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Focusing on Gold's Resilient Base

By Joe Foster, Portfolio Manager and Strategist

Gold Trended Higher Early, But Ended April Slightly Down as Dollar Strengthened

Gold trended higher in early April due to trade tensions between the U.S. and China, prospects of airstrikes on Syria, and heightened inflation expectations following a higher than expected March Producers Price Index (PPI)[1] and a 2.1% annual rise in the core Consumer Price Index[2]. Gold topped at $1,365 per ounce on April 11. This level has been the proverbial price ceiling for gold since 2014. Gold subsequently moved lower as a number of generally positive economic releases enabled the U.S. dollar to trend to its high for the year on May 1. Gold was also pressured by real rates that moved higher with U.S. Treasuries. The yield on the 10-year Treasury surpassed 3% for the first time since 2013. For the month, gold incurred a small loss of $9.65 (0.7%) to finish at $1,315.35 per ounce.

Despite No Surprises in Earnings, Gold Stocks With Small Gains

Physical While there was a lack of positive surprises in first quarter earnings, gold stocks were still able to eke out gains as the NYSE Arca Gold Miners Index (GDMNTR)[3] rose 1.7% and the MVIS Global Junior Gold Miners Index (MVGDXJTR)[4] advanced 1.8%.

Gold's Resilient Price Floor Has Been Rising Since 2015; Likely to Be Tested Again

Gold While $1,365 per ounce has been the ceiling for the gold price, the floor has been rising consistently since 2015 in a positive trend of higher lows. The base of this trend is currently around the $1,285 per ounce level. As expectations for a June 12 Fed rate increase mount, gold might test the trend's base in the coming month. Given the resilience the gold price has shown amid concerns over geopolitical risks, trade tensions, and inflation, we would be surprised to see gold fall below this level. Perhaps gold will take another run at $1,365 in the second half of 2018.

Response to Earnings Highlights Lack of Interest in Gold Stocks

A lack of interest in gold stocks over the past year has caused them to fall short of performance expectations, which we highlighted anecdotally in our March commentary. In an April report, RBC Capital Markets was able to quantify this by looking at performance following earnings beats and misses over the last five years. They found that the sustainability of gains from earnings beats has declined in the last two years. Meanwhile, losses on earnings misses have gotten much worse in the last 1-2 years and the loss is sustained over a longer period. RBC also found that the value traded per day in 2018 is at levels last seen at the end of the bear market in 2015, when gold bottomed at $1,050. This points to a lack of buying interest. Absent are those momentum players that follow the winners who beat and value players that pick up the losers who miss. While this lack of interest sounds negative, we are excited by the opportunity it presents. We believe gold equities are undervalued, and the companies are fundamentally sound. A spark that moves the gold price through its $1,365 ceiling may rekindle interest in the miners.

"Gold is Where You Find It"

According to an old prospector saying, "Gold is where you find it". Many of the companies we follow have found it in very out-of-the-way places. Not next to a highway in Ohio, but near a glacier in British Columbia, in the Atacama desert at 14,000 feet altitude, or 10,000 feet underground in South Africa. Companies must be skilled at building infrastructure in these remote areas.

Understanding Geopolitical Risk

Gold is also often found in places with geopolitical risk. In order to invest in a company, we must be convinced geopolitical risk can be mitigated, if not eliminated by management. Geopolitical risk comes in various forms at the national, state/provincial, and local levels. The most common risks at the national level are changes in taxes or royalties and import/export restrictions. At the state/provincial level, there are risks of legislation that might make mining prohibitively expensive. At the local level, disgruntled groups may blockade an operation and unions sometimes engage in work stoppages. These risks tend to be higher in emerging or frontier countries; however, developed countries are not immune. For example, the largest open pit gold operation in Ontario, Canada has delayed expansion plans to 2026 due to a lack of support from a local Aboriginal community.

Conversely, places assumed to be politically risky to a generalist may, in reality, be very favorable mining jurisdictions. The West African nation of Burkina Faso is one of the best places to build a mine. The gold industry is growing and exciting discoveries are being found. The permitting process is straightforward and efficient. A mining culture has developed, and materials and supplies are becoming more available. While the general election in 2015 was not without drama, in the end there was a peaceful transfer of power. The gold industry is a significant part of the Burkina economy that no leader wants to disrupt.

Argentina and the Impact of Geopolitics on Gold Projects

One of our more successful investments historically was Andean Resources. In 2007, Andean discovered high-grade veins on the Cerro Negro property in Santa Cruz Province of southern Argentina, a part of Patagonia. By 2010, Andean had delineated a 2.5 million ounce reserve, and the company was sold to Goldcorp, Inc. (2.9% of Fund net assets*) for $3.4 billion. The stock gained 1,800% from our first investment in 2007 to the 2010 acquisition. By 2010 it became obvious that the administration of former president Cristina Elisabet Fernández de Kirchner was driving the Argentinian economy into a ditch. The last geopolitical straw came in 2011, when exchange controls were announced and we began to avoid the country due to its growing hostility towards mining and other business.

We took a renewed interest in Argentina in 2015 with the election of Mauricio Macri. President Macri has invigorated business by unwinding exchange controls, export duties, capital restrictions, and many other impediments left from 12 years of Kirchner rule. This year we returned to Argentina to visit gold properties and assess the geopolitical climate. Cerro Negro is now one of Goldcorp's core operations, producing 452,000 ounces in 2017 with a reserve of 4.9 million ounces. The Macri Administration eliminated a tax on reserves that had essentially stopped exploration spending. Goldcorp started drilling again, and they were proud to show off the Silica Cap discovery. Silica Cap is a vein system that we estimate could bring over 2 million ounces into the reserve.

Photo courtesy of Joe Foster. Drilling the Silica Cap system. Silica Cap outcrops visible as dark patches on skyline.

Another highlight of the trip was Yamana Gold's (2.7% of Fund net assets*) Cerro Morro project, also a high-grade vein system that aims to start production in May. Yamana was able to draw on its expertise from similar operations in Chile and Mexico. We expect to see a smooth start-up that ramps to 180,000 ounces of gold and 7 million ounces of silver annually.

Yamana and Goldcorp have assets across the Americas, so their exposure to Argentina is limited. While we were pleased with the progress companies are making, there are still concerns that keep us from investing in a pure play in Argentina. Unions continue to exert extraordinary power. They are involved in many aspects of planning and decision-making at the mine level. Work stoppages are not uncommon, sometimes for reasons unrelated to mining that are beyond the control of management. Provincial rules can differ widely. Across the border in Chubut Province, open pit mining and the use of cyanide is banned, which is effectively a ban on gold mining. Inflation is running at 25%, and it remains to be seen if the central bank can bring it back to acceptable levels. Mary Anastasia O'Grady of the Wall Street Journal leads an April op-ed with: "Are Argentines ready to throw off the yoke of peronista populism, thuggery, and politics by roadblock that has destroyed their nation, and to rebuild the free republic of the 19th century?" If Macri can maintain popularity into the December 2019 elections while continuing reforms and taming inflation, then perhaps Argentina again becomes an investment destination for us.

IMPORTANT DISCLOSURE

*All company weightings, if mentioned, are as of April 30, 2018, unless otherwise noted

[1]The Producer Price index (PPI) is a family of indexes that measures the average change in selling prices received by domestic producers of goods and services over time.

[2]The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them.

[3]NYSE Arca Gold Miners Index (GDMNTR) is a modified market capitalization-weighted index comprised of publicly traded companies involved primarily in the mining for gold.

[4]MVIS® Global Junior Gold Miners Index (MVGDXJTR) is a rules-based, modified market capitalization-weighted, float-adjusted index comprised of a global universe of publicly traded small- and medium-capitalization companies that generate at least 50% of their revenues from gold and/or silver mining, hold real property that has the potential to produce at least 50% of the company's revenue from gold or silver mining when developed, or primarily invest in gold or silver.

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