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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](http://sprott.com/gold-team) for more information.*

## The Gold Investment Thesis Revisited

April 9, 2021

### Recent Corrective Action Ignores the Fundamentals

Since gold's intraday August 7, 2020, high of \$2,075 per ounce, the metal has retreated 17.69% to \$1,708 as of March 31, 2021. Precious metals mining equities declined 23.56% over the same period. Eight months of corrective action has occurred despite solid and visible strengthening fundamentals for gold, leaving proponents of gold to wonder what they are missing.

Missing, in our opinion, are the yet unseen consequences from extreme financial asset valuations supported by the rapid expansion of new public and private sector debt. Economic nirvana, founded on path-dependent monetary and fiscal policy, is impossible. The punchbowl cannot be taken away without wrecking the economy and the markets. Public servants are unwilling and incapable of doing so. Intoxicants will most likely disappear for unforeseen reasons. We believe that gold will sense adverse outcomes long before they have been articulated.

"Which snowflake triggers an avalanche?  
What you need to know is that the massive buildup of systemic risk since 2008 is largely underappreciated."

### Four familiar refrains explain gold's recent correction:

#### 1 Rising interest rates.

Gold has been battered by the gale of microscopic advancements in U.S. 10-year Treasury yields and the expectation of higher yields to come. Rate increases are viewed as a "healthy" sign that all is well with the economic recovery. Scant consideration is given to systemic risks stemming from indigestion of the oversupply of new U.S. Treasuries relative to the lack of buying interest from traditional investors.

Little thought seems to be given to the possibility that higher interest rates could short circuit the economic recovery. As noted by MacroMavens (3/22/2021), economic sensitivity to "rate increases move alongside the total level of debt. If debt levels double, for example, the interest rate required to precipitate a crisis should be around half of what it was previously. As it turns out, total non-financial debt in the U.S. today is roughly double what it was at the end of 2006 (\$61 trillion vs. \$30 trillion when the housing bubble began to deflate). It goes without saying that the reason why financial and economic crises have been occurring at successively lower and lower levels of interest rates is that we, as an economy, have been taking on ever-increasing amounts of debt." Rate increases, as minuscule as they may be, may have little room to rise before triggering another financial crisis.

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## 2 Exposure to gold could dilute strong returns achievable in financial assets.

Secular bull markets in equities and bonds dull investor interest in risk mitigation. As noted by Simon Mikhailovich of TBR (*The Bullion Reserve*, 3/1/2021), “gold is behaving exactly like insurance should behave — rising and falling with confidence and catastrophic risk perceptions.”

The 2020 peak in gold was driven by acute concern over potential damage from the COVID-19 global pandemic. News of vaccine efficacy opened the door for projections of robust economic growth in 2021. Risk perceptions retreated along with the gold price. However, equity and fixed income valuations stand at all-time highs, with many metrics ranking at 100% of historical experience.

As noted by David Rosenberg (Rosenberg Research, 3/29/2021): “proliferation of IPOs [initial public offerings], retail participation, leverage, liquidity and SPACs [special purpose acquisition companies] should be a concern with anyone who has a keen sense of the history of what speculative-driven markets look like.”

At moments of maximum valuation, risk is highest and perception of it is lowest. According to the March 18 SentimenTrader (quoted in *The Belkin Report*, 3/22/2021): “By the end of last week, nearly 100% of traders were in a risk-on mode. A risk-on mentality has been so strong that the 50-day average of the aggregate indicator has climbed to 90.5%....Our backtest engine shows that when the 50-day average has been this high, future returns have been poor.” As famously noted by Bob Farrell, markets are mean reverting. Upside overshoots in valuation lead to overshoots on the downside. (See [Bob Farrell's 10 Rules](#).)

## 3 Bitcoin is the new gold.

Bitcoin has diverted money flows from gold. Perhaps the 2020 August peak in gold would have been \$200-\$300 ounces higher without speculation that Bitcoin will displace gold. A persuasive *Grant's Interest Rate Observer* essay, “[Bitcoin Goes to Wall Street](#),” suggests otherwise: “There will be a crash as Bitcoin is a bubble...Stripped of its monetary pretensions, Bitcoin will revert to its legacy role as a crypto version of a Western Union International wire transfer.”<sup>2</sup>

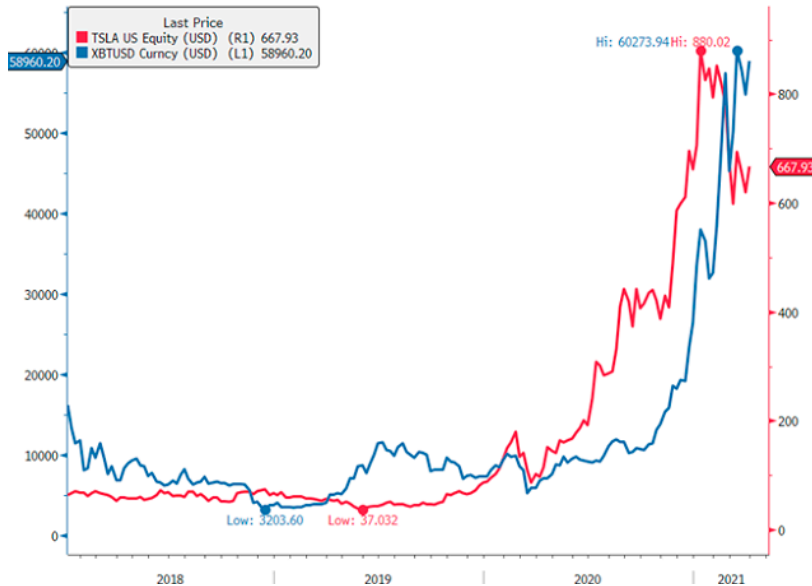
Bitcoin is internet dependent. If Australia was able to silence Facebook for incurring government displeasure, what are the implications for digital currency payments that escape the tax collector? Bitcoin price behavior is indicative of epic speculation. Little difference can be seen in Figure 1 which overlays the price patterns of Bitcoin and Tesla.

The movement towards digital currencies is inexorable and will tighten the government's grip on taxpayers. Gold is physical property. It [usually] stands alone as an off-the-grid store of value with minimal counterparty risk. Gold's usefulness in transactions was written out of the script for a century. Few proponents would argue that the metal's value depends on utility for routine day-to-day payments. On the other hand, blockchain technology holds favorable implications for gold. Digitization of almost anything is possible. Digital gold tokens for those who wish to transact in the metal already exist and could come into wide use by the end of this decade. More important, blockchain will connect lenders and borrowers, allowing owners to earn interest on their physical holdings.

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Figure 1. Price Patterns of Bitcoin and Tesla (2018-2021)



Source: Bloomberg. Data as of 3/31/2021.

### 3 Strong economic growth will significantly reduce and possibly negate systemic risk concerns implied by unprecedented public and private sector leverage.

Consensus is united on this — typical is the quote from Cornerstone Macro: “The March U.S. Markit Services PMI added 0.2 percentage points to 60.0%, its highest level since July 2014, with the future output index jumping 5.2 percentage points to 72.7%, its highest-ever level. Strength was broad based: employment (+2.0 percentage points), new orders (+0.6 percentage points ). Note: services include travel & tourism, the sectors hardest hit by the outbreak. February’s pullback represents a temporary — likely supply-chain driven — pause in the long-term manufacturing rebound. Manufacturing will continue to be an important driver of activity this cycle. And it’s not just high-profile auto demand — it’s a healthy U.S. domestic CAPEX cycle and an improving trend in exports, supported by China’s ongoing recovery. And tailwinds from the U.S. Manufacturing Renaissance/onshoring theme will continue. They have a long way to run.”

Central to this view is faith that monetary and fiscal policy support extends as far as the eye can see. Referring back to Farrell, “When all the experts and forecasts agree, something else is going to happen.” The time to be bullish was exactly one year ago when fear was pervasive. Bullish arguments like the one above are long in the tooth. Data that falls short of consensus is brushed aside, for example, harsh weather, a colossal ship aground in the Suez Canal, seasonality or a shortage of semiconductors leading to disappointing car sales. Surging economic strength is old news, priced into sky-high valuations and in our opinion likely to prove short lived. The Chinese PMI (purchasing managers index) is rolling over, emerging market economies are sputtering, Europe remains in pandemic semi-lockdown and the bloom of the “commodity supercycle” is fading.

### The Market Bubble Will End Badly

Our contrarian view is that the market bubble will end badly. “Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways (Farrell’s Rule #4). Well chronicled are the risks implied by record valuations (“Bubble Deniers Abound to Dismiss Valuation Metrics,” Bloomberg, March 27, 2021).

In our opinion, a bear market is the single most critical catalyst missing to revive interest in gold. The multi-billion Archegos Capital Management margin call exemplifies the reckless use of leverage likely seen only as markets top. The episode is most likely not an isolated event. There is never just one cockroach. Losses to hedge funds and their prime brokers will get little political sympathy, but a wipeout of small investors will attract close scrutiny from Washington D.C.

Bear markets progress in three stages (Farrell’s Rule #8) — a sharp drop, an oversold bounce and a protracted grind lower as fundamentals deteriorate. The last grinding bear market took place in the 1970s. Few active investors today recollect the experience of a decade-long march lower in prices that led to a sea of change in attitudes, expectations and psychology. Sharp selloffs since the 1970s have been short circuited by monetary interventions and caused any potential bear market to be still born. The “buy the dip” mentality has been programmed into investor reflexes. Repeated reliance on easy money to quell market selloffs has neutered public policy. The Fed has become “path dependent,” both arsonist and firefighter, as explained from time to time in *Grant’s Interest Rate Observer*.<sup>3</sup> Faith in central banker omnipotence is the cornerstone of the financial asset super bubble.

For the time being, the Fed tolerates rising rates on Treasuries because it believes the baton has been passed along to fiscal policy. The Biden administration obliges. Expectations for economic growth based on dramatic increases in government spending seem boundless. As noted by Andy Kessler (*The Wall Street Journal*, 12/6/2020): “Expect more multiplier mumbo jumbo as the Biden administration begins its tax-and-spend fiesta....Multipliers are a canard, a Keynesian conceit.”

The economy is bouncing back from the pandemic-induced recession. It tends to always bounce back from a downturn. But there is good reason to think that this post-recession bounce is sustainable. The marginal utility of debt stimulus is subject to the law of diminishing returns. Odds are strong that the bounce will fizzle and open the door to even greater debt creation that the market cannot digest at submarket interest rates.

### Inflation or Deflation? Gold Performs Well Either Way

Either inflation or deflation seems possible at this moment. A strong case can be made for both. Gold exposure wins out either way. We are quite confident that if central bankers achieve their desired 2% inflation, it will not be transitory or easily dispatched. “I can tell you that we have the tools to deal with that risk (inflation) if it materializes,” said Janet Yellen, U.S. Secretary of the Treasury. Policymakers are omniscient and all powerful, Yellen would have us believe. Credulous markets swallow this nonsense for now.

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As noted by Joseph C. Sternberg (*The Wall Street Journal*, "What Inflation Debates Miss: Inflation," February 11, 2021): "Inflation in the academic and policy jargon has come to mean a specific event: a rapid run-up in consumer prices." In Sternberg's view, the too narrow CPI (consumer price index) goalposts do not capture the essence of inflation, including deep social, political, and psychological aspects. "Malfunctioning price signals (read: inflation) make it impossible for a society to allocate its resources with any rationality or fairness." Tame CPI (consumer price index) readings are blind to the "phenomenal bid-up in prices for financial assets," which "wreck the value of and income from" the savings of investors. The seeds of inflation have already taken root. Indices designed and maintained by high IQ government bureaucrats (such as CPI, PCE (personal consumption expenditures), Core PCE, WPI (wholesale price index), etc.) will sound the alarm too late for the Federal Reserve to gently tap the brakes.

The deflation case rests on the idea that overreliance on debt issuance for economic stimulation causes inescapable economic lassitude. According to Lacy Hunt of Hoisington Investment Management Company, "public and private debt in the United States rose last year to 405.9% of GDP [gross domestic product], up from 365.9% in 2019." Overuse of debt becomes a "persistent drag" on economic activity because of ever-increasing amounts of resources that must be consumed for debt service. Hunt believes that government stimulus has become counterproductive to economic growth. That view seems to pass the test of common sense and extensive historical data supports Hunt's view.

Gold and gold mining shares performed well in the inflationary 1970s and the deflationary 1930s. Monetary disorder leading to capital destruction was the common thread.

## The Deflationary 1930s

The 1930s deflation was characterized by an extended severe economic contraction (The Great Depression). The famous market crash was preceded by the rash speculation, unchecked optimism of the 1920s and excessive leverage. The Fed tightened monetary policy during the downturn to make matters worse. The fall in the general price level does not capture the essence of deflation. The essence was a general collapse in confidence leading to cascading credit defaults. Loss of confidence in financial conventions led to sweeping political change and monetary debasement in the form of dollar devaluation vs. gold. Interest rates crashed while gold appreciated 70% and gold stocks became market favorites.

## The Inflationary 1970s

The inflationary 1970s were set off by the Vietnam War and amped up social spending deficits abetted by easy money policies of a politically pressured Federal Reserve. Monetary debasement took the form of consumer price inflation which destroyed capital, particularly for debt investors. Interest rates soared and gold rose nearly 24 fold<sup>4</sup> in nominal terms. Capital losses in real terms were disguised by a rise in the general price level. Gold stocks became market favorites.

Prolonged austerity forced a rise in savings and was the cure in both historical cases. World War II imposed a moratorium on consumer spending resulting in the buildup of savings, pent-up consumer demand and a post-war boom. The Volcker prescription of ultra-tight monetary policies triggered a politically unpopular protracted recession during which savings increased and savers were rewarded by high real interest rates. A secular bull market followed.

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## Which Snowflake Triggers an Avalanche?

What will trigger the next financial crisis? Which snowflake triggers an avalanche? What you need to know is that the massive buildup of systemic risk since 2008 is largely underappreciated. From “Fixed-Income Powder Keg” (*Grant’s Interest Rate Observer*, 3/19/2021)<sup>5</sup>: “When you suppress one market artificially, as they have the rate market, the volatility that is normally expressed there — goes somewhere else.”

The origin of the next financial crisis, whatever it turns out to be, will be sourced in financial dementia. As noted by economist John Kenneth Galbraith, “there can be few fields of endeavor where history counts for so little as in the world of finance....The world of finance hails the invention of the wheel over and over again, often in a slightly more unstable version. All financial innovation involves, in one form or another, the creation of debt secured in greater or lesser adequacy, by real assets.” (*A Short History of Financial Euphoria*, 1994).

## Gold is the Obvious Answer

Defensive investment strategies are few and far between. Fixed income, debased by artificially low rates, no longer passes muster. Selling volatility to generate income seems like a form of insanity. Gold is the obvious answer. Whether in physical form or precious metals mining shares sporting good dividend yields and trading at depressed valuations, we believe this unwanted investment strategy will prove seaworthy for all conditions.

## Bob Farrell’s 10 Rules for Investing

Bob Farrell, the legendary Merrill Lynch market strategist, compiled 10 Rules for Investing which offer timeless and timely advice for today’s markets.<sup>1</sup>

1. **Markets tend to return to the mean over time.**
2. **Excesses in one direction will lead to an opposite excess in the other direction.**
3. **There are no new eras — excesses are never permanent.**
4. **Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways.**
5. **The public buys the most at the top and the least at the bottom.**
6. **Fear and greed are stronger than long-term resolve.**
7. **Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names.**
8. **Bear markets have three stages — sharp down, reflexive rebound and a drawn-out fundamental downtrend.**
9. **When all the experts and forecasts agree — something else is going to happen.**
10. **Bull markets are more fun than bear markets.**

Source: [Bob Farrell’s 10 Rules](#).

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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](mailto:invest@sprott.com).

<sup>1</sup> Bob Farrell is a Wall Street veteran who draws on some 50 years of experience in crafting his investing rules. After finishing a master's program at Columbia Business School, Farrell launched his career as a technical analyst with Merrill Lynch in 1957.

<sup>2</sup> Reprinted by permission from Grant's Interest Rate Observer, "Bitcoin Goes to Wall Street."

<sup>3</sup> Reprinted by permission from Grant's Interest Rate Observer.

<sup>4</sup> "24 fold" is calculated by dividing the average price of gold in 1980 (\$850 per ounce) by the average price of gold in 1970 (\$35 per ounce).

<sup>5</sup> Reprinted by permission from Grant's Interest Rate Observer.

<sup>6</sup> Bubble Deniers Abound to Dismiss Valuation Metrics," Bloomberg, March 27, 2021

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