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Sprott Gold Equities Strategy

Q3 2021 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.

It's Show Time for the Fed

October 18, 2021

Despite lackluster third quarter and year-to-date performance for gold, the fundamental backdrop for precious metals and related mining share prices continues to strengthen in our opinion. Here's why we believe this:

- Inflation has become increasingly problematic and more persistent than previous sanguine assessments by Federal Reserve Board (Fed) Chairman Jay Powell and other Fed officials.[1]
- Real interest rates remain deeply negative, a positive for gold. The average annual return on gold during periods of negative real interest rates has been a stellar 21.12%.[2]
- Monetary policy continues to be highly accommodative. The bearish case for gold rests on the deteriorating probability of the Fed tapering asset purchases in November.[3]
- The global economy is beginning to sputter. Spreading economic weakness will make any tightening moves by central banks difficult to implement without broader repercussions.
- Physical gold buying centered in India and China has risen dramatically. Indian demand alone is 500 tonnes greater than it was in 2020, more than enough to absorb current mine supply.[4]
- Net buying of gold bullion by central banks is likely to continue and may possibly increase.[5]
- Positioning by commodity traders is at negative extremes and is usually followed by short-covering rallies. The selling of paper gold on the thesis of Fed tightening is already priced into the market.[6]
- Gold mining equities are trading at deep value while generating record cash flow.

> "Overconfidence, complacency, recklessness and intoxication come to mind when characterizing the current financial market zeitgeist."

Loss of Faith in the Fed Could Benefit Gold

Notwithstanding the wide array of bullish considerations (all of which deserve paragraphs of exposition that have been written elsewhere and are omitted here for the sake of brevity), the number one game changer for gold could be a loss of faith in the U.S. Federal Reserve Board. Unshakeable confidence in the Fed's stewardship of the financial system and the economy has been the anchor for the bull market in financial assets. That trust is at great risk, in our opinion, when (and if) tapering begins. In our Q2 Gold Strategy Letter ("You Gotta Have Faith"), we concluded:

> "Faith in the Fed's omniscience is convenient to the investment consensus because it underpins the extraordinary overvaluation of financial assets. The relationship between overvalued financial assets and belief in an all-knowing Fed is symbiotic. Loss of that faith for heavily sedated markets would lead to losses of trillions of dollars in the world of financial assets."

The fourth quarter of 2021 poses a moment of truth for the Fed. If the Fed reacts to persistently hot inflation readings with tough talk but no action, its credibility may wither. If the tapering promised for November triggers falling stock and bond prices, a very likely event in our opinion, the Fed will take the blame, also damaging its credibility. Moreover, will persistent tapering be enough to tamp down intransigent inflation? Any of these possibilities would diminish investor trust.

The Fed's Game of Chicken

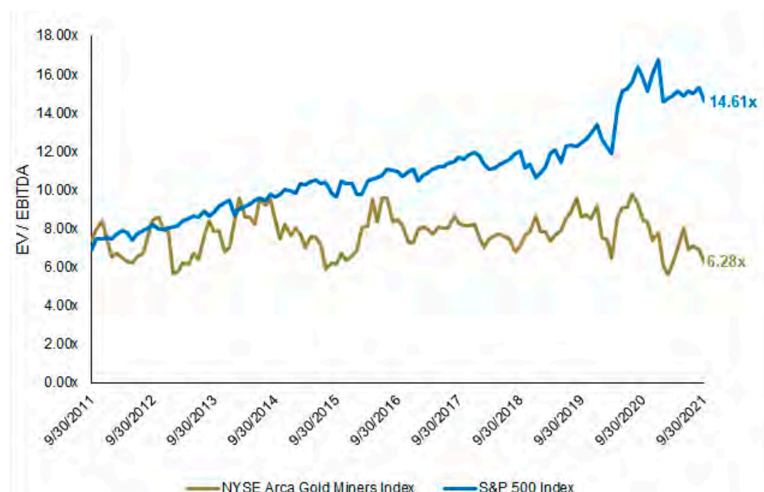
Chairman Powell also knows that the Fed cannot afford to reverse course as quickly as in 2018 — when it attempted balance sheet normalization and rate hikes — without again embarrassing the institution. Therefore, the Fed may this time stick to its guns and attempt to ride out market adversity, an unpopular decision, especially if the already weakening economy slows further. The Fed can only lose the upcoming game of chicken and it will be interesting to see how it narrates its way out of this predicament. The question is, how much market and economic damage precedes the inevitable pivot?

Overconfidence, complacency, recklessness and intoxication come to mind when characterizing the current financial market zeitgeist. Market positioning for an abrupt loss of confidence in the mechanism inflating the bubble is almost non-existent, in our opinion. Sobriety is scarce and denial of risk is commonplace. As noted by Michael Solomon in a recent investor letter:

> "A survey reported by Bloomberg [see Appendix A] confirms the absurdity and lack of rationality that we perceive in much of the market's behavior. In that survey, 59% of members of Gen Z (defined as 9 to 24-year-olds) confessed to being drunk when they trade. Of all investors surveyed, 32% admit to having traded when intoxicated." (Source: Marlin Sams Fund, LP 10/1/2021)

We believe gold mining stocks represent huge upside leverage to a potential loss of confidence. Downside risk is low because of their deeply discounted valuations. Figures 1-3 demonstrate the compelling absolute and relative value offered by gold mining shares as well as the asymmetric risk/reward proposition they represent:

Figure 1. EV/EBITDA: Gold Mining Equities vs. S&P 500 (2011-2021)



Source: Bloomberg as of 9/30/2021. Gold mining equities are represented by the NYSE Arca Gold Miners Index (GDM). Reflects the Enterprise Value (Market Capitalization plus Total Debt less Cash) to estimates of forward EBITDA compiled by Bloomberg. Higher figures reflect companies are trading at a higher premium relative to their earnings. You cannot invest directly in an index. Past performance is no guarantee of future results.

Figure 2. Gold Miners Showing Superior Metrics to S&P 500

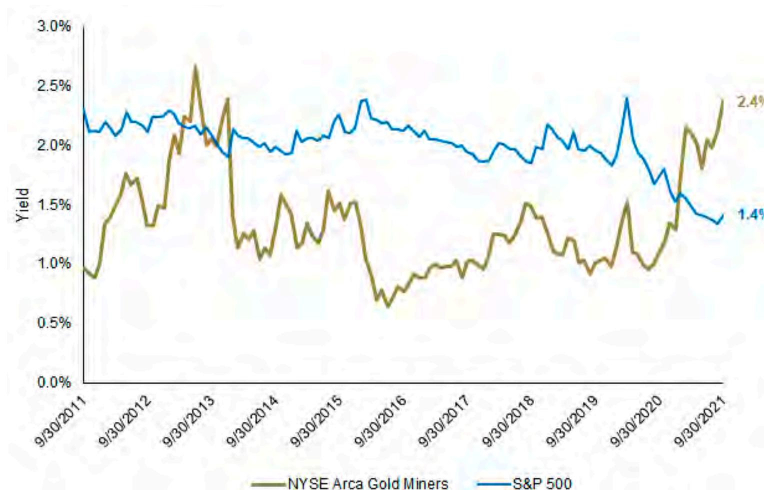
Valuations and Fundamentals: Gold Mining Equities vs. S&P 500 as of 9/30/2021

	Gold Miners (GDM)	S&P 500	Comments
EV/EBITDA	6.30x	14.61x	GDM trading at ~40%
Free Cash Flow Yield	7.33%	3.37%	GDM >2x free cash flow yield
Return on Capital	10.36%	8.50%	GDM ~25% higher
Net Debt/EBITDA	0.14%	1.11%	GDM ~10% as levered
Profit Margin	17.96%	13.28%	GDM 35% higher

Source: Bloomberg as of 9/30/2021. Gold mining equities are represented by the NYSE Arca Gold Miners Index (GDM). See definitions on page 5. You cannot invest directly in an index. Past performance is no guarantee of future results.

Figure 3. Gold Miners Offer Higher Dividend Yields than the S&P 500

Dividend Yield: Gold Mining Equities vs. S&P 500 (2011-2021)



Source: Bloomberg as of 9/30/2021. Gold mining equities are represented by the NYSE Arca Gold Miners Index (GDM). You cannot invest directly in an index. Past performance is no guarantee of future results.

A Near Perfect Environment for Gold and Gold Miners?

Since mid-June, gold and related mining stocks have been over-sold, shorted or ignored. The bearish thesis for gold and gold mining stocks has been that the Fed will slay inflation by "tapering" asset purchases, in stark contrast to their general dovishness over the past several economic cycles.

Now the rubber hits the road; **the bear case for gold depends on the following fantasies:**

- **Tapering is different than raising interest rates.**
  Our Counter: They're the same thing — both restrictive monetary policies are designed to accomplish similar outcomes.
- **The global economy can withstand a small increase in borrowing costs.**
  Our Counter: It can't. Excessive leverage will result in spreading defaults of marginal borrowers.

- **A 2022 slowdown is not in the cards.**
  Our Counter: It is. Multiple signs of weakness are already showing up, including weak employment reports, poor consumer sentiment and negative China Caixin Manufacturing PMI (purchasing manager's index).
- **Nosebleed financial asset valuations are impervious to rising interest rates.**
  Our Counter: They're not. There are plenty of signs of market averages topping.
- **Inflation is transitory.**
  Our Counter: Evidence is increasing that it is intransigent and unlikely to be stemmed by tapering.

In our opinion, the number one reason for disinterest in gold has been the seemingly endless equity bull market. However, it would seem that things can hardly get better for equity bulls. The rosy economic outlook, super easy monetary policy and bullish crowd psychology are not immutable. Odds suggest that future changes are more likely to be negative at the margin than positive.

As noted by Bob Farrell, "Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways." Risks unperceived at market peaks can begin to multiply faster than investors can react. An unraveling of the current speculative euphoria, at a time when precious metals fundamentals have rarely been more solid, would constitute a near perfect environment for gold and gold miners.

Expectations for rising interest rates seem to be moving into high gear (see Cornerstone Macro). Somehow, these expectations are deemed to be harmful to gold but no threat to financial asset valuations in general. Perhaps this inconsistency can be explained (1) by the consensus belief that economic growth and strong earnings will be sufficient to offset the damage from rising rates and (2) that interest rates will rise just enough to put a lid on inflation but not economic growth and thereby render more draconian monetary tightening unnecessary. To us, this view ignores the yawning mismatch between the incremental supply of deficit-driven Treasuries and the lack of demand at ultra-low interest rates. As recently noted by Macromavens (10/12/2021):

> "The point being that, as troubling as the recent backup in rates has been, it is FAR worse than surface-scanning investors dare imagine. **The fact that $20 billion in foreign purchases, $38B in bank purchases, $8B in spec buying (and $40B in purchases by the Fed!) — which annualize to roughly $2.8 trillion in Treasury demand — failed to arrest the backup in rates** (much less send them tumbling downward) **SHOULD send ice cold shivers down the market's spine.** For, unless one imagines that the pace of Treasury issuance is about to slow big time, (and that requires one hell of an imagination!) **the recent action in the Treasury market reveals how impossible our financing situation has become."**

Precisely. The financial markets have not taken into account the magnitude of supply or the distortion of interest rate price discovery caused by quantitative easing. The impending attempt at balance sheet normalization could prove far more disturbing to financial markets than the failed 2018 episode.

Appendix A

Amid "Gamification" Concerns, Nearly 6 in 10 Gen Z Investors Admit to Trading While Drunk

By Weston Blasi, (MarketWatch) Bloomberg 8.27.2021

Overview: According to a new survey, 59% of Gen Z traders claim to have bought or sold an investment while inebriated. Should you have to pass a breathalyzer to make trades on Robinhood (HOOD) or Charles Schwab (SCHW)? According to a new survey from consumer finance website MagnifyMoney, 32% of U.S. investors say they have made trades while drunk. Gen Zers fell into the trap most of any generation with 59% confessing to drunk trading — just 9% of baby boomers admitted to drunk trading.

Cornerstone Macro

Rate Hike Expectations are Rising

Quote from: Roberto Perli, Partner, Head of Global Policy, Cornerstone Macro

"This view is getting more and more traction in the market, and unfortunately is getting more and more likely. A big reason is that it's hard for Powell to manage the hawks in the FOMC when he is in limbo. By delaying his renomination, the Admin is also making a big policy error."

Figure 2 Definitions

EV/EBITDA: Enterprise Value (Market Capitalization plus Total Debt less Cash) to estimates of forward EBITDA compiled by Bloomberg. Higher figures reflect companies are trading at a higher valuation premium relative to their earnings. Free Cash Flow Yield: Operating Cash Flow less Capital Expenditure less Net Working Capital divided by the current stock price. Higher free cash flow yields reflect companies are generating greater amounts of cash flow relative to their share price. Return on Capital: measured by adjusted net income divided by total capital (total investment of shareholders and debt holders). Higher return on capital reflects that companies are better at turning outside investment into profits. Net Debt/EBITDA reflects total debt less cash divided by estimates of forward EBITDA compiled by Bloomberg. Companies with lower figures reflect lower leverage and debt as a percent of earnings. Profit Margin reflects forward estimates of net income divided by forward estimates of revenue, compiled by Bloomberg. Higher figures reflect companies are able to generate more earnings as a percent of top line sales, an indication of operating efficiency and expense management.

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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] Source: WSJ, by the Editorial Board. The Inflation Tax Rises; 10/13/2021.

[2] Source: Bloomberg. Data for the period 12/31/1984 to 12/31/2020. Gold bullion is measured by the Bloomberg GOLDS Comdty Spot Price.

[3] Source: "Monetary policy is the wrong tool": Why economist El-Erian thinks the Fed is making a mistake.

[4] Source: LAWRIE WILLIAMS: China's 2021 gold demand already exceeds full year 2020.

[5] Source: BNN Bloomberg. Gold regains shine after central bank buying drops to decade low.

[6] Source: Meridian Macro Gold and Silver Report 10/16/2021.

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