

Gold Wave Likely Regardless of U.S. Election Outcome

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October was a flat month for gold bullion, with the yellow metal losing 0.37%. Year-to-date through October 31, 2020, gold has gained 23.83.¹ Silver bullion² climbed 1.81% in October and has risen 32.51% YTD. Gold mining equities pulled back in October but have gained 27.57% YTD and 32.83% YOY as of October 31 (as measured by SGDM³). This compares to 2.77% YTD and 9.71% YOY returns for the S&P 500 TR Index.⁶

Month of October 2020

Indicator	10/31/2020	9/30/2020	Change	Mo % Change	YTD % Change	Analysis
Gold Bullion ¹	\$1,878.81	\$1,885.82	(\$7.01)	(0.37)%	23.83%	Narrow trade range in October
Silver Bullion ²	\$23.66	\$23.24	\$0.42	1.81%	32.51%	Narrow trade range in October
Gold Equities (SGDM) ³	\$32.00	\$33.47	(\$1.47)	(4.39)%	27.57%	Gold equities back to support
Gold Equities (GD ⁴)	\$37.49	\$39.16	(\$1.67)	(4.26)%	28.04%	Same as above
DXY US Dollar Index ⁵	94.04	93.89	0.15	0.16%	(2.44)%	Range bound at lower range
S&P 500 Index (Price Return) ⁶	3,269.96	3,363.00	(93.04)	(2.77)%	1.21%	Wide choppy trade range
U.S. Treasury Index	\$2,556.44	\$2,580.77	(24.3)%	(0.94)%	7.88%	Did not offset equity decline
U.S. Treasury 10 YR Yield	0.87%	0.68%	0.19%	27.73%	(1.04)%	Bear steepener, reflation expectation
U.S. Treasury 10 YR Real Yield	(0.84)%	(0.95)%	0.12%	(12.12)%	(0.97)%	Less negative but still near lower range
Silver ETFs (Total Known Holdings ETSITITL Index Bloomberg)	885.52	869.99	15.53	1.79%	45.92%	Dip buying, <1.3% from all-time highs
Gold ETFs (Total Known Holdings ETFGTOTL Index Bloomberg)	110.84	110.65	0.19	0.17%	33.68%	Monthly high, <0.4% from all-time high

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Figure 1. Gold Bullion Continues to Outperform Major Asset Classes YTD



Source: Bloomberg. Period from 12/31/2019-10/31/2020. Gold is measured by GOLDS Comdty; US Agg Bond Index is measured by the Bloomberg Barclays US Agg Total Return Value Unhedged USD (LBUSTRUU Index); S&P 500 TR is measured by the SPX; and the U.S. Dollar is measured by DXY Curncy. You cannot invest directly in an index. Past performance is no guarantee of future results.

Awaiting the Pivotal U.S. Election Outcome

October was a predominantly quiet month for all asset classes, until the last week, from a liquidity and trading perspective. As expected, post the September OpEx (options expiration), all markets saw reduced activity ahead of today's U.S. election. The uncertainty over the U.S. election has been priced in the volatility market where volume pricing shows an elevated level in November through to January.

Since the summer, anxiety levels have ebbed and flowed with three rotating themes:

1) Increased market chaos given heightened election uncertainty; 2) A possible Democratic (Blue Wave) sweep resulting in massive fiscal stimulus and a more significant reflation outcome despite higher taxes; and 3) A Republican retained Senate leading to much lower fiscal stimulus and an uncertain reflation outlook. While the market has been trying to price in a possible election outcome, the COVID-19 pandemic entered its second wave in both the U.S. and Europe and ushered in the risk of further restrictions that will damage economies.

Investors stepped away from markets in October due to the twin uncertainties of the election outcome and the COVID's surging second wave. The most notable market impact was the sharp reduction in trading liquidity and market depth as fund positioning collapsed into a holding pattern. Dealers backed away from liquidity provision and facilitation due to the problematic nature of hedging idiosyncratic election risk. Finally, in the last week of October, we witnessed a sharp market selloff due to the growing restrictions and containment in Europe as COVID cases crept higher, decreased odds of a Red Wave in the U.S. election and failure to pass a COVID relief package before the election. Economic growth expectations took a hit, and indiscriminate risk aversion in an illiquid market resulted in chaotic price action but minimal market signal.

"Gold's bullish wave remains intact, and both gold bullion and gold mining equities are well-positioned under most plausible U.S. election scenarios."

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Gold Bullion: The Tale of Two Markets Continues

In October, spot gold fell \$7 per ounce (-0.37%) to close at \$1,879 in a narrow trading band. For gold bullion, we continue to see a tale of two markets. In our September monthly (Gold's Breather Creates Buying Opportunity), we highlighted the two groups representing the dominant holders of gold bullion. ETF investors represent the largest group, which we described as more long-term macro-fundamental driven. The other group consists of futures traders who are focused on positioning and are liquidity-driven. The trend we highlighted last month remains in place: ETF buying continues among investors while futures traders are reducing positions. Everything macroeconomic (i.e., M2 money supply, the U.S. dollar, real interest rates, etc.) continues to be gold bullish long-term and short-term, or sideways at worst. Everything market depth and liquidity-related weakened as we headed closer to the U.S. election. Figure 2 highlights the intact bullish trend and the most recent correction compared to the prior short-term pullbacks.

Figure 2. Gold Bullion is in a Familiar Corrective Pattern



Source: Bloomberg. Data as of 11/01/2020. Gold bullion price is measured by the Bloomberg GOLDS Comdty Index. You cannot invest directly in an index. Past performance is no guarantee of future results.

Despite the intense focus on the possible outcomes of today's U.S. election and the COVID pandemic's burgeoning second wave, we are in a "risk mitigation" (or derisking) type market, not an "event risk" market (significant cross-asset class repricing). Market systemic risk measures such as interest rate swaps (IRS), overnight index swaps (OIS) and U.S. dollar swaps (USD swaps) remain well under any "event risk" measure (unlike February to March of this year). In general terms, gold tends to have mixed results for risk mitigation purposes, which usually translates to portfolio exposure reduction. Event risk would see a major repricing of asset classes and wide-scale changes in volatility exposures and expectations. The market may reach an event risk if the U.S. election results in chaos, but that is not the situation at this writing.

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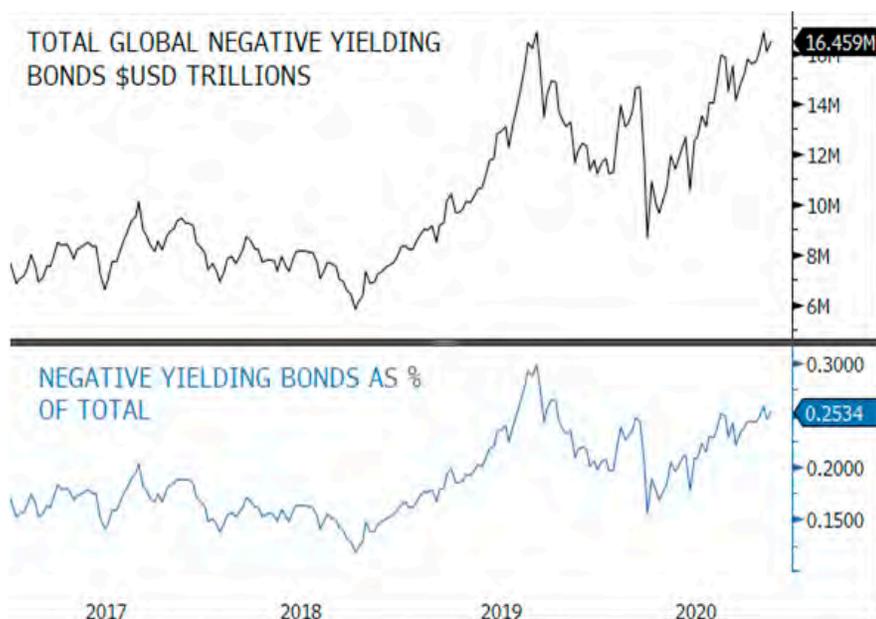
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A Decade of Extreme Monetary Policy, Extreme Fiscal Policy Next?

For decades now, central banks have been left alone to fight disinflation and stimulate growth. After the great financial crisis (GFC) and now the COVID pandemic, monetary accommodation has reached extreme levels with zero to negative interest rate policies in place in almost all developed economies. Global central banks have now bought roughly \$19 trillion in bonds via various quantitative easing (QE) programs since the end of the GFC (2010). There is now \$16.5 trillion of negative-yielding bonds globally (near the 2019 highs) or about 25% of all outstanding global bond issuances (see Figure 3).

With the growing restrictions in Europe due to COVID's growing second wave, the European Central Bank (ECB) appears ready to bring out another big monetary bazooka by its December meeting or even earlier. The risk is building that Europe may experience a double-dip recession. We expect that the amount of negative-yielding bonds will reach new highs well before year-end. The favorable opportunity costs of owning gold rather than negative-yielding bonds continues to strengthen.

Figure 3. Level of Global Negative-Yielding Bonds Continues to Expand



Source: Bloomberg. Data as of 11/01/2020. Bonds are measured by the BNYDMYU Index (Bloomberg Barclays Global Agg Neg Yielding Debt Market Value USD), in Millions of Millions = Trillions. You cannot invest directly in an index. Past performance is no guarantee of future results.

If today's election results in a Democratic sweep, we will likely see the progression to "extreme fiscal stimulus." The U.S. Federal Reserve (Fed) has already monetized the more than \$2 trillion fiscal stimulus package released in the spring. The Fed will also monetize the next fiscal stimulus package of another estimated \$2 trillion under a Democratic sweep. In fact, in speeches and testimonies, Fed Chairman Powell has already called for monetary-fiscal coordination while reiterating monetary policy's limitations as the sole economic stimulus provider. And the groundwork has already been prepared. The Fed's zero interest rate policy (ZIRP) has virtually guaranteed that U.S. government borrowing costs will be low (close to zero) in perpetuity.

Furthermore, the Fed still has two tools to keep interest rates from becoming disorderly. The first is increasing the weighted average maturity of its QE purchases further out on the interest rate curve, and it can also increase the size of its QE. The other tool the Fed has on standby is yield curve control (YCC). Even if they overshoot, the Fed's new AIT (average inflation targeting) rate increases will not occur until the Fed sees a sustainable economy as defined by its target level of full employment.

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A \$2 trillion level fiscal stimulus bill is now the consensus given a Democratic sweep. An infrastructure bill is also a consensus. While the cost is unknown, it will be in the multi-trillion-dollar range (the Biden green energy plan has a \$2 trillion price tag alone). Undoubtedly, other progressive spending bills as part of Biden's Build Back Better plans will be discussed in the coming months. This next level of extreme fiscal stimulus certainly looks like modern monetary theory (MMT); it just will not be implicitly called MMT. We are possibly an election outcome away from "Fiscal-Infinity" joining "QE-Infinity" for better or worse.

Gold Equities Pullback to Support Level

Gold equities drifted back to the important support level in October, trending lower to the \$37-\$38 range, as measured by GD_X.³ Trading and activity fell away as we approached today's election. Since their August peak, gold mining equities have been in a corrective phase (a five-wave pattern) to test the primary chart support level just above the rising 200-day moving average. Thus far, only a half dozen large gold companies have reported for Q3, but the following trends are quite pronounced. As mining operations return to normal in the current gold pricing environment, we see significant margin increases and free cash flow generation, leading to substantial dividend increases. For example, two of the largest gold producers announced quarterly dividend increases of 60-70%. In previous reports, we have highlighted the significant earnings power of gold mining companies. Q3 and Q4 earnings results will illustrate this point.

Figure 4. Gold Miners Retesting Support



Source: Bloomberg. Data as of 11/01/2020. Gold equities are measured by GD_X. Past performance is no guarantee of future results.

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Gold Equities: This Cycle vs. the Prior Cycle

During the prior gold equity bull market cycle, from the trough in 2000 to the peak in 2011, gold miners returned about 900% (23.6% annualized). The incredible rise and fall was characterized by the industry's "growth at any cost" approach. Growth at any cost in any industry, let alone a capital intensive one, inevitably results in write-downs and capital destruction. The gold mining industry during the prior bull cycle was a prime example of this. However, the current bull cycle is shaping to be vastly different as the pendulum has swung mightily. The painful lessons of the prolonged bear market that followed 2011 have resulted in the gold industry shifting to a sustainable return on capital model from the prior unsustainable growth model. This cycle is shaping up to be radically different from the previous one on virtually all measures that matter to shareholders.

One of the most significant differences from the prior cycle is industry cost structure. The last cycle was a period of almost hyperinflationary cost for miners driven by the rapid ascension of China's economy and its almost insatiable demand for practically every commodity. From 2001 to 2011, China's annual gross domestic product (GDP) averaged +10.2%, as it focused its economy on the export market (productive capacity) and domestic construction, both due to its intensive labor component. Building and construction, in particular, fueled China's enormous demand for bulk commodities. Massive investments in iron ore, met coal and other bulk commodities resulted in a global mining boom driving up the cost for engineering equipment and personnel, components, reagents, etc. Virtually every input cost for operating gold mines was in a hyperinflationary mode. New mines that were built in this inflationary environment saw cost overruns explode and return on capital implode.

Gold Miners are Now Focused on Capital Discipline

In the current bull cycle, costs are now well contained, with disinflationary pressures remaining. The two primary operating cost inputs of any gold mine are energy and labor. Crude oil is well below \$40 a barrel and demand has not recovered yet (no V-recovery here), and the futures curve is flat. The average price of crude from 2004 to 2011 was approximately \$76 per barrel, almost twice the current price. Labor cost pressure this cycle is likely to be muted as the global economic recovery struggles to find its footing. Before COVID, China's GDP had stabilized in the +6% range for the past several years, with excess capacity and overinvestment an ongoing concern.

While global cost pressures are usually beyond management's control, capital discipline and corporate capital structure are under its control. Again, the contrast is stark. Currently, balance sheets are nearly unleveraged versus highly leveraged in the prior cycle. M&A activity is now measured versus very active (growth at any cost). Return on capital is sustainable versus a non-priority. High levels of free cash flow are being generated today compared to none for most of the prior cycle. Capital spending is conservative compared to a CapEx that soared with bullion prices. The gold mining industry could not be more different now than from the preceding cycle.

Despite what we see as a multi-year bull market in gold bullion, a disinflationary cost environment, and an industry now focused on capital discipline, valuations are still in bear market pricing ranges. Figure 5 highlights the historical EV/EBITDA valuation (enterprise value to earnings before interest, taxes, depreciation and amortization)⁷ for the GDM Index (NYSE Arca Gold Miners Index⁸) with the S&P 500 EV/EBITDA for reference. The GDM Index peaked out in September 2011 (marked by the dashed vertical blue line). The prior bull market trading range is marked with the green lines and the bear market valuation range in red.

Despite all the macro-level improvement for gold bullion, cost structures, and industry capital discipline, gold equities are firmly trading in bear market valuation levels signifying the extreme valuation disparity with the broader market. The S&P 500 this year alone saw a near +65% EV/EBITDA multiple expansion from March, and that is with the S&P 500 actual EBITDA declining 7.4%. Since March, gold miners EBITDA has increased by +17% (this does not include the blowout Q3 results that are still coming in).

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Figure 5. Gold Miners EV/EBITDA Trading at Bear Market Valuation Levels



Source: Bloomberg. Data as of 11/01/2020. S&P 500 Index is measured by the SPXEVEBT Index and Gold Mining Equities are measured by the GDMEVEBT Index. You cannot invest directly in an index. Past performance is no guarantee of future results.

The Gold Wave: Gold Likely to Elevate or Escalate Higher

Over the next few months (or hopefully sooner), there will be greater clarity about the election's consequences, the path of COVID and the state of the global economy. Gold bullion and gold mining equities remain well-positioned under most plausible scenarios. As we prepare to exit this consolidation period, all fundamental drivers indicate higher price levels despite the horrible liquidity, depth and multiple election outcome scenarios.

The market has partially priced one scenario: an uncontested election result and a Blue Wave sweep (the right tail risk scenario). Gold would do well (elevator up) in this Democratic sweep scenario. Much higher levels of fiscal stimulus would send M2 soaring again. The USD would weaken as wider deficits in a ZIRP environment with higher taxes would take hold. Real yields will go deeper negative as breakeven yields climb while the Fed holds down nominal yields due to their commitment to engineering an inflation overshoot.

However, a contested scenario with a Republican retained U.S. Senate would likely see a continuation of market uncertainty with even worse liquidity and market depth and a possible shock to the economy (reduced spending and civil unrest). Eventually, there will be a resolution to the election, and though the GOP-held Senate may be reluctant, further fiscal stimulus will ultimately be required. Depending on how severe the second COVID wave becomes, it may not matter who wins; there will be a massive stimulus. Gold takes the escalator up.

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¹ Gold bullion is measured by the Bloomberg GOLDS Comdty Index.

² Spot silver is measured by Bloomberg Silver (XAG) Spot Rate.

³ Sprott Gold Miners Exchange Traded Fund (NYSE Arca: SGDM) 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.

⁴ 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. The SPDR Gold Shares ETF (GLD) is one of the largest gold ETFs.

⁵ The U.S. Dollar Index (USDX, DXY, DX) is an index (or measure) of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies.

⁶ The S&P 500 or Standard & Poor's 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies. (TR indicates total return and reflects the reinvestment of any dividends).

⁷ The EV/EBITDA ratio is a popular metric used as a valuation tool to compare the value of a company, debt included, to the company's cash earnings less non-cash expenses.

⁸ NYSE Arca Gold Miners Index (GDM) is a modified market capitalization weighted index comprised of publicly traded companies primarily involved in the mining of gold and silver in locations around the world.

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