TOCQUEVILLE

Tocqueville Gold Strategy First Quarter 2019 Investor Letter

BY JOHN HATHAWAY ON ***APRIL 12, 2019***

What If "Whatever It Takes" Isn't Enough?

Reasons to buy gold and precious metals mining stocks have been numerous for many years. Rarely, however, have so many of these considerations been as timely as now. To summarize, and connect as many dots as possible in a brief note, here are ten that come to mind (all in our opinion):

1. **US fiscal situation is dreadful and promises to worsen**
2. **Rising populism**
3. **Positive supply and demand fundamentals**
4. **Global economy weakening**
5. **Monetary policy turning dovish globally**
6. **Inflation is rising**
7. **Gold is undervalued and unloved**
8. **Gold has gone through a multi-year correction/base-building process**
9. **Gold is a proven diversifier, risk mitigator, and capital protector**
10. **Outlier/Systemic Risks**

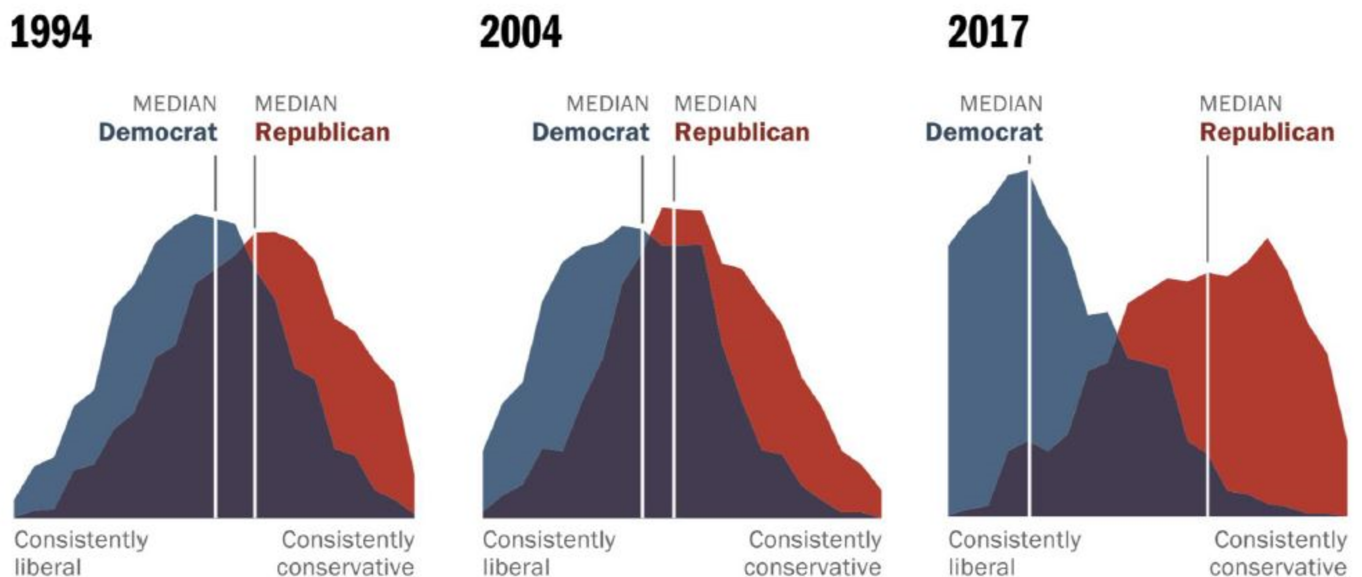
Fiscal

Debt to GDP slightly exceeds 100%. At the 100% threshold, the math becomes increasingly difficult for GDP growth to outpace debt growth. It is a foot race that has and will almost always be won by debt. For a full discussion of relevant dynamics, please see our website article "Going Bananas."

The investment implication is for potential slippage in the US credit rating, which could lead to an unwelcome and uncontrolled rise in interest rates. Connecting the dominoes, a weak USD could topple current historically high valuations of financial assets. We believe that there will be increasing investor focus on this issue as the 2020 elections approach.

Populism

Rising populism is bipartisan. The political center has been gutted as the Pew Research chart below illustrates. To us, that suggests that whichever party wins in 2020, there will be scant advocacy for fiscal responsibility. In our view, rising populism seems likely to translate directly into widening deficits, deterioration of US credit, a weaker US dollar, inflation, and a bear market.



Positive Supply and Demand Fundamentals

Production of newly mined gold appears to have peaked out. The reserve life of the mining industry is the lowest in three decades, reflecting cost-cutting by major mining companies and the scarcity of equity capital for junior mining companies, which had historically discovered and developed new orebodies. There are many barriers to increasing gold production over the near to intermediate term. A large and sustained gold price rise of 25-50% is necessary, in our opinion, to alter the declining production outlook beyond the next 4 to 5 years.

On the demand side, central banks have been aggressive buyers of bullion, buying more than at any time since 1971 and increasing 74% on a year over year basis in 2018. In many cases, including Russia and China, gold has been a replacement for US dollar assets. Retail demand in Asia continues to be steady. While investment demand in Western financial centers has been soft, global ETF holdings of metal have increased a moderate 3.64% over the last twelve months.

Weakening Global Economy

A sampling of recent headlines (excerpted from the April 1 "Belkin Report"):

> "Weak February US retail sales underscore slowing economy (CNBC April 1); German manufacturing slump deepens in warning for euro area (Bloomberg April 1); China industrial profits suffer biggest fall in almost a decade (FT March 28); UK retailers suffer biggest sales drop in 17 months as Brexit Nears (Reuters March 27)."

It appears to us that a global economic slump is underway. Declining interest rates, the flat yield curve, and anticipated Q1 2019 weak corporate earnings reinforce this outlook. The S&P 500 has declined an average of 29% in the 10 recessions since 1949 (Haver Analytics, Gluskin Sheff).

Global Monetary Policy is Turning Dovish

Central bankers (US, Eurozone, and Japan) appear to have abandoned any pretense of tightening monetary policy, and are set to embark on a new round of monetary laxity that could include rate cuts and renewed quantitative easing. US Fed Chairman Jerome Powell signaled this in his January 30 press conference this year. In a forward to the ECB annual report released April 1st, President Mario Draghi cited the "persistence of uncertainties" in Europe to justify further stimulus. Gold responded favorably to Powell's January press conference. We believe that there are many more shoes to drop on this front. We believe that the combination of a weakening economy and the approach of 2020 elections promises to break new ground in terms of aggressive policy.

Rising Inflation

Wage rates are an important determinant of inflation. As labor costs rise, companies must raise prices in order to maintain profitability. The most recent report on hourly wages is a 3.4% rate of increase. With unemployment at multi-decade lows, the labor market is tight. It would seem that wage gains will continue to be strong.

Companies are responding by raising prices. A sampling of 2019 announced price increases includes Proctor & Gamble (4%-5% on basic brands), tire companies (5%-12%), Netflix (10%), Whole Foods (raising prices on some items and discontinuing others as it gets ravaged by rising cost – from *Business Insider*, 2/12/19), etc. There is a long and diverse list of examples. So far, these increases have not been captured in the widely followed Bureau of Labor Statistics (BLS) CPI, which in turn explains the investment consensus outlook for tame inflation. Measuring inflation is complicated. The BLS employs large numbers of well-paid professionals to do the job, as well as complicated formulas and adjustments to collected data. The CPI and similar measures are the guideposts for investment thinking and policy-making.

We believe that conventional inflation benchmarks are inaccurate and understate the actual level. Common sense suggests to us that consensus sanguine inflation expectations are flat-out wrong. An ultra-tight labor market, scores upon scores of announced price increases, a return to easy money, and growing fiscal deficits are already causing inflation. We believe that inflation will turn out to be problematic long before the 2020 election.

Gold Is Unloved and Undervalued

Gold is a classic contrarian investment. It has been unpopular for several years. According to Dr. Marc Faber, investment exposure is at a 20-year low. GLD gold holdings, an excellent proxy for investment demand, hover at levels similar to 2014. Valuations of gold and silver mining stocks, another excellent proxy for investment sentiment, are the cheapest in terms of price to net present value (NPV) in two decades. The ratio of the HUI index of leading gold and silver equities relative to the gold price is .132, below the five-year average of .145, and well below the 15-year average of .313.

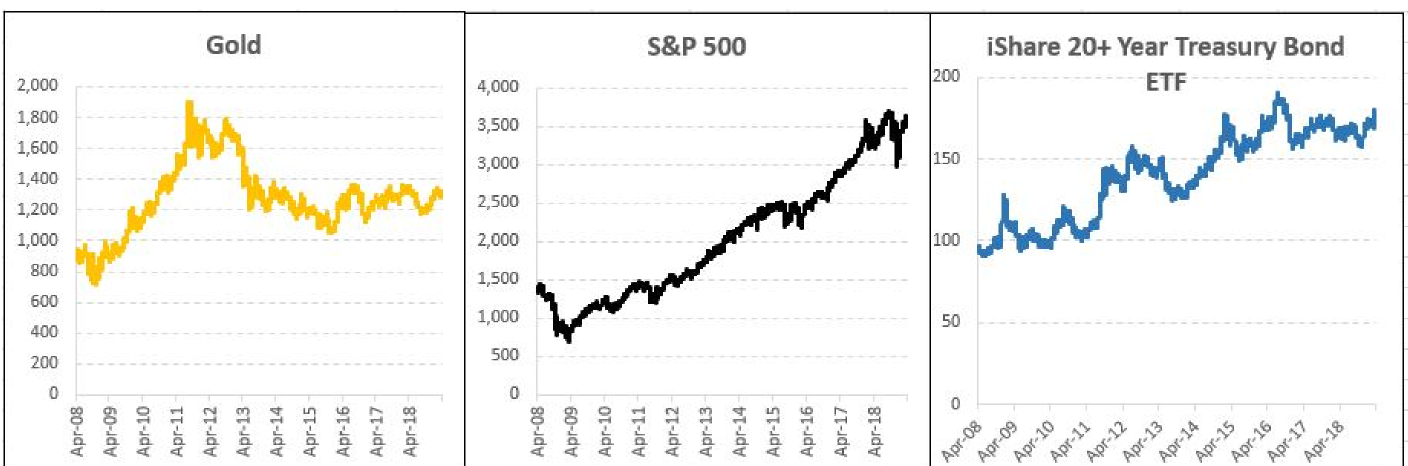
Financial assets, both bonds and equities, appear fully valued and may possibly be quite expensive if a recession occurs. According to David Rosenberg of Gluskin Sheff, the current equity market is the third most expensive since 1925, based on a cyclically adjusted price-to-earnings ratio. Gold and gold mining stocks, by contrast, appear to be an island of value. Most sport valuations of mid- to high-single-digit price to cash-flow multiples. Price to sales multiples hover near ten-year lows despite low metals prices:

Gold Miners: Average Price/Sales Ratio*

*monthly data (20 miners within GDX)

Gold Is Consolidating/Basing; Financial Asset Valuations are Extended/Topping

Gold has been trading quietly for several years. It generates little financial-media interest and excites none. In contrast, equities and bond markets trade near secular highs at a time when fundamentals for both are slipping. We believe that gold is basing while financial asset valuations could be topping. A look at the ten-year charts of each below is enough to make the point:



At worst, in our view, initiating gold exposure now carries the risk of boredom. Time could pass with meager results. However, big losses seem unlikely. We have less confidence to say the same for equities or bonds.

Gold Is a Proven Risk Mitigator and Capital Protector

The table below shows that gold has performed well during recent periods of market distress. Longer term, gold correlates inversely to financial assets. Most investors are not accustomed to thinking in generational terms, but it is in a generational context that gold's appeal is most apparent. Gold is a physical asset whose value does not depend on the existence of or access to a financial grid. It is one of the most reliable ways to pass wealth along to successive generations.

Blending gold with mainstream equity and bond strategies can seem to be unproductive and unnecessary for years or decades at a time. Unfortunately, the financial and market events that make gold seem compelling most often appear out of nowhere, catching most by surprise. In many cases, episodic rises occur quickly enough to negate the protection advantage of exposure for those not already positioned. In our view, it is preferable to layer in financial insurance when it is cheap and unwanted.

	Start	End	S&P 500 Index	U.S. Treasurys	Gold
1987 crash	8/25/87	10/19/87	-33.2%	-2.6%	5.0%
Iraq invades Kuwait	7/17/90	10/12/90	-17.6%	0.8%	7.6%
Asia crisis	10/7/97	10/28/97	-6.2%	0.0%	-4.6%
Russia/LTCM crisis	7/20/98	10/8/98	-18.7%	5.3%	1.2%
September 11, 2001	9/10/01	10/11/02	-22.3%	11.2%	16.6%
Global financial crisis	10/11/07	3/6/09	-54.5%	15.8%	25.6%
2010 Euro zone crisis and flash crash	4/20/10	7/1/10	-14.5%	4.5%	5.1%
U.S. sovereign debt downgrade	7/25/11	8/9/11	-12.3%	3.6%	7.8%
Taper tantrum	5/22/13	6/24/13	-4.8%	-2.0%	-6.4%
China worries	8/18/15	2/11/16	-11.8%	3.5%	11.5%
Fed rate increase & U.S.-China trade war	9/20/18	12/24/18	-17.9%	2.5%	5.1%
Average			**-19.4%**	**3.9%**	**6.8%**

Source: Bloomberg

Outlier/Systemic Risks

Should inflation rise, the markets fall, the economy slump, the dollar weaken, deficits widen, or populism run rampant, we believe that gold should benefit. However, should these unexpected and unwanted outcomes interact, serious potential for a credit meltdown on the scale of the 2008 global financial crisis would seem to exist. In our view, the 2008 and subsequent policy solutions to "save the system" amounted

to nothing more than layering on of new and larger quantities of public and private debt.

It is quite possible, in our view, that ground zero for the next systemic crisis will be sovereign credit itself. The promise to do "whatever it takes" in the application of monetary and fiscal policies, no matter how drastic or innovative, could appear impotent. Since Mario Draghi's famous pronouncement of 7/26/12, financial markets have been buoyed, in our opinion, by the expectation that public policy would always backstop downside exposure to a possible repeat of the 2008 global financial crisis. We are not so sure that investor faith in Draghi's promise is well founded. More debt issuance, more deeply negative interest rates, wider budget deficits, and overt money-printing (Modern Monetary Theory) have, in our opinion, already run into the brick wall of diminishing returns. If so, exposure to gold, even in small proportions – the only systemically bulletproof asset that is both liquid and readily deployable – will, in our opinion, prove highly satisfactory.

Tocqueville Gold Monitor [PDF]

John Hathaway

Senior Portfolio Manager

© Tocqueville Asset Management L.P.

April 9, 2019

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. Past performance is not a guide to future performance. Securities that are referenced may be held in portfolios managed by Tocqueville or by principals, employees and associates of Tocqueville, and such references should not be deemed as an understanding of any future position, buying or selling, that may be taken by Tocqueville. We will periodically reprint charts or quote extensively from articles published by other sources. When we do, we will provide appropriate source information. The quotes and material that we reproduce are selected because, in our view, they provide an interesting, provocative or enlightening perspective on current events. Their reproduction in no way implies that we endorse any part of the material or investment recommendations published on those sites.