Are Gold Stocks Still Cheap?

Description

The price of gold continues to reach new multi-year highs, and investors are starting to wonder if the rally is going to take the precious metal to a new record.

Background

Gold rose from US$300 per ounce in 2002 to its peak roughly eight years ago around US$1,900. It then went into a downturn, falling below US$1,100 in late 2015. Since then, gold has pretty much traded in a range of US$1,150-1,350 until the big breakout began in June 2019.

In the past few months, the yellow metal has surged from US$1,300 to above US$1,550, and pundits are starting to suggest this could just be the beginning of another multi-year run.

Upside

As crazy as it sounds, [$2,000] might be a modest target.

Why?

Gold tends to find favour when interest rates are falling and when global traders are searching for a safe place to stash funds to protect capital.

The U.S. Federal Reserve recently cut its target interest rate for the first time in a decade, reducing the rate by 25 basis points. This was practically unthinkable just one year ago, but the ramp up in the trade war between the United States and China is threatening to push the U.S. economy into a recession. As a result, the Fed is forced to lower rates to try to offset the pain.

Falling interest rates normally translate into lower returns on guaranteed investments, and that reduces the opportunity cost of holding gold, which doesn't offer any yield. Suddenly, gold is catching a bid.

The longer the trade dispute between China and the U.S. continues, the more likely it is that the entire global economy could hit a rough patch. Governments around the world are already cutting interest rates in a defensive move to support their economies.

This drives gold demand in two more ways. First, the reduction of interest rates is a tool countries use to try to weaken their currencies. With governments in a currency war, global investors are concerned about protecting their purchasing power. Owning gold, which trades in U.S. dollars, is one way to meet that objective.

Second, there is an uncomfortable trend occurring in the global bond market with more than $17 trillion in government bonds now providing negative yields. It's tough to get your head around the concept, but in a nutshell, the government might borrow $100 from you today with a promise to give you $99 back after 10 years.

In this situation, a zero return from gold starts to look good for institutional investment funds that would normally hold a significant amount of government debt.

Additional geopolitical threats are providing even more support for gold. Brexit is a mere two months away, and the risk of a no-deal divorce between the U.K. and European Union is driving safe-haven demand.

Tensions in the Middle East continue to keep investors on edge, and the latest spat between India and Pakistan isn't making them feel any better about global stability. North Korea also remains a wildcard.

Any one of these situations on its own wouldn't normally drive a flood of money into gold, but the combination of the various threats is likely driving new gold demand.

How to invest

Gold stocks have rallied 50-100% since June, but many still appear cheap, especially if the gold rally is in its early stages.

The miners had fallen so far from previous levels that the upside potential is significant. Many of the gold producers have worked hard to clean up their balance sheets and are focused on developing high-return assets. The bulk of the top players were already making money at US$1,200 per ounce.

With gold now well above US$1,500, there is an opportunity to generate truckloads of free cash flow, and the market might not be fully appreciating the impact a US$300 gain can have on profits.

For example, **Barrick Gold** is targeting annual gold production of better than five million ounces. A sustained US$300-per-ounce increase in gold prices puts an extra US$1.5 billion in the bank account. In the event gold moves to US$1,800 and stays there, you are suddenly looking at an extra US$3 billion.

Gold can be volatile, and any positive developments in the trade disputes would likely trigger a healthy pullback, but the medium-term trend should be positive for the yellow metal, and gold stocks still look undervalued.

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