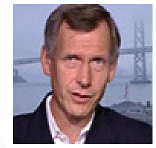
Time for Gold & Gold Miners In a Volatile Environment

Axel Merk, President & Chief Investment Officer with Merk Investments and the Closed-End Fund Association discuss the outlook for gold and gold miners in this volatile economic environment.



Axel Merk

CEFA: **Welcome to CEF Insights, your source for closed-end fund information and education brought to you by the Closed-End Fund Association. My name is Diane Merritt. Today, we are joined again by Tom Roseen, Head of Research Services with Lipper from Refinitiv and author of the Fund Market Insight Report, which provides in-depth monthly commentary on the closed-end fund market. We are happy to have you with us today, Tom.**

AM: Great to be with you.

CEFA: **Axel, since we last spoke in February, the world and markets have gone through dramatic shifts in the wake of the COVID-19 pandemic. Some have said the cure may actually be worse than the disease. What challenges do you see regarding the level of policy response and the degree of economic shutdown?**

AM: Well, we've certainly had some very interesting times and, obviously, just about everything is new in this environment, but one of the things that everybody's learning is that we can spend billions if not trillions and print trillions and get away with it. That may well change the mindset going forward. Notably, a lot of what's been happening has a far more direct impact on the folks that actually may need the money. And, of course, in some ways that's appropriate, but just think about it. A corporate tax cut like we've had in the past isn't exactly inflationary. Whereas, if you give money to people that actually use it, or if down the road we have a stimulus package that's an infrastructure spending package, things like that may well be far more inflationary, than past policies, and so the reaction in the markets may be very different from after the financial crisis. And, at the same time, we are extremely complacent about that. Fed Chair Powell has said that he's not even thinking about thinking about inflation.

CEFA: **Now, as states are reopening, how do you see the US economy getting started again?**

AM: Well, the US is different from most other countries in that it is highly decentralized. Even if there were the will, the central coordination would be all but impossible. And so, we're going to have this highly localized approach to it with back and forth and good and bad happening everywhere. One of the beauties about the US economy is that it adjusts very quickly, and my best guess is that the US economy will reshape more through all this than economies in other parts of the world. In other parts of the world where the shutdown was more effective, they shut down, they're reopening and sure, they have some challenges, but they may well go back to business as usual. I don't think that will happen in many parts in the US and, in the short term, that might be more challenging. In the long run, that might make the economy here more robust for other things coming down the road. But, for the time being, it's going to be a very choppy road, which also means that the policy response is going to be prolonged and quite significant.

CEFA: Axel, at some point we expect to get past the challenges of COVID-19. What is your longer term outlook for US markets?

AM: Well, we've been printing money like there's no tomorrow. Fed Chair Powell says he doesn't think that inflation is any issue whatsoever. He is alluding to that he may well want to wait for unemployment to be as low as it was before COVID and then some, because there's no inflation. So, we are all but assuring an extremely accommodative environment, which, on the one hand, should kind of boost asset prices. I mentioned earlier inflation may be an issue, and indeed, most people say, "Hey, deflation is an issue right now." Well, that's part of the problem. We might have inflation expectations unanchored, which means they may fall too low in the short term and then on the way back up, we might get "surprised" as things that accelerate on the upside. And so, there's plenty of opportunity for policymakers to make mistakes.

As an investor, my role is to think about the things that can go wrong in the markets and it doesn't really matter what my crystal ball is. It matters whether the average investor takes certain risks into account. And so, it's in that sort of context that I see and we see asset prices very high. I do see inflationary issues down the road, and I take it you're going to bridge here in a moment to gold and precious metals, and that's exactly the sort of diversification that I think more and more investors might be looking at.

CEFA: Well, Axel, your firm manages a closed-end fund, ASA Gold and Precious Metals, symbol ASA. ASA has an investment focus on gold, precious metals, and minerals. What is your outlook for the sector, given your thoughts on the broader US economy?

AM: Yes. We invest in the mining companies and since we've taken over the management in April of 2019, we have significantly shifted downstream the sort of exposure we have, meaning focus on the smaller mining companies. And if you recall, during the very long bear market that the gold mining industry had, a lot of cost cutting took place. That means also that the most senior companies invested fairly little in exploration, or at least to the extent they invested, they weren't very successful. So, we expect there to be significant M & A activity, that the smaller companies may be taken out, and we think that that's where the value is. Those sort of smaller companies are, I mean, this sector is volatile to begin with, but the smaller companies, they're really options on striking gold, literally so.

And so, ASA's portfolio has been positioning gradually downstream and we think in a favorable gold environment, and many of these companies budget a significantly lower gold price than we have right now, those companies, even if the price of gold were not to move any higher, could be highly profitable. And in that context, I think these are very speculative investments, of course, compared to many other things that investor could do, but we think that there might be very substantial opportunity.

CEFA: How have mining companies handled the COVID-19 situation and has this impacted production?

AM: Well, clearly everybody has been affected. That said, mining companies in some parts of the world, say South Africa, have long had to deal with disease or outbreaks, be that Ebola, be that AIDS and other things, and so they have some more experience. Also, they do work in some remote areas sometimes where the indigenous populations, and many of these mines have shut down before they had a government mandate because they know that in some of those areas, there hadn't been significant health care.

AM: Now, all that said, especially the junior companies, many of them are not operating. They're just drilling. And so, pausing the drilling, pausing things, isn't quite as expensive as with the more senior companies. In that sense, it's not really very harmful for them. Now, that said, in the eye of the storm in March, because many of these junior companies periodically need access to credit, they were sold together with everything else and suffered quite a bit, and since then have recovered rather substantially.

CEFA: Are valuations in the precious metal space at attractive levels?

AM: Well, companies have gone up in price very substantially. That said, given the amazing margin expansion that the higher price of gold represents, we think that, yes, those are attractive. Now, they are not attractive if you think the price of gold is going to fall back down, and by all means that price may well be volatile. But we think that there is a significant demand for gold, and with that also for the mining sector. Again, the old economics work much better than in the previous cycle.

Also, one thing that happened the previous cycle, about 20% to 25% of mining expense is the price of energy. The energy costs are much lower. And so, similarly, many of these costs were much, much higher and because these firms are managed much more prudently, we think that a lot of the additional margin and profitability is not yet reflected in the prices.

CEFA: How do you believe in allocation to equities of companies in the precious metal sector is best positioned in an investor's diversified portfolio?

AM: Well, as I indicated, those companies and investment, they say, it's a highly volatile investment. And what we see is, and we're not making an investment recommendation here, is in some ways investors want to have their cake and eat it. And what I mean with that is, as we've had this ongoing bull market, which was interrupted by the severe decline here in between, many investors want to stay in equities but, at the same time, they want to be protected. Now, having something as volatile as gold mining, obviously, it doesn't sound like protection, but gold miners are, over the medium term, not very correlated to equities. And so, with a fairly small allocation to mining, investors hope to get very substantial diversification. Now, we happen to be very positive on the space and, of course, we can't make that call for others, but that's what we see. Investors just have to be aware of risks that come with that sort of investment, because if somebody is really scared about the markets, cash isn't such a bad alternative. But it seems like investors are hungry for returns, and with ASA, there suddenly have been returns. In March, they were negative. We hope to have them positive in the medium and long term. We think that if somebody wants to, with a fairly small allocation, get a big diversification, bigger they could than with many other things, then this is something where they may want to look at ASA.

CEFA: Axel, thank you so much for taking the time to join us today.

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