The Natural Resources Sector in 2020:
Precious metals shine through a shifting global economic outlook

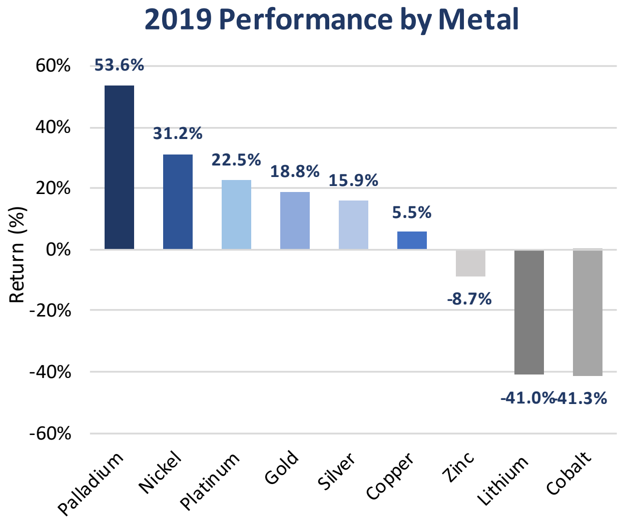
Baker Steel Capital Managers LLP

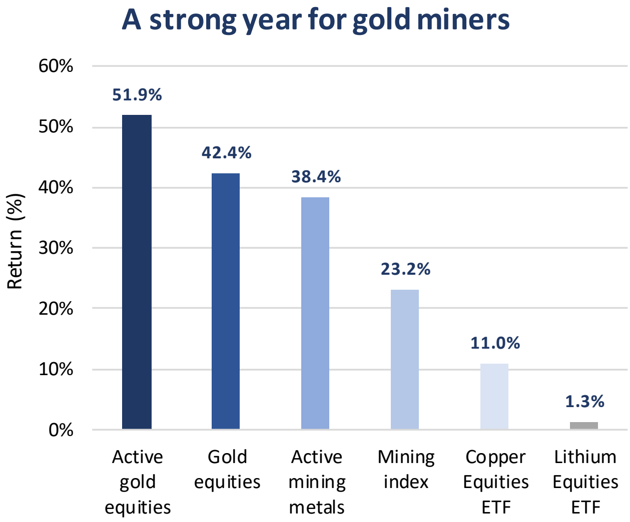
January 2020

At the start of a new year and a new decade Baker Steel's Investment Team sees a multitude of opportunities for investors in mining equities, from the recovery of the gold sector, the emergence of green shoots for general miners and rising demand for speciality metals from new technology. As active investment managers and natural resources sector specialists, Baker Steel is well-positioned to capitalise on trends within the natural resources sector, to the benefit of our Funds and Clients.

Trade war, turbulent geopolitics and new technologies: What happened to natural resources in 2019?

2019 was an important year for natural resources investors as the combination of volatile geopolitics, deteriorating global economic outlook and the rapid expansion of new technologies exerted a multitude of positive and negative pressures on metals prices and producers. The result was substantial disparities in performance between sub-sectors of the mining industry. The precious metals sector shone during the year, while broader commodity markets faced mixed fortunes.





Source: Bloomberg, Baker Steel internal. Data at 31 December 2019. Data in USD terms.
Note, Active gold equities are represented by BAKERSTEEL Precious Metals Fund, active speciality metals equities are represented by BAKERSTEEL Electrum Fund.

A major theme for resource investors in 2019 was the rising gold price and the recovery of the precious metals sector, resulting in improving profitability and strong share price performance for gold and silver producers. Meanwhile a rebound for certain speciality metals, notably nickel and platinum group metals ("PGMs") such as palladium, highlighted the impact of new technology on the resources sector and the vast potential for new metals and materials demand from electrification, renewable energy and automation. More broadly, industrial metals faced a mixed picture as investor concerns over slowing growth and the trade war weighed on sentiment. Copper and zinc prices remained under pressure for much of the year.

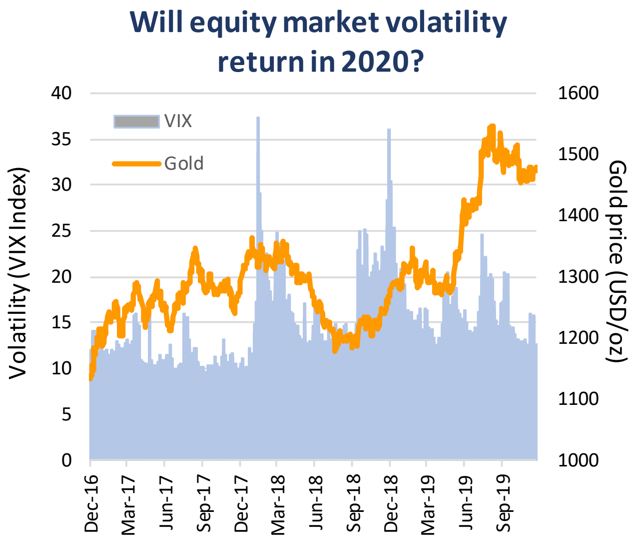
As in previous years, active management proved to be the most effective method for investing in the mining sector, with its specific complexities and intricacies. Looking ahead we see opportunities for generally strong but differentiated performance across the commodities we focus on. Consolidation in the broader mining sector has opened a range of opportunities for active managers as this long-overlooked sector moves towards recovery.

Precious Metals – Gold's bull market is gaining pace

Themes for the precious metals sector in 2020:

- Producers' profitability is improving due to higher gold prices, but significant disparities exist between companies.
- Selected producers have implemented reforms to improve capital discipline and cost controls.
- The macroeconomic conditions for the gold sector are supportive. Low real interest rates, expanding debt levels and the currency war are supportive factors for higher gold prices in 2020.
- Heightened financial market risk is likely to drive demand for gold for portfolio diversification.
- Geopolitical tension shows no sign of abating, as highlighted by the recent resurgent tensions between Iran and the US.
- The outlook for the US dollar appears uncertain, with political turmoil likely to impact currency markets in 2020.
- Gold equities are undervalued compared to historic valuations.
- Constructive M&A in the precious metals sector appears likely to continue.
- Shareholder returns are improving with many gold producers increasing dividends.

Investor sentiment towards gold has been improving gradually in recent years, since the gold price reached its cyclical low in 2015. A core reason for investors' return to gold has been growing demand for portfolio diversification following years of strong equity market gains, low volatility and historically low bond yields. There are signs that the longest ever US equity bull market, which has run for over 10 years, is near its end. Warning lights are flashing, with slowing manufacturing, a job market near full employment and periodic yield curve inversion signalling that a slowdown in economic growth and business activity may be due. Regular bouts of equity market volatility have occurred over the past year, posing an increasing risk to investors after years of low volatility and steady gains.

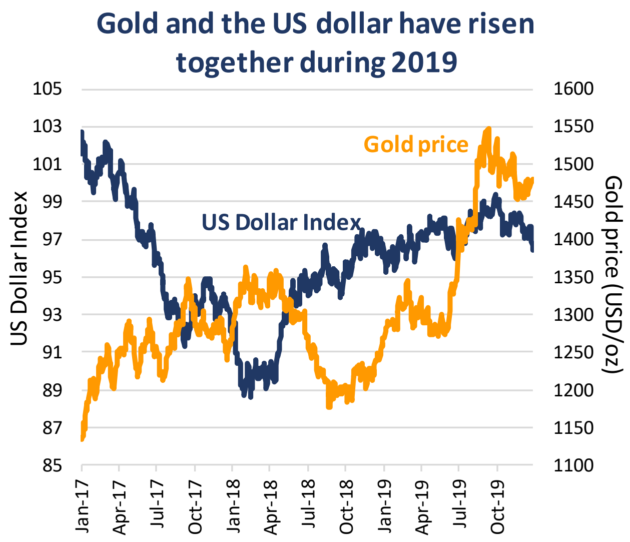


Source: Bloomberg. Data at 31 December 2019.

Gold is an effective portfolio diversifier, being largely uncorrelated to most major asset classes and being a proven safe haven investment. Likewise, gold equities offer diversification benefits, but in a slightly different way. As equities, gold stocks can be negatively impacted by a general equity market sell-off, initially at least, yet gold miners offer the advantages of operational leverage to a rising gold price and superior upside potential relative to a holding in physical gold, while paying a yield. Typically, this has resulted in gold equities outperforming gold by multiples during a gold sector rally and, as is usually the case in this sector, active investment management and stock picking can generate superior risk-adjusted returns.

Against a backdrop of improving macroeconomic factors and market conditions for the precious metals sector, both gold and silver appear well-positioned to continue to outperform during 2020. Low and negative real interest rates appear likely to remain as policymakers face a slowing economic outlook. Global low and negative yielding debt expanded in 2019, with more than USD 11 trillion in debt with sub-zero real yields near the end of 2019. Historically low real interest rates are a highly positive environment for gold, which pays no yield, and it seems the political appetite for loose monetary policy in developed markets is likely to remain dominant for the foreseeable future.

Meanwhile the renewed focus on the impact of currency devaluation on international trade, led by the Trump Administration, has put currency competition in the spotlight. US dollar strength has proved a headwind for gold in recent years, however 2019 has seen gold and the dollar rally together. We expect to see a mixed conditions for the dollar in 2020 and potentially a rise in volatility driven by the impeachment proceedings and Presidential Election, as well as a continuation of the geopolitical tension and trade confrontation which has been such a dominant theme of recent years.



Source: Bloomberg. Data at 31 December 2019.

Baker Steel considers that the most substantial opportunity in the precious metals sector is the recovery of the miners themselves, many of which are now in their strongest position for some years, having benefitted from management reforms, improved cost discipline and increased profitability.

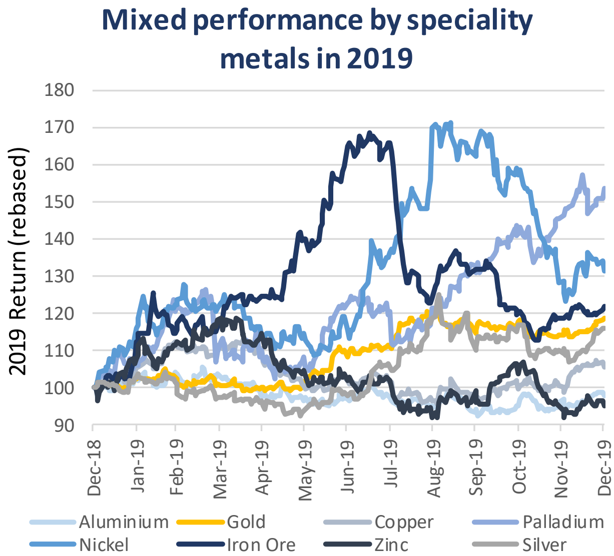
Furthermore, with a number of recent high-profile, value-creating, M&A transactions in the gold sector it seems that management teams are increasingly engaging in constructive consolidation. Following Barrick Gold's acquisition of Randgold Resources last year the number of notable transactions has risen, including Northern Star and Saracen acquiring Barrick and Newmont's Kalgoorlie operations, Kirkland Lake's proposal to buy Detour Gold and Evolution Mining acquiring the Red Lake gold complex from Newmont Goldcorp. It is an encouraging sign for the sector that these deals have largely proved beneficial for investors rather than value-destructive.

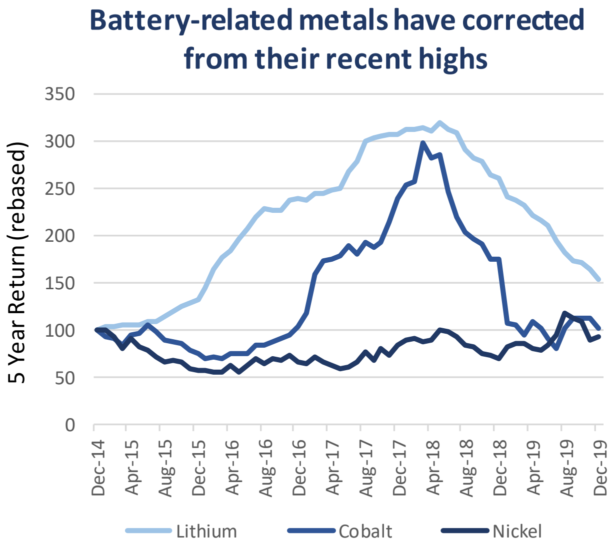
Increasing dividend payments by gold producers presents a further positive development for investors, with Newmont Mining and Yamana Gold having both raised their dividends in recent months for example. Management teams' increased focus on returns to shareholders is a marked shift in an industry which historically has not been known for paying high dividends.

As active investment managers, Baker Steel is focused on gold and silver producers with the highest quality assets, effective management teams and a commitment to returns to shareholders, often through dividends. Through its emphasis on high quality companies, our investment approach is intended to deliver superior returns under all market conditions relative to a passive holding in gold equities.

Speciality Metals – A stronger outlook for 2020 and beyond

The performance of speciality metals prices in 2019 was varied, as a range of economic, political and industrial factors impacted prices. While there were some bright spots driven by supply tightness for certain strategic metals during 2019, others faced demand weakness and destocking which weighed on prices. However, longer-term the outlook appears much brighter, with vast potential for new demand for speciality metals from the development of new technologies, most notably electric vehicles ("EVs"), the development of battery technology and more broadly from the transition towards decarbonisation through the adoption of green technology.





Source: Bloomberg. Data at 31 December 2019.

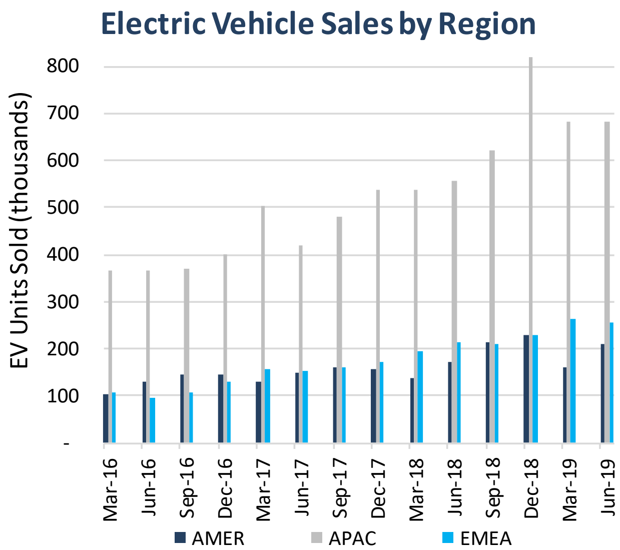
The top performing metals during 2019 included palladium, which benefitted from continued strong fundamentals, and nickel, which saw significant price gains in Q3 due to record low inventories and concerns over restricted supply from Indonesia.

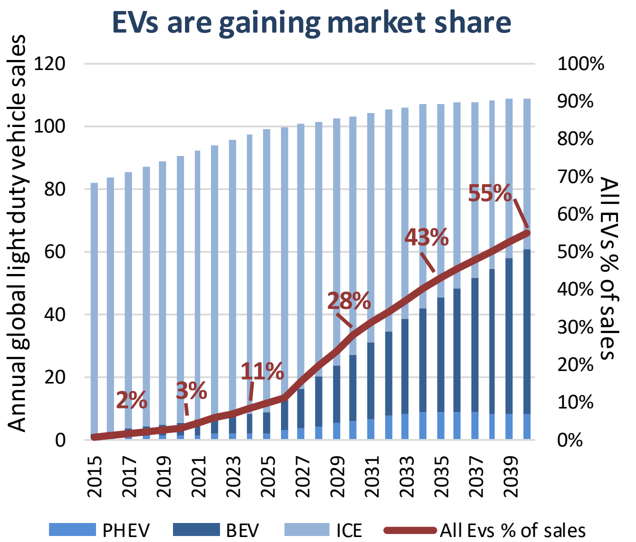
Nickel inventories are still low notwithstanding the recent increases and meaningful new supply is still a couple of years away. Whilst steel demand is still a key driver of nickel's supply and demand picture, EV demand adds another layer of complexity to the market, with premiums and spreads having expanded significantly for certain products during 2019.

Palladium has been a consistently strong performer over the last few years and fundamentals suggest higher prices ahead, amid continued strong demand from the auto sector. That said, we are cautious of the risks posed by platinum substitution and the level of complacency a one-way bet can lure the market into. Platinum itself appears oversold but lacks demand drivers.

A number of speciality metals faced weakness during 2019. Vanadium was the biggest casualty as prices collapsed due to niobium substitution and high levels of by-product production within China. Meanwhile, metals associated with EVs and battery technology, such as lithium, cobalt and graphite, faced fundamentally driven declines. The lithium market in particular has been challenging over the past year, with weaker than expected demand as a result of Chinese EV subsidy cuts and continued oversupply from loss-making Australian mines. 2020 appears likely to be a better year as demand picks up due to rising European EV sales. Longer-term fundamentals appear positive, with potential supply issues for the industry highlighted recently by Chilean lithium producer SQM's expansion permit being declined again at the end of 2019.

The development of the EV market remains a core long-term driver for many speciality metals, while more broadly the trend towards electrification holds far-reaching implications across the commodities spectrum. In recent years some of the key metals involved in current battery technology, most notably lithium and cobalt, have seen rapid price gains, often driven by over-enthusiasm regarding future demand potential, followed by subsequent steep declines as demand lagged expectations and oversupply occurred in some sectors.





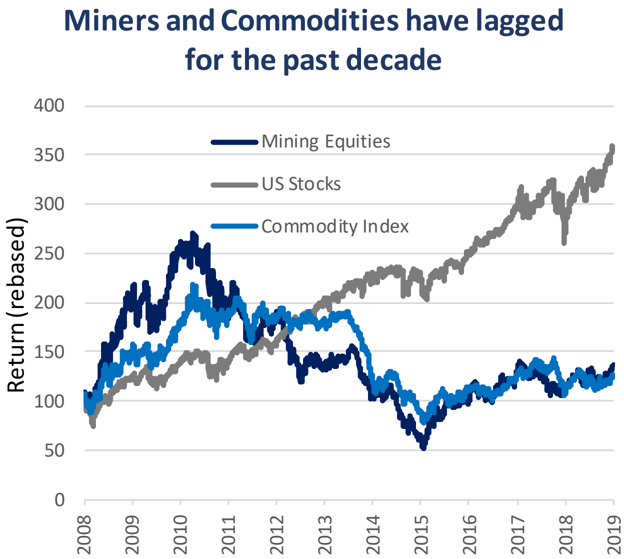
Source: Bloomberg, BNEF. Data at 30 June 2019.

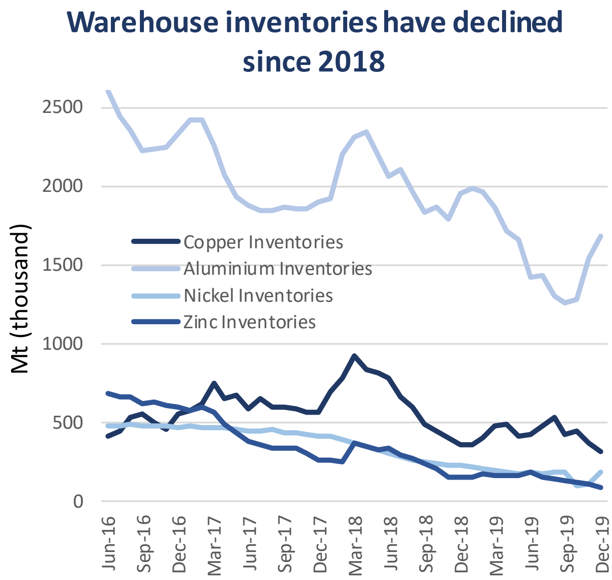
Europe appears likely to continue to lead the way in EV adoption with some countries exhibiting particularly fast growth, such as Norway where EV sales accounted for 58% of new car sales in 2019. Stringent incoming EU legislation is coming into effect in 2021, with new rules which will force carmakers to meet lower CO2 emissions standards for their fleet, rather than individual models, with substantial fines implemented for sales of vehicles which fail to meet the target. As a result, we expect many more vehicles to be launched during the year and public attention to increase markedly. Not only do we expect a material increase in metal demand associated with EVs, but for demand to be concentrated within certain types and grades of specification of each commodity. The demand mix will be subtly different to the Chinese market.

Industrial Metals – Headwinds remain but miners have substantial upside potential

Many industrial commodities came under pressure during 2019, largely due to subdued investor sentiment and concerns over economic growth caused by uncertainty over the US-China trade war and heightened geopolitical tension globally. The recovery of industrial metals and miners from the lows of the past few years has been slow. Mining stocks remain undervalued relative to historic levels and have lagged behind general equity markets over the past 5 years. Yet the outlook for industrials is improving, in some areas at least, with inventories for certain metals having declined in recent years, indicating tighter supply, along with rising demand potential from growth sectors.

Copper provides a good example of an industrial metal which has faced recent weakness, despite a strong longer-term fundamental outlook. Lower copper prices are typically associated with a bearish outlook for global economic growth and prices fell during 2019 along with emerging market indices. Near-term catalysts for a copper rally include potential improvements to the broader macroeconomic outlook, while longer-term the metal stands to benefit substantially from the electrification of transport and transition towards clean energy. By way of example, plug-in electric cars now use four times more copper than conventional internal combustion engine cars, with the potential to rise further for larger vehicles.





Source: Bloomberg. Data at 31 December 2019.

As fundamentals for the copper industry improve, we see an opportunity for investors to benefit from the recovery of copper equities. Currently a selection of high-quality copper producers remain attractively valued, with strong cash positions and compelling upside potential at higher copper prices.

A strong outlook for metals and miners in 2020

With the precious metals sector in recovery and brightening prospects for speciality metals, the year ahead promises to be an important time for investors in metals and mining. Gold's strong performance in 2019 indicates that the bull market is intact, and that substantial upside remains for the metal and for gold equities. The gold price is still far from its historic high of around USD 1900/oz while gold miners are still emerging from the severe downturn in the sector which ended in late-2015. During each historic gold bull market the gold price has exceeded its previous high, indicating the recovery phase has some way to go. Gold equities continue to demonstrate that they offer operational leverage to a rising gold price and with many gold miners having undergone operational and management reforms in recent years, improving cost discipline and shareholder returns policies, we believe the sector has become more investible than for many years. As tends to be the case in this specialist sector, stock picking and active management can offer enhanced risk-adjusted returns.

While precious metals appear to be leading the mining sector's recovery, the opportunities for investors in broader metals and mining in the coming years are equally exciting. A mixed outlook for global economic growth may continue to weigh on investor sentiment towards resources, however growth sectors and the development of new technologies, particularly those associated with the trends of electrification, battery technology, decarbonisation and sustainability, hold enormous potential for metals and miners. Further themes such as increased engagement with environmental, social and governance issues ("ESG"), by a selection of miners are also positive trends for the industry as it approaches a recovery phase.

Baker Steel focuses its investments on high quality producers with long-life mines, low production costs and competent management. Our team prefers to invest where companies have an ability to capture the full value for their product which means having the necessary processing infrastructure in place. As always, we look to share in the upside of a price surge by investing in companies which have a clear and coherent shareholder returns strategy preferably tied to revenue.

About Baker Steel Capital Managers LLP

*Baker Steel Capital Managers LLP manages the **BAKERSTEEL Precious Metals Fund, BAKERSTEEL Electrum Fund** and **Baker Steel Resources Trust**.*

*Baker Steel has 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 2019** and were awarded **Fund Manager of the Year** at the **2019 Mines & Money Awards**.*

*BAKERSTEEL Precious Metals Fund is the 2019 winner for the fourth year running of the **Lipper Fund Award** for Best Fund over 3 years and 5 years, Equity Sector Gold and Precious Metals while Baker Steel Resources Trust has been named **Investment Company of the Year 2019**, Natural Resources, by Investment Week.*

Sources: Bloomberg, Baker Steel Capital Managers LLP, BHP, Bernstein Research.

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