Sprott

Sprott Gold Equities Strategy

Q2 2020 Commentary

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John Hathaway, Senior Portfolio Manager, joined Sprott Asset Management on January 17, 2020, following Sprott's successful acquisition and reorganization of the Tocqueville gold strategies. The Sprott Gold Team welcomes Hathaway, along with Doug Groh, Senior Portfolio Manager, and Victor Huwang, Director, U.S. Operations. The Sprott Gold Team offers world-class expertise in the active management of precious metals equities. Visit sprott.com/gold-team for more information.

Gold Mining Equities: A Very Fat Pitch

July 21, 2020

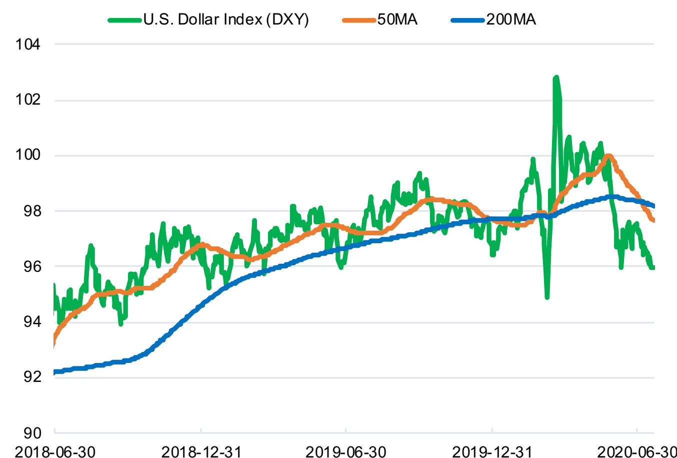
Gold bullion continues to exhibit strength against a very favorable backdrop of ongoing monetary debasement. It currently sells at only $60 below its all-time high of $1,900 reached in September of 2011. While the next few months could consist of further base building before exceeding the previous record, a breakout seems inevitable. Once a new U.S. dollar high is achieved, we believe follow on gains will be surprisingly swift and dramatic. Therefore, we recommend taking advantage of whatever market lull remains to build positions.

Gold mining stocks are exceptionally undervalued both on an absolute scale and relative to the metal itself. Almost all companies are generating strong year-over-year earnings comparisons and free cash flow while the rest of the global economy remains hobbled by COVID-19 mandated restrictions and excessive debt. If one believes bullion prices are headed higher, mining stocks leverage that view. Potential gains of 100% or more across the board could be in the cards.

The U.S. dollar gold price is treading water well below where it could and probably should trade. Gold already commands record prices in every currency other than the U.S. dollar. One important remaining obstacle to mass buying interest is the fact that the metal still has yet to sell at a record high in U.S. dollars. It is encouraging that the dollar is showing signs of weakening against other paper currencies. It would not take much of a further decline to flip the switch for algos and quants [algorithms used in quantitative trading] to drive dollar gold prices to new highs.

Figure 1. U.S. Dollar is Weakening (2017-2020)

DXY[1] versus the 50 moving average (50MA is the medium-term outlook) and the 200 moving average (200MA is the trend bias).



Source: Bloomberg. Data as of June 30, 2020.

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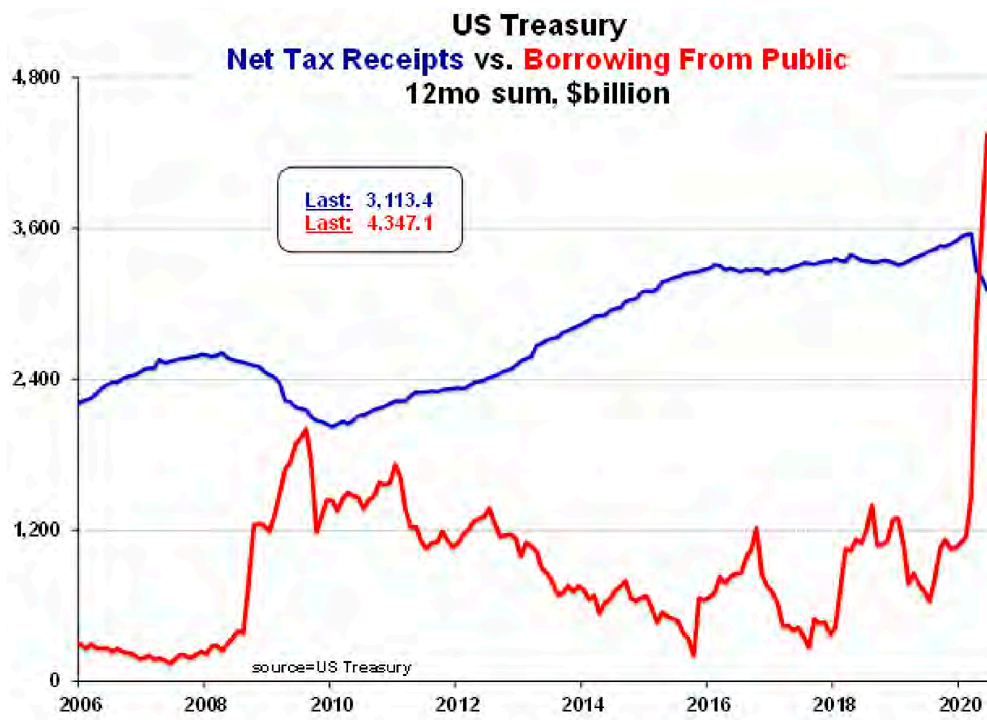
At gold's previous peak in September 2011, the U.S. Federal Reserve (Fed) balance sheet footed to approximately $3 trillion. Today, that number is $7 trillion, and by year end, it could easily approach $10 trillion. Based on that simple metric, gold has the potential to double or triple in price. While not necessarily a causal factor, Fed balance sheet growth is symptomatic of the acute fiscal illness that underlies all U.S. financial obligations including the U.S. dollar itself. A gain of 2x or 3x in the bullion price would sync with the currency destruction implied in the Fed's rapid balance sheet expansion.

> "We believe that the macro forces for gold and gold mining stocks have coalesced into what may be one of the 'fattest investment pitches' of our time."

Why Own U.S. Dollars?

The U.S. fiscal picture is horrific. It seems inconceivable that the taxing power of the government will be sufficient to service government debt unless interest rates remain pinned near zero or less, quite possibly for a decade. A few more years of sub par economic growth (which is a reasonable bet) would put the exclamation point on that view. Fed Chairman Powell has stated that the Fed is not even thinking about raising rates before 2022. Even a slight rise in rates could trigger widespread credit defaults and severe economic weakness. What rational long-term investor would want to own U.S. dollar denominated bonds against this backdrop?

Figure 2. U.S. Debt Burden has Exploded and Tax Receipts Are Falling



Source: Meridian Macro Research LLC.

An under appreciated tenet of the case for gold is that miniscule interest rates open the door for the metal to serve, by process of elimination, as a portfolio risk diversifier. Low rates enervate the functionality of the traditional portfolio construction that employs 60% equity/40% fixed income to balance risk. With interest rates near or below zero across the yield curve, bonds have taken on cash like characteristics in that they offer little upside during an economic downturn, but expose investors to significant downside if interest rates or inflation increase, or if the U.S. dollar weakens substantially against competitor paper currencies. We understand the deflationist argument that further fixed income appreciation could occur with deeply negative nominal rates. However, in our mind, betting on fixed income exposure against a backdrop of extended deflation within the contemporary political landscape seems risky. The social contract governing traditional relationships between creditors and borrowers, including the notion that the latter must eventually repay the former, could be threatened.

Bonds have come perilously close to a dead end in terms of their usefulness for portfolio risk mitigation. Mohamed El-Erian (Chief Economic Adviser of Allianz) recognized this when he tweeted the following on June 26, 2020:

Figure 3. El-Erian on Gold

Source: Twitter.

A shift from bonds to gold, even if only small, could drive the bullion price substantially higher. A large rise would be plausible even in the absence of resurgent inflation.

Only last month, Reuters recently reported that "before the COVID-19 pandemic, most private banks recommended their clients hold none or just a tiny amount of gold." Large institutional pools of capital have only just started to wake up to the implications of the new macro landscape. Many institutions are still asleep at the switch. In June, the $400 billion CalPERS pension fund (the California Public Employees' Retirement System) announced increased allocation to private equity which it expects to produce returns of 8.3% versus only 2.8% for fixed income. It plans to enhance returns further by leveraging the portfolio by 20% in order to meet its long-term goal of 7% returns. The CalPERS announcement highlights the fixed income dilemma facing large fiduciary pools of capital. Either take on more risk or cut plan benefits.[2]

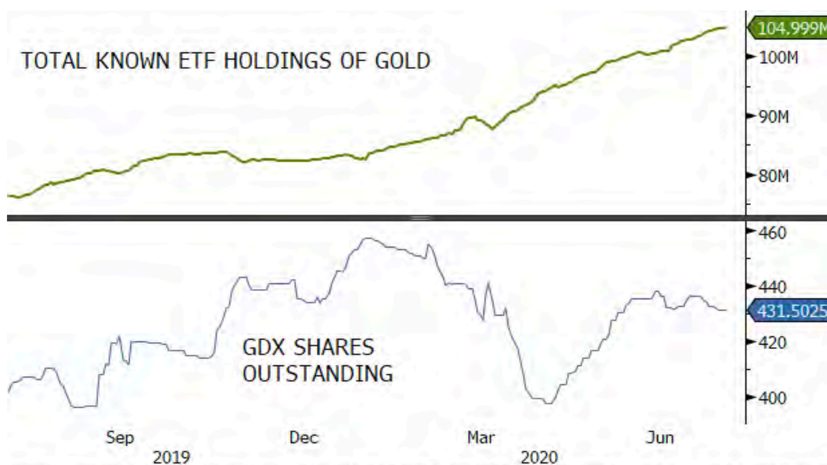
Tremendous Upside Potential for Gold Mining Stocks

If gold has the potential to double or triple from current levels, the upside potential for gold mining stocks could be even greater. The ratio of gold mining stocks to the metal (basis HUI[3]) stands at only 0.16, compared to a range of .25 to .60 during the bull market from 2000-2010, as shown in Figure 4 (top chart). While investor flows, mainly retail and small institutions, into gold-backed ETFs have been strong, with first half inflows exceeding any previous year, interest in gold mining stocks remains sporadic despite the fact that the group has outperformed the S&P 500 Index[4] year-to-date June 30, 2020 (25.85% versus -3.08%) and are up 44.00%[5] on a 12-month basis depending on the benchmark (see bottom chart in Figure 4). Anemic investor inflows suggest that despite strong performance, the move into mining equities has barely started. If the gold price is too low, mining share prices are even more so.

Figure 4. Gold Bullion and Gold Stock Sentiment

The HUI-Gold Ratio Measures Investor Sentiment on Gold

Source: Bloomberg. Data as of June 30, 2020.



Source: Bloomberg. Data as of June 30, 2020.

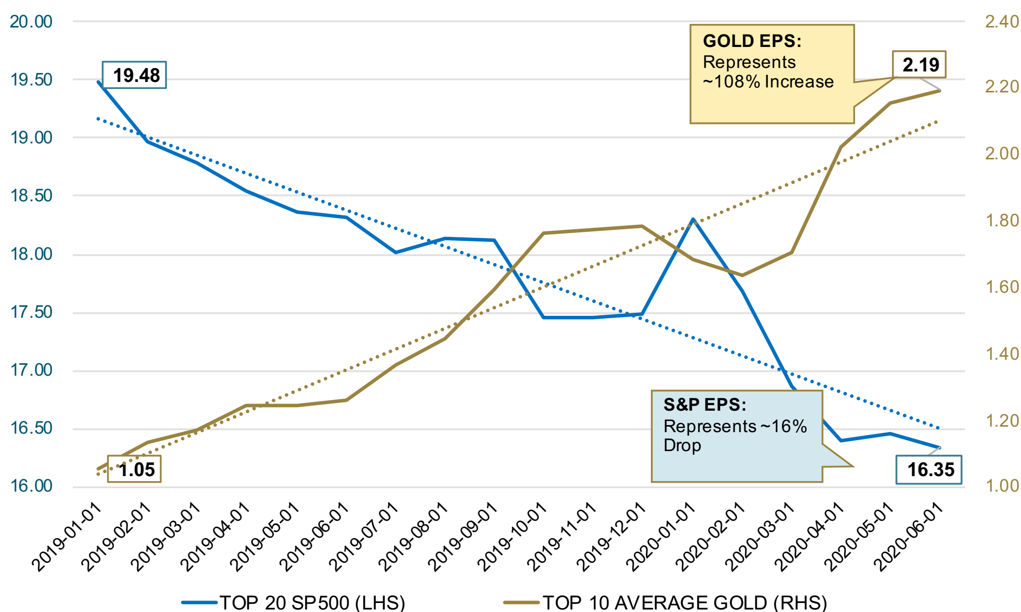
In a deflationary world, the economics of gold production have become highly attractive. Input costs such as energy are falling while bullion prices are rising. The average production cost per ounce of gold is roughly $1,000 (ASIC, or all in sustaining cost) and looks to be stable to lower over the next few years. Profit margins are rapidly expanding. The average gold price of approximately $1,393 for 2019 meant that the cash profit margin per ounce was $393. Based on the current bullion price of $1,800, that profit margin has expanded to $800 an ounce, a 104% increase in just one year. Even though precious metal mining shares have on average increased 44%[5] over the past year, profitability at current gold prices has outpaced that gain.

Gold Miners are Very Healthy

While most of corporate America is struggling, the gold mining sector is financially robust. Free cash flow generation is more common than not for gold producers, balance sheets are strengthening and dividends are increasing. The current world mining infrastructure could not be replicated at anything close to historical book value. Therefore, the appetite and financial capacity is low for large scale capital expenditures that would significantly increase global mining output. While most mainstream companies that populate the S&P 500 Index face a sub par earnings outlook, mining companies look forward to rising earnings and favorable year-over-year earnings comparisons.

The valuation contrast between main stream investment strategies and the mining sector is stark. The forward earnings multiple on the S&P is 25.9x, the fifth highest since 1991 and close to the 28.2x (1998) and 29.3x (1999) multiples that preceded the dot com crash of 2000. Many mid- to small-cap mining equities trade at modest single digit multiples of enterprise value to EBITDA.

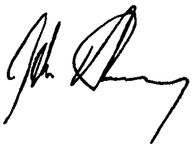
Figure 5. Earnings Per Share (EPS) Estimates are Up ~108% for Gold Miners



Source: Meridian Macro.

Low valuation, strong financials and a bright earnings outlook add up to a highly attractive investment case for the gold miners. We were recently reminded that investment legend Stan Druckenmiller once shared a key secret for his success. That secret was to stand pat for long periods, years if necessary, until exceptional opportunity presented itself. In baseball lingo, such an opportunity is called a "Fat Pitch". We believe that the macro forces for gold and related mining stocks have coalesced into what may be one of the fattest investment pitches of our time. A fat pitch is a momentary event, akin to catching a major trend change in the financial markets. Such opportunities do not come around often. They deserve serious consideration and expeditious response.

Authored by John Hathaway, CFA



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Please contact the Sprott Team at **888.622.1813** for more information. You can also email us at **invest@sprott.com**.

[1] The U.S. Dollar Index (USDX, DXY) is an index of the value of the U.S. dollar relative to a basket of foreign currencies.

[2] Source: Calpers CIO Eyes More Private Equity, Leverage to Hit Target.

[3] The NYSE Arca Gold BUGS Index (HUI) is a modified equal dollar weighted index of companies involved in gold mining. BUGS stands for Basket of Unhedged Gold Stocks.

[4] The S&P 500 Index (SPX) is an index of 505 stocks issued by 500 large U.S. companies with market capitalizations of at least $6.1 billion.

[5] Based on the performance of Sprott Gold Miners ETF (SGDM), which seeks investment results that correspond (before fees and expenses) generally to the performance of its underlying index, the Solactive Gold Miners Custom Factors Index (Index Ticker: SOLGMCFT). The Index aims to track the performance of larger-sized gold companies whose stocks are listed on Canadian and major U.S. exchanges.

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