How Low Can the Price of Gold Fall?

Description

There are signs that the recent gold rally, kicked off by growing uncertainty in emerging markets earlier this year, is well and truly over. After rallying to a five- month high of $1,387 per ounce in mid-March 2014, the gold price has continued to soften to now be down by over 6%.

The downward pressure on the gold price can be attributed to stronger than expected U.S. and Chinese economic growth, the ongoing tapering of the Feds quantitative easing program and a recovery in emerging markets. Furthermore, the downward pressure is continuing despite the fears associated with the ongoing geo-political tensions in Ukraine and expected increased demand for bullion from China.

What is the outlook for gold?
Recently, Goldman Sachs reaffirmed its 2014 forecast gold price of $1,050 per ounce, which is around 19% lower than the current price and significantly lower than the outlook provided by a number of other investment banks. Goldman Sachs expects the gold price to decline as Chinese credit concerns and Ukraine tensions ease, coupled with stronger U.S. and Chinese economic activity.

Already we are witnessing stronger than expected economic activity in China, with first quarter 2014 GDP expanding by 7.4%, which is marginally higher than the 7.3% which was expected. Retail sales also surged during March 2014 to be up 12.2% in comparison to the same period in the previous year, reflecting the efforts made by the government to boost domestic demand.

Industrial activity also continued to increase, the purchasing managers index — a measure of industrial activity — inched upwards in March 2014 to 50.3 points from 50.2 points in February. But this also indicates industrial activity is not growing at the rate expected by Beijing, leading to increasing speculation a government led stimulus package is imminent. U.S. economic activity is also expanding at a faster rate than expected with first quarter 2014 industrial activity in particular stronger than forecast.

The perceived strength of global and Canadian economic growth can already be seen with the Bank of Canada opting to leave interest rates unchanged with the governor, Stephen Poloz, stating he believes global and Canadian economic recoveries are picking up steam and disinflationary pressure is waning.

All of these indicators of stronger economic growth, support Goldman Sachs' view that gold will continue to soften, with stronger economic activity boding well for the performance of the Canadian stock market.

What does this mean for investors?
Any sustained fall in the price of gold will significantly impact the share prices of gold miners and see the recent gains made on the back of the gold rally quickly melt away. It will have the greatest impact on those miners with high all-in-sustaining-costs per ounce produced, with many forced to operate at a loss if gold hits and then settles at $1,050 per ounce.

Among those that would be affected are **Iamgold** (TSX: IMG)(NYSE: IAG), which for 2014 has estimated all-in-sustaining-costs of between $1,150 and 1,250 per ounce. If gold hit $1,050 an ounce and stayed there Iamgold would become unprofitable, making it a double whammy for shareholders, with the company having performed dismally in 2013.

Lower cost miners including **Barrick Gold** (TSX: ABX)(NYSE: ABX), **New Gold** (TSX: NGD)(NYSE: NGD), and **Yamana Gold** (TSX: YRI)(NYSE: AUY), which have estimated 2014 all-in-sustaining-costs of $980, $815 and $925 per ounce respectively, would likely remain profitable.

But if gold falls to a low of $1,050 per ounce the impact will not only be to their profitability. It will also force them to further decrease capital expenditure negatively impacting exploration and mine development programs. In many cases I would also expect to see a number of miners revise their gold reserves downwards, because many have used a higher price per ounce to calculate those reserves.

One of the hardest hit would be **Goldcorp** (TSX:G)(NYSE:GG),which calculated its 2013 year end gold reserves using $1,300 per ounce, which is 20% higher than the price target set by Goldman Sachs. It may also have a marginal impact on Barrick which used $1,100 per ounce. Whereas, there would be no impact on Yamana, which calculated its 2013 year end reserves using $950 per ounce

Foolish bottom line
The outlook for gold continues to remain uncertain. While ongoing geopolitical tensions in the Ukraine coupled with growing demand from China will drive demand higher this will not be sufficient to sustain a rally to higher prices with global economic growth stronger than expected. Any significant fall in the gold price will significantly impact gold miners with the higher cost operators the most affected.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:ABX (Barrick Mining)
2. TSX:IMG (IAMGOLD Corporation)
3. TSX:NGD (New Gold Inc.)
4. TSX:YRI (Yamana Gold)

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Date
2025/08/17
Date Created
2014/04/18
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