Tocqueville Gold Strategy Investor Letter Fourth Quarter 2015

BY JOHN HATHAWAY ON *JANUARY 12, 2016*

During 2015 gold bullion declined 10.4 percent, to $1061.4, while gold mining stocks (basis XAU Philadelphia Stock Exchange Index of Gold and Silver Stocks) declined 33.4 percent. 2015 was the third consecutive year of declines in the precious metals complex, a correction from all-time highs that appears overextended and ripe for a trend reversal. We believe that the trend reversal will be triggered by a broad decline in the value of financial assets, which have been in an extended bull market since 2009. When capital flows return to gold, we expect the response to be dynamic. An expanded, more detailed version of this view is available.

An acute shortage of readily marketable physical gold is developing that we believe will deepen in years to come. This possibility seems to be unrecognized by those who are short the gold market through paper contracts. The relentless dumping of synthetic or paper gold contracts since 2011 by speculators in Western financial markets has caused the shortage. The steady selling has driven down the price of physical gold, hobbled the gold-mining industry, and drained the stores of gold held in the vaults of Western financial centers. We believe that the shortage will worsen because (1) the precursors of production (exploration, discovery, reserve life) are very negative, (2) the mining industry has little financial credibility and seems unlikely to attract capital even with a big rise in gold prices, and (3) refining capacity limitations tend to create supply bottlenecks when physical demand spikes.

Therefore, absent any significant and sustained rise in the gold price, we expect few new mines to be built for many, many years to replace depleting and aging mine reserves. In addition, refining capacity should remain static for the foreseeable future. At the same time, the pool of vaulted gold in readily marketable form that supports paper/synthetic gold trading has all but vanished as Asian demand has drained inventories in London and other Western storage complexes.
The seemingly endless supply of notional gold coming from the sellers of synthetic is the strongest explanation for the extended, and in our view overdone, decline in the gold price from peak levels of 2011. Quantities of synthetic gold sold are created out of thin air, with almost no connection to physical metal. The negative investment thesis seems to rest upon confidence that central bankers, and the Fed in particular, will steer a course away from radical monetary experimentation that will return to a normal structure of interest rates and robust economic growth. The fact that these expectations have not been fulfilled in the nearly nine years since the initiation of zero interest rates, notwithstanding the recent 25-basis-point Fed rate hike, leads us to believe that investor credulity in central bankers may be stretched about as far as it can go.

The very popular short exposure in gold is, in our opinion, vulnerable to a trend reversal/mega short squeeze. This would occur if gold ETF assets under management (AUMs) were to rebuild or if holders of COMEX futures were to stand for delivery in a big way. Gold ETF AUMs peaked at 2400 metric tons (“t”) in December 2012 vs. 1300 currently. A 200- or 300-t influx to GLD and other ETFs would put a severe strain on London liquidity, which we estimate to be substantially below 1000 t currently. When and why a trend reversal might occur is a matter of guesswork, but a trend change is inevitable (as in all markets), and the dynamics promise to be powerful. In our view, the short interest in paper gold rests on a credit pyramid that is precarious. When a trend reversal occurs, we expect that machine-driven trading, which is agnostic as to investment fundamentals, will serve as a powerful accelerant to the upside, just as it has led to overshooting on the downside.

We construe the incapacity of the gold-mining industry to be extremely bullish for future gold prices. There are many reasons to consider investing selectively in gold-mining equities. There are important exceptions to the sins and shortcomings of the industry at large. Value creation, even if currently unrecognized by the market, is in our view taking place in the form of accretive acquisitions by companies with access to capital and good balance sheets from those forced to sell quality assets to address excessive balance-sheet leverage. In addition, there are new mines that have been under construction for several years that should begin to produce gold, profitable even at current prices, at a time when industry production is shrinking. We believe that they will be sought-after acquisition targets as other producers deplete reserves. Other notable exceptions include companies that are still in good financial condition with attractive assets and positive cash generation. Their equities offer dynamic exposure to the repricing of gold that we regard as inevitable.

We believe that our gold-strategy portfolios consist of value-creating companies. Value creation has gone unnoticed by investors during the lengthy five-year correction, but we believe a trend reversal in the dollar price of gold will cause investors that have been sitting on the sidelines to scour the entire universe of mining companies for value, and that our holdings will not be overlooked.

With best wishes for a prosperous 2016!

Tocqueville Gold Monitor
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January 12, 2016

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Source: Tocqueville
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