Gold's mid-cycle pullback leaves miners historically undervalued and poised for recovery

An update on the precious metals sector and miners' results

Baker Steel Capital Managers LLP

22 March 2021

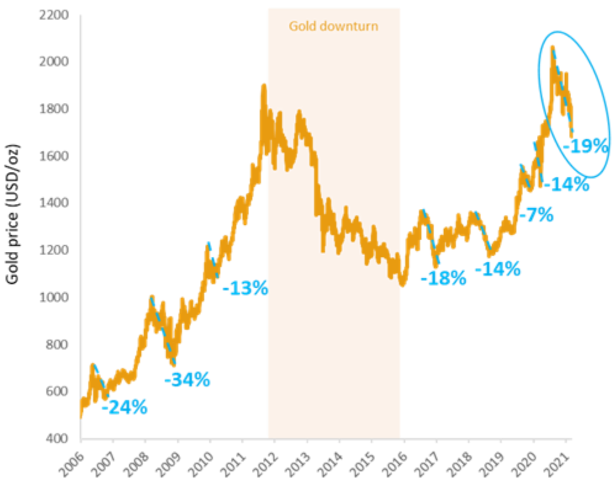
As the gold price begins to recover after touching a 9-month low in recent weeks, investors may be left wondering whether the sector's recent sell-off is over. Gold has fallen by around -19% from its highs of August 2020, pushed lower in recent weeks by rising US yields, as forecasts indicated a strong post-COVID recovery for the US. Gold and gold miners have seen collateral damage during the bond market sell-off, however we consider that the sector offers compelling value at these levels amid a positive, if somewhat volatile, outlook in the aftermath of COVID-19.

With gold trading at around USD 1700/oz in recent weeks, the metal's recent decline is in-line with previous mid-cycle pullbacks and, in our view, does not change the medium-term outlook for gold and gold miners. All the factors driving the bull market cycle for precious metals remain in place; low and negative real interest rates, rapidly expanding money supply and debt, persistent geopolitical tension, as well as ultimately growth and wealth generation, which are key drivers of gold demand. Most importantly for gold, nothing is diminished with respect to inflationary risk, a significant potential catalyst for higher gold prices in the months ahead. Moreover, we consider that following the recent sell-off, gold equities have become heavily undervalued on a fundamental basis, as well as relative to historical levels.

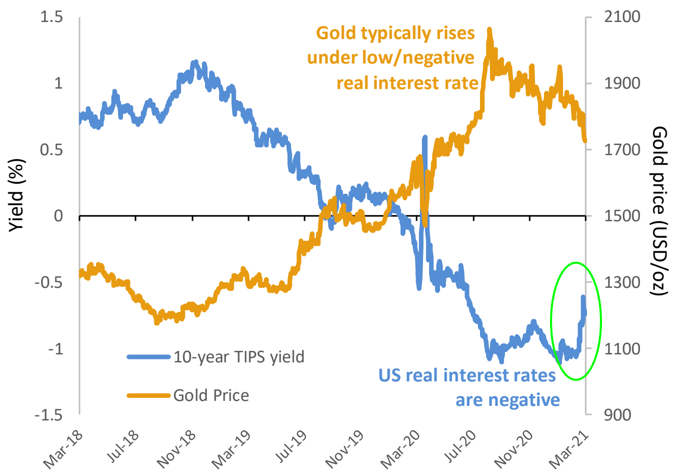
Baker Steel's team have drawn attention to the increasingly strong position of gold miners for some time, and we are pleased to see companies' 2020 results showing improvements to profitability and shareholder returns. The recent BMO Global Metals and Mining Conference, a key annual industry event, highlighted the healthy state of the industry, despite the short-term head winds which gold has faced. With the themes of margin expansion, dividend increases and cost controls in mind, our team has been able to respond quickly to gold's sell-off, to ensure our funds are best positioned to deliver a strong recovery from the sector's current slump.

A mid-cycle pullback - Gold's recent sell-off is consistent with past cycles

Gold's recovery will not follow a straight line



Despite the recent spike real yields remain negative



Source: Bloomberg, Baker Steel Capital Managers LLP. Data at 15 March 2021.

As long-term investors in the precious metals sector we observe that bull market cycles for gold tend not to follow a straight line. During the past cycle we have seen regular sell-offs, averaging -18%, which punctuated the broader upward trajectory of gold prices. It is our view that the recent sell-off was exactly that, a short-term dip in prices caused by a spike in yields, which seems unlikely to alter the longer-term direction of gold prices.

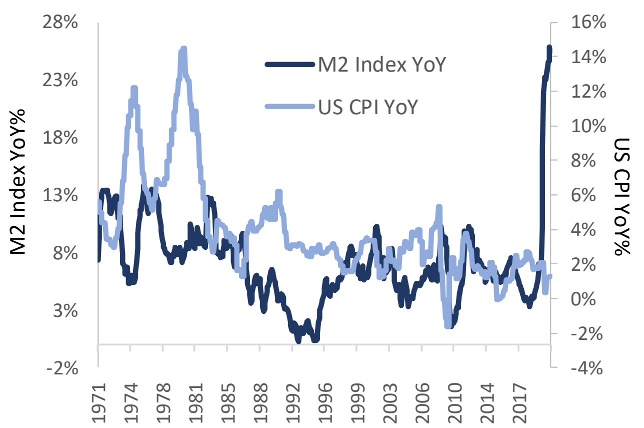
Of course, the impact of higher US yields on gold remains a key question for investors. We have seen many cases historically where a spike in yields, typically resulting from a resurgence of optimism regarding the US economic performance, have caused a short sell-off of gold. But while movements in nominal rates may present a headwind for the gold price in the short-term, we observe that it is the level of real interest rates which historically proves to be the most significant driver of gold prices.

Despite the recent rise in US yields, negative real interest rates remain prevalent around the world and with firm indications from policymakers that monetary policy will remain accommodative, even in the face of growing inflationary pressure, low and negative real rates appear likely to persist, creating what has historically been a highly supportive environment for gold.

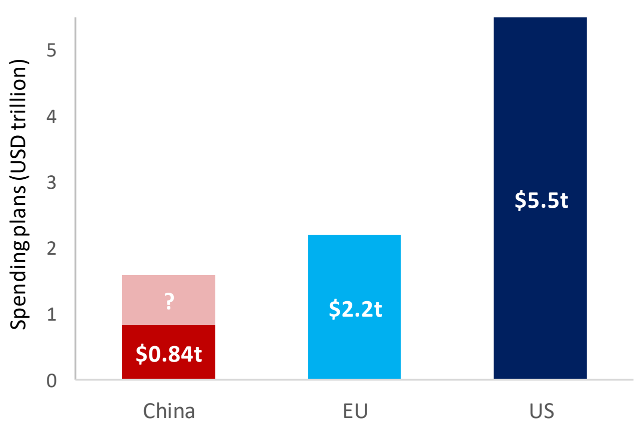
Inflationary pressure is building - A catalyst for higher gold prices?

The return of inflation is a significant potential catalyst for gold. Gold has historically thrived as an inflation hedge during periods of rising prices. While inflation has remained low for most major economies over the past decade, the global economic response to the COVID-19 crisis, driven by historic levels of economic stimulus, appears likely to unleash inflationary pressures in the months and years ahead. Money printing, heightened government spending on infrastructure and the "green deal" fuelled by debt, increased bank lending and pent-up consumer demand, alongside supply-side factors including "reshoring" and the impact of lengthy economic shutdowns, indicate a rise in consumer prices is likely.

US money supply has surged



Planned COVID-19 economic stimulus



Source: Bloomberg, SCMP, Baker Steel Capital Managers LLP. Data at 26 February 2021.

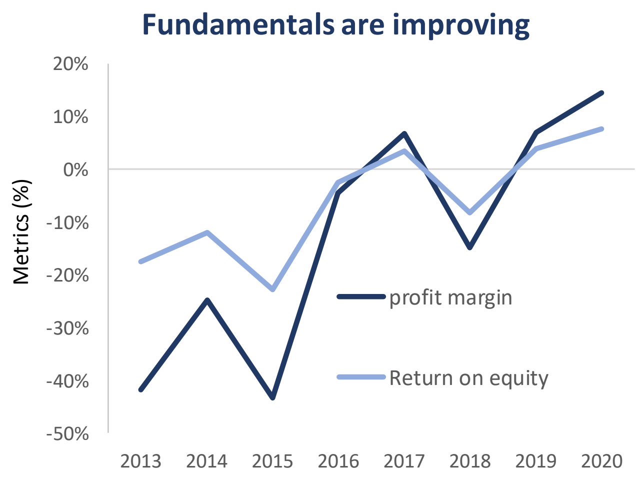
COVID-19 recovery stimulus funding has topped USD 15 trillion globally so far, following the approval this month of an additional USD 1.9 trillion package approved by the Biden Administration, and this total seems likely to grow in the months ahead. The impact on money supply has been dramatic, highlighted by US M2 which has risen by 25% year-on-year (at 1 March 2021). While it remains to be seen what impact this unprecedented expansion of money supply will have on inflation, historically sharp rises in M2 have coincided with an increase in the inflation rate.

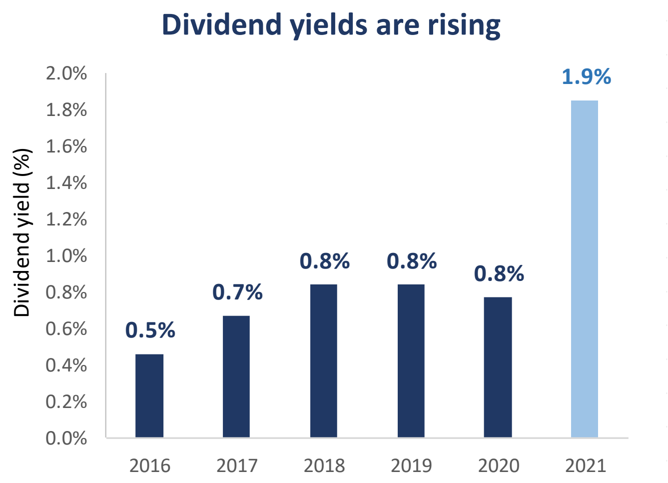
A return of inflation holds positive implications for commodity prices, particularly precious metals. While central banks may move to raise interest rates in response to signs of inflation, it is clear that policymakers will be unable to undertake aggressive hikes without risking potentially severe damage to their heavily indebted administrations, businesses and citizens. Indeed policymakers, led by the Federal Reserve, have indicated that they will allow inflation to overshoot target levels before considering a "normalisation" of rates.

Furthermore, should inflation remain subdued, or rise only slightly, then we would expect to see more aggressive policy measures implemented by policymakers. Yield curve control remains a potential policy measure by the Fed, while debate over Modern Monetary Theory (MMT) continues to inform policymakers' views.

2020 Earnings results indicate the gold sector is in strong shape

Recent weeks have seen companies reporting their 2020 results and outlook for the year ahead. While as ever there are large disparities in quality, overall we have been encouraged by the strong position in which many miners now find themselves. Profits are rising and free cash flow is increasing. Meanwhile company balance sheets are looking much healthier. On the topic of growth, we see signs that many companies are looking at M&A deals, the pace is still subdued due to COVID-19 limiting due diligence and volatility impacting valuations.





Source: Bloomberg. Data as 9 March 2021. Based on the XAU Index.

We are witnessing cautious increases to dividends and buybacks are being undertaken. Questions remain for miners regarding how best to return capital to investors, with some companies favouring a cautious progressive dividend while others seek a base dividend, supplemented with buybacks or special dividends. Furthermore, we see a divergence in approach between companies with strong core assets and a focus on returns, and those that have growth and production challenges.

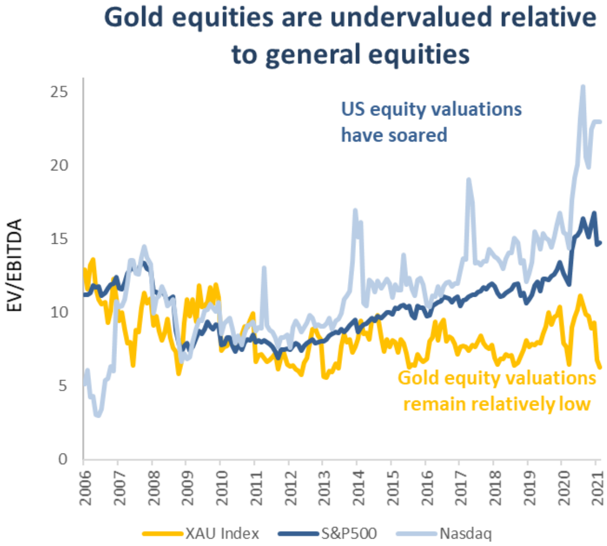
A key development across the mining sector during 2020 has been that environmental, social and governance ("ESG") is now a key focus for management, with a recent poll indicating that ESG factors are becoming as important as the topics of growth and returns. Particular areas of priority include carbon emissions, water usage and energy efficiency. The sector has reached that tipping point where most stakeholders, including investors, will not accept economic returns that come at the expense of mediocre ESG practices. This could create a virtuous circle for the good companies to achieve higher premium valuations (and a death spiral for the bad ones as access to capital and projects becomes limited).

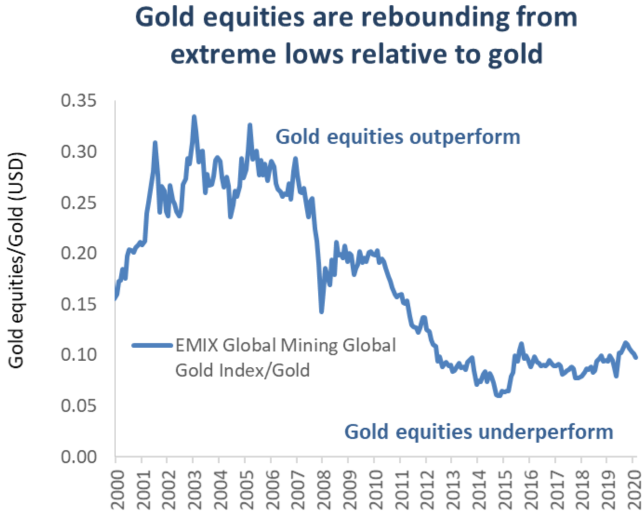
An important takeaway from the 2020 results is that the industry has generally weathered COVID-19 well, albeit with some limited costs pressure. In fact, many companies have improved productivity during this period. The move to remote working, restructured shift patterns, remote mining and technical innovations are boosting efficiency, with these initiatives having been accelerated during the COVID-19 crisis.

A volatile environment, yet gold miners are historically undervalued

The last few weeks have highlighted that as the world economy moves towards recovery, periodic bouts of higher volatility and risk for gold and gold equities will likely occur as investors respond to the macroeconomic realities of the aftermath of the COVID-19 crisis.

Overall economic and market conditions appear conducive for higher gold prices, particularly given the outlook for real interest rates, although the recovery is unlikely to be in a straight line.





Source: Bloomberg. Data as 9 March 2021.

The 2020 earnings and results have reconfirmed to us that the gold industry is in the healthiest shape it has been in for a long time, but company valuations are far from reflecting this. We see historic levels of fundamental undervaluation in precious metals equities, with many companies experiencing margin expansion and poised for re-rating by the market. Furthermore, on a relative basis, gold equities are trading on metrics far below that of broader equity markets, while relative to the gold price itself, miners have a long way to go.

The recent sell-off has highlighted opportunities as well as risks for investors in this sector. As seen from previous gold cycles, pullbacks often occur on a temporary basis, during a longer-term gold bull market. At present, we see sector profitability, capital discipline and returns continuing to improve, at a time when the macroeconomic backdrop for gold appears favourable. For our award-winning range of funds in this sector, Baker Steel's experienced team and unique investment approach ensure our strategies are positioned to take advantage of these themes.

About Baker Steel Capital Managers LLP

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

Baker Steel has a strong track record of outperformance relative to its peers and relative to a passive holding in gold or gold equities. Fund Managers Mark Burridge and David Baker have been awarded ***two Sauren Gold Medals for 2020*** *and were awarded* ***Fund Manager of the Year*** *at the* ***2020 & 2019 Mines & Money Awards****.*

BAKERSTEEL Precious Metals Fund is the ***2020 winner*** *for the fourth year running of the* ***Lipper Fund Award*** *for Best Fund over 3 years and 5 years, Equity Sector Gold and Precious Metals while Baker Steel Resources Trust has been named* ***Investment Company of the Year 2020 & 2019****, Natural Resources, by Investment Week.*

Sources: Bloomberg, Company Reports, Baker Steel Capital Managers LLP, White & Chase.

Important

Please Note: This document is issued by Baker Steel Capital Managers LLP (a limited liability partnership registered in England, No. OC301191 and authorised and regulated by the Financial Conduct Authority) for the information of a limited number of institutional investors (as defined in the Fund prospectus) on a confidential basis solely for the use of the person to whom it has been addressed. This document does not constitute or form part of any offer to issue or sell, or any solicitation of any offer to subscribe or purchase any shares or any other interests nor shall it or the fact of its distribution form the basis of, or be relied on in connection with, any contract therefor. Recipients of this document who intend to apply for shares or interests in Baker Steel's funds are reminded that any such application may be made solely on the basis of the information and opinions contained in the relevant prospectus or other offering document relating thereto, which may be different from the information and opinions contained in this document. This report may not be reproduced or provided to any other person and any other person should not rely upon the contents. The distribution of this information does not constitute or form part of any offer to participate in any investment. This report does not purport to give investment advice in any way. Past performance should not be relied upon as an indication of future performance. Future performance may be materially worse than past performance and may cause substantial or total loss.