Sprott

A Message from the CEO

March 19, 2020

Peter Grosskopf
Chief Executive Officer,
Sprott Inc.

Keep the Faith

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Chief Executive Officer, Sprott Inc.; Managing Director, Sprott Resource Lending

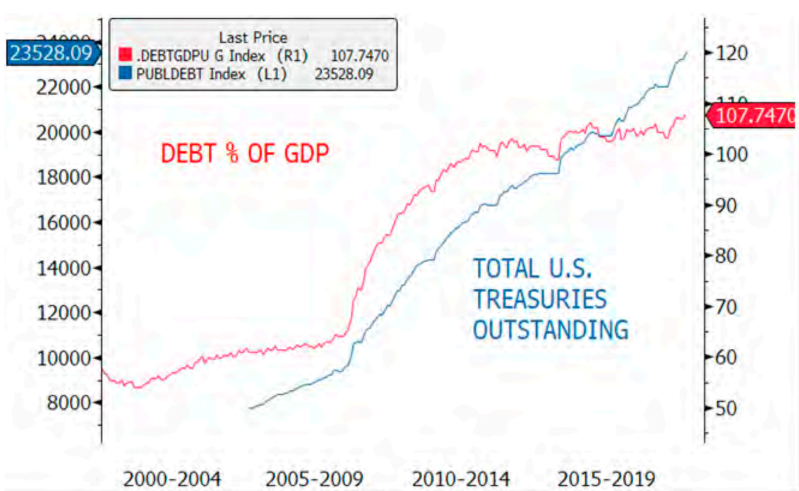
It has been a very difficult couple of weeks for the precious metals complex, the financial markets and the general population. No doubt that the impacts of the coronavirus outbreak will be shouldered by many over both the short and long terms. Some industries, such as travel and hospitality, will require assistance while others, such as medical and long-term care, will need massive investment. I trust that our collective resilience and determination will prevail and that the vast majority of us will be safe and more grateful than we were before 2020.

Sprott is Well Positioned

Sprott is well positioned for these uncertain times. As our clients and shareholders are aware, our firm has been at the forefront of the notion that systematic risks in the markets have been building for years. We believed that there was bound to be some event that served as a catalyst to a sea-change in the perception and pricing of those risks (see *This Tide Will Turn*, December 2019).

Our thesis has been underpinned by one central premise: that the $250+ trillion build-up in global debt was serving to unnaturally extend the business cycle and asset prices in the same misguided way as during prior bubbles. And, that the economy was no longer growing enough or large enough to support this massive debt balance. We believe it was already, prior to this crisis, an unsolvable equation that had reached its Minsky Moment (see Figure 1).

Figure 1. Debt to GDP Equation No Longer Solvable



Source: Bloomberg. Data as of 3/18/2020.

Concurrently, central banks have become influenced by their political masters and now serve widely to provide the financing and stimulus required to hold the equation in abeyance. Negative interest rates never made sense to us and neither do seemingly permanent budget deficits after a 10-year bull market. Sadly, the coronavirus pandemic has now provided the pin which has burst the bubble.

Long-Term View Unchanged

From the perspective of Sprott and the positioning of our clients and firm, nothing has changed over the last two weeks. Our clients have co-invested with us in gold and related assets to protect their wealth from the current global reset, a strategy that has historically always paid dividends. We are now several giant steps further into the process of financial repression which is required for the "books to balance".

Clearly, more quantitative easing ("QE") needs to be unleashed, no matter what you call it, in order to provide the liquidity the system desperately requires. Interest rates cannot rise without making the situation much worse, so central banks will do what is necessary to keep a lid on rates. Fiscal stimulus is also on the way because even after 10 years of recovery, the economy is nowhere near strong enough to handle the stresses of a coronavirus slowdown. In summary, more low rates, more printing, more budget deficits. Nothing we weren't expecting, just more severe than we anticipated.

> "We believe that gold provided what it should during times of crisis, a form of insurance to cash in when liquidity was required.... We believe that long-term investors, not subject to margin pressures, will be similarly rewarded by owning gold at this time."

What is New

When the coronavirus crisis hit, governments adopted the strategy of trying to stop its spread at all costs. This has become much more difficult than expected in Western societies and has far greater implications for the global economy. I think we all appreciate that this may become a slowdown unlike any seen in our generation. The risks of leverage and performance are now much greater than they have been since the global financial crisis ("GFC"). Risk premia required for investment have increased dramatically.

The short-term impacts on the markets are severely deflationary. Asset and collateral prices have fallen and the effects on private asset markets such as real estate and infrastructure are only now starting. This process will take a long time, and the pendulum usually swings too far.

Credit spreads have increased and stress is now apparent (see Figure 2). The deleveraging process for many levered borrowers will add a painful overhang to the markets, distressed situations will emerge and valuations will fall to much more attractive levels.

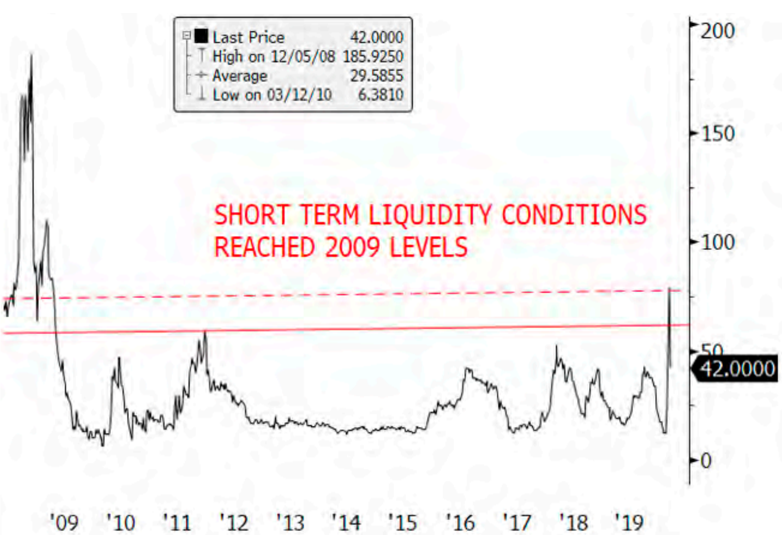
Figure 2. Investment Grade CDS (Credit Default Swap Spreads) Have Spiked

Source: Bloomberg. Data as of 3/18/2020.

Liquidity Crunch

The slowdown associated with the coronavirus spurred an immediate drop in revenues which has reverberated through the global system. As the news worsened, markets fell and hedging exacerbated their fall. My colleague Paul Wong has researched the effects of the spikes in volatility, combined with less-liquid-than expected markets, which required the deleveraging of Commodity Trading Accounts ("CTAs") and the highly-levered risk parity funds. Together with the stresses in the energy and non-investment grade bond markets, the rush to liquidity disrupted the U.S. dollar ("USD") funding market and produced the largest "market margin call" since 2008. As shown in Figure 3, the spike in one-month U.S. dollar financing cost was epic.

Figure 3. Spike in One-Month USD Financing is Epic



Source: Bloomberg. Data as of 3/18/2020.

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In response, the U.S. Federal Reserve added $1.5 trillion to the short-term funding markets last week and while it stabilized the market by weeks' end, much stress was still apparent. We believe central banks will stop at nothing to provide the required accommodations, so eventually, as was the case post the Lehman event during the GFC, liquidity will be restored.

Even U.S. Treasuries Affected

The U.S. Government Securities Liquidity Index (see Figure 4) is a measure of the prevailing liquidity conditions in the $17 trillion U.S. Treasury market, which is the world's largest market. The rate of change indicates a shock event and that the U.S. Treasury market is not functioning properly due to enormous liquidity strain. At the apex of last week's market crisis, U.S. Treasury prices moved lockstep lower with equity markets. The TLT,[1] a $20 billion ETF (exchange traded fund) of treasuries, is currently trading at a non-sensical discount to its NAV.

Figure 4. Liquidity Stress in Treasuries

Source: Bloomberg. Data as of 3/18/2020.

To add to the funding strain, we anticipate that fiscal stimulus, in the form of announced tax cuts and relief packages for various industries, will also arrive on the scene globally with many acronyms requiring trillions of dollars over time. Our ominous observation is that the Treasury markets were saturated even before the financing of this wave of fiscal stimulus. We believe the challenges of funding the Treasury without raising rates will require continued monetization of debt by the Federal Reserve.

Our conclusion is that sovereign bond markets currently offer investors reward-free risk. In most inflationary or even normalization scenarios, the losses from long-term bond positions would be substantial.

Update on the Gold Trade: Refuge in a Time of Crisis

Closer to home, the raging liquidity vortex seriously impacted the gold price, which retreated more than 10% from its recent peak. We note that the price of gold is always vulnerable when sentiment is overextended and it is over-bought based on technical measures such as RSI (relative strength index) and net commercial versus speculative positions. USD strength last week hurt as well. As usual, the trading of gold was likely dominated by margined entities trading "paper" as opposed to physical transactions, usually by a factor of 100:1 or more.

Most importantly, we believe that gold provided what it should during times of crisis, a form of insurance to cash in when liquidity was required. Gold has lousy margin rates for levered funds and is, by default, one of the first assets to be cashed in when leverage is reduced. We are comforted that throughout this "policy payout," it has mimicked its performance in the GFC, during which it was first sold down by holders requiring funds for other purposes and then skyrocketed once liquidity was rebalanced and QE began in earnest. We believe that long-term investors, not subject to margin pressures, will be similarly rewarded by owning gold at this time.

Liquidity concerns also played a prominent role in gold producer equity trading. Gold funds, of which the largest are ETFs, were sold aggressively by margined investors and computer-based traders. The largest gold mining ETFs, the GDX[2] and GDXJ,[3] were so oversold that they diverged from their closing NAVs by wide margins (see Figure 5). Small- and mid-cap gold stocks lost their bids entirely and fell further from already depressed levels. In our opinion, many now trade under their liquidation values. We remind our clientele that gold producers are enjoying healthy, increasing margins and that their earnings performance should handily outperform other industries in this environment.

Figure 5. Forced Liquidations Causing Dislocation in Gold ETFs

Source: Bloomberg. Data as of 3/18/2020.

Our position on gold is unchanged, which is that it should become a preferred currency and liquidity position for investors, with an essential utility as an insurance policy for more difficult markets to come. Artificially-sponsored negative real rates are already severely damaging purchasing power within portfolios. Permanent government debt "monetization" began in 2019 and will now need to accelerate. In the long term, we are convinced that this process of unabated money printing will eventually spur inflation. Admittedly, it is challenging to see beyond the short-term deflationary event and the government-doctored CPI statistics to the eventual reflationary process. Fortunately, either way, this environment is nirvana for gold as a real asset with purchasing power protection.

Sprott's Business and Strategy

In my opinion, the past two weeks have highlighted the importance of Sprott and our mission to help our clients preserve wealth in uncertain times. We are brave, contrarian and committed to providing our clients with the best investment opportunities in our sector. Nothing has changed in this strategy save for the pricing of the opportunity.

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Sprott, as a company, has never been in better health. Our employees are safe and accustomed to working collaboratively from remote locations. Our margins are strong, our assets and client base are growing and we have multiple opportunities for expansion. We are committed to our dividend policy, which provides our shareholders with a healthy yield and to maintaining a strong balance sheet. We liken Sprott to a management company that earns a royalty from our assets under management and as such, we believe our shares are undervalued and are actively repurchasing them for cancellation.

We advise our clients to add to their gold positions over the coming weeks and to use periods of short-term weakness as buying opportunities.

Be safe, this too shall pass and we will get through this challenging period together.

Please feel free to reach out to us at the telephone numbers/email addresses below.

Sincerely,

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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.

For more information, please visit **sprott.com**

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[1] The iShares 20+ Year Treasury Bond ETF (TLT) seeks to track the investment results of an index composed of U.S. Treasury bonds with remaining maturities greater than twenty years.
[2] VanEck Vectors Gold Miners ETF (GDX) seeks to replicate as closely as possible, before fees and expenses, the price and yield performance of the NYSE Arca Gold Miners Index (GDMNTR), which is intended to track the overall performance of companies involved in the gold mining industry.
[3] VanEck Vectors Junior Gold Miners ETF (GDXJ) seeks to replicate the MVIS Global Junior Gold Miners Index (MVGDXJTR), which is intended to track the overall performance of small-capitalization companies that are involved primarily in the mining for gold and/or silver.

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