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BARRON'S COVER

Gold Is Cheap. Inflation Is Coming. You Do the Math

By *Andrew Bary* Sept. 21, 2018 10:14 p.m. ET



ILLUSTRATION: JONATHAN BARTLETT

Gold has gotten a bad rap.

Long seen as the investment choice of the cranky and the fearful, the metal yields nothing; as Warren Buffett says, it just “looks at you.”

This year has been especially lackluster for gold. Its price has slumped 8%, to about \$1,200 an ounce, down more than 35% from its high of \$1,900 in 2011. Adding insult to injury, Vanguard will soon rechristen the large-cap, gold-oriented U.S. mutual fund and shift its focus away from the metal.

But this out-of-favor asset class now deserves a place in investment portfolios.

Compared with stocks and other financial assets, gold looks inexpensive. More important, inflation is surging in the U.S. and in much of the world as central banks shrink their enormous balance sheets. And gold has long represented a good defense against inflation eroding the value of a stock or bond portfolio. Over time, gold's value has risen against the dollar. Gold was \$20.67 an ounce 100 years ago and that bought a good men's suit. Today, one ounce, the same is true today.

“Gold is rare, and it's hard to rapidly increase the supply of it,” says Keith Trauner, co-portfolio manager of GoodHaven (ticker: GOODX) mutual fund, which holds Barrick Gold (ABX), a leading mining company. “Historically, it has been viewed as a hedge against government depreciation of local currency.”

There are an estimated six billion ounces of gold in the world, worth more than \$7 trillion, about 30% of the value of the S&P 500. Annual new mined supply adds less than 2% to the global total.

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“Virtually every government in the world is trying to promote inflation partly because the sovereign debt,” Trauner says. When there is so much debt, he contends, governments have three choices: default, restructure, or inflate the currency. “Politicians, when given the chance will choose the latter.”

Naysayers point to higher interest rates as a negative for gold because it increases the cost of holding cash. But gold had one of its best decades during the inflationary 1970s, when rates soared.

One catalyst that could change investor sentiment on gold is a decline in the U.S. dollar.

“Gold is the anti-dollar,” says Pierre Lassonde, the chairman and a co-founder of Franco-Nevada (FNV), a mining royalty company with an \$12 billion stock market value. “When the dollar is strong, there is no reason to buy gold. But when the dollar is weak, people go back to gold.”

Historically, gold and the dollar have a negative correlation of 80% to 85%. The dollar has been supported by expectations that the Federal Reserve will keep tightening and lift its benchmark, the federal-funds rate, from the current range of 1.75% to 2% by the end of 2019.

Trey Reik, a metals strategist at Sprott USA, says the Fed may have to relent, in part because the upward pressure on rates is squeezing developing economies that have dollar-denominated bonds or other obligations. If the Fed senses that the dollar is about to hold off, the dollar could drop and gold would probably rally. His view is based on the enormous portfolio utility in today’s complex and treacherous investment environment.”

Currently, many U.S. investors own little or no gold, but there are a few prominent bulls on the metal. Charles Gundlach, the outspoken and often prescient CEO of DoubleLine Capital, the big bond-oriented investment manager, is one.

“In my June webcast, I recommended that gold bugs wait until \$1,200 to buy because it had just broke down from a point at \$1,290, Gundlach wrote in an email to *Barron’s*. He turned positive early this month when gold rallied. Based on the technicals, “I am now bullish,” he concluded.

Gold has been a traditional hedge against financial and economic crises, playing that role during the 2008 meltdown. Gold rallied 17% from the collapse of Lehman Brothers on Sept. 15, 2008, until the stock market bottomed on March 9, 2009—a period during which the S&P 500 fell more than 40%.

Cryptocurrencies have lately been touted as taking over gold’s role in a crisis. But a 55% drop in Bitcoin in August, and slumps in other cryptocurrencies, have taken the shine off that market. And there is no easy way to get exposure to Bitcoin.

In comparison, gold has had allure as a store of value and measure of wealth for thousands of years. And it is so in much of the world, including China and India. Before the 1930s, it was used as money in U.S.

How cheap is gold today?

One way to measure it against stocks is a comparison with the Dow Jones Industrial Average. It takes 100 ounces of gold to buy one unit of the Dow, which finished on Friday at a record 26,743. The most recent low in the relationship occurred in 2011, when the Dow/gold ratio dropped to 7.8. Then, gold was near its all-time high of \$1,900 an ounce.

The century-old peak of 40 occurred in 1999, when gold traded at about \$290 an ounce and the Dow was at 11,500. The low came at the top of the commodity boom in 1980, when the metal and the Dow were at 800 after a decade-long stretch when the Dow moved little. Commodities overall are historically cheap.

In the futures markets, speculators, who are normally long gold, are now in the rare position of being net short. Analysts view speculative positions as a contrary indicator and the current situation as bullish.

The knocks against gold are many. It's a static asset that yields nothing, and physical gold costs more. Berkshire Hathaway CEO Buffett says he would rather own productive assets like businesses, farms, or things that get dug out of the ground in Africa or someplace," he noted 20 years ago. "Then we melt it down, dig it up, bury it again, and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head."

Worse still, doubts have arisen over whether gold remains a good hedge against disaster, even if it did during the 2008 financial crisis.

The recent troubles in emerging markets, for example, have not given the price a lift. "With the market doing well, people don't feel the need to have the defensive protection that they presumably get from gold," says Byron Wien, a vice chairman in the Private Wealth Solutions Group and an investment strategist at the group. "In a severe bear market, it likely will provide some protection, but in a correction in a bull market, it won't."

Last month, Wien held his annual series of lunches with 100 leading investors and others in the Hamptons. He had little interest in gold.

For those who are interested in gold, there are plenty of ways to play it. Commodity exchange-traded funds include the industry-leading SPDR Gold Trust (GLD), trading around \$114, and the lower-fee iShares (IAU), now around \$114. SPDR ETF has an annual fee of 0.4%, and the iShares, 0.25%. The newer MiniShares Trust (GLDM), at just 0.18%.

It's a measure of gold's unpopularity that the size of the SPDR ETF is now \$29 billion, about a 10th the size of the largest equity exchange-traded fund, the SPY. When gold peaked at about \$1,900 in 2011, the two were the same size at \$75 billion.

Indeed, open-end precious-metals mutual funds have had a decade to forget. On average, they've fallen according to Morningstar. Big funds include Fidelity Select Advisor Gold Portfolio (FSAGX), First Eagle Gold Fund (FEGD) and VanEck International Investors Gold (INIVX).

In July, Vanguard announced that the \$1.8 billion Vanguard Precious Metals & Mining fund (VGPMX), the largest U.S. mutual fund, would be renamed Vanguard Global Capital Cycles later this month and the metal mining exposure would be reduced in favor of other commodity-related industries and global in general, such as telecommunications. Gold and precious-metals mining stocks will make up at least 25% of the fund.

Gold bulls see the action as a sign of capitulation. Vanguard's move in 2001 to take the "gold" out of the fund and broaden its mandate coincided with a bottom at about \$255 an ounce.

Some closed-end funds own physical gold. For example, Sprott Gold & Silver Trust (CEF), holds roughly equal parts of its assets in gold and a third in silver. That longstanding fund, formerly known as the Central Fund of Canada (CEF), is around \$11.75, a 4% discount to its net asset value. Toronto-based Sprott also runs the Sprott Physical Gold Trust (PHYS). Both funds, unlike the SPDR ETF, allow holders to take physical delivery of the yellow metal. They attract survivalists, who populate the ranks of gold bugs.

Gold-mining stocks, like other natural-resource producers, can offer a leveraged play on the commodity. When prices rise, mining earnings typically increase by a greater percentage. Take a mining company with a price of \$1,000 per ounce. If gold rises 25%, to \$1,250, profits could more than double, with margins going from 50% to 75%.

Now however, gold-mining shares are even more depressed than the metal itself because of financial leverage. The largest gold-mining ETF, the \$8 billion VanEck Vectors Gold Miners (GDX), is down 19% this year, after hitting a 52-week low recently. Its largest holdings include industry leaders Newmont Mining (NEM), Goldcorp (GG), and Franco-Nevada.

Mining companies have many challenges, to be sure. Countries in Africa and elsewhere are trying to gain control of their resources, and projects can face environmental opposition. Major finds are rare. But the companies are showing greater capital discipline and now trade at historically low levels of cash flow.

Reflecting the frustration with the miners' performance, a group including billionaire hedge fund manager Paulson announced on Friday the formation of a coalition of 16 investment managers called the Share Council to publish research and "promote best practices" in the industry.

Newmont is the industry leader with a \$17 billion market value, a strong balance sheet with under \$1 billion in debt and a dividend yield of almost 2%. The only gold stock in the S&P 500, it trades for \$31, or 24 times price.

earnings of \$1.30 a share. That's not a cheap multiple, but Newmont and other big miners rarely trade price/earnings ratios and often are evaluated on their "option" value, meaning they offer a long-term price that could rise with potentially higher gold prices.

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"Newmont has been one of the most successful majors in fixing its balance sheet and reorganizing its production," says John Bridges, a mining analyst with JPMorgan. He has an Overweight rating on Newmont stock, with a \$40 price target. Newmont's production is seen holding steady at about five million ounces annually over the next five years.

Newmont's gold output generally comes from relatively safe locations, with North America accounting for about 70% of it. Bridges says that the U.S. is now viewed as one of the best places to mine gold, thanks to the cut in the corporate tax rate and other tax breaks. So, Newmont and other miners are expanding domestically.

Barrick Gold has been a turnaround story. In recent years, the company has cut debt by nearly \$10 billion through asset sales and internally generated cash flow. The shares, at about \$10.50, trade for 19 times earnings of 55 cents a share and yield just over 1%.

The driving force at Barrick has been its chairman, John Thornton, a former top Goldman Sachs executive. From his Goldman roots, he has sought to bring what he calls a "partnership culture" to Barrick. He wants the company to focus on increasing shareholder returns and not fall into a common industry trap of chasing "ounces," without regard to costs.

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"Barrick is a relatively low-cost operator, with people at the top who are focused on profit over growth, rather than growth for growth's sake," says Trauner, the GoodHaven portfolio manager. He holds Barrick. He argues that at its current share price, Barrick offers a nearly free option on gold prices. In a better environment, the stock could be a lot higher. Barrick earned more than \$500 million in 2011 when gold peaked at \$1,900 an ounce.

The knock on Barrick is that Thornton's focus on returns has gone too far and that the company's gold production, which is expected to decline to about 4.75 million ounces this year from 5.5 million ounces in 2017, could drop further. The company has run into political problems with miners in the Democratic Republic of Congo and Tanzania.

"Barrick fixed the balance sheet and stabilized the business. Now, it needs to show that it can grow in a sensible way," Trauner says. Some think that Barrick could become a takeover target for Newmont. Thornton has cultivated a strong relationship with the Chinese, with Shandong Gold buying a 10% interest in a large South American mine from Barrick.

Franco-Nevada has been the top-performing major gold-mining stock since its inception in late 2007, annually, handily topping the metal, the VanEck ETF, and the S&P 500 index.

The company owes its success to an attractive portfolio of assets and a capital-light business model that gives investors effective exposure to the equivalent of nearly 500,000 ounces of annual gold production. Franco doesn't own or operate mines. Instead, it makes investments in new and existing gold, precious metal, and other assets in return for revenue streams from ongoing production. Franco-Nevada's operating margins are double that of the typical miner.

Lassonde, the Franco-Nevada chairman, calls it "the best business model on the planet" because of its growing portfolio of what he considers to be appealing mining properties. The company has just 31 employees.

TELL US WHAT YOU THINK

Would you consider investing now in gold or in shares of gold mining companies? Write us at mail@barrons.com and we may publish your take. Find out more at barrons.com/mailbag.

The stock yields 1.5%.

Bridges, the JPMorgan analyst, calls Franco-Nevada the "Mercedes" of the gold-mining industry because the company has been able to protect investors in down gold markets while giving them upside in a rising market. The company carries a Neutral rating on the shares with an \$85 price target. With the stock down from a peak of \$85, investors can get the Mercedes at a discount.

Investors
recognize
Nevada's
company
trade are
fetches 5
estimate

U.S. stocks are at record levels exactly at a time when global stress—trade tensions, populist nationali —appears to be growing. This may be an opportune moment for investors to shift at least a portion of to gold: both the metal and depressed mining shares.

To flip Buffett's phrase, gold may do more than just look back at you in the coming years.

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