Tocqueville Gold Strategy Investor Letter First Quarter 2012

BY JOHN HATHAWAY ON *APRIL 9, 2012*

During the first quarter of 2012, precious metals equities, as measured by the XAU index, declined 2.4% to 175.46, while gold bullion rose 6.7% to $1668.35. In our opinion, the first quarter consisted of an important test of the low made by the metal in December at $1522.65. Precious metals shares have been marking time during this testing phase. We previously commented that precious metals equities represented outstanding value at year end 2011. In light of first quarter action, the value proposition is, to us, even more compelling for precious metals shares.

Discouraged investors must be asking what it will take for precious metals shares to break out of their extended funk. We believe that the catalyst will be a move to new highs by gold during the remainder of this year. While this assertion may seem simplistic, the shares have underperformed the metal for an extended period, despite record earnings, cash flow, and dividends. From a contrarian point of view, the stocks are table pounding buys unless the gold price plummets to levels substantially below that of December. We believe such a scenario is highly unlikely. The mining share sector has been subjected to a litany of negative news developments ranging from political adversity to stupid acquisitions. All of this is known and can be found in extensive and dreary commentary by most sell side research. In the last few weeks, we have been visited by no fewer than five well known sell side analysts who initiated the meetings by apologizing for the fact that they were here to discuss gold mining equities.

We take a contrarian and more optimistic view than the consensus. Mining gold and silver has become a decent business. It is generating surplus cash flow. Industry managements, sometimes because of vocal shareholder criticism, are considering ways to improve returns. Share issuance, once torrential, has slowed considerably. (see figure 51, page 12 in the Gold Monitor) Dividend hikes are becoming commonplace. Bit by bit, this should and, in our opinion, will add up to better returns for shareholders.

Macro Considerations

Three important changes in the macro climate are becoming evident: rising interest rates, rising inflation, and a slowdown in China. Meanwhile, the sovereign debt crisis in Europe is far from over. All of these issues present troublesome consequences for the financial markets and all but insure that fiscal and monetary policies of the Western democracies will continue to cheapen their currencies. In short, we believe that the gold bull market is about to move into a more dynamic phase. The correction in the metal price from last September's high of $1921.55 appears to be in its final stages. Sentiment for mining shares is extremely pessimistic. (see figures 52, 55, and 56 on pps. 12-13) In our opinion, the close of Q1, 2012 was an important inflection point and an excellent buying opportunity for the metal and the mining shares.

Headlines that longer term interest rates have reversed course and now appear headed higher are incorrectly attributed to the notion that the economy is gaining strength. We believe the appearance of economic strength in the U.S. is due to seasonal adjustment factors in the data. While the rise in rates is real, the condition of the economy remains feeble. Our expectation is that rate increases and higher fuel prices to impede further progress.

Headline inflation of 2.9% is above the Fed's long term target. Yet, easy money is justified on the view that the drivers of higher inflation, primarily oil prices and related inputs are deemed transitory. Inflation in China and India remains serious. The cost of imported goods, about 15% of GDP, is affected by inflationary conditions there. The continuation of easy money in the face of these developments could nurture the advance of inflation and inflationary psychology. We expect inflation to worsen as 2012 progresses to the point where it becomes a headline issue.

Slowing economic growth in China and other emerging economies means that they are generating fewer dollars with which to buy U.S. Treasuries. In fact, China has been a seller of Treasuries since August 2011. Who will buy treasuries with negative real returns if not sovereign nations intent on manipulating currency exchange rates? The answer, we believe, is no one other than the Fed, which bought 61% of all Treasury issuance in 2011.

As noted by Stephanie Pomboy (MacroMavens- 3/22/12), global forex accumulation has declined dramatically from twelve months ago. (see figure 25, page 5) The share of diminishing forex being recycled into dollars is also shrinking. (see figure 28, page 5) This is why we anticipate that interest rates will rise faster than anyone expects unless the Fed and other central banks begin a renewed expansion of their already bloated balance sheets. Whether that expansion is labeled quantitative easing or not, it should drive liquid, risk-avoiding capital in the direction of gold.

The work of the Fed and other central banks is far from over. Fed Chairman Bernanke's February 29th statement that further quantitative easing was off the table resulted in a sharp selloff in precious metals. Implied in this statement was a view that the economic recovery was sustainable without further stimulus. We believe that this forecast will prove to be as inaccurate as most other Fed forecasts in recent years.

Even if the Fed abstains from further QE for the time being, there is the issue of excess liquidity in the banking system resulting from previous rounds of unprecedented stimulus. At present, excess reserves in the banking system amount to $1.5 trillion versus $2 billion on average prior to the 2008 global credit meltdown. Excess reserves of this magnitude are the fuel for future inflation. Any significant reduction of excess reserves is sure to drive interest rates higher than any central banker or politician would be willing to tolerate. That is why we regard discussions by Fed officials of exit strategies as meaningless posturing.

In our view, monetary policy has been boxed in by previous actions, election year politics (and even more broadly by the dynamics of the contemporary state of democracy), and the slowdown in global forex accumulation. The result, we expect, will be a continuation of financial repression under the most optimistic of scenarios. At the very least, returns on liquid capital could remain negative for many years to come. Under such circumstances, demand for the protection offered by gold should remain strong. Should the presumed economic recovery falter, we anticipate that the calls for renewed QE will be deafening.

Tocqueville Gold Monitor 1Q12

John Hathaway
Portfolio Manager and Senior Managing Director
April 9, 2012