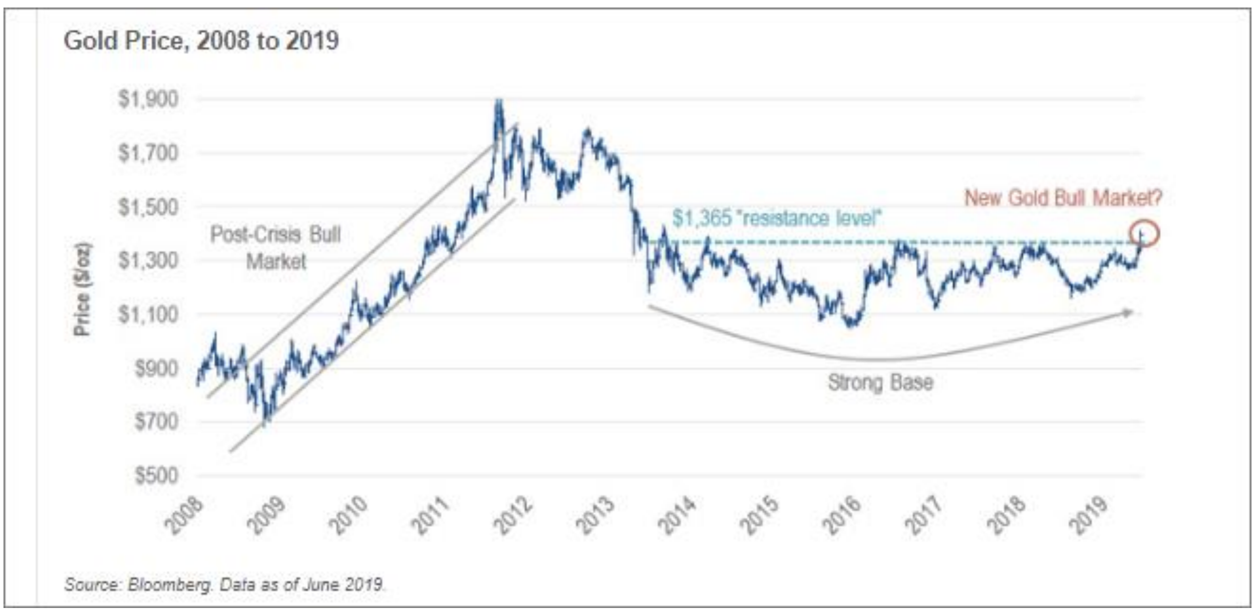
Has the Gold Market Spoken?

Tocqueville Gold Strategy

Second Quarter 2019 Investor Letter

"It Ain't What You Don't Know That Gets You Into Trouble. It's What You Know For Sure That Just Ain't So." – Attr. Mark Twain

Gold has broken out from a massive base formed over a six-year consolidation. The breakout has left most investors on the sidelines. The powerful rally from below $1,300 to over $1,400 and a 6 year high caught most either wrong-footed (short) or flat footed (no exposure at all.) That is why we believe substantial further upside lies ahead. Gold's allure (and the explanations for it) should grow as the price advances in the months and years ahead. See chart below:



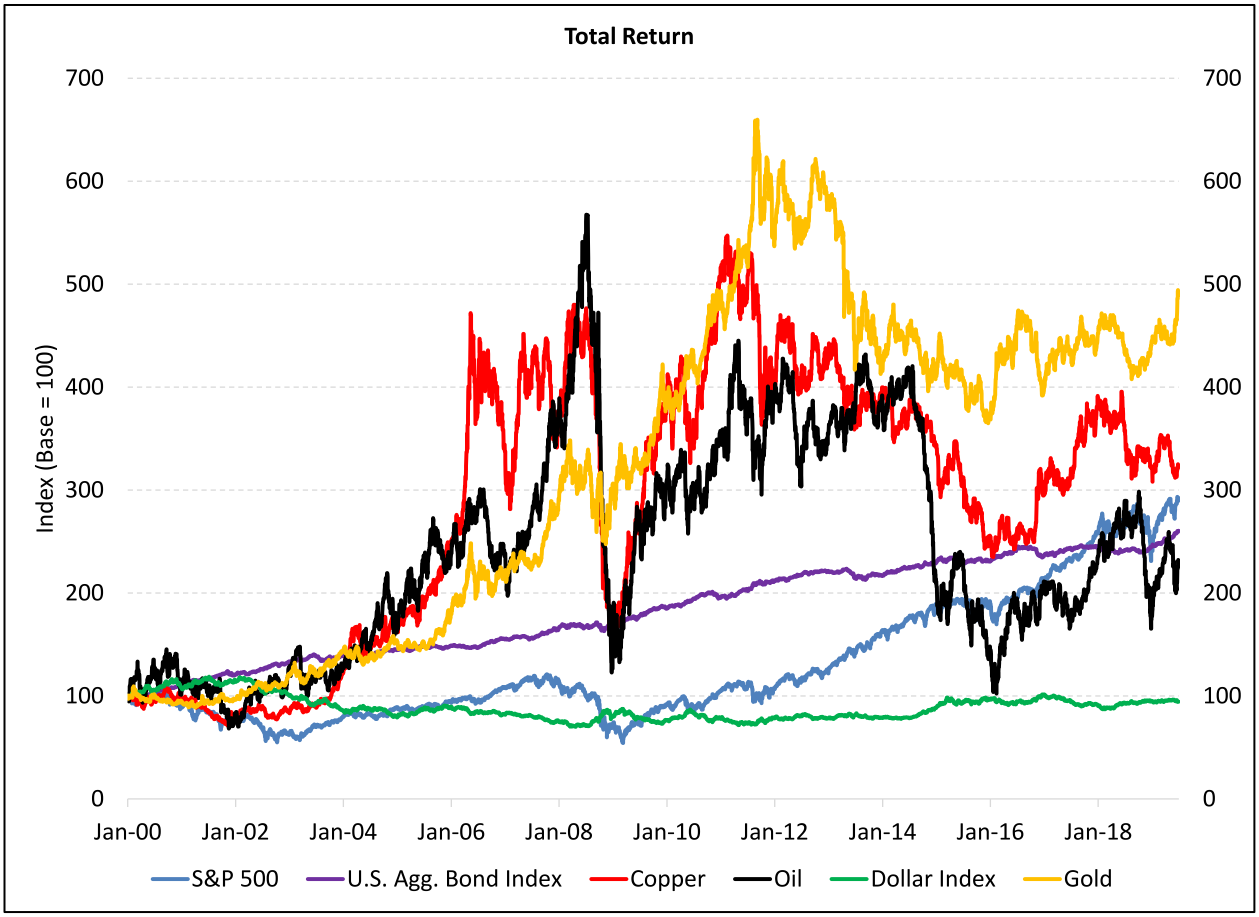
Prior to the breakout, analysts, opinion makers, and pundits were either negative or parked squarely on the sidelines. Most that we monitor remain tentative or call for a pullback. Others regard the move as unsustainable. It would be a mistake in our opinion to make too little of this price development. We think the breakout is a big deal. It could be an early warning that the global financial order may be headed for significant change.

It is a market maxim that price action must be respected. Headlines will follow. The investment arguments in favor of gold exposure that we and others have made over the past several years have been valid, but timing has been problematic. The fundamental macroeconomic analysis for higher gold price has not changed. What is about to change is market recognition of already existing facts and forces that have been long underway.

Why should one not consider the possibility of adverse consequences rooted in a decade of manipulated interest rates, radical central bank monetary practices, disregard of orthodox fiscal practices (both in the government and private sector), historically expensive financial asset valuations, and a bubble in complacency? The current bubble in complacency is so pernicious because "it has left investors defenseless by instilling blind faith in the ability to hedge systemic risks with instruments that are vulnerable to very risks they are supposed to hedge" (The Bubble in Complacency – Simon Mikhailovich 6/19). In markets priced to perfection, the practice of risk mitigation through the positioning in physical gold, an asset safely uncorrelated to financial assets, seems to have been embraced by only a few skeptics.

Gold bottomed in 1999 well before the dot com crash, the attack on the Twin Towers, and the 2008 global financial meltdown made front page news. The world of today closely parallels that of 1999 in our opinion. Once again, gold is an investment idea that is reviled and disrespected. We believe the recent breakout of gold portends a significant recalibration of commonly accepted macroeconomic fundamentals. As in 1999, the script, the timing, and the moment of recognition by a wider audience is a somewhat speculative exercise.

Gold has disappointed since 2012, even though it has outperformed stocks and bonds since 2000, the dawn of radical monetary experimentation. However, financial market memories are short. Gold is a big macro idea that offers substantial reward for those with the requisite patience.



Source: Bloomberg.

When will that patience be rewarded? For timing clues, it is helpful to look through a contrarian lens at those embedded consensus views most likely to be discredited. As noted by James Grant in the June 14 Grant's Interest Rate Observer: "A hardened consensus of financial opinion is proverbially treacherous." Timing the point at which those views are fully reflected in financial markets, asset valuations, and investment practices and therefore at their most vulnerable is unfortunately a matter of art and experience. Many, including us, have gotten the timing wrong. However, now the market has spoken.

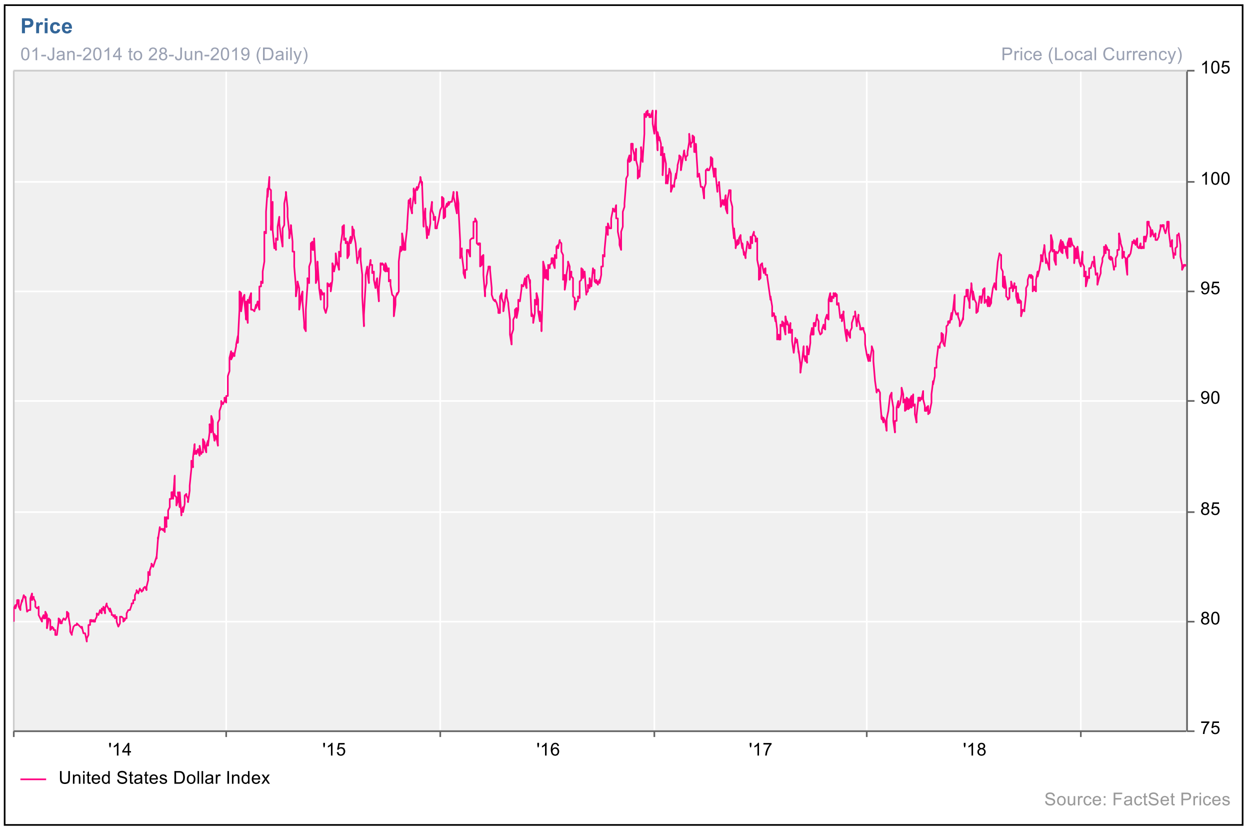
Here are five (of many possible) consensus views that seem excessively brittle. Each is worthy of more extensive discussion than space here allows. (Some links are provided for elaboration):

– **The Fed Put --** Belief that the Fed and world central banks can and will underpin serious weakness in financial asset prices by lowering interest rates and quantitative easing (or similar) practices has become an article of faith in the financial markets. We believe that gold's breakout predicts universal discovery of finite limits to the seemingly endless creation of sovereign credit to rescue financial markets short of currency destruction. Please refer to the Q1 letter "What If Whatever It Takes Isn't Enough?"

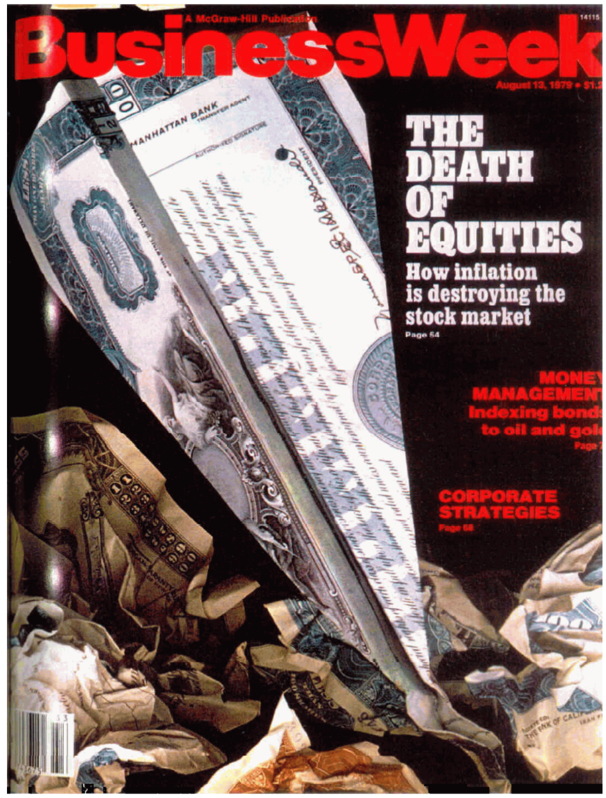
– **Fiscal Deficits Don't Matter --** We think that gold's breakout is in part a response to the implications of spreading populism, at its core incompatible with the idea of squaring government spending with income. The footrace between US economic growth and national debt has been all but lost. In our view, US economic growth can no longer keep up with the expansion of national debt. A credit downgrade seems inevitable and may already be underway in light of record purchases of gold by central banks and divestment of US dollars. Adverse repercussions for interest rates and financial asset valuations could in our opinion exceed the power of public policy to overcome. Our Q4 2018 letter "Going Bananas" has more detail.

– **No Alternative to the US dollar --** Beyond the world of Bloomberg and CNBC, other nations question whether the "least dirty shirt in the laundry basket" is a viable foundation for global banking and trade. For example, please see Takashi Nakano's article in the Nikkei Asian Review. A potential breakdown in DXY (chart below) coincided with the breakout in gold. The Fed's capitulation on monetary tightening, the dollar's reduced yield advantage vs. non-US dollar alternatives, a significant shortfall in purchasing power parity vs. the euro (22% according to OECD data), and Trump's persistent calls for a weaker currency are very bullish for gold.

United States Dollar Index



– **No Inflation…Ever Again!** -- $12 trillion of negative yielding global sovereign debt attests to the mass ingestion of this notion. The April 22, 2019 cover of Bloomberg Businessweek (see below) heralds the death of inflation, a reliable contrarian signal that inflation will resurface. (Next to it is the infamous "The Death of Equities" BusinessWeek cover that preceded the bull market of the 1980's and 90's.) It is hard to imagine that the intellectually justified flouting of fiscal discipline (Modern Monetary Theory), the embrace of fiscal laxity by populist politicians, and the abandonment of monetary tightening by world central banks will not rekindle inflation. Inflation is a "sickness of money, unlikely to be foreseen by widely followed benchmarks such as the CPI (consumer price index). See the excellent discussion in the 5/3/19 Grant's Interest Rate Observer titled "Buried alive in 'Businessweek,'" which we have appended.



– **Mining is Synonymous with Bad Management --** Historically poor management of gold mining companies puts their shares off limits for all but high rollers. However, we observe significant improvement in important aspects of mining company management including alignment of executive and employee incentives with shareholder interests, improved capital allocation decisions, and technology advances that will lower production costs. We have written more about this in a recent article titled "Building Shareholder Value in the Gold Mining Sector." In our opinion, mining shares remain episodically depressed. They offer superior leverage to anticipated further rises in metals prices.

An impotent Fed, resurgent inflation, out of control fiscal deficits, a reset of the international monetary system, and financial media acclamation of excellence in mine company management? It's all just too hard to imagine. Still, the consensus certainty that not one of these dark horses could finish in the money persuades us that gold is a worthwhile bet. As to timing, it has always been hard to say. What is certain is that during gold's six years in the penalty box, the underlying forces that have made the metal a superior strategic investment over centuries have not been idle. The extrapolation of current conditions into unrealistic expectations is a dependable flaw of human nature. The capacity of physical gold and precious metals mining shares to absorb inflows has greatly diminished because of the prolonged attrition of investment interest. Once capital market flows revive, there is real potential in our opinion for parabolic upside in the metal and the shares.

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