Are We About to Enter a New Golden Age for Gold?

Description

The world's bond market has suddenly gotten very interesting.

With stocks selling off pretty aggressively in seemingly every market, investors have rushed into the safety of bonds. Essentially, it's the same thing that happens during every bear market: investors rush from riskier assets into safer ones.

What's interesting this time around is how low interest rates are. Demand from bond buyers around the world is pushing up the price of bonds, sending already low yields crashing down even further. In both Europe and Japan, this has created a situation where negative rates are the norm. Imagine buying a bond or sticking your cash in the bank while aware of the fact you won't get all of your money back.

Investors in those countries are very willing to do so, and certain pundits are arguing that negative rates may make their way to Canada in the coming months. Canada's economy is struggling, which justifies cutting rates further from the Bank of Canada overnight rate, which currently stands at 0.5%. Bond investors seem to be pricing in lower rates, since the current yield for a Government of Canada five-year bond is less than 0.6%.

In a world where negative rates seem to be spreading, it's only natural that investors might look for other so-called safe haven investments that aren't bonds. These investors might turn to things like GICs, corporate bonds, or dividend-paying stocks as substitutes to bonds.

There's one other asset that starts to look attractive in a world where bonds pay negative rates.

Gold

Gold has been considered a store of value for centuries. It has fallen out of favour lately because of a dismal price performance while seemingly every other asset went up in value.

In a world where negative rates are commonplace, the thesis for holding gold becomes far more interesting. Like bonds, it functions as a store of value, but it doesn't cost an investor negative interest to hold the yellow metal. This could help push gold higher.

One of the major factors holding down the price of gold is the strength of the U.S. dollar. In 2015 when gold fell approximately 10%, most of the decline can be attributed to the fall in the U.S. dollar. If you price gold in Canadian dollars, it's up nearly 14% since the beginning of 2015.

The combination of negative rates and a weakening U.S. dollar could be huge for the price of gold going forward.

How to play it?

If an investor is convinced gold is heading higher, how can one profit?

One of my favourite plays is the **Central Fund of Canada Limited** (TSX:CEF.A)(NYSE:CEF). This is a simple closed-end fund that holds 1.69 million ounces of physical gold bullion and 76.96 million ounces of silver. The Canadian listing trades at a 6.4% discount to the value of the assets. Back in 2011 when the sector was on fire, Central Fund regularly traded at a healthy premium to its net asset value.

But there's one problem with buying physical gold itself, and that's a lack of operating leverage. For a producer with a slight profit when gold is US$1,000 per ounce, $1,200 per ounce is a big win. The extra $200 per ounce flows straight to the bottom line.

This is why **Kinross Gold Corporation** (TSX:K)(NYSE:KGC) looks very attractive in a rising gold-price environment. The company has global production, relatively low all-in sustaining costs of less than US$970 per ounce produced, and a balance sheet with only $950 million in net debt and an additional $1.5 billion in borrowing power.

On a free cash flow basis, the company is expected to be nicely profitable in 2016. According to its most recent investor presentation, Kinross investors can expect a free cash flow yield of more than 20% if everything goes to plan in 2016. And with a net debt-to-EBITDA ratio of 1.1, Kinross is in good shape to borrow to expand some of its lower-cost production, like in Russia.

Ultimately, gold could continue to look very attractive compared to many government bonds. This, combined with further weakness in an overvalued U.S. dollar, could be very good news for gold producers like Kinross.

CATEGORY

1. Investing
2. Metals and Mining Stocks

TICKERS GLOBAL

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Author
nelsonpsmith