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Could 2021 be a transformational year for precious and speciality metals?

Outlook for precious, speciality and industrial metals and miners in 2021

Baker Steel Capital Managers LLP

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2020 will go down as one of the most challenging years on record for societies, economies and financial markets around the world. The COVID-19 crisis brought business activity to a standstill, forced seismic changes across many sectors, and prompted unprecedented action by governments, at a time when rapid technological and societal change is already transforming whole industries.

While the natural resources sector faced difficulties during 2020, precious metals delivered strong performance and many industrial metals have recovered after the initial pressure. Mining companies have largely demonstrated operational resilience during the crisis, enabling them to emerge well-positioned to take advantage of the key themes that are developing out of this extraordinary year.

In particular, the green revolution is progressing even faster than we could have anticipated at the start of the year and is likely to be boosted by targeted stimulus spending. At the same time, the economic and political environment is proving very supportive for gold as real interest rates are set to remain low, monetary policy builds inflationary pressure and political tensions remain.

These themes set the stage for a transformation in demand for precious and speciality metals and will be key drivers for metals and mining in 2021. The mining industry is set to undergo a transformation in the years ahead and, as long-term investors in this sector, our team feels that the sector may be at the start of something very big.

Key themes for natural resources in 2021:

- The gold price is backed by a supportive macroeconomic and geopolitical environment.
- Gold miners are benefitting from margin expansion and dividends are increasing.
- The global movement towards sustainability will drive a surge in demand for certain metals.
- Historic levels of economic stimulus will boost broad demand for industrial and speciality metals.
- Geopolitical tension and “reshoring” of supply chains could impact metals producers.
- Environment, social and governance (“ESG”) factors will become an even bigger focus.

With far-reaching implications for the metals and mining sector, these themes indicate a year of strong performance ahead for gold and silver producers and for producers of certain speciality and industrial metals. It is these opportunities which Baker Steel aims to give our investors exposure to through our range of award-winning, actively managed equity funds.

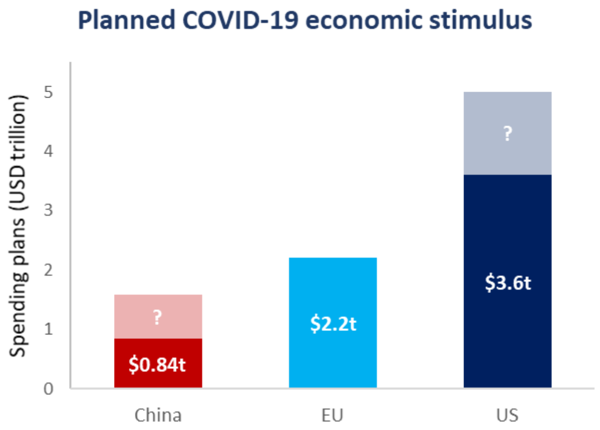
A supportive macroeconomic environment

The policy response to COVID-19 and a new direction for central banks offers substantial promise for miners

With a global economic contraction of -4.4% forecast for 2020, followed by a recovery of +5.2% in 2021 (IMF) and slowing growth thereafter, policymakers face substantial challenges. Amid the broad policy response internationally, three themes which are of particular significance for the metals and mining sector:

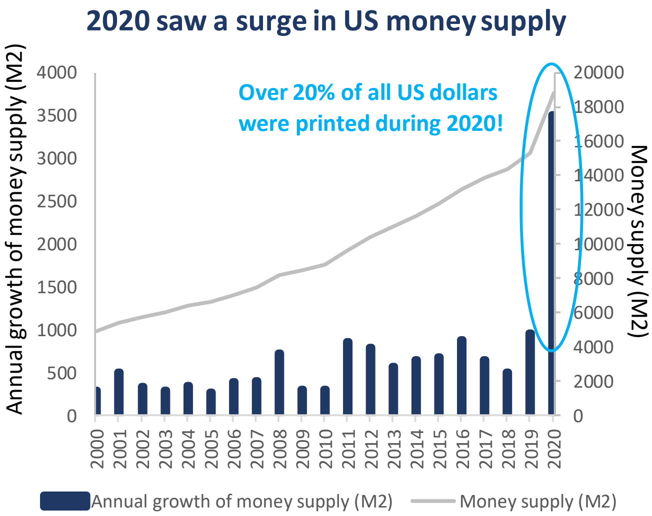
1. **A 'green recovery' will boost low carbon industries and demand for raw materials.**
2. **Historic levels of economic stimulus are driving unprecedented growth of monetary supply and debt.**
3. **A shift in major central banks' approach to inflation management is positive for gold.**

Policymakers globally have pledged over USD 15 trillion in economic stimulus, far outstripping that of the Global Financial Crisis a little over a decade ago. While the scale and focus of this vast expenditure is as yet unclear, it is highly likely that a significant portion will be focused towards infrastructure spending, technological development, improving sustainability, support for industries with a green focus, all supported by ultra-loose monetary policy and debt. The consequences of historic levels of economic stimulus for public finances are profound. Increased political support for government spending and rapid expansion of debt is a significant departure from the politics of the past decades. Money supply (M2) has accelerated at a record pace as policymakers stepped in, to shore up flagging economic activity.



Source: European Commission, National Peoples Congress. Bloomberg.

Importantly, government actions globally to guarantee billions in loans, employment protection schemes and benefits is a major change to fiscal spending models. Under such schemes cash will go directly to the small business or the general population via commercial banks, rather than being used by the banks themselves, largely for asset purchases. Whereas we have seen asset price inflation over the last decade we could now be at the start of a period of general inflation.



Source: Bloomberg, Baker Steel Capital Managers LLP. Data at 30 November 2020.

Central bankers' attitudes towards inflation management have shifted significantly during 2020. One of the most significant monetary policy changes of the last year has been the recognition by central banks that historic low interest rates should be maintained even as inflation begins to rise. The best example of this is the US Federal Reserve's new framework, unveiled by Fed Chair Jay Powell over the summer, to use average inflation targeting, replacing the old 2% inflation target. This flexible approach allows inflation to run during certain periods, without compelling the Fed to raise rates in response. Similarly, at the European Central Bank, President Christine Lagarde hinted during September that the ECB may take a similar approach.

Under this new approach the door is open to significant inflationary pressures, presenting a potent catalyst for higher commodity prices, particularly precious metals. Real interest rates continue to be among the most important factors for the gold price. Low real interest rates reduce the opportunity cost of holding gold, while negative real interest rates increase gold's appeal as a real asset and a safe-haven investment. Historically, periods of low real interest rates have proven highly supportive of rising gold prices.

A further noteworthy feature of the macroeconomic backdrop at the start of 2021 is the persistence of populism, economic nationalism and geopolitical tension, most notably between the US and China. In many ways the COVID-19 crisis has amplified these factors, drawing attention to the fragility of developed nations' supply chains of vital resources and technology and the benefits of 'reshoring', while forcing governments to take a larger role in economic activity. This trend seems likely to continue and holds consequences for the resources sector, as governments increase efforts to develop domestic deposits of strategic metals and minerals, impacting certain subsectors of the mining industry, alongside uncertainty over potential currency volatility and competitive devaluation, all positive factors in terms of demand for gold.

Precious metals equities are poised to re-rate

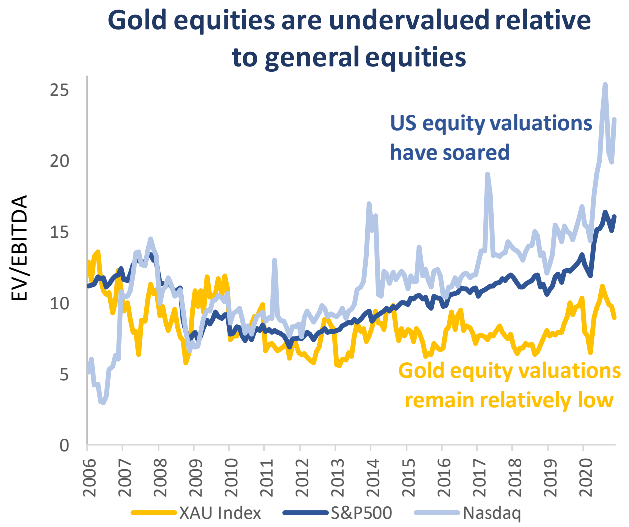
Margin expansion during 2020 will drive strong results in 2021

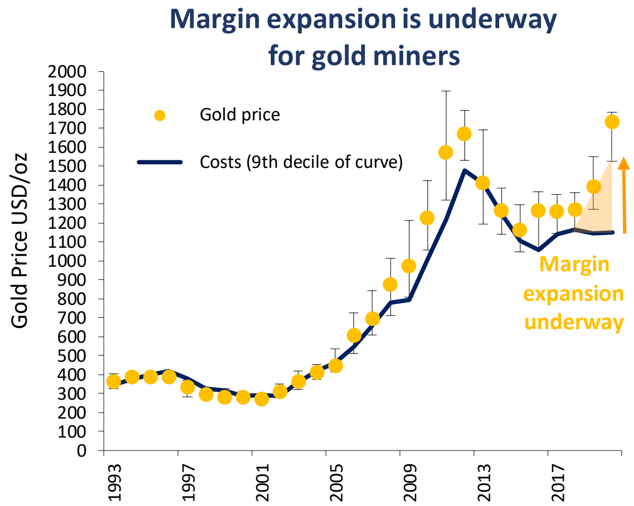
As our team have highlighted throughout 2020, the gold mining sector is in its strongest shape for many years and is poised for re-rating by the market. Yet recognition of the sector's growing profitability and returns potential has been overshadowed by the dominant events of 2020. The onset of COVID-19 dampened the sector's Q2 results, while the US Election drowned out the Q3 company results, drawing attention away from the positive trends underway for precious metals miners.

1. **The gold price recovery cycle is backed by a supportive macroeconomic backdrop.**
2. **The gold sector has weathered the COVID-19 crisis well and is in healthy financial shape.**
3. **Margin expansion and dividend increases are underway in the gold equities sector.**
4. **Gold companies appear to be trading at a large valuation discount.**
5. **ESG has become a core focus for miners.**

On the whole, producers have fixed their balance sheets, cut costs, rationalised and consolidated over the past several years. Most companies, with a handful of exceptions, are being disciplined, maintaining conservative assumptions in planning and reserve estimation. As active investment managers, we strive to invest in those producers which have the best sustainable and growing margins. Revenue has risen with higher gold prices, while costs have largely been kept in line, assisted by the deflationary impact of lower energy costs. Mining companies can also determine their costs per ounce by varying the grade at which they mine their ore bodies. We are encouraged to see that many gold companies continue to show discipline and continue to use a gold price of $1200/oz, about 40% below where the metal is trading today, for financial planning.

Despite these positive developments for the gold sector, gold miners remain at low valuations on a historic and relative basis.





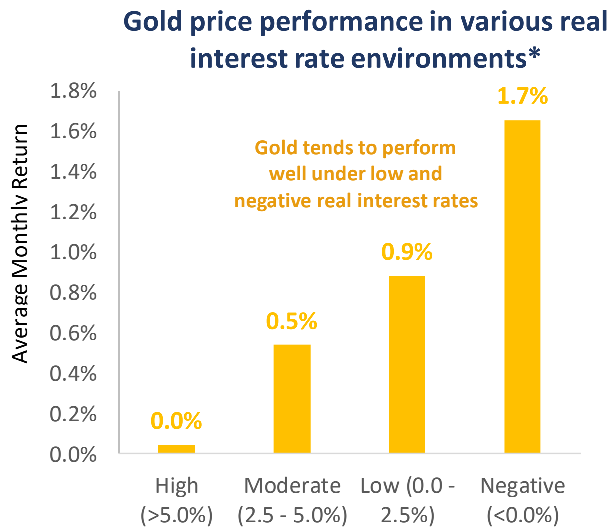
Source: Bloomberg, Baker Steel Capital Managers LLP. Data at 30 November 2020.

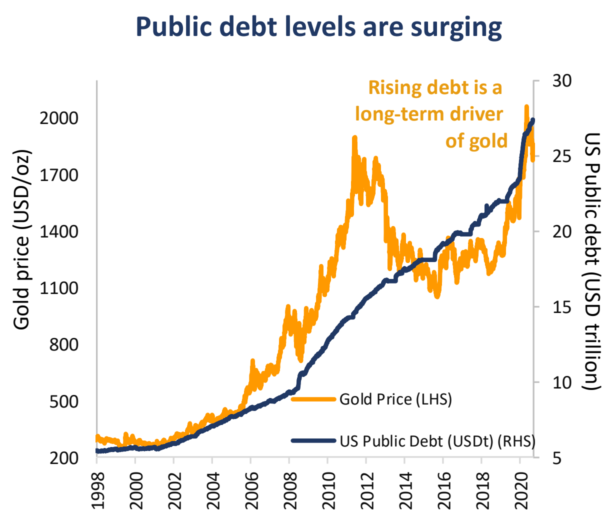
Cash generation by gold producers is growing as margins expand, in some cases quite significantly, offering the potential for higher dividends. A core element of Baker Steel's active investment process is to focus on shareholder returns policies and yield analysis is incorporated into our value-driven investment process. Rising dividends are a significant trend for gold equities, particularly at a time when yields are falling in other sectors, and the capacity for further dividend increases, as margins expand, is a key driver for the sector's re-rating potential in the months and years ahead.

A positive development for the gold sector has been the growing focus on ESG by miners, many of which are engaging constructively with investors on issues such as tailings management. As active investment managers, ESG factors are incorporated into Baker Steel's investment process during stock screening and company analysis, as well as being directly addressed with company management during meetings and on-site visits. In addition, having closely monitored companies' responses to the COVID-19 pandemic since February, it is our view that the gold sector weathered the crisis well, with most companies having implemented effective strategies to protect staff and operations during this uncertain time.

How far can the gold sector rise?

As the macroeconomic factors we have already highlighted indicate, we see a number of long-term drivers behind gold's recovery cycle, many of which have been amplified by the policy response to the COVID-19 crisis. Negative real interest rates appear to be here to stay, inflationary pressures are building, debt levels are surging, and the US dollar continues to have a mixed outlook.





Source: Bloomberg, Baker Steel Capital Managers LLP. Data at 30 November 2020.

The gold price has risen by around +70% (USD) from its lows of late-2015, steadily building momentum, yet previous bull cycles have seen gold prices rise by substantially more; gold rallied +289% between 2001 and 2008 and +159% in the aftermath of the 2008 financial crisis (in USD terms).

Backed by a positive outlook for the gold price, the upside potential for gold miners is substantial. Gold equities typically offer operational leverage to a rising gold price, as producers benefit from margin expansion at higher gold prices. Historically this thesis has been tested successfully during previous gold bull markets, although a core theme for investors has been the need for active stock selection and a focus on quality to generate superior risk adjusted returns.

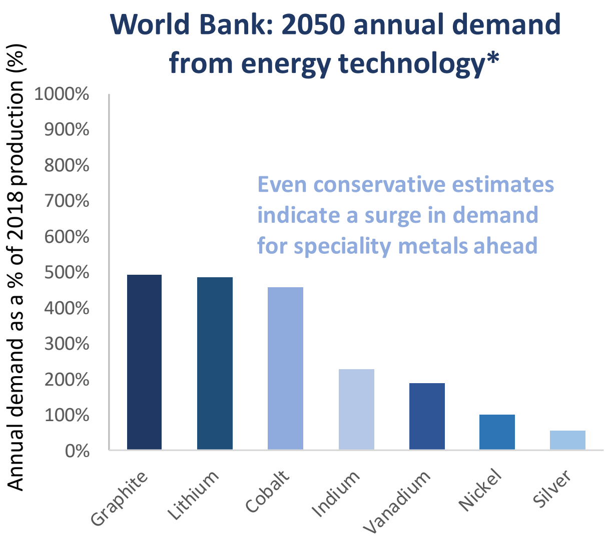
Speciality and industrial metals equities face rising demand

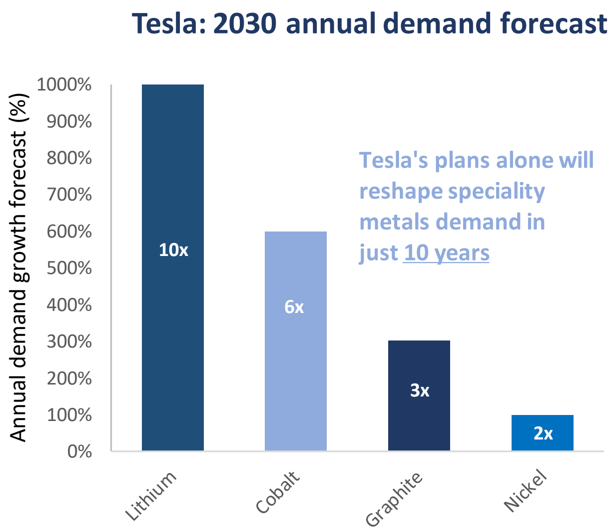
The green technology revolution will transform demand for speciality metals, while recovery is in sight for industrial metals.

- **Demand for speciality metals is forecast to soar, amid the rapid development and adoption of green technology.**
- **A 'green recovery' from the COVID-19 crisis offers the sector a boost from stimulus.**
- **Battery metals prices have lagged EV manufacturers' rapid share price gains.**
- **Industrial metals producers faced an uncertain growth outlook in 2020, yet prospects are improving.**
- **The mining sector is historically undervalued relative to broader financial assets.**

The themes of sustainability and climate change have implications across a multitude of industries, yet among those facing the largest transformation in the years ahead is the mining industry. The growth of renewable energy, electrification of transport and the development of battery technology, among other themes, will have profound consequences for the producers of the metals used for these industries.

The opportunity in speciality metals was compelling at the start of 2020, but the scope has accelerated rapidly during the year. The charts below compare a World Bank report released in early-2020 with Tesla's demand forecasts released in the second half of the year. Both data sets highlight the substantial forecasts for rising demand for speciality metals, yet the World Bank's forecasts, which include a +487% increase in lithium demand by 2050, +458% increase in cobalt demand and a +492% increase in graphite demand, pale in comparison to Tesla's projections. The company's planned 3TWH of battery capacity could require 10x the current lithium market, 6x the current cobalt market and 2x the current nickel market, over just the next ten years.





Source: World Bank, Minerals for Climate Action: The Mineral Intensity of the Clean Energy Transition, Telsa, Baker Steel Capital Managers LLP. *Note, based on a 2-degree scenario.

With demand for speciality metals forecast to surge amid potential supply shortages, a return to incentive pricing is needed to bring on supply and prevent sharper price spikes in future. While such price spikes might be positive for investors in the short-term, the longer-term development of these green industries requires project development to increase supply of these vital metals responsibly and time is running short. Importantly, EV manufacturers' valuations have reflected the growth potential for the sector, yet the underlying commodity prices have remained subdued so far, and it is increasingly clear that the market is underestimating the future demand implications. Overall, as Tesla and other manufacturers move closer to realising their ambitions for battery technology, the demand for these raw materials is set to rise exorbitantly and supply needs to keep up.

Aside from the market factors which will drive demand for speciality metals, government support will remain a key driver, particularly in the aftermath of COVID-19, as policymakers seek to achieve a 'green recovery'. Amid strong political support for higher levels of government spending and intervention, economic stimulus packages focused on low carbon industries and green technology is a major theme for miners. Europe has led the way with its Next Generation EU initiatives, a part of its recovery plan and economic stimulus package which contains commitments to fight climate change and boost technological development. The US, which has lagged behind global efforts to reduce emissions and improve sustainability during the Trump era, now appears likely to move towards a greener agenda under the incoming Biden administration.

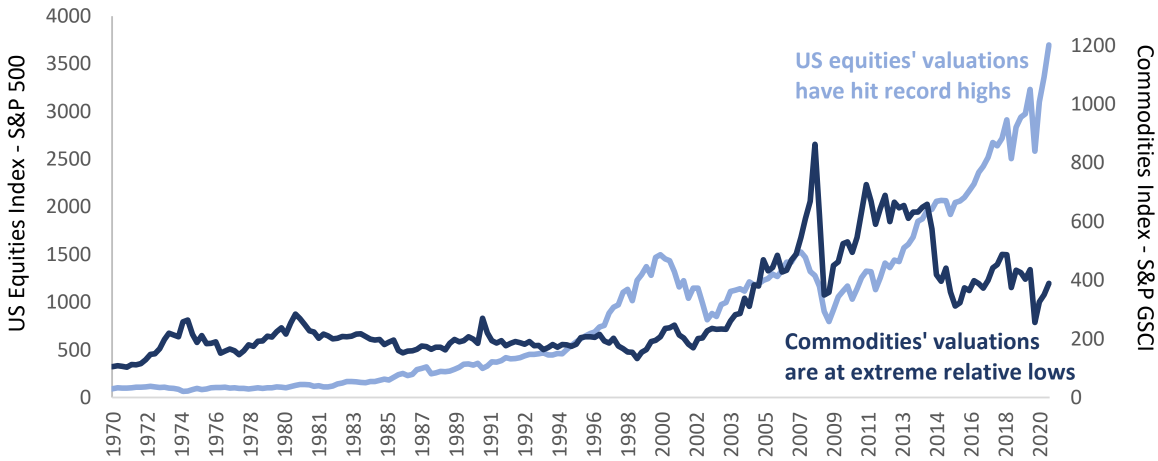
As specialists in this sector, we aim to identify the commodities most likely to benefit from various 'new green deals', such as vanadium, certain grades of graphite, and high purity alumina. We expect volatility to continue in the speciality metals sector, which is fast developing.

The mining sector is historically undervalued relative to broader financial assets.

As the global economy begins to emerge from the COVID-19 crisis, which sparked sharp recessions and a historic response by policymakers, the outlook for metals and mining is shifting rapidly. Prior to the onset of COVID-19, the natural resources sector was already under pressure from the US-China trade war and its associated geopolitical and economic uncertainty. The world has changed dramatically over the past year and the decline in economic activity during 2020 has set the stage for a global economic recovery, supported by historic levels of economic stimulus, and aided by the emergence of potential vaccines which will be rolled out by governments in the months ahead. Signs of recovery have caused rallies for several metals, notably copper and iron ore at the time of writing.

While risks remain for industrial metals, given the ongoing uncertainty over the global economic growth outlook, we note that the mining sector remains historically undervalued relative to broader equity markets (below). At the same time, we expect the prospect of unprecedented levels of stimulus investment spending to support demand for industrial metals.

Commodities are historically undervalued relative to equities



Source: Bloomberg. Data at 7 December 2020.

2021: A green recovery for miners and the next phase of gold's bull market

The year ahead offers a positive outlook for miners, but risks remain, and investors should be selective

We have reached a critical juncture for the mining sector, as the global economy moves into recovery supported by historic economic stimulus packages, funded by debt, with a particular focus on boosting the growth of low carbon industry and green technology. Going into 2021 we believe there is a lot more to come from the mining sector, as the global economy moves into the aftermath of the COVID-19 crisis and towards recovery.

We believe active management will be needed in the months and years ahead to benefit, firstly, from those sub-sectors of the mining industry which will be driven by secular trends, while secondly offering risk-adjusted exposure to the broader recovery of commodity prices which we believe is likely, given the macroeconomic backdrop. Market volatility has created and will likely continue to create non-fundamental pricing opportunities in companies with strong balance sheets and low costs.

Speciality metals producers face a transformation of demand, driven by the green recovery and the transition towards sustainability, while precious metals are backed by a highly supportive macroeconomic environment of low real interest rates, soaring debt and rising inflationary pressure. Most importantly for Baker Steel is the margin expansion currently underway, led by the gold equities sector. Producers' margins are expanding, and dividends are increasing, yet the sector remains fundamentally undervalued. Our team remain focused on identifying those producers which are best positioned to benefit from margin expansion and a share price re-rating as the gold price moves higher.

If you would like to learn more about Baker Steel's views on the metals and mining sector or would like more information on our range of funds, please do not hesitate to contact our team.

Sources: Bloomberg, BMO Capital Markets, IMF, European Commission, Company Reports, Baker Steel Capital Managers LLP.

Important

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