Where Does the Gold Trade Stand?

By: Trey Reik

We have all read the latest crop of media articles challenging gold's investment relevance. The typical approach to bearish gold analysis is to attribute hypothetical fears to gold investors, and then point out these concerns have failed to materialize. Sprott believes the investment thesis for gold is a bit more complex than simplistic motivations commonly cited in financial press. We would suggest gold's relatively methodical advance since the turn of the millennium has had less to do with investor fears of hyperinflation or U.S. dollar collapse than it has with persistent desire to allocate a small portion of global wealth away from traditional financial assets and the fiat currencies in which they are priced.

At Sprott, we are amazed that gold's role as a productive portfolio-diversifying asset is still questioned by so many. During the past decade-and-a-half, gold has posted the most consistently positive performance of any global asset, yet is still scorned by consensus. What part of gold's track record is so difficult to understand? Figure 1, below, outlines performance of spot gold in nine global currencies during the past 15 years. Despite widely divergent monetary and financial conditions, the performance of gold since 2000 has significantly exceeded any asset class with which we are familiar. How could such an admirably performing asset continue to elicit such broad indifference?

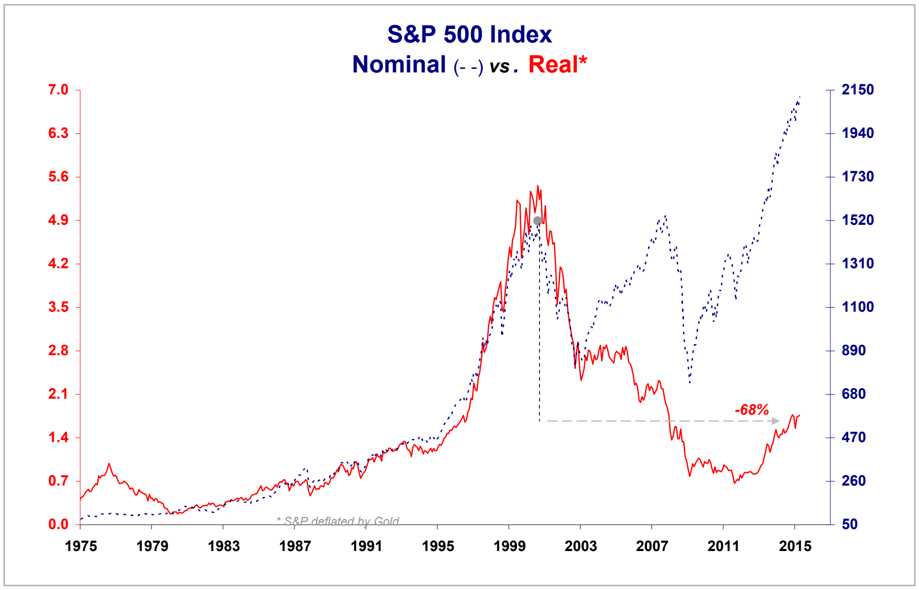
Now that the S&P 500 Index has more than tripled from March 2009 lows, the investment world is once again replete with portfolio gains from U.S. equities. We recognize few asset classes can challenge the pedigree of the S&P 500 Index, and even fewer investors would consider gold on par with the S&P 500 as an important

FIGURE 1: ANNUAL PERFORMANCE OF SPOT GOLD IN NINE GLOBAL CURRENCIES (2001-2015) [BLOOMBERG]

Year	US Dollar	Euro	Yuan	Rupee	Yen	Pound	CAD	AUD	CHF	Average
2001	2.46%	8.13%	2.45%	5.90%	17.62%	5.25%	8.65%	11.80%	5.32%	7.51%
2002	24.78%	5.76%	24.78%	24.08%	12.64%	12.67%	23.48%	13.85%	3.87%	16.21%
2003	19.37%	-0.21%	19.36%	13.52%	8.04%	7.80%	-1.81%	-11.22%	7.32%	6.91%
2004	5.54%	-2.19%	5.54%	0.54%	0.66%	-1.76%	-2.19%	1.40%	-3.10%	0.49%
2005	17.92%	35.09%	14.98%	22.23%	35.70%	31.44%	14.06%	25.84%	35.97%	25.91%
2006	23.16%	10.51%	19.11%	21.00%	24.32%	8.17%	23.46%	14.61%	14.24%	17.62%
2007	30.98%	18.46%	22.46%	16.64%	22.96%	29.28%	11.40%	17.77%	21.96%	21.32%
2008	5.78%	10.55%	-1.07%	30.62%	-14.10%	43.89%	29.91%	31.59%	-4.90%	14.70%
2009	24.37%	21.09%	24.40%	18.88%	27.38%	12.25%	7.90%	-2.39%	20.40%	17.14%
2010	29.52%	38.88%	25.02%	24.45%	12.75%	34.15%	21.95%	13.66%	16.91%	24.14%
2011	10.06%	13.51%	5.22%	30.74%	4.35%	10.65%	12.53%	9.81%	10.63%	11.94%
2012	7.14%	5.22%	6.04%	10.54%	20.84%	2.31%	4.86%	5.82%	4.39%	7.46%
2013	-28.04%	-31.13%	-30.15%	-18.76%	-12.42%	-29.45%	-23.13%	-16.30%	-30.09%	-24.39%
2014	-1.72%	11.99%	0.79%	0.45%	11.81%	4.48%	7.40%	7.44%	9.92%	5.84%
4/23/2015	0.77%	12.65%	0.62%	0.79%	0.70%	4.30%	5.27%	5.75%	-3.26%	3.07%

portfolio building block. However, as shown in Figure 2, below, the fact remains that even at its current level of 2,112 (4/23), the S&P 500 Index is trading today ***68% lower in gold terms*** than at its 2000 peak. During the past two corrections in the S&P 500, during which the Index declined 50.50% (2000-2) and 57.70% (2007-9), gold provided unparalleled protection of real purchasing power in all global currencies. We believe the next correction in U.S. equities will prove no different. We are not sure what percentage in the cumulative relationship between gold and the S&P 500 will finally earn gold its deserved profile as a mandatory, diversifying portfolio asset, but we suspect we are about to find out.

FIGURE 2: S&P 500 INDEX PERFORMANCE SINCE 1975 (NOMINAL & DEFLATED BY GOLD PRICE) [MACROMAVENS]



Gold is an asset without peer in terms of the sheer number of investment perspectives leading to its ownership. Some perceive gold as an inflation hedge, others as a deflation hedge. During times of financial stress, some view gold as an asset to own, while safe-haven U.S. dollar traders see gold as an asset to short. Many view gold as the ultimate "risk off" asset, and just as many view gold as the ultimate "risk on" trade. What can then explain gold's meticulous advance versus prominent fiat currencies in all but one (2013) of the past 15 years, despite the myriad of economic, fiscal and monetary conditions which prevailed during those years?

After all, since 2000 the world has witnessed at least two deflation scares (2002 and 2009), various periods of inflationary concern (2005 and 2008), exceptional U.S. GDP strength (2004) and weakness (2001 and 2009), rising (2004 and 2005) and falling U.S. short rates, rising (2003 and 2006) and falling (2002, 2008 and 2011) Treasury rates, multiple roundtrips for equities, bonds and commodities and a euro trading range of US$0.83 to US$1.60. In other words, every popular variable to which some portion of consensus attributes strong gold correlation has oscillated repeatedly during the past fifteen years, yet gold has increased in every year but one. Must there not be something happening here which defies simple categorization?

We would suggest there is indeed one overarching theme to gold's performance which generally escapes popular reporting: we attribute gold's comparatively consistent 15-year performance to methodical migration of global wealth from the immense pile of outstanding financial assets (roughly $300 trillion) to the comparatively tiny stock of investable gold (roughly $2.4 trillion). In essence, gold is increasingly about global willingness to hold paper assets. Given the gaping disconnect between global paper claims and underlying productive output, as well as the unwavering penchant for global central bankers to debase fiat currencies in their attempts to bridge this chasm, we believe the gold thesis remains in its early innings. While these arguments may appear detached and academic in light of recent tape action, we remain committed to our analysis because we believe it is correct. No matter what one's individual investment perspective may be, it is difficult to argue that the world's monetary system is not becoming increasingly dysfunctional. For these reasons, we believe gold's most dramatic advances remain ahead of us.

The resurgent bear thesis for gold currently rests on four key assumptions:

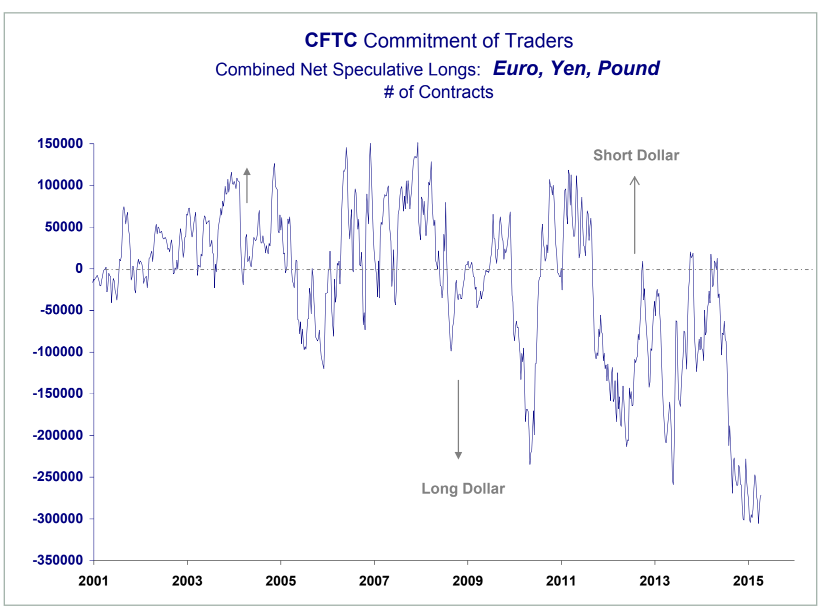
- ***protracted U.S. dollar strength,***
- ***significant Fed tightening,***
- ***escape velocity U.S. economic performance, and***
- ***further increases in U.S. equities***

Because we believe each of these assumptions is already in the process of being disproved, we expect Western investment demand for gold to surge dramatically in coming years.

Protracted U.S. Dollar Strength?

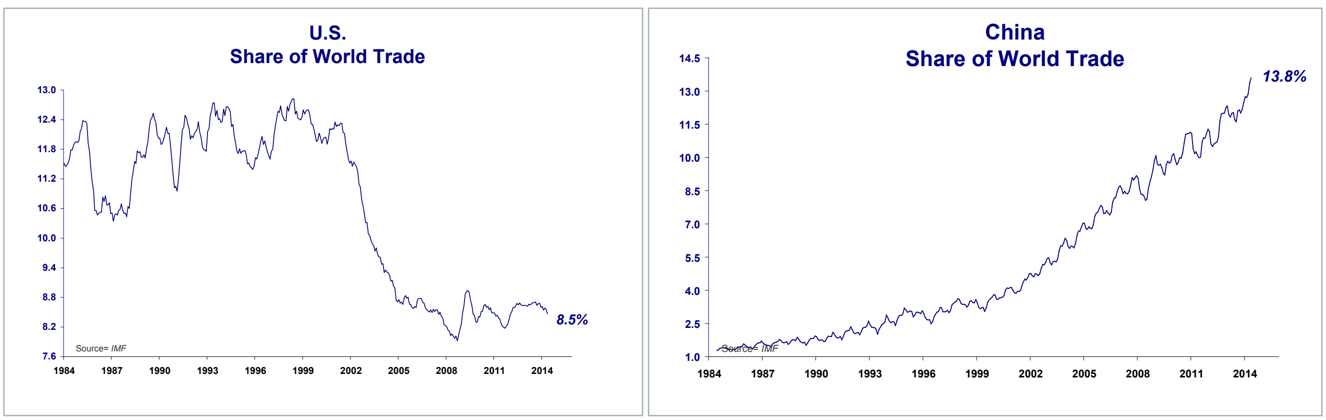
Since gold's September 2011 peak, Western consensus has vocally forecast U.S. dollar strength. For two-and-a-half years through mid-2014, however, no consensus view proved more off the mark—despite near universal prognostications for dollar strength, the prominent DXY Index actually declined marginally between 12/31/11 and 6/30/14 (from 80.18 to 79.78). From July 2014 through mid-March 2015, however, the DXY staged an impressive 26% rally, much to the detriment of gold and broad commodities. What powered this rally? Perhaps egged on by years of disappointment, dogged dollar bugs have unleashed in recent months a truly historic sentiment extreme. For two days in mid-March (3/10 and 3/11), the Bernstein Daily Sentiment Index for the U.S. dollar (poll of active futures traders) registered a ridiculous 97% bullish. Our favored macro impresario, Stephanie Pomboy (MacroMavens), fleshes-out the dollar-sentiment craze in Figure 3, below. As measured by aggregate net speculative shorts against the euro, yen and pound, bullish dollar speculation has inhabited unprecedented levels for several months.

FIGURE 3: COMBINED NET SPECULATIVE LONGS EURO, YEN, POUND (2001-PRESENT) [CFTC, MACROMAVENS]



We believe Western dollar bullishness rests largely on investor expectations for divergent central bank behavior in coming years (U.S. tightening while Japan, Europe and China ease). However, this expectation ignores growing global disenchantment with the dollar-standard system. The world has made no secret of mounting resentment toward dollar-denominated trade. During the past two years, China, Russia, India and an array of resource-rich and resource-needy countries have announced an expanding mosaic of currency-swap and bilateral trade agreements. Why have they done this? To begin with, eroding percentages of U.S. share of global trade increasingly stretch the logic of pricing global trade-flows in dollars. As shown in Figure 4, below, U.S. share of world trade has shrunk to 8.5%, while China's share has expanded to 13.8%. Why should China price anything in dollars?

FIGURE 4: SHARE OF WORLD TRADE U.S. AND CHINA (1984-PRESENT) [MACROMAVENS]



We believe Western investors are prone to ignore the significance of shifting global economic allegiances. While we are in no way endorsing a "decline of America" argument, we do believe resentment of American dominance of the global financial system, and increasingly frequent crises emanating from that stewardship, is galvanizing resolve around the world to develop alternatives to the dollar-standard system. For those with an open mind, we believe this process is plainly evident wherever one looks.

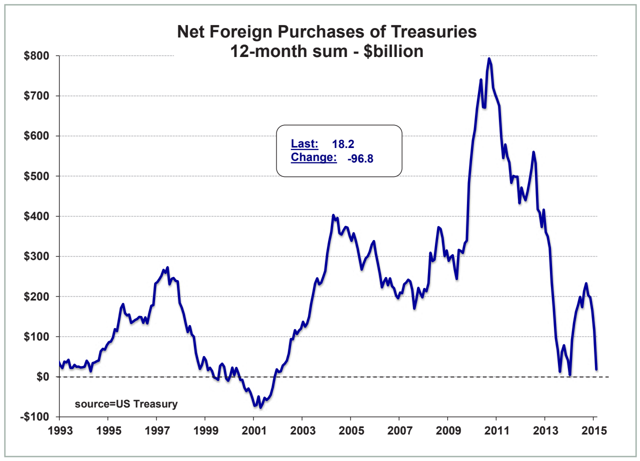
Even at G-20 meetings, criticism of the dollar–standard system has become increasingly sharp (Argentina, Mexico and Indonesia). And more recently, even G-7 allies such as France and Germany have voiced concern over unilateral U.S. regulations, sanctions and legal dictums. In the wake of BNP Paribas' recent U.S. fine, Bank of France Governor and ECB Governing Council member Christian Noyer raised eyebrows 7/5/14 in suggesting:

> *We could say that companies would have maximum interest to do the most possible transactions in other currencies. Trade between China and Europe -- do it in euros, do it in renminbi, stop doing it in dollars.*

At the risk of appearing overly dramatic, we felt one especially concise exchange between President Obama and German Chancellor Angela Merkel summed things concisely this past summer. On August 26, President Obama proclaimed, "The United States is and will remain the one indispensable nation in the world. No other nation can do what we do." The following day, German Chancellor Angela Merkel responded directly, "Even a superpower can't solve all of the problems alone."

While the dollar's role in global monetary affairs is not about to disappear anytime soon, it is pretty clear the dollar's dominance as hegemonic reserve currency ***diminishes*** with each passing day. Proof of the pudding abounds in global financial flows. Amid nonstop geopolitical events traditionally supportive of the dollar's safe-haven status, foreign interest in U.S. financial assets has plummeted in recent years. As shown in Figure 5, below, the annual run-rate of net foreign purchases of U.S. treasuries has collapsed from $800 billion to virtually zero. These realities are particularly stark in the context of some $5 trillion of global sovereign bonds with negative yields (including German bunds in recent weeks with negative yields out nine years) and a nearly 200 basis point spread between 10-year Treasuries and bunds!

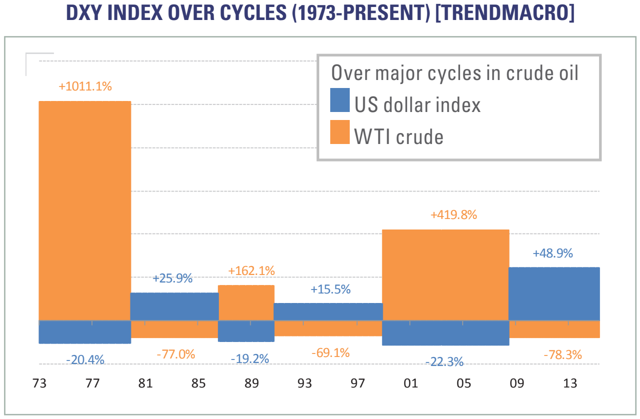
FIGURE 5: NET FOREIGN TREASURY PURCHASES (1992-PRESENT) [TREASURY, MERIDIAN MACRO]



We view the dollar's vertiginous rally since June less as a discretionary vote of preference than a reflexive manifestation of two gut-wrenching but finite developments in global asset markets. First, a half-decade of Fed largesse has fostered trillions-of-dollars-worth of dollar-denominated debt around the globe. The Bank of International Settlements estimates this obelisk of carry trades, investments, loans and office-balance sheet commitments now stands at some $9 trillion. With the dollar up 25% since June, rough math suggests there are over $2 trillion worth of paper losses percolating on global balance sheets. In a very real sense, recent dollar strength reflects self-reinforcing urgency to settle dollar obligations before they inflict further damage. This brand of mechanical dollar demand is notorious for reversing course once the "synthetic short" is satisfied.

Second, we believe consensus underestimates the pervasive inverse relationship between oil prices and the U.S. dollar. Our friends at TrendMacro have memorialized this uncanny bond quite succinctly in Figure 6, below. Empirically, the dollar has weakened during every major oil bull market since 1973, and strengthened during every oil bear market. Leaving cause and effect for others to debate, we would suggest that if the oil price has set rough lows in the recent sell-off, a significant "component" of dollar strength may already be behind us.

FIGURE 6: INVERSE PERFORMANCE OF WTI CRUDE OIL AND DXY INDEX OVER CYCLES (1973-PRESENT) [TRENDMACRO]



We believe extreme Western spec positioning, exploding carry trades and a plummeting oil price have temporarily masked the ongoing erosion of the dollar's hegemonic reserve-currency role. We expect the basis for much dollar enthusiasm (expectations for Fed rate increases) will prove just as misguided as consensus Fed analysis during the past half-decade. Indeed, we expect a key investment theme in 2015 to be surprising weakness in the U.S. dollar.

Significant Fed Tightening?

Perhaps the single greatest misconception about gold, especially in contemporary trading circles, is the erroneous belief that rising U.S. short-term interest rates are inherently threatening to gold's prospects. Sprott believes rising short rates have much less to do with gold's performance than the reasons why rates are rising and whether the Fed is deemed to be in control. After all, when gold exploded to all-time highs in January 1980, the Fed's discount rate was 12% and fed funds were targeted at 14%. Many will object that the January 1980 experience is not germane, because conditions in 1979 were substantially unique (inflation, oil shock, Iran hostages and Hunt brothers). Conceding all decades are different, we turn to the current decade for evidence rising short rates can coexist with surging gold prices. During the past ten years, has the Fed ever raised short rates aggressively for an extended period of time? What impact did those policies have on the gold price?

FIGURE 7: SPOT GOLD VERSUS FOMC TARGET FED FUND RATE (JULY 2003-MARCH 2007) [BLOOMBERG]

In Figure 7, above, we plot the Fed's target funds rate versus spot gold from mid-2003 through early-2007. Between June 2004 and June 2006, the FOMC increased its target funds rate by 25 basis points at 17 consecutive meetings! During the span, fed funds more than quintupled, from 1.0% to 5.25%, yet spot gold climbed 81%, from $395 to $715. Obviously, Fed tightening has far less reflexive impact on the gold price than commonly perceived. During the next few years, we find prospects for Fed tightening likely to be limited to a few symbolic gestures, the impact of which should prove virtually meaningless to gold.

Most investors have viewed Fed QE programs as discretionary efforts to target full employment and escape-velocity U.S. economic growth. We have viewed the Fed's QE efforts as tacit admission of their concerns over lingering stress in the financial system. We believe the Fed cannot tighten meaningfully because the Fed must provide a liquidity bridge to offset insufficient non-financial credit growth in the U.S. economy (an $18 trillion economy cannot efficiently service $59 trillion in debt). In direct contrast to our views, broad consensus has incorrectly forecast three distinct cycles of unwinding of Fed asset-purchase programs during the past five years.

- Throughout 2010, consensus projected outright Fed asset sales in late-2010 to unwind asset purchases of QE1. Instead, the Fed launched QE2 in November 2010.
- Throughout 2011, consensus projected outright asset sales in 2012 to unwind QE2. Instead, in September 2011, the Fed conceded not only that outright asset sales were too dangerous but that even allowing MBS to roll off naturally was far too risky for financial markets, and launched Operation Twist.
- Throughout 2012, consensus projected outright asset sales in 2013, to finally unwind QE1 and QE2. Instead, the Fed launched QE3, designed to gobble up MBS and Treasuries at roughly the rate of QE1 and QE2 combined.

Because most Fed projections have been so utterly wrong for so long, we give little credence to current consensus that the Fed is nearing "liftoff" of a meaningful tightening cycle.

FIGURE 8: COMPARATIVE ECONOMIC STATISTICS AT THE LAUNCH OF QE1, QE2, QE3 AND TODAY [MACROMAVENS]

	Labor Partic. Rate	Unemployment Rate	Core PCE Deflator yy	Retail Sales yy	Nom. GDP yy
QE1 Launch (Nov08)	65.9%	6.8%	1.7%	-9.7%	-1.0%
QE2 Launch (Nov10)	64.6%	9.8%	1.0%	6.5%	4.6%
QE3 Launch (Sep12)	63.6%	7.8%	1.7%	5.4%	4.5%
Today	62.7%	5.5%	1.4%	1.3%	3.7%

As MacroMavens reminds us, in table 8, above, salient measures of economic performance generally rest today at levels below comparative levels at which the Fed felt compelled to launch QE2 and QE3. Even improvement in the BLS unemployment rate appears a bit pyrrhic, when viewed in the context of four-decade lows for the labor participation rate. What is so different about 2015 that will permit the Fed to raise rates significantly when they have felt unable to do so in recent years?

Escape Velocity U.S. Economic Performance?

To us, U.S. economic performance is patently sub-par. Despite the most indulgent monetary policies in U.S. history, economic growth during the past 15 years has been the worst 15-year stretch on record. More specifically, since 2009 lows, one of the strongest bull markets in U.S. history has been accompanied by the weakest postwar economic recovery. Why has this historic U.S. economic weakness persisted? We believe central tenets of Austrian economic analysis are finally coming home to roost. Poor economic decisions and excessive debt in a world of ZIRP and nonfinancial credit growth ***unbacked by savings*** have destroyed the potential for true capital creation in the United States.

Without question, the single greatest contributor to U.S. economic activity in recent years has been the shale-led boom in the energy sector. We believe shale investments in the United States represent an interesting microcosm of ZIRP distortions. While energy represents roughly 5%-to-6% of global GDP, it represents roughly a third of global capex, by far the largest single component. We believe Fed ZIRP policies have clearly fostered overinvestment (we would say malinvestment) in domestic shale projects. We expect the $50 decline in WTI to threaten viability of a huge component of these capital investments, with significant implications for fragile U.S. economic growth and high-yield bond markets (energy 21% of total issuance), as well as U.S. regional energy economies and their supporting banks.

To us, the most telling aspect of the sub-par performance of the U.S. economy is the degree to which Fed ZIRP policies have extinguished the U.S. capex cycle. Outside the oil patch, American corporations have conceded overwhelmingly that investing in their own businesses is far less attractive than simply buying back shares. Somewhere along the line, mainstream financial analysis has given up questioning whether earnings gains from stock buybacks should be viewed as additive on balance. If shares are overvalued, every share repurchased should lead to a deduction from per-share valuations for any individual company, not an addition.

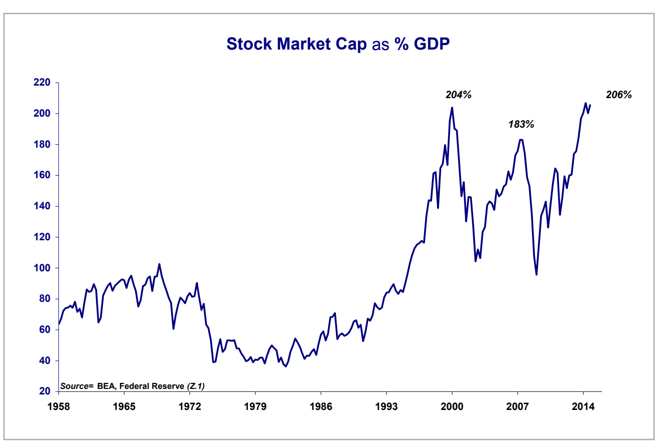
We find the list of American corporations which chose to slash capex in 2013 and 2014, while committing massive resources toward share repurchase, to be an aspect of contemporary U.S. corporate performance that will engender lingering study in years to come. While hundreds of Fortune 500 companies (with which all U.S. investors should be familiar) have cut capex budgets far below rates of stock buybacks, we are aware of no train of institutional analysis which has yet objected to this trend. Quite simply, Fed ZIRP policies have crushed expected rates of return on capital investment and incented corporations to borrow money to retire equity–***U.S. corporate income statements are now consuming U.S. corporate balance sheets at a fairly accelerated pace!***

Further Increases in U.S. Equities?

Since March of 2009, valuation of U.S. equities (Russell 3000 Index) has increased by some $15.7 trillion. With coincident U.S. non-financial credit rising by some $7.4 trillion, the value of primary paper claims on U.S. productive output has increased by roughly $23.1 trillion. During this entire period, U.S. Real GDP has risen only $3.6 trillion. While we recognize the intoxicating effect of rising stock prices, there is nothing of which we are more certain than the fact that ***claims on productive output cannot increase almost seven times faster than output forever!***

By many measures, equity prices have now surpassed relative valuation levels from which they collapsed by more than half on ***two*** occasions since 2000. Further, one could argue quite logically that the aggregate claim which U.S. equities hold over U.S. productive output in 2015 is far more tenuous than in 2000, as the load of more senior debt claims has ballooned over the period by $33.1 trillion (while coincident GDP has increased a little over $8.2 trillion). Warren Buffet suggests the ratio of equity-market-cap-to-GDP, "is probably the best single measure of where valuations stand at any given moment." As the owner of more stocks than any other human being, Mr. Buffett is unlikely to call for a market correction anytime soon. However, as the MacroMavens iteration of Mr. Buffett's indicator demonstrates in Figure 9, below, U.S. equities are trading at starkly rarified levels.

FIGURE 9: RATIO OF U.S. CORPORATE EQUITIES-TO-GDP (1958-PRESENT) [MACROMAVENS]



What about Gold Equities?

During the past 20 years (Figure 10, below), the S&P 500 and the NYSE Arca Gold Miners Index (the GDM Index) have carved out extremely lumpy surges of performance, heavily influenced by the ebb-and-flow of prevailing sentiment towards U.S. financial assets. Along the way, there have been two salient periods in which the performance of gold equities has demonstrated strong negative correlation to the S&P 500. The first period stretched from late-1996 through early-2003. From 1996 through early 2000, optimistic sentiment in equity markets became ***increasingly incorrigible*** and gold shares were pretty much ***left for dead***. However, as the S&P 500 collapsed 51% from excessive 2000 ebullience through mid-2002, the GDM Index nearly tripled.

FIGURE 10: PERFORMANCE OF S&P 500 INDEX (WHITE) VERSUS GDM INDEX (GOLD) (JANUARY 1997-PRESENT) [BLOOMBERG]

We see strong similarities between the 2000 experience and that unfolding today. From 2011 highs, gold shares declined 75% through November 2014 lows and remain 71% off 2011 highs, while the S&P 500 has rallied 83%! In essence optimistic sentiment in equity markets has again become ***increasingly incorrigible*** and gold shares have been ***left for dead***. As was the case in March 2000, we believe redeployment of a small percentage of investment capital from the S&P 500 to the GDM Index is a portfolio allocation decision with exceedingly high total-return prospects!

As demonstrated in Figure 11, below, the three primary advances of gold shares during the past fifteen years have generated aggregate returns which have been nothing short of spectacular. The GDM Index has posted three roughly three-year advances since 2000, with individual gains of 342.76% (11/17/00-12/02/03), 185.62% (5/16/05-3/14/08), and 309.74% (10/27/08-9/8/11). Coincident moves in the S&P 500 during these three periods were a decline of 22.01% and gains of 10.50% and 39.70%. Despite debilitating intervening corrections for gold shares which have offset completely their prodigious gains, the fact remains that the

FIGURE 11: GROSS PERCENTAGE GAINS FOR GDM INDEX (VERSUS S&P 500) DURING KEY ADVANCES SINCE 2000 [BLOOMBERG]

Date	GDM	S&P 500
11/17/00	180.57	1367.72
12/02/03	799.50	1066.62
% Increase:	+342.76%	-22.01%

Date	GDM	S&P 500
05/16/05	543.83	1165.69
03/14/08	1553.31	1288.14
% Increase:	+185.62%	+10.50%

Date	GDM	S&P 500
10/27/08	450.32	848.92
09/08/11	1845.16	1185.90
% Increase:	+309.74%	+39.70%

compound performance of gold shares during the three primary moves of the GDM Index since 2000 totaled 5,082%, while the aggregate coincident performance of the S&P 500 totaled just 20.4%. In other words, during roughly nine of the past 14 years, or some 63% of the time, gold shares have outperformed the S&P 500 by a factor of 249-to-1. In essence, when faith in U.S. financial assets has been challenged, no asset has provided a more productive portfolio hedge than gold shares. While it is impossible to foresee how gold shares will respond to any future diminution of confidence in U.S. financial assets, we believe their pedigree as a portfolio diversifying asset is both established and compelling.

At Sprott, we continue to believe high-quality gold mining companies provide significant leverage to the secular opportunity of rising gold prices. Emerging producers (and high quality miners developing new projects) bring a tangible value-creation proposition to the gold investment thesis. Despite the volatility of gold shares since 2000, their performance in up-cycles for the gold complex has provided unparalleled alpha. We are of the strong opinion that allocations toward high-quality gold shares are about to be rewarded handsomely and we look forward to communicating our progress in coming months.

Sincerely,
Trey Reik, Senior Portfolio Manager

About the Author

Trey Reik,
Senior Portfolio Manager

I joined Sprott Asset Management USA, Inc., in March 2015. After thirteen years investing in gold-focused partnerships, I joined Sprott because I believe the firm represents one of the world's preeminent precious metal investment franchises. In my view, gold represents an extremely compelling investment opportunity during the next decade and Sprott is exceptionally well positioned to benefit from strength in precious metal markets. Sprott has asked me to share my thoughts on gold markets with Sprott clients on a regular basis. While I look forward to doing so, I remind all readers that my views represent one opinion among many in the Sprott organization. I look forward to continuing the conversation.

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