

# Gold Bull Market Gains Momentum

By Joe Foster, Gold Strategist

## Market Review

There were several macroeconomic surprises around the globe that raised financial risks, propelling gold to new, near-term highs. On June 3, the U.S. Department of Labor's May jobs report fell far short of expectations, continuing a pattern of declining job growth that began in March. The odds of a U.S. Federal Reserve (Fed) rate increase tanked along with the U.S. dollar and gold advanced \$34 per ounce to \$1,244 per ounce. This allowed the metal to continue to establish a firm base above the technically important \$1,200 level.

Markets have become conditioned to expect economic life support from central banks. On June 16, the Bank of Japan disappointed markets by refraining from adding stimulus. The Nikkei 225 Stock Average<sup>1</sup> fell 3.1% and gold soared to a new intraday high for the year of \$1,315 per ounce.

On June 23, the United Kingdom (UK) defied market expectations by passing a referendum to leave the European Union (EU), commonly referred to as Brexit. The financial and geopolitical ramifications of this were felt across stocks, bonds, and currencies. Now the UK and EU must work out the conditions of their divorce, and we know that few divorces end harmoniously. The level of uncertainty is high and outcomes that damage growth and trade are easier to imagine than a win-win scenario. The ultimate risk in the longer term is the viability of the EU and the possibility that other countries seek to exit or

dismantle it. We hope for a more positive outcome and that Brexit acts as: 1) a wake-up call for the EU to become a more streamlined enabler of growth, rather than the stifling super-state it has, in our view, become, and; 2) a policy catalyst for the UK to again become a leader in trade and commerce that countries seek to emulate.

Once Brexit results were known, on June 24 gold soared to new two-year highs, reaching an intraday peak of \$1,359 per ounce. Gold finished the month at \$1,322.20 for a \$106.87 (8.8%) per ounce gain. Strong investment demand continued, as demonstrated by inflows into gold bullion exchange traded products (ETPs). Inflows haven't been this strong since 2009 when investors sought out bullion after the subprime credit crisis. A key difference in today's market is that investors are being proactive rather than reactive. Many are seeing the looming potential for another financial crisis and making a strategic allocation to bullion as a hedge against systemic risk.

As has been the case all year, gold stocks reacted strongly to the move in gold. The NYSE Arca Gold Miners Index (GDMNTR)<sup>2</sup> advanced 22.7%, while the MVIS Global Junior Gold Miners Index (MVGDXJTR)<sup>3</sup> gained 26.1%. Also, silver showed strong momentum gaining 17.0% in June to close the month at \$18.71 per ounce, its highest level since September 2014.

## Market Outlook

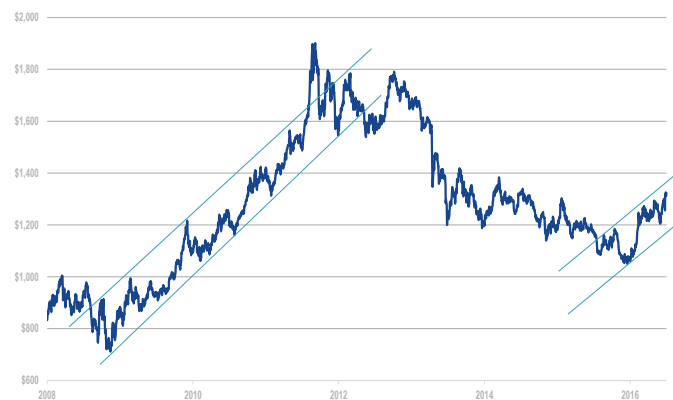
Last year we talked about the depth and duration of the gold bear market being on par with the worst in history and we began to adjust the portfolio in anticipation of a turnaround. This year we have highlighted the strength and resilience of the gold market. In our last monthly update, we gained the conviction to declare a new bull market. Given the events of the first half, it is not hard to imagine a robust market for the remainder of the year. We believe gold will test the \$1,400 per ounce level in the second half of 2016 and we do not believe it will end there. In addition to EU uncertainties, there are many other reasons we believe gold is (re) entering a secular bull market:

- **Monetary Policies** – Unconventional monetary policies are not working as planned, causing central banks to resort to even more radical and unproven tactics with unknown consequences. According to a Fitch Ratings report, there is now over \$11 trillion worth of sovereign debt with negative yields. The European Central Bank (ECB) started buying high yield corporate (junk) bonds on June 8.
- **Fiscal Policies** – Global non-financial debt-to-GDP ratios have risen to new highs. In the U.S., total non-financial debt/GDP has reached 250%, helped by \$1.2 trillion in student loans, many of which may never be repaid. China has total debt of around 225% of GDP, with corporate debt alone comprising an astounding 145% of GDP.
- **Economic Malaise** – Global growth has been unable to muster strength, even with massive central bank stimulus and cheap energy provided by a historic crash in oil prices.
- **Currency Turbulence** – No government wants a strong currency and Brexit has caused unwanted volatility that may bring destabilizing intervention.
- **U.S. Elections** – At this time, there seems, in our view, as if there are no good outcomes in the upcoming election. A Clinton victory is likely to bring a continuation of Obama policies that have resulted in a weak economy, rising debt, weak productivity, lack of business formation, and divisive politics. A Trump victory brings uncertainty and the potential for destabilizing policies if his rhetoric on trade, immigration, and debt service are pursued.
- **Low Returns** – The six-year bull market in U.S. stocks appears to be over. The S&P<sup>®</sup> 500<sup>4</sup> has struggled since reaching an all-time high in June 2015. Bonds no longer provide safe and steady returns. Investors may seek alternatives to help preserve their wealth.

All of these developments can create risks for mainstream investments that potentially drive investors to gold as a currency hedge, store of wealth, or for insurance against financial and geopolitical turmoil. We are not promoting gloom and doom; however, as gold advocates, our role is to point out potential risks to an investment portfolio. Unfortunately, it seems that risks abound as a result of a financial system that has become overburdened with government intervention that stifles enterprise and free markets.

If the fundamentals are supportive of a gold bull market, where might we expect the gold price to go in the future? For that we look at certain chart patterns. Markets usually trend higher or lower over periods measured in months or years. The trends are defined by a sequence of higher highs and higher lows in a bull market and lower highs and lower lows in a bear market. With the gold move following Brexit, a new gold trend may be emerging (Figure 1). This trend has broken the 2013 – 2015 bear trend. The trajectory of the new trend is similar to the post-crisis trend from 2008 – 2011. In fact, some of the drivers, such as central bank intervention, increasing debt, and EU turmoil, are the same. This indicates that gold has completed a mid-cycle correction and is resuming the secular bull market that began in 2001.

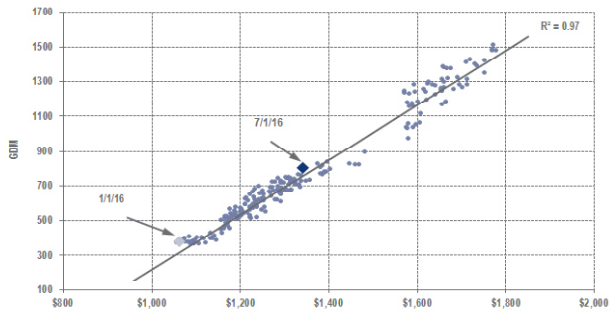
Figure 1: Gold Price, 2008 to 2016



Source: Bloomberg, VanEck Research

For an idea of where gold stocks might be heading, we use a plot of gold versus the GDMNTR Index. Figure 2 shows the relationship of gold stocks to gold since 2012, which is roughly the time in which managements at many gold firms turned their companies around to become more efficient and focused on returns. The correlation<sup>5</sup> statistic of 0.97 is a near perfect 1.00, which shows the strong relationship between gold and gold stocks.

Figure 2: Gold vs. GDMNTR, 2012 to 2016 (Weekly Close)

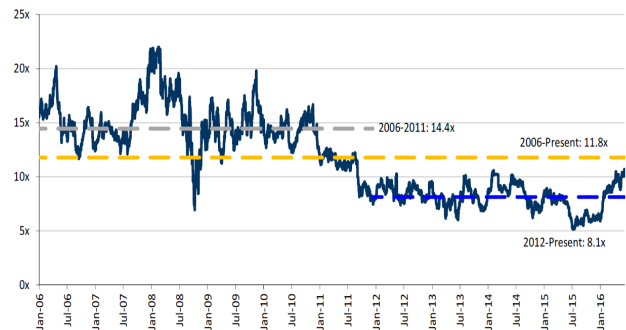


Source: Bloomberg, VanEck Research

Over the first half of 2016 gold has advanced \$260 per ounce or 24.6%. The GDMNTR has gained 102.6% over this period, leading many investors to question whether gold stocks have any upside left. While we don't expect such heady gains going forward, given the tight relationship between gold and gold stocks, we can use this trendline to estimate potential stock gains at higher gold prices. If gold were to advance another \$260 (19.7%) from the June close, it would reach \$1,582 per ounce. A trendline plot at \$1,582 gives a GDMNTR value of 1135, an additional 47% gain from the June close of 769. This beta or leverage to the gold price is a result of the strong cash generation that comes from higher gold prices.

It is also important to consider valuations. The performance of gold stocks has resulted in a strong increase in Price to Cash Flow (P/CF) in 2016, as shown in Figure 3. However, gold stocks became oversold in the recent bear market, driving valuations to historic lows. The strong stock gains in 2016 have yet to return gold stocks to their long-term P/CF averages, and they remain far below peak valuations.

Figure 3: Price to Cash Flow of Senior and Mid-Tier Producers, 2006 to 2016



Source: Bloomberg, RBC Capital Markets

<sup>1</sup>The Nikkei 225 Stock Average is a price-weighted index comprised of Japan's top 225 blue-chip companies traded on the Tokyo Stock Exchange. <sup>2</sup>NYSE Arca Gold Miners Index (GDMNTR) is a modified market capitalization-weighted index comprised of publicly traded companies involved primarily in the mining for gold. <sup>3</sup>MVIS Global Junior Gold Miners Index (MVGDXJTR) is a rules-based, modified market capitalization-weighted, float-adjusted index comprised of a global universe of publicly traded small- and medium-capitalization companies that generate at least 50% of their revenues from gold and/or silver mining, hold real property that has the potential to produce at least 50% of the company's revenue from gold or silver mining when developed, or primarily invest in gold or silver. <sup>4</sup>S&P 500 @ Index (S&P 500) consists of 500 widely held common stocks, covering four broad sectors (industrials, utilities, financial and transportation). <sup>5</sup>The correlation coefficient is a measure that determines the degree to which two variables' movements are associated and will vary from -1.0 to 1.0. -1.0 indicates perfect negative correlation, and 1.0 indicates perfect positive correlation.

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