As gold approaches new highs, is it time for precious metals miners to shine?

With gold approaching new highs, the bull market for precious metals miners is just getting started

Baker Steel Capital Managers LLP

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As the economic environment shifts, we identify two key points for investors:

1. **A new bull market phase is likely underway -** Gold and silver are breaking out relative to other asset classes.
2. **Precious metals miners are poised to outperform -** Miners offer value, strong margins and shareholder returns.

Precious metals prices have continued to move higher in recent weeks, with gold now approaching its all-time high, and silver at a twelve-month high. Followers of Baker Steel will know that in recent months our team has made the case for new highs in the gold price, as the headwinds which have constrained precious metals over the past two years fade. The US interest rate hike cycle is nearing completion and US dollar strength is receding, while supportive factors are increasing, such as rising economic and geopolitical risk and a lower outlook for real interest rates. Demand dynamics for gold are also becoming more favourable, with record central bank buying in 2022, amid rising geopolitical tension and economic uncertainty.

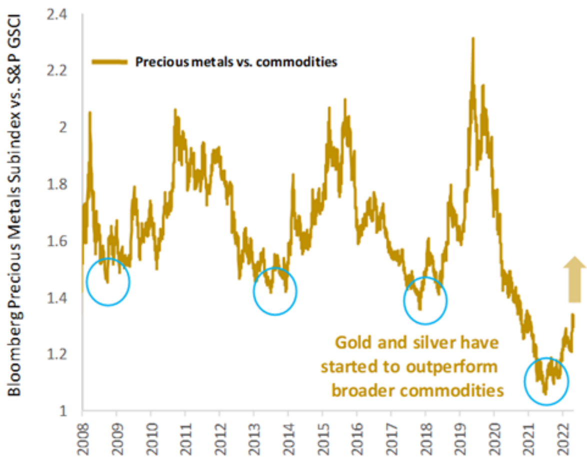
Gold and silver miners' share prices are also regaining momentum. As long-term investors in this sector, Baker Steel's team has rarely been as optimistic for the prospects of precious metals equities as we are today. The sector's relative and fundamental undervaluation has been evident for some time, yet recent years have seen many companies strengthen their financial position, with robust margins and healthy balance sheets, and ESG improvements. Constructive M&A is also underway in the sector.

The gold price has exceeded $2000/oz in recent weeks and appears poised to re-test its all-time high set in 2020 during the height of the COVID-19 pandemic (to which gold briefly returned in early-2022 as Russia's invasion of Ukraine sparked safe haven demand). Importantly, gold has already broken out to new highs in many major currencies, including Euro, Sterling, Canadian dollars and Australian dollars.

Precious metals breaking out relative to equities, bonds and broader commodities

Historically, the end of a US interest rate hiking cycle has proven to be highly supportive for precious metals, with gold typically hitting new highs in the months and years after a pause or cut to rates. In keeping with this precedent, precious metals' recovery is now underway, amid indications the US Fed will pause its hikes in the coming months. Gold is breaking out relative to broader commodity markets (LHS chart below) as well as relative to financial assets, illustrated by gold's performance relative to a traditional 60:40 portfolio of bonds and stocks (RHS chart below).

Precious metals are recovering relative to broader commodities



Gold is outperforming the traditional 60:40 portfolio of stocks and bonds

Source: Bloomberg, Baker Steel Capital Managers LLP. Data at 31 March 2023.

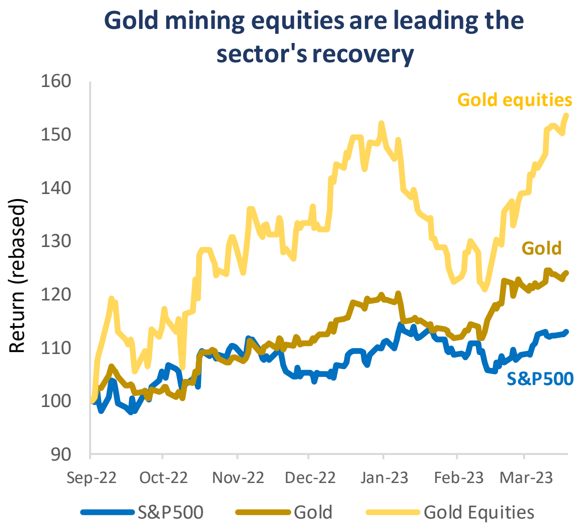
Gold's recent performance demonstrates the value an allocation to the gold sector can bring to a portfolio, in particular highlighting gold's relevance to investors in uncertain times. Yet with rampant inflation across developed economies over the past year, some investors may question why gold prices have not risen sooner, given the metal's historic reputation as an inflation hedge. Gold has faced conflicting drivers since the current inflationary surge gained pace in early 2022, as rising consumer prices, which are typically positive for gold, were counterbalanced by the sharpest interest rate hikes programmes by central bankers in decades. Typically, the gold price tends to be negatively correlated with US real interest rates, which have risen over the past year as hawkish rhetoric from central bankers drove up interest rate expectations.

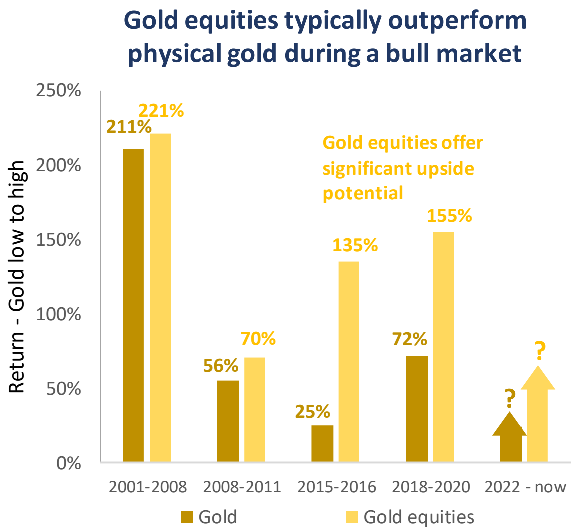
Today however, we believe an inflection point has been reached regarding the interplay between inflation and interest rates, with the end of the interest rate cycle in sight but with inflation still persistently above central bankers' targets. Following the inflationary fear and hawkish rhetoric which dominated 2022, the negative impact of higher rates on economic activity is starting to become apparent for policymakers. The string of bank collapses in the US and Europe and weakness across global equity markets are stark warning signs for policymakers, and we suspect that we have yet to see the true impact on employment and business activity from the sharpest monetary tightening in recent history. Our team has for some time considered stagflation to be a probable outcome of Fed policy, and historically this environment has been positive for gold and gold miners due to the resulting low or negative real interest rates and heightened risk across most other asset classes.

Alongside rising financial sector risk, the geopolitical environment is becoming tenser and more fragmented. The extent to which the world is moving towards a multi-polar international order remains to be seen, however one area where change is certainly underway is in central banks' foreign exchange reserves. 2022 saw a record level of gold purchases by central banks (World Gold Council), and we expect this trend to continue. A combination of factors is driving central banks to increase their gold reserves, notably gold's well-documented role as an effective portfolio diversifier during times of heightened economic and geopolitical risk. A further consequence of geopolitical fragmentation and the shifting international order is the potential impact on the US dollar, amid a growing recognition amongst developing nations of the negative impact of dollar-dominance on their economies. Should political support for de-dollarisation gain pace, as it may amongst the BRICS, a period of structural weakening for the US dollar could ensue, amid a shrinking share of world trade. While a decisive shift away from US dollar denominated trade is some way off, this trend supports our view that fading US dollar strength is a likely theme in the years ahead.

Time for gold and silver miners to shine?

As the precious metals sector enters a new bull market phase and gold moves towards new highs, we consider that precious metals equities offer substantial upside potential. Mining companies can offer operational leverage to rising metals prices and historically during a gold bull market gold miners can outperform the physical metal by multiples of up to 5x, as highlighted on the chart below (RHS). The past six months have seen momentum starting to return to the sector (LHS chart below), with precious metals equities breaking out relative to physical gold as well as broader financial assets. As in previous bull cycles this is likely just the beginning. Gold miners remain far from their historic highs, illustrated by the EMIX Global Mining Gold Index which would have to recover by around 75% to regain its all-time highs (data in USD terms, at 31/3/2023).





Source: Bloomberg, Baker Steel Capital Managers LLP. Data in USD, at 12 April 2023. Note, Gold Equities represented by XAU Index.

As gold moves towards new highs and the silver price continues its recovery, we expect precious metals equities to deliver strong returns, as in previous cycles. Today, the upside potential for miners is enhanced by the fact that many companies are in the strongest shape that they have been in for many years, offering robust margins and paying shareholder returns. We are also seeing a rise in constructive M&A activity (see our recent **article**) which has continued in recent days with the announcement of an enhanced offer for Newcrest Mining from Newmont Mining, a transaction between two gold majors which would be highly significant for the industry. In terms of valuation, we consider that gold and silver miners continue to appear undervalued on both a fundamental and relative basis. Margins are strong, yet bull market over-exuberance certainly appears a long way off and capital discipline remains prevalent.

Miners faced headwinds in 2021 and 2022, primarily due to a lack of gold price momentum as well as rising costs, however these risks are now fading. With regard to cost inflation for miners, we have observed around 10% operating cost inflation over the past year, however most high-quality gold miners have managed rising costs well through technological improvements and continuous operational efficiencies. That said, some miners do face challenges, particularly those with large CAPEX commitments.

Gold equities poised to outperform, amid a secular growth trend for commodities

As the market conditions for precious metals become increasingly favourable, we believe the most effective strategy to capitalise on the sector's move towards new highs is to invest in high quality mining equities which stand to benefit from margin expansion as gold and silver prices rise. We consider that active management can add significant value for investors during periods such as this through a focus on margins and value, as well as helping to avoid pitfalls, notably from ESG issues.

Gold's new upcycle comes at a time when broader commodity markets face secular growth trends, most notably from the rapid development of green technology, which is causing demand forecasts for critical metals and materials to soar. The green revolution is also beneficial for precious metals, notably silver, which is a key industrial metal with applications across green technology, most notably in solar photovoltaic cells.

Overall, as gold and silver prices move higher, driven by shifting macroeconomic conditions, monetary policy direction, and robust physical demand from central banks and investors, we consider a substantial upwards re-rating of miners' share prices is likely. The precious metals mining sector's progress in recent years, with regard to profitability, shareholder returns and ESG, has set the scene for a period of outperformance relative to other asset classes, which we believe is now underway.

Important

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