July 3rd 2020; Market overview & Gold Commentary

BMO Nesbitt Burns

Week in Review

BMO Wealth Management
BMO Nesbitt Burns

Market Overview:

The economy continues to rapidly rebound from its lows of March and April, but recent data shows just how long it might take for a full recovery to take place. Until a vaccine or treatment is available, there are entire industries that will remain impaired and as seen in the US currently, rolling lockdowns will be a part of life. Overall, this is likely a recipe for continued volatile markets and perhaps overall sideways movement in the market until grounds for great optimism (or pessimism) take place.

Gold Sector Commentary:

Gold's potential has been a focus for investors this year, and many analysts have boosted price expectations. Goldman Sachs, JPM, UBS, RBC and BMO have all lifted their near-term forecasts for gold to ~US$1750-$1,800 per ounce as a base case with upside scenarios ~$2000 citing mounting economic challenges due to the COVID-19 health crisis. BMO's commodity strategist from June 25th reports that "From a defensive angle, in a loose monetary policy environment, gold typically screens well from an asset allocation perspective. And while our upside from current levels through year-end is less than for other metals, we are still looking at a very strong gold price, and an extremely profitable one for gold companies as discussed in our recent long-term price upgrade."

The set up for gold is really in its positive correlation to low and negative real rates. Real rates are the returns investors can expect after the return is adjusted for inflation. As an example, the 10 yr Canada Bond is trading with a yield to maturity currently of 0.5%, and adjusting for inflation of ~1% to more like an average 2.5% traditionally would leave investors with less money in 10 years than they have today. The massive stimulus packages needed to combat the problems in the global economy and the low growth prospects may keep both nominal and real rates low for an extended period. Also, the possibility that the US Government will need to pump even more capital into the economy to keep it moving before the election makes us believe this will be a continuing scenario with potentially further upside.

Overall we believe as strongly as ever that investors should hold Gold as a key diversifier in portfolio's. Being negatively correlated to the US Dollar, and uncorrelated to some extent to the US S&P 500, we believe Gold to be an important defensive hedge to portfolios and a theme that is becoming more and more accepted by portfolio managers globally given the current economic uncertainties.

Our base allocation is 5% of most portfolios, with potentially higher allocations for portfolios with more defensive characteristics would also be encouraged.

Our current holdings are primarily positions of Franco Nevada and Gold Bullion which will not change. Some portfolios will have an allocation to the producers who structurally have higher risk/leverage. However our pecking order switches for new investment to 1) Gold Bullion, 2) Large cap producers, and 3) Franco Nevada. This is all after Franco's massive outperformance, and now trading at a significant premium…even to its historical significant premium.

							P/NAV	P/CF	Cash Costs	
Gold Royalties/Large Cap Producers	Symbol	Price	Yield	Mkt Cap	Consensus Target	Potential Return	5% spot	2020E	2020E	2021E
FRANCO-NEVADA CORP	FNV-T	$186.43	0.8%	$35.41	$192.71	4.1%	2.9x	35.8X	$293.00	$257.00
WHEATON PRECIOUS METALS CORP	WPM-T	$58.53	0.9%	$26.24	$64.18	10.6%	1.9X	26.1X	$409.00	$412.00
NEWMONT CORPORATION	NEM-US	$60.96	1.6%	$48.93	$72.94	21.3%	1.3x	11x	$856.00	$720.00
BARRICK GOLD CORP	GOLD-US	$26.27	1.1%	$46.71	$41.01	57.2%	1.6x	9.4x	$812.00	$758.00
AGNICO EAGLE MINES LTD	AEM-US	$62.83	1.3%	$15.10	$95.68	53.6%	1.8x	13.2x	$815.00	$679.00
KINROSS GOLD CORP	KGC-US	$7.17	0.0%	$9.01	$11.88	65.7%	1.1x	5.9x	$768.00	$689.00

Franco Nevada

Benefiting from significant fund flows into the gold space of late, Franco Nevada, a Gold focused royalty with little operational exposure, has produced a one year return of ~73% and a 5 year track record of ~27% annualized returns in C$. The quality of the business model and an exceptional management team combined producing operational efficiency has created one of the most sought after investments in the Gold space. This outperformance has arguably created the situation which we are in now, where FNV is trading at a significant premium, to its historical premium on a number different metrics. Thought its current valuation may look irrationally high, the quality and performance will likely continue to be solid as a FNV is a core holding for institutional investors.

We may trim FNV in portfolios where it has become an overweight, however it will stay as a core of our gold exposure going forward. If the valuation corrects, we would advocate adding more aggressively to the position, but in the meantime are watching their Oil and Gas Royalty strategy (capped at 20% revenue) which we view as a distraction to the thesis.

Gold Bullion

Our Gold bullion holding (correlated only to the price of the metal) is through the ETF, ticker GLD. The GLD has returned ~30% over a one year period and 10.2% annualized in Canadian dollars on a 5 year basis. The GLD is the largest and most popular gold ETF as it offer investors a relatively cost efficient and secure way to access the gold market. The ETF holds physical gold to back it shares, and though physical delivery is an option, the delivery only comes in 'baskets' of 100,000 shares or about $16.8M of USD of market value. The tracking error of GLD to the price of bullion is historically about ~0.8% which is made up of its 0.4% MER, plus cash holdings and various other funds expenses. Though not perfect – it is likely the lowest risk of the gold investments and the most effective as a true hedge.

Newmont, Agnico, Kinross

Newmont Corporation is the world's largest gold company, formed in April 2019 after Newmont completed its acquisition of fellow senior gold producer Goldcorp. Though this acquisition was questionable at the time, with time it seems that the price was reasonable and that NEM was aware of the opportunities to create value within the Goldcorp portfolio. NEM operates mines in some of the more stable geographies with the bulk of production coming from Australia, Canada, Mexico and in Nevada with a joint venture with Barrick Gold. NEM has a solid pipeline and is forecasted to maintain production of 6-7 million ounces annually through 2024. One of the few gold companies with a dividend (1.6%), and given the stable free cash over the next several year with the positive outlook for gold prices, we expect NEM to invest in growth but also to return significant cash to shareholders. We would add Newmont to create leverage beyond FNV and GLD for those who have a higher risk tolerance.

Agnico Eagle is another gold producer with assets located in politically safe jurisdictions, including Canada, Mexico, and Finland. Agnico's strong corporate culture and track record of excellence has made the company a leader in the industry. Combined with Agnico's attractive pipeline of longer-term organic growth projects (and track record of execution), is expected to support a return to its premium valuation multiple. Trading at a slight discount to its historical premium we would add selectively for those with a higher risk tolerance to complement the above.

Kinross represents a very growth focused Gold company with all of its cash flow reinvested to grow its resource. Kinross maintains a global operating footprint of producing mines in Russia, Brazil, Mauritania and the US and has demonstrated one of the best track records of execution over the last two years among its peers in BMO's view, despite its difficult political geographies at times. Being focused on growth, having slightly higher political risk due to its jurisdictions, and having yet to implement "shareholder friendly" i.e. a dividend strategy; Kinross is the least expensive of the names above and would have the most leverage to any swing in Gold prices. We could add for those with a higher risk tolerance and a bullish view on the Gold price.

The table below details that a *Balanced Portfolio* would have returned 0.31% YTD (in C$ terms) with the bond and gold allocations offsetting negative returns of the equity markets.

Performance Benchmarks				
2020 year to date 30-Jun-20	**Benchmark Symbol**	**Total Return in C$ 2020***	**Model Allocation**	**Allocated Return - C$**
C$ Cash			0.0%	0.00%
US$ Cash			0.0%	0.00%
Agg. Bond C$	VAB	7.4%	15.0%	1.11%
Agg. Bond US$	BND	11.7%	10.0%	1.17%
Prefs	CPD	-11.7%	10.0%	-1.17%
Cash & Bonds			**35.0%**	
TSX	XIU	-6.3%	30.0%	-1.90%
S&P 500 in C$	SPY	1.6%	25.0%	0.40%
International	VGK	-8.7%	5.0%	-0.43%
Equity			**60.0%**	
Gold	**GLD**	**22.9%**	**5.0%**	1.14%
Total			**100.0%**	**0.31%**
***including dividends and interest**				

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Sources: Bloomberg, JP Morgan, Thomson & BMO Nesbitt Burns research. We deliver a full complement of thoughtful, customized wealth solutions for private clients and institutions, drawing upon global resources, top ranked research and the collective wisdom of BMO Nesbitt Burns and our internal and external partners. For more information on our team we invite you to contact us.

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