A golden opportunity as stocks trail the commodity's price

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Body

The US dollar gold price is currently near all-time high nominal levels of $US2520 an ounce, rising about 22 per cent so far this calendar year, and heading for its best year since 2020. Gold has also had double-digit returns in most other major currencies, including the Australian dollar, where it has surged by an impressive 25 per cent.

These gains have been driven by investor optimism about upcoming US interest rate cuts and lingering geopolitical risks. In the past three interest rate easing -cycles in the US, the US dollar gold price has averaged an increase of 40 per cent.

Despite the gold price being near all-time high levels, gold equities have underperformed. Since August 2020, when the Australian gold equities index was at its all-time high, gold equities have underperformed the gold price by about 45 per cent. In our view, the potential for gold equities to catch up is a significant opportunity for investors, given the fundamentals for gold remain very strong.

To date, gold's performance has been due to significant buying from central banks and eastern investors who have mainly acquired physical gold. In contrast, western investors, who typically favour gold mining equities, have for the large part not participated in the gold run so far.

Recent figures indicate that the average investor currently holds less than 1 per cent of gold in their total portfolio, which is significantly less than the four-decade average of 2 per cent. This is even lower than the estimated 6 per cent in 1980 when the last inflation-led gold bull market occurred and the gold price reached its all-time high of about $US2850 per ounce on an inflation-adjusted basis. The potential entry of western investors and a higher gold price is likely to be a tailwind for the gold equities to rerate higher. The fight for relevance in investor portfolios has been challenging for the gold sector versus other more favoured sectors, such as technology. Persistent cost pressures have negatively impacted gold miners' ability to generate free cashflow and provide an attractive return to investors.

However, with gold prices now rising faster than inflation, cash margins are expanding. We estimate that the average cash margin for the Australian gold miners is at record levels of $1700 an ounce of gold produced. Recent company results indicate this is being translated into financial performance, with Australian gold miners such as

Northern Star and ***Ramelius*** generating strong free cashflow, allowing them to return capital to investors through increased dividends.

The relative valuation of gold miners versus the rest of the market is also attractive. Based on forward earnings multiples, Aus-tralian gold miners are trading at a 40 per cent discount to the rest of the market. In addition, the market consensus gold price for the next 12 months is about 10 per cent lower than the current gold price of $3780 in Australian dollars. Should the gold price remain at these levels for an extended period, then the market will need to upgrade its forward earnings forecasts, making gold equities even cheaper. Gold miners' cashflow generation potential and attractive valuation compared to the rest of the market cannot be ignored by the market for too long.

The disconnect in equity performance is even more apparent in the gold developers and explorers. The outperformance of developers and explorers is typically later in the cycle when investors are looking for value further down the mine life cycle. At current discounted levels, it remains cheaper to acquire someone else's ounces than it is to discover new ounces. The potential for sector consolidation could further enhance the appeal of gold miners as an investment, particularly in an environment where the price of physical gold continues to rise, and more investors seek exposure.

The Victor Smorgon Group has been well placed in gold for some time now and has capitalised on the record run of the precious metal. Our Global Multi Strategy Fund and ***Resources*** Gold Fund can invest internationally, and prefer stocks that are attractively priced, operate in safe jurisdictions and are forecast to generate strong cashflow yields in the next year. Australian gold miners that we are attracted to include ***Ramelius*** and Red5. International gold miners that have consistently delivered include -Agnico Eagle and Alamos Gold. Cameron Judd is the portfolio manager for the gold strategy in the Global Multi-Strategy Fund at the Victor Smorgon Group.

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