Sprott

A Message from the CEO

October 18, 2019

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Checkmate

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Gold is on a Tear

Gold has been on a tear in 2019. The gold price recently breached $1,500, after smashing the $1,370 ceiling of its long-term range in June. This is impressive when considered in the context of a reasonable economy, a strong U.S. dollar and resilient equity markets throughout 2019. The seesaw between risk-on and risk-off, the ongoing debate over economic data and forecasts, permutations around the U.S.-China trade situation and, most recently, the beginning of an impeachment inquiry, all seem to have little effect on gold, which has posted positive daily performance on both sides of those short-term influences.

So, what gives?

Gold Has Dual Purpose: Portfolio Insurance for Inflation *or* Deflation

Like other forms of faith, those who believe in gold will not apostatize, and most who do not believe cannot be convinced. That is the generational fallout from some 50 years throughout which the majority of the global population believed that fiat currency was the only legitimate store of value. On that score, I would hope that gold will eventually be judged on the quality of its track record — its massive liquidity, strong price performance versus fiat currencies, and eventual use as a digital savings asset and payments medium (see The Rebirth of Gold as Money).

My career has involved interacting with many of the most notable investors in the gold sector. Although these gold aficionados all share a similar long-term belief in the advantages of gold, it has never ceased to amaze me how different their macro-economic outlooks are, especially as it relates to the potential for harmful inflation or deflation. Few strategists or economists go into depth about what extreme scenarios could play out for either of these possibilities. Let's consider both in the context of gold's utility as an asset.

Gold has successfully been used by savers as a store of value during periods of high inflation and corresponding currency devaluation. Deflation, on the other hand, triggers debilitating solvency and liquidity issues which usually lead to severe market corrections, again leaving gold as a better asset to own outside of those correlated with credit and equity markets. The reason why gold supporters do not debate their differentiated macro forecasts is that gold is a chameleon that can benefit from both outcomes, and thereby provides insurance from negative market developments stemming from polarized monetary outcomes, as shown in Figure 1.

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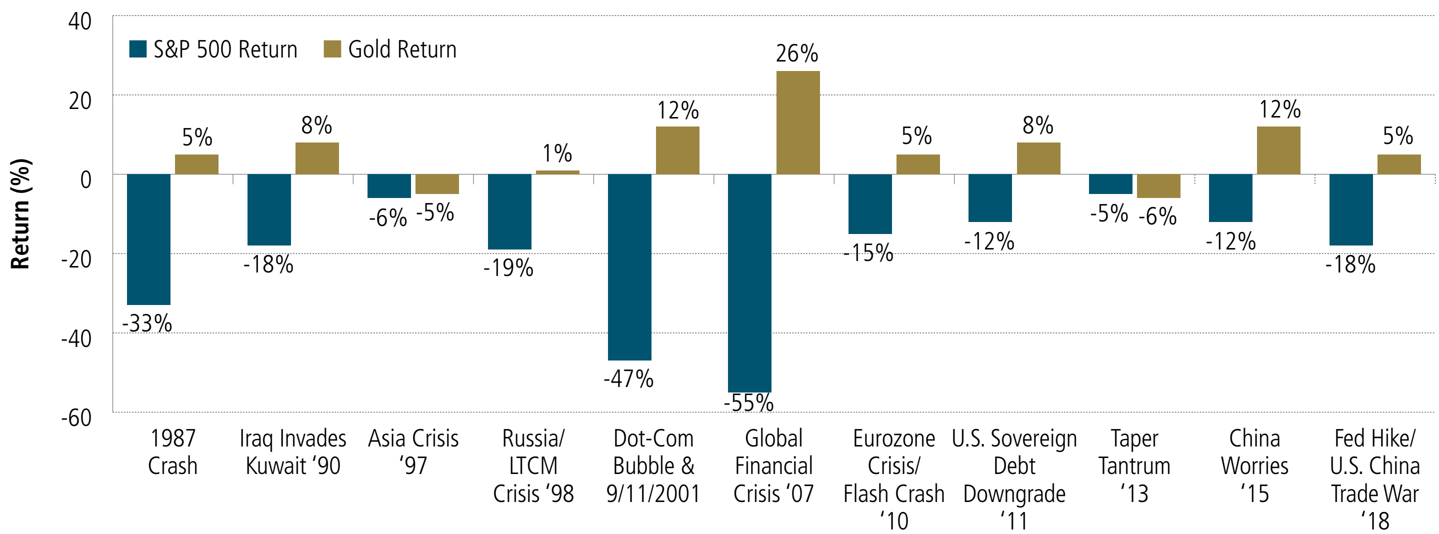
Figure 1. Gold Provides Proven Portfolio Protection

This chart measures the performance of Spot Gold versus the S&P 500 Index versus during 11 crisis periods since 1985. Gold returned an average +6.4% compared to -21.7% for the S&P 500 for these 11 crisis periods.



Source: Tocqueville Asset Management. Dates used: 1987 Crash: 8/25/87-10/19/87; Iraq Invades Kuwait: 7/17/90-10/12/90; Asia Crisis: 10/7/97-10/28/97; Russia/ LTCM Crisis: 7/20/98-10/8/98; Dot-Com Bubble & 9/11: 9/10/01-10/11/02; Global Financial Crisis: 10/11/07-3/6/09; Eurozone Crisis: 4/20/10-7/1/10; U.S. Sovereign Debt Downgrade: 7/25/11-8/9/11; Taper Tantrum: 5/22/13-6/24/13; China Worries: 8/18/15-2/11/16; Fed Rate Hike & China Trade War: 9/20/18-12/24/18.

Gold: A Mandatory Portfolio Allocation

This observation about gold fits like a glove to the current set of circumstances in the financial world. Theoretical models predict that record low and negative interest rates should drive extraordinary investment in even marginally accretive economic and national projects, creating tightness in the economy, rising labor costs and ultimately inflation.

On the contrary, many current economic indicators, including the yield curve, suggest that investors should raise cash and prepare for the worst. That is also not happening, as equity markets are buoyant, at least in the U.S., and indicators of credit stress remain resilient. Nevertheless, the situation is like a coiled spring, ready to fire in either direction.

Furthermore, ten years of growth have left both equity and credit markets expensive and over-bought. Likewise, the values of infrastructure and real estate projects have been run up by historically low cap rates and high leverage ratios. Correlation among all these markets is dangerously high, and low volatility levels signal that complacency has set it. Leading indicators of credit stress, while still relaxed, are just starting to show signs of over-exuberance. In the context of markets, which we propose (at this stage) require tail-risk hedging, gold has an enviable track record as a non-correlated store of value and insurance provider.

Another factor that underscores gold's increasing importance as a crisis offset asset can also now be demonstrated — that U.S. Treasuries are no longer asymmetrically correlated to market risk. As we illustrate in Figure 2, Treasuries now carry more correlation to equity market risks than they have historically, while gold displays low correlation to traditional asset classes and provides protection against portfolio drawdowns.

> "The Fed is in checkmate, and gold is now a mandatory, dual purpose, portfolio insurance asset."

Figure 2. Treasuries Are No Longer Asymmetrically Correlated to Market Risk

Correlation between U.S. 2-Year Treasuries and S&P 500 (2000-2019)

Source: Bloomberg as of 10/04/19. S&P 500 Total Return Index (SPX Index) vs. U.S. 2-Year Treasuries (USGG2YR Index).

We conclude that gold provides a high degree of liquidity, more negative correlation and therefore a greater risk offset than other asset classes.

I would suggest that gold's 2019 performance is quite different than prior rallies in that the gold market is no longer small and gold is no longer seen as a fringe asset. We believe that even broader levels of participation will occur as investors accept that gold should serve as a mandatory insurance asset within most cash and investment portfolios. The debate as to which risk is more likely to spur a payoff event should fade, as both institutional and retail investors are attracted to gold as a tool to make their portfolios less risky.

Checkmate

No subject garners more media attention these days than the messaging of the Federal Reserve and the central banks of Europe, Japan and China. The markets gyrate daily as trading systems and algorithms parse their statements. I believe this underscores a significant misconception — that the leanings of these central planners continue to matter given the size of the future obligations that they have created. As we recently outlined in Minsky Moment, the global debt pile has become so large that it requires close to zero interest rates to prevent insolvency and deflation — which NO government or market can currently withstand.

Additionally, it seems that constant loosening of money supply is required simply to keep the system liquid. The recent unexpected Federal Reserve accommodation in the overnight repo markets is yet another indicator of the underlying liquidity stress in the funding markets. Statements from Powell that this money printing is "in no sense QE" (quantitative easing) in fact "doth protest too much".

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Overall, we contend that monetary policy has reached the point of becoming ineffectual because even negative interest rates and loose monetary policy do not spur enough economic activity to enable the growth rate of economies to exceed the growth rate of debt balances.

Not only is there no gas left in the tank to push rates higher, negative rates are required simply to stop the equation from getting worse.

On that subject, the product of the current yield-suck vortex is that U.S. debt securities now pay more than 90 percent of the positive carry of all global investment grade debt. As summarized recently in Negative Rate Folly, this fact is far more foreboding than a debate over slowing economies or the timing of the next recession. The already corrosive effect of negative yields on the world's financial assets and savings protocol will be multiplied when rates begin to reverse, and the epic pileup of debt unleashes carnage on debt service ratios and valuations alike.

There is no way out of this negative yield quagmire without serious financial repercussions.

That brings us to a more careful consideration of the two moves the Fed has left: (1) helicopter money, in the form of basic minimum income, and its counterpart (2) fiscal spending increases as funded by ever-increasing deficits. Both are being warmed up by political parties across the world, none of whom believe they will be elected unless they campaign on promises financed by these gluttonous twins.

It seems that U.S. policy is almost unanimously geared to running increasing deficits, forever. Should the combination of these two policies be pursued with enough vigor, they may have the traction to create some desperately wanted inflation. However, we believe that the ingredients in this powder keg will combine to make it impossible to control whether inflation expectations will increase at digestible levels, or much more, because as we've already stated, future interest rate increases are out of the question. Through the combination of higher inflation and government-suppressed interest rates, investors are likely to be faced with financial repression and currency debasement at painful levels for the foreseeable future.

Most importantly, for the purposes of this piece, we combined the titles above to form our advice. The Fed is in checkmate, and gold is now a mandatory, dual purpose, portfolio insurance asset. Gold investors will be in for a good run, while the majority of non-believers are steadily converted and buy-in.

We believe that gold should be overweight in your portfolio at this time.

Peter Grosskopf, CEO

About Sprott

Sprott is a global alternative asset manager with a defining focus on precious metals and real assets investments. Through our subsidiaries in Canada, the U.S. and Asia, Sprott is dedicated to providing investors with world-class investment strategies that include exchange-listed products, active equity strategies and highly-specialized real asset investments. Our deep sector expertise creates investment and financing solutions unparalleled in the industry.

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