Tocqueville Gold Second Quarter 2012 Investor Letter

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 29 th , 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 $1523/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 $2000/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 fundaments 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 nterest 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.

John Hathaway
Portfolio Manager and Senior Managing Director

July 2, 2012

SECTION I: MACRO

Fig. 1: Gold and U.S. Real Rates

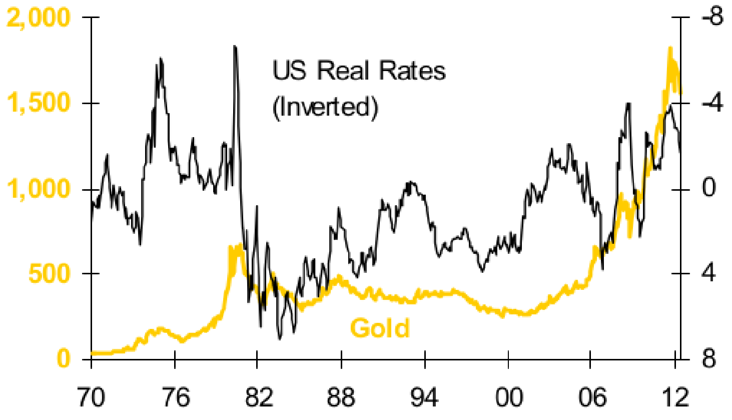


Fig. 2: Fed Balance Sheet (US$B)

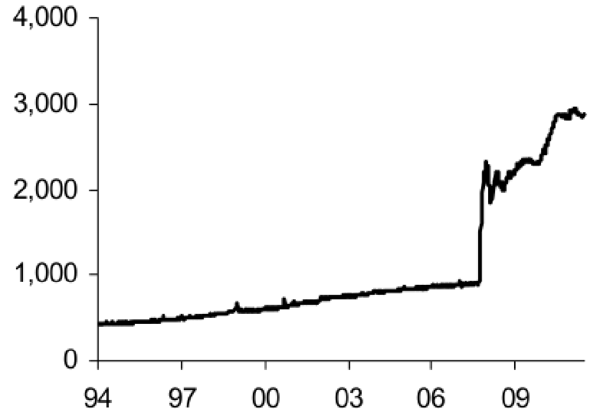


Fig. 3: Gold and ECB Real Rates

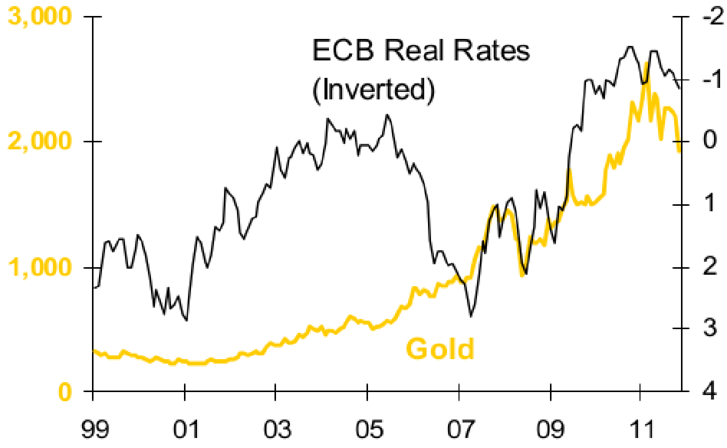


Fig. 4: ECB Balance Sheet (euro B)

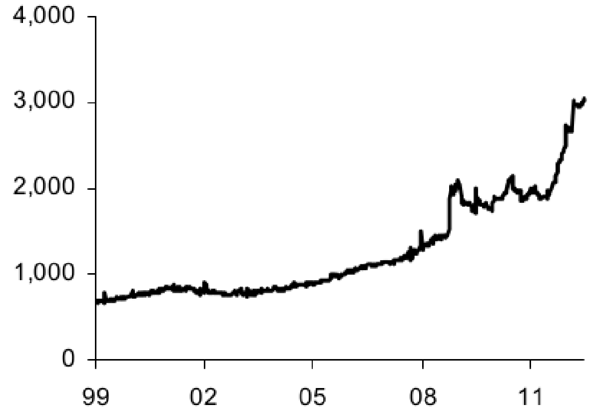


Fig. 5: Gold and Chinese Real Rates

Fig. 6: PBoC Balance Sheet (RMB B)

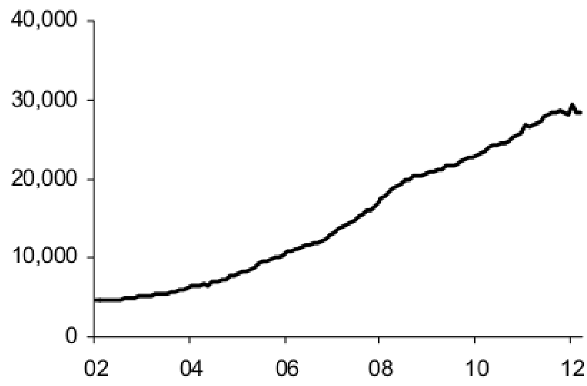
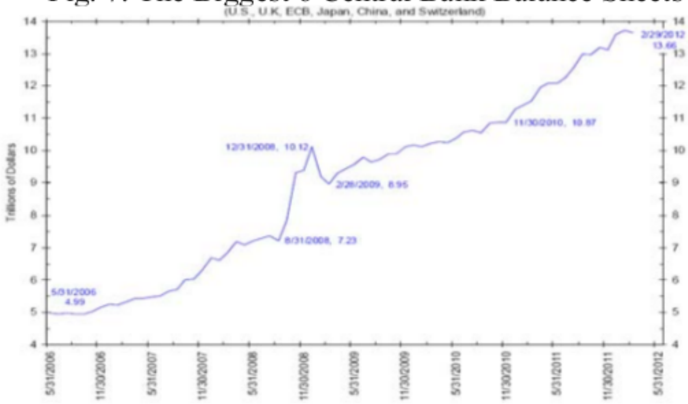


Fig. 7: The Biggest 6 Central Bank Balance Sheets



Source: Bianco Research

Fig. 8: Gold and M2 (US$T; Fed, ECB, PBoC)

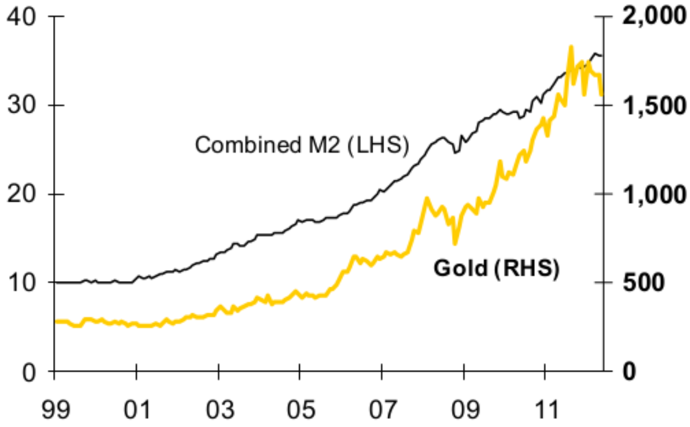


Fig. 9: U.S. M1 (YoY %)

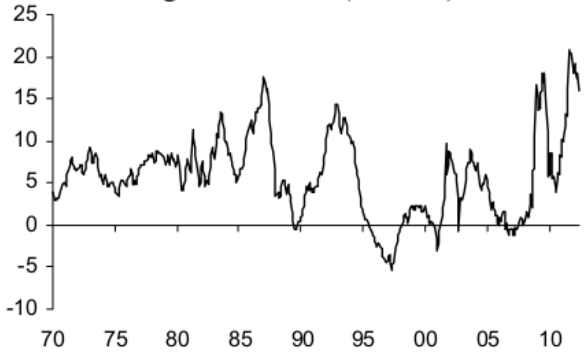


Fig. 10: U.S. M2 (YoY %)

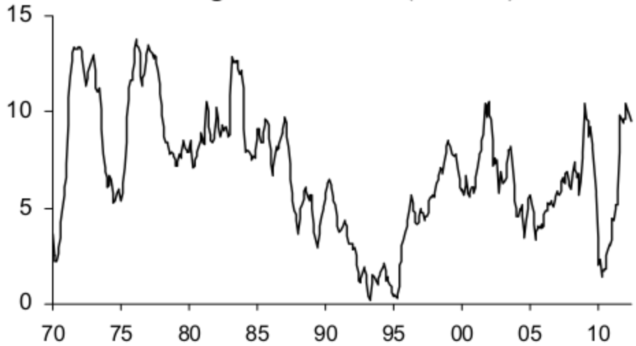


Fig. 11: ECB M1 (YoY %)

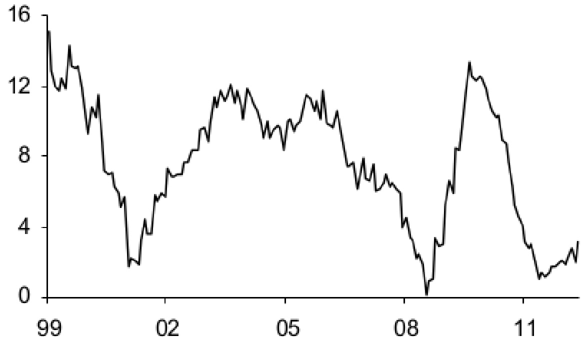


Fig. 12: ECB M2 (YoY %)

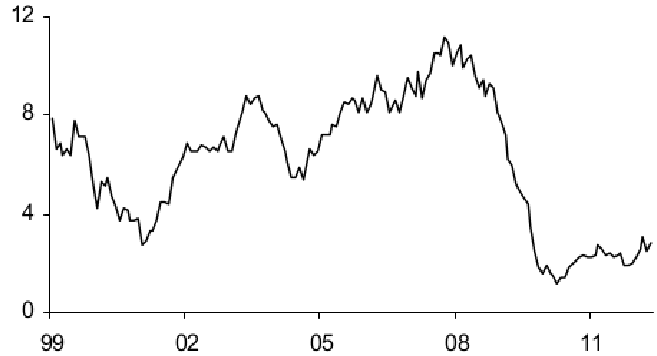


Fig. 13: PBoC M1 (YoY %)

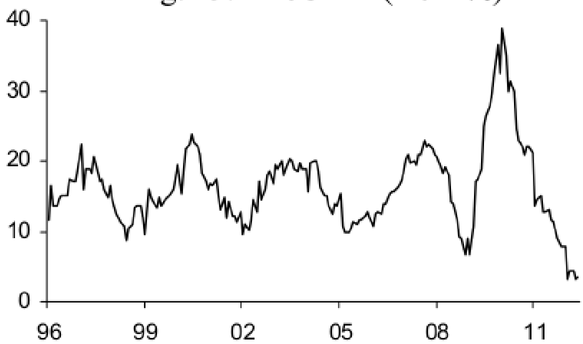


Fig. 14: PBoC M2 (YoY %)

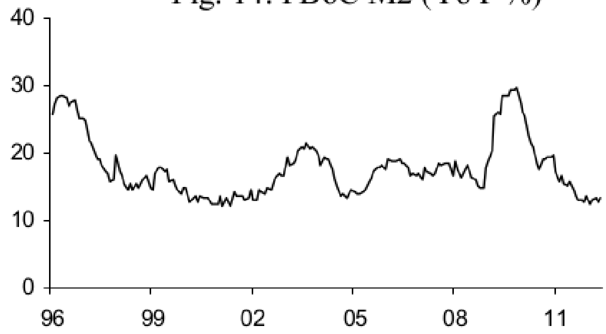
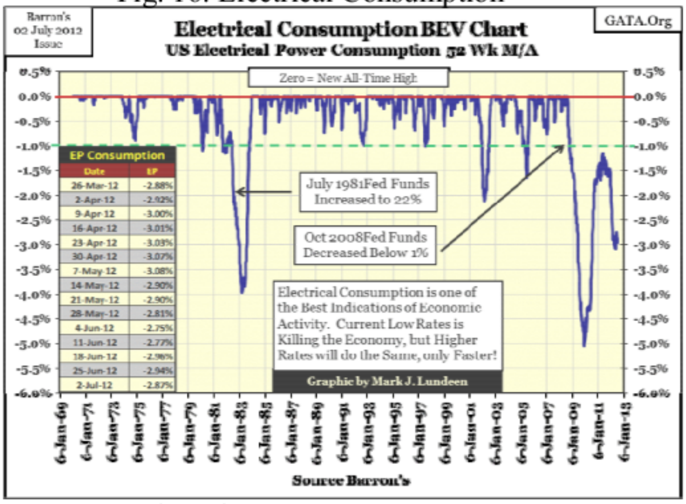


Fig. 15: Inflation

	U.S. (May)	Euro area (May)	China (May)
Headline CPI	1.7%	2.4%	3.0%
Core CPI	2.3%	1.6%	N/A
Shadowstats	9.3%	N/A	N/A
MIT Billion Prices	1.5%	N/A	N/A

Fig. 16: Electrical Consumption

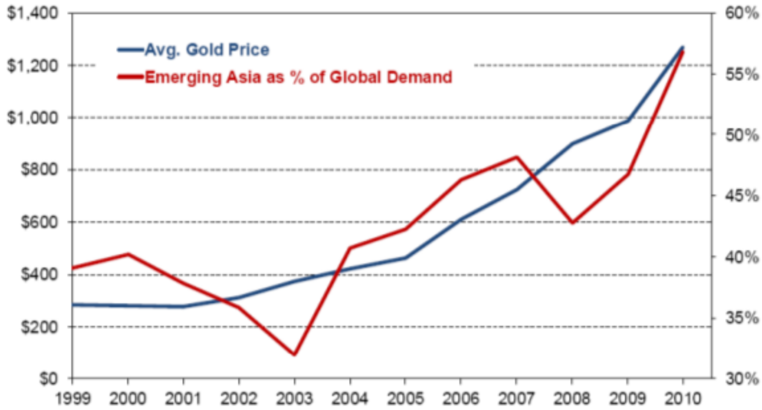


Source: Mark Lundeen, Barron's

Fig. 17: Central Banks Holdings of Gold (tonnes)

Source: World Gold Council

Fig. 18: Emerging Asia's Share of Gold Demand

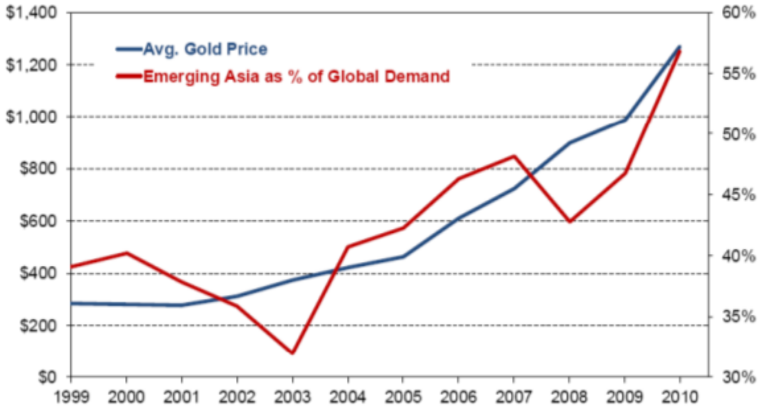


Source: GMO, GFMS, World Gold Council, Bloomberg

Fig. 17: Central Banks Holdings of Gold (tonnes)

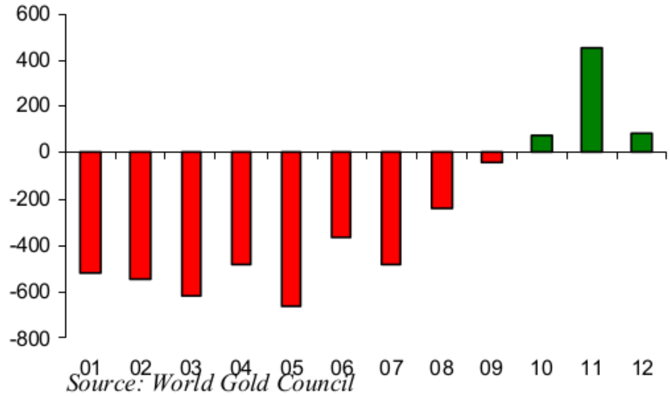
Source: World Gold Council

Fig. 18: Emerging Asia's Share of Gold Demand



Source: GMO, GFMS, World Gold Council, Bloomberg

Fig. 19: Central Banks Net Purchases (tonnes)



Source: World Gold Council

Fig. 20: Notable Transactions in Q1

Country	Tonnes	Transaction
Philippines	35.1	Purchased
Mexico	16.6	Addition
Turkey	14.3	Addition
Kazakhstan	14.2	Purchased

Source: World Gold Council

Fig. 21: Total Credit Market Debt as a % of GDP

Source: Ned Davis Research

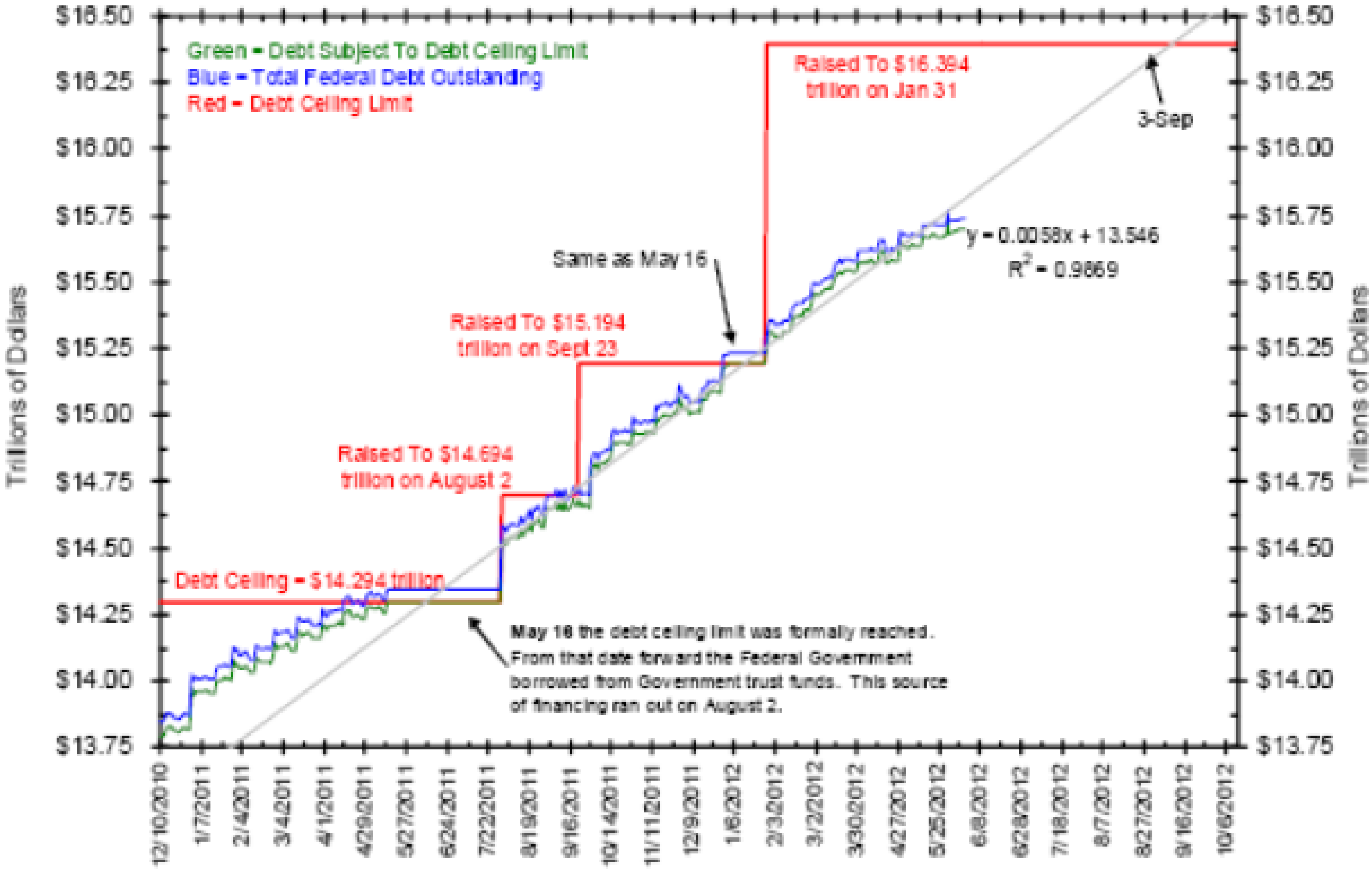
Fig. 22: Interest Expense on U.S. Public Debt

	Interest Expense (US$B)	Implied Interest Rate
FY06	406	5.1%
FY07	430	5.1%
FY08	451	5.0%
FY09	383	3.8%
FY10	414	3.5%
FY11	454	3.4%
FY12	272	2.8%

**Note: FY12 figures only include interest expense through May*

Source: Meridian Macro Research LLC

Fig. 23: The Debt Ceiling



Source: Bianco Research

Fig. 24: Quality Spread and Gold

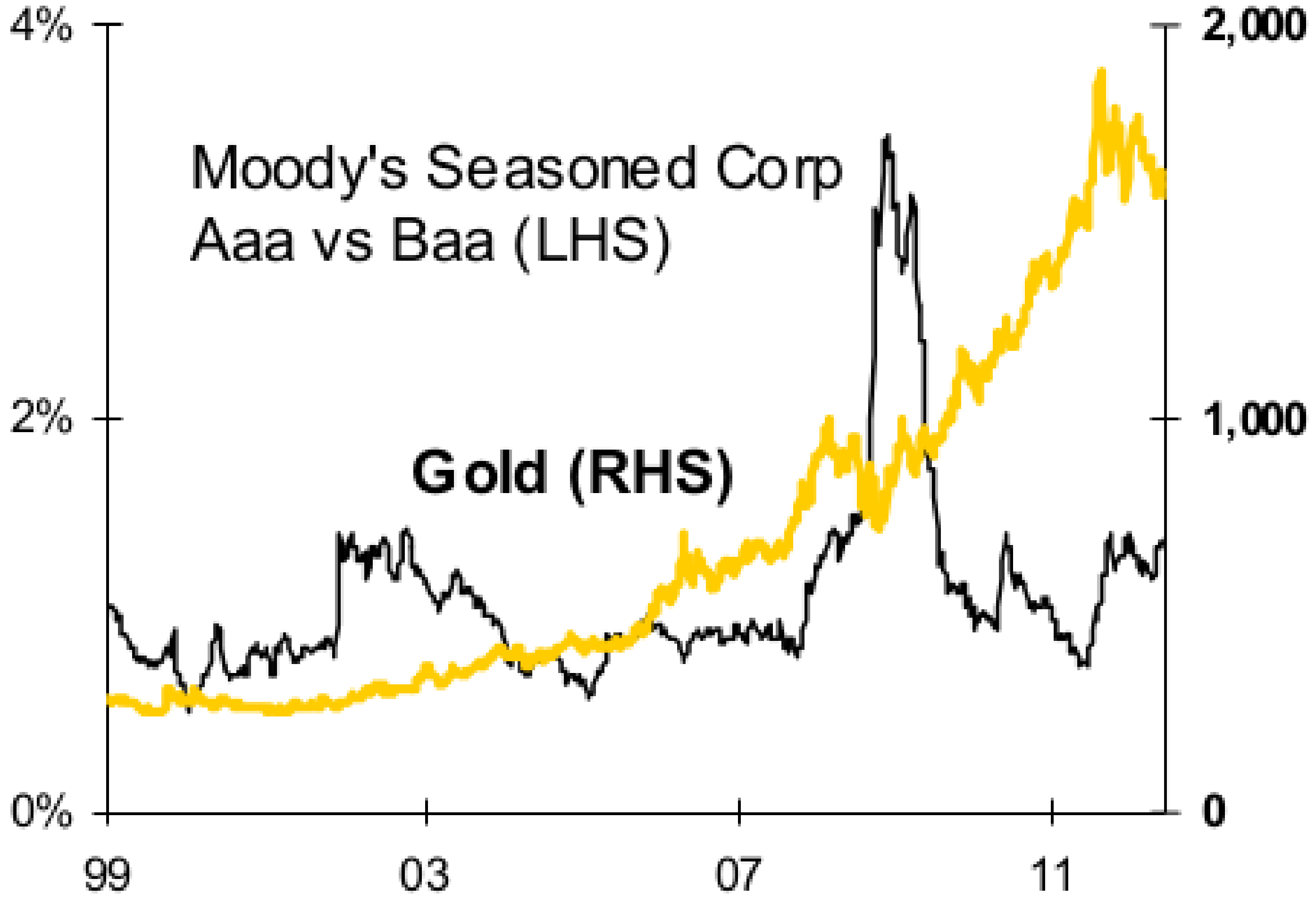
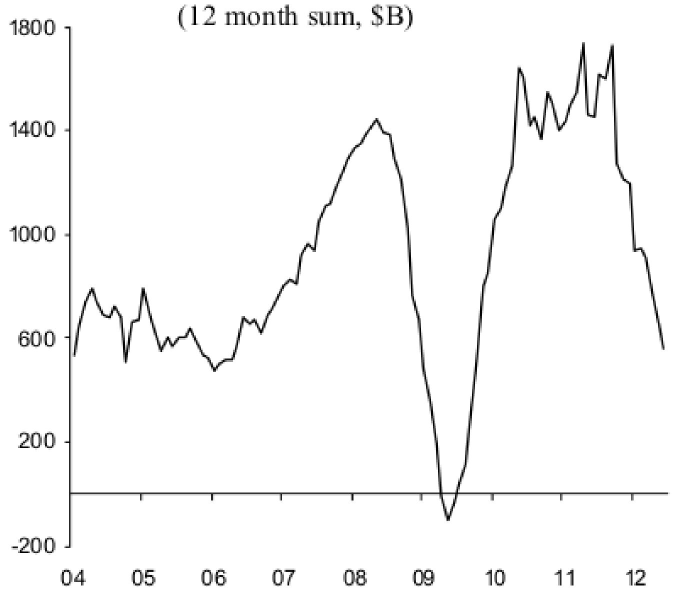


Fig. 25: Global Forex Accumulation
(12 month sum, $B)



Source: MacroMavens, LLC

Fig. 26: Annualized Monthly Growth in
Treasury and Agency Holdings under Custody ($B)

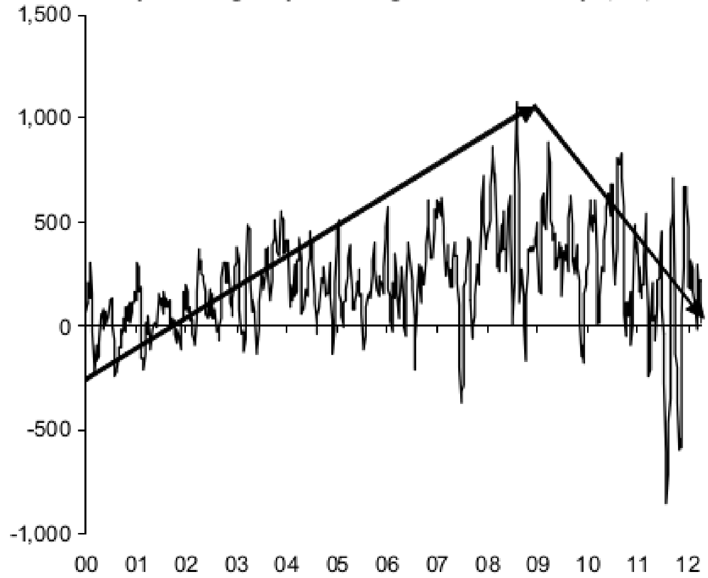
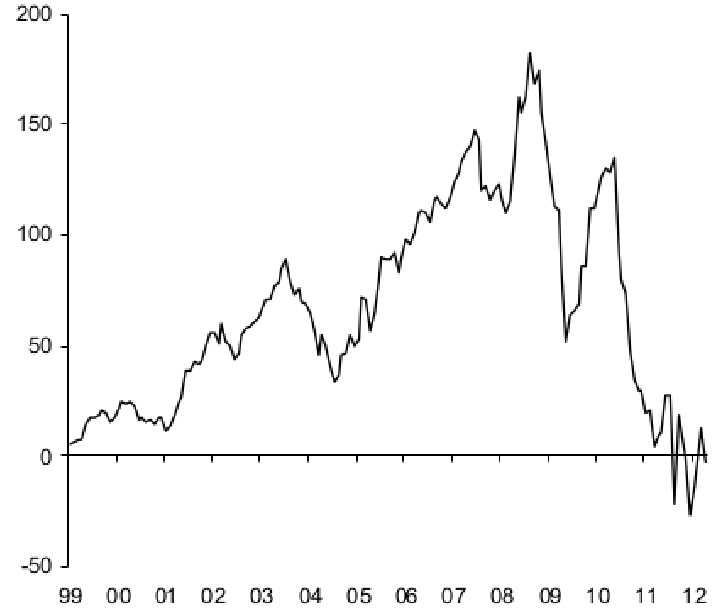
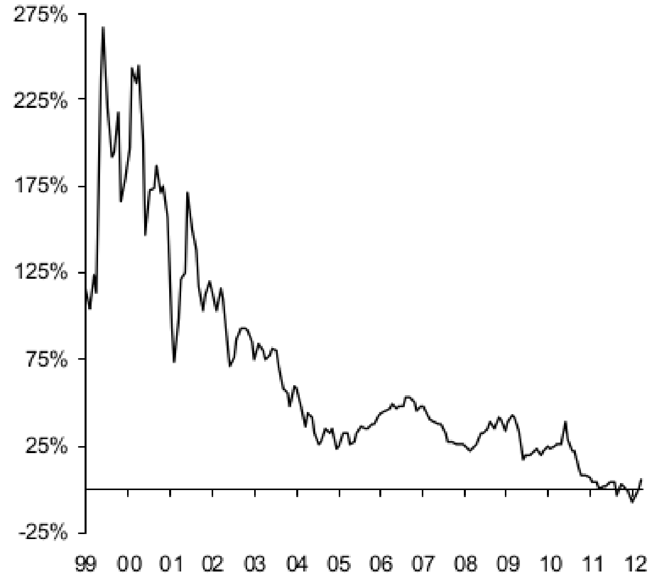


Fig. 27: China Net Purchases
of LT U.S. Securities (Annual $B)



Source: MacroMavens, LLC

Fig. 28: China Recycling
Purchases of U.S. Securities as % Forex Accumulation



Source: MacroMavens, LLC

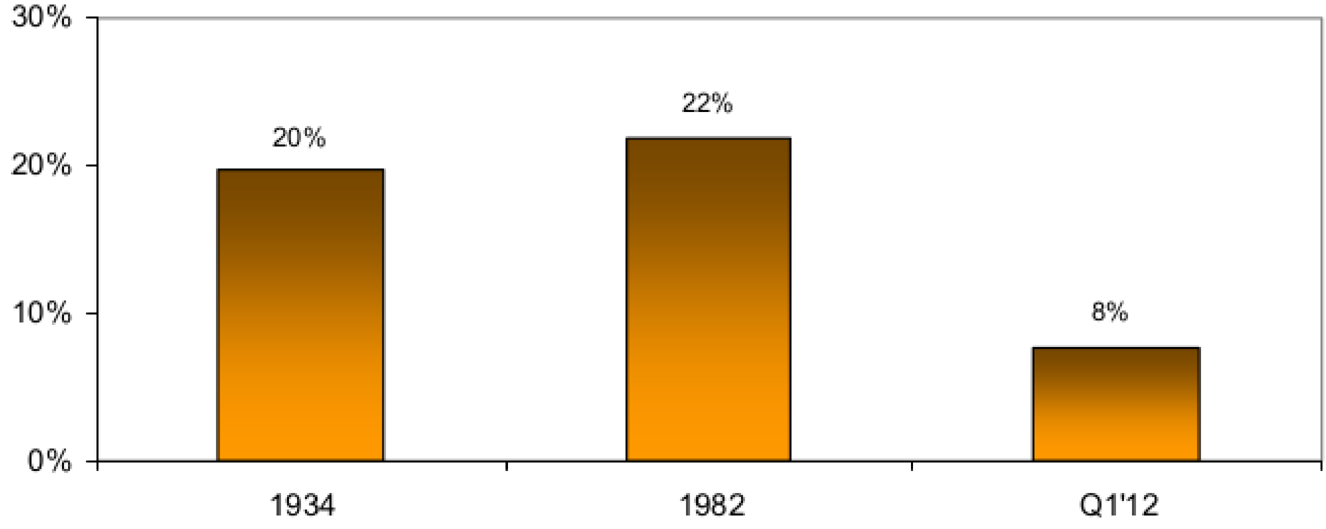
SECTION II: GOLD

Fig. 29: GFMS Gold Supply and Demand (tonnes)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011e
Supply											
Mine production	2 646	2 618	2 623	2 494	2 550	2 485	2 478	2 409	2 572	2 693	2 812
Old gold scrap	749	872	985	878	898	1 129	958	1 217	1 674	1 651	1 689
Subtotal: Traditional supply	**3 395**	**3 490**	**3 608**	**3 372**	**3 448**	**3 614**	**3 436**	**3 626**	**4 246**	**4 344**	**4 501**
Net official sector sales	520	547	620	479	663	365	484	236	41	0	0
Net producer hedging	0	0	0	0	0	0	0	0	0	0	32
Implied net disinvestments	0	0	0	15	0	0	0	0	0	0	0
Total supply	**3 915**	**4 037**	**4 228**	**3 866**	**4 111**	**3 979**	**3 920**	**3 862**	**4 287**	**4 344**	**4 533**
Demand											
Jewellery	3 009	2 662	2 484	2 616	2 718	2 298	2 417	2 193	1 759	2 017	2 032
Other	474	481	515	555	581	650	672	696	658	767	809
Total fabrication	**3 483**	**3 143**	**2 999**	**3 171**	**3 299**	**2 948**	**3 089**	**2 889**	**2 417**	**2 784**	**2 841**
Net official sector purchase	0	0	0	0	0	0	0	0	0	77	336
Bar hoarding	261	264	180	257	264	235	236	386	187	859	1 065
Net producer de-hedging	151	412	289	438	92	434	444	352	254	108	0
Implied net investments	20	220	760	0	459	365	169	330	1 429	516	292
Total Demand	**3 915**	**4 039**	**4 228**	**3 866**	**4 114**	**3 982**	**3 938**	**3 957**	**4 287**	**4 344**	**4 534**

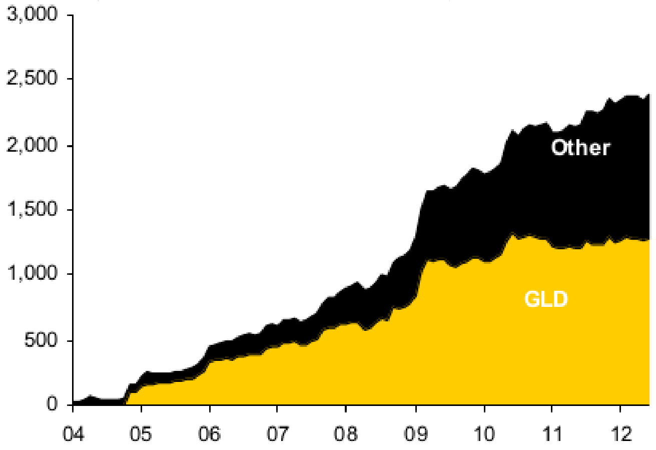
Source: AngloGold Ashanti, GFMS

Fig. 30: Market Cap of Above Ground Gold/ U.S. Financial Assets



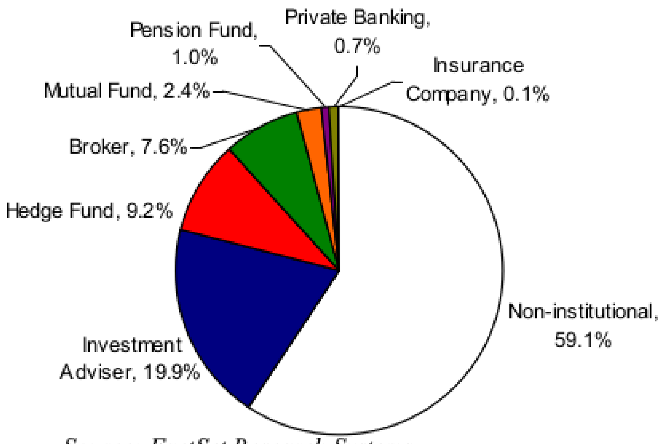
Source: Tocqueville Asset Management

Fig. 31: Tonnes of Gold Held by Gold ETFs



Source: World Gold Council

Fig. 32: Ownership of GLD by Type



Source: FactSet Research Systems

Fig. 33: Google Searches for: "Gold Bubble"

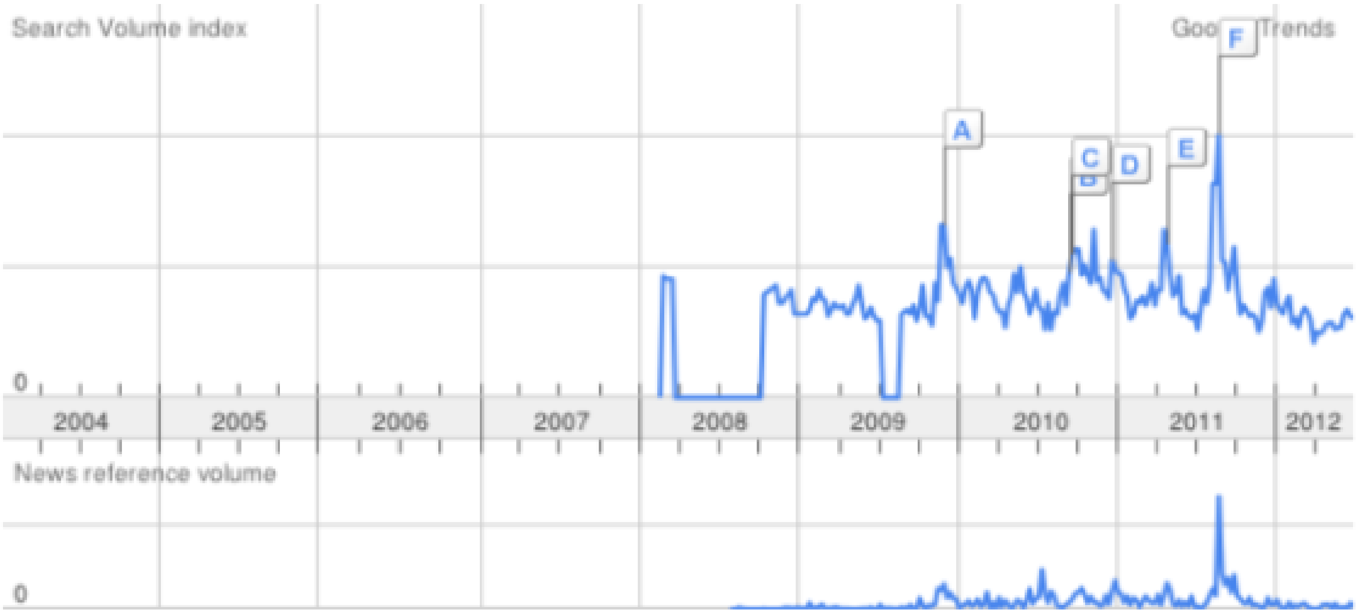


Fig. 34: “Gold Investment”

Fig. 35: Ned Davis Research Gold Sentiment Composite

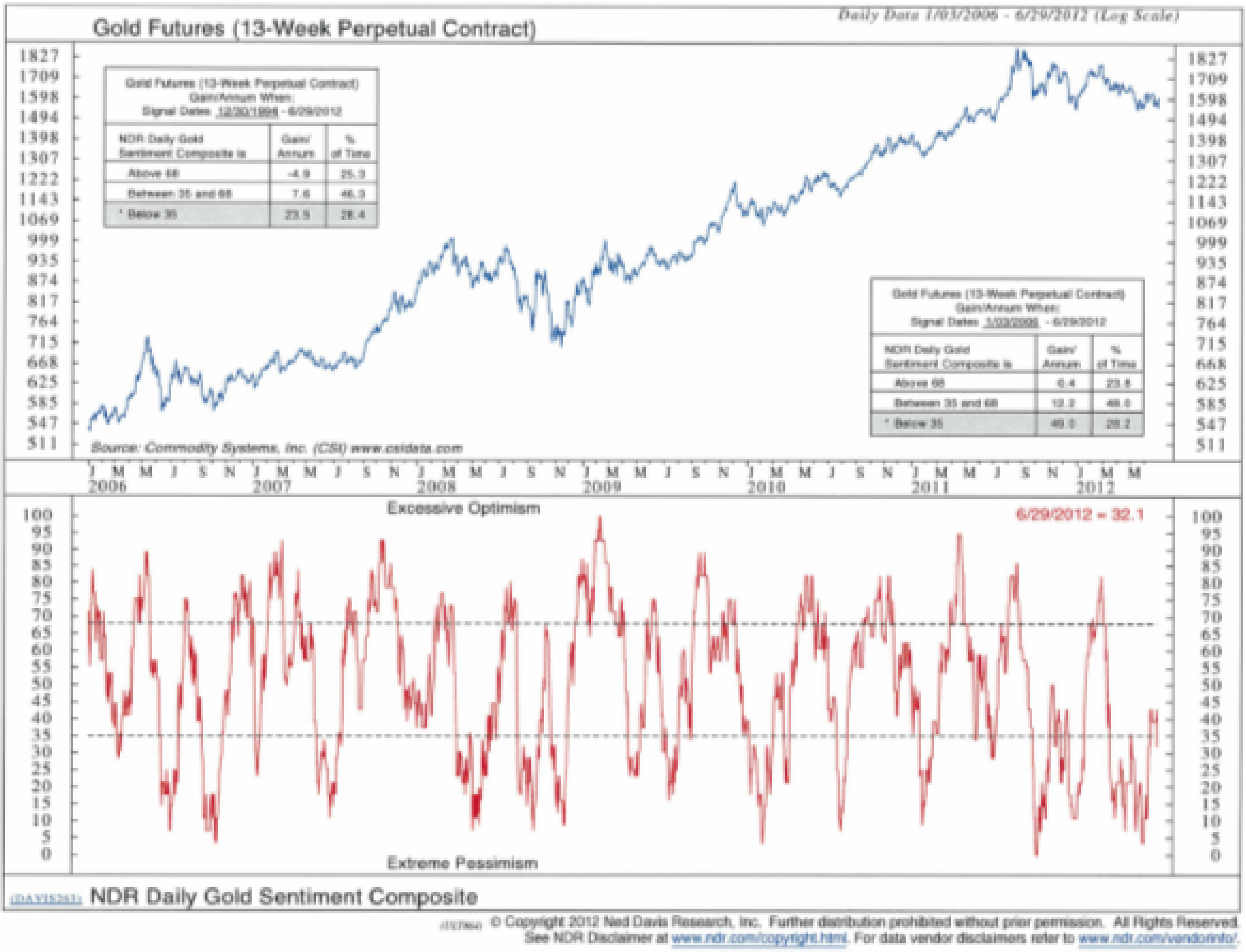


Fig. 36: Hulbert Newsletter Gold Sentiment Index

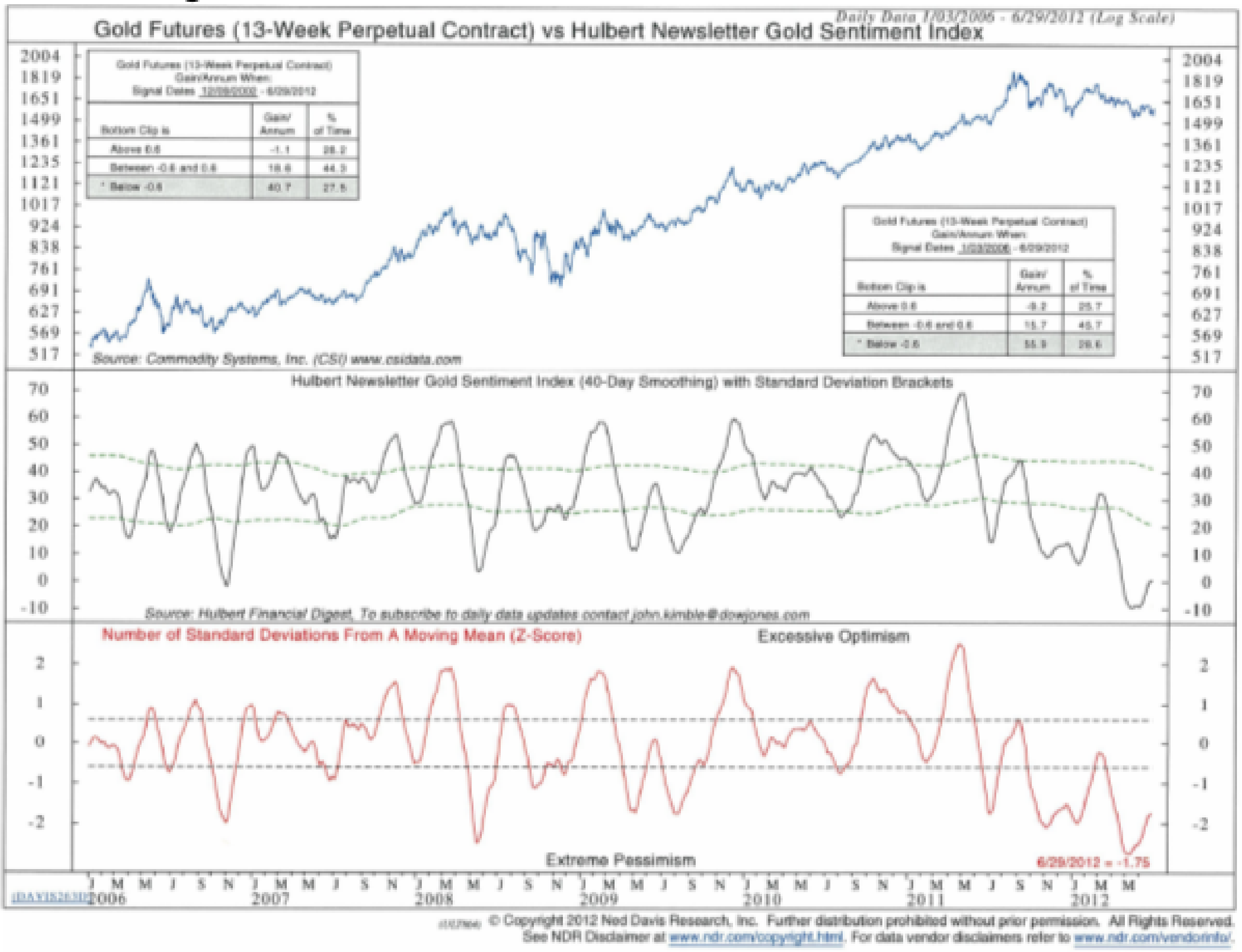
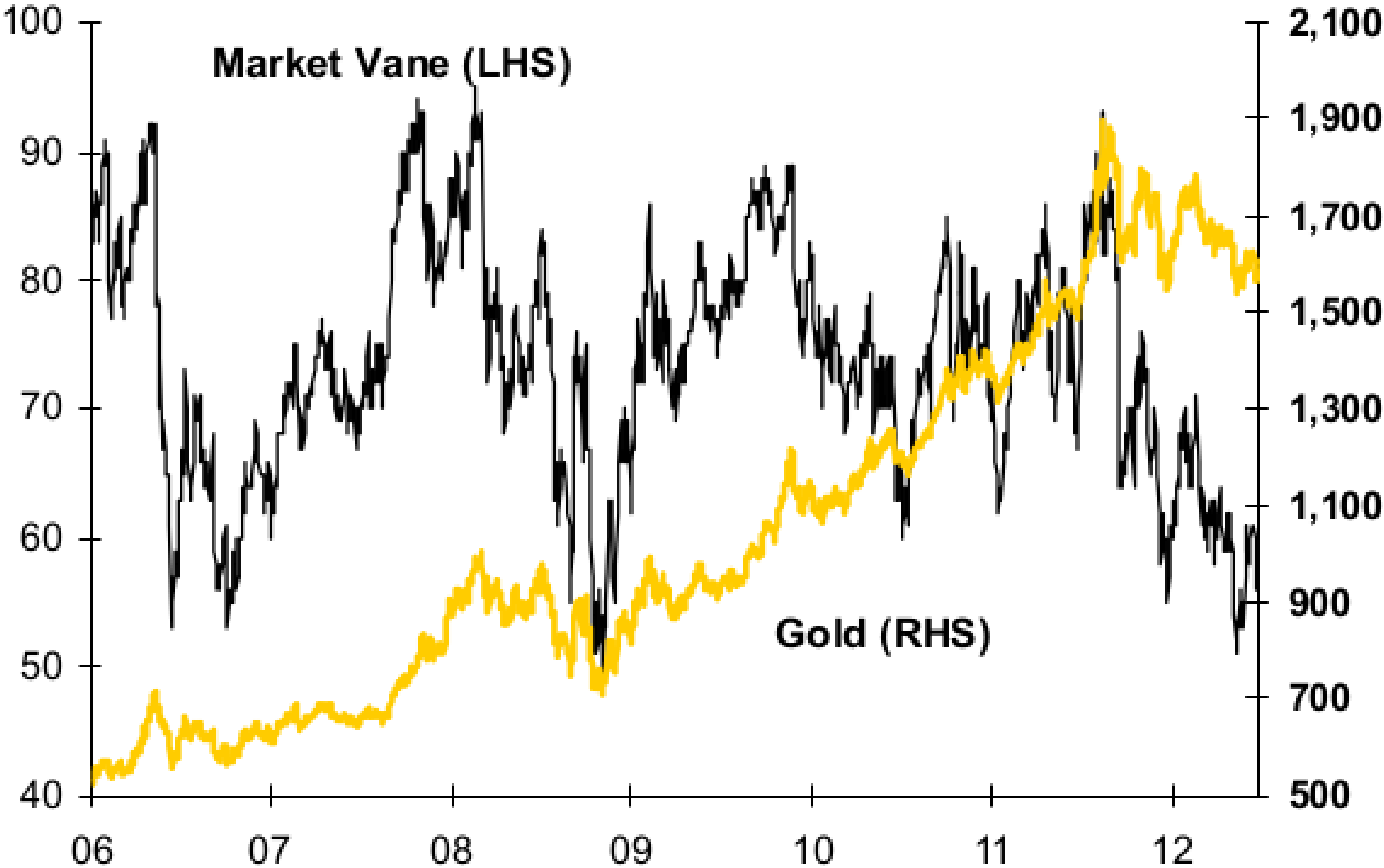
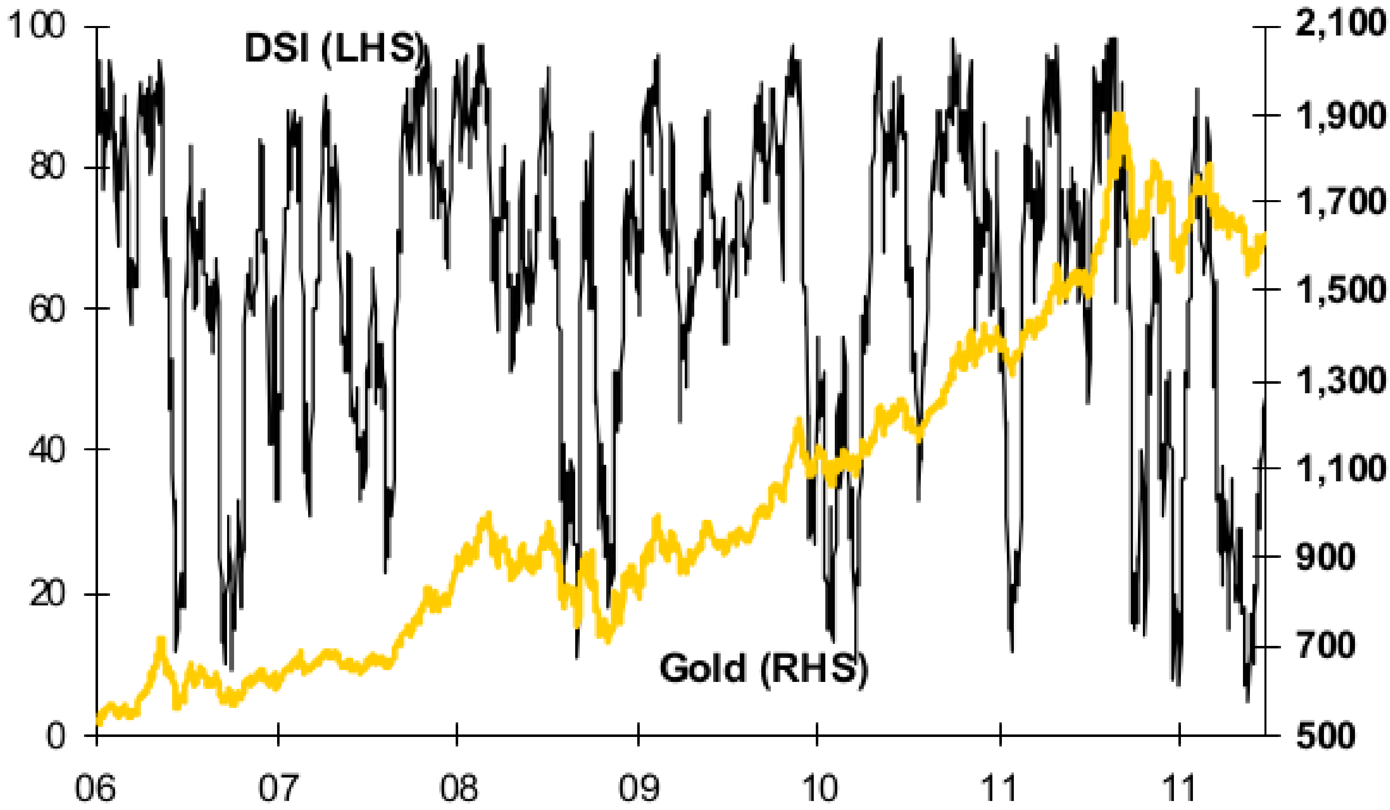


Fig. 37: Market Vane Bullish Consensus



Source: Market Vane

Fig. 38: Bernstein's Daily Sentiment Index



Source: Bernstein's DSI

Fig. 39: COMEX Gold Futures
Open Interest (tonnes)

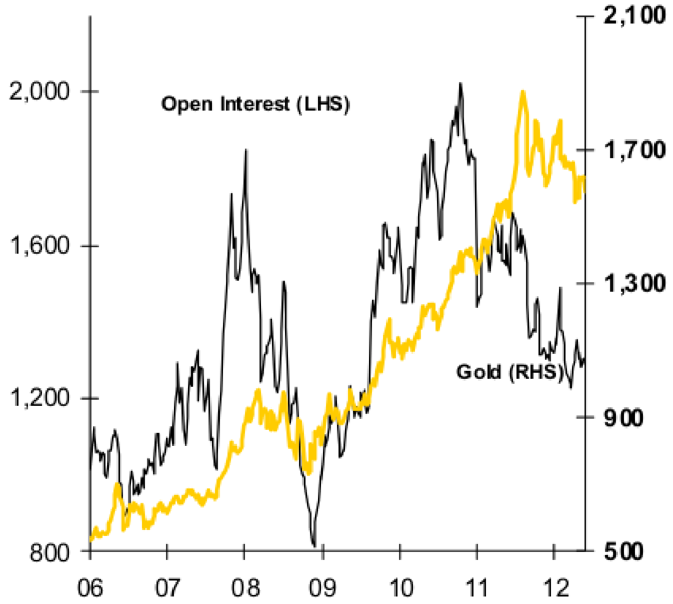


Fig. 40: COMEX Gold Futures
Activity (tonnes)

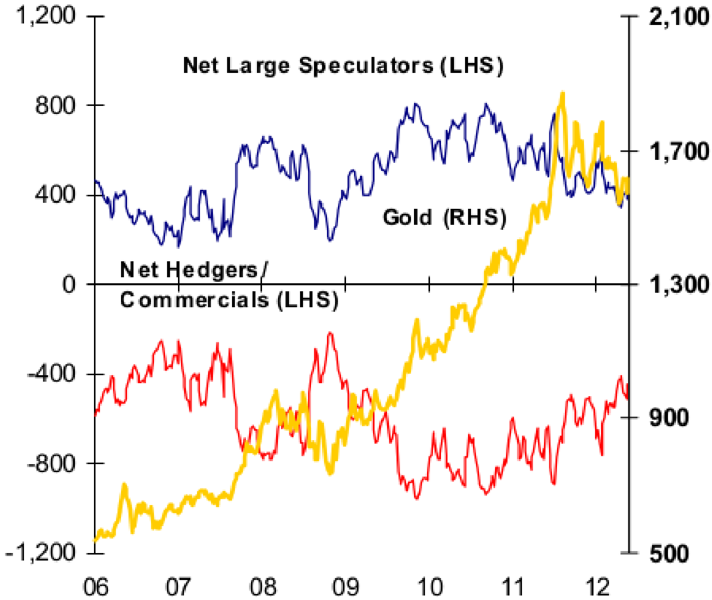
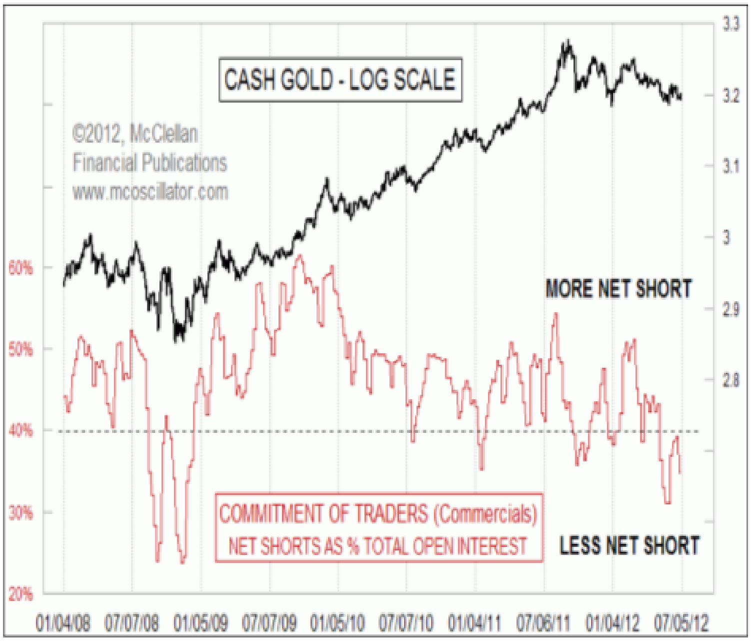


Fig. 41: Commercial Net Shorts
as a % of Open Interest



Source: The McClellan Market Report

Fig. 42: Gold
vs. Continuous Commodity Index

SECTION III: MINING EQUITIES

Fig. 43: XAU and HUI as a Ratio of Gold

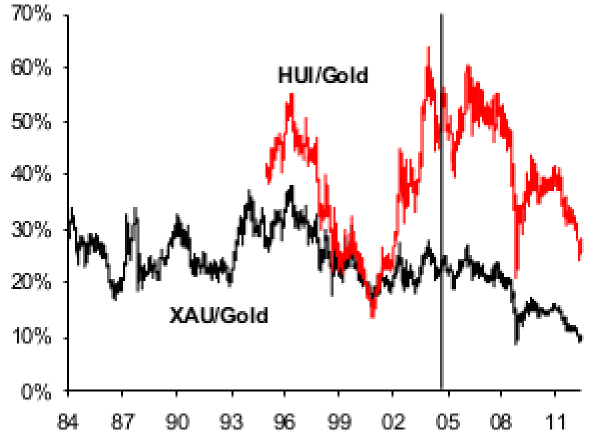


Fig. 44: GSA's Gold Stocks' Valuation

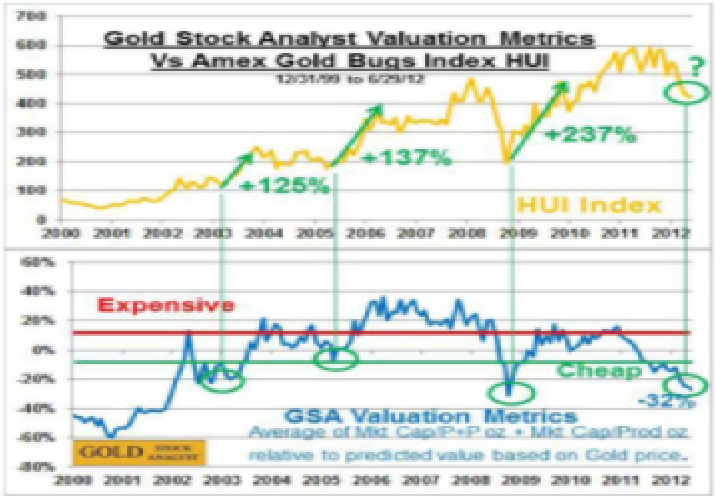
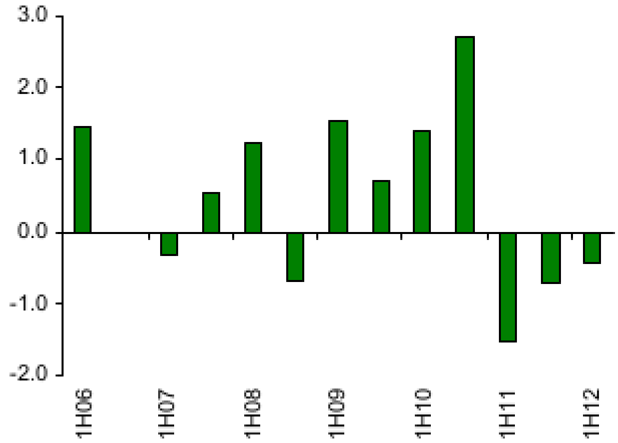


Fig. 45: Net Fund Flows for Lipper's Equity Precious Metals Fund Universe ($B)*



*Note: 1H12 figures do not include June.

Fig. 46: Market Cap of Van Eck Gold Equity ETFs ($B)

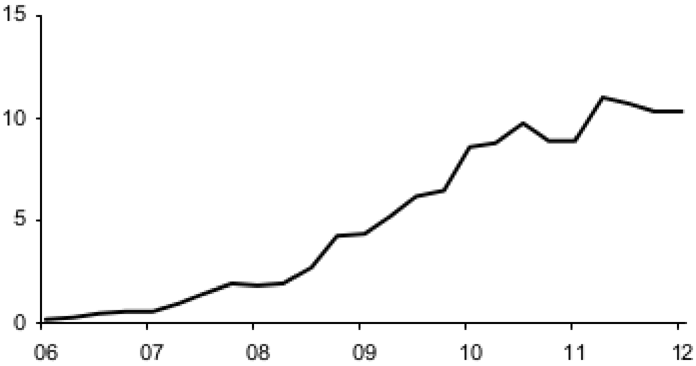
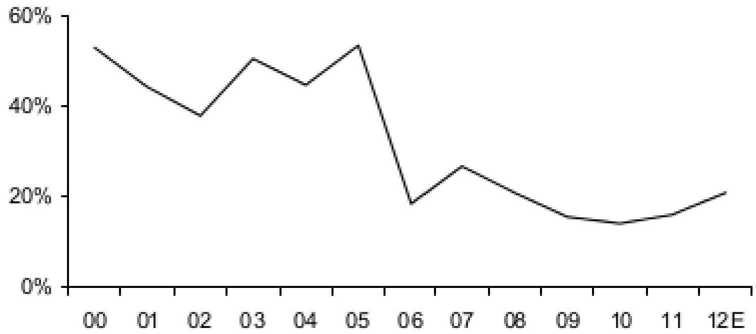
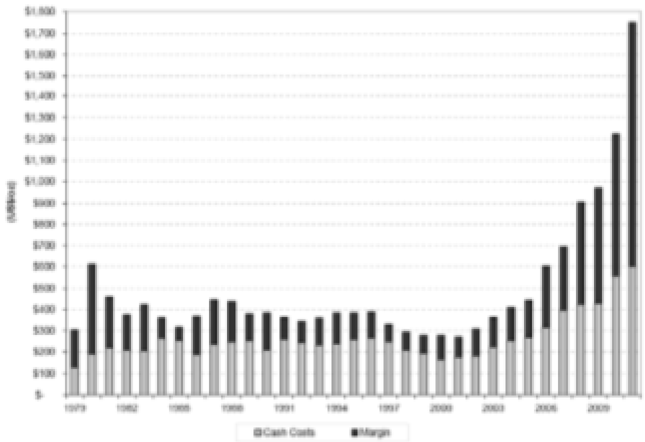


Fig. 47: Gold Miners Dividend Payout Ratio*



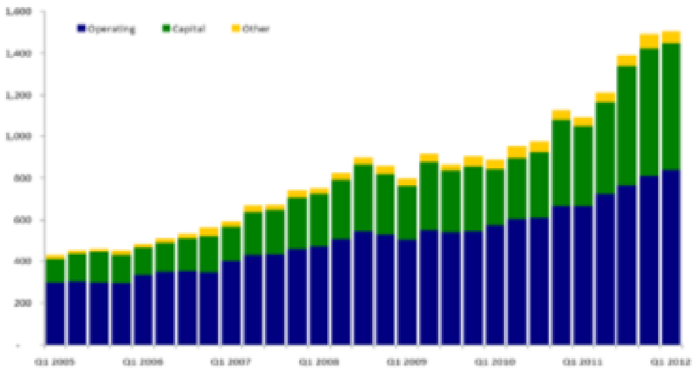
*Universe includes: ABX, NEM, GG, AU, GFI, KGC, NCM, BVN, HMY, AUY, AEM, IAG, CG, EGO, and GOLD

Fig. 48: Cash Costs and Margin



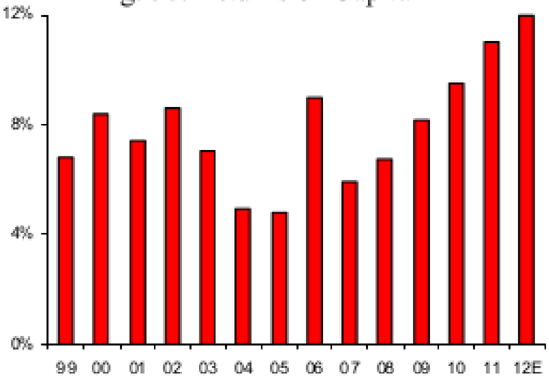
Source: Scotia Capital, GFMS

Fig. 49: Total Cash Outflow ($/oz)



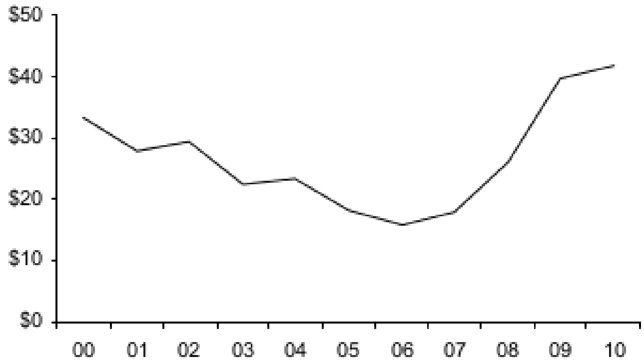
Note: Operating = Operating costs + Corporate costs + Exploration costs +Royalties; Capital = Ongoing + Expansion capital; Other = Finance costs and Other cash outflows
Source: Gold Fields

Fig. 50: Returns on Capital*



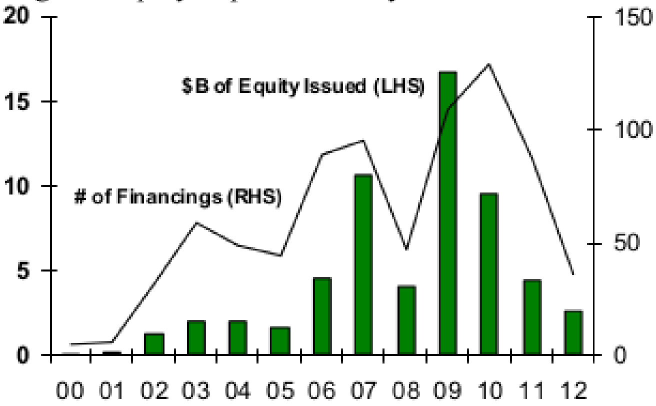
**Universe: ABX, NEM, GG, AU, GFI, KGC, NCM, BVN, HMY, AEM, IAG, GOLD, HL, BGO, CBJ, GLG, LIHR, MDG, PDG, HM, NDY, ASL*

Fig. 51: Average Discovery Cost ($/oz)



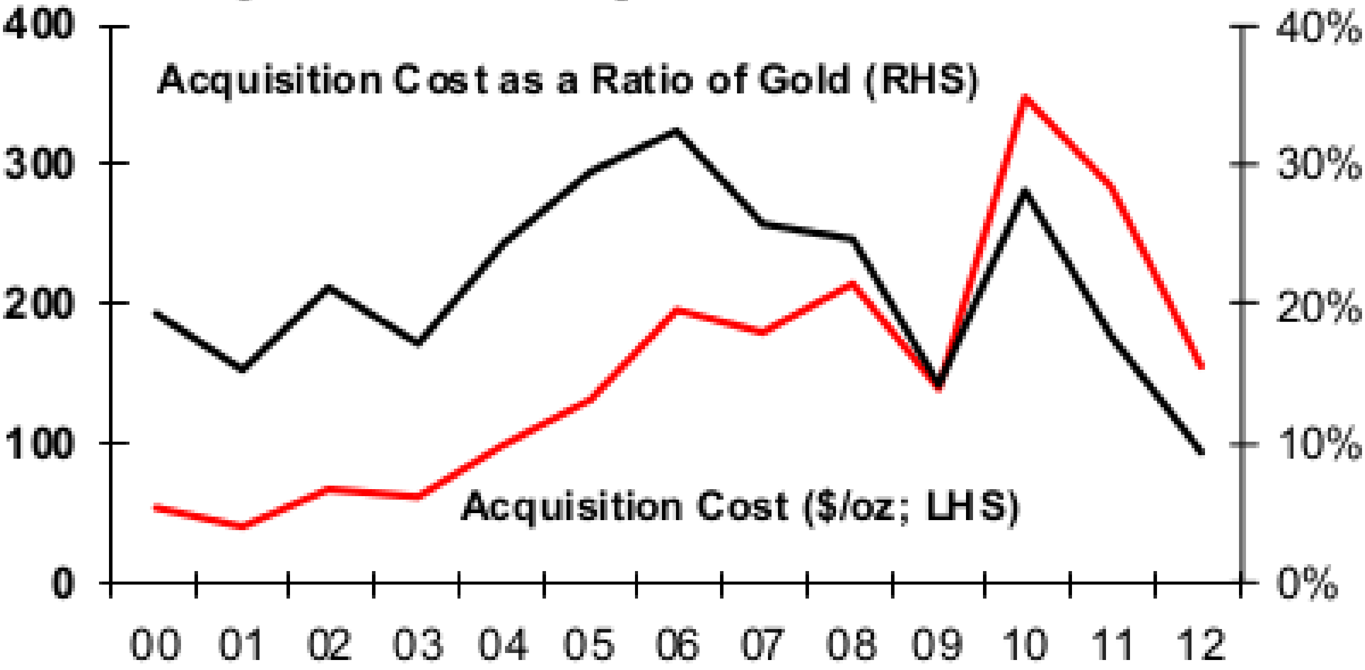
Source: Gold Fields, MinEx Consulting, MEG

Fig. 52: Equity Capital Issued by Gold Miners



Source: RBC Capital Markets, BMO Capital Markets

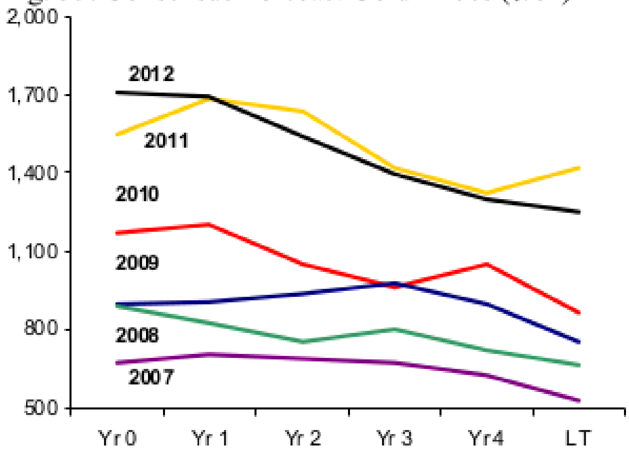
Fig. 53: Cost of Acquisitions in the Gold Sector



Source: RBC Capital Markets, BMO Capital Markets

Fig. 54: Gold Price Discounted by the Market

Fig. 55: Consensus Forecast Gold Prices ($/oz)

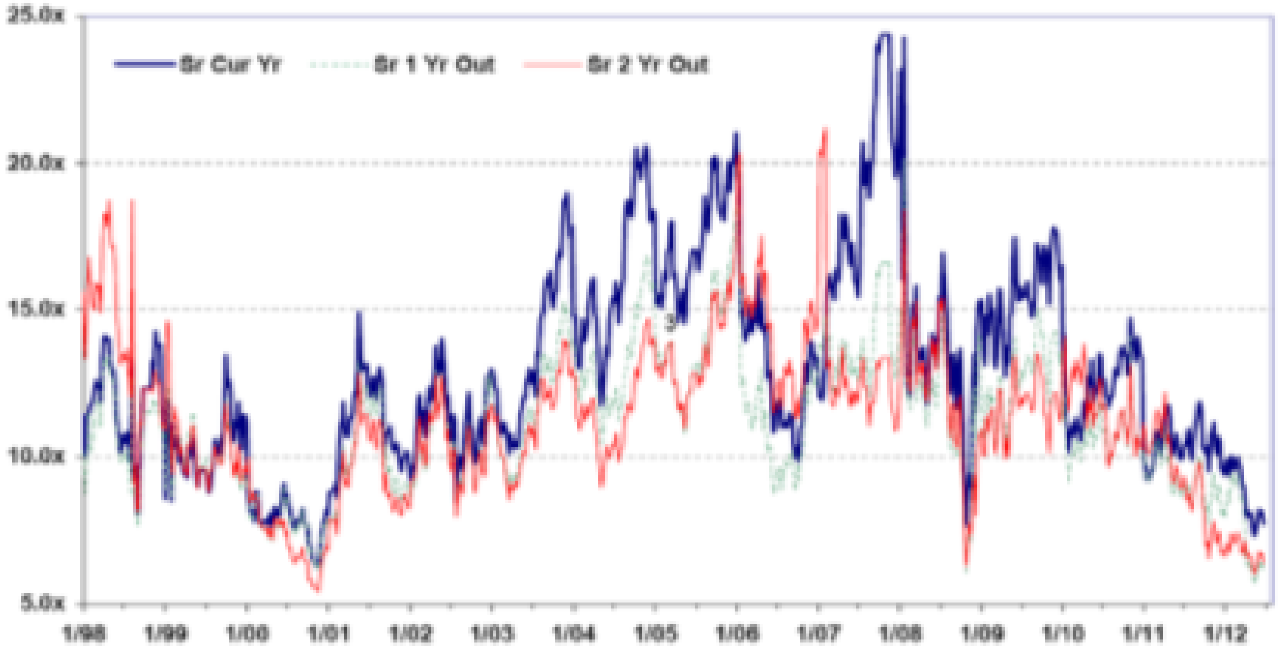


Source: Assorted N.A. Brokerage Research

Fig. 56: NAV Premiums- Senior & Intermediate Producers (N.A.)

Source: BMO Capital Markets

Fig. 57: P/CF – Senior Producers (N.A.)



Source: BMO Capital Markets

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