Gold Price Soars 25%: Should You Buy Gold Stocks Now?

Description

The price of gold just topped its highest level since early 2013, and investors are wondering if the recent strength is the start of a new rally that could see the price of the precious metal hit a record.

Momentum

The rally in the price of gold started in late May last year when gold traded at less than US$1,300 per ounce. A strong move through the summer months took the price to US$1,560 in early September. Traders booked profits in the next three months, and gold slipped back to US$1,460.

A new upswing kicked in to finish 2019 and has continued through the first part of 2020.

At the time of writing, gold trades at US$1,620 per ounce, up 25% in less than a year. Pundits are now saying a gold price of US$2,000 is possible in the next 12-24 months. Gold hit a record high above US$1,900 per ounce in 2011.

Fear and interest rates are key drivers for the price of gold. In 2019, both factors contributed to the rally, as investors added gold exposure to their portfolios.

The U.S. government reduced interest rates three times last year. Lower interest rates result in weaker yields that investors can receive by parking their money in guaranteed investments. As a result, the opportunity cost of owning gold, which offers no yield, is reduced.

Falling bond yields also have an impact. The world is witnessing a trend toward negative interest rates on government debt. Germany and Japan, among other countries, have trillions of dollars of debt, and it now costs the investor money to own bonds, rather than offering a return. In this scenario, holding no-yield gold starts to be attractive.

On the fear side, the trade battle between the United States and China fuelled safe-haven demand in the past year, as investors shifted to gold as a hedge against a potential economic downturn. The announcement of a phase one trade agreement didn't do much to alleviate the concerns, as tariffs remain in place and companies are delaying investment decisions.

The coronavirus outbreak is adding to the fear that a global economic slowdown could be on the way. China is a key player in the smooth operation of global trade, and the disruptions to supply chains could have a broad-based impact.

Governments often cut interest rates to soften the blow of a weakening economy. This would further support gold demand. In addition, holders of currencies other than the U.S. dollar might buy gold to protect purchasing power. Gold is traded in U.S. dollars, and there is a risk of a race to devalue currencies as a means to make exports more attractive to international buyers.

Even if the devaluation isn't official policy, it can still occur. The Canadian dollar, for example, traded at par with the U.S. dollar in early 2013. Today, the loonie only buys US$0.75.

Should you buy gold stocks?

Gold stocks are moving higher, but many miners still sit well below their 2011 highs, and the sector is arguably in much better financial shape.

Barrick Gold (TSX:ABX)(NYSE:GOLD) has gone from being nearly buried under US$13 billion in debt to finishing 2019 with net debt of US$2.2 billion. If gold maintains its recent gains, Barrick Gold could be effectively debt-free by the end of 2020.

The company has streamlined its operations and is focusing on high-return mines with an eye to generate strong free cash flow. The board just raised the dividend by 40%, and more increases should be on the way. Large players, such as Barrick Gold, stand to benefit significantly when the price of gold rises. Barrick Gold is targeting average annual gold production of about five million ounces per year.

In the event the price of gold rises another 25%, or US$400 per ounce, and sustains the gains, the company would pull in an additional US$2 billion per year.

Barrick Gold trades at close to $28 per share right now. In 2011, it was above $50, so there is solid upside potential.

Gold can be volatile, but the rally is starting to pick up strength, and the factors supporting the increase should remain in place through 2020 and into next year.

If you have some cash on the sidelines, gold stocks deserve to be on your radar today.

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