Contrarian Investors: Are Gold Stocks Oversold?

Description

Contrarian investors are always searching for beaten-up stocks that could be on the verge of a recovery.

Let’s take a look at the situation in the gold market to determine if this is the right time to buy gold producers.

Volatility

The price of gold has been on a roller-coaster ride in the past 12 months, ranging from a low of about US$1,130 per ounce to a high close to US$1,350.

At the time of writing, the precious metal is extending its recent downtrend and trades for US$1,250 per ounce.

What’s going on?

The price of gold is generally driven by two factors — the fear trade and the outlook for interest rates.

On the fear side, safe-haven seekers have historically shifted funds to gold when there is concern about geopolitical upheaval or perceived risks of a meltdown in financial markets.

In recent years, however, traders have become rather numb to geopolitical situations. Gold barely budged after the Brexit vote, and increased terror attacks have had little impact on the market.

Nuclear threats from North Korea fueled some gold buying earlier this year, but even that has fizzled out, as the media shifts its focus to other stories.

So, betting on gold as a safe-haven play to hedge against geopolitical risk only appears to be valuable for short-term positions rather than long-term holdings. In addition, stock markets continue to hit new highs, so there is little support for hiding from a downturn in the financial market, at least in the near term.

The interest rate situation is likely playing a larger part in the volatility of the yellow metal.

Rising interest rates tend to be negative for gold as they increase the opportunity cost of owning the precious metal, which doesn't provide any yield. Higher rates in the United States can also put upward pressure on the American dollar, in which gold is priced.

This makes gold more expensive for holders of other currencies and can have a negative impact on demand.

Other factors can come into play, and we have actually seen weakness in the U.S. dollar in the past year, despite increases in U.S. rates.

What about inflation?

Gold is also seen as a hedge against inflation. For the time being, inflation doesn't appear to be much of a concern, although some rumblings are beginning to emerge about inflationary threats.

Former Fed Chair Alan Greenspan recently said the proposed tax-overhaul by Republicans could send inflation "dangerously higher."

Should you buy gold stocks?

Volatility will likely continue, and the current momentum suggests gold could extend its recent pullback.

As such, you really have to be a long-term gold bull to own the miners today. If you fall in that camp, **Barrick Gold Corp.** (TSX:ABX)(NYSE:ABX) might be a good place to start.

Barrick is making good progress on its turnaround efforts and has significantly reduced its debt position in the past two years. Management plans to strengthen the balance sheet ever further and increased the dividend in 2017.

The company is the world's largest gold producer with very low all-in sustaining costs, so rising prices can have a large impact on margins and free cash flow.

The stock currently trades near its 12-month low and might be getting oversold as investors bail out of the sector.

I wouldn't back up the truck, but gold bulls might consider starting a contrarian position on additional weakness.

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Author
aswalker