Caught in the downturn – can the gold sector still offer respite from market chaos?

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The gold price fell sharply last week, as traders and speculators sold the metal to cover their margins and pay for their losses during the largest stock market crash since 1987's "Black Monday". The sell-off in the gold sector and the volatility of gold stocks has led some investors to question whether the gold sector is still a safe haven. Yet with financial markets in turmoil, economic activity collapsing and policymakers implementing the largest injection of stimulus since the Global Financial Crisis, there is significant potential for a recovery of gold and gold equities in the coming weeks and months. The risks remain high, but as the crisis runs its course, we expect opportunities to emerge in the gold sector, where many companies show rising profitability and strong balance sheets, as fundamental value comes back into play.

Gold has been shown time and again to be a safe haven in times of crisis, but it is also a liquid financial asset which can be impacted in the short-term by the actions of traders and speculators. Likewise, past crises have shown that gold equities, which offer operational leverage to the gold price, can come under pressure from non-fundamental factors during these times. However, a deeper look at the state of the gold sector today and the longer-term drivers for the gold price suggests that current weakness is likely to be temporary.

As COVID-19, otherwise known as coronavirus, spreads and its impact on individuals, businesses and trade grows, the global economy faces a crisis of historic magnitude. The increased probability of global recession, volatile currency markets and sharp declines of major equity markets, compounded by an oil price crash, have left investors with nowhere to hide. The initial response from policymakers around the world has fallen short, as interest rate cuts and a rapid ramp-up in spending to combat the spread of the virus fail to satisfy investors' fears.

Why have gold and gold equities sold-off?

Gold, the embattled safe haven, has faced losses in recent days which have caught many investors by surprise. As we addressed in our recent piece ("Is gold still a safe haven? Previous crises shed some light"), gold and gold miners have historically faced volatility and short-term declines during periods of crisis, but have also tended to be one of the best performing asset classes in the aftermath of these crises, as 2

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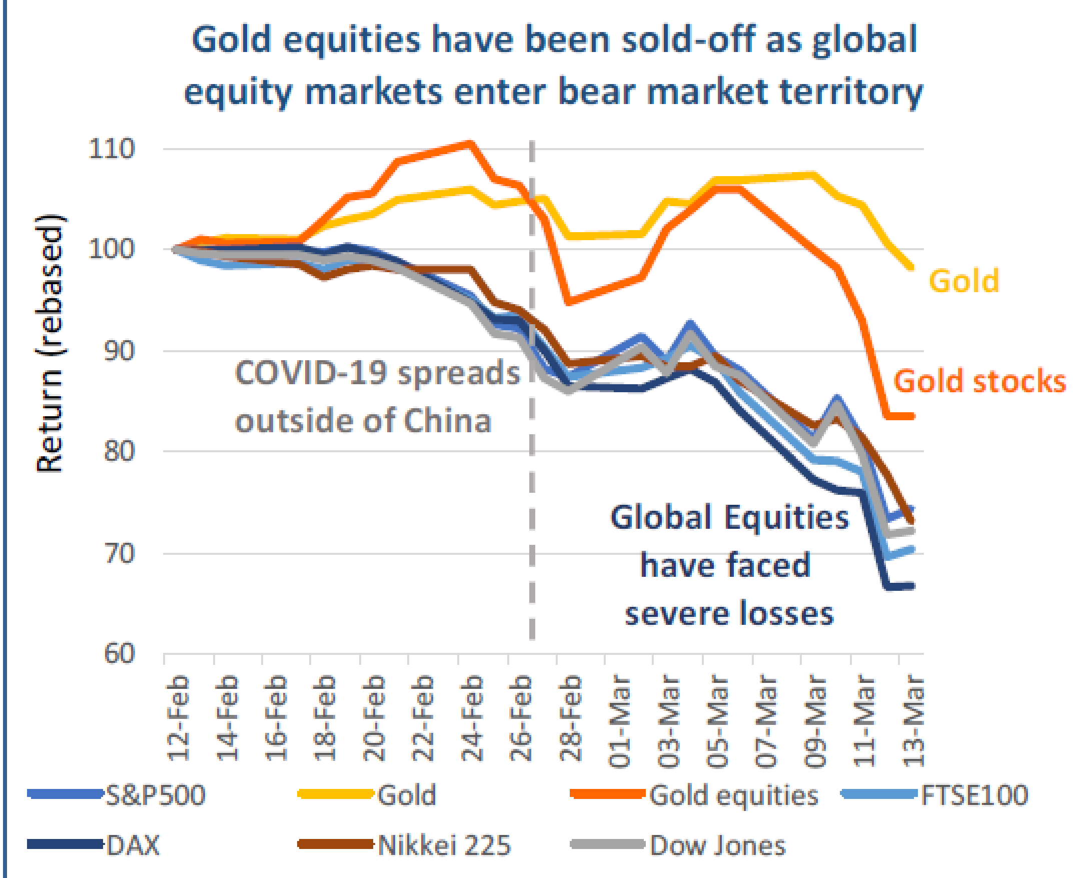
policymakers' actions to loosen monetary policy, weaken currencies, expand debt and increase spending boosts demand for gold.



Source: Bloomberg. Data at 13 March 2020.

A key factor behind the gold sector's current woes has been margin covering by traders facing severe losses across their portfolios. Gold and gold equities have been sold down alongside other liquid assets in recent days as traders respond to the sizable declines in general equity markets, resulting in gold price weakness and heightened volatility for gold equities.

With gold miners caught up in panic selling of liquid assets, we have seen indiscriminate drawdowns across the sector, with little regard for company quality or outlook. The popular GDX and GDXJ gold equity ETFs declined -35.4% and -44.7% respectively last week, due primarily to large-scale liquidation by hedge funds. This sell-off highlights that ETFs such as these are heavily used by speculators, resulting in heightened volatility relative to the rest of the market.

On the physical demand side, while the true impact of the virus on gold demand will come to light in the coming weeks and months, we expect to see demand for gold remain robust. The value of gold-backed ETF products reached an all-time high in February 2020, as reported by the World Gold Council, offsetting weaker demand for bars, coins and jewellery towards the end of last year. In recent weeks bullion dealers have reported soaring demand for precious metals and rising premiums, while the US Mint announced a shortage of bullion coins for sale. While these factors suggest demand for precious metals will rise, we must *also expect that this will be offset somewhat by a potential slowdown in jewellery demand as Asian economies see economic growth forecasts cut.*

The gold sector faces exceptional circumstances following gold and gold equities' sell-off, reflecting the unprecedented nature of the COVID-19 crisis. However, with gold backed by robust demand and supply dynamics and with many high-quality gold producers showing improving profitability and rising dividends, we suspect that weakness in this sector will be temporary. The most important factor for gold and gold equities in the coming days and weeks will be the policy response and changes to the macroeconomic environment. Should governments and central banks choose to fight economic slowdown with loose monetary policy, economic stimulus, debt and other inflationary tools, gold and gold producers may find their fortunes improving rapidly.

Here comes the largest stimulus package since the aftermath of the Global Financial Crisis

After the initial policy response from governments and central banks last week failed to end the chaos in financial markets, policymakers are ramping up measures to counter the impending global economic slowdown.

In a major move the US Federal Reserve slashed interest rates to almost zero, following the recent 50bp cut which did little to counter the rout in equity markets or improve business confidence. The coming days will show whether these drastic measures will improve the situation, however with the Fed already in an interest rate cutting cycle, this rapid acceleration of cuts in response to the crisis highlights the unprecedented nature of this crisis and its threat to the US economy. Historically the gold price has responded positively to lower US interest rates, and with real interest rates now firmly in negative territory and likely to stay there for some time, the conditions for gold's recovery are becoming ever more supportive.

The US dollar has largely held up, for now, while treasuries have seen declines, despite the Fed having announced a sweeping package of measures last week intended to ease trading conditions, including pumping trillions of dollars into the financial system. Yet recent months show that a strong US dollar is no barrier to a 3 rising gold price, as is sometimes perceived. It is not uncommon for gold and the US dollar to strengthen simultaneously, particularly during periods of heightened financial sector risk. While the Trump administration could be perceived to have been initially slow to react to the crisis, there is no doubt now that US economic activity will be heavily impacted by measures to slow the spread of the virus. With travel restrictions in place, a national emergency declared and a growing number of cases, the coming weeks will be critical for the world's largest economy.

In Europe, now the epicentre of the pandemic, monetary conditions are already at historic levels, with little room to cut rates in response to the crisis. European policymakers have stepped up spending, with Germany pledging unlimited cash to support business. A rapid expansion of debt is inevitable, along with heightened political uncertainty as some European countries, including those in the Schengen zone, act to close their borders in contravention of one of the EU's core principles.

Even as gold faces questions over its safe-haven status, it is clear that investors will need safe-haven assets more than ever in the weeks and months ahead. With monetary conditions already loose by historic standards, it is likely that fiscal measures will take a central role in policymakers' response to the crisis, through bailouts, tax deferrals and *emergency loans. Policy direction points to a macroeconomic environment of persistent low real interest rates, a vast expansion of debt and a surge in spending by governments. These have typically been supportive conditions for the gold sector.*

Can gold and gold equities offer a respite from market chaos?

The economic scars of the COVID-19 crisis will take years to fade, but as the spread of the virus runs its course as it appears to have done in areas of China where the virus originated, investors must navigate what is likely to be a volatile and uneven recovery. While the short-term outlook is certainly volatile, we believe gold and gold equities will be substantial beneficiaries of the economic conditions and post-crisis policies which we see beginning to be implemented currently.

The conditions are in place for a major potential recovery of the gold sector in the coming weeks and months, as falling real interest rates, currency debasement and vast debt expansion prompts a rebound for the gold price and miners see their profitability increase as margins expand. As active investment managers, Baker Steel's investment strategies remain well-positioned to lead in this recovery, through our focus on the highest quality gold and silver producers, with effective management teams and a commitment to returns to shareholders.

The risks remain high, but the coming weeks and months will see substantial opportunities emerge. As the COVID-19 crisis runs its course we expect to see some fundamental value come back into play in the sector. Gold mining is a rare sector which faces rising profitability, with selected producers set to benefit from margin expansion, driven by a rising gold price and low costs, helped by the recent oil price collapse. With many gold miners raising their dividends and with a constructive wave of M&A underway in the sector, the recent pull-back presents a multitude of buying opportunities for investors in this historically undervalued sector.