Sprott

Special Report

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Five Reasons Why Gold Stocks Make Sense

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Gold mining stocks have soared approximately 30% so far in 2019, based on the performance of the NYSE Arca Gold Miners Index (GDM) as of November 15.[1] Over the last 12 months, the sector is up nearly 50%. Some investors may assume that gold stocks have run their course. On the contrary, we think that the gold mining equities still have a great deal of upside to offer.

In brief, we think we're in the early stages of a prolonged bull market for gold. While the relationship between the prices for gold bullion and gold stocks isn't a linear one, rising demand for the yellow metal commodity has historically driven stock performance. Moreover, despite the recent rally, gold mining stocks have yet to recover from the beating they suffered starting in 2011. Still, recent outperformance — coupled with improving fundamentals — creates momentum, a key factor in many quantitative strategies.

Gold has been a store of value since the beginning of civilization, and yet the nuances of investing in gold — be it the metal or miners — is still a source of confusion. As we see it, that also means opportunity.

Here are five reasons to consider investing in gold equities now.

REASON #1. Rising Gold Prices Drive Demand

Figure 1. Gold Bull Market is Just Getting Started

Source: Bloomberg as of 11/15/19. Gold was $1,514 on 11/1/19, and $1,468 as of 11/15/19.

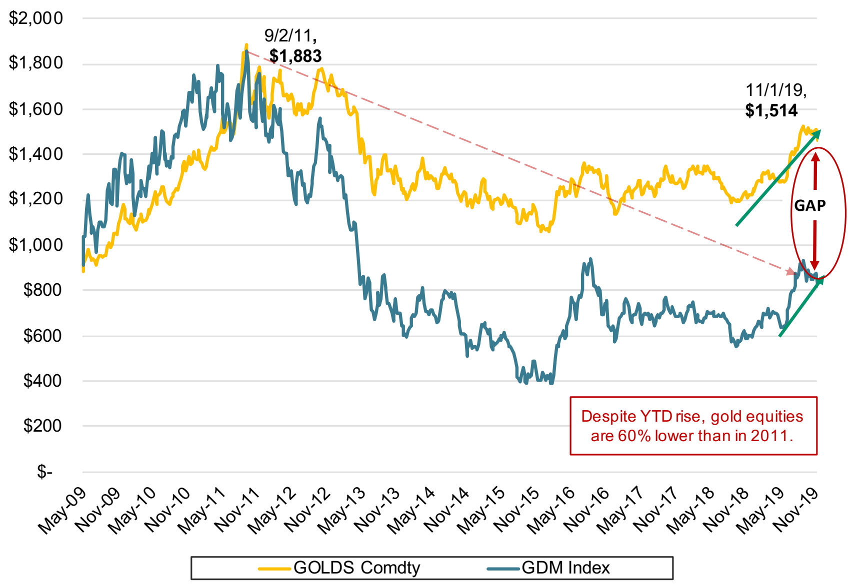
Gold recently broke past $1,500 an ounce for the first time since 2013 (Figure 1), as global political and macroeconomic trends are driving demand for the yellow metal. Along with other strategists, we think gold bullion could surpass its all-time high of $1,900 within the next couple of years. Key factors driving long-term demand for gold as a store of value and defensive asset, especially among central banks and institutions, include low-to-negative interest rates, rising debt levels, trade tensions and intensifying geopolitical risk.

Price movements for physical gold and gold-mining stocks aren't perfectly in sync, but the relationship between them is strong and persistent, across economic cycles.

Historically, rising (and falling) gold prices have a three-times multiplier effect on gold stocks: If the value of gold bullion increases by 10%, mining stocks tend to increase by 30%, and vice versa. The reason: Miners have significant fixed operating costs and high operating leverage, meaning big swings in physical gold prices have a larger impact on miners' profitability.

This relationship cuts both ways, as we saw after physical gold prices peaked in late 2011. As the value of gold subsequently declined (Figure 2), the value of gold stocks plummeted even more. Between 2011 and 2018, the sector posted negative returns in six out of eight calendar years. Even with recent gains, gold mining stocks have yet to recover relative to historical valuations. Since the sector peak in April 2011, gold mining equities are still off by more than 60%.

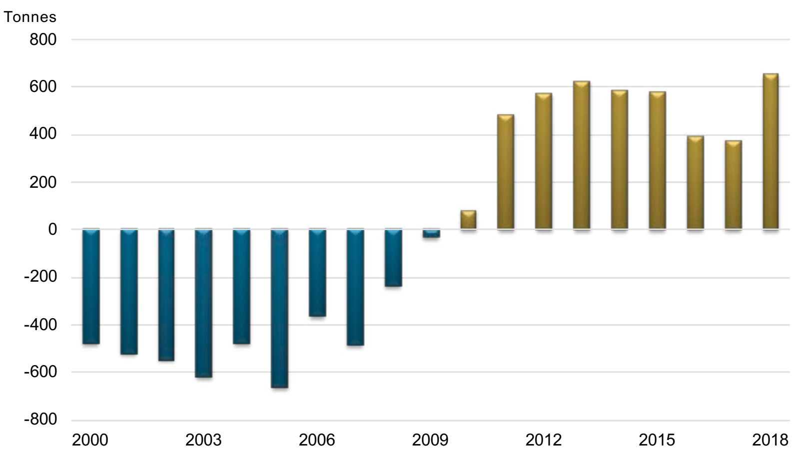
Figure 2. Gold Mining Equities are Very Undervalued



Source: Bloomberg as of 11/12/19.

Figure 3. Gold Demand Has Rebounded: Purchases by Central Banks

Central banks have been net buyers of gold over the past 10 years. Gold plays an important part in central banks' reserves management, and they are significant holders of gold. According to the World Gold Council: "Today, central banks own almost 34,000 tonnes (t) of gold, making it the third-largest reserve asset in the world. The increase in central bank demand for gold reflects current geopolitical, political and economic conditions, as well as structural changes in the global economy. Gold is both a liquid, counter-cyclical asset and a long-term store of value. As such, it can help central banks meet their core objectives of safety, liquidity and return."



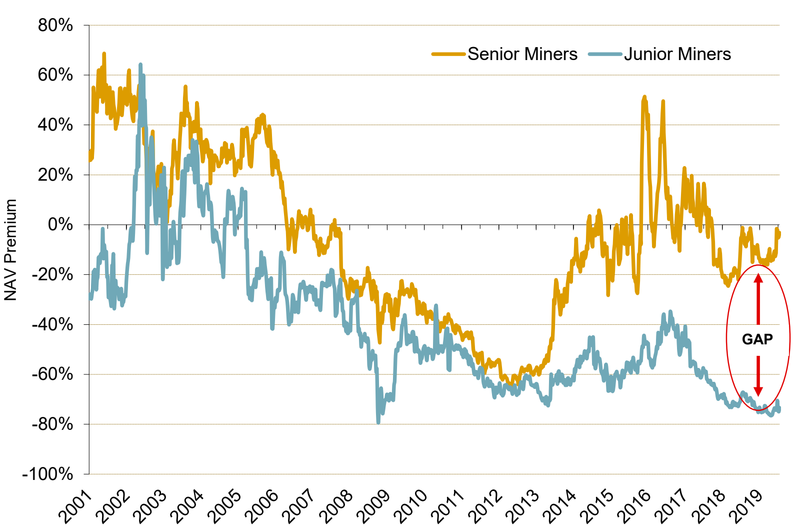
Source: Metals Focus, Refinitiv GFMS, World Gold Council. As of June 30, 2019.

REASON #2. Gold Stocks are Severely Undervalued

Given the amplified volatility of gold stocks relative to gold, investors need to go in with their eyes wide open. Nevertheless, multi-year declines may now set the stage for significant upside.

While miners as a group still trade below their net asset values, the discounts of smaller, "junior" miners are especially extreme, as much of the recent rally has been driven by the largest, "senior" gold miners. In fact, the valuation gap between North American junior and senior gold miners is the widest it's ever been.

Figure 4. The Valuation Gap Between Senior and Juniors is at Historic Extremes



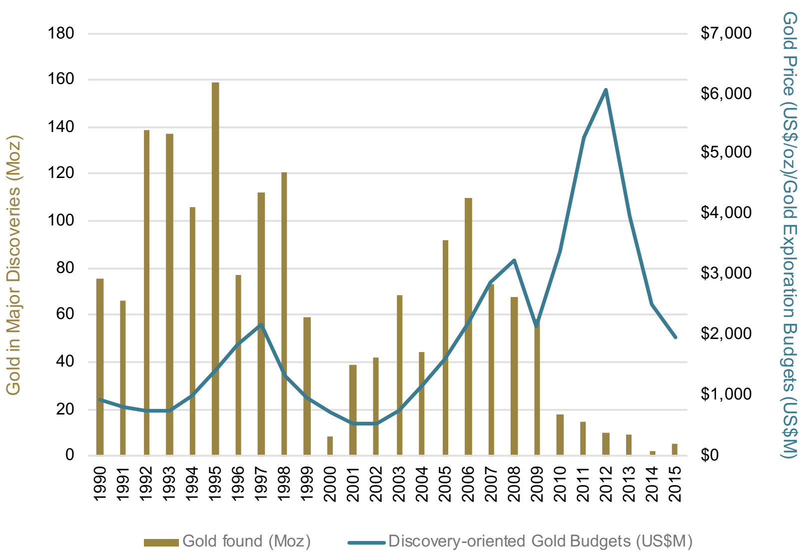
Source: BMO Capital Markets, FactSet. North American senior vs. junior gold miners. As of 7/19/19.

REASON #3. Supplies are Limited

Most investors grasp the importance of investing in companies whose business models are protected by "competitive moats." Gold miners have this in spades, as it can take 15 years from discovery of a new gold mine to successful ore production. The barriers to entry are enormous for newcomers in this sector, given the need for expensive and specialized equipment, environmental regulations and political considerations.

Meanwhile, the supply of gold is finite and there have been increasingly fewer gold discoveries in recent years. This dynamic — combined with depressed valuations of junior gold miners — is driving consolidation in the industry. It is far cheaper for senior miners to buy new gold production than to "build" capacity themselves. In fact, based on an analysis of recent transactions, there is a 35% discount for buying ounces in the market via acquisitions versus discovering new ounces (according to Scotiabank).

Figure 5. Major Gold Discoveries have Declined Significantly



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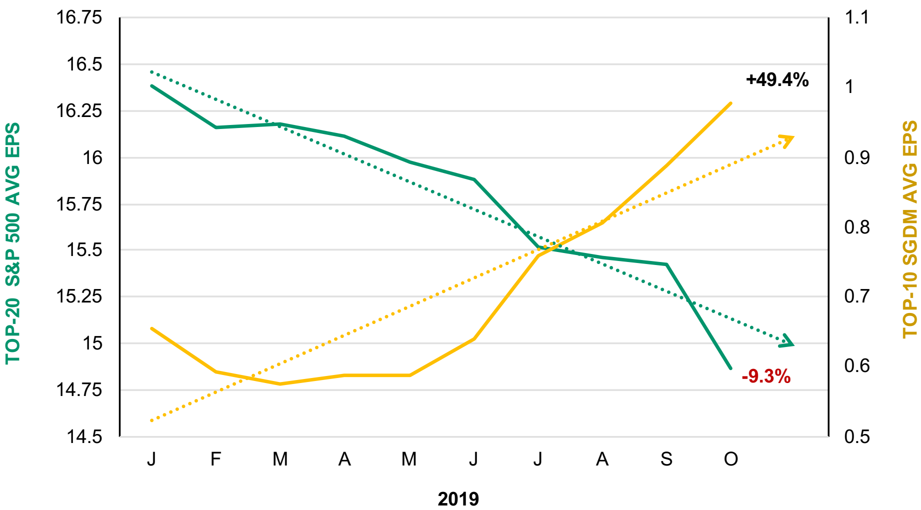
REASON #4. Momentum May Turn Positive

Investors love momentum — following positive trends in prices, earnings and other factors — and the rise of quantitative strategies has made this market phenomenon even more pervasive. For the last eight years, momentum has largely worked against the gold mining sector, but now there are signs the wind is shifting, and that momentum could soon work in its favor.

Analysts covering the sector have understandably been conservative in their estimates and may soon be playing catch up, given higher gold prices and a leveling off of mining costs. Any improvements in earnings outlooks could potentially accelerate positive momentum for the sector. As my colleague Paul Wong wrote earlier this month in The Sweet Spot for Gold Equities: "At this stage in the gold cycle, we are in the sweet spot for gold mining company earnings. A starting low gold price base will result in earnings changes with a high percentage increase when measured quarter-over-quarter or year-over-year."

In Figure 6, we highlight the progression of 2020E EPS (estimates of earnings-per-share) revisions for the top-10 gold mining companies in SGDM[2] versus the average 2020E EPS for the top-20 companies in the S&P 500 Index.[3] Since January 2019, the average 2020E EPS for the top-10 gold mining companies had increased from $0.65 to $0.98 by the end of October, representing a 50% jump, compared to a decline of 9% for the S&P 500. After the Q3 reporting season, we would expect that 2020E EPS for gold miners will be revised even higher.

Figure 6. Sweet Spot for Gold Mining Company Earnings



Source: Bloomberg as of 10/31/19.

REASON #5. Gold Stocks Play a Different Role than Bullion

As with any investment, it's important to think about the role of gold stocks in the context of a broader portfolio. One common misconception is that gold stocks and physical gold are two sides of the same coin. While their fates are certainly correlated, as asset classes they could not be more different.

Physical gold, whether it's in the form of coin, bar or a trust (for example, Sprott Physical Gold Trust, NYSE Arca: PHYS), should be viewed as a stable store of value. It's counter-cyclical and has proven over millennia to be an effective hedge against market turbulence and volatility.

As such, we recommend that investors allocate between 5% to 10% of their assets to physical gold and precious metals.

Gold stocks, conversely, should be viewed in the context of an investor's overall equity portfolio; the size of the allocation will depend on many factors, including risk tolerance. Strategists advocate owning gold stocks continuously, in part because they have low correlations to the broader market. However, most investors view gold stocks as tactical investments. When valuations are severely depressed, as they are now, gold stocks may have the potential to outperform.

At Sprott, we believe that it may be time to consider investing in gold stocks, in addition to physical gold.

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	Sprott Physical Bullion Trusts*	Precious Metals: Coins, Bullion, ETFs
Tax Treatment if Held More Than 1 Year	**15%** or **20%** Taxed at capital gains tax rate**	**28%** Taxed at collectibles tax rate

* Requires the timely filing of a QEF form for your tax return.

** 15% for single filers earning under $400,000; 20% for married filers earning over $450,000 and single filers earning over $400,000.

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[1] Based on the performance of the NYSE Arca Gold Miners Index (GDM), a rules-based index designed to measure the performance of highly capitalized companies in the Gold Mining industry.

[2] Sprott Gold Miners Exchange Traded Fund (NYSE Arca: SGDM) seeks investment results that correspond (before fees and expenses) generally to the performance of its underlying index, the Solactive Gold Miners Custom Factors Index (Index Ticker: SOLGMCFT). The Index aims to track the performance of larger-sized gold companies whose stocks are listed on Canadian and major U.S. exchanges.

[3] The S&P 500 Index (SPX) is an index of 505 stocks issued by 500 large U.S. companies with market capitalizations of at least $6.1 billion.

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