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Outlook still bright for gold and gold stocks

George Cheveley
Portfolio manager

Key points

- Gold gained 24% in the first nine months of 2020 due to coronavirus-related uncertainty, a weakening US dollar and low interest rates.
- Gold equities are attracting a broad spread of investors partly due to gold producers' potential to pay and even increase dividends when many other sectors are having to cut payouts.
- We expect the current gold price to remain supported, and we maintain our view that gold equities have significant potential even after their gains so far this year.

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Economic uncertainty has risen sharply due to the pandemic, supporting gold

2020 so far has been heavily defined by the coronavirus pandemic, which has led to human suffering and global economic disruption, with most economies grinding to a halt amid lockdowns. One consequence has been that the US officially entered a recession, ending the longest economic expansion (128 months) in its history. In response, we saw unprecedented monetary loosening and fiscal stimulus across all major regions.

Even prior to the virus turning into a full-blown global pandemic, a string of events had impacted markets in 2020, including heightened tensions in the Middle East, bushfires in Australia and an oil-price war between major producers, as well as further political polarisation in the US ahead of the November 2020 election. Continued tensions between the US and China showed no sign of abating, with Chinese social-media apps TikTok and WeChat the most recent causes of escalation. It is possible tensions will continue as Trump seeks a second term in the White House.

After an initial drop, gold and gold equities have moved decisively higher

As at the end of September 2020, the gold price had risen 24% since the start of the year. It broke briefly through the US$2,000/ounce barrier and reached a level almost double its value five years ago as investors worried about COVID-19, as well as rising geopolitical tensions and a weakening of the US dollar.

Despite being caught in the sharp sell-off in mid-March, gold resumed its role as a safe haven, recovering strongly through April. This was similar to the 2008 crisis, where gold sold off initially as investors 'dashed for cash', only to recover quickly as they looked to diversify their cash holdings. Gold equities were hit harder in the sell-off, due to their lower liquidity and concerns over supply disruptions in the pandemic, but they bounced back very strongly in April to finish the month up 11% year-to-date in line with gold.

After pausing in May and for most of June, gold and gold equities broke decisively higher from late June through July. For us, this did not come as a surprise. Against a backdrop of trillions of dollars of added liquidity and the US Federal Reserve's recent shift to targeting average inflation (rather than a simple 2% level), which will result in more-negative real (net of inflation) interest rates, gold is attractive. A further tailwind for the precious metal has been the weakness of the US dollar. Once also regarded as a safe-haven asset, continued COVID-19 uncertainties and expansionary monetary and fiscal policies have reversed investors' perceptions of the dollar. A weak dollar is traditionally good news for the price of gold, which is viewed as a more stable store of value.

Gold equities are emerging as income stocks

Following Barrick's merger with Randgold two years ago and Newmont's acquisition of Goldcorp soon after, both companies have consistently stated their strategy of focusing on shareholder returns rather than volume growth. Both have increased dividends and emphasised that they have the asset life and diversity to maintain payouts over the longer term. This has not gone unnoticed by other gold companies, many of which are striving to match these aims, and investors, who are looking for income. This was highlighted by the report that Berkshire Hathaway had built a US$500 million stake in Barrick this year. Some were surprised since Warren Buffett has always been seen as sceptical of gold as, in his own words, "it lacks utility" and "does not produce anything".

However, this move highlights a key strength of the gold-mining sector currently, which is its ability to pay and even increase dividends when many other sectors are having to cut payouts. Compounding returns have always been the focus of Buffett's investment philosophy and, after many years of chasing growth alone, gold companies are now focused on improving returns and returning some of the cash they are generating to shareholders. We expect more generalist investors to begin looking at this sector more keenly and gold companies are now increasingly focusing their businesses on attracting these long-term and large investors.

Gold prices look well supported and the equities are enjoying their highest margins since 1980

We expect the current gold price to remain supported. The combination of negative real yields, significant central-bank stimulus and a weakening US dollar supports financial demand. The adverse relationship between gold and real yields is well-established and recent central-bank interventions have reinforced the case for holding gold and gold equities as long-term portfolio diversifiers.

We maintain our view that gold equities have significant potential, even after their gains so far this year. Gold equities clearly provide positive leverage to the rising gold price; however, even if the gold price remains in its current range, gold companies are enjoying very high margins and producing, in most cases, very high levels of free cashflow. Balance sheets are strong, management teams have improved, their focus is on cashflow and returns rather than volume, hedging is less than 10% of production so exposure to the spot price is good, technology is reducing costs, and exploration spend has been low so not too many projects are in development.

In addition, as investors consider the pandemic's longer-term implications, they are likely to look harder at their exposure to sovereign debt and the solvency of indebted governments. This further increases the attractiveness of gold. And while gold offers no income, gold equities increasingly do, in the form of dividends.

Looking forward, while there is uncertainty in the macro outlook, for us, there remains certainty in the importance of gold and gold equities as a strategic portfolio holding.

Australia

Level 28 Suite 3
Chifley Tower
2 Chifley Square
Sydney, NSW 2000
Telephone: +61 2 9160 8400
australia@ninetyone.com

Hong Kong

Suites 1201 – 1206, 12/F,
One Pacific Place
88 Queensway, Admiralty
Telephone: +852 2861 6888
hongkong@ninetyone.com

Singapore

25 Duxton Hill #03-01
Singapore 089608
Telephone: +65 6653 5550
singapore@ninetyone.com

United Kingdom

55 Gresham Street
London, EC2V 7EL
Telephone: +44 (0)20 3938 1900
enquiries@ninetyone.com

Botswana

Plot 64511, Unit 5
Fairgrounds, Gaborone
Telephone: +267 318 0112
botswanaclientservice@ninetyone.com

Italy

Palazzo Toschi Corneliani
Corso Venezia 44
20121, Milan
Telephone: +39 02 3658 1590
enquiries@ninetyone.com

South Africa

4th Floor, Menlyn Maine Precinct
Park Lane West
180-197 Amarand Avenue
Pretoria, 0181
Telephone: +27 (0)21 901 1000
enquiries@ninetyone.com

United States

65 E 55th St, 30th Floor
New York, 10022
US Toll Free: +1 800 434 5623
usa@ninetyone.com

Channel Islands

PO Box 250, St Peter Port
Guernsey, GY1 3QH
Telephone: +44 (0)1481 710 404
enquiries@ninetyone.com

Luxembourg

2-4, Avenue Marie-Thérèse
L-2132 Luxembourg
Telephone: +352 28 12 77 20
enquiries@ninetyone.com

Sweden

Grev Turegatan 3,
114 46, Stockholm
Telephone: +46 850 243 820
enquiries@ninetyone.com

Germany

Bockenheimer Landstraße 23
60325 Frankfurt am Main
Telephone: +49 (0)69 7158 5900
deutschland@ninetyone.com

Namibia

First Floor, 6 Thorer Street
Windhoek
Telephone: +264 (61) 389 500
namibia@ninetyone.com

Switzerland

Seefeldstrasse 69
8008 Zurich
Telephone: +41 44 262 00 44
enquiries@ninetyone.com

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