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Rising gold prices and improved balance sheets drive gold miners’ positive credit outlook

by [Anthony Prayugo]

- **NUS-CRI Forward PD time series indicates an improving short-term credit outlook for gold miners**
- **Improved balance sheets reduced gold miners’ vulnerability to changes in gold prices thus lowering their credit risks**

It is all cheers for gold miners this year as gold prices continue to climb up amid the global economic slowdown. After a strong showing in 2019, gold prices jumped by approximately 30% this year. Despite the positives, one cannot help making a comparison between the current situation and the post-2008 financial crisis. Buoyant and encouraged by the high prices, gold miners took on [a significant amount of debt] in an attempt to chase volumes during the early 2010s, driving costs upwards in the process. The gold price crash in 2013 forced several miners into a cash crunch and heightened default risks. Moving forward to the present time, the situation could not have been more different. Armed with relatively stronger balance sheets and with prices that are set to stay strong, the credit outlook for gold miners looks increasingly positive.

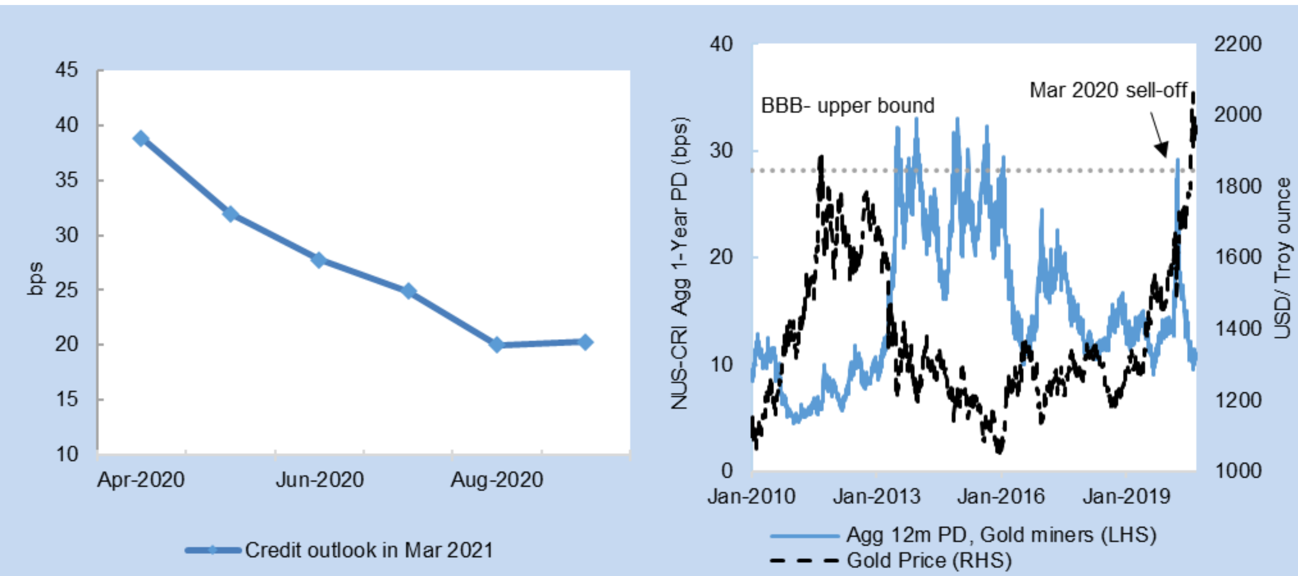

Figure 1a (LHS): NUS-CRI Agg Forward 1-year PD time series for gold miners based on information from different historical months looking to March 2021. Figure 1b (RHS): NUS-CRI Agg 1-year PD for publicly-listed gold miners when referenced to PDiR2.0[1] bounds and gold spot price from 2010. *Source: NUS-CRI, Bloomberg*

The NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) time series in Figure 1a also attests to the notion of the gold miners’ improving credit outlook. Based on data from Apr 2020 to Sep 2020, we focus on the credit forecast for Mar 2021. The Forward PD time series has shown a decreasing trend since Apr 2020, indicating a positive credit outlook. In Apr 2020 for instance, the probability of a typical gold miner to

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P’s historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.
[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm’s survival in the next 6 months.

default from Mar 2021 to Mar 2022 was 38.9bps. In contrast, the current probability of defaulting during the same period almost halved to 20.3bps.

One of the main drivers for the upbeat outlook is the expectation that gold prices will remain strong at least in the short term. As the world continues to grapple with the pandemic-induced economic downturn, central banks will likely keep interest rates low and maintain their quantitative easing (QE) programs, thus incentivizing investors to hold gold. The longstanding feud between the US and China further contributed to the global macroeconomic uncertainties and thus drove demand for gold upwards. Coupled with its countercyclical characteristics and safe-haven status, it is, therefore, unsurprising to see if gold prices continue to hold firm at least in the near term.

Unlike during the previous cycle, miners adopted a more conservative financial strategy. During the period of 2010-2013, when gold prices were booming in the aftermath of the global financial crisis, they spent USD 45bn on projects and acquisitions in a bid to chase volume. Miners raked up more debt to enable the expansions which forced some of them into facing heightened default risks as soon as gold prices crashed in 2013. The associated price increase during that boom cycle was also accompanied by a significant increase in the costs of mining, which has left many miners spending more money than they were earning. The cost of mining an ounce of gold rose from USD 280 in 2005 to USD 775 in 2012. Wary of repeating the mistakes, miners now are hesitant to invest in projects that require sizable capital and take years to break even, preferring instead to focus on fiscal discipline – that is to ensure sufficient free cash flow level and repaying their debts. As shown in Figure 2a below, gold miners' capital expenditure has been trending down for the past 8 years, highlighting the more conservative business expansion.

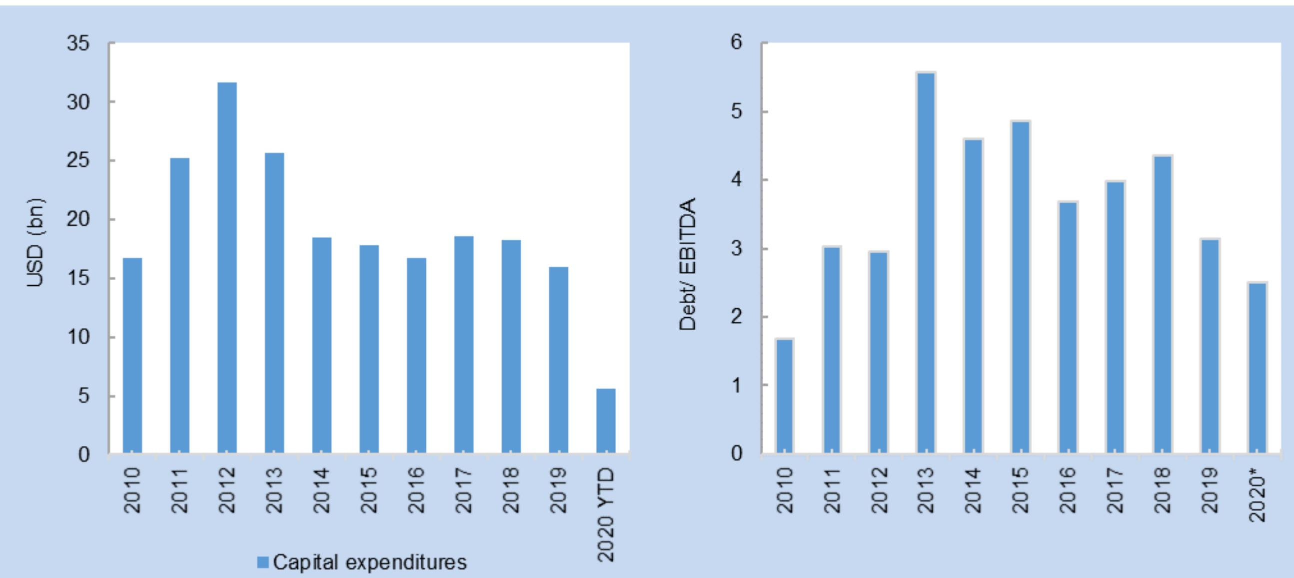

Figure 2a (LHS): Gold miners' capital expenditures from 2010-2020 YTD. Figure 2b (RHS): Gold miners' Debt/ EBITDA from 2010-2020 (*Debt/ EBITDA based on Jun 2020 data is being used for the year 2020). *Source: Bloomberg*

Consequently, gold miners' balance sheets are also in a better shape compared to a couple of years ago. Current gold miners' Debt/EBITDA based on Jun 2020 data of 2.5 compares favourably to Debt/ EBITDA of 5.6 in 2013 (see Figure 2b). The previous price crash has induced gold miners to focus on repairing their balance sheets. Gold miners managed to achieve this by selling their non-core assets and utilizing their cash flow. Take Barrick Gold Corp (Barrick), one of the largest gold producers in the world, for instance. Barrick has managed to reduce its debt by around 56% from USD 13bn in 2014 to USD 5.7bn in 2018, thereby also reducing its total debt to equity ratio from 102% to 61% during the same period. Gold miners' healthier balance sheets reduced their vulnerability to changes in gold prices, thus lowering their credit risks. Barring the Mar 2020 sell-off when investors were in a rush to chase liquidity, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) in Figure 1b indicates that the credit risks of publicly-listed gold miners have been consistently lower than during the 2013-2016 period.

While gold miners have so far maintained their fiscal discipline, it is essential to remain vigilant of the challenges that could arise from the present situation. In Q2 2020, top gold miners reported an increase in their all-in sustaining costs (AISC), the second quarter in a row amid mine shutdowns related to COVID-19. Despite managing to offset some of the losses in revenue by the soaring gold prices, it is imperative for gold miners to keep the costs at a sustainable level. The inability to prevent costs from climbing to an unsustainable level would also translate to the inability to adapt to a lower price environment, should the need arise. In all, however, equipped with solid balance sheets and an environment ideal for high gold prices, gold miners' short-term credit outlook will remain positive.

Credit News

Corporate debt frenzy rolls on as worries loom over markets

Sep 19. Even with the US Federal Reserve providing a gloomier than expected economic outlook at the September meeting, corporate bond issuance is set to continue at record breaking rates this current week. Last week has seen USD 42bn worth of high-grade debt come to market in 39 deals. Half of the USD 1.7tn debt issued so far this year has gone towards refinancing existing debt to lower interest expenses. This trend is likely to continue as the demand remains high for the next few weeks as historically low rates drive a hunt for yield despite a host of economic and political concerns. However, junk-rated issuers are still likely to face accessing the market if the nascent US recovery stalls. With most big-name investment-grade companies already refinancing, the remainder of 2020 could see smaller companies dominate issuances. (Reuters)

Federal aid impasse heightens US muni market credit risk

Sep 19. The political deadlock over the new round of federal aid has elevated the credit risk of the USD 3.9tn municipal bond market. With no agreement on the horizon, the credit quality of states, cities and other debt issuers is set to deteriorate, causing the default rate to remain elevated for the time being. The Public finance ratings have seen a total of 81 downgrades and 52 upgrades in Q2 2020, the first time in 3 years that downgrades have outpaced upgrades. The states and local governments face a total of USD 450bn in budget shortfalls through fiscal 2022, which could rise to USD 650bn if there is a second wave of COVID-19. (Reuters)

Presidential election is the only cloud for credit investors

Sep 17. With the US presidential election looming after the rally in the credit markets, the options market saw high demand for hedges against a possible selloff in Nov 2020. Conventionally, the term structure would increase as time is projected to further out. However, it is noted that the Nov 2020's expected volatility is elevated relative to the rates for Dec 2020. Nevertheless, future uncertainty does not make the credit market's recovery from Mar 2020 any less. PGIM's Greg Peter termed the period where many firms showcased conservative balance sheet management as "a golden age for credit". (WSJ)

Bond investors regain appetite for emerging markets

Sep 17. Due to falling rates within the European and US bond markets, investors are making their comeback to the emerging markets in search of more attractive yields. This is evident in a risk-on approach despite the series of high profile defaults and the poor economic environment. A large proportion of the inflow, up to USD 8 billion, came in the past 3 weeks. Bonds rated below investment-grade originated from the emerging markets, on average, pay 2.1% more than that of the issuances from the US markets. Along with the central bank intervention, these resulted in a lift in bond prices. However, few warned that the rally within the emerging markets may be short-lived as the US presidential election period kicks in. (WSJ)

September green bond flurry puts market on track for record year

Sep 17. Green bonds are heading towards a record year as a flurry of new issues has revived the market following a slump in sales due to COVID-19 earlier this year. The European Union contributed greatly to this recovery when it announced that a third of its EUR 750bn COVID-19 recovery fund would be financed by green debt. The green issuance this year is expected to surpass last year's USD 206bn record with the bond market being fairly resilient and companies committed to the issue. (Reuters)

China's Moutai comes to home province's rescue with bond purchase (Nikkei Asian Review)

YPF leads Argentina corporate bond rout on new forex limits (Bloomberg)

Asset managers, companies lagging in Libor transition: HK regulator (Reuters)

Regulatory Updates

Fed signals rock-bottom rates until at least end of 2023

Sep 17. The US Federal Reserve (Fed) has boosted its monetary response to the pandemic as it projects no interest rate increases until at least the end of 2023. It also stated that it would not tighten the policy until inflation is higher than 2% for a prolonged period. Despite the US economy bouncing back faster than the Fed predicted, the recovery is still far from complete due to the uncertain health outlook, waning support from fiscal policy and 11 million Americans still unemployed. The Fed also announced that it would be increasing its holdings of Treasury securities and agency mortgage-backed securities to sustain smooth market functioning and fostering accommodative financial conditions, supporting the flow of credit to households and businesses. (FT)

ECB relaxes bank leverage regulation in attempt to boost economy

Sep 17. The European Central Bank (ECB) has relaxed regulations on Eurozone banks, freeing up EUR 73bn of capital in an attempt to boost lending to prevent the economic crisis from triggering a credit crunch. The changes announce would allow banks to exclude EUR 2tn of cash and deposits that they hold in the central bank from the calculation of their leverage ratio. This will prevent a buildup of reserves from weighing on the bank's capital needs. The relaxing of the rule will last till June 2021 whereby the 3% leverage rule will then become binding for all Eurozone banks. (FT)

Hungary extends loan moratorium as economy struggles to recover from pandemic (Reuters)

Germany plans reform to avoid bankruptcy wave due to corona (Reuters)

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