Sprott

Monthly Report

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Gold Poised to Climb on Fed's Inflation Dilemma

Gold bullion[1] regained some ground in October, climbing 1.50% for the month. Gold, however, remains underwater at -6.06% YTD through October 31, 2021. Gold mining equities[3] also rebounded in October, up 8.15%, but are down 11.35% YTD as of October 31. Silver[2] gained ground in October (7.81%) but is down 9.47% YTD.

Month of October 2021

Indicator	10/31/2021	9/30/2021	Change	Mo % Change	YTD % Change	*Analysis on October*
Gold Bullion[1]	**$1,783.38**	**$1,756.95**	**$26.43**	**1.50%**	**(6.06)%**	**Recovering from deeply oversold September**
Silver Bullion[2]	**$23.90**	**$22.17**	**$1.73**	**7.81%**	**(9.47)%**	**Recovered from late September sell-off**
Gold Senior Equities (SOLGMCFT Index)[3]	**120.43**	**111.35**	**9.08**	**8.15%**	**(11.35)%**	**Snap back from extreme oversold**
Gold Equities (GDX)[4]	$31.71	$29.47	$2.24	7.60%	(11.97)%	(Same as above)
DXY US Dollar Index[5]	94.12	94.23	(0.11)	(0.11)%	4.65%	Climbing within a gradual trend
S&P 500 TR Index[6]	4,605.38	4,307.54	297.84	6.91%	22.61%	New all-time monthly high
U.S. Treasury Index	$2,493.76	$2,495.52	$(1.76)	(0.07)%	(2.56)%	Short end chaotic, long end policy mistake
U.S. Treasury 10 YR Yield*	1.55%	1.49%	0.06%	6 BPS	64 BPS	Backing down on growth concerns
U.S. Treasury 10 YR *Real* Yield*	(1.04)%	(0.89)%	(0.15)%	-15 BPS	6 BPS	Back to lower trading range
Silver ETFs (Total Known Holdings ETSITOTL Index Bloomberg)	908.61	914.11	(5.50)	(0.60)%	2.13%	Drifted lower, selling mainly via options
Gold ETFs (Total Known Holdings ETFGTOTL Index Bloomberg)	98.30	99.20	(0.90)	(0.91)%	(8.18)%	Drifted lower, selling mainly via options

*Mo % Chg and YTD % Chg for these Indexes are calculated as a difference in yield in terms of basis points (BPS) instead of a percentage change.

October in Review

Spot gold closed October at $1,783.38, gaining $26.43 for the month (or 1.50%). Gold managed to recover from the late September swoon that saw a positioning cleanse, which sent the entire precious metals complex into extreme oversold conditions. Most of the late September pressure originated from heavy selling in call options across the board (GLD ETF[7] call options for gold, December futures calls for silver and GDX call options). The Federal Reserve ("Fed") taper signal at its September 22 Federal Open

Marketing Committee Meeting (FOMC) coincided with the September quarterly options expiry, amplifying gold price swings. The liquidation of gold positions continued but slowed in October, and gold's positive divergent price action is a sign of selling exhaustion. We will expand on this point in the positioning data later in the commentary.

Gold continues to feel pressure from the market's intense focus on pricing in the developed central banks' exits from the COVID-pandemic stimulus, despite the evident inflationary pressures and policy mistake risk. Global bond markets have aggressively raised their expectations for policy tightening, as surging energy prices and rampant supply chain issues have propelled inflation higher. The U.S. bond market has now moved up the date of pricing in the first hike for July 2022 despite tapering expected to end by June 2022. Still, this extreme hawkish view of Fed hikes may not force the desired Fed response.

> "The Fed is likely to err on the side of growth with inflation than to risk a recession for a low inflation outcome."

The Fed continues to view this current inflation wave in transitory terms and is aware that cost-push inflation generally does not respond to rate hikes. The market is pricing in a policy mistake (tightening into a slowdown). The Fed's reaction function will stay primed to a growth outcome more than to inflation. In other words, the Fed is likely to err on the side of growth with inflation than to risk a recession for a low inflation outcome. If the Fed does not meet the market's expected hawkish response (more than mere tapering), it will likely pivot and seek out inflation protection assets (such as gold) if the Fed is willing to "run it hot." No matter how the bond market reacts in the short term, the Fed will begin the taper process and combined with the current fiscal deceleration, these two forces will lower the growth outlook.

Technical Chart Updates

Since the August 2020 peak, gold has been carving out a corrective pattern (red concave line below the downtrend line). Despite the many negative headlines, selling waves and temporarily broken support levels, there has been no sustained selling; instead, we have seen multiple mean-reverting trade events.

Figure 1. Gold Bullion: Carving Out a Corrective Base

Source: Bloomberg as of 10/30/2021. Spot gold is measured by the Bloomberg GOLDS Comdty Index.
You cannot invest directly in an index. Past performance is no guarantee of future results.
Included for illustrative purposes only.

Figure 2. Silver Bullion: Holding the Channel

Source: Bloomberg as of 10/30/2021. Spot silver is measured by the Bloomberg SILV Comdty.
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Included for illustrative purposes only.

Figure 3. Gold Equities: Recovered to Above Support

Source: Bloomberg as of 10/30/2021. Gold equities are measured by GDX. You cannot invest directly in an index. Past performance is no guarantee of future results. Included for illustrative purposes only.

The Challenges Begin to Mount: Eyes on China and Energy

As we advance into the fourth quarter of 2021, there are no shortages of challenges facing markets. The ongoing global COVID pandemic continues while monetary and fiscal impulses have already turned lower and will continue to trend lower through at least mid-2022 — or until a risk event forces policymakers to reverse course back to stimulus. Personal and corporate taxes are set to rise, and inflation is at its highest level in decades and still climbing. Raw material shortages, labor shortages and supply chain disruptions are expected to last well into 2022. Topping these headwinds, however, are the numerous challenges facing China and the burgeoning global energy crisis; we see these challenges as having the most significant potential for tail-type risks.

Let's address China. The risk of a severe, extended property-led slowdown in China is rising. China's position as the second-largest and fastest-growing major economy over the past two decades means that the global economy is inextricably linked to China. A smooth decoupling is unlikely. China's current regulatory tightening cycle is beyond anything seen in the past in its breadth, severity and duration. The crackdown in the property market continues to slow growth and raise the potential for systemic risks. The China property market is one of the largest asset classes globally, accounting for approximately 20% of China's gross domestic product (GDP) and about two-thirds of its household assets. China appears committed to deleveraging its property market, sacrificing short-term growth, while hoping to avoid tripping any systematic risk event that would endanger a hard landing. Other significant growth headwinds for China include a further power crunch (more global supply chain disruptions), a zero-tolerance COVID policy (more lockdowns) and numerous social goals (curbing inequality and environmental targets). Our view is that a shock event followed by a flood of stimulus is on the table.

An Energy Crisis Feels Close at Hand

Surging global prices across the entire energy chain (natural gas, coal, liquefied natural gas (LNG), electricity, oil, etc.) are among the primary sources of a stagflation threat. Surging energy prices add to high inflationary pressures, while power outages and high prices or demand destruction drag on growth. Years of under-investment in energy combined with ESG (environmental, social and governance) investment restrictions, geopolitics and other ideological limits have created the conditions for an energy crisis. Surging demand for energy products (especially LNG), along with operational supply issues, are creating eye-popping global price spikes.

We have seen natural gas trade at the rough equivalent of a $200 barrel of oil in the European Union (EU), while China is experiencing rolling blackouts and rationing. We are seemingly a cold winter away from the next energy shock event. The energy crisis is not going away soon since there is no quick supply fix after several years of underinvestment. And it won't come from demand destruction as no policymaker anywhere wants to take that path. As we transition away to greener energy sources, power crunches will be ongoing. Whether it is a geopolitical event or cold winter, our view is that the risk of a full-blown energy crisis capable of destabilizing financial markets and economies is close at hand.

Fed Dilemma: Inflation, Stagflation or Bad Inflation

Inflation continues to broaden out (especially via energy price increases), inconsistent with the Fed's "transitory" outlook. When the Fed set out over a year ago with AIT (average inflation targeting), it likely focused on inflation's "good reflation" aspect (i.e., full and inclusive employment and avoiding a descent into a Japan-style never-ending deflation). Also, the Fed probably saw any inflation overshoot(s) as mostly benign and likely to retreat as the COVID pandemic waned. Instead, we are witnessing big inflation overshoots in the areas most painful (energy, food and consumer goods) to the disadvantaged consumer groups that the Fed tried to help with AIT.

The stagflation scenario (below-trend growth with above-trend inflation) also continues to be a market concern. Historically, stagflationary periods have been the most challenging investment environments and have demonstrated the worst historical performance for equities (sales weak, costs up, margins down, high rates compress valuation multiples, etc.).

In today's modern market structure, stagflation brings new additional capital market risks. Namely, nobody (humans or machines) knows how to trade in a stagflationary market. Humans have seen nothing but a 40-year long secular bond bull market. Virtually a vast majority of quant-type funds and their VaR (value at risk) rules were built and calibrated in the post-GFC (global financial crisis) slow-flation, low-volatility market regime, the antithesis of a stagflationary world.

Central Banks "Pushing on a String"

In the years after the GFC, central banks have pushed on a string (see Special Note) trying to reflate the real economy. Now the question pivots to, can central banks reign in real-world inflation caused by an extraneous shock without unduly damaging growth? If policymakers and politicians see inflation damaging growth and approval ratings, will policy pivot from pro-growth to anti-inflation? In a cost-push inflation environment, rate hikes cannot fix broken supply chains or increase supply across the energy chain; however, they can destroy demand.

Fed in a Quandary, Markets at an Inflection Point

That leaves the Fed in a quandary. Does the Fed a) remain ultra-accommodative and risk that prices spiral higher, or b) tighten to preempt inflationary pressures and exacerbate the slowdown? Neither scenario under the current market conditions is attractive. Under the first scenario (stay accommodative), the market will likely move to inflation protection assets, and bond yields will continue to rise, pressuring valuations. If growth recovers and outpaces yield increases, then conditions will stabilize. Thus far, the U.S. Treasury 2YR/10YR and 5YR/30YR bond yield curves are responding with an emphatic "no," as both curves continue to fall on growth concerns driven by fears of Fed policy mistakes.

The second scenario — (b) in which the market is pricing (aggressive tightening) —could exacerbate the current slowdown and affect market valuations and increase market volatility and risk. It would also be alarmingly close to regime change territory. The challenge with leaving a highly accommodative monetary policy in place is that money and assets are priced off the risk-free rate. With the risk-free rate at zero (or below) for such a long time, asset prices have long adapted and adjusted.

Even a slight increase in the Fed Funds rate or a small reduction in the Fed's balance sheet (see 2018 Fed action) could dramatically impact asset prices and may quickly lead to tighter financial conditions. There are enormous amounts of duration embedded in all markets and asset classes, a legacy of central bank extreme ultra-accommodative policy since the GFC. The risk of a Fed policy mistake is there (tightening into a slowdown), but so are deeper more embedded market risks. In this scenario, we epcet safe-haven assets like gold and other precious metals to quickly be re-priced and back into demand.

Precious Metals Positioning Update: Well Positioned for 2013…

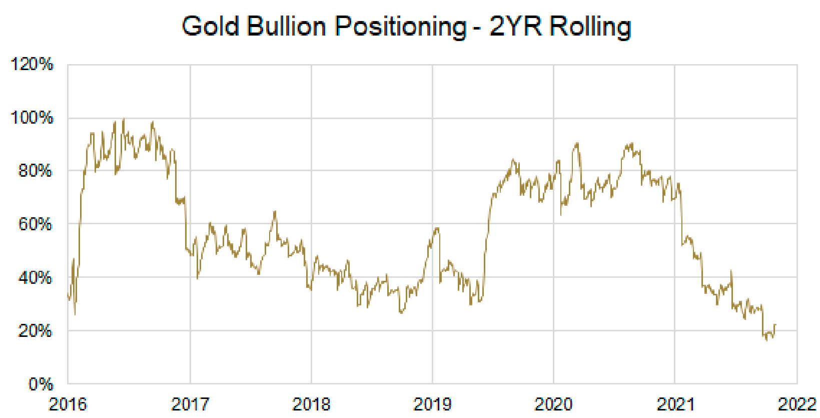
As we head toward year-end, market expectations have come down dramatically on the global economic growth outlook. Inflation has been more than persistent with the bond market pricing in aggressive rate hikes and fears of a Fed policy mistake.

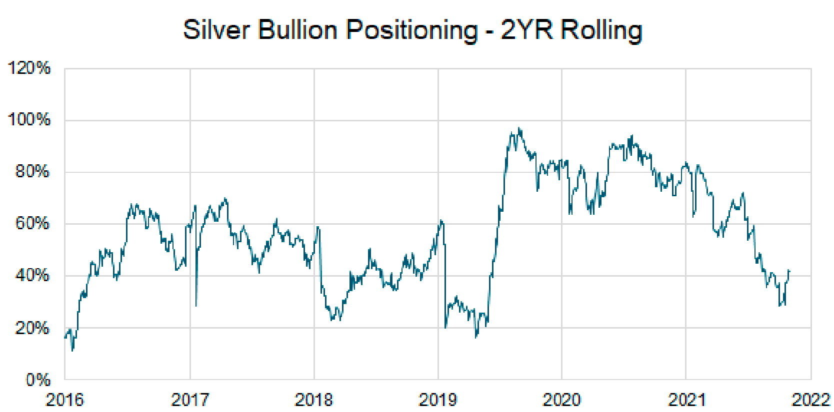
Throughout 2021, positioning in precious metals has been reduced significantly, to the point where it has likely fully discounted the Fed's coming taper/tightening action, essentially pricing in a 2013 replay of the gold sell-off. However, in 2013/14, there was no economic growth concern (yield curve was steepening) and there was low inflation risk.

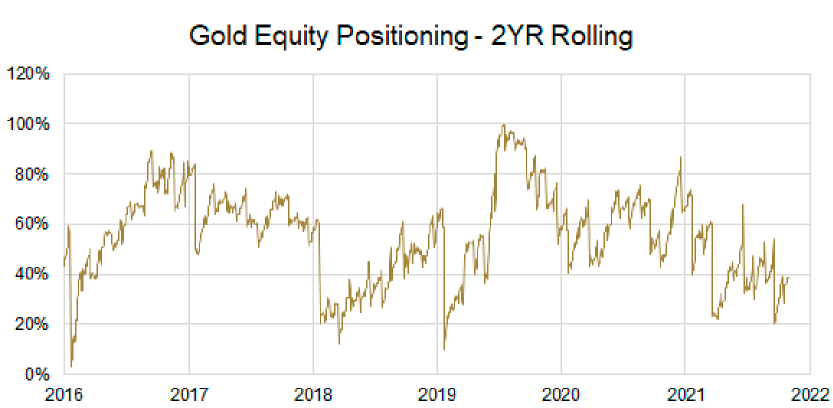
The weaker precious metals prices since June of this year reflect a hyper-focus on the coming Fed taper/tightening but ignore the consequences of a Fed policy mistake and the building inflation risk. There are other growing right-tail risk events that are supportive for gold. For example, a cold winter could send energy prices soaring and stagflationary risk higher in an asymmetrical manner. And or a financial risk event in China could send global growth tumbling while bringing forward the prospect of another eventual round of global central bank stimulus, pulling forward inflation sentiment higher.

When the Fed's taper announcement finally arrives, it may turn out to be a "buy on the news" event for gold. While the bond market is experiencing a violent re-pricing in the short end due to uncertainty around taper/tightening, precious metals have already priced in taper/tightening. Figure 4 shows positioning data extracted from our custom Sprott Sentiment Indices. The data represents multiple sources of holdings for gold, silver and gold equities, which are then normalized over a rolling two-year period. Gold bullion holdings, in particular, have been wiped out. We are likely heading towards an inflection point in the market with precious metals positioning at washed-out levels. Our positioning data would indicate the potential upward price squeeze has become significant.

Figure 4. Sprott Sentiment Indices: Gold Bullion, Silver and Gold Equities Positioning







Source: Sprott Asset Management. Data as of 10/30/2021. You cannot invest directly in an index.
Past performance is no guarantee of future results. Included for illustrative purposes only.
Learn how the Sprott Gold Bullion Index is calculated.

Looking Under the Hood of Gold Positioning Sentiment

The positioning graphs in Figure 4 are an amalgamation of different sources of gold holdings, but sometimes the details become obscured for simplicity. Figure 5 is total open interest in GLD ETF calls minus puts, expressed in notional ounces for easier comparison. As a reminder, these are notional ounces; the market value will be determined by how far out of the money the strike prices are. We overlayed gold held in ETFs, the largest aggregation of gold ounces, to illustrate how potentially significant GLD calls can be. This measure has made new 10-year lows, lower than any point during the bear market in terms of speculative interest via options.

Figure 5. GLD ETF Calls Minus Puts Expressed as Notional Ounces

Source: Bloomberg as of 10/30/2021. You cannot invest directly in an index.
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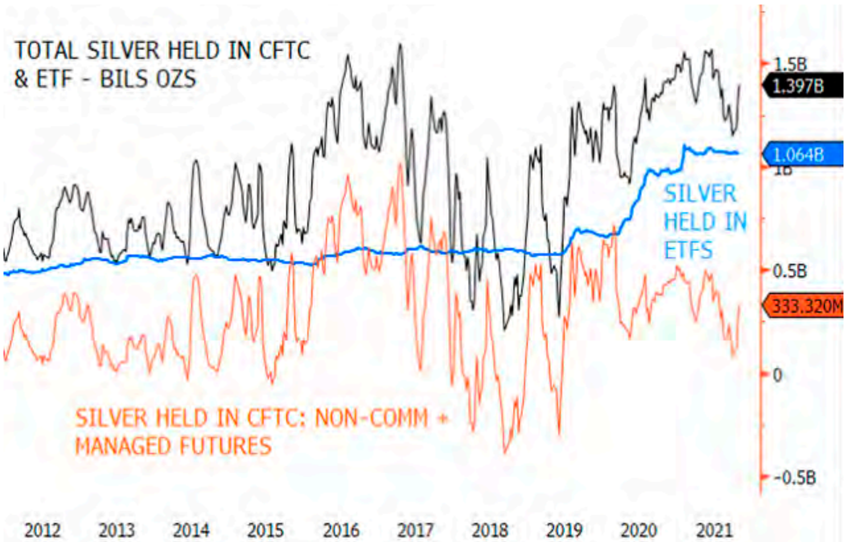
Silver Positioning: The Devil's in the Details

Figure 6 shows the amount of silver in ounces, held in ETFs and held in CFTC (Commodity Futures Trading Commission)[8] Net Non-Commercial and Managed Futures. Silver in ETFs (primarily retail and smaller funds) is remarkably steady, as seen in the blue line in Figure 6. Note the doubling of silver ounces in ETFs in 2020. Visually, it is clear that CFTC and managed futures account for virtually all trading volatility. Since 2016, note the increase in the amplitude of positioning swings as quantitative-types (mainly CTAs, or commodity trading advisor hedge funds) become dominant. The wild swings in CFTC positioning are most certainly not dictated by conventional fundamental drivers but by algorithmic metrics.

Though the number of silver ounces held in ETFs (1.06 billion ounces) is now about four times the long-term average of CFTC positioning (283 million ounces), the trading volatility remains unchanged. With more ounces held in ETFs (passives) reducing overall net liquidity, the more the tail is wagging the dog. It is not difficult to envision what would happen if everyone decided to buy silver at once.

Figure 6. Silver Held in ETFs and Silver Held in CFTC



Source: Bloomberg as of 10/30/2021. You cannot invest directly in an index.
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A Changing Landscape

The extraordinary monetary stimulus unleashed by the global central banks in response to the COVID pandemic is ending. The fiscal impulse has also peaked and will be trending lower. The worldwide surge in inflation has already pressured several developed central banks to taper/tighten very abruptly. The Fed appears set to begin its taper process this week at its November 2-3 FOMC meeting. Already, the U.S. bond market is pricing in a policy mistake (tightening into a slowdown). As I have noted, the Fed is in a quandary; it will either have to tighten conditions to head off inflation and risk slowing growth even further, or the Fed will remain accommodative to continue growth and risk broadening and pushing inflation. Either option will elevate market risk conditions.

Gold is likely to react positively to either scenario, with the higher inflation one being more immediate. Either way, precious metals positioning has been brought down to low enough levels that any upward pressure would see prices advance meaningfully. We believe that precious metals are set up for a squeeze higher and are simply awaiting a catalyst. Remember, catalysts speed up reactions, and there appear to be several sources of potential activation energy for gold.

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Special Note

In economics, "pushing on a string" specifically refers to a situation where expansionary monetary policy is ineffective at raising an economy out of a recession. Source: Investopedia.

While the phrase "pushing on a string" is often attributed to English economist John Maynard Keynes, there is no evidence he used it. However, this exact metaphor was used in U.S. Congressional testimony in 1935, when Federal Reserve Governor Marriner Eccles, echoing the phrase uttered by Congressman T. Alan Goldsborough, said there was little the Fed could do to stimulate the economy and end the Great Depression:

Governor Eccles: *Under present circumstances, there is very little, if anything, that can be done.*

Congressman T. Alan Goldsborough: *You mean you cannot push a string?*

Governor Eccles: *That is a good way to put it, one cannot push a string. We are in the depths of a depression and... beyond creating an easy money situation through reduction of discount rates and through the creation of excess reserves, there is very little if anything that the reserve organization can do toward bringing about recovery.*

The Sprott Gold Bullion Sentiment Index

The Sprott Gold Bullion Sentiment Index includes several inputs based on options activity (e.g., open interest, call buying, put/call ratios), flows (gold purchases) and technical indicators (e.g., trend following, momentum, dispersion). The various models are combined and normalized over a rolling two-year period and expressed as an Index ranging from 0 to 100. We believe this approach has several advantages over a single-input sentiment type index. The most pertinent would be that different input variables can drive gold, and the magnitude can fluctuate over time. This methodology should minimize "false extremes" due to normalizing the data and the multiple models used. Figure 4 highlights the +/-2 standard deviation lines where a +2 standard deviation reading represents extreme bullishness and a -2 standard deviation is extreme bearishness.

When the Sprott Gold Bullion Sentiment Index hits a -2 standard deviation reading (extreme bearishness), the average one-year return on gold bullion is +20%. Not only is gold bullion currently very oversold, but any weak holders (i.e., those who even thought about selling, have sold) are now gone. This extreme bearishness has only occurred four times over the past seven years and has generally marked the lows. Any positive gold event will have a significant effect due to the low base effect.

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[1] Gold bullion is measured by the Bloomberg GOLDS Comdty Spot Price.
[2] Silver bullion is measured by Bloomberg Silver (XAG Curncy) U.S. dollar spot rate.
[3] The Solactive Gold Miners Custom Factors Index (Index Ticker: SOLGMCFT) aims to track the performance of larger-sized gold mining 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.
[7] The SPDR Gold Shares ETF (GLD) tracks the price of gold bullion in the over-the-counter (OTC) market.
[8] CFTC markets refers to the Commodity Futures Trading Commission, an independent U.S. government agency that regulates the U.S. derivatives markets, including futures, options, and swaps.

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