WILSONS

Why Gold Equities can Outperform During an Inflation Scare

Our weekly view on Australian equities.

25 November 2021

The Case for Gold Equities

In four equity market sell-offs since 2007, physical gold not only generated positive returns but it significantly outperformed equities during risk-off events.

In periods where an acceleration in inflation drives the risk-off event - like the 1970/80s - physical gold proves to have even stronger diversification benefits vs equities. Better still, gold equities significantly outpace the physical gold price proving to be true portfolio diversifiers during periods of high inflation.

The case for holding gold equities in non-inflationary-driven risk-off periods also holds, with clear outperformance of gold equities over the broader market as the recovery phase takes hold. What we do find is the outperformance is almost double what has been observed during non-inflation-driven risk-off periods.

It is not out of the question in the current environment - with the strongest uptick in inflation (US) since the 1970s - that we get an inflation-driven risk-off event over 2022/23.

We explore this in Re-Examining the Case for Gold in Multi-Asset Portfolios

Gold equities that offer a combination of both production and earnings growth tend to perform the strongest through the cycle. Amongst the major producers in Australia, Evolution Mining (EVN) and Northern Star (NST) (Wilsons Australian Focus List Members) have significantly outperformed the largest listed gold company Newcrest (NCM).

Both EVN and NST have demonstrated superior rates of production growth, operational consistency and capital discipline – factors that have contributed to total returns outstripping NCM by 7x and 10x respectively over the past five years.

Can Gold Equities Provide a Portfolio Hedge?

Across the risk-off periods we have analysed, Australian gold equities outperformed the market by between 40-100% over a 12-18-month period. Whilst each risk-off event has subtle differences, gold equities do best when the fear of higher inflation (and a central bank response) is the overriding narrative. During the 1970s gold equities outperformed the market by +100%

This phenomenon is also observable in Canadian gold equities – the largest gold equity market in the world.

In risk-off periods without a strong inflation narrative, gold equities tend to stumble before ultimately proving their value as a portfolio hedge. The outperformance though is more limited, with gold equities ultimately outperforming by ~40%.

Where gold equities tend to stumble in non-inflation-driven risk-off events is in the initial period of a crisis. Share prices of gold equities appear to adopt an equity beta closer to 1, compared to a long-term equity beta of ~0.5 against the broader market in the initial stages of a risk-off event.

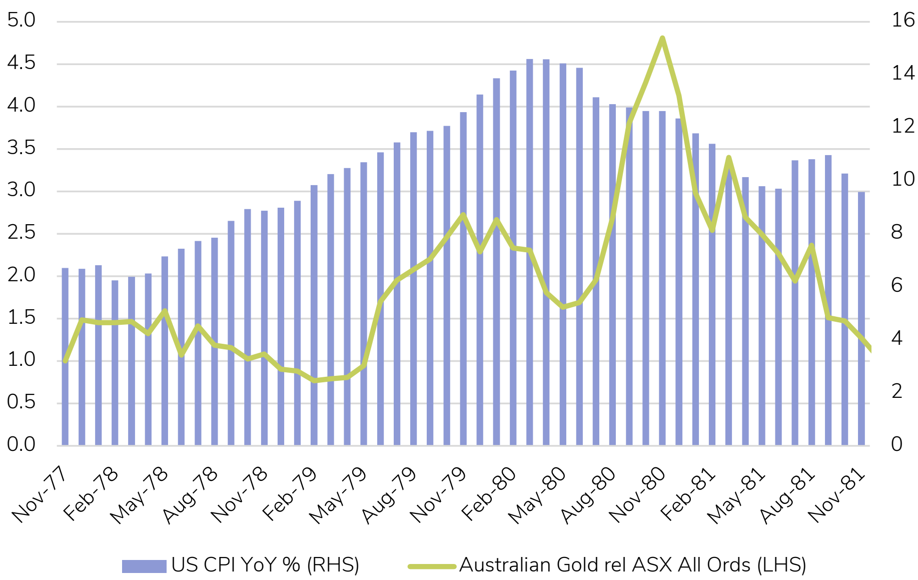
Exhibit 1: Gold equities typically outperform in risk-off events, with performance in inflationary periods being exceptional*

Time Period	Event	Physical Gold Price Change	CPI Change	ASX Gold Stocks	ASX All Ords	Outperformance
Oct 1979-Oct 1980	High US CPI	68%	12.6%	204%	77%	126%
Oct-87	Black Monday	2%	NA	-40.1%	-46%	6%
Oct 2007-Mar 2009	GFC	27%	1.6%	0%	-47%	47%
Mar-20	COVID-19	-1%	NA	-28%	-32%	5%

*Headline US Consumer Price Index

Source: Refinitiv, Wilsons

Exhibit 2: Australian gold equities in the late 1970s inflation scare outperformed the market by +100%*



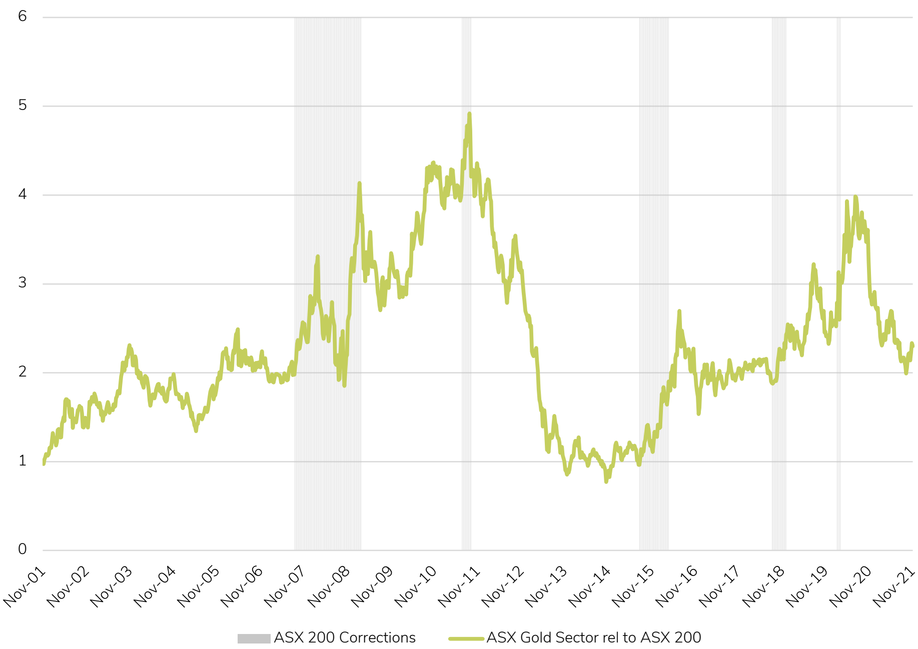
*Datastream gold mining index vs All Ordinaries Index

Source: Refinitiv, Wilsons

Once the initial stage of the crisis has passed, gold equities outperform the broader market in all scenarios analysed.

In both inflation and non-inflationary risk-off events, the rally in gold equities is historically powerful not only in size, but also over a relatively short period of time.

Exhibit 3: Australian gold equities have typically outperformed the index during equity market risk-off events*

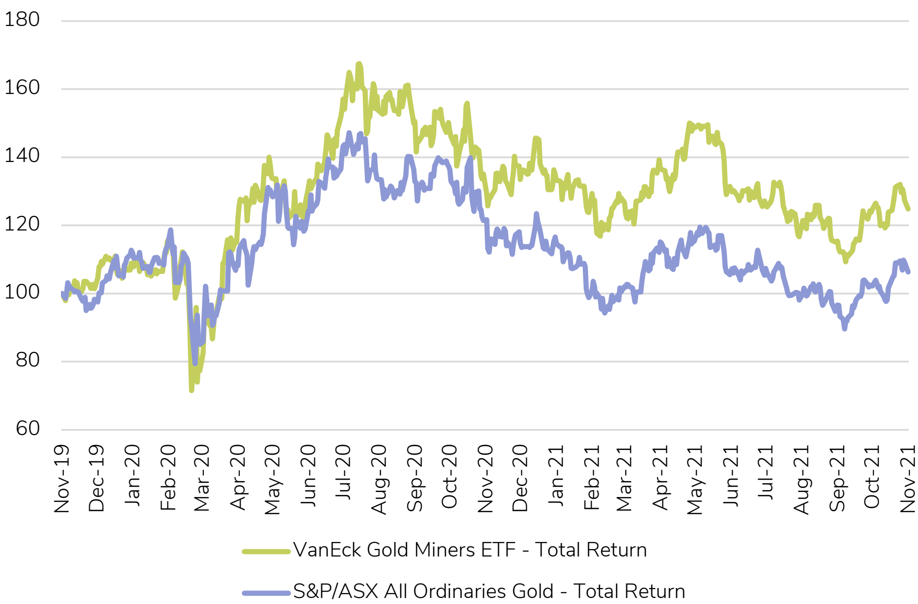


*S&P/ASX All Ordinaries Gold vs S&P/ASX 200

Source: Refinitiv, Wilsons

Australian Gold Equities have Lagged Global Gold Equities

Exhibit 4: Australian gold equities (XGD) have lagged global gold equities (GDX) since 3Q20



*Australian gold companies make up 13% of VanEck Gold Miners ETF

Source: Refinitiv, Wilsons

Australian gold equities have significantly outperformed global gold equities over the long-term. Primarily due to a combination of stronger production growth and a view that Australia is a tier 1 jurisdiction to both mine or list a gold company. Since 2006, the outperformance of Australian gold equities vs global gold equities has been greater than 60% in A$ terms.

Currently, Australian gold equities are coming off a period of significant underperformance vs global gold equities. The underperformance is close to 20% since 2019, matching two prior periods of underperformance 2008-09 and 2011-2013 of similar magnitude. Poor performances by sector leader NCM (which dominates the Australian gold index), and both NST and EVN over the past 12 months are key contributors.

We think this level of underperformance looks somewhat over-done, especially when considering the level of growth that Australian gold companies can provide. We suspect domestic state border closures (particularly WA) and the impact of cost bases partly explains the underperformance.

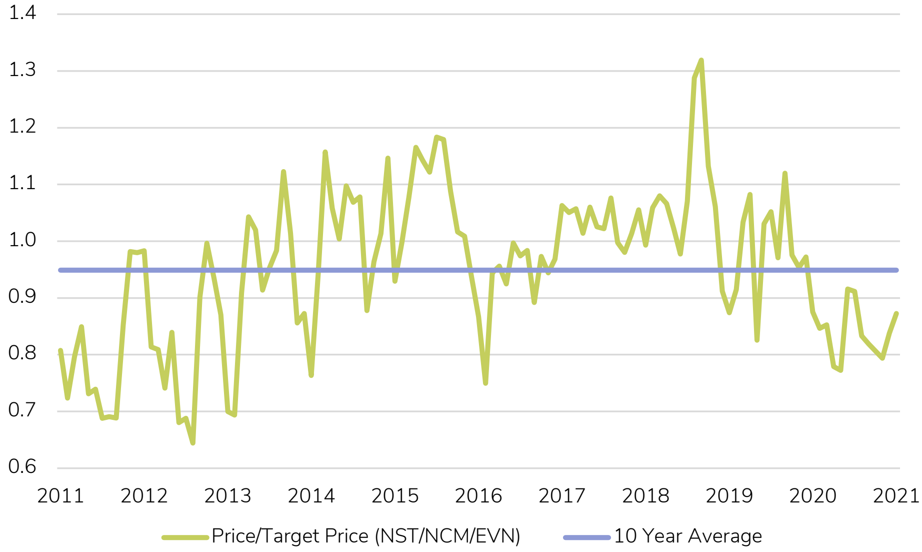
Gold Sector Valuations

The underperformance of Australian gold vs global gold equities has opened a level of valuation appeal not seen since 2016. Current prices of Australian gold equities relative to consensus target prices (a good proxy of discounted cash flow (DCF) valuation imply sector upside of 10-15%.

There are few sectors across the market at present that offer clear valuation upside, which adds to the case for gold equities at present. The reopening of domestic borders in early 1Q22 could prove to be a catalyst to close the valuation gap.

If we use spot prices, the sector valuation improves further (+5% on average) following the almost A$200 rise in the gold price over the past month.

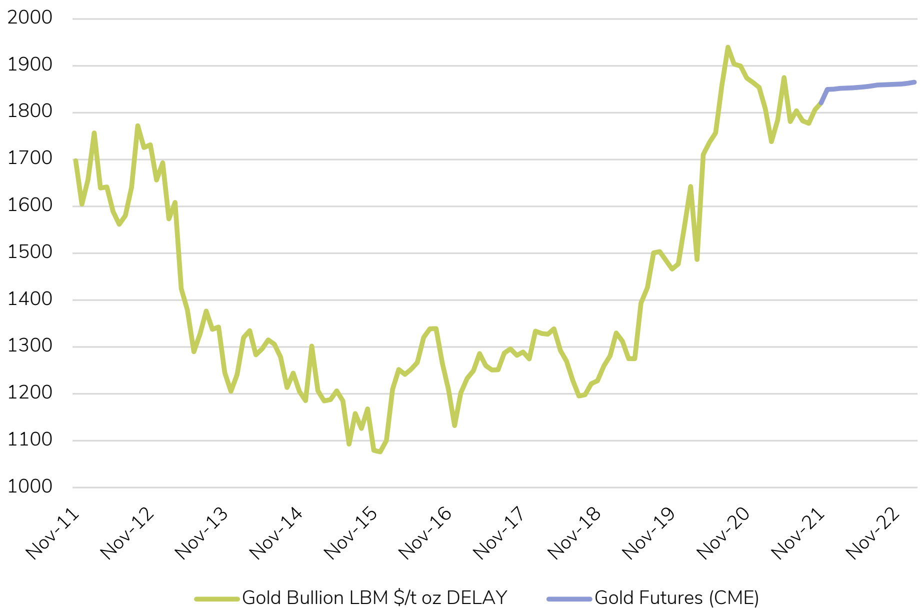
Exhibit 5: Selected Australian gold companies discount to fair value*



*Discount refers to share price vs consensus target price

Source: Refinitiv, Wilsons

Exhibit 6: A$ gold price and gold futures imply a flat gold price over the next 12 months



Source: CME, Refinitiv, Wilsons.

Northern Star preferred

NST is our preferred exposure in Australian gold equities. Over the long-term gold producers that can demonstrate operational excellence, financial discipline (capital allocation), and management teams that understand the importance of both factors tend to outperform.

A track record in all three areas, NST has been strong over many years. Central to NST's ability to generate returns has been the simplicity of operations. Three mine areas - two located in Australia and one in Canada - keep the complexity to a minimum. All three mining areas have brownfields growth optionality available.

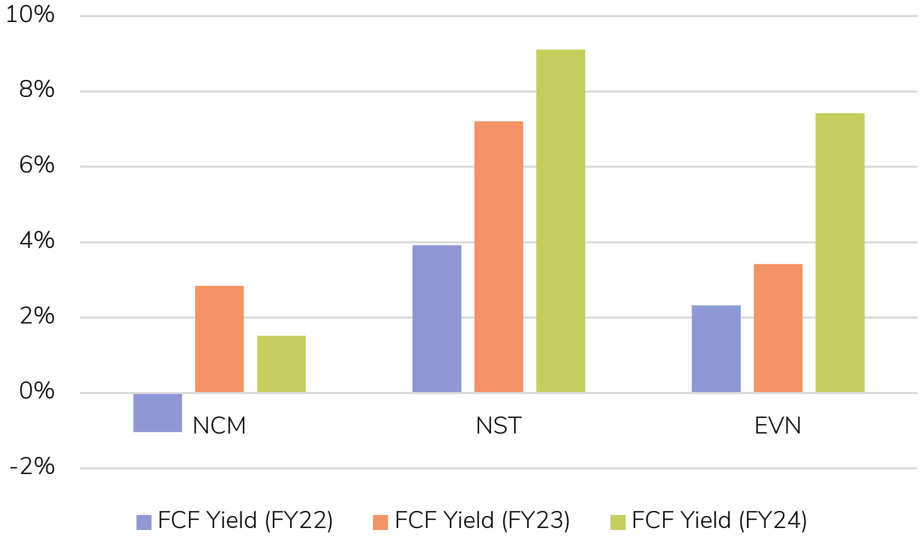
NST's merger with Saracen (SAR) brings the Kalgoorlie Super Pit (KCGM) under a single owner for the first time in its history. We remain bullish on the prospects of improved operational and financial performance. KCGM is the biggest lever in the NST portfolio to create additional value. Current mill operations run at 13Mtpa, with scoping studies underway to see a lift to 17Mtpa and 22Mtpa. Both imply upside beyond the 2Mozpa FY26 gold production target NST has set itself (and vs market forecasts).

Near-term, free cash flow (FCF, earnings less investment spend) is constrained as NST reinvests into mine expansions. There remains a clear pathway to see the FCF yield move from 3% in FY22E into the low single digits in FY24E (with no reliance on higher gold prices).

We think this improvement in FCF will be hard for the market to ignore, providing a pathway for the NST valuation gap to close. Focus List weighting 3%.

We see EVN as a quality Australian gold producer offering both production and FCF growth in coming years. Our preference for NST is primarily based on greater portfolio optionality long-term vs EVN and larger discount to valuation.

Exhibit 6: NST offers the strongest rate of FCF yield improvement into FY24E



Source: Refinitiv, Wilsons.

Exhibit 7: Australian gold producers. NST offers growth through a disciplined financial lens with sector leading ROE.

Company	Ticker	Mcap (A$bn)	Asset Location	Status	Target Gold Production (Moz)	Production CAGR (FY22-FY24)	EPS CAGR (FY22-FY24)	ROE Average (FY16-FY21)	ROE Average (FY22-FY24)
Newcrest Mining	NCM	19.8	Australia/Canada/PNG	Producer	2000	-2%	-9%	7%	8%
Northern Star Resources	NST	11.4	Australia/Canada	Producer	2000	8%	21%	26%	8%
Evolution Mining	EVN	7.5	Australia/Canada	Producer	915	27%	24%	12%	15%
Silver Lake Resources	SLR	1.5	Australia	Producer/Explorer	250	4%	9%	11%	10%
Regis Resources	RRL	1.5	Australia	Producer/Explorer	500	1%	3%	24%	11%

Source: Refinitiv, Wilsons.

Newcrest least preferred

Newcrest is the largest producer in the sector. Over the past 10 years, NCM has been a disappointing experience for investors. Relative to NST and EVN, NCM has had a series of issues across both operations, execution, and financial discipline. Management turnover has been higher than the sector average.

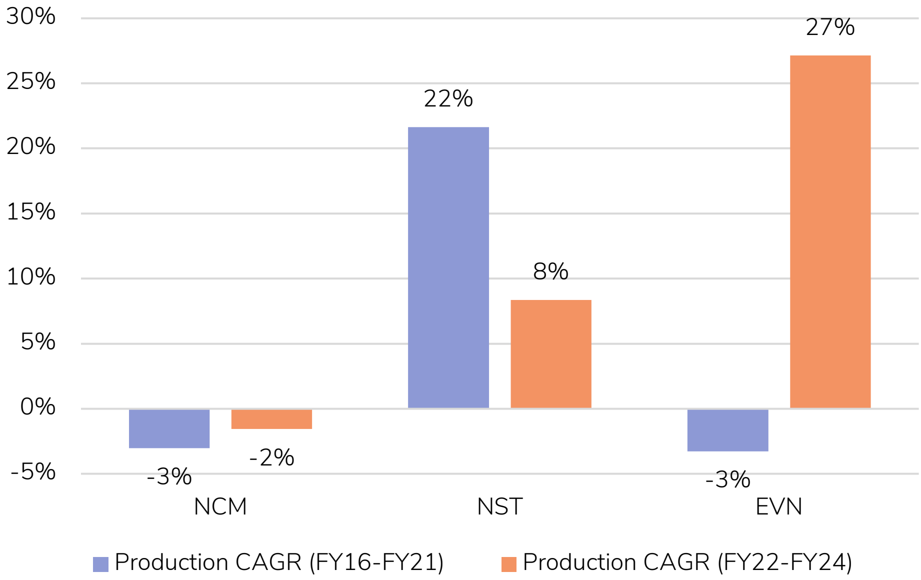
We continue to view NCM as overly focused on being a large producer, which comes at a cost in terms of financial performance. The asset base is both too large and too diverse, increasing the operational complexity.

The acquisition of Lihir in PNG in 2010 - 25% of NCM asset base today - embedded a mindset of growth for growth's sake. Lihir had little in common with the Australian assets. The combination of mining directly adjacent to an ocean, in a geologically unstable region, and a tier 2 jurisdiction has been a source of operational disappointments over many years.

Notwithstanding this backdrop, NCM is pushing ahead with new developments in Canada (Red Chris) and an adjacent mine at Telfer in WA which would transform Telfer from a break-even proposition to a tier 2 asset. Combined, both expansions could be worth an incremental >US$3.5bn for NCM (implying +20% improvement on current market cap).

If NCM were to push ahead concurrently with four major growth projects under consideration, FCF growth would likely be constrained over the next 5-years to the tune of ~$US1bn of investment each year. With constrained FCF growth and development execution risks across multiple geographies, we are less convinced the market will re-rerate NCM. We elect to observe NCM from the sidelines.

Exhibit 8: Forecast NCM production growth lags both EVN and NST



Source: Refinitiv, Wilsons.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

Disclaimer

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