Should You Dump Gold Stocks in Anticipation of the Fed Rate Hike in June?

Description

Minutes of the U.S. Federal Reserve's meeting last month revealed that majority of the policy makers are in favour of increasing interest rates as early as June if incoming economic data remains upbeat. Interestingly, the latest data from April appears to be just that, making the case for a rate hike pretty strong:

- U.S. industrial production clocked its biggest gains since November 2014, fueled by strong demand for natural gas, electricity, and auto.
- Retail sales rose 1.3% in April to post its biggest gains since March 2015, driven primarily by strong auto sales.
- U.S. new home sales shot up to eight-year highs in April, and housing starts came in better than expected, suggesting an uptick in construction activity.
- U.S. consumer prices shot up at a pace last seen in early 2013, indicating higher inflation–one of the factors supporting a rate increase.
- Labour markets are improving with the number of jobs rising in April even as unemployment rate remained flat.

Why a higher rate hurts gold prices

A higher interest rate is a headwind for gold for several reasons:

- It increases the opportunity cost of holding the metal.
- It boosts the U.S. dollar–the currency gold is denominated in, thus making the metal expensive.
- It makes zero-interest-paying gold less attractive as yields on money market and debt instruments linked to the U.S. rates improve.

The above factors combined with others pressure gold prices when interest rates go up.

Could gold slump?

While there's no denying that gold prices drop in rising interest rate scenarios, history reveals that gold also has a tendency to bounce back within months of a rate increase. Gold's rally since the Fed's last rate increase in December 2015 is an example.

The point I'm trying to drive home is that while the interest rate is a key driver of gold prices, it isn't the only one. For instance, the demand for gold from major markets like India and China is largely consumer driven and not investor driven. So any fall in prices of the yellow metal may result in higher demand from these nations and help provide a floor to prices.

Moreover, as a classic hedge instrument, gold may not lose much sheen or gain back any losses quickly, given the growing uncertainty in global markets like China and Brazil.

What should you do with gold stocks?

Gold miners are in a better position than they were before Fed's December rate move. Miners are improving operating efficiencies like never before by slashing costs while exploiting lower input costs. **Barrick Gold Corp.** (TSX:ABX)(NYSE:ABX) and **Yamana Gold Inc.** (TSX:YRI)(NYSE:AUY) lowered their all-in sustaining costs (AISC) by 24% and 10%, respectively, during the first quarter, while **Goldcorp Inc.** (TSX:G)(NYSE:GG) saw its AISC drop 6% year over year in Q1.

More importantly, most miners have been conservative in their outlook, perhaps factoring the possibility of a dip in gold prices going forward. Barrick, for instance, is striving to turn free cash flow positive this year at gold prices as low as US$1,000 per ounce. Goldcorp believes it has "more than sufficient" cash flow at current gold prices to fund debt and growth projects and pay a sustainable dividend. So investors will probably not have to hit the panic button on miners' cash flows even if gold prices slip about 10-15%.

Of course, any speculation or negative news could see gold stocks swing wildly, especially after their massive run up this year. So you can expect better entry points in near weeks. But if you can stomach the volatility, holding on to promising low-cost miners like Barrick–and even buying more on dips–should be a prudent approach for long-term investors right now.

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2. Metals and Mining Stocks

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Date
2025/09/15
Date Created
2016/05/26
Author
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