Commentary

Bullish on gold

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Thanks to increasing signs of central bank policy failure, gold has had a strong run as of late. Can that run continue? Kevin MacLean, the lead manager for Sentry Precious Metals Fund and a six-time winner of a Brendan Wood International TopGun Investment Minds Award, shares his thoughts on the gold market.

KEY DRIVERS OF THE CURRENT GOLD RALLY:

- Gold has a correlation with the U.S. deficit. The deficit is considered to have bottomed last year; it is now starting to rise and is projected to rise for the next 10 years.
- Even if things go really well (in the U.S.), the growing deficit shows that fiscal stress in the U.S. is going to become quite severe, back to greater than a $1 trillion deficit. That one point alone is hugely bullish for gold. It shows that the fiscal position is not under control at all.

GOLD PRODUCTION:

- Production in the gold industry fell from 2001 to 2008. It did that in part because the industry high-graded like mad during the 1997-2001 period to try to stay in business when the gold price was sub-US$300. When the gold price recovered, they did not have any good stuff left and grades in the industry collapsed by about 40% over that eight years and production fell. By the time we got to 2008, there were projects that made sense to build with gold at US$1,000 instead of gold at US$250, and those projects were built. There were a few new discoveries; those projects were built. So gold production from 2008-2015 climbed.
- In 2015, it was expected that gold production would peak. Normally the 4th quarter is the strongest production quarter of the year; last year was different. Production peaked in the 3rd quarter, about three or four months before the gold price actually bottomed, and that production peak should be in effect for the next seven years. So just like 2001-2008, production declined for seven years. I think we're back into another production decline of seven years. It's not going to be 10% a year, but it's going to be a couple percent a year. The point is that supply is going to start to fall so you're going to have to have higher prices to maintain supply.

TOTAL GOLD SUPPLY IS INELASTIC:

- The supply of gold last year was about 4,300 tons all in. That's about the same as the supply of gold in 1997, so it really hasn't varied much in 20 years. Now, we're into that happy backdrop where production is going to fall for seven years, which is, for any commodity, a reason to buy it.

GOLD IS MONEY:

- Gold competes with paper money that has a yield; gold has no yield. The market expectation, as everyone knows for the past two years, is that the U.S. economy, and global economies, would eventually catch fire and monetary policy would be tightened, nominal interest rates would go up, real interest rates would go up, and gold does not compete well with rising real interest rates.
- The gold price rally that we've had is being driven higher as confirmation becomes more and more obvious, to everybody, that real rates of return are no threat to gold.
- In fact, for the first time ever, gold is competing with negative yield, and that negative yield contagion is spreading. In turn, deflationary pressures are increased by this tax on savings.

CONFIDENCE IN CENTRAL BANK POLICY:

- In January this year I think we reached an inflection point where confidence in central bank policy globally cracked. They are trying to extend the credit cycle, and all they have really done is accelerate the global growth of sovereign debt. Japan is one of the most aggressive money printers, to try and keep their economy from sinking into deflation. At some point in the future, if people say: "You know what? I don't want any more yen. I don't want any more euros. I don't want any more yuan. You just keep printing them and throwing them at me. I don't want any more. I want stuff that's real."
- A number of European institutions in particular have opted to sell their negative yield bonds and buy gold. I think gold will crush bonds over a 10-year period in terms of total return.

U.S. DOLLAR AND GOLD:

- How do you forecast gold based on even a perfect knowledge of the U.S. dollar index – it's useless because the dollar is being priced against other debasing currencies. It's a completely useless, broken metric.

GOLD PURCHASERS:

- Interestingly, the main buyers of gold are Western organizations, developed country organizations and investors, and they are doing it through the ETFs; they are doing it through COMEX.

RUN-UP IN GOLD PARALLEL TO RECENT HIGHS IN THE STOCK MARKETS?

- There is no rule that says gold has to go down when the stock markets go up. It's quite true that from 1982-2000, gold went nowhere while the stock market boomed, but that was in the context of very high real rates, and production growth for 20 years. In the 2011-2015 period, gold went down while the stock market went up, and you could say there is some causality there. I won't argue that there is some; it's hard to quantify. But I think the factors about monetary policy are helping stocks as well.

VALUATIONS

- We have gone from discounted valuations where companies were trading at a discount to net asset value last year, to now trading at quite a wide range.
- We think the valuations are quite reasonable. We think the wealth creation potential of the names that we own does allow you to pay more than 1x NAV. Investing in the gold sector, even though we're valuation junkies, is still a bit of an art because, like any sector that becomes attractive to investors, the valuations can get skewed. But we're not anywhere near anything that's not completely normal in terms of valuation metrics.

ARE CENTRAL BANKS CURRENTLY BUYING OR SELLING THEIR GOLD SUPPLIES?

- They are net buying, primarily China and Russia. China has actually slowed down. They were buying 200 tons a year, last year. They slowed that down by about half this year, in response to prices jumping up. Venezuela has been a seller but only has a few billion dollars worth left. So, central banks are not the driver for gold going up here: it's investment demand.

SILVER'S FUTURE:

- Silver has had a significant rally. Production seems to be decreasing slowly. I would say that silver has caught up a little bit to gold, and the silver/gold ratio has declined. The production profile of silver going forward is not as positive in the sense that we don't see silver production declining as quickly as gold production, so we don't think it's as attractive from that perspective. We look at the fundamental demand factors driving silver demand higher, mainly solar panels. That can give it a couple percent growth a year.
- It's a small market. When the precious metals sectors move, silver tends to outperform. We like gold better, but when it comes to making a decision, we're not going to say we're only going to buy gold companies because we like gold better. In fact, many of our investments have both gold and silver. We're far more focused on the wealth creation potential of any given company as opposed to whether it's gold or silver.

SUMMARY:

- Deficits, production, monetary policy, negative rates, the dollar, deflation risk – all of these factors are flashing green for gold. I was asked in December when I went bullish on gold internally, how long I thought the rally would last, and I said, "From a technical perspective, I could see three years easily." From a fundamental perspective, I can now see 10 years."
- At the start of the year, I had a short-term target price of US$1,392. We got to US$1,375 so far. I think there is a decent chance we'll get to test US$1,400 in the next month or so. My medium-term target is US$1,660, and then after that, new highs. Let me just say that the direction of gold is strongly up, and if gold was up strongly, there's going to be no meaningful supply response.
- I think this could easily be a decade rally. I think it will be stronger than 2001-2008, which saw gold quadruple, because the monetary backdrop is vastly stronger. I think gold could be, over the next several years, above US$4,000 an ounce. If you're worried about gold pulling back, yes, it might pull back three seconds after you invest in it, but I wouldn't worry about it too much.