Tocqueville Gold Strategy Investor Letter Third Quarter 2015

BY JOHN HATHAWAY ON *OCTOBER 12, 2015*

Financial market turmoil has been what was needed to rekindle investment interest in gold, as we have argued in our investor letters this year here. The onset of a bear market is what we envisioned in making this statement. A preliminary glimpse of what is what is needed to turn the tide for the gold market occurred in the 3rd quarter with a sharp decline in all global equity markets. On a year to date basis, most of the leading stock market averages are now in the red. The Dow Jones Industrial average has now declined for three consecutive quarters, only the third such string of losses in 40 years.

While the investment consensus appears to have shifted very slightly from complacent to wary, more damage to confidence must occur in our opinion for precious metals to shift into high gear. On a year to date basis through September 30th, gold bullion declined 5.9% and our benchmark, the XAU Index, fell 32.2%. During the third quarter, gold showed signs of stabilizing, however, having recovered from its low of $1085/oz. in late July to $1115/oz. as of September 30th, resulting in a decline of 4.9% for the quarter.

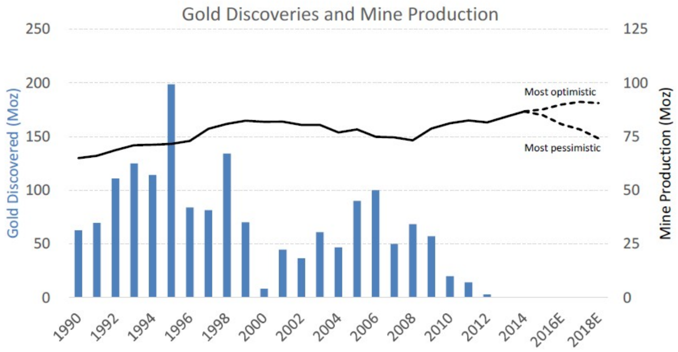
Our thinking is that unprecedented and radical monetary policy will end badly. On this point, we are in agreement with many financial luminaries who we have cited in past letters. They include Seth Klarman of Baupost Group, Stan Druckenmiller of Duquesne Capital Management, and Paul Singer of Elliott Capital Management. The effect (and possibly the design) of zero interest rates and quantitative easing has been to force investor savings into risky assets such as overvalued Nasdaq stocks, junk bonds, and emerging markets. The most obvious way for monetary policy to end badly is for investors of all stripes to suffer a prolonged bout of financial market adversity. Losses in risky assets will dissipate investor confidence, undermine economic activity, and leave the Fed with little choice other than to step on the accelerator for more easy money. It is in the midst of this sequence that we expect investors to rediscover gold in a big way. The flywheel that has driven the price of gold downward over the past four years is the same one that will in our opinion propel the gold price to new highs. That flywheel, for lack of a better term, is synthetic or paper gold. Paper gold consists of futures contracts, options, and derivatives traded on the Comex and more opaquely over the counter in NY and London. The predominant players in synthetic gold are high frequency traders whose computer models are agnostic and impervious to the considerations of fundamental analysis. The magnitude of paper gold trading is an extraordinary multiple of physical gold trading, with credible estimates ranging as high 80 to 1.

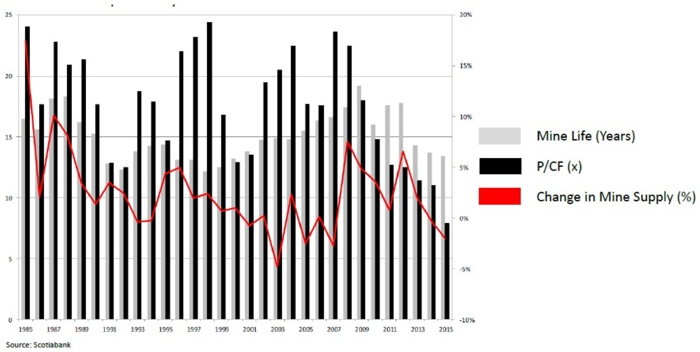
In our view, the artificial intelligence of computer generated synthetic gold traders will sniff out a directional change in the market long before the fundamentals can be articulated. As in all markets, price precedes headlines. We judge the pile on effect from the synthetic gold market to be equally potent in either direction, and we therefore expect the extreme, intense lows that we are currently experiencing to be followed by new all-time highs.

We believe that the positive story for gold will have four distinct facets. At the macroeconomic level, it will be the impending exposure of monetary policy, and the central bankers who conduct it, as fraudulent and a threat to general welfare. Think of it as checkmate for public policy. As one articulate observer put it:

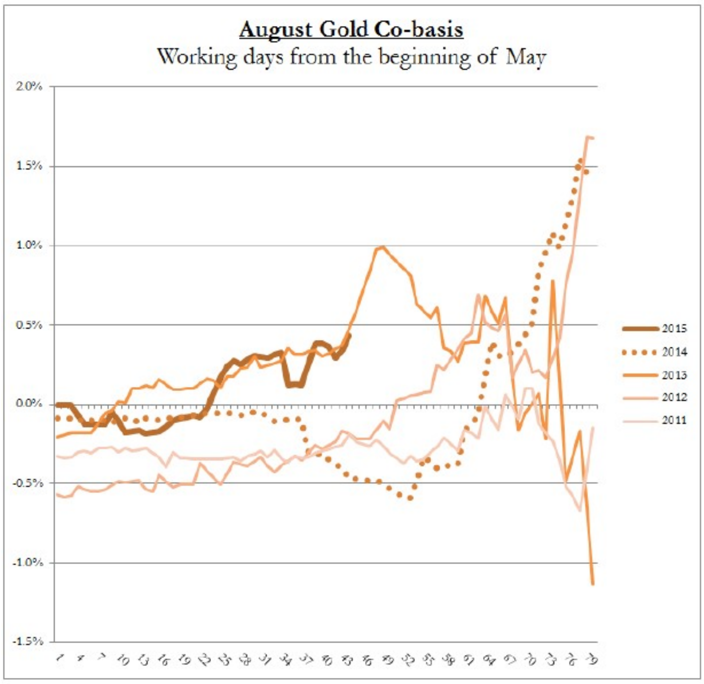
Gold and The Dollar: Everything Yellen has said is wrong. The U.S. economy is not recovering and the U.S. short term interest rates are not going to rise which removes the argument for being long the Dollar vs. the Yen and Euro. (Belkin Report 10/4/15)

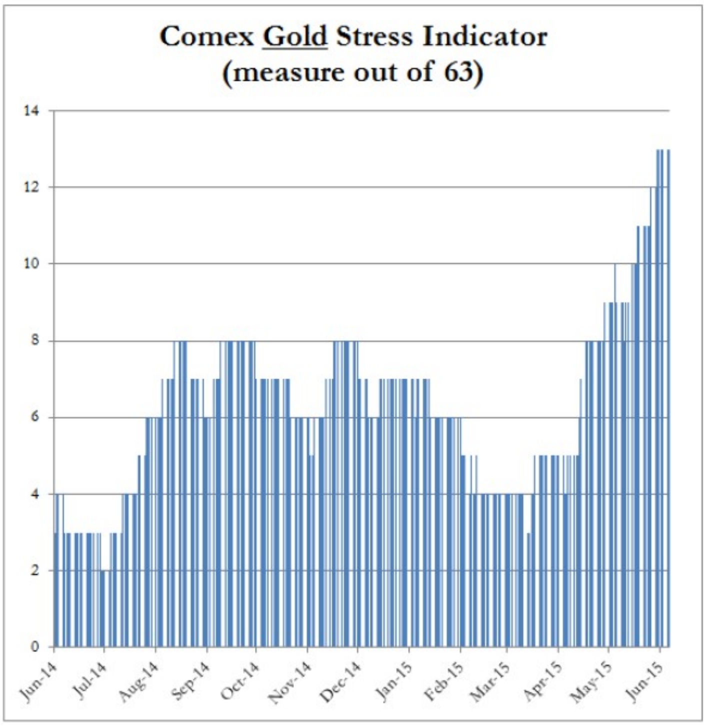
On a microeconomic level, the positive story will be that the lack of discovery of new gold reserves by the struggling gold mining industry which, absent a significant rise in the gold price, will lead to a supply crunch. The rate of discovery of new gold is at a multi-year low and the mine reserve life currently stands at a perilous 13 years, the lowest in 30 years:





On a technical level, the well documented shift of physical gold ownership from Western investment hands to Asian will in our opinion threaten the highly levered institutions that intermediate financial and physical gold markets. The intermediaries include Comex, LBMA, Over the Counter market, and bullion banks. We expect the gold drain from West to East to be resolved by a short squeeze. Signs of stress that reflect a growing shortage of physical gold to support the paper market include the prolonged backwardation of the co-basis which has existed now for 3 ½ years and now approaching extremes last seen at the bottom of the gold market at year end 2008:

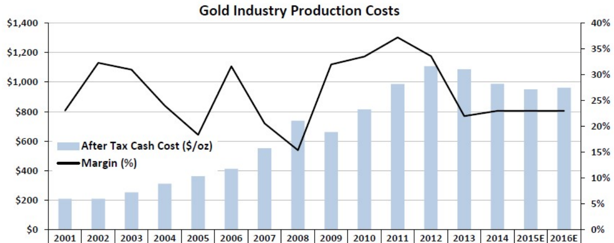




On a market psychology level, gold will benefit when the historically reliable cycle of descent from euphoria and well-being to discomfort and malaise starts to kick in. As noted by Fred Hickey in his October High-Tech Strategist: “Bear markets always start out as ‘healthy corrections’ and only over time does it become clear that it’s something much worse.”

In our opinion, the most dynamic way for investors to position for these changes is through a diversified holding of well selected gold mining equities, which stand to benefit in a dramatic way from a better gold price environment and improved investor sentiment. The industry has done an excellent job, in our opinion, of pairing costs as well as shedding assets to improve balance sheets. These measures are already showing up in improved production costs and more robust cash flows even at current low gold prices.

Gold Industry Production Costs



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015E	2016E
After Tax Cash Cost ($/oz)	209	210	253	311	363	413	552	738	661	814	987	1,108	1,087	988	950	961
Margin (%)	23%	32%	31%	24%	18%	32%	21%	15%	32%	34%	37%	34%	22%	23%	23%	23%

Costs reflect historical results for approximately 30% of annual global gold production from 13 of the largest producers; while 2015 - 2016 estimates are based on FactSet consensus estimates for the same producers.
Source: Tocqueville Asset Management, FactSet.

Our research process consists of continuous, intensive and extensive due diligence. We believe that our portfolios represent the best possible mix of high quality assets, financial staying power, and dynamic exposure to the better gold price environment that we expect.

In our view, gold is exceptionally cheap at the moment because the radical monetary policies practiced by the world's leading central banks have led to an egregious mispricing of risk by investors at large. We believe that the Fed's continuing (and increasingly glaring) inability to normalize interest rates validates our long standing thesis that monetary extremism cannot be unwound without triggering a slew of unacceptably painful consequences for the holders of risk assets and bonds. The dollar gold price has been the main loser from the resurgence of confidence in financial assets and the resultant multiyear rally. Once investors discover that there is a bite to the "risk" in risk assets, gold could be the big winner.

Tocqueville Gold Monitor

John Hathaway
Senior Portfolio Manager

October 12, 2015