Gold and gold equities in 2019:
Recovery amid rising financial market risk

Baker Steel Capital Managers LLP

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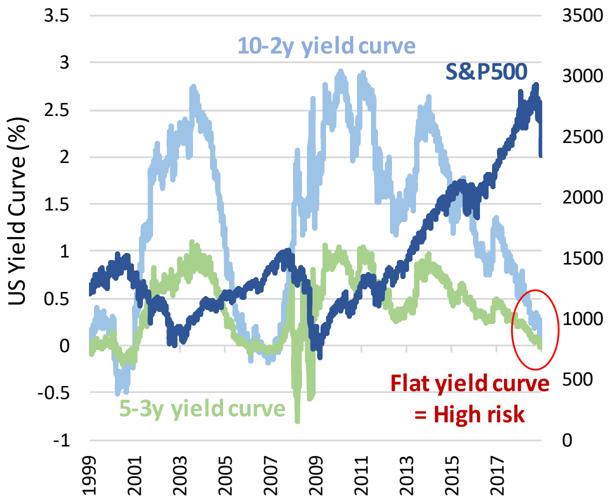
A fundamental shift is underway in global financial markets. 2018 was defined by an increase in financial market risk, highlighted by heightened volatility in equity markets and growing pessimism among investors as the decade long US equity bull market shows signs of fading. As the era of low volatility, steady equity market returns and bullish sentiment draws to an end, gold and gold equities appear poised for recovery, backed by a range of supportive macroeconomic drivers and rising demand from investors facing an uncertain economic outlook and seeking protection from tumultuous equity market conditions.

Themes for the gold sector in 2019:

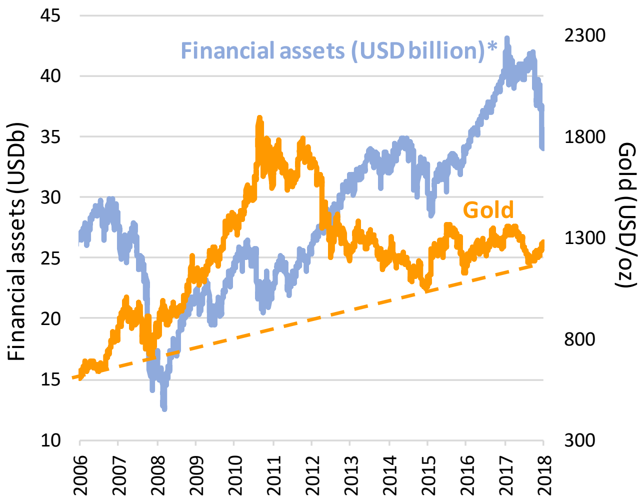
- Rising financial market risk presents a significant driver of gold demand.
- Real interest rates are likely to remain low as the US rate hike cycle slows and inflationary pressures remain.
- Expanding debt levels are a growing concern for policymakers and investors.
- The outlook for the US dollar appears weaker.
- Gold equities are undervalued relative to broader markets and compared to historic valuations.
- Reforms within the gold mining sector are making gold equities more investible than for some time.
- Geopolitical tension shows no sign of abating.

The final months of 2018 saw a deterioration in the outlook for global financial markets, yet market conditions for the precious metals sector appear to be improving. Among the major themes for investors in 2019 will be policymakers' response to slowing economic growth and rising financial market risk. Warning signs are flashing in financial markets, including the flattening of the yield curve, an indicator of tightening financial conditions which has historically signalled an imminent economic slowdown, and rising volatility at time of historically high valuations in US equity markets.

Flattening yield curve implies rising risk



Real assets are postioned for recovery

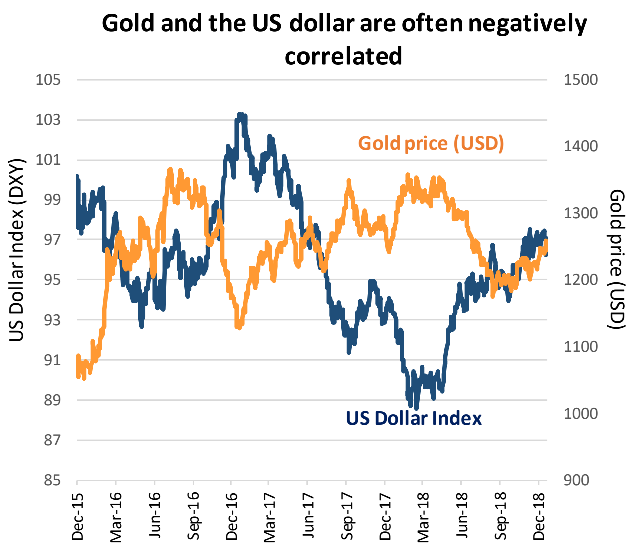


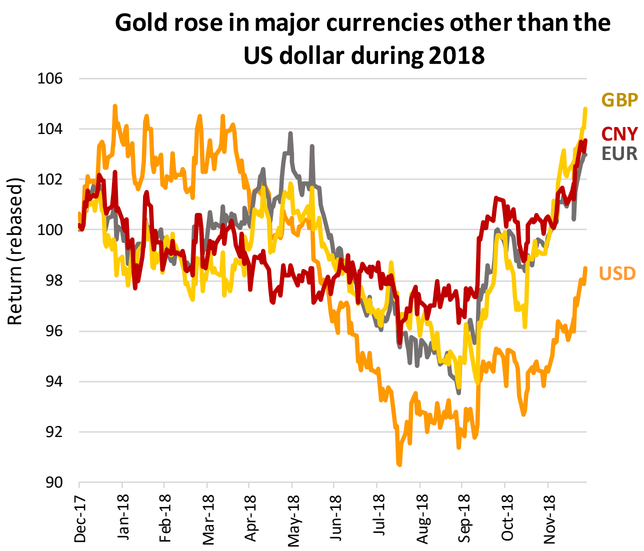
Source: Baker Steel internal. Bloomberg. Data at 28 December 2018. *Mkt cap of the MSCI world index.

After a year of mixed performance, the gold sector is positioned for recovery

2018 proved a mixed year for the gold sector, in US dollar terms at least, as bullish sentiment towards US equity markets and US assets caused the metal to be side-lined for much of the year by investors. However, these placid market conditions ended abruptly in October 2018 as rising fears over the US-China trade war and concerns over the negative impact of rising interest rates spooked financial markets, which had hit record highs during September. Equity markets finished the year substantially down, with the S&P500 and the Dow Jones Industrial Average registering their worst annual returns since 2008. Similarly, European indices, including the Stoxx 50, registered their worst annual performance in many years.

In contrast to general equity markets, the gold sector rebounded convincingly during the fourth quarter of 2018, as investors sought portfolio protection, diversification and a safe haven from equity market turmoil. Since reaching the lows of its last cycle in December 2015, the gold price has steadily built its recovery. A correction during Q3 2018 sent the metal to the lows of its recent trading range, yet gold has held its upwards trajectory, in the face of a strong US dollar, and appears positioned for a recovery amid an increasingly supportive economic backdrop. The strength of the US dollar presented a headwind for gold during 2018, as the strong performance of the US economy dominated financial markets and kept pressure on gold and gold equities. While gold finished the year slightly down in US dollar terms, the metal made gains in major currencies other than the US dollar, rising modestly in Euro, Sterling and Renminbi terms. Importantly for gold equities the gold price made gains in producer currencies, such as the Australian and Canadian dollar, representing margin expansion benefits for selected gold producers.

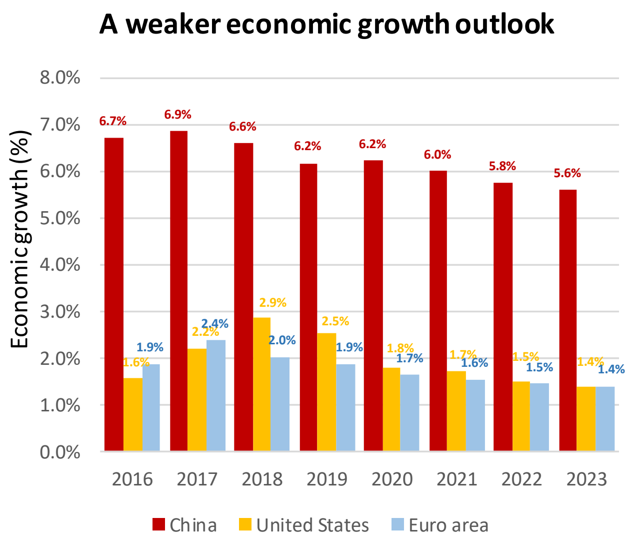


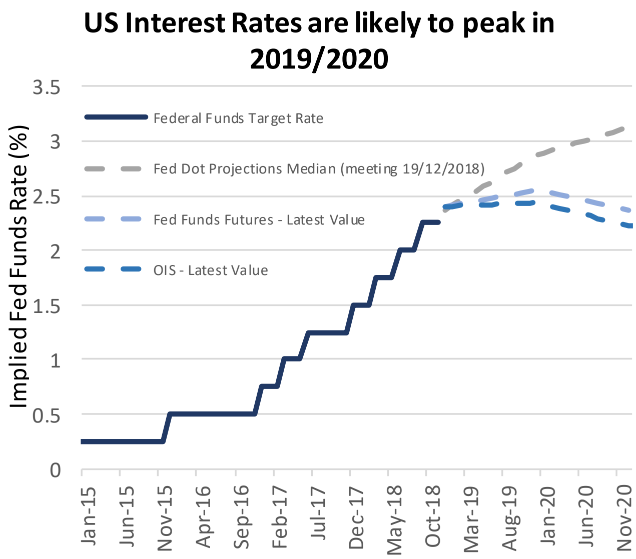


Source: Bloomberg. Data at 28 December 2018.

Global economic growth is slowing, yet the macroeconomic environment is supportive for gold

Evidence of a global economic slowdown is building, highlighted by a reduced growth outlook in the US, Europe, China and emerging markets. The US economy's performance during 2018 was largely been shielded by the positive effects of Trump's tax cuts, which boosted economic activity and confidence, however the outlook for growth is weakening as the beneficial impact of the tax cuts wears off and as tighter monetary conditions, rising public and private debt burdens, the strong US dollar and the uncertainty of the trade war take their toll. The return of fear and uncertainty to global financial markets in late-2018 presents a sea-change for investors, after the years of low volatility, steady market gains, optimism and complacency. A steady flow of positive US economic data during much of 2018 has buoyed US equity markets, however the best days of the US equity bull market are likely behind it.

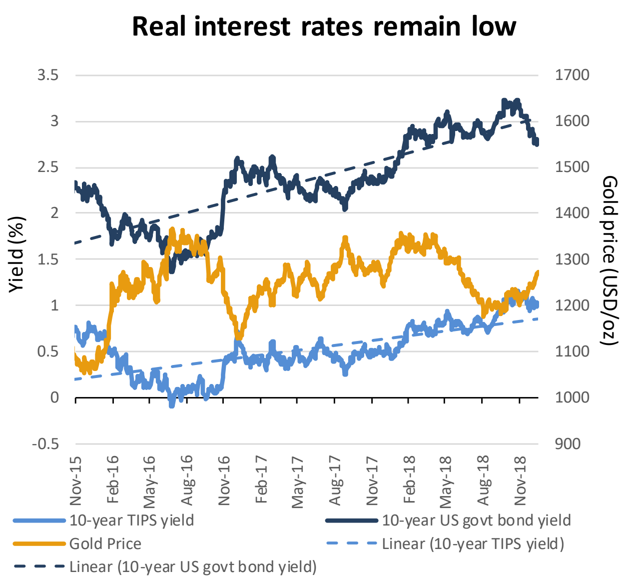


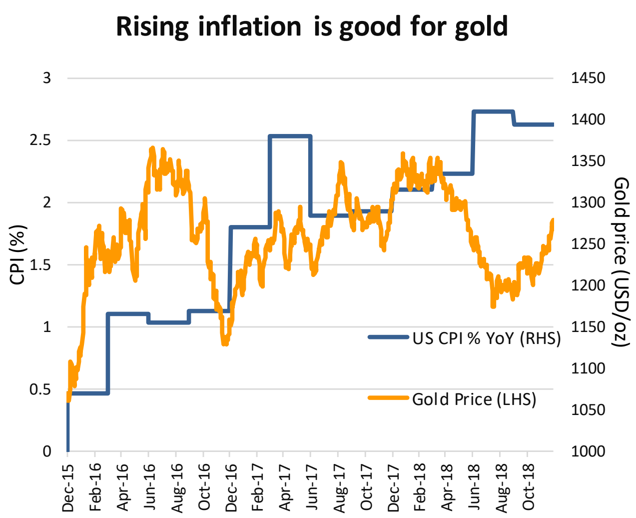


Source: Bloomberg, IMF, Baker Steel Capital Managers LLP. Data at 28 December 2018.

The outlook for the global economy and broader financial markets is highly significant for the gold sector, given gold's status as a safe haven asset and portfolio diversifier. However, given the importance of wealth creation on demand for precious metals, a potential economic slowdown also poses threats for the gold sector, as it does for many industries.

Firstly, we identify several key positive factors for gold under current economic conditions. Most significantly for gold, US real interest rates appear likely to fall, or at least remain low for the foreseeable future. Low real rates are supportive for gold as low yields reduce the opportunity cost of holding gold for investors, as well as boosting inflationary pressures. After three years of interest rate 'normalisation' in the US, the pressure of higher nominal rates on economic activity is starting to show, yet real rates have remained low. The US Federal Reserve has resolutely stuck to its interest rate hike programme in the face of opposition from the White House, attracting frequent bursts of social media outrage at rising rates from the President, and concern from Wall Street, where the impact can be seen in recent troubled US equity market performance.





Source: Bloomberg. Data at 28 December 2018.

High debt levels are a growing concern for policymakers after years of low rates and threaten to amplify the negative economic impact of hiking rates. The impact of rising borrowing costs and debt servicing on businesses and consumers should provide a further incentive for the Fed to avoid raising rates significantly beyond current levels. Should the Fed opt to pause its rate hikes, or even cut rates, during 2019 this would be highly significant for gold. The gold price hit its lows as the Fed announced the first rate hike of the current cycle in December 2015 yet recovered in the following years as it became clear the pace of hikes would be slow and that real interest rates would remain low.

Steadily rising inflation in the US presents a further macroeconomic driver for gold in 2019. Having been absent from official statistics in recent years, inflationary pressures appear to be building and several factors suggest inflation is unlikely to subside in 2019. In particular, the US tariffs imposed during 2018, coupled with a tight labour market, are likely to continue to exert upward pressure on consumer prices. Trade disputes, tariffs and economic nationalism, led by the Trump Administration, are likely to remain a key theme during 2019. A rising inflation rate, alongside a lower outlook for interest rates, would indicate a supportive economic environment for gold in 2019, despite the threat of economic slowdown.

Despite the range of positive economic factors for gold in 2019, there are potential threats for the precious metals sector under an environment of slowing growth and rising financial market risk. Historically, economic growth is supportive of a rising gold price, with the 'wealth effect' typically acting as a beneficial driver for physical gold demand. While a slowdown of economic activity implies a potential slowing of gold demand for jewellery and technology, it is our view that demand for physical gold will remain robust due to supportive demographic changes in the key markets, central bank purchasing of gold, and investment demand for bars and coins in both developed and emerging markets.

The long-term demographic changes under way in the influential Indian and Chinese markets are expected to continue, as the emerging middle class and growing consumption and investment levels in these economies drives gold demand. During 2018 China, the world's largest gold bullion market, saw demand for gold bars and coins rise by +28% year-on-year (at 28 September 2018). Even with slower economic growth in China and India, we would expect the growth of these markets to outweigh any potential demand weakness elsewhere. Demand for physical gold also remains strong in developed markets, notably in Europe and particularly in Germany, which saw demand for gold bars and coins rise +10% year-on-year (at 28 September 2018). This demand growth highlights gold's ongoing relevance for investors in developed markets, who face a multitude of economic and political risks, from the ongoing Italian budget and debt concerns to the fallout from Brexit and the rise of populism in many European countries. Similarly, central bank gold purchases show no sign of slowing, with Q3 2018 registering the largest quarterly net purchases of gold since 2015, led by China and Russia, with no material net sellers.

Against this positive backdrop for physical gold demand it is notable that gold supply tightness is likely to remain. With exploration expenditure by gold producers having fallen significantly over the past five years and a lack of recent major gold discoveries, it may take some years and likely a substantially higher gold price before any substantial supply increases are likely.

Will gold equities outperform in 2019?

Gold stocks delivered strong performance during the fourth quarter of 2018, in contrast to general equity markets, against a backdrop of rising financial sector risk. This renewed momentum follows gold stocks' lacklustre performance for much of 2018 and a broad sell-off over the summer, as gold stocks came under pressure from weak investor sentiment towards gold and a strong US dollar. The sector remains substantially undervalued relative to historical levels and relative to general markets. An allocation to gold equities typically offers enhanced upside potential relative to gold, in a rising gold price environment, and given the increasingly supportive economic and market conditions for gold we anticipate that 2019 will prove to be a year of recovery for gold equities. However, given the significant disparities which currently exists between gold producers, in terms of asset quality, operations, management and share price performance, it is our view that a 'passive' investment in the sector, such as via an ETF, does not offer the best mechanism for investing in such a specialist sector. Historical returns demonstrate clearly that an actively managed gold equities fund, such as BAKERSTEEL Precious Metals Fund, can offer a superior upside, with lower or similar volatility, relative to an index-tracking fund or an ETF.

Alongside the positive outlook for the gold price, key themes for investors in the gold equities sector include significant reforms which have implemented within the industry since the gold sector's downturn ended three years ago. In a sector which has at times been known for wasteful management practices, unwise M&A deals and often for value-destruction for shareholders, our team have been encouraged to see a selection of gold companies enacting much-needed reforms and a renewed focus on returns to shareholders. Improvements to capital discipline and management reforms have been undertaken, while dividend policies are becoming increasingly common-place, a significant factor for active investors seeking management alignment with shareholders.

Regarding M&A, the most notable transaction of 2018 was the merger of Randgold Resources and Barrick Gold, two majors, to create the largest gold producer globally. The fact that this merger occurred at zero premium of is significance for the gold sector, where premiums have historically been high. Outperformance by Barrick, Randgold and other major producers on the back of optimism surrounding the deal provided a boost to large-cap gold stocks toward year end. While the mid-cap portion of the sector lagged behind during Q4 2018, further dragged down by selling by a large mutual fund undergoing restructuring. Ironically, much of the selling by this fund has impacted the liquid, quality, mid-cap producers in the gold sector, creating a distortion of valuations relative to the larger-cap companies. For active investment managers, the recent underperformance of the mid-cap gold producers has created opportunities to build positions in high quality companies in this segment of the market.

After a year of reform, consolidation and shifting investor sentiment, the gold and gold equities sector is positioned for recovery. The sector is backed by a supportive macroeconomic environment, market conditions are conducive of higher gold prices, gold producers remain undervalued and with a selection of companies having undergone reforms, the potential for investors in 2019 appears substantial. With an increasingly pessimistic outlook for general equities on the back of slowing economic activity, a re-rating of the gold sector, back by robust physical demand, safe haven purchasing, and diversification appears a strong possibility. Timing entry to the gold sector can be difficult for investors, yet historically a strategy of 'averaging in' to build a position in gold and gold equities over a few months has proven to be effective. Active management remains the best method to access the upside potential of a selection of gold producers, with the best assets, quality management and alignment of interest with shareholders.

*Baker Steel Capital Managers LLP manages the **BAKERSTEEL Precious Metals Fund**, an actively managed gold equities fund with a strong track record of outperformance relative to its peers and relative to a passive holding in gold or gold equities.*

*Fund Managers Mark Burridge and David Baker have been awarded **two Sauren Gold Medals for 2018**, and the Fund is the 2018 winner for the third year running of the **Lipper Fund Award** for Best Fund over 3 years and 5 years, Equity Sector Gold and Precious Metals, for Austria, France, UK and Europe and winner over 5 years for Switzerland and Germany.*

Sources: Bloomberg, IMF, World Gold Council, Baker Steel Capital Managers LLP.

Important

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