Digging for winners as gold price climbs

Opinions are divided on the outlook for the sector and the top picks within it

RUDI FILAPEK-VANDYCK

As the price of gold has broken out on further central bank policy easing, stockbroking analysts are assessing what has already been priced in, and which gold stocks still offer great opportunity.

With the underlying commodity lifting fast, it's no surprise to see the share prices of Australian gold producers flying high as investors watch rates and bond yields drop again.

A rejuvenated gold price — both in US and Australian dollars — has pulled the eternal gold bulls out of the shadows of financial markets. One gold bull last week predicted that $20 for Northern Star (NST) shares should not be considered impossible, and neither is $100 per share for Newcrest Mining (NCM).

Ahem! Well, we'll see. What is seldom highlighted is that that same gold sector locally is home to some serious capital destruction for investors who picked the wrong stocks in the year past.

Which is why Bell Potter's sector update last week was such a refreshing exercise. The analysts felt compelled to highlight the "spectacular wipe-outs" (their terminology) that have equally characterised the gold sector domestically, including significant share price falls for:

- Gascoyne Resources (GCY);
- Dacian Gold (DCN);
- St Barbara (SBM);
- Blackham Resources (BLK);
- Eastern Goldfields (EGS); and
- Artemis Resources (ARV).

For investors who still want exposure, while avoiding the worst possible outcome from investing in the sector, Bell Potter has nominated top picks Pantoro (PNR) and Regis Resources (RRL).

Analysts at Credit Suisse express the view that, while gold priced in Australian dollars has surged to record highs this month, the rally in gold producers' equities has generated stretched valuations all around.

The analysts have tried to assess what is being implied by the various share prices and come up with the following conclusion.

Shares in medium-large companies including Newcrest Mining, Evolution Mining (EVN) and Northern Star are implicitly pricing gold at $US1750 an ounce (it is only about $US1400 now), while shares in mid-cap producers OceanaGold (OGC), Regis Resources and St Barbara are still equivalent to gold priced at $US1277-$US1339 an ounce.

The immediate conclusion to draw is that larger-cap, quality names are trading at a premium, both to gold and to the rest of the sector, while many smaller-cap producers are still incorporating a discount towards gold.

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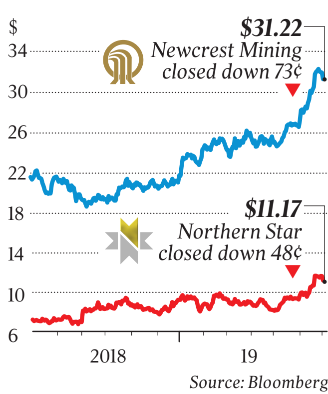
At Morgan Stanley, gold stocks have completely fallen out of favour. Morgan Stanley's commodities analysts used a general sector update to downgrade Newcrest Mining to underweight, and to announce that none of Australian gold producers under coverage were left carrying a rating other than underweight.

The reason is, on Morgan Stanley's calculations, share prices for Newcrest, Regis Resources, Evolution Mining and Northern Star are all reflecting a gold price above $US2000 an ounce, and this makes them overly expensive.

And then there is Canaccord Genuity, where mining and metals analysts are ostentatiously more enthusiastic, both in North America and locally. Canaccord's view is that gold priced in US dollars and in Australian dollars can surge even higher, supported by the view that the Australian dollar has decoupled from bullion and is destined for more weakness.



Similar to peers, Canaccord Genuity has upgraded gold bullion forecasts. The average price out to 2025 has been lifted by 5 per cent to $US1508. In Australian currency, the average forecast has lifted by 6 per cent to $2154.

OceanaGold has been upgraded to buy, from hold, with a revised price target of $5, but Saracen Mineral Holdings (SAR) was downgraded to sell, from hold, with a revised price target of $2.65.

Other buy-rated gold producers include Northern Star (target $12), Resolute Mining (target $1.90), Perseus Mining (target $1), Westgold Resources (WGX, target $2.80) and Dacian Gold as a speculative buy with a target of $1.20 (down from $2.25).

Top picks as nominated by the commodities desk at Canaccord Genuity are Northern Star among mid-cap producers; Perseus Mining and Westgold Resources among the smaller caps; and Bellevue Gold (BGL) among developers.

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However, if you do not share the view of a weaker Australian dollar for the years ahead, the outlook for local gold producers starts looking a whole lot different. This, essentially, is the proposition put forward by analysts at Citi.

Citi has equally upped bullion price forecasts to an average of $US1466 for 2020, with gold anticipated to reach $US1700 in 2023, but alongside this new forecast sits the expectation of a gradually strengthening Australian dollar against the greenback.

Citi analysts are not trying to be contrarian just for the sake of it. Every analyst in the market is trying to assess what lower bond yields and a Federal Reserve returning to stimulus actually means for the US dollar in the medium and longer term.

At this point, we can but report that opinions across various experts are sharply divided. Except that in the short term, the US dollar should weaken, which is what we are experiencing right now.

If Citi's view of the Australian dollar appreciating to US77c by 2023 proves correct (implying the US dollar is embarking on a drawn-out cycle of weakness), then gold priced in Australian dollars looks unlikely to continue to reach for record highs.

Citi, too, has downgraded Newcrest to neutral, with the biggest impact in terms of earnings boost felt by Dacian Gold, as that's how this whole thing works out for high-cost producers.

There is also a positive impact for base metals producers who just happen to also mine gold, including OZ Minerals (OZL) and Independence Group (IGO). The only pure gold producers left with a buy rating at Citi are Perseus Mining (revised target 75c) and Resolute Mining (target $2.05), but both carry a "high risk" tag.

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Three reasons to hold yellow metal as part of a diversified portfolio

CHRIS BRYCKI

With the exception of perhaps bitcoin, there are few investments as polarising as gold. Warren Buffet has avoided it since it has no "utility value". But then again Ray Dalio of the $175 billion Bridgewater Associates group preaches the opposite. Dalio suggests: "If you don't own gold ... there is no sensible reason other than you don't know history or you don't know the economics of it."

Clearly, gold is a difficult asset to value and market commentators love to speculate on what is causing its daily moves. As a result of this fixation on short-term issues, little discussion seems to go into the value of owning gold as part of a long-term portfolio.

Unlike shares and bonds, which generate dividends, gold doesn't generate regular cash flows, so investors in gold can only benefit from capital returns. Separately, in contrast to other commodities such as iron ore or oil, there's little industrial use for gold. It doesn't power our smartphones or enable the production of steel for buildings. Gold can't be depleted or destroyed, either.

The majority of the demand for gold in the world comes either for "investment" or jewellery. So when investors buy gold they are investing in an asset where the major use is simply as "an investment" — and not much else.

I've been recommending an allocation to gold (via the GOLD exchange-traded fund) since 2014. Gold ETFs are physically backed by gold bullion stored in vaults. It's unhedged, so investors benefit from a falling Australian dollar.

More recently, I've recommended an increase in that allocation: In late 2017, the gold allocation target was lifted from 10 per cent to 12.3 per cent of all client portfolios.

The negative correlation between shares and bonds had weakened, which meant that bonds may not provide as much of a cushion in a sharemarket correction scenario. Meanwhile, the yellow metal has since performed better than most asset classes, including Australian and global shares, notching up a return of 23 per cent since late last year.

There are three reasons I continue to directly recommend gold:

As a diversifier

Harry Markowitz won the 1990 Nobel Prize in Economics by showing how to achieve the best return potential by combining assets with a negative relationship to each other (negative correlation). His seminal work, Modern Portfolio Theory (MPT), continues to be the best regarded theory for managing portfolios and is how I approach building portfolios.

Gold has a low or negative correlation with most other investment assets, which is why it typically moves in a different direction to shares. This is rare for an asset and it means gold can to reduce the risk of a portfolio. In finance-speak, gold helps to improve the quality of the portfolio returns, which means you can earn a similar return with less risk.

As an insurance policy

Gold has historically been an effective way to preserve the real value of your wealth since it acts as an insurance policy against currency devaluation. This happens when your home currency loses its global purchasing power either because of economic factors or monetary policy. While gold in US dollars is well below where it traded in 2012, in Australian dollars it trades at an all-time high due to our weak currency — it recently crossed $2000 for the first time.

As a safe haven

Government bonds have historically been one of the safest places to park your money. However, today there is a record $US14 trillion of government debt issued by creditworthy governments that trade on negative yields. In countries such as Japan, Switzerland and Germany, you need to pay the government to borrow your money. While gold doesn't have a yield, it's still a more positive yielding asset than negative-yielding government bonds that penalise owners. As the amount of negative-yielding government debt increases, so too does the attractiveness of gold.

Gold remains an important portfolio diversifier regardless of your investment horizon or risk capacity. It's even more important for growth-focused investors right now, since shares and bonds are dancing to the same tune.

Moreover, gold historically has been able to maintain its purchasing power and provide portfolio insurance in times of need. It will continue to benefit from the swelling pool of negative-yielding government debt. Like insurance, it's the part of your portfolio you'll be glad you have when the rest of the investment world isn't shining.

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Driverless cars head towards road bumps

ROGER MONTGOMERY

Some time ago I found myself joining a meeting of a handful of extraordinarily wealthy individuals being pitched the opportunity to invest in an unlisted autonomous vehicle (AV) start-up. While it was the veritable tidal wave of competitors, a lack of patentable IP and valuation of $3 billion that caused me to baulk, it nevertheless got me thinking about how realistic it is to accept that the world will soon be overrun by robotaxis, autonomous road trains and autonomous wheelie bins (yes really).

Putting aside the impacts on society and the urban landscape, as well as questions of ethics and trust, and the regulatory nightmare that may or may not unlock enormous productivity, life and cost savings for the world, I wonder just how close we really are.

The advent of autonomous vehicles is expected to be associated with acute changes to many industries including, for example, general insurance and logistics. Sectors to benefit might include internet (data needs), utilities (power), semiconductors (build), telcos (communications networks) and tyres (AVs will be driving constantly, wearing out tyres much more frequently).

AVs and autonomous features in human-operated vehicles are already being introduced globally. Through autonomous forms of public transport (the recent launch of the Sydney metro trains in NSW being an example), through ride-hailing company research and development, and by individuals purchasing private vehicles with autonomous features such as lane holding, autonomous parking, emergency braking and adaptive cruise control. We can already experience some aspects of the AV revolution.

But does that mean we are close to fleets of AI-driven AVs on our roads?

Much of the commentary around the development of the autonomous vehicle paints an inevitability about their universal adoption. Even I have previously hypothesised my yet-to-be-born grandchildren pointing to a picture of my house, asking what the garage was used for. And most forecasters and analysts believe logistics and robotaxis in urban areas will be the first business use cases to see mass adoption. That seems rational.

The only problem, however, is that local, state and federal governments as well as private road owners will need to spend vast amounts of money upgrading roads to ensure the safe operation of millions of AVs by multiple original equipment manufacturers (OEMs). It's all very well that Waymo announced in 2010 that its car was safely self-driving around San Francisco without dedicated roadside infrastructure. Since then, Waymo has been actively seeking a partner to defray the billions being lost in trying to get it right, and Honda most recently walked away.

Upgrading and the standardisation of road markings and signage will be just the smallest of the spend to be considered.

Autonomous cars require hi-tech infrastructure, prohibitively expensive lidar and radar, and expensive deals with cloud computing and mapping suppliers. The business case to justify these spends does not yet exist. Neither does the integrated technology infrastructure.

AV promoters have pointed to the life-saving benefits of the technology. The logic is simple; remove humans and save lives. According to the Association for Safe International Road Travel, nearly 1.25 million people die in road crashes each year — an average 3300 deaths a day. An additional 20 million-50 million are injured or disabled.

It's easy to see why governments are interested. The problem for the safety argument, however, is that 80 per cent of the life-saving benefits are delivered by level-two (low-level) automation — features such as lane holding, distance maintenance and emergency braking. Those features are already finding their way into mid-tier car models and will soon be standard across all price points. And governments can delay for a very long time any infrastructure spending required.

It's fair to say we are close to peak hype when it comes to AVs and may be beyond it.

In 2018 alone almost $US4bn was raised for AV start-ups, more than double the amount raised over the previous decade. Meanwhile, the number of deals rose from 11 in 2013 to nearly 70 last year. One of those start-ups is a company called Smart Bins, whose autonomous garbage bins know when they are full and take themselves to the kerb: clearly one of humankind's most urgent needs.

In 2019, however, the hype around AVs crashed. In Las Vegas at CES, the giant annual electronics show, executives from self-driving hopefuls and software companies agreed it was time to lower expectations.

The CEO of German auto supplier Continental was quoted as saying: "Until 2030, the market will be driven mainly by assistance systems. Significant revenues will only come thereafter."

Danny Shapiro, senior director of automotive at Nvidia, noted that its technology would be keeping the driver in the loop. And in late 2018, Missy Cummings, director of the Humans and Autonomy Lab at Duke University, said driverless cars were still very immature technologies, adding: "I think there's a ridiculous amount of tech illiteracy running amok ... even among the people who are running these companies."

Even Waymo cancelled plans to offer a fully driverless service, keeping safety drivers behind the wheel.

AVs will arrive one day, but their rate of development may slow if free and easy money dries up. Their rate of adoption will be delayed by government and regulatory inertia.

For investors it means being very careful about the prices being paid to invest, and more importantly to remember that throughout history, world-changing technology has benefited its consumers more than its investors.

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