Tocqueville Gold Strategy Investor Letter Third Quarter 2012

BY JOHN HATHAWAY ON *OCTOBER 9, 2012*

Gold and precious metals stocks rallied sharply in the third quarter. The rally suggests that the lengthy correction which began in August of 2011 has been completed, setting the stage for a powerful new leg in the bull market for precious metals and related mining shares. During the quarter, the metal rose 10.9% to $1,772/oz. while the XAU index rose 21.7% to 191. Since mid- May, precious metals shares as measured by the XAU have outperformed gold bullion, with the XAU index rising 35.9% against a 14.8% advance for the metal. Outperformance by the shares over the metal has historically coincided with the strongest advances in both absolute and relative terms for the precious metals complex.

The trigger for the strong advance was the overt resumption of quantitative easing by the Fed and ECB in late August. The resumption of aggressive monetary easing, in our opinion, had been foreshadowed by the failure of gold to make new lows after repeated denials by the Fed during the first half of 2012 that such action was "off the table." As we opined in 1Q12 and 2Q12 quarterly commentaries, as well as our web site article Gold, Gold Mining Shares, and QE; gold's resilience in the face of superficially "bad news" was signaling that repeated Fed disavowals of the need for more monetary stimulus would prove to be misguided and misleading.

Where do we go from here? We expect gold to trade at new highs against the $US in the next twelve months. It is already trading at record levels against the euro. We believe that precious metals stocks will rally strongly once the metal shows that it can breach the previous high and trade sustainably in new high territory. It has been our conviction over the past year that the main thing ailing precious metals stocks was market uncertainty as to the future direction of the gold price. The headwind of a year-long correction in the metal prices was the principal reason for the dismal performance of mining shares. All of the other reasons advanced to explain the poor performance of the shares was, in our opinion, sell-side research gibberish that extrapolated past transgressions of the mining companies into future expectations. For this reason, we believe that a more favorable perception of the condition of the gold bull market will translate into outsized relative performance for the mining shares.

What are the fundamentals that will drive gold to new highs? We believe it all starts with negative real interest rates. Negative real rates are the universal source of dissatisfaction and potential mayhem in the capital markets. They drive capital to seek alternatives to what would otherwise be regarded as safe havens for liquid assets and in the process misprice both safety and risk. Real interest rates at 4% in 90 day Treasuries would represent a significant headwind for gold. However, it is difficult to imagine a transition to real rates of 4% without inflicting significant damage to the financial markets or the economy.

Some suggest that a Republican victory in November would be a game changer for gold. It could bring about the dismissal of Bernanke, the taming of fiscal deficits, the painless elimination of excess liquidity from bloated central bank balance sheets, and the restoration of robust economic growth. All of this would need occur within the four years allotted to a new administration while voters patiently awaited the magic to take effect. While this rosy scenario is possible, we believe it would be a long shot. Therefore, we regard any possible pre-election weakness in gold and mining stocks based on such a possibility as a buying opportunity.

Another scary scenario for gold would be that the lame duck congress, post the election, embraces something akin to the Simpson Bowles plan. One only has to look at previous attempts to introduce formulas to limit government spending and reform the tax code to see that this is a long shot as well. In our opinion, there is no political consensus to implement the kind of change required for meaningful reform. Political consensus of the sort required for a basic alteration of entitlement programs and the tax code will most likely arise from a financial crisis on the order of 2008. We believe that the fiscal and monetary policies that are currently in place will lead to such an outcome. Until then, we find exposure to gold a strategic imperative.

The appended Gold Monitor consists of three sections: Macro, Gold Specific, and Mining Equities. There are 60 separate charts, graphs and tables pertinent to these categories. A few observations:

Macro: Real interest rates remain negative for most key economies and central bank balance sheets are bloated. Reported inflation is muted and economic activity is lackluster. Credit spreads are creeping higher, and are almost at levels preceding the 2008 financial meltdown. This is a space to watch. Minimal interest rates in our opinion represent a time bomb with the interest component of the federal budget at the lowest level since 1988 despite an increase in the federal debt outstanding of 6.2x. China is exhibiting a growing distaste for U.S. securities.

Gold Specific: Sentiment has improved substantially since the historic lows earlier this year, suggesting the possibility of a short term pullback. Central banks have moved decisively to the buy side over the past few years, but are very “underweight” the metal and “overweight” paper with no yield. Mining production is creeping higher at best, but represents no threat to gold prices. Since 2008, gold has outperformed other “hard assets” by a wide margin.

Mining Equities: The shares remain historically cheap. Profit margins are at record highs and returns on capital are approaching respectable levels. Equity capital issuance has dropped sharply in the last few years, a reflection of the industry’s much improved profitability. The sell side consensus assumes forward gold price is $1,313/oz., a discount of 26% to current spot.

Tocqueville Gold Monitor 3Q12 [PDF]
Tocqueville Gold 3Q12 Letter and Monitor [PDF]

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

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.