



Tocqueville Gold Strategy Investor Letter Second Quarter 2012

BY JOHN HATHAWAY ON *JULY 2, 2012*

During the second quarter, the gold price declined 4.3% from \$1,668 to \$1,597. On a year to date basis, gold has appreciated 2.2%. Gold mining shares as measured by the XAU Index (PHLX Gold/Silver Sector Index) declined 9.7% in the second quarter and 11.9% on a year to date basis. That is the bad news. The good news is that the lengthy ten month correction in the metal and the shares appears to have reached a conclusion. On Friday June 29th, gold rose \$45/oz. and the XAU jumped 3.4%. While it might be premature to declare an end to the correction based on the action of one day, we believe that the weight of all evidence as discussed in the following paragraphs provides a substantial basis to suggest the stage has been set for a resumption of gold's multi year advance.

The immediate catalyst for Friday's rally was the conclusion of the summit of European leaders which signaled that Germany had relaxed its rigid stance against direct lending by the European Central Bank to recapitalize the European banking system. As noted by David Zervos of Jeffries in his 6/29/12 commentary, "The ESM, with access to the ECB balance sheet for leverage, is now a fiscal backstop (with a printing press) for the resolution of bad European banks...This is a huge step in the right direction for the global reflation trade." In short, when push comes to shove, political leadership in all Western democracies lean towards inflationary policies and back away from fiscal austerity.

Gold and precious metals mining shares are in strong hands. As we have noted elsewhere (Gold, Gold Mining Shares, and QE), gold has held above its December 29, 2011 low of \$1,523/oz. despite several attempts to break below that level. In all cases, sharp but brief declines in the gold price during the first half of this year were closely linked to statements by the Fed that no further quantitative easing would take place past the scheduled expiration of Operation Twist on June 30, 2012. Despite those previous denials, the FOMC statement of June – indicated that (surprise!) Operation Twist will be extended through the end of 2012. It appears that cessation of QE turns out to be far more difficult than previously imagined by Fed policy makers. The exit strategy from unprecedented financial liquidity is at best an academic exercise for the PhD's at the Fed. In the real world, chaos theory suggests that scale and risk are positively correlated. What works on the lab bench doesn't necessarily translate to large systemic issues. The credibility of the Fed, in our opinion, has sunk to all-time lows and currency debasement is in full bloom on both sides of the Atlantic.

To this observer, it appears that any market which has been given multiple chances to trade lower but still holds its ground is signaling exhaustion of selling pressure. This certainly seems to be the case for gold. We will not be surprised if gold revisits the high of last year (\$1,900) or pushes through to new all-time highs by year end. As we stated in our March 31 quarterly letter, gold stocks should respond very favorably to the perception of a directional change in bullion. We believe that the ten month decline in the gold price has been the major headwind for gold mining stocks. Why would anyone own them other than for the possibility of a higher gold price? While we do not wish to minimize such issues as capital spending cost pressures, resource nationalism, or competition from GLD and similar instruments, we believe those concerns will fall by the wayside with the resumption of the bull market in the metal. If gold were to trade at \$2,000/oz. later this year, and should the ratio of gold mining shares (XAU basis) return to the mid-point of its range since the launch of GLD in 2004, or roughly 15% versus the current level roughly 10%, mining stocks could double on a 25% increase in the gold price.

The data contained in the appendix continues to paint a picture of an important low in the precious metals complex. The data speaks to the rock bottom valuation of mining shares, dispirited sentiment, and compelling macroeconomic fundamentals supportive of the gold price. It portrays a landscape of opportunity for the contrarian minded investor. The past ten months, and especially the most recent six months have been an incredibly difficult test of investor fortitude and steadfastness. It is in the nature of all bull markets, and (perversely) especially so for precious metals, to shake out as many as possible along the way to minimize participation to the fewest possible stalwarts. Turns from such a lengthy and important bottom are not designed for instant gratification. Their length is designed to produce maximum demoralization as investors ruminate on the paradox of stellar fundamentals that go unrewarded by market action.

What might the headlines be when gold trades at new highs? The list is long and by its very nature speculative. The key undisputable fact is persistent negative real interest rates which is the swamp which motivates investment capital to seek out gold. Negative real interest rates or financial repression means distortion of markets in such a way as to create the potential for financial accidents. The overhang of bad baggage from ten years of predominantly negative real interest rates is in our opinion weightier than anything in history. The policy challenges facing the Volcker Fed and the Reagan administration that ultimately capped the previous bull market in gold seem mild by comparison to those of today. We believe that gold remains under owned and misunderstood notwithstanding a thirteen year bull market. It is considered a fringe strategy to most, a little bit exotic and slightly risqué to the mainstream investor. While policy makers attempt to buy time by inventing solutions that are incomprehensible to most, the dream of mainstream investors for robust growth amidst stable economic conditions remains alive. Faith in half-baked policy improvisations that are nothing more than repackaging bad debt in the envelope of sovereign credit, along with hope that ever increasing quantities of sovereign debt will generate growth is, in our opinion, delusional. It is a smoke screen that obscures reality and will most likely result in further misdirection of capital. When adverse outcomes become obvious, gold will seem pricey. In the current confusion of misplaced faith, it seems to us downright reasonable.

Tocqueville Gold Monitor 2Q12

John Hathaway

Portfolio Manager and Senior Managing Director

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