
Tocqueville Gold Year-End Investor Letter - 2011

January 3, 2012



2011 was a good year for gold bullion, up 11.3%, but a tough year for gold stocks which declined 18.3% based on the XAU index of gold and silver stocks. We addressed the reasons for the disparity between the performance of gold bullion and gold mining stocks at length in our web site article (The Golden Mulligan-September 2011). We concluded then, and still maintain, that gold mining equities represent a compelling investment strategy to participate in the secular bull market in gold bullion, and conversely, the secular bear market in paper currencies.

Since its peak price of \$1,921/ounce on September 6 of this year, the metal has corrected 18.6% to its current price of \$1,564. The four month pullback has taken its toll on gold mining shares, which declined 20.4% during the same period. For reasons to be elaborated in the following paragraphs, we believe that the decline in both the metal and the shares has run its course. We also believe that this painful correction has set the stage for significant new highs in both the metal and the shares in 2012.

Since the global credit meltdown of 2008, governments in the Western democracies have stepped in to stabilize the financial and economic system. Their strategy has been to substitute sovereign for private credit. Unfortunately, changing the wrapping does not alter the contents. This approach bought time, but now time is running out as sovereign credit itself is under attack. Stress is most visible in Europe, but the U.S. is implicated because the Fed is complicit in measures to shore up the European banking system through dollar swap arrangements. The contagion is not limited to a few peripheral states in Europe that have spent beyond their means. In our opinion it is a fundamental ailment common to democratic societies, reversible only through a financial and economic crisis sufficient to galvanize public will.

What this portends for 2012, we believe, is unfortunately, further turbulence in the financial markets, anemic economic conditions, and ultimately, overt and undisguised monetary debasement. The flashpoint for gold and related equities will, in all likelihood, occur when central bankers and political leaders cave in to market stress. In the absence of economic growth, mob clamor for money printing to ease the burden of debt that is destabilizing markets and economic activity seems likely. Therefore, maintaining precious metals exposure while this painful correction winds down would appear to be the most advisable course of action. When the policy dilemma becomes so obvious that central banks begin dumping dollars for gold, it may be too late to replace positions. Gold has a history of shaking out all but its staunchest holders and making losers out of sold out bulls.

This letter is appended by numerous charts and tables, divided into three sections, macro, gold, and mining equities. Each section conveys an important aspect of the fundamental case for gold and gold mining shares more efficiently than a lengthy number of paragraphs.

[CLICK HERE TO DOWNLOAD CHARTS/TABLES](#)

The macro charts (section I) show unprecedented growth in central bank assets. This growth is the substitution of sovereign for private sector credit. Financial repression is indicated by negative real interest rates across the globe, and a green light for capital to flee financial assets for gold and other safe havens. Look for financial repression to become part of everyday terminology in 2012. Aside from negative real rates, financial repression would include mandatory investment in treasury debt for institutions and possibly individuals. It might include restrictions on capital transfers across borders. Such measures might be seen as a way to keep a lid on interest rates and control capital flows.

Central bank balance sheet expansion has resulted in rapid monetary growth in the U.S., but not as yet in Europe. We expect European monetary aggregates to accelerate in 2012. Macro charts to watch are purchases of Treasury securities by China, which slowed dramatically in the second half of 2011. Should this continue, it could pressure U.S. interest rates. A 200-300 basis point rise in U.S. nominal rates would likely offset prospective progress in reigning in the fiscal deficit. Inflation is rising but understated by official government statistics. The Shadowstats inflation series is based on the calculation methodology used before numerous revisions under the Clinton and Bush administrations. We believe that the all but unstated intention of the Fed is to ignite inflation, as it represents the most politically expedient path to lower debt burdens.

In the charts specific to gold (section II), note the rise in central bank purchases. We expect more of this to come as important central banks, particularly China, India, Brazil etc. look for alternatives to their reserve holdings of euros and dollars. There is a steady stream of commentary from central bank officials in these countries indicating a desire to expand gold reserves. The respective exits and entryways from the dollar and into gold are very narrow and therefore a concerted shift by the official

sector into gold would have a dynamic impact on the metal's price. Also noteworthy are the various sentiment gauges (Market Vane, Hulbert, DSI etc.) which are at rock bottom levels across the board. They tell a story of a market that is bottoming. Markets in which fear is dominant have historically represented excellent buying points.

The section on mining equities (III) reflects strong fundamentals and extraordinary valuations. Even if the gold price does not rise in 2012 as we would expect, the companies should continue to report strong earnings and cash flow. There will be pressure from investors, including Tocqueville, to increase dividend payouts. Those companies that respond accordingly will in our opinion generate the best market performance. Valuations, as reflected by the discount of the shares to the metal prices, and other important indicators, are historically low. While the merits of gold bullion are many, it yields nothing and generates no internal growth. Gold mining equities provide both and in addition represent deep in the money long term call options on possible future appreciation in the gold price.

In summary, a strategic investment commitment to gold and gold shares continues to make sense based on the prospect for continued monetary debasement. The difficult correction of the last four months has shaken out all but the strongest holders, a perfect set up for advances to new all- time highs in the coming year.

With deep appreciation for your continued support and best wishes for the New Year,

John Hathaway
Portfolio Manager and Senior Managing Director
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