Tocqueville Gold Strategy Third Quarter 2018 Investor Letter

BY JOHN HATHAWAY ON *OCTOBER 2, 2018*

“Disorder in the house

There’s a flaw in the system

And the fly in the ointment’s gonna bring the whole thing down”

-Warren Zevon

In our August 21, 2018, strategy letter (“Gold: A Case of Extremes”), we focused on market structure and explained why we thought the chances were good that gold and mining shares were in the process of making an important low. In this letter, we focus on what we believe to be a key fundamental factor that could push the metal and share prices higher – the soon-to-be-obvious deterioration of US sovereign credit:

1. The US fiscal deficit is out of control. The August monthly deficit was the fifth largest on record. The 11-month number has already exceeded CBO’s forecast for the entire year. If the deficit expands by $1 trillion for the next 5 years, the nation’s current debt load of $21.5 trillion will compound at over 4%, assuming no recession and no rise in interest rates. We believe that it would be a stretch to contend that comparable GDP growth is likely. We also believe that nominal interest rates are set to rise and that there is a good chance of a recession by 2023. If so, the US debt burden will grow at a substantially faster pace than 4%. It is hard not to conclude that the US credit rating will slide in future years, and that current dollar strength must give way to glaring dollar weakness.
2. Crowding out. As the Fed winds down its balance sheet, public borrowing must increasingly fund the rising deficit. Treasury borrowing from the public through August 2018 was $970 billion, vs. negative $53 billion in 2017 from year over year through August. The planned winding down of Fed holdings of US Treasuries will be compounded by the fact that Social Security is now running a deficit. Interest rates will surely rise.
3. Interest expense on Federal government debt is currently $320.3 billion, but the interest rate hovers near a 10-year low at 2.47%. It is amazing that despite the low nominal rate, the budgetary outlay for interest is the highest since 2005. Average maturity is relatively short at 65 months and 42% matures in two years or less. The sensitivity of the fiscal deficit to a rise in rates is high. Each 1% increase in federal interest expense would add around $150 billion, or approximately 15% of the expected 2018 deficit.
4. Outlays for interest, entitlements (social security and health care), and veterans’ benefits exceed individual income tax receipts by 28%. These outlays are on automatic pilot, and impossible to reduce except through inflation, in our opinion.
5. 60% of personal income tax receipts are paid by 5% of the population. This equates to slightly above $1 trillion, or about 30% of total tax receipts of $3.3 trillion. According to Luke Gromen (writer of the excellent newsletter *Forest for the Trees*), “Since the Clinton administration rendered executive cash compensation above $1mm non-deductible for tax purposes, compensation for this elite 5% of tax payers has shifted from straight salaries to equity options and other forms of deferred compensation highly sensitive to the stock market. A decline in the stock market is therefore likely to increase already high US deficits in a non-linear fashion, putting further pressure on the US fiscal picture, and with it the US credit worthiness.”
6. The “jump to default risk” is high for US sovereign credit, in our opinion. It would be triggered by

rising interest rates, intractable fiscal deficits, and surging issuance of government debt. Higher interest rates threaten lofty financial-asset valuations. A sharp or prolonged decline in the equity market, because of its crucial linkage to government revenue, could quickly lead to a run on the US currency.

According to Ray Dalio, in a Bloomberg interview (Sept. 12, 2018), there is a risk of a "30% depreciation of the dollar" over the next two years. His reasoning is the same as ours. We agree that a general loss of confidence in the US currency is credible risk. Dalio thinks that a dollar crisis is still two years away. We disagree; we believe that it could happen sooner. Investors, in our opinion, are generally complacent to this issue, but we believe that they will not remain clueless for that long, as there will be too many signs well in advance of the fiscal predicament.

We believe that the gold market bottomed in August, and that exposure to precious metals is a credible strategy to mitigate risk of a dollar collapse.

Tocqueville Gold Monitor [pdf]

John Hathaway

Senior Portfolio Manager

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