TOCQUEVILLE

Tocqueville Gold Strategy First Quarter 2018 Investor Letter

BY JOHN HATHAWAY ON *APRIL 4, 2018*

Gold's Dot Plot

The Fed dot plot, published after every Fed meeting, shows where each of the 16 members of the FOMC (Fed Open Market Committee) expect interest rates to be at the end of the various calendar years displayed, as well as the peak level of rates upon completion of the tightening cycle. From time to time, the price of gold begs to differ with the Fed's – and by extension, the investment world's – consensus on the course of the economic path forward. Note that the gold price continues to grind higher, having dipped to a low of $1051/oz at year-end 2015, and now trades approximately $300/oz higher. Should bullion begin to trade above the 12-month range currently capped at around $1360, it will signify that the Fed's dot plot is due for an overhaul. We write this note in anticipation that an overhaul of mainstream expectations is long overdue, and likely to occur in the remainder of calendar year 2018.

In our 2017 year-end letter, "Connecting the Dots," we mentioned several factors likely to rekindle dormant investor interest in gold and gold mining shares. These included (1) extreme valuations of US financial assets, (2) a potential worsening of the US fiscal position, (3) the possibility of rising inflation, (4) precarious financial-market structure (reflexive risks posed by wide use of risk-mitigating and passive-investment strategies), and (5) an expected further weakening of the US dollar against other currencies, and each is discussed further below. Of these, we highlighted potential financial market losses as the most likely catalyst to cause investors to rethink their exposure to risk and the merits of gold as a risk dampener:

> …there can be little debate that financial-asset prices now sit at valuation extremes that have been, without exception, followed by periods of meaningful disappointment. In our view, valuation excesses signify systemic risk.

(1) During the quarter, the metal price was up 7%. However, the financial markets began to exhibit extreme volatility. Although the S&P 500 declined only 1.2%, there were trading moves of -10.2% from peak to trough, far greater than quarterly ranges in 2017, which averaged only 5.6%. We believe that if these patterns continue, risk preferences of a broad range of investors will shift from targeting maximum gains to avoiding significant losses. As of this writing, the major US averages are trading at or below their 200-day moving averages, while many foreign-stock indices are trading well below this widely accepted benchmark of market health.

(2) The fiscal position of the US has begun to exhibit significant deterioration; this in turn has resulted in a dramatic increase in the supply of new treasury issuance. In February the deficit was 12% above year-ago levels and the largest in 6 years. In our previous letter, we stated that $1 trillion fiscal deficits could become commonplace, which would lead to an annual increment to national debt outstanding of 5% per annum, assuming a continuation of very low interest rates. We also noted that an increase of only 1% on outstanding US debt would balloon those deficits by $140 billion, a legitimate concern since the average maturity on outstanding debt is only 70 months.

(3) Inflation appears to be on the rise. The consumer price index (CPI – admittedly volatile) rose .5% in January (6% annualized) and .2% in February (2.4% annualized). The March CPI will not be reported until April 11, and one could argue that the jury is still out on inflation. However, important labor statistics

suggest that a steady rise in wages is taking place, and tight labor-market conditions make a continuation seem likely. The ECEC (Employer Cost of Employee Compensation) rose 2.9% in Q4 2017. This is a real-time measure of actual labor costs. This index has been increasing at close to 4% per year (the most recent quarterly increase at only a slightly lower rate, but an increase nevertheless). Labor-market conditions are extremely tight, with unemployment claims the lowest in 45 years.

Nevertheless, the prevailing view among economists and market strategists appears to be that inflation will remain dormant. Inflation numbers that are higher than consensus will in our opinion pressure the Fed to raise rates at a faster pace than current expectations, which in turn could prove harmful to financial-asset valuations.

(4) We believe that the rise in market volatility underscores the precarious nature of market structure. The wild swings that have occurred year-to-date reflect, in our opinion, telltale tremors in the highly confident bullish consensus that existed only a few months ago. Thus, the January run-up to all-time highs in the popular indices is coming into question. If consensus-thinking shifts on such issues as overconcentration in FANG (Facebook, Amazon, Netflix, and Google stocks), expectations that emerging markets and Trump administration policies will fuel global growth, and the extreme short exposure of traders to long-term bonds, we believe that the fallout will be more than just a gentle market correction that is easy for all to tolerate. As noted by Simon Mikhailovich (and quoted in our year-end letter):

> Any industry that turns on its customers, and the asset-management industry has, is vulnerable to disruption. After decades of underperformance, conflicts of interest, and egregious excess, many investors are forsaking active managers for passive strategies, which rely on dubious and unproven financial technologies, such as ETFs, robo-advisory software, levered derivatives, etc. These new strategies carry significant risks that are being widely ignored so long as the markets keep making new highs. However, having moved away from the relationship to the transactional model, the new strategies do not engender loyalty and are vulnerable to mass defections whenever the markets reverse and reveal their embedded weaknesses.

(5) Dollar weakness continued into the first quarter with the DXY registering a decline of about 2%. Near term, it seems to us that, based on the positioning of CBOE traders, dollar bearishness may be overdone and that a short-term rally is possible. Still, based on fundamentals – most especially the fiscal realities discussed under (2) and the likely intensification of inflation (3) – the intermediate- to longer-term trend of the dollar vs. other major currencies (and more especially, gold) is down.

To conclude, we believe that 2018 will mark a significant turn in the financial markets, which will be adverse for conventional, consensus-based investment strategies and quite positive for gold and other safe-haven assets. It is quite likely, in our view, that a new up-cycle for gold could register new highs for the metal price (up at least 50%) and gains of 100% or more for many precious-metals mining shares. In a financial world that has been notable for disruptive change, there remains one constant: human nature and the resulting inevitable ebb and flow of greed and fear. Gold, a proven antidote to systemic risk, is in our view likely to return to favor.

Tocqueville Gold Monitor [pdf]

John Hathaway

Senior Portfolio Manager

April 4, 2018

This article reflects the views of the author as of the date or dates cited and may change at any time. The information should not be construed as investment advice. No representation is made concerning the accuracy of cited data, nor is there any guarantee that any projection, forecast or opinion will be realized. References to stocks, securities or investments should not be considered recommendations to buy or sell.