Gold Miners May Finally Be Worth a Look

A gold price rally has some investors thinking it might finally be time to start looking at gold mining stocks.

Gold prices are just off two-month highs, outperforming commodity and financial markets in 2016 as fears about China's stock market and its economy sent shock waves across global financial markets, hitting U.S. stock markets.

The yellow metal's rise to around $1,100 an ounce comes after a few years of losses. Prices fell about 43 percent from their 2011 peak of over $1,900 an ounce – a nominal record high. Additionally, the Philadelphia Gold and Silver Index (ticker: XAU), an index of 30 precious-metals miners, slid about 82 percent from its 2010 peak. But with the current strength, some gold-market watchers said 2016 might be the year prices are bottoming, and gold miners might be at least worth a look.

"What's impressed me the most is that gold has not fallen apart with the decline in oil," says Frank Holmes, chief executive officer and chief investment officer of San Antonio-based U.S. Global Investors.

West Texas Intermediate crude-oil values dipped under $30 a barrel to 12-year lows this year, dragging down other commodities, except gold, on concerns about global demand, especially from China. These geopolitical factors renewed gold's status as a safe haven in turbulent times. These factors can be transient, though, and when they subside, gold prices can retreat.

That's happened a little bit with gold, but the metal is also holding above its 2015 lows around $1,045, which is why some market watchers think gold might be trying to finally stabilize. That could be good news for beleaguered gold mining stocks, too.

But don't let gold's 2016 glimmer become too blinding. While a few analysts are turning a little more neutral, there are still plenty of people who remain negative on the price outlook. Headwinds for the metal remain, such as U.S. dollar strength and the possibility of the Federal Reserve further hiking interest rates this year.

Will gold stabilize or sink further? Adrian Day, chairman and chief executive officer of Adrian Day Asset Management in Annapolis, Maryland, says he believes gold prices are stabilizing and will slowly turn higher. He notes after gold's rally in the 1970s, prices declined 47 percent.

"The [current] decline in percentage terms is not so great. More significant is that it's gone on for four years. It just takes time to turn. … You have people who are nervous, people who bought before, people who buy and get a $100 rally and say that's good enough," he says.

There are forecasts for lower prices. In 2015, gold fell to a low of around $1,045, its weakest price since 2009. Barclays analysts peg their 2016 average price at $1,054, and analysts at Natixis have a base price forecast of $970. Both say the pace of Federal Reserve rate hikes will direct gold's path this year.

Erica Rannestad, Chicago-based senior analyst with the GFMS team at Thomson Reuters, which produces commodities research and forecasts, says while GFMS sees gold prices rising in the second half of the year, be cautious about the current strength.

"It's hard to decide if the strength is a result of the January effect or something different," she says, noting that historically, gold prices usually rise in January.

Its 2016 average price forecast is $1,164, but she notes its fourth quarter average price call is $1,280, based on ideas that the Fed will slow the pace of rate hikes.

Gold stocks to watch. Although gold prices are up, stock performance for gold miners has been mixed for 2016, as a higher gold price is only one consideration for miners.

Both Holmes and Day say that while the U.S. dollar rally hurt the gold price, it's helped some gold-mining firms with operations outside the U.S. Many of these firms' costs are in their local currency, but they can sell their production in dollars, and that's helped offset the decline in the gold price. A drop in oil prices has also helped.

Their top pick for a gold stock is Toronto-based Franco-Nevada Corp. (FNV), which they say they both own. Franco-Nevada is a royalty company that provides money upfront to gold miners to help bring the mine to production. The company receives royalty payments on future output.

"They're a first-class company. Why buy Barrick (Gold Corp, ABX) or Newmont (NEM), when you can buy Franco?" Holmes says.

Day says Canadian miner Agnico Eagle Mines (AEM) and Channel Island-based Randgold Resources (GOLD) are two other favorites.

The precipitous drop in gold prices led many firms to cancel new projects and reduce spending on exploration. Rannestad says gold supplies from mining likely peaked last year, and GFMS forecasts a 4 percent decline in global gold-mine output for 2016.

"GFMS forecasts a long-term decline in mine production going forward and sees a chronic reduction in mine output, which will get the fundamentals to reassert themselves. But this is a long-term effect. It won't have an immediate impact … [It's] increased justification for higher gold prices going forward," she says.

Considering it can take around 15 years for mines to come into production from first discovery, that can support both gold prices and gold miner stocks if metal supplies fall, Day and Holmes say.

Day cautions would-be investors to look at corporate balance sheets of gold miners if metal prices rise. A strong move up in gold can cause the miners with the most debt and highest cost of production to see their stock values rally the most.

"A small move in the price [of gold] makes a big difference if your cost of production is marginal," he says. "If you produce gold at $600, your profit doesn't go up much if gold moves from $1,100 to $1,200. But it makes a huge difference if your cost of production is $1,150."