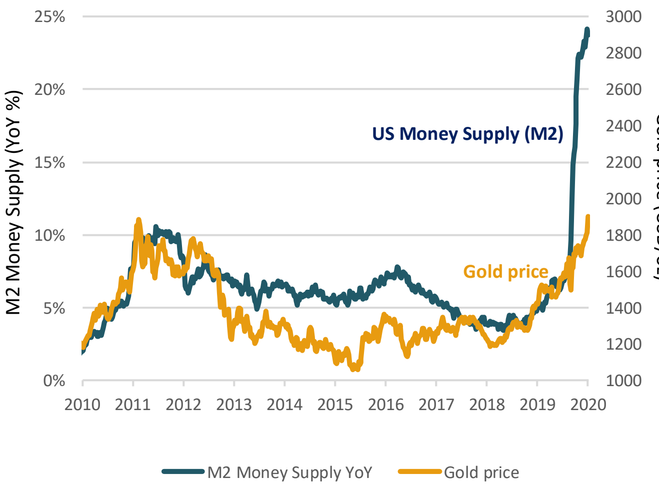
A macroeconomic shift is underway - Money printing, debt and negative real interest rates

While the post-COVID-19 economic environment shares some similarities with the aftermath of the Global Financial Crisis (GFC), during which quantitative easing, low real rates and ballooning debt supported a historic bull run in the gold sector, there are meaningful differences between the economic recovery from COVID-19 and previous crises. Drastic action by policymakers globally in response to the economic slowdown highlights the fundamental macroeconomic shift which is underway.

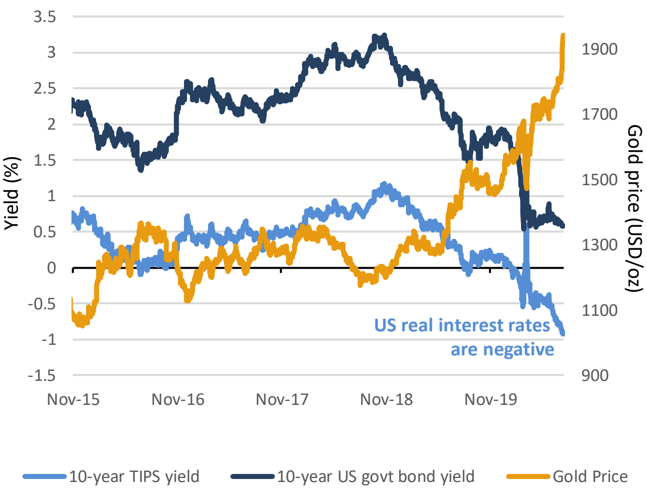
Firstly, the historic levels of economic stimulus which have been announced by developed economies goes substantially further than the quantitative easing measures implemented following the GFC, with profound potential consequences for inflation and public finances. Enthusiasm for government spending, funded by debt, has ballooned, as highlighted by the EU's EUR 750 billion joint debt deal clinched last week. The consensus for a rapid expansion of debt by developed economies is a departure from the politics of the past decades, particularly as the potential for more spending in response to the crisis appears limitless.

A second factor is the increased willingness of policymakers to engage in the creation of new money supply, through purchasing public and private debt. Government actions globally to guarantee billions in higher-risk small company loans issued via commercial banks, furlough schemes and unemployment benefits, is a major change to fiscal spending models. Under such schemes cash will go direct to the small business or the general population via commercial banks, rather than being used by the banks themselves, largely for asset purchases. Whereas we have seen asset price inflation over the last decade we could now be at the start of a period of general inflation. Overall, money supply (M2) has accelerated at a record pace as policymakers stepped in to sure up flagging economic activity.

Gold typically rises as money supply increases



Negative real interest rates are positive for gold



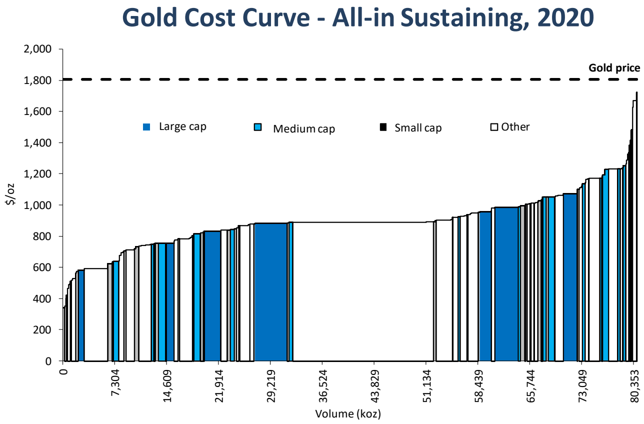
Source: Bloomberg. Data at 27 July 2020.

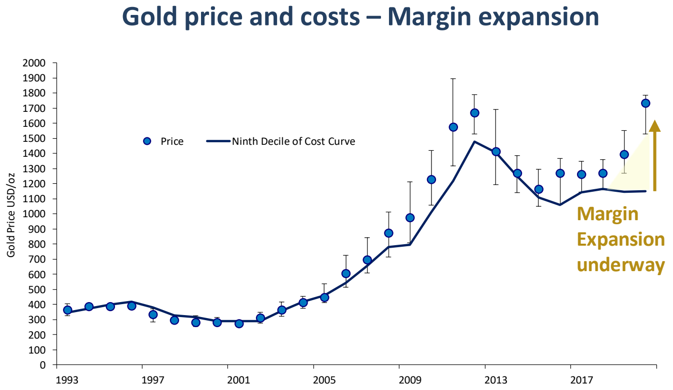
A further change we are seeing is a shift in central bankers' attitudes towards the role of monetary policy in inflation management, with the potential to open the door to significant inflationary pressures, which have been missing from major economies for the past few decades. In recent weeks the US Federal Reserve indicated that it is moving away from the Philips Curve approach to tracking inflation, which relies on the theory that inflation accelerates as unemployment falls, and instead will allow inflation to exceed its 2% target before considering any action to raise interest rates (Bloomberg). Real interest rates remain among the most important factors for the gold price. Low real interest rates reduce the opportunity cost of holding gold, while negative real interest rates increase gold's appeal as a real asset and a safe haven investment. Historically, periods of low real interest rates have proven highly supportive of rising gold prices and we consider the commitment by central banks around the world to maintain low interest rates to be one of the most significant factors for the development of the new gold bull market.

A final feature of the shifting macroeconomic environment, which has resulted from the economic response to the COVID-19 crisis, is the growing role of the state in economic activity. Governments have stepped in to support industries, secure employment and underwrite debt in a way which, just a few years ago, would have been unthinkable. Against a backdrop of slowing economic growth and increasing geopolitical tension, most notably between the US and China, this trend seems likely to continue as governments flex their muscles to safeguard their economic interests through protectionist policies, economic nationalism and "reshoring" as well as through competitive currency devaluation. With uncertain times ahead for investors, we believe these geopolitical and macroeconomic conditions will continue to drive demand for gold as a portfolio diversifier and a safe haven investment.

Gold equities are poised to re-rate - Margin expansion, rising profits and dividends

The second core theme we identify for gold investors at present is the potential for a substantial re-rating of gold equities in the months ahead. Gold producers' margins are expanding as the gold price rises while costs, most notably energy, are largely under control. The potential for dividends is rising with many gold companies reviewing their shareholder returns policies in a way not seen before in the gold sector. Overall, we consider that, with many gold producers having gone through a lengthy period of reform and rationalisation, momentum is building and the sector is positioned for a significant re-rating of valuations to reflect companies' rising profitability and shareholder returns potential.



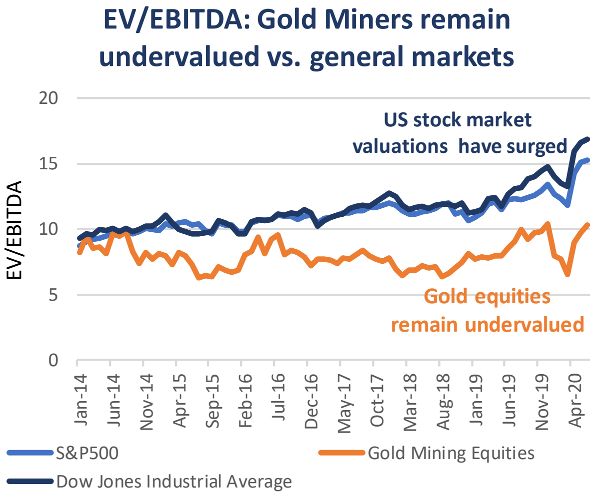


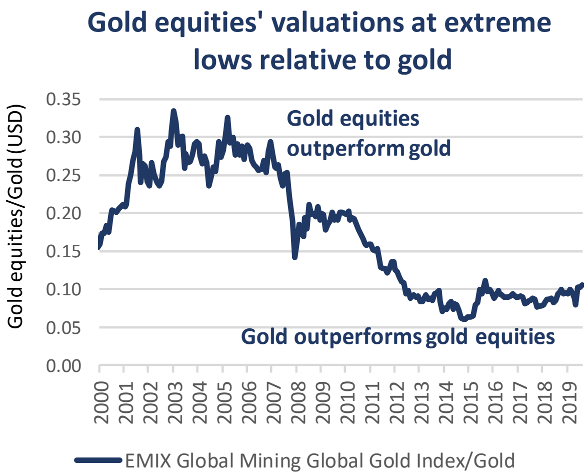
Source: BMO Capital Markets, WoodMac, Company reports, Baker Steel Capital Managers LLP.
Note, All-in Sustaining cost includes Total Cash Cost + Sustaining Capex.

The cost structure of the gold mining industry today highlights the potential profitability of gold miners. With the gold price having surpassed $1900/oz at the time of writing, gold producers face rising revenues, while cost inflation has so far been subdued. The median for all-in sustaining costs ("AISC") is around $900/oz for the industry (see above). In 2019 the gold price averaged around $1400/oz, which implied a gross margin of approximately $500/oz for the industry. With gold at $1900/oz, that average margin has risen significantly to around $1000/oz today, providing substantial discretionary income and cashflow to companies with which to consider increased returns to shareholders. Our analysis of a selection of leading gold producers suggests that if these companies returned $250/oz of this margin to shareholders, the average dividend yield of this group would be over 5%, despite recent gains in share prices for gold companies. The positive implications of this margin expansion, as well as the potential for dividends, are far from being discounted by the market as yet.

In previous cycles, energy costs have been a major inflationary factor, being a significant component of mining costs, however persistent low oil prices present a boon for miners' costs. Overall capital discipline has improved markedly in the gold sector since the rapid cost inflation seen in the late-2000s; however, differences exist between companies and it is likely we will see cost disparities grow as the bull market develops, which will be reflected in companies' valuations. We believe a key element of active investment management is avoiding those companies which lack capital discipline as much as identifying those with efficient management and cost controls, alongside high-quality assets.

With a positive outlook for miners' profitability and strong indications that many producers will increase dividends, we expect to see rising investor interest in gold equities and an increase in portfolio weightings towards this undervalued sector. Gold miners have now exited the COVID-19 crisis having largely avoided long-term damage to the industry, yet the sector continues to trade at new historically low relative valuations. Gold equities have lagged the rise in general equity market valuations in recent years, as illustrated by historic EBITDA multiples below, presenting an attractively valued opportunity for portfolio diversification. Furthermore, gold equities' valuations relative to the gold price remain at extreme lows compared to historical levels. The potential for catch up as gold equities move towards a valuation re-rating is clear; however, selectivity will remain key to achieving superior risk-adjusted returns in this sector.





Source: Bloomberg. Data at 30 June 2020.

Are we at the start of a historic bull market for precious metals and miners?

After years of being largely neglected by the bulk of institutional investors, it is notable that a number of global banks are starting to identify the opportunity in gold and gold equities. Many banks have increased their forecasts for the gold price, including Bank of America which raised its 18-month target price to $3,000/oz in recent weeks. Notably, gold equities have started to attract more capital, with USD 2.4 billion in secondary equity offerings during Q2 2020, the highest level since 2013 (Bloomberg). Signs of improving sentiment towards the gold sector, amid growing recognition of the positive macroeconomic conditions for the metal, supports increased asset allocation towards the sector in the months ahead. Meanwhile, with investors globally facing lower yields and declining dividends across global equity markets, rising dividends in the gold sector have the potential to draw in more generalists. With a total size of around USD 550 billion the gold equities sector is undoubtedly quite small compared to other sectors; however, a result of this is that a shift in asset allocation by investors and institutions towards gold stocks could have dramatic impact on miners' share prices.

Amid favourable market conditions and a supportive macroeconomic environment in the aftermath of the COVID-19 crisis, we expect to see gold and gold equities continue to make gains in the weeks and months ahead, as the new gold bull market gains pace. Alongside the longer-term macroeconomic drivers for gold of low and negative real interest rates, soaring debt levels and rising inflationary pressure, we consider that a range of shorter-term factors will impact the sector. A stalling economic recovery, trade tensions, geopolitical flare-ups between the US and China, elevated social unrest over factors such as economic inequality, all support the case for portfolio diversification, safe-haven investments and real assets. Of course, it is highly likely the sector will also see pullbacks, as is the case in any bull market, and it is our view that these will prove to be worthwhile buying opportunities. However, as seen in recent weeks the gold equities sector can move quickly once momentum starts to build and waiting for pullbacks can prove costly in terms of lost upside. In the gold equities sector, active management and a focus on stock selection have consistently delivered outperformance relative to passive holdings in ETFs or index-focused mutual funds. Our team remains focused on identifying those producers which are best positioned to benefit from margin expansion and a share price re-rating as the gold price moves higher.

About Baker Steel Capital Managers LLP

*Baker Steel Capital Managers LLP manages the **Baker Steel Gold Fund**, **BAKERSTEEL Precious Metals Fund, BAKERSTEEL Electrum Fund**, **Baker Steel Resources Trust** and **ES Gold & Precious Metals Fund**.*

*Baker Steel has a strong track record of outperformance relative to its peers and relative to a passive holding in gold or gold equities. Fund Managers Mark Burridge and David Baker have been awarded **two Sauren Gold Medals for 2019** and were awarded **Fund Manager of the Year** at the **2019 Mines & Money Awards**.*

*BAKERSTEEL Precious Metals Fund is the **2020 winner** for the fourth year running of the **Lipper Fund Award** for Best Fund over 3 years and 5 years, Equity Sector Gold and Precious Metals while Baker Steel Resources Trust has been named **Investment Company of the Year 2019**, Natural Resources, by Investment Week.*

Sources: Bloomberg, BMO Capital Markets, Baker Steel Capital Managers LLP.

Important

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