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Gold boom need mining rethink

A future of unprecedentedly higher gold prices should mean a rethink about gold mining production strategies.

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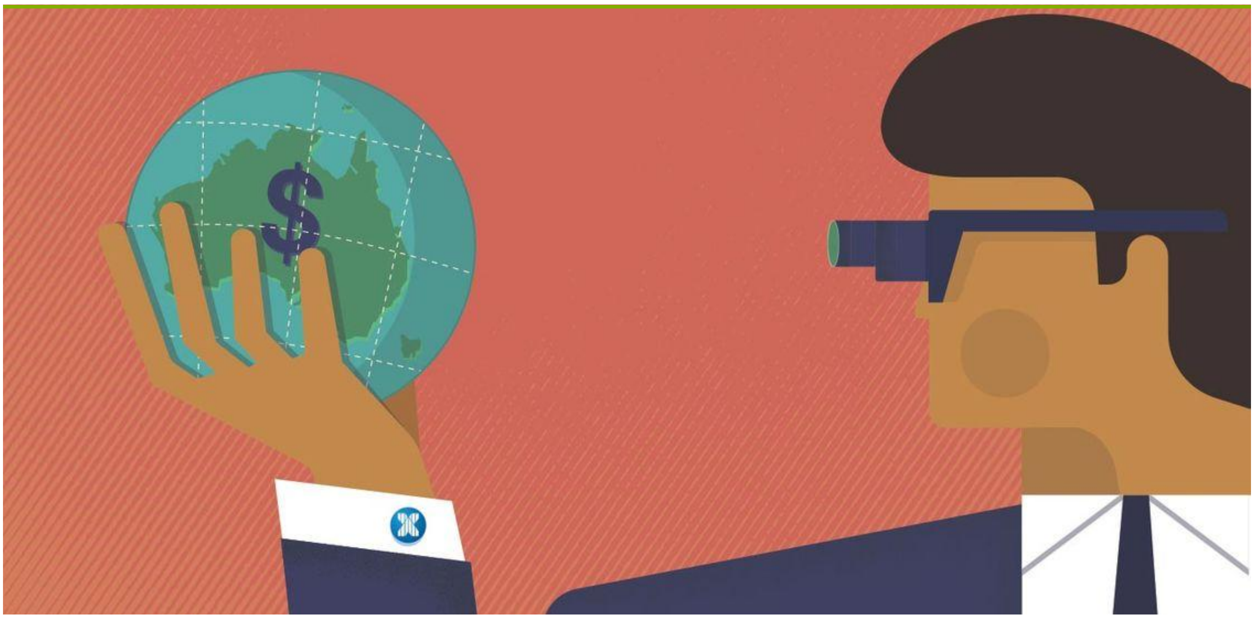

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Matterhorn Asset Management managing partner Egon von Greyerz predicted the collapse of the global financial system under an unbearably heavy load of debt, in a recent online gold conference. Mining Journal reported his views on August 24.

Only those holding gold will have real wealth after the financial meltdown, according to the von Greyerz keynote presentation.

Whether or not the von Greyerz thesis eventually unfolds, his address to the conference seemed at odds with the strategic approach of the dozen gold mining company executives who followed him with their investment pitches.

In stark contrast to von Greyerz's warnings, all the presenting companies were intent on converting physical gold holdings into fiat currencies as speedily as possible and without regard to the unique attributes of gold as an intergenerational store of wealth. They were following a standard industry model.

A common scenario might involve an investment of, say, US$200 million to produce one million ounces of gold over 10 years after two or three years of post-discovery development effort. If the gold price was sustained at US$2,000/oz, annual cash profits of $90 million could be expected with all-up costs at US$1,100/oz.

The described scenario would be equivalent to investing in a bond with a 27% yield and would, most likely, beat any conventional financial hurdles to enable funding and project completion.

But von Greyerz is saying that the gold price is going to be much higher. He has not been entirely explicit about how much higher but is talking of a 10 or 20 fold rise as other assets lose more than 90% of their value.

To be sure, von Greyerz is at the extreme end of any gold price forecasts. Life on earth will be horribly grim, if he is right. Survivors might look back on the good old COVID-19 days with some fondness so great will be the economic and social misery.

> “ **Gold miners have a strategic advantage in deciding when to mine. Gold mining adds 1-2% to the investible base each year. If all gold mining ceased, few commercial activities would be disrupted. In contrast, cessation of copper mining or oil production would have catastrophic consequences for global output, earnings and living standards, even in a COVID-19 riven economy**

If the von Greyerz view has any validity, owners of gold mineralisation should be asking whether they are better off mining today or whether they should plan for the promise of a radically different world in, say, 10 or 15 years.

Gold miners have a strategic advantage in deciding when to mine. Gold mining adds 1-2% to the investible base each year. If all gold mining ceased, few commercial activities would be disrupted. In contrast, cessation of copper mining or oil production would have catastrophic consequences for global output, earnings and living standards, even in a COVID-19 riven economy.

Unmined gold has value. Public markets might pay around US$40 per ounce of gold in the ground or 2% of its refined value. Discovery costs can be as low as $15/oz. A one-million-ounce resource involving expenditure of $15 million over four years offers the equivalent of a bond with a 42% yield.

Let's assume that, after 15 years, the gold price jumps to $5,000 per ounce, a still modest climb by the von Greyerz standard, as other financial asset values tumble and gold fulfils its safety net role. If markets continue to price an ounce of gold in the ground at 2% of the refined value, the bond-yield equivalent would be 38%. The investment return on capital would be superior to the mining alternative and more long-lasting.

Absolute values could be made even more attractive by ongoing resource building. And, for cream on top, the value of gold in the ground may rise from 2% to something more like 5%. That would take the annualised payback over 15 years to more than 100%.

In the von Greyerz paradigm, mining gold does not make sense. By selling their gold as soon as possible, miners are misreading the message behind his thoughts about the future course of markets. Conference organisers should be too embarrassed to put von Greyerz on the same stage as gold miners. They are talking at cross purposes.

In the real world, more mundane incentives are likely to play a role in strategic decisions about when to produce. Company managers know their salaries will multiply the quicker they get production underway. Despite all the talk about management interests coinciding with those of shareholders, the two are at odds.

As long as managers are given a personal incentive to build a mine and liquidate their gold holdings as quickly as possible, they are unlikely to do what makes most sense for those who want to use gold to protect their wealth.

Of course, von Greyerz might simply be wrong. Many before him have foreseen similarly cataclysmic economic outcomes as a consequence of large-scale government borrowings. The apocalyptic demise of fiat currencies has been nowhere near an accurate assessment of the economic consequences of governments living beyond their means.

In any event, the most strident promoters of gold as an antidote to financial Armageddon also remain blind to the real-life consequences of a financial breakdown. An entitlement to a permanently disproportionate share of global assets by a tiny minority of the population, simply based on precious metal ownership, would not be tolerated.

Other means of exchange allowing for a more equitable sharing of global resources would almost certainly emerge. The logical conclusion of the anticipated financial apocalypse is the confiscation of gold or its compulsory redistribution. Concentrated ownership will ensure that gold becomes an unacceptable means of exchange.

The most favourable conditions for gold investment are not a financial death spiral but continued non-gold wealth accumulation. Unabated prosperity is the most favourable backdrop for higher gold prices.

Gold miners are implicitly rejecting prognostications about the collapse of the global financial system. Paradoxically, surging interest in gold equity investments is an endorsement of fiat currencies as investors look to turn gold into dollars as quickly as possible.

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