

Financial Markets, Gold and Miners - Outlook

By Markus Bachmann & Douglas Orsmond | 13 December 2018

Our recently published market comments (August 22nd, September 4th) took a deeper dive into some of the disruptions in financial markets that have emerged since the beginning of this year. What has become apparent, is that as 2018 has evolved, *macro factors* became the dominant force directing investment behaviour. As we approach the final weeks of 2018, many investors are coming to the realisation that the environment has become very treacherous, complex and confusing, and what has worked for nearly a decade or longer now has to be questioned. We dare to connect a few dots and try to approach topics that could be critical in the months and years to come, mindful of the famous Yogi Berra quote that *"it is tough to make predictions, especially about the future."*

Indeed, we try to have a deeper understanding about gold and other precious metals as well as the companies that explore and produce these materials. However, that sector forms only a small part of a much bigger picture. The manner in which the broader environment evolves will have a massive impact on this asset class. Therefore, the attention given to the potential mechanics and dynamics of the broader picture is warranted and necessary. This market comment is longer than normal, but we trust that the content and insights will be worth the reader's time.

The US markets, the Fed policy and the US economy will have centre stage over the coming chapters. Whatever happens in the world's biggest economy will have far reaching consequences on all global asset classes and financial markets. What does quantitative tightening mean? The formal definition refers to the withdrawal of money from the system through a central bank reducing its assets (holdings of government debt), this it is the opposite of Quantitative Easing. Practically it is accompanied by a swathe of tightening financial conditions. These tightening financial conditions are becoming visible in particular for the US consumer and we try to qualify and quantify the real fears of an imminent US recession. The decline of the oil price is a welcome relief for the consumer but bad news for the US economy. US equities show strong signs of a significant long-term top and the next 12 months could be a difficult and treacherous journey to investors.

In the second section, we will take a deeper dive into gold and assess whether the long awaited inflection point for a strong move upward is getting closer. With the exception of a selected view, the pattern of gold miners in recent months was non-sensical. We try to get to the bottom of it. Many miners trade at price to cash flow levels in the very low single digits. We look at some companies, debt free and with sizeable production, that trade at a forward price to cash flow ratio of less than 2x. A level we never expected to see in our investing careers.

Part I

US Economy & Equities – Hard Times Coming

Quantitative Tightening – Tightening Financial Conditions

QT – A Tidal Change to Monetary Policy

Our [market comment](#) of the 4th of September went into detail about the origins of the emerging market crisis that has become a dominant topic since April of this year. Hedge fund investor George Soros's wrote as far back as the late 90's about "how a crisis at the periphery (i.e. emerging markets) could lead to a crisis at the core"¹. It seems that we are now seeing the first signs of that emerging.

One of the origins of this year's disruptions is a distinctly different approach by the US Fed towards its monetary policy. New Chair Powell inherited a legacy of an "über-accomodative" monetary policy that dates back as far as August 1987 under then Fed Chairman Alan Greenspan. Factually, a first timid step towards Quantitative Tightening was implemented by Powell's predecessor Mrs. Yellen in late 2017 but the new Fed Chair was confronted with a dilemma in early 2018.

The US economy appeared to go from strength to strength and in recent years the Fed was highly reluctant to adjust its interest rates to a "normal" level. On the top of an already robust economy, the Trump administration implemented with *appalling* timing a very aggressive fiscal stimulus program that could see the annual debt to GDP ratio increasing to 10% by 2020. Aggressive tax cuts are encouraging US companies to repatriate funds back to the US and excess liquidity has been fuelling US equity markets through unprecedented share buy backs this year. Further, the tax cuts also seemed to have encouraged US consumers to take more debt onto their already-stretched balance sheets.

Entering his new role, Chair Powell was confronted with a situation where he had to act. *Loose fiscal and monetary conditions intuitively demand a tightening stance* and Powell was not in favour of QE anyway. Some investors perceive QT and the resulting tightening financial conditions purely as a function of rising interest rates but that is just one instrument of many.

What are the tools that define tightening financial conditions?

The QT Tool Kit

Quantitative tightening will become visible via tighter financial conditions and it results in an accelerative *decline of Central Bank injected liquidity* into the global financial system. The shrinking of the balance sheet of the US Fed² that started under Yellen and accelerated under Powell is contributing to a structural shortage of US dollars in the global financial system. Investors need to be aware that the supply reduction can potentially do more harm than interest rate increases - it reduces the dollar supply to countries that in total make up some 70% of global GDP. It is no coincidence that emerging market equities peaked at the same time as the reduction of the Fed balance sheet commenced. This is the periphery that Soros talked about and the knock-on effects could be carried through to the centre quite rapidly. The combination of less available dollars, increased interest rates and a weakening domestic currency was the toxic mix that pushed many emerging markets closer to the edge earlier this year.

So what are the tools that can deliver tightening financial conditions?

¹ George Soros, *The Crisis of Global Capitalism: Open Society Endangered*, 1998

² See Chart Pack slide 2: QT – US Fed Balance Sheet Reducing

First is the *Fed Fund rate*³ and the Reserve Bank has used this tool since the bottom of the interest rate cycle in December 2015.

A stronger *Dollar* is the second factor that is contributing to more tightening financial conditions. Its impact has been felt this year but the acceleration of the dollar against other currencies has not yet disrupted the entire global financial system. However, any further significant strengthening will increase the probabilities of causing a severe stir.

Tightening bond yields are the third factor that could contribute to tightening financial conditions. It has to be noted that the 30 year US treasury yield recently broke through its 100 month moving average, the first time since 1985 this has occurred⁴. Note also that the 3 month US treasury yield as at the 7th of December is at 2.38%. This is not insignificant as for the first time since the Great Financial Crisis, income orientated investors can receive a higher yield in “Risk-Free” money compared to the dividend yield of the S&P 500, which is around 1.9%. Higher treasury yields have an impact on highly indebted high profile companies that were driving the Nasdaq to a 5 fold increase since 2009. Some of the sharp corrections seen in tech stocks in October and November this year might also have been caused by concerns about the increasing debt servicing costs of some of the previous high flyers. But as it stands for now, global financial markets can still absorb higher yields and the pain threshold has not been breached.

Widening credit spreads is another area to look for clues for tightening financial conditions. The cost of debt financing is rising, which will impact corporate earnings, cash flows and the quality of the balance sheets. At the moment, the spreads still look “tame” but investors are well advised to monitor this area very closely. Of potential grave concern is the BBB investment grade corporate bond market⁵ in particular.

BBB investment grade is the most significant investment grade rated bond market in size: it has grown to a size of 3 trillion US dollars in recent years and **now has a similar volume to the subprime market** in 2008 before it collapsed. As rising interest rates start to bite, it could potentially put many companies under pressure. Morgan Stanley in a recent study concluded, that 1/3 of BBB rated companies could face a downgrade. Energy companies are well represented in that group and the *oil price collapse* makes the risk of a downgrade even more relevant. This is a brew with a toxic scent and presents a considerable risk to financial markets. Knock-on effects are plentiful and BBB is potentially the biggest risk to global financial markets in 2019.

Equity markets are the fifth factor impacting financial conditions. Although US equity markets are showing some strong signs of topping out, the recent volatility won't impact financial conditions negatively – just yet. However, the 10 year upward trend is significantly compromised.

To summarize, none of the individual components that can contribute to a tightening of financial conditions are at sufficient levels to ring the alarm bells. However, they should be watched very closely as they carry many seeds of a trend change. Some of them (i.e. interest rates, shortage of dollars in the global financial system) nevertheless have started to bite and the next chapter is trying to provide some insight where it may start to show (emerging markets aside). It is starting to hit into the core of US growth, in our view. Conditions for the American consumer are becoming tight, at least when looking beyond the still favourable economic headline numbers.

³ Mandate is to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates.

⁴ See Chart Pack slide 3: Long Term Bond Yields Rising

⁵ I.e. General Electric is at risk of a downgrade to junk status – the company carries \$ 120 bn of debt on its balance sheet

Recession Fears

The Great Financial Crisis of 2008 was a crisis that originated in debt, or in particular too much of it. This is a common denominator that was the cause of every financial crisis over the past few decades. The Fed, and in its tailwind all major global central banks, decided in their wisdom that the cure to the subprime crisis was more debt. In addition, extremely loose monetary conditions facilitated one of the biggest equity bull markets in history, in particular in the US. The same conditions pushed down volatility to artificially low levels for an extended period of time. The topic of a debt bubble forms an integral part of every investment narrative. At very low interest rates, it is tempting to be complacent about it. However, once financial conditions change, too much debt becomes an issue. As it stands, a reversal of loose financial conditions is inevitable and the unfolding dynamics must be monitored closely in 2019.

Hard times coming?

Over the past few months, market observers started pointing towards a possible recession in the US in 2020, ending one of the longest economic expansion phases on record.

In our view recession fears are real. There is a distinct possibility that an economic downturn in the US will materialize next year already and the outcome could be more severe that most investors anticipate.

Financial conditions are showing the first signs of tightening in the US, albeit not at an alarming rate yet. At first glance, interest rates are still low and further hikes by the Fed remain a possibility. Consumer confidence remains highly elevated and seems to be strongly correlated with equity markets, similar to the situation in 2000. So all is good! Is the worst possible outcome a “kind recession”, according to then Fed Chair Mrs. Yellen?

The reality is different and a very worrisome picture is emerging, contradicting the still-strong economic data. The pillar and driving force of US economic growth, the American consumer, is seemingly in trouble. It is correct that interest rates are low by historical standards but what really matters here is not the level of rates, it is the **rate of change**⁶! Available economic data paint an increasing worrying picture about the state of the American consumer and a closer look is warranted.

What can be observed is a severe tightening of financial conditions for the average household over the past 12 months. The debt servicing burden is rising rapidly. Any continuation of the interest hiking cycle by the Fed exponentially increases the probability of a bad outcome for both the consumer and US economic growth.

Since the Great Financial Crisis of 2008, debt has exploded for both corporate America and for the consumer. Over the past 12 months, interest rate expenses of the consumer have increased by 20%, eating deeply into the disposable income of the average household. Again, it is critical to highlight that it is the rate of change that matters, how much monthly interest has to be paid for the outstanding amount of debt.

For far too long, the market has been focusing on *total household debt as a percentage of US GDP*⁷. Viewed from that perspective, total household debt as a part of GDP has been declining in recent years.

⁶ See Chart Pack slide 4: Increase in Interest Rates

⁷ See Chart Pack Slide 5: Household Debt as % of GDP

But there is a catch! Real GDP is up by 17% since 2007, however, the real median household income has grown over the same time period by only 3%⁸. It appears that Americans have *not* benefited from the longest economic expansion on record. Meanwhile, total household debt increased to an all-time high in 2018. In an ultra low interest rate environment the consumer might get away with it and will not feel the pinch. However, interest rates have been increasing since 2015 and homeowners will have to refinance a significant part of their mortgage debt. Mortgage related interest rate payments have increased significantly over the past 48 months (by up to 40%). US total mortgage debt outstanding has increased to an all-time high in 2018⁹. A similar picture emerges when assessing the outstanding credit card debt and other consumer related debt¹⁰. It appears that the average consumer is digging deeper into credit card debt to finance consumption. Also here, interest rate expenses start to hurt the household budget¹¹. Delinquency rates are regarded as an early warning indicator. Lower tier banks tend to serve the lower income segment and these institutions are witnessing exploding delinquency rates at a percentage level higher than the 2009 post crisis levels¹². Car loans are also at record high levels, adding to the debt and interest rate servicing burden of consumers¹³. The 3% real increase in median household income since 2007 mentioned above does not compare well with the increase in health care costs since then. These have risen by 53% over the same time period and now represent a significant part, some 28%, of the average household's fixed costs¹⁴.

To see the impacts on the real economy look no further than the trend in building permits, a useful leading indicator: they are on the decline¹⁵. Further evidence of a slow down can be found in the decline of the homebuilder's index¹⁶. Bank deposits are another gauge of the financial health of consumers. Despite rising interest rates, growth rates of bank deposits have retraced back to levels last seen just after the financial crisis. However, the tightening conditions seemed to have little impact on the consumer confidence – yet. The strong correlation between the S&P 500 (i.e equity markets) and consumer confidence is blatant¹⁷. In late 2018, the stock market IS the economy. A similar situation occurred in 2000 and once the stock market turned, so did the consumer confidence. A recession followed suit.

Bottom line

*The current strong economic data continues to paint a favourable picture of the state of the US economy. However, there are some underlying trends that are deeply disturbing and 2019 could well turn into a show stopper. The US consumer is the engine of economic growth and this engine is staring to run short of fuel. Any further tightening by the Fed will increase the interest rate servicing burden. In short, blind optimism is utterly misplaced. **The threat of a recession in 2019 is real.***

The risk of a falling oil price to the US economy

Talking of fuel, the potential impact of the collapse in the oil price should not be ignored¹⁸. Declining gasoline prices are a welcome relief to consumers, without a doubt. But the US economy is very closely

⁸ See Chart Pack Slide 6: Household Income in US

⁹ See Chart Pack Slide 7: US Total Mortgage Debt Outstanding

¹⁰ See Chart Pack Slide 8: Credit Card Debt

¹¹ See Chart Pack Slide 9: Credit Card Interest Rates

¹² See Chart Pack Slide 10: Credit Card Delinquency Rates

¹³ See Chart Pack Slide 11: Car Loans

¹⁴ See Chart Pack Slide 12: Health Care Expenditure as % of Household Income

¹⁵ See Chart Pack Slide 13: Building Permits

¹⁶ See Chart Pack Slide 14: Homebuilders declining

¹⁷ See Chart Pack Slide 15: Overconfident Consumers

¹⁸ See Chart Pack Slide 16: Oil Price

tied to the oil price: according to statistics provided by the St Louis Fed, the oil industry's share of US industrial production was 12.4% to the end of September¹⁹. Oil companies earnings will be impacted by oil's sharpest down move in its history and they form an integral part of US stock indices. Will the recent slump in oil be the final nail in the coffin for US GDP?

Equity Markets, QT and Liquidity

"No crystal ball here but a very bad feeling for 2019"

US equity markets show strong signs of topping out. That said, that doesn't mean that they couldn't reach new all time highs in the near future but we feel uncomfortable about the medium term outlook. From a chart technical perspective the highs reached in September have the potential of a *significant* top from the move that started in Q1 2009. A 20% + correction in US equities is a possible scenario for 2019 and caution is warranted²⁰.

US equities decoupled profoundly in recent years from most major global equity indices²¹ and undoubtedly there are some amazing and exciting companies that drove both the Nasdaq and the S&P 500 to such elevated levels. Our discomfort regarding US equities is *not* based on valuations; we doubt that there is too much fundamental analysis these days to start with. The unprecedented equity rally over the past ten years has also been facilitated by a highly accommodative and loose monetary policy in the US (and elsewhere). Under new Fed Chair Powell, the transition is from QE to QT. Other Central Banks are to follow. Quantitative tightening will reduce the amount of "financial heroin" provided to financial markets and it would be prudent to anticipate a slightly different outcome under fundamentally changing conditions, wouldn't it? A recent all-time high in the S&P 500 was reached on the 20th of September 2018. The market reaction for the few days from October 5th onwards was intriguing; the S&P 500 lost nearly 6% within a few trading sessions. Is there any significance to investors in this time window? On October 5th the ECB tapered its asset purchase program by half to a monthly 15 billion Euros. The correction in tandem with the ECB tapering may just be a coincidence – or maybe not.

Readers will take note of the context: by the end of 2017, global QE was running at a \$ 2.1 trillion run rate per annum²², providing financial markets with excess liquidity. During 2018, QE was steadily reduced and come 2019, *the taps will run dry*. As from next January, the ECB will terminate its asset repurchasing program and for the first time in 10 years (and since the start of the equity bull market) the global Central Banks will go negative on liquidity.

The next year might turn out to be very challenging for investors. Financial conditions that will drive returns of nearly all assets classes are going to be different. Expect 2019 to be a watershed year. 2018 will be remembered as a transition period and the first warning signs are visible; according to Deutsche Bank research some 89% of all asset classes worldwide yielded negative returns year to date.

Critical readers will identify a potential contradiction in this narrative: if the US Fed has been at the forefront of quantitative tightening since the end of last year, why did US equities continued their incredible run, outperforming most of their global peers?

¹⁹ See Chart Pack Slide 17: Oil – Significant Portion of US Industrial Production

²⁰ Chart technicians regard the S&P 2100 – 2200 as a high probability target, based on a standard 38.2% Fibonacci retracement from the September 20th top of 2920.

²¹ See Chart Pack Slide 18: US Equities vs Rest of World Equities

²² Source: Danielle DiMartino, previous senior researcher to Dallas Fed president Richard Fisher, 26th of November 2018.

Again, *liquidity* plays a pivotal role. Excess liquidity was released into the market through the US administrations tax bill. An estimated additional \$300 bn was invested in share buy backs by US companies (on the top of \$500 bn already available to these programs). Share buy backs have been identified as a strong supportive factor for US equity performance this year. Not only was this financial fire power unique to US stocks (compared to their global counterparts), it is also expected to fade in 2019. More dots need to be connected to the slump of the main indices after October 5th. Not only did the ECB reduce their asset purchases, nearly all US listed companies were restricted from buying back shares due to the upcoming reporting season. Was this a pre-course to the menu that is going to be served to investors in 2019?

Another bright yellow flag that warrants caution for the outlook for US equities is a by-product of 10 years of QE. It is the massive rise of passive investment products. Estimates are that currently some 45% of equity vehicles on Wall Street are of passive nature. ETF's are a kind investment tool to many because they allow a market exposure on the cheap. The strategy works well (and beats many active managers) in a market that is going up year by year. It favours larger capitalized index firms and the more these companies go up the more they will be bought again by the ETF's. A cynic could describe them as sophisticated Ponzi schemes as similar characteristics apply: they do well as long as they are provided with liquidity (i.e. flows) and the underlying exposure increases too. The darker side, and the unintended consequences, of passive investing will be tested soon and we sense that many investors could face a very rude awakening. The theme for the past decade was "buy the market". Maybe that is why the likes of an Amazon or a Netflix trade at multiples last seen during the peak of the Nasdaq bubble in 2000. For the curious reader: compare a Cisco chart from 2000 with, for example, Netflix version 2018 and it will send shivers down your spine (for those who do not recall, it did not end well for Cisco shareholders). Many other high-flying names deserve a similar comparison. 2019 will be the first real test for passive investment vehicles. How will they fare if the fuel which has fired up the markets for a decade runs dry? How will they react if the gift that kept on giving (i.e. investment flows) turns into reverse? The recent market corrections gave a first hint of what could occur, as market heavy-weights were not treated kindly during the sell-offs.

Connecting the Dots

The investment environment is changing rapidly and there is a strong undercurrent emerging in both the US economy and in global financial markets. QT is a reality and its first impacts have become visible during the last few months. The lack of excess liquidity provided by global Central Banks will redefine the rules of the game and this is new territory for an entire generation of investors. A healthy portion of caution will not be misplaced. QE provided the platform for an unprecedented rise in assets and QT will likely facilitate a different outcome. The BBB corporate bond market should be on the radar screen of investors; if downgrades do indeed materialize then it will spread quickly into fixed income and equity markets. Upcoming US economic data will be critical to judge if the US consumer can withstand the pressure of an increasingly expanding debt service burden. Any material deterioration could redefine the Fed's intention to further hike interest rates to a normalized level (3% - 3.5%). If US equities roll over, the markets could be in for a volatile and treacherous "chopfest" for the next while. Passive investments might well have peaked and we could see a distinct move towards actively managed money. With regard to rising interest rates, investors need to be reminded that it is the rate of change that matters and the rate of change is the highest on record for an extended period of time. Therefore, not only the health of the consumer's balance sheet and income statement has to be considered. It applies equally that companies and names with highly indebted balance sheets should be treated with caution.

Capital preservation should become a higher priority to investors. Cash could turn out to be a reasonable asset class for the next while, as could gold. Gold has many compelling attributes as a negatively correlated asset class and as a tool of capital preservation. If our recession fears materialize, then the US Treasuries should really do well too. Emerging market assets have taken a severe blow in the early phases of QT and resulting dollar strength, but going forward they could do significantly better than the S&P 500 or the Nasdaq. Commodities have been outright out of favour for many years and relative valuations compared to US equities reached multi decade lows in 2018. That relationship is overdue for a strong reversal.

Some readers might conclude that our view of the state of affairs is too negative and that we are "über-cautious" on both the US economy and US equities. The Federal Reserve Bank of Chicago recently hosted its 32nd Economic Outlook Symposium and of 150 economist in attendance only 2 voted for a recession in 2019. So any criticism on our view, that US recession fears for next years are real and increasing, is well understood. We hope that we are proven wrong because if our concerns are even partially confirmed, the outcome will be most unpleasant for the US consumer and investors alike.

Then "the future ain't what it used to be.." to close with another Yogi Berra pearl of timeless wisdom.

Part II

Gold & Miners

Gold: Symphony Nr. 8 (B minor)

Some readers may have spotted in the title Franz Schubert's masterpiece, the "Unfinished Symphony" or "Die Unvollendete", composed in 1822. Somehow, that is how the gold market has treated investors for the past 3 years. The sharp increase from the cyclical bottom in December 2015 to the interim highs in July/August 2016 followed a period that can be best described as "unfulfilled expectations". Regular readers know that we expected a breakout of the gold price over the \$1380 level²³ for quite some time. However, the market didn't match our expectations on multiple occasions. The correction from April this year to the lows in August left a feeling of a lack of closure – and let's be frank, disappointment. Investors sense a missing part in this equation and closure will be only found once the gold price will be able to break through the highs of 2016, entering the first part of a new bull market. That this scenario will materialize remains our primary expectation.

Intuitively we, as managers of a precious metals strategy, feel that this year has not been great at all. But this sentiment originates as a function of the disappointing absolute performance of the miners themselves. It was without a doubt the most challenging year in a decade.

It is difficult to find asset classes with positive returns for the current year. If there is an easy winner to spot then it is the US Dollar. From that background, there are *two significant observations*:

1. At the time of writing the year to date return of gold in US Dollars is – 4%. One would expect it to be worse, given the still widespread negative sentiment towards bullion. However, *measured in other key currencies* (i.e. Euro, AUD, CAD, GBP, RMB's) *gold is in positive territory for the year*²⁴ and well above the key 200-day moving average.
2. Gold reached the year's low in August, at the height of the emerging market crisis. It remained weak for over a month before recovering from \$1182/oz from late September, gaining over 5% to \$1245/oz at the time of writing. Over this period, the Dollar Index DXY has also gained considerably (+2.0%) proving ***that gold and the dollar can rally together***²⁵, contrary to most market commentary. The direction and the correlation for both assets are defined by the broader financial conditions dominating the markets.

Within the parameters of increasingly difficult overall market conditions, investors should take note of this development. First, gold has recently moved higher in tandem with a strengthening dollar. Second, as the going is getting tough in US equity markets, the need for capital preservation seems to be on the rise.

Circling back on our discussion of the impact of QT and tightening financial conditions on financial assets, it would appear that this could be indeed the defining moment of a new trend that will break the deadlock that gold has been caught in for past 2½ years. Therefore, the probabilities that gold marked the year's bottom in August have increased.

²³ We refer throughout to gold prices in terms of US dollars per ounce.

²⁴ See Chart Pack Slide 19: Gold in various currencies

²⁵ See Chart Pack Slide 20: Gold Price and US Dollar have rallied together

We note that since gold started its recovery in late September, physical gold ETFs saw *net inflows* of around US\$1.6bn (1.3m ounces)²⁶. This improved sentiment towards gold has also shown in the movements of gold speculators on the Comex futures exchange. The *record high level of short positions* in August has now reduced by half, taking the net positions back into a (small) net long position²⁷. However, this situation remains supportive for gold, as a return to more normal positioning would still entail a significant amount of long contracts added, or short contracts closed out, which usually coincides with gains in the gold price.

Chart technicians²⁸ point out, that a gold price level of \$1140 should provide *very strong support* for any retracement. Since our last market comment, two important resistance levels have been taken out and became support: \$1198 and \$1217. At the time of writing, bullion is trying to work through the next key resistance of \$1249. Chart technicians point towards \$1270 and \$1307 - \$1330 as important milestones on the path towards a break out. The area between \$1380 and \$1400 remains the “all clear” towards a break out of what has been a lengthy and draining bottoming- out process for the yellow metal.

Next important catalyst, not only for gold but also the market overall, is the upcoming Fed meeting of December 19th. A further interest rate hike is widely expected. Considering the increasingly tight financial conditions of the American consumer, any additional hike after that, towards a “normalization of interest rates”, could be the famous stretch-too-far. It would not be the first time that the Fed pushes the economy into recession.

January will mark the termination of the ECB’s QE. This step will further tighten global financial conditions.

We concluded in part one that a very difficult and volatile market environment is likely to occur in 2019 - and most probably beyond. Gold has found the support needed and is grinding upwards. Investors will remember again that gold usually has a negative correlation with nearly every asset class. This was a severe handicap for many years during the unprecedented asset inflation in global markets of the past 10 years, facilitated in part through synchronised Central Bank policies. There are early but strong signs that the tables are turning.

Gold miners

While the tide may have turned for the gold price, history shows that gold mining equities do not necessarily track the fortunes of the metal in all periods.

Gold mining equities have shown disappointing returns this year. Rising risk aversion in global markets, driven by turmoil in emerging markets, saw US investors retreat to core large sectors in US equities. The gold sector remains almost completely ignored by generalist investors, with very little new money flowing into the sector. Any new investment into gold miners seems to have flowed into passive investments, most of it into the large capitalisation miners ETF such as the Van Eck’s Gold Miners ETF.

During the previous bull market, gold miners faced rising operating costs which eroded the expected margin gains, delivering disappointing cashflow despite gold’s rally. Investors also became increasingly concerned about high debt levels of (some but not most) gold companies.

²⁶ See Chart Pack Slide 21: Gold ETFs have seen inflows

²⁷ See Chart Pack Slide 22: Gold Futures – Speculators Still Betting on Lower Gold

²⁸ See Chart Pack Slide 23: Gold price Resistance Levels

We discuss below some details on the current status of the gold sector. We show that cash flow is expected to grow significantly (even with a flat gold price outlook) but that this is not reflected in share prices, as valuation multiples remain extremely low. Debt levels have reduced dramatically (although even previously, were not a problem for most of the sector). We note that while gold equity indices may have shown a recovery in the past few months, this has been *mostly confined to major gold companies*. This was driven by a major event within the sector, the *merger of heavyweights Barrick Gold and Randgold*. Smaller companies remain very cheap (we highlight a few valuation examples that defy belief).

In summary, the gold mining sector is on a solid fundamental footing, but most of the shares remain as cheap as when the sector was on its knees in early 2016.

Gold miners debt and costs improved

In recent years, investors viewed the gold sector as being *burdened by high debt levels*. We had noted in the past that most companies had low debt or even net cash, although several (mostly major producers) did have high debt levels. How has the debt level of the sector changed? Should it be a concern to investors?

It is almost 3 years since the gold price reached a low point of \$1051 in late 2015, with gold equities forming a low shortly thereafter in late January 2016. A comparison between early 2016 and now, across the same group of 29 major, mid-sized and small producers²⁹ shows *how much the sector overall has reduced debt levels*. In 2016, the total debt for the group was \$17.7bn, which has now reduced to \$11.9bn. Back then, the highest debt load was in the major gold producers, with an average Net Debt / Forward EBITDA ratio of 1.4x. This ratio has now reduced to 0.77x (using a similar gold price forecast). The equivalent ratio for medium sized producers overall, although only slightly improved since 2016 remains a low-risk 0.4x . *Small producers in aggregate have moved into a net cash position*.

It is not just the debt level of the sector that has improved since 2016. The outlook for *operating costs* is significantly lower than they were in 2016. Back then, the group was expected to show average *All-In Sustaining Cost* in the year ahead of US\$880/oz, while for the coming year it is forecast to be US\$775/oz. This translates into a 30% gain in forecast *All-In Sustaining Margins* (assuming the same US\$1225/oz gold price forecast) compared with the outlook back in 2016.

Comparing the gold producers now against the equivalent group back near the low point of the sector in early 2016, highlights how unloved the sector is. The companies are in much better shape in terms of balance sheets and forecast operating margins (at the same gold price). Yet market capitalisation remains what it was back near the height of pessimism towards the sector.

This dichotomy points to both the lack of investor interest, or even conscious aversion, towards the industry. It also emphasizes the excellent opportunity for investors who own the gold miners at this point.

²⁹ Our analysis is based on data and research by Bank of Montreal, covering 45 gold producers, of which 29 producers have comparable data for 2016.

Gold sector – making strong cashflow, yet deep value!

The gold producers sector³⁰ is forecast to show a *strong rebound in cash flows* going forward. Operating Cash Flow is forecast to grow to over \$16bn in 2019 (assuming a gold price of US\$1225/oz) from under \$13bn in 2018. That puts the sector at a Price/Cash Flow of 6.5x. This is well below the long term range of 10-20x, and only slightly above the cheapest levels of around 5x which the sector reached as the gold price crashed in 2013 and again in early 2016 before the strong rally in gold shares. Cash flows would *rise significantly* with a moderate gain in the gold price. A 10% higher gold price (to \$1347) would see that group of gold producers generating 21% more cash, at \$19.8bn.

Looking at Free Cash Flow, which captures the cash spent on capital expenditure, the sector is forecast to be roughly breakeven in 2018 (i.e. cashflow covers capex on new mines). However, in 2019, Free Cash Flow for the sector is forecast to *expand rapidly* to around \$5.6bn. This puts the overall gold producers sector at a Free Cash Flow yield of around 5.3% for next year. At a 10% higher gold price this would jump to over \$9bn, a yield of 8.6%.

Within the sector, we note a marked variation between the large capitalisation, major gold producers and the mid-sized and smaller producers. The small gold producers in the group in aggregate trade at an average P/CF for 2019 of 3.7x - exactly half the ratio of the major producers 7.4x. With cash flows forecast to increase further in 2020, the majors average 6.7x Cash Flow, but small producers remain around half that ratio.

Most of the sector is cheap against historical ranges but some shares are extremely cheap. We highlight **Argonaut Gold**, a holding in the Craton Capital Precious Metal Fund. The consensus forecast is for operating cash flow of US\$90m in 2019. This seems almost incongruous with the Market Capitalisation of around US\$160m. Yes, the share is trading at a forward *Price/Cash Flow of under 1.8x!* At a 10% higher gold price, that ratio would be 1.5x. Argonaut has no debt, a strong gold production growth profile and operates in Mexico (a well-established and relatively stable mining jurisdiction), yet it is cheap, even compared with some similar sized producers.

A direct comparison against large diversified gold producers is not valid for stock-picking purposes but it does highlight some interesting points in the sector. Barrick Gold is expected to generate Free Cash Flow of US\$700m next year – 14x higher than Argonaut's, yet it has an *enterprise value of 140x* that of Argonaut!

Argonaut is not alone in trading at extremely cheap levels. Another holding in the fund, **Gascoyne Resources**, has a market capitalisation of only US\$41m. The company does have a sizeable debt position, having just built and started up its first mine, and the mine start-up did not proceed as quickly or smoothly as hoped. However, we feel these negative points do not warrant the massive selling pressure on the share recently and the current large discount in the share price. The company assets are in Western Australia, a top mining domicile, the mine is expected to generate free cash flow in 2019 of US\$20m and the company has another promising project with over 1 million ounces of resources.

Another cheap holding in the fund is **Leagold**. The company owns several operating mines in Mexico and Brazil. Its market capitalisation of US\$300m and enterprise value of US\$500m are cheap compared with expected cash flows of US\$170m next year. In fact, after some capital spending in 2019 to restart one mine, Leagold is expected to produce Free Cash Flow of around US\$200m per year from 2020 onwards.

³⁰ Gold producers in this section is based on 45 companies under coverage by Bank of Montreal.

While not all holdings in the fund have such cheap valuation metrics, the focus on value stocks is evident. The average across all gold producer holdings for 2019 is a Price / Cash Flow ratio of 4.1x and a Free Cash Flow yield of 11%. The fund holdings thus have attractive valuations compared against the sector average (discussed above) on these as well as other metrics, such as Price/ Net Asset Value averaging 0.76x against the sector average of 1.6x (weighted by market capitalisation).

The average production rate in 2019 is 450'000 ounces per year, well below the (equal weighted) average of 750'000 ounces average for the main 70 gold producers we follow. The average All-In Sustaining Cost forecast for next year of US\$816 /oz, and 2 year production growth of 34%, are better than the sector average of US\$850/oz and 11% respectively. The clear bias towards mid-cap producers thus delivers attractive valuation multiples, operating margins and production growth. Unfortunately, this has also led to the fund lagging behind major gold producers (and thus the benchmark) performance for the year, in line with the underperformance of mid- and small-capitalisation gold shares.

Major merger skews the sector and benchmark performance

On 24th September 2018, the second largest gold producer Barrick Gold announced a planned merger with Randgold Resources, another top tier gold company. Both shares outperformed strongly after the deal was announced, with Barrick *gaining* 27% in the subsequent month, outperforming the broader gold sector **by 20%**. The pair constitutes *over 20% of the FT Global Golds Index* (the fund's benchmark index) and their outperformance alone contributed nearly 2/3 of the benchmark's gain since the announcement (6.5% contribution, including Barrick subsidiary Acacia, of the 10.7% benchmark return). The fund did not hold either share, leading to underperformance against the benchmark. We offer here a few thoughts on the merged entity, its outperformance and outlook.

The deal included a commitment from Chinese company Shandong Gold to buy up to US\$300m of Barrick shares in the open market, adding a tailwind to the Barrick share price. We believe most of the Barrick outperformance was due to investor expectations that the company will be significantly better run under the new management (mostly the Randgold team) and it will sell its high-cost or smaller scale operations (presumably at a fair price). The remaining entity could emerge as a large, high quality, well-run gold company and become the go-to gold mining investment. We expect the company to sell off lower margin or smaller scale operations, as indicated by management. However, we are less convinced that it will receive sufficient value for the sales (especially compared to its current premium valuation to Net Asset Value). We remain sceptical that the overall asset quality and jurisdictions will warrant its status as the sector's best quality company. We note that a significant fraction (albeit not a majority) of production and value of new company will be in African domiciles. Some of these are acceptable, in our view, but some are particularly high risk. We believe African domiciled assets have attracted a higher discount through 2018 (most of it unwarranted in our view), as investors extrapolated negative developments in one or two countries and sold out of whole region. Barrick may find it difficult to shine as a high quality company if this sentiment persists.

The new Barrick will have a relatively stable gold production outlook for 5 years, but production and cash flow is forecast to decline sharply thereafter. While this timeframe and production profile is not uncommon in the gold sector, the size of the company makes it much more difficult to replace production over time. It is easier to find and develop new gold deposits to replace 200'000 ounces per year (a typical mid-sized gold producer), than the 5 million ounces that Barrick will be producing.

In summary, we recognise that the merger may improve the quality of the company and it has renewed broader investor interest in the sector. However, we believe the share price of Barrick has run well ahead of the fundamentals of the merged company.

Larger gold miners have run ahead

The Barrick – Randgold merger seems to have sparked broader investor interest in the gold sector. Initially this was confined to the companies affected, before flowing over into other major gold shares. However, so far this renewed interest has not moved down to mid-sized and smaller gold stocks, which mostly lag far behind their large capitalisation peers.

The flows of the two largest gold equity ETFs, *Van Eck's Gold Miners (GDX)* and *Junior Gold Miners (GDXJ) ETFs*, seem to confirm this investor preference. Since the deal was announced to the end of November, the Gold Miners ETF, focused on large sized gold producers, received *net inflows* of around US\$500m, and showed a small gain of +1.7% in unit price. In contrast, the Junior Gold Miners ETF saw *net outflows* of around \$300m and the unit price declined 5.3%. This aversion to smaller capitalisation shares is consistent with the rising risk aversion noted in broader markets in recent quarters, illustrated by the step up in the *VIX index*³¹ from around 13 to over 20 in early October. The broad-based *Citi Macro Risk Index* also gained significantly from 0.4 to over 0.7 in the same period. Historically, a rise in these risk metrics coincided with relative underperformance for mid- and smaller gold shares against large golds. This time was no different.

The Toronto Stock Exchange is the largest exchange for gold equities globally. Traditionally, Canadian retail and speculative investors played an important role in the sector, especially for smaller and mid-sized gold shares. Since 2017, a lot of this investment capital, and share trading liquidity, has been lured away from golds by the new sectors of cryptocurrency and the *cannabis*. The diminished investor interest created notable headwinds for smaller gold shares. The plunging value of most cryptocurrencies has made headlines this year. The cannabis sector has retreated from the highs of January, but still has the aura of a frenetic Wild West scramble for space, and may still end in big losses for most stocks. Over time, retail and speculators will return to the smaller gold sector, reviving the support and liquidity it previously enjoyed.

This year also saw the *Vanguard Precious Metal Fund* (a massive fund with over US\$2 bn in assets, a significant size for the sector) undergo a conversion to a cyclical capital fund. The fund effectively exited the precious metal sector, which created large selling pressure in numerous shares – a serious negative impact for many smaller to mid-sized gold shares.

³¹ See Chart Pack Slide 24: VIX

Summary and Investment Outlook

The first section of this document discusses how central banks monetary policy is finally turning, after a decade of easy money. The US consumer (and thus the US economy) is not in the strong shape that headline numbers may imply. The withdrawal of liquidity from the system could very well tip it into recession. A dramatic decline from the peak asset pricing, driven as much by cheap money as by underlying fundamentals, especially for US equities is a very real possibility. The need for capital preservation and a safe haven asset has already helped gold, but will likely drive the gold price higher still.

Many gold shares seem to be in “the opposite of an investment bubble”, with valuations well below normal despite solid underlying company fundamentals. We have detailed several shares trading at a Price/Cash Flow of under 2x, valuation levels which are not sustainable and cannot be ignored by investors indefinitely. The sector overall is generating strong cash flow, has reduced debt considerably (for those few companies where debt was actually a concern) yet has seen share prices decline this year as generalist investors continued to focus on US equities.

We have included some of the reasons for the disappointing performance in 2018, of both the precious metals sector as well as the Craton Capital Precious Metal Fund. Rising risk aversion through the year drove investors away from gold equities (as well as emerging markets and almost anything else apart from core, large capitalisation US equities). These drivers have hit the mid and smaller golds particularly hard, in contrast to the resurgence that large golds have enjoyed in recent months. The fund does not merely follow large capitalisation indices. We seek to find, through detailed fundamental analysis, those shares that are underpriced against the company’s intrinsic value, but with clear catalysts to unlock the discount. Some of the fund holdings may not have achieved their catalysts yet or faced minor headwinds. But it is more perplexing when the underlying business is improving and delivering cashflow, production growth or reductions in risk, yet the response from the market place, investors and share valuations is a silent “Don’t Care!” .

However, with the underlying business of many shares and holdings in the fund being very strong, the valuations will not remain depressed for long – investors or larger corporates will step in eventually. The upside does not even rely on a rallying gold price, that will just be further upside leverage.

Moving into 2019 we cannot ignore the potential impact of QT on broader financial conditions. After 10 years of a general equity bull market, it might turn out to be a very difficult and treacherous environment in which to invest. Many indicators and observations lead us to conclude that capital preservation might be high up on the priority list of investors across the globe. It appears that gold could find itself in a much better position to finally embark on the first leg of a new up-cycle. Regardless, most gold miners are now trading at valuation levels rarely seen in the past and most of them are destined to produce lots of cash for years to come. They have been ignored, ridiculed and took the knock for many developments unrelated to their core business model. Factors that provided headwinds in recent months could easily turn into strong tailwinds.

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