Contrarian Music

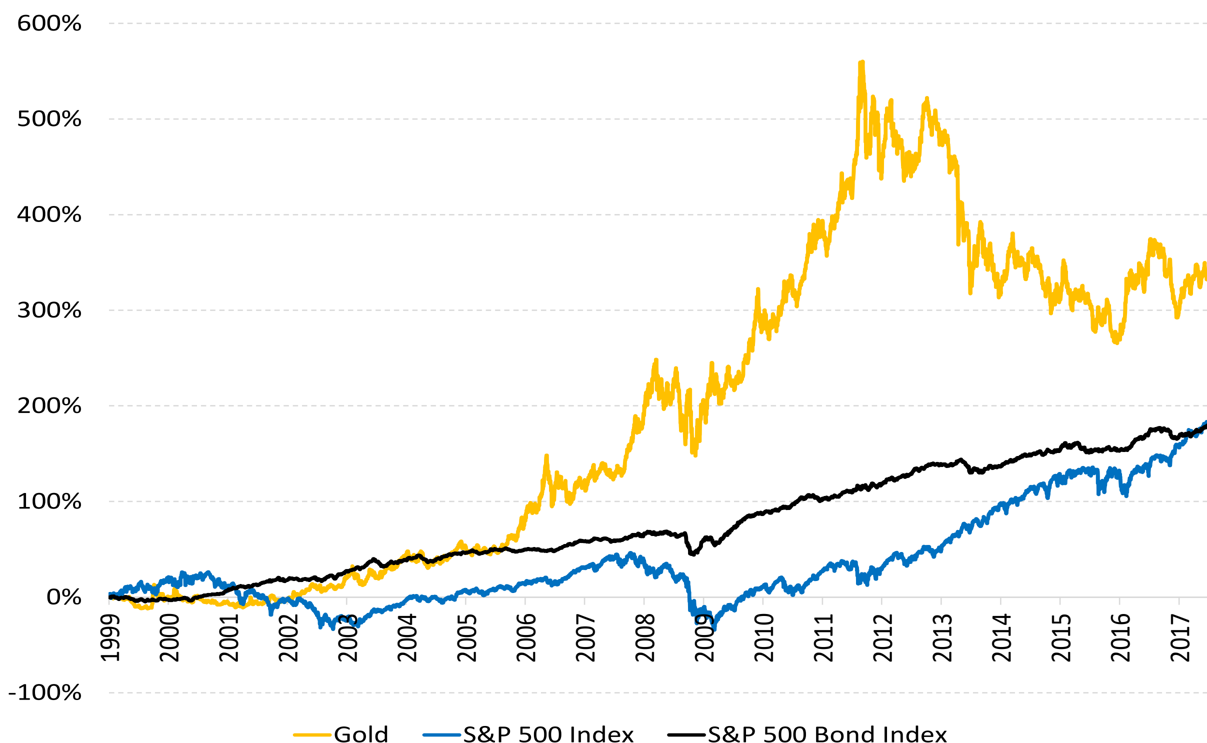
Tocqueville Gold Strategy

Third Quarter 2017 Investor Letter

Gold appears to have formed a solid base since bottoming at year-end 2015 at $1060.00/oz. Through 9/29/17, the metal's price increased 11.10%, even after a sharp pullback from its early September 2017 high of $1355. As of September 30, 2017, the price stood at $1280.15, 20.75% above its low at year-end 2015.

In our view, gold and the precious-metals complex is in the early stages of a dynamic up-cycle that will match or exceed the run from 2000 to 2011. Downside appears limited; the greatest challenge for investors will be to muster the necessary patience to hang on until the up-cycle becomes more assertive and evident.

Despite the four-year correction from $1900/oz. to $1060 at year-end 2015, gold has outperformed stocks and bonds since 2000, the dawn of radical monetary practices by the world's central banks. We have shown the chart below in previous letters, and repeat it again here only to emphasize this under-recognized fact.

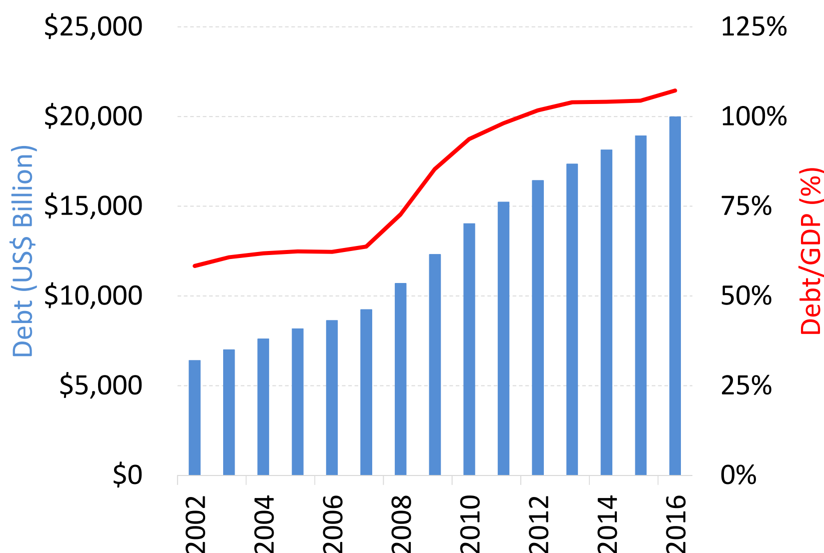


Despite this record, gold is deeply out of favor and dramatically underrepresented in the portfolios of wealthy families and institutions in the Western world. Gold mining shares

have uncharacteristically barely kept pace with the gold price (GDX, the most commonly followed mining-share ETF, has risen only 9.75% year-to-date). This tepid performance relative to the metal is one of many signs of prevailing negative sentiment. Despite modest gains year-to-date, gold mining shares remain sold out and very cheap in light of their upside potential, which will be driven by their own fundamentals as well as those affecting the gold price.

Unsound monetary policy is the most important driver of our gold thesis. The exit from radical monetary policy will be difficult, if not impossible. On this point, we recently had an off-the-record conversation with a former governor of the Fed, who wholeheartedly agreed with this assessment.

Gold is an efficient hedge against the real possibility that the Fed will be unable to exit its super-easy stance without triggering significant disruptions in financial asset valuations, imperiling already weak economic momentum, and destroying any pretense of fiscal sanity. A 1% rise in interest rates increases the federal deficit by 25% to 3.9% of GDP. The fiscal vulnerability is underscored by the fact that 50% of the debt matures in less than three years.



The US debt-to-GDP ratio is now 106%, a level that has historically been economically destabilizing to other countries and that has often led to blatant monetary printing and currency destruction. It is not just a U.S. problem, world-wide global debt burdens are sufficiently high that only small rate increases are required to inflict significant economic and market damage.

Concern over North Korean nukes is commonly credited as the reason for gold's push to new high ground this summer. Of course, we hope that these concerns prove to be transient.

Also credited with gold's recent strength, according to conventional wisdom, is the pronounced dollar weakness according to the U.S. dollar index (DXY), which blossomed during July and August. Keep in mind that gold rose from roughly $300 to $1900 from 2000 to 2011. That 11-year period encompassed intervals of both extended dollar strength and weakness. It is therefore incorrect, in our opinion, to attribute primary influence for gold's direction to short-term fluctuations in the dollar exchange rate.

In 1999 gold began to rally, and few could figure why. Anticipating proximate causes for major price trends is only speculation. Gold was well into a major upswing before the dot-com bust, 9/11, ultra- low interest rates, the housing bubble and mortgage-backed securities debacle, and the 2008 credit crash. These headlines of course fueled a bull trend that was already well underway. At the end of the day, price makes news and the headlines follow. The obvious lesson is that all markets, including gold, discount future events and that the development of prices in the absence of easily articulated causes must be respected.

The prospects for gold and its price behavior today appear similar to those of the early 2000s. The gold price has been advancing for nearly two years for no obviously apparent reason. What we know is that the financial markets are bulging with systemic risk. Financial-asset valuations by many measures (see below) are at all-time highs; to our way of thinking, they constitute prima-facie evidence of significant risk.

Source: John Hussman

What we also know is that gold production is peaking out, and is likely to decline over the intermediate term even if gold prices rise substantially. Should investor demand reawaken, there is very little slack in supply to absorb it. The depletion of gold inventories in London

and other Western vaults – a result of demand in Asia – is a finite process with measurable limits. There are many signs that those limits are being reached.

Finally, we know that the fiscal position of Western democracies is perilous and worsening. History teaches that resolution of fiscal impasses most often results in monetary debasement, which has invariably led to a rise in the nominal value and purchasing power of liquid assets that cannot be debased. Gold and silver constitute a short list of non-financial assets with monetary characteristics.

Fundamental facts that can be ascertained today rarely provide clues to the timing of what they portend. However, they help to gauge the potential for return on capital deployed in anticipation. As in the period from 2000 to 2011, the gold price moved well in advance of the headlines. However, it was quite possible to assess systemic risk by observing the extreme market valuations of the late 1990s. We believe that a reversion to the mean from the giddy financial-asset valuations of 2017 is inevitable, and that it will occur sooner rather than later. In contrast to the mainstream financial assets that the crowds seem to clamor for, gold and gold mining shares enjoy pariah status. That alone is music to our contrarian ears.

John Hathaway
Senior Portfolio Manager
© Tocqueville Asset Management L.P.
October 9, 2017

This article reflects the views of the author as of the date or dates cited and may change at any time. The information should not be construed as investment advice. No representation is made concerning the accuracy of cited data, nor is there any guarantee that any projection, forecast or opinion will be realized. References to stocks, securities or investments should not be considered recommendations to buy or sell. Past performance is not a guide to future performance. Securities that are referenced may be held in portfolios managed by Tocqueville or by principals, employees and associates of Tocqueville, and such references should not be deemed as an understanding of any future position, buying or selling, that may be taken by Tocqueville. We will periodically reprint charts or quote extensively from articles published by other sources. When we do, we will provide appropriate source information. The quotes and material that we reproduce are selected because, in our view, they provide an interesting, provocative or enlightening perspective on current events. Their reproduction in no way implies that we endorse any part of the material or investment recommendations published on those sites.