Why Gold Stocks Look Cheap Today

Description

The price of gold is starting to recover from a recent pullback, but gold stocks are not rebounding as much as one might expect and still appear undervalued today.

Gold outlook

Gold trades near US$1,790 per ounce at the time of writing. The price of the yellow metal hit a record high around US$2,080 last August and fell back below US$1,700 in March. Since then gold has been as high as US$1,900.

Gold bears say rising inflation could force the U.S. Federal Reserve to raise interest rates sooner and by much more than the market expected just a few months ago. Gold plunged in June after Fed officials indicated they anticipate two rate hikes by the end of 2023 as opposed to the guidance provided in March that saw no moves before 2024.

Why is this important?

Higher interest rates normally boost the return investors can get from no-risk investments. This can trigger a move of funds from gold that doesn't pay any interest. In a zero-yield or negative yield world, gold looks pretty good. Once the opportunity cost of owning gold increases, the gold market can see headwinds.

Analysts are also trying to decide if cryptocurrencies are replacing gold as an alternative investment to protect buying power and hedge against economic uncertainty. The drop in the price of gold through the first quarter of 2021 is partly blamed on traders shifting funds out of the metal to bet on the bitcoin rally.

The subsequent 50% sell-off in bitcoin might have led to the surge in gold to US$1,900 last month as money rotated back to gold. If significant institutional money is bouncing back and forth between the two, investors could be in for some added volatility in the coming years.

Gold bulls see inflation as a reason to buy. The precious metal has a long history of being favoured by investors who want to protect purchasing power. The global trend towards negative real yields on government bonds that occurred in recent years could also accelerate in an environment with high inflation.

This, in theory, makes gold a more attractive option. Zero-yield gold starts to look good when the alternative is to pay the government to borrow your money or to receive a negative return when adjusted for inflation.

Gold stocks look cheap

Gold miners spent the past decade cleaning up their balance sheets after a wave of expensive acquisitions during the last boom saddled many of the top players with massive debts. Across the industry, management is now focused on delivering strong free cash flow on high-return assets.

Mergers are occurring at small premiums and balance sheets are now in great shape thanks to disciplined cost-cutting, non-core asset sales, and a rebound in the price of gold.

Barrick Gold (TSX:ABX)(NYSE:GOLD) is a good example. The company went from having US$13 billion in debt to its current position of zero net debt. Barrick Gold generates significant free cash flow at the current gold price and is rewarding investors with rising dividends and bonus payouts via a US$750 million return of capital in 2021.

The price of gold is down about 14% from 2020 highs. Barrick Gold's share price is off 35%. The share prices of the mining companies typically move more than the price of the precious metal, but the spread looks way overdone right now.

The bottom line on gold stocks

Gold bulls might want to add top gold stocks to their portfolios right now while the group appears cheap. The gold sector could see a meaningful move to the upside through the end of the year and into 2022 if gold continues to drift higher.

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