TOCQUEVILLE

Tocqueville Gold Strategy Investor Letter First Quarter 2016

BY JOHN HATHAWAY ON ***APRIL 12, 2016***

The dollar price of gold rallied 16.14 percent during the first quarter while gold mining equities rallied 53.45 percent (XAU Gold & Silver Index). It appears to us that the nearly five-year decline in the precious metals sector has concluded, and that the stage is set for a renewed advance towards all-time highs. What is the investment rationale to support our view?

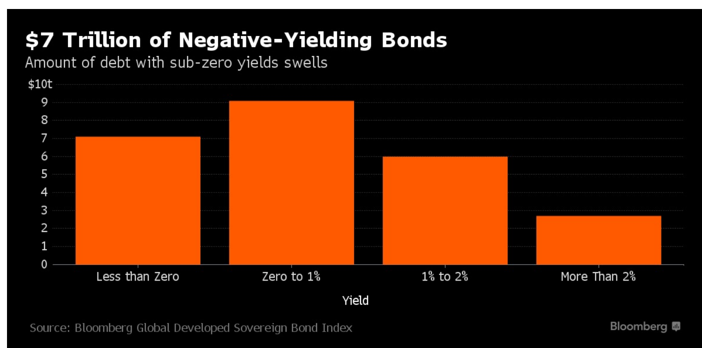
1. The war on savings and capital being conducted by central banks seems likely to drive investors towards alternative safe assets. We believe that prominent among the available options is gold.
2. At the zero interest-rate boundary, bonds are no longer capable of providing a stability hedge for equity portfolios; investors may look to gold to fill that vacuum.
3. A deepening shortage of physical gold means that even modest capital inflows into precious metals should drive an outsized price response.

War on Savings and Capital

Two percent inflation has become a stated objective of Fed and ECB monetary policy. Inflation diminishes the purchasing power of cash. The central bank rationale for creating inflation is to encourage households to spend and not to save, thereby paving a magical path towards economic growth. However, inflation is the archenemy of thrift. Currency debasement is an attack on saving and traditional channels of capital formation.
Until inflation germinates, financial repression (or zero interest rates) is the central bankers' weapon of

choice. Miniscule returns on safe assets such as savings accounts and short-duration treasuries are meant to force savers, investors, and financial institutions into riskier investments, namely long-duration bonds, equities, or worse. In our view, financial repression is a major explanation for the seven-year bull market in equities and bonds. While investors have benefitted, the real economy remains stagnant. The levitation of bond and equity prices that has resulted from financial repression in the absence of meaningful economic growth over the past several years means that risky assets have become even riskier, and more dependent than ever on perpetual monetary stimulus.

Central bankers and policy makers appear to be doubling down on easy money as they now discuss more radical variations. There is serious consideration for the elimination of large denomination cash notes (Mario Draghi, Lawrence Summers). Savers are being charged to hold money in banks instead of receiving interest in several European countries. Similar ideas are being considered in Japan and the US at high policy levels. $7 trillion of sovereign debt trades at negative nominal interest rates. Holders of what was formerly regarded as the safest of all liquid assets are guaranteed to lose money.



Andrew Haldane, chief economist of the Bank of England, along with others, floats the idea of digital cash to compete with bank deposits: “[Digital cash] would allow negative interest rates to be levied on currency easily and speedily” (Ben Dyson, “Positive Money,” 9/2015), giving policymakers more control over the actions of savers and investors. We continue to receive numerous anecdotal reports of increased restrictions and paperwork that must accompany cash transactions, even at relatively low thresholds.

The potential elimination of cash and the repression of interest rates on other safe assets assault the notion of unconstrained liquidity and maximum optionality, hitherto the principal attraction of these assets. “It appears that the one remaining escape hatch for private citizens is being closed…. The cashless society which appears over the horizon may come sooner that the demise of the penny!” (Bill Gross, Janus Capital, 3/16 Investment Outlook)

Bonds Can No Longer Serve as an Effective Hedge for Equity Portfolios

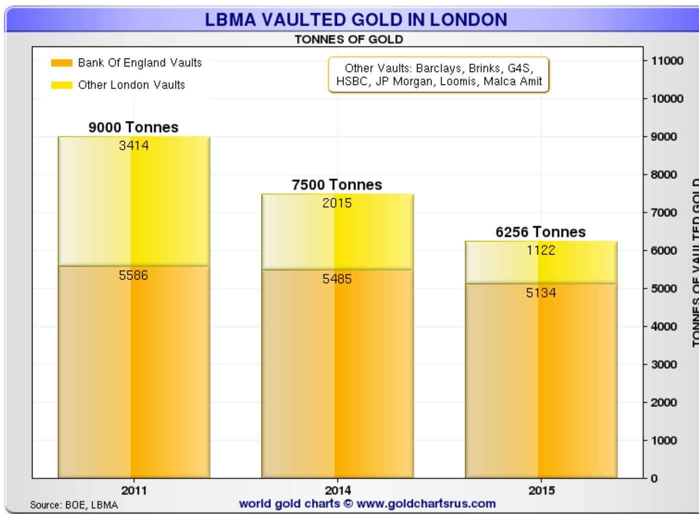
If central bank policies that have boosted financial asset prices since 2008 are beginning to lose effectiveness – leading central bankers to consider even more radical measures – what is the possible upside for bonds and equities? Bonds have been a traditional hedge to balance risk of long-only equity portfolios, a basic tenet of Modern Portfolio Theory (“MPT”) since the 1950’s. However, over the last five years, returns on bonds and equities have been highly correlated. The chart below overlays the performance of TLT (ETF of 20-year treasuries) vs. the S&P:

Source: Bloomberg

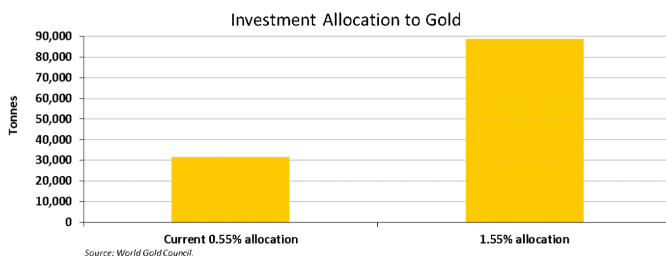
In MPT theory, observes Dan Tapiero (founding partner of Gold Bullion International, Gold as the New Government Bonds, 2/21/16), bonds provide a stabilizing influence to equity portfolios, because recessionary periods that negatively affect equity valuations have historically boosted bond prices. That is because monetary stimulus applied by central banking to combat recessions results in lower interest rates, and therefore higher bond prices.
At nominal interest rates near or below zero, there seems to be no possible way that bonds can offer investors their traditional effect of stabilizing portfolio returns. At the zero interest rate boundary (“ZIRB”), nominal interest rates have little room to decline and boost bond prices. We thus believe that radical monetary policies have undermined the potency of sovereign debt to balance portfolio risk.
Investors therefore must look elsewhere for portfolio balance. There are few alternatives that offer the ease of access, safety, and liquidity once offered by sovereign debt. We believe that the search for portfolio balance may well lead the investment community to stumble upon gold to replace or augment the stabilizing influence once provided by bonds.
Since 2000, gold has provided a compound annual growth rate (“CAGR”) of roughly 10 percent, greater than stocks or bonds over that same period. Gold is liquid, high quality, easily accessed, and provides unquestioned portfolio-diversification properties. According to the World Gold Council, the current investment allocation of world institutional portfolios to gold is a miniscule .55 percent. The flows resulting from a return of investment interest in gold for hedging purposes only, and in the best of all possible worlds (robust economic growth, world peace, etc.), would seem to have a potentially powerful impact on gold prices.

There Is a Deepening Shortage of Physical Gold

The outlook for future gold mine production is clouded by the roughly 40 percent decline in gold prices over the past five years. This decline has hobbled the gold mining industry in such a way that we expect the supply of newly mined gold to plateau at current levels in a best-case scenario, or decline by as much as 25 percent by 2020 in the absence of a sustained rise in the gold price of at least 50 percent. The reasons are discussed in detail in our website article “Synthetic Gold: Utopia for Alchemists.”
In addition to the dim prospects for increasing mine supply, the liquid inventories of physical gold vaulted in western financial centers (London, NY, and Switzerland) have been severely depleted by demand from Asian investors. As documented in our website article “Synthetic Gold” (1/7/2016), the “float” of easily accessed allocated physical gold has declined by approximately 67 percent since 2011. Much of the gold that has moved to Asia will not return to circulation in the absence of a sustained move higher. That is because it has been refined into levels of purity and bar shapes favored in Asian markets that are not readily accepted in Western capital markets. The chart below shows the 67% decline in private vault holdings. Central bank gold held at the Band of England is not in play for purposes of this discussion.



Resurgence in the current negligible investment interest in gold by Western investors will most likely be expressed in the form of capital inflows into gold ETFs such as GLD. In the first quarter, inflows into GLD were 5,687,970 Troy ounces, the highest since 2010, 18 months prior to the run-up of gold prices to all-time highs. GLD and other similar synthetic instruments are required by charter to have 100 percent backing by physical metal.
A continuation of first quarter strong inflows into gold-backed ETFs seems likely to exert a powerful marginal impact on gold prices. We estimate the demand for a 1-percent increase in gold allocations (from .55 to 1.55 percent) would equate to 56,075 tonnes of gold (chart below), much more than exists in the known float. Under this reallocation scenario, the scarcity of physical gold will most likely generate capital flows into synthetic instruments such as derivatives, structured notes, managed futures, and options, all of which entail high levels of fees and introduce heightened and varying levels of counterparty risk. However, investor scrutiny of these arrangements will in our opinion intensify in a rising gold-price environment. Substitutes for allocated physical gold will become decreasingly acceptable, leading to a scramble for the real thing.



Conclusion

We believe that the stage is set for powerful new advance in gold prices. The extreme monetary policies responsible for boosting financial-asset prices in recent years seem to be running out of steam. There seems to be growing evidence that investor confidence in these policies is fading. Policymakers appear to be grasping at straws such as digital cash, negative nominal rates, and the elimination of large-denomination cash notes. In his just-published book, The New Case For Gold (Penguin, April 2016), James Rickards identifies 13 policy shifts by the Fed since the first round of QE. It seems clear to us that this continuing reinvention of policy is a never-ending experiment; and there appears to be no clear path for reversal or policy normalization.
We believe that a decline in financial-market asset values is all that is needed to destroy whatever fragile confidence remains in paper currency and present-day financial conventions. Such a decline could come about for many reasons and at any time due to the buildup of systemic risk. Ray Dalio, iconic founder of Bridgewater Associates, has stated, “…most people should have roughly 10 percent of their assets in gold, not only as a good long-term investment, but also for its effectiveness in diversifying the other 90 percent of

assets people hold." It would not take a reallocation of 10 percent, or even 1 percent, to send the dollar gold price to all-time highs, in our opinion. Only .1 percent, requiring 5600 tonnes, would do the trick, as it would represent a demand increment that would swamp the supply of physical gold.

We continue to recommend exposure to physical gold and gold mining stocks, which would be the prime beneficiary of a renewed advance in precious-metals prices. Despite their substantial rally in the most recent quarter, we believe that gold mining equities remain severely undervalued long-term options on the potential increase in the gold price that we foresee.

Tocqueville Gold Monitor

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