TOCQUEVILLE

Gold, Gold Mining Shares, and QE

BY JOHN HATHAWAY ON *JUNE 13, 2012*

The protracted correction in gold and precious metals stocks that began in September 2011 appears to have ended. Our conclusion is based on historically reliable gauges of sentiment, valuation and technical factors. (We will publish the specific readings on these gauges with our second quarter investment letter on June 30.) This basing, in our view, should establish a solid platform to launch both the metals and the related mining shares to new highs within the next year. The investment sentiment for gold and especially mining shares is demoralized and confused. This setting, in our opinion, equates to an outstanding, low risk entry point to both the metals and the shares in anticipation of future monetary debasement.

Question # 1: Gold Price Outlook and QE

The fundamentals that led gold to trade briefly above $1900/oz. nine months ago are, if anything, more compelling and supportive than ever. These include, but are not limited to, sputtering economic conditions, intractable fiscal issues in all Western democracies, the slow motion demise of the euro as a credible reserve currency, a loss of faith in traditional economic prescriptions, alarm at the readiness of policy makers to resort to radical, ad hoc measures to buy time, and general disaffection among disparate social factions with the status quo.

Traditional economic analysis seems to offer little to explain the contemporary social and economic drift. In our opinion, more enlightenment can be found in the study of complex systems and chaos theory. As explained by James Rickards in “Currency Wars”, systemic scale and risk correlate in a positive way. What works on a smaller scale does not translate to large systems. In large systems, “minutely small changes in initial conditions can lead to catastrophically different results.” The extrapolation of outcomes based on historical models and policy applications is a fruitless exercise. The evolution of Western democracy over many decades has resulted in a systemic structure that bears no resemblance to precedent. Rickards notes that “a phase transition from stability to collapse can begin in imperceptible ways based on tiny changes in individual preferences impossible to detect in real time.”

Citing the work of anthropologist Joseph Tainter (The Collapse of Complex Societies) who analyzed factors leading to the collapse of 27 civilizations, Rickards suggests that highly evolved societies generate the seeds of their own instability through complexity. The marginal benefit gained from contributing to the general well-being eventually vanishes as creative energy is diverted into propping up cumbersome and unproductive legacies. Rickards explains that the crossover occurs when the “elite echelons of society go from leading to leeching.” In other words, the viability of a fiat currency system depends in large part on a widely shared sense as to the political legitimacy of the issuer. In purely monetary terms, the euro crisis will ultimately seed doubt as to the utility and efficacy of any fiat currency system, including the dollar. The life expectancy of faith based currencies is, in our opinion, quite short. Whatever path the loss of faith takes is impossible to know, but the result will undoubtedly will, in our opinion, result in the permanent re-pricing of gold in terms of defunct paper currencies.

This brief, highly condensed reference to complexity and chaos theory is to suggest that a superior framework for understanding the world exists than that which has underpinned economic policy since World War II. The reflexive, almost Pavlovian resort of world leaders to traditional fiscal and monetary responses to economic sluggishness betrays the intellectual bankruptcy that ossifies political elites. Market hopes for positive yield from such policy initiatives seem likely to meet with disappointment.

Ruminations as to whether or not additional rounds of quantitative easing ("QE") will be forthcoming have strongly influenced fluctuations in the gold price over the past twelve months. While additional rounds of QE would undoubtedly benefit the dollar gold price, it is easy to forget that gold rose from $256 in August of 1999 to $1000 in March of 2008, well before quantitative easing entered the daily narrative. QE 3 or not, we believe the gold price is headed towards new high territory. The specifics of the future daily narrative are impossible to know. However, they will emanate from the terminal condition of public policy as it struggles, most likely unsuccessfully, with the overhang of debt that has corrupted balance sheets of the banking system and fundamentally altered behavior in the private and public sectors.

On three occasions since the December 29, 2011 low of $1523.90/ounce, the Bernanke Fed has stated that further rounds of QE were off the table. The first was during congressional testimony February 29th. Gold reacted by dropping more than $100 in 24 hours to $1688. The second was the release of the Fed minutes April 3, 2012. The reiteration of Bernanke's earlier stance led gold to drop $72 in two days to $1613. The final instance came in Bernanke's congressional testimony of June 6, when, following a very weak jobs report and a subsequent sharp rally in the gold price to $1640 intraday, he again disappointed the gold market by removing the prospect for additional QE. Gold dropped $86 to $1556 in two days. In no moment of QE disappointment did gold fall to a lower low than the $1523 of year end 2011.

With respect to more QE, we believe the risk/reward posture of the gold market is asymmetric. By now, it seems that market expectations for additional QE have been sufficiently dashed; that any new round of monetary easing will come as a big surprise. The possible absence of QE seems unlikely to inflict incremental damage to the gold price. On the other hand, a new round of QE will most likely be triggered by emergency conditions in the financial markets and be seen as both an act of desperation and a tacit admission by policy makers that they really have no answers. In such a moment, we would not be surprised by a leap in the gold price approaching several hundred and possibly thousands of dollars an ounce in too short a period for significant capital to enter.

It is of course possible that a political sea change could occur in the United States election this coming November that would lead to a meaningful restructuring of the fiscal and monetary position underlying the U.S. dollar. However, based on the precedent set by Europe in which clamor for fiscal reform has been silenced by austerity fatigue, we have serious doubts that such a shift would yield durable progress on issues that undermine the dollar's credibility.

Beyond QE, we believe there are many factors that should remain supportive of the gold price. These include the unresolved issue as to how the Fed will exit the liquidity of its bloated balance sheet, the unresolved issue of fiscal deficits in all Western democracies, and the never ending travails of the euro zone. And when chaos and complexity gain the upper hand, there are too many permutations to enumerate.

Question # 2: Gold Mining Stocks vs. Bullion

The next phase of the gold bull market will, in our opinion, be marked by the relative outperformance of mining shares in relation to the metal itself. Mining stocks have underperformed the metal for a lengthy period, leaving investors demoralized and antagonistic. However, the business of mining precious metals has become quite robust. Profit margins and returns on capital are at record levels since the bull market in gold started in 1999, despite rising costs of production. For the senior, large cap mining companies, dividend yields are competitive with non-mining stocks despite low payout ratios. These changes are outlined in detail in the charts and tables that will be published with our second quarter comments on June 30th. Managements are beginning to take a more enlightened view of the need to return capital and further enhance returns for equity investors.

Among the 29 sell side research firms that we monitor, the consensus expectation for the forward gold price is $1270/oz. vs. the current spot price of approximately $1600/oz. Such a view has had a profound impact on valuation models such as net present value which are inherently subjective and influenced by sentiment. Should the macro forces that we have enumerated in part drive gold prices substantially higher as we expect, the mechanics of adjusting NPV models and similar constructs will impact valuations in a dynamic way to say the least. While there are many components to these models, the forward gold price is by far the most important. Should market sentiment for the forward gold price shift from the current negative bias to a more bullish one, gold mining shares will inevitably enjoy a significant rerating. Mining shares are essentially long duration, in the money options on the gold price. As second derivatives of the metal itself, the upside potential for them on a percentage basis should exceed that for gold during a more positive part of the cycle. The fact that belief for such a scenario is so scant among current investors and bystanders only reinforces our expectation for its likelihood.

Whatever monetary regime succeeds the current dollar reserve system will involve a significant and permanent re- pricing of gold. Gold will not fall back to lower price levels that prevailed until after the crisis that is at hand has run its course. The nature of earnings from precious metals miners will therefore be seen by the market as sustainable at higher levels and will not be seen as fleeting and subject to major declines based on the gold price. As such, valuations will be more generous than the current miserly levels. The case for precious metals equities therefore rests both on their optionality to higher gold prices and the potential for a significant rerating.

To conclude, the opportunity that has been provided by the nine month correction in the precious metals sector is of the sort that only comes along once in a decade. Many Investors have been shaken out and still more sit on the sidelines, wondering whether the correction has run its course and awaiting better buying opportunities ahead. Despite near term paralysis, increasing numbers of investors recognize that a commitment to gold is becoming a strategic imperative. By focusing on timing issues, one runs the grave risk of sitting on the sidelines as this next cycle in the precious metals bull market gathers force. The history of gold bull markets has been to shakeout all but the most ardent and bloodied investors. Those who obsess about the gold price on a daily basis, betray only their ignorance. The acquisition and possession of gold is not a speculation on higher prices. It has become a core component for the preservation of wealth in a cosmos of complexity and chaos.

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June 13, 2012