Gold Stocks' Corner Office Catalyst

By Joe Foster, Portfolio Manager and Strategist

Strong U.S. Dollar Weakens Gold in June

The gold price faced pressure on several fronts in June. The dominant headwind was the U.S. dollar, as the US Dollar Index (DXY)[1] reached new highs for the year. The synchronized global growth theme that markets were counting on early in the year faded as economic indicators from Europe and many emerging markets have failed to keep pace with those in the U.S. Additional demand for dollars is coming from U.S. government policies, where the Treasury is issuing increasing quantities of debt to fund tax cuts and spending, and the Fed is selling down its hoard of government securities.

Impact of Trade and Tariffs Could Support Gold

Gold was also caught in the June metals selloff. Copper and zinc suffered sharp falls amid concerns that the Trump administration's tariff policies will likely dampen demand. While trade policies have adversely affected a number of companies, there is not yet evidence that they are affecting the broader economy or creating additional inflationary pressure. We believe gold will not react positively unless markets see this broader systemic risk emerge. Harley-Davidson announced plans to move some production to its local markets to avoid tariffs. This might become the start of a trend that places the global economy at risk. The Wall Street Journal found that a car costs 50% more in Brazil than a comparable model does in Mexico due to Brazilian protectionist rules that require cars to be assembled in country. Also, the strong U.S. dollar and stimulative fiscal policies are creating import demand that might be temporarily masking the adverse effects of tariff policies.

Gold Stocks Have Outperformed Gold Since February

Finally, the Fed raised rates for the second time this year on June 13 and upped its guidance to four rate increases in 2018. This lent additional strength to the U.S. dollar, putting pressure on gold. During June, gold fell $45.35 (3.5%), ending at its low for the year at $1,253.17 per ounce. Gold stocks outperformed gold in June, as the NYSE Arca Gold Miners Index (GDMNTR)[2] and the MVIS Global Junior Gold Miners Index (MVGDXJTR)[3] both fell 0.2%. Gold and gold stocks have shown similar performance in the first half of 2018. Gold declined 3.8%, while the GDMNTR fell 4.0% and the MVGDXJTR declined 4.4%. The gold price was held in check by a lack of macroeconomic catalysts and the strength of the U.S. dollar. Gold stocks significantly underperformed gold early in the year, with the underperformance reaching 10% in February. However, since then, stocks have outperformed to pull even with gold at mid-year.

Following Rate Hike, Gold Could Rally Following July 4th Holiday

The gold price has shown weakness ahead of every Fed rate increase since the hiking cycle started in December 2015. Gold has also rallied immediately after every rate increase, except for two. In June 2017, gold continued to fall after the Fed rate decision, but then rallied following the July 4th holiday week. Again this year, gold continued to fall after the June rate hike and into the week of the holiday. Positioning in the futures market suggests gold is oversold, so we expect to see another delayed rally once the thin holiday trading has passed.

Reinvented Gold Industry Healthy and Competitive Again

We frequently explain to investors how the gold mining industry has reinvented itself after years of mismanagement. The chart shows that the return on invested capital (ROIC) for senior gold companies fell below industry peers from 2012 to 2015. ROIC has since risen to historic norms and is again competitive. A number of factors have contributed to the gold industry's turnaround.

Balance sheets are healthy again. CIBC World Markets finds net debt levels have fallen from $31 billion in 2014 to $17 billion in 2017, and we expect them to continue to fall. Mining costs have declined roughly 25% since 2012. Adoption of new technologies should allow costs to remain low. Free cash flow yields are expected to rise from 1.8% in 2018 to 8.1% in 2020, assuming a $1,300 per ounce gold price. Companies have recalibrated their portfolio of mines to focus on properties where they can create the most value. They have also become much better at hitting their targets. RBC Capital Markets found that in 2012, 60% of companies achieved production guidance and less than 50% delivered on original cost guidance. In 2017, production and cost guidance were achieved by 76% and 79% of companies, respectively.

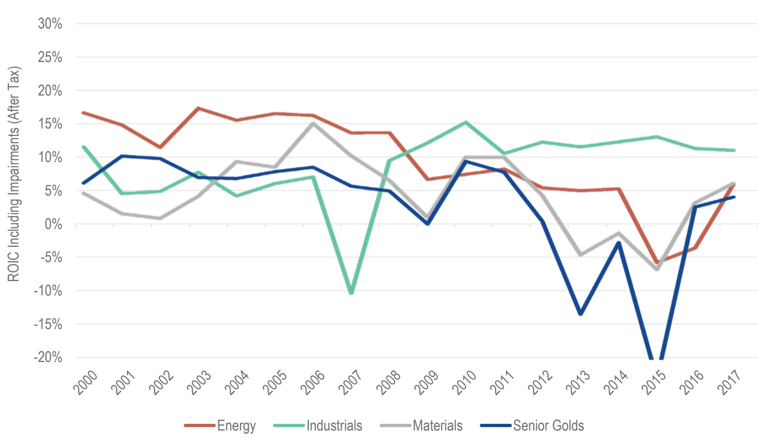
Lasting Management Changes Key to Rekindling Investor Interest

Gold equity valuations are attractive, yet few investors are interested in gold stocks in the current environment. In order to attract investors in the next cycle, we feel companies must show that all of these changes are fundamental and lasting, rather than window dressing to cope with low gold prices. We believe there have been several fundamental changes that insure that wasteful management practices are gone for good:

- Management incentives have changed substantially at the board level. Historically, incentives were centered on production growth. However, it has become very difficult for large gold companies to generate growth and shareholder returns simultaneously. Returns suffered as the quality of gold deposits have declined and costs to develop have increased. Recently boards have restructured incentives to focus on returns rather than growth. As a result, managements are finding innovative ways to mine efficiently and build projects that contribute more to the bottom line.
- We expect shareholders to be more vigilant in holding managements accountable. The bear market from 2011 to 2015 was the worst peak to trough performance ever for gold equities. Investors have scars that will not be forgotten as the gold price improves. A recent example of shareholder involvement is Detour Gold (0% of net assets*), who operates the largest open pit gold mine in Ontario, Canada. A June Bloomberg article shows many of the company's largest shareholders are unhappy with management. A letter to the company that was made public states that directors had "failed to recruit and oversee a management team capable of operating the Detour Lake mine in a manner that delivers returns to shareholders."
- Passive gold equity funds have changed the structure of capital formation. In 2011, assets under management (AUM) by dedicated precious metals equity funds was divided 94% active (mainly mutual funds) versus 6% passive (ETFs). CIBC estimates the split is now 33% active and 67% passive. Passive funds are not able to participate in secondary offerings or initial public offerings (IPOs). This reduced pool of active funds means the industry has fewer options when it comes to raising capital. We believe companies have no choice but to become more fiscally disciplined to generate funding internally.

We will soon see if the gold price again shows positive moves following the July 4th holiday week. We continue to believe gold may take another run at the $1,365 per ounce level that has served as the price ceiling since 2014. A successful test of this level is probably needed to bring investor interest back to gold stocks.

With Improved ROIC, Gold's Again Competitive With Other Industries



Source: CapIQ; CIBC World Markets Inc. Report as of May 30, 2018. Past performance is no guarantee of future results. Chart is for illustrative purposes only.

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

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[1]U.S. Dollar Index (DXY) indicates the general international value of the U.S. dollar. The DXY does this by averaging the exchange rates between the U.S. dollar and six major world currencies: Euro, Japanese yen, Pound sterling, Canadian dollar, Swedish kroner, and Swiss franc.

[2]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.

[3]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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