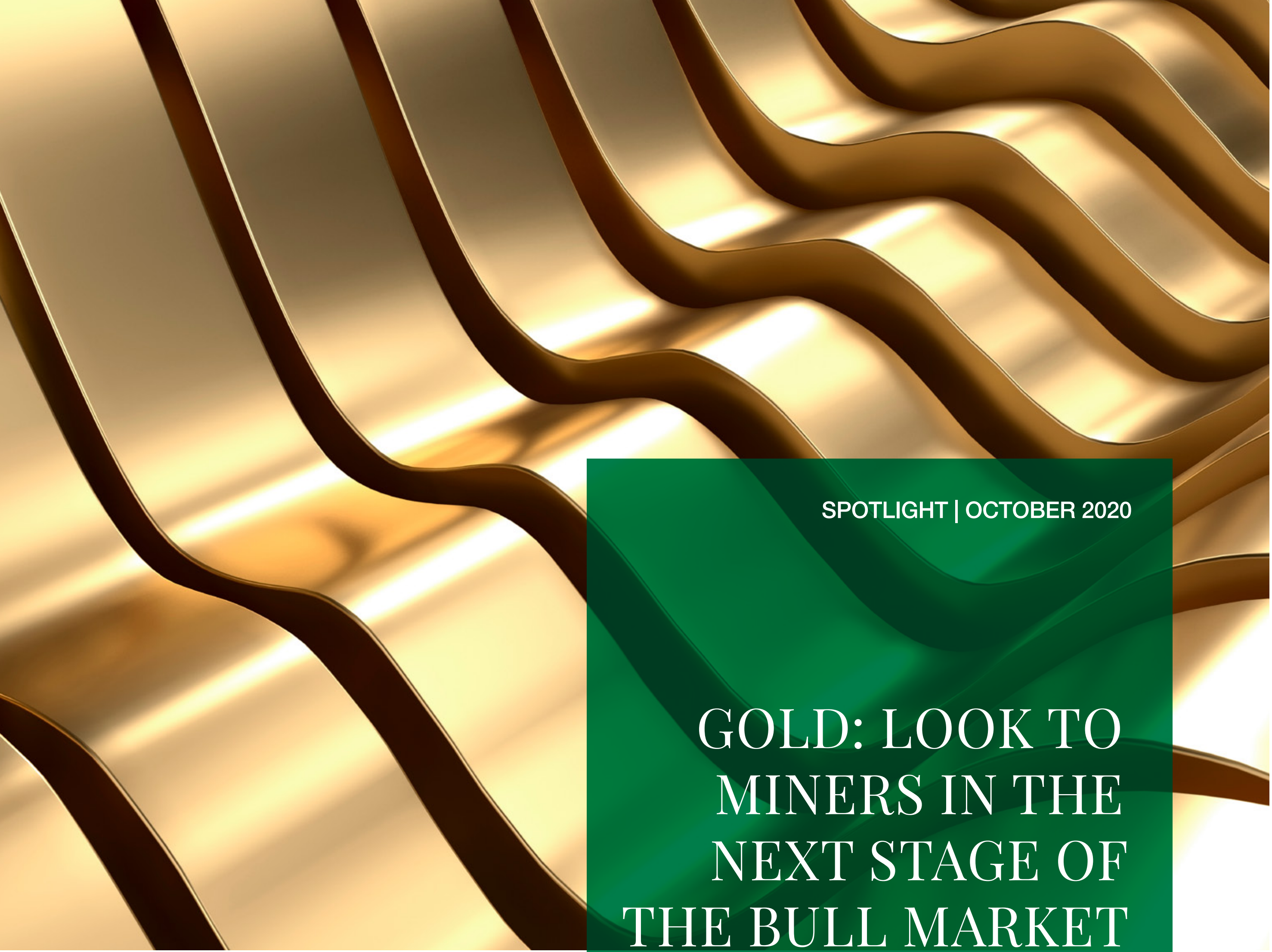

SPOTLIGHT | OCTOBER 2020

GOLD: LOOK TO MINERS IN THE NEXT STAGE OF THE BULL MARKET

Key points

- Despite the correction of the past weeks, we continue to believe gold remains in a long-cycle bull market that should resume as stimulus accelerates again in early-2021.
- The pause provides an opportunity for investors not only to continue building positions in the physical metal following the sharp rally from the March, 2020 lows, but also to refocus on the gold mining sector which should see multiple drivers beyond rising gold prices as a performance catalyst.
- Historically, low energy prices and falling local currency production costs mean that gold miners will see their costs fall by as much as 13% to USD 900/ounce or more than 50% below current spot gold prices.
- Beyond this, mine reopenings in late-July and August following their COVID-19 related closures in the first half of the year should see volumes return to match the cyclically high margins in the sector and drive the next stage of earnings growth as companies report 3rd quarter earnings in the weeks ahead.
- Strong cost management combined with the bull market in the underlying metal suggest that high quality producers may see rising dividends as well as value accretive acquisitions looking ahead.
- Consequently, gold miners position investors to benefit not only from the resumption of the long-cycle bull market we expect in early-2021 but also a near-term earnings catalyst as volumes rebound in the coming quarters and a long-term driver via rising dividends and earnings accretive M&A.

Global Investment Committee

UNION BANCAIRE PRIVÉE

Gold bull market set to resume going into 2021

The inability of US fiscal authorities to agree on additional relief measures ahead of the November US elections and the hesitance on the part of the Federal Reserve to fill the policy gap that has emerged to support the recovery has resulted in a correction in the gold bull market that began with the end of the Fed's last rate hiking cycle in late-2018.

Fed policy holds the key to the next leg of the gold bull market in 2021

Sources: Bloomberg Finance L.P. and UBP

However, once the election season passes, we expect that US fiscal resolve combined with the resumption of Fed support via bond buying should provide the next tailwind to the gold bull market.

While in the near term volatility may persist especially entering the uncertain US election season, we continue to expect to see gold reaching USD 2,200/oz. by December, 2021 as the US strategy of deeply negative inflation adjusted interest rates more formally takes hold in the new year (please see UBP Spotlight: *Investing in a New Fed Policy Regime*, September 2020 for more details).

Fundamentals add near- and medium-term drivers to gold miners…

During this transition, investors looking to build positions in the sector should search beyond simply the physical metal and also consider gold miners where fundamental catalysts put in place during the previous bear market have already begun to serve as a tailwind to earnings as an additional driver in the months and years ahead.

In particular, the gold bear market from 2012-18 has forced the industry not only to consolidate but also to undertake a transformation that has driven sustained falls in the costs of production from as high as USD 1,200 per ounce in 2013-14 to closer to USD 900 per ounce currently, more than 50% below the current spot price of gold.

This has been supported by the secular decline in energy costs since Saudi Arabia began the first of two price wars in 2014 to contain the output of high cost crude producers. With Saudi Arabia continuing in this effort, combined with the prospect of a 'green' movement bearing down on demand, energy cost containment should continue to be a feature for the segment looking ahead in marked contrast to the 2000-2008 gold bull market which coincided with an oil bull market where crude prices rose from USD 20/barrel to USD 140/barrel at their peak.

With the combination of rising gold prices and falling energy costs, margins for the sector have already reached the levels seen at their previous peaks. This margin expansion alone has driven earnings growth in the sector to a pace beyond that seen at the height of the 2000-2011 bull market.

Despite this, the coming quarters should see an additional earnings catalyst as companies report their results. The lockdowns in early 2020 hit mining companies particularly hard as mine closures due to spreading COVID-19 infections stalled production growth, limited sales and constrained earnings growth in the period.

With mines having begun to reopen in late-July and August, the upcoming earnings seasons should allow volume growth to join wide margins and high prices as a driver to the next round of earnings expansion for the sector in the quarters ahead.

Mine closures in 1H2020 have meant a bull market in gold prices but not yet a bull market in gold sales for miners

Sources: NYSE Arca, Bloomberg Finance L.P. and UBP

Beyond resuming production at previously shuttered mines to drive near-term earnings surprises, investors could see more medium-term benefits as well. This emerging cost and margin dynamic means the potential for a new free cash flow regime for the sector, historically known in previous cycles as a consumer rather than a generator of cash.

This cash generation should provide flexibility amongst some of the sector's largest producers to continue raising dividends, increasing total returns to shareholders in the process.

Moreover, as gold mine supply is set to peak and go into secular decline in the decade ahead, free cash flow may force producers to turn increasingly to mergers and/or acquisitions of stakes in individual projects to consolidate and enhance output amongst junior miners in the sector.

Unlike acquisitions in previous cycles which were focused on scale and growth, we expect these acquisitions to instead be smaller and concentrated on being incrementally accretive to earnings.

Positioning in the gold mining segment

Admittedly, the gold mining sector as a whole has historically been a destroyer of value for shareholders due to imprudent deployment of capital usually near the peak of the long mining cycle, resulting in a high degree of volatility in mining shares.

Indeed, in the most recent bear phase from 2011 to 2018 when gold prices fell nearly 45%, gold mining stocks lost 84% on aggregate from peak to trough. In the current bull market, a passive investor in gold mining stocks has outpaced the 45% rise in gold prices since early-2019, more than doubling the initial investment outlay. As a result, we recommend an active, quality-biased stock selection focused approach when investing in the gold mining segment.

Royalty and streaming companies may provide a comparatively lower risk entry point into the sector for investors. Such companies are those which provide gold producers with upfront financing in exchange for a share of gold production or revenue generated from a particular project.

Typically, these companies are less exposed to the operational risks of a project as their share comes from the revenue line rather than via a share of profits. In this way, royalty and streaming companies provide leverage to changes in the gold price without the operating leverage and the associated capital and operating costs, and exploration risks of producers.

When financing is tight, as during the 2011-18 bear market in gold, royalty and streaming companies are better able to secure attractive projects to finance.

However, with free cash flow currently strong across many miners, attractive projects in need of capital are more challenging to identify and more competitive to secure for royalty companies making them increasingly reliant on a combination of their existing project portfolio built up over recent years and rising metal prices to drive earnings.

Large, diversified, well run producers offer another option for investors into the mining space. Benefitting from exposure to rising gold prices, large, diversified producers mitigate the risks of poor capital allocation decisions due to their size and longevity in the industry.

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