Sprott

Monthly Report

December 6, 2021

Paul Wong, CFA
Market Strategist

Gold Correction Nearing its End

Gold bullion[1] lost some ground in November, closing the month at $1,775, off $8.86 from October's finish of $1,784. Gold remains underwater at -6.52% YTD through November 30, 2021. By contrast, gold mining equities[3] gained an iota of ground in November, up 0.79%, but are down 10.65% YTD as of November 30. Silver[2] lost more ground than gold in November (-4.47%) and is down 13.51% YTD.

Month of November 2021

Indicator	10/31/2021	9/30/2021	Change	Mo % Change	YTD % Change	*Analysis on October*
Gold Bullion[1]	**$1,774.52**	**$1,783.95**	**$(8.86)**	**(0.50)%**	**(6.52)%**	**Accelerated taper fears vs. inflation fear**
Silver Bullion[2]	**$22.84**	**$23.90**	**$(1.07)**	**(4.47)%**	**(13.51)%**	**Bumpy seasonal contract roll**
Gold Senior Equities (SOLGMCFT Index)[3]	**121.38**	**120.43**	**0.95**	**0.79%**	**(10.65)%**	**Outperforming bullion since September washout**
Gold Equities (GDX)[4]	$31.80	$31.71	$0.09	0.28%	(11.72)%	(Same as above)
DXY US Dollar Index[5]	95.99	94.12	1.87	1.99%	6.73%	USD strength tied to rate hike outlook
S&P 500 Index6	4,567.00	4,605.38	(38.38)	(-0.83)%	21.59%	Financial conditions > macro risk for now
U.S. Treasury Index	$2,512.85	$2,493.76	$19.09	0.77%	(1.82)%	Late month safe haven flow
U.S. Treasury 10 YR Yield*	1.44%	1.55%	(0.11)%	-11 BPS	53 BPS	Not reflecting inflation for now
U.S. Treasury 10 YR Real Yield*	(1.09)%	(1.04)%	(0.05)%	-5 BPS	0 BP	Volatile month but still near lows
Silver ETFs (Total Known Holdings ETSITOTL Index Bloomberg)	907.38	908.61	(1.24)	(0.14)%	1.99%	Little activity since summer
Gold ETFs (Total Known Holdings ETFGTOTL Index Bloomberg)	98.50	98.30	0.20	0.21%	(7.99)%	Little activity since summer

*YTD % Chg for this Index is calculated as the difference between the month end's yield and the year end's yield, instead of the percentage change.

A Bumpy November: Taper, CPI, Accelerated Taper, Omicron and Goodbye Transitory

Spot gold bullion fell $8.86, or 0.50%, to close at $1,774.52 for November. Gold bullion pricing and positioning firmed after the September quarter-end cleansing only to retreat in the last week of November on fears of a possible accelerated Federal Reserve ("Fed") taper timeline. Gold eased mildly into the November 2-3 Federal Open Market Committee (FOMC) meeting but began to rally immediately after the long-awaited taper announcement (buy on the news). Gold peaked at $1,867 after yet another very hot inflation print. For October, U.S. CPI (consumer price index) year-over-year was 6.2%, the biggest one-year jump in 30 years. After the monthly options expiry, gold retreated as flows backed away and the market began to price in the possibility of an "accelerated taper and tightening" announcement at the December 14-15 FOMC meeting.

The accelerated taper scenario was gaining momentum just as news of a possible new COVID variant (Omicron) broke during the U.S. Thanksgiving Holiday, sending markets into near panic. The half-day holiday liquidity highly exacerbated the price reaction. The risk that the Omicron variant poses is still unknown, and the range of possible outcomes remains wide at this writing. On the last day of the month, Fed Chairman Powell delivered a surprisingly hawkish Senate testimony. After months of repeated Fed messages of patience, Powell will likely remove the word "transitory" from describing inflation, acknowledging that the inflation risk is indeed persistently higher and broader.

We believe the end of gold bullion's consolidation is near (*goodbye to Groundhog Day $1,800* at last?). Since gold's August 2020 peak (see Figure 1), the metal has been consolidating the breakout from the multi-year base pattern highlighted with the dotted blue lines. Though the past year has seen many price swoons and exhausting trading, gold was never in danger, technically, of breaking its secular bullish pattern. As we wind down 2021, we see several elevated markers of macro risk that the market will not likely be able to ignore for much longer — risks that we believe to be in the regime-changing category.

Figure 1. Gold Bullion: Consolidating the Large Base Breakout (2010-2021)

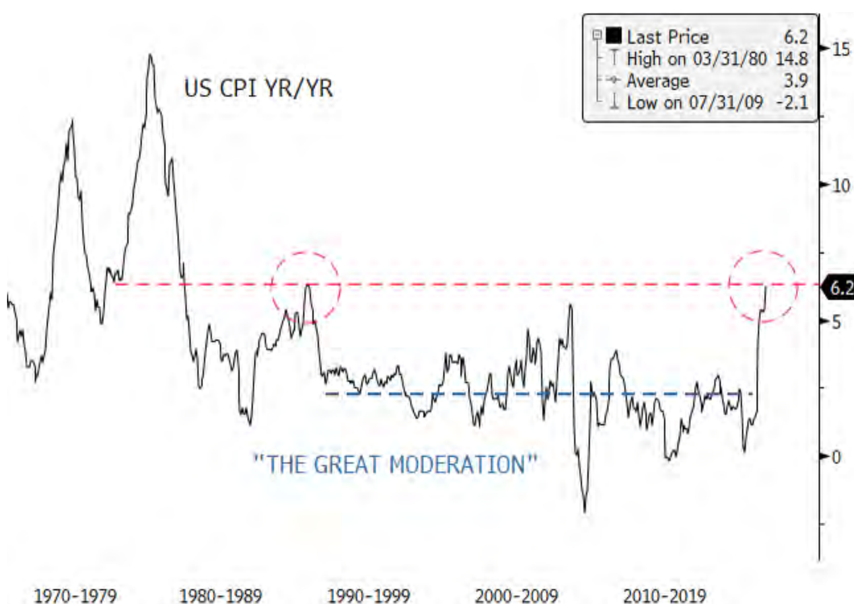
Source: Sprott, Bloomberg as of 11/30/2021. Included for illustrative purposes only.

Official Taper Announcement and a Hot CPI Print

The long-awaited Fed taper announcement finally arrived without much fanfare. Gold rallied before the formal announcement. During the November FOMC meeting, the Fed (regarding inflation) acknowledged that its tools could not ease supply constraints, but its policy would adapt appropriately, and it would not allow high inflation to become a permanent feature. Essentially, the Fed is promising to thread the needle on inflation. The Fed is attempting to correctly determine the right amount (and timing) of pre-emptive tightening to control inflation without impairing growth, despite admitting that interest rate hikes will have minimal effect on cost-push[8] inflation.

Shortly after, the October CPI printed its highest number since 1990, a 6.2% year-over-year reading versus expectations of 5.9% (Figure 2). Rising food and energy prices have been a big driver of inflation over the past year. Rent inflation is also starting to appear in the data and will soon join food and energy as another inelastic inflation factor. With the Fed now admitting that the risk of persistently higher inflation has increased and is likely to be broader in scope, we wonder if the market will start to price the possible end of the "great moderation" of the past few decades? (The great moderation marks a period of growth with low inflation and low macro-level volatility, which has lasted since the end of the 1990 recession period.)

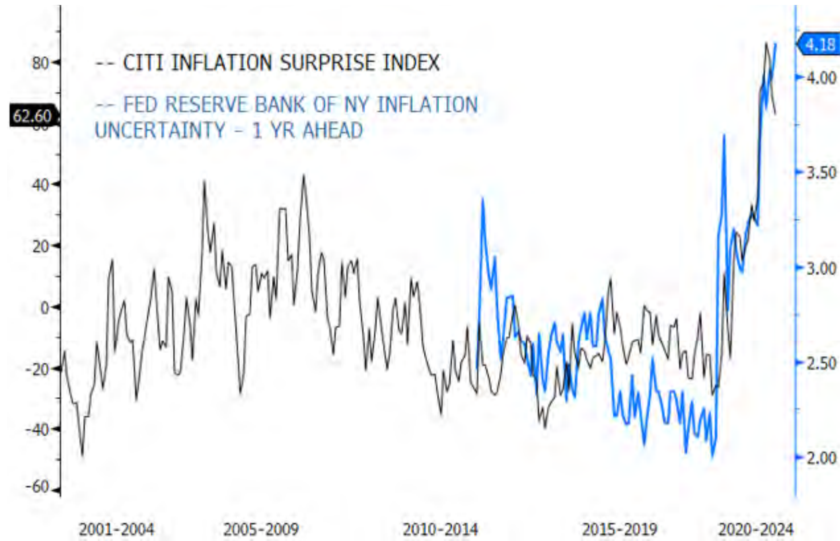
Figure 2. U.S. CPI Year-over-Year Change Hits 30-Year High (1970-2021)



Source: Sprott, Bloomberg as of 11/30/2021. Included for illustrative purposes only.

Questions about inflation expectations — an important psychological mechanism — are becoming paramount. But predicting whether inflation expectations become ingrained in consumers' mindsets is difficult to forecast. If consumers start reacting as if inflation has become entrenched, it will be harder for the Fed to rein in expectations, especially on the wage front. The current degree of uncertainty and the surprisingly high levels of inflation are not helping. Figure 3 highlights how elevated these measures are and how they kept rising throughout this year despite the Fed and most economists stating since Q1 that inflation is "transitory." The Fed call and consensus was that inflation would be transitory until mid-2022. This seems to have changed in Powell's latest testimony before the Senate Banking Committee.

Figure 3. Citi Inflation Surprise Index and Reserve Bank of NY Inflation Uncertainty Index: Surprisingly Uncertain (2001-2024)



Source: Sprott, Bloomberg as of 11/30/2021. Included for illustrative purposes only.

Real Interest Rates: That '70s Show

Evidence has been building all year that inflation is not nearly as transitory as expected. Though the data is limited to only several months, the correlation of inflation to interest rates now appears broken compared to historical norms. U.S. 10-year Treasury yields, despite U.S. CPI at 6.2% and PCEPI (personal consumption expenditure price index) inflation at 4.1% (both well above the Fed's 2% target), remain below 1.50%. Using any number of regression fit calculations, 10-year yields would be expected to be above 8% at current inflation levels. As the Fed maintains low nominal yields, despite the scorching inflation numbers, real yields as measured by the U.S. 10-year Treasury yield minus CPI have reached the nadir of the 1970s (see Figure 4). If the goal of the Fed is to deflate away the debt via inflation, it is doing a remarkable job. Real wealth, however, is also being eroded in the collateral damage — financial repression at work.

Figure 4. Real Yields as Measured by U.S. 10-Year Treasury Yield Minus CPI (1970-2021)

Source: Sprott, Bloomberg as of 11/30/2021. Included for illustrative purposes only.

Inflation Meets the Zero Bound

Since about 2001, there has been a pronounced negative correlation between bonds and equities. The Fed policy of targeting 2% provided an inflation anchor, and the emergence of China as a major economy kept prices in check as offshoring (globalization) lowered costs. Throughout this period, deflationary growth shocks were the primary risk tail for both bonds and equities. The Fed's standard policy response was to cut interest rates and pump liquidity into the financial system via debt expansion at every significant risk event. But even into a recovery, interest rates were never allowed to retrace entirely due to the higher debt load. After multiple risk events, we have seemingly come to the inevitable conclusion of inflation meeting the zero bound.

In prior decades, bond volatility eventually became a "good form" of bond volatility through lower interest rates. Ever lower rates, driven by the Fed, have propelled bond markets higher and raised equity valuations. However, at the zero bound, the scope for good bond volatility is minimal (very little room is left for rates to decline). An unexpected surge in cost-push inflation, where central bankers have limited influence, is the "bad kind of bond volatility." More so when it occurs at the zero bound as there is only one way to go — up. When the risk-free asset becomes a source of risk and volatility, we highly question the continuation of the negative correlation between bonds and equities. As a safe haven asset and diversifier in a multi-asset portfolio, we believe gold will become more critical and relevant in short order.

When All Asset Class Volatility Rises

As measured by the MOVE Index,[7] bond volatility has been rising throughout 2021, outpacing equity and currency volatility measures. Lately, all three volatility indices have been rising. The top panel in Figure 5 is a weighted combined average of equity, bond and currency volatility indices. The bottom panel is the price of gold bullion. The pattern is clear: we believe gold becomes highly attractive as a hedge when volatility rises simultaneously in all asset classes. Figure 5 shows that gold becomes more attractive when the most common and used hedge (the bond/equity hedge) is no longer effective. As pointed out in prior commentaries, gold positioning is near multi-year lows.

Figure 5. Weighted Equity, Bond and Currency Index and Gold Bullion (2018-2021)

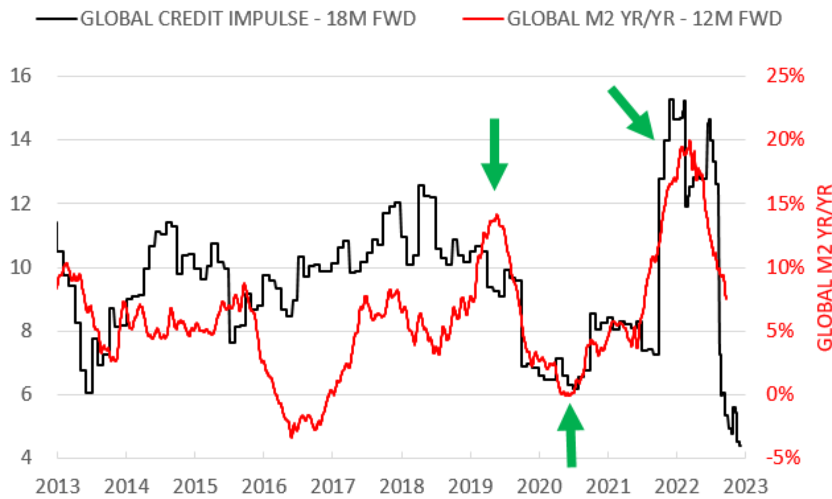
Source: Sprott, Bloomberg as of 11/30/2021. Included for illustrative purposes only.

What if Omicron Hits Economic Growth Hard?

At this time, we have limited information on the omicron variant, so the range of possible outcomes is wide. If the new variant damages the growth outlook, we expect it to accelerate the existing downside forces. In our September commentary, Doug Groh highlighted the peak in the global credit impulse. Global credit impulse measures the change in new credit as a % of GDP (gross domestic product; fiscal impulse). Global credit impulse is an excellent lead indicator for GDP growth and tends to lead by 1.5 years. The global M2[9] money supply (monetary impulse) is also a great lead indicator and tends to lead by a year.

When these two indicators are time aligned (see Figure 6), they provide strong evidence of when growth will crest or bottom, especially if synchronicity occurs. Currently, Q1 2022 appears to be when marked growth pressures should start in earnest. Before that happens, there should be signs of a slowdown and divergences, which is happening (i.e., yield curve flattening). By the second half of 2022, these two indicators should show a more pronounced weakness. By this timeframe, the market is pricing the completion of taper and the beginning of rate hikes. By Q1 2022, we doubt the taper process will go smoothly (Omicron variant or not). There is a probability that Fed rate hike expectations by July 2022 will give way to talk of stimulus by the end of 2022. Note the green arrow in Figure 6 during early 2019. By early Q1 2019, we went from the Fed trying to normalize its balance sheet to the Powell Pivot. That data was already generated in 2017/18. Sometime in 2022, be on the lookout for some variation of Powell Pivot 2.0.

Figure 6. Global M2 Money Supply and Global Credit Impulse Time Aligned (2013-2021)



Source: Sprott, Bloomberg as of 11/30/2021. Included for illustrative purposes only.

Macro Risk index Already at the Upper End

Months before the news of the Omicron variant and before the 6.2% October CPI figure, macro risk as measured by the Citi Macro Risk Index[10] had registered a low (Figure 7). By November month-end, it had entered the high-risk zone. We will likely see a very elevated macro risk coincide with Fed tapering, along with global credit impulse and global M2 rollover effects in place. Asset prices, however, have held up remarkably well, mainly due to the highly accommodative financial conditions put in place by the Fed. Essentially, massive monthly asset purchases devoid of price valuation considerations have created and supported overvalued assets — for example, equities trading near dot.com valuations and bond prices detached from inflation. If the financial conditions index deteriorates, perhaps in part due to accelerated tapering, the "mark-to-market gap" relative to macro risk would be significant.

Figure 7. Citi Macro Risk Index and Goldman Sachs Financial Condition Index (2012-2021)

Source: Sprott, Bloomberg as of 11/30/2021. Included for illustrative purposes only.

Not surprisingly, when macro risk rises, gold (as a safe haven) relative to equities outperform, as illustrated in Figure 8. The bottom panel is the gold bullion to S&P 500 ratio on a year-over-year change basis. The dashed arrows help highlight the relationship. The gold to S&P 500 ratio will likely rise if any combination of inflation pressures, Omicron risk, tapering or the slowdown worsens the macro risk picture.

Figure 8. Citi Macro Risk Index and the Gold Bullion to S&P 500 Ratio (2012-2021)

Source: Sprott, Bloomberg as of 11/30/2021. Included for illustrative purposes only.

Nearing the End of the Gold Correction

By most measures that we consider significant to gold pricing dynamics (our list is long and varied), we believe we are near the end of gold's price correction. Monetary and fiscal impulses are rolling over. Macro risk conditions appear to already be at the red line. Inflation risk continues to build and broaden out. Another possible problematic COVID variant has arrived. Earnings momentum is now rolling over, and margin pressures are mounting. Yields are rising, with most asset classes carrying large amounts of embedded duration. We believe the two-decades-long negative bond equity correlation is at an uncomfortable degree of ending. All asset class volatility is rising, but this time bond volatility is leading (the risk-free asset). Fed accommodation will be unwinding soon, and while the overall economy may be relatively immune, richly priced assets may not.

Yet gold bullion continues to trade almost exclusively to the outlook for taper due to the current short-term dominance of the quantitative-type funds (i.e., CTAs,[11] systematics, quants, algorithmic, etc.). The degree to which macro risks and headwinds are piling up is considerable. When juxtaposed against a near positioning wipeout for gold bullion, we are confident the plus year-long correction in gold is near its end.

About Sprott

Sprott is a global asset manager providing investors with access to highly-differentiated precious metals strategies. We are specialists. Our in-depth knowledge, experience and relationships separate us from the generalists. Sprott's specialized investment products include innovative physical bullion trusts, managed equities, mining ETFs, as well as private equity and debt strategies. We also partner with natural resource companies to help meet their capital needs through our brokerage and resource lending activities. Sprott is a global asset manager with offices in Toronto, New York and London. Sprott's common shares are listed on the New York Stock Exchange and the Toronto Stock Exchange under the symbol "SII".

Sprott

sprott.com

[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] MOVE Index: Merrill Lynch Option Volatility Estimate is an index that measures bond market sentiment.
[8] Cost-push inflation occurs when the aggregate supply of goods and services decreases because of an increase in production costs.
[9] M2 is a measure of the money supply that includes cash, checking deposits and easily convertible near money. M2 is a broader measure of the money supply than M1, which simply includes cash and checking deposits.
[10] The Citi Macro Risk Index, calculated based on credit spreads, swap spreads, and implied volatility on major asset classes, is often used to measure risk aversion in global financial markets.
[11] CTAs: Commodity Trading Advisors, i.e., quant funds, an investment fund that selects securities using advanced quantitative analysis.

Past performance is no guarantee of future results. You cannot invest directly in an index. Investments, commentary and statements are unique and may not be reflective of investments and commentary in other strategies managed by Sprott Asset Management USA, Inc., Sprott Asset Management LP, Sprott Inc., or any other Sprott entity or affiliate. Opinions expressed in this presentation are those of the presenter and may vary widely from opinions of other Sprott affiliated Portfolio Managers or investment professionals.

Sprott Asset Management LP is the investment manager to the Sprott Physical Bullion Trusts (the "Trusts"). Important information about the Trusts, including the investment objectives and strategies, purchase options, applicable management fees, and expenses, is contained in the prospectus. Please read the document carefully before investing. Investment funds are not guaranteed, their values change frequently and past performance may not be repeated. This communication does not constitute an offer to sell or solicitation to purchase securities of the Trusts.

The risks associated with investing in a Trust depend on the securities and assets in which the Trust invests, based upon the Trust's particular objectives. There is no assurance that any Trust will achieve its investment objective, and its net asset value, yield and investment return will fluctuate from time to time with market conditions. There is no guarantee that the full amount of your original investment in a Trust will be returned to you. The Trusts are not insured by the Canada Deposit Insurance Corporation or any other government deposit insurer. Please read a Trust's prospectus before investing.

The information contained herein does not constitute an offer or solicitation to anyone in the United States or in any other jurisdiction in which such an offer or solicitation is not authorized or to any person to whom it is unlawful to make such an offer or solicitation. Prospective investors who are not resident in Canada or the United States should contact their financial advisor to determine whether securities of the Funds may be lawfully sold in their jurisdiction.

The information provided is general in nature and is provided with the understanding that it may not be relied upon as, nor considered to be, the rendering or tax, legal, accounting or professional advice. Readers should consult with their own accountants and/or lawyers for advice on the specific circumstances before taking any action.

This article may not be reproduced in any form, or referred to in any other publication, without acknowledgement that it was produced by Sprott Asset Management LP and a reference to www.sprott.com. The opinions, estimates and projections ("information") contained within this report are solely those of Sprott Asset Management LP ("SAM LP") and are subject to change without notice. SAM LP makes every effort to ensure that the information has been derived from sources believed to be reliable and accurate. However, SAM LP assumes no responsibility for any losses or damages, whether direct or indirect, which arise out of the use of this information. SAM LP is not under any obligation to update or keep current the information contained herein. The information should not be regarded by recipients as a substitute for the exercise of their own judgment. Please contact your own personal advisor on your particular circumstances. Views expressed regarding a particular company, security, industry or market sector should not be considered an indication of trading intent of any investment funds managed by Sprott Asset Management LP. These views are not to be considered as investment advice nor should they be considered a recommendation to buy or sell. SAM LP and/or its affiliates may collectively beneficially own/control 1% or more of any class of the equity securities of the issuers mentioned in this report. SAM LP and/or its affiliates may hold short position in any class of the equity securities of the issuers mentioned in this report. During the preceding 12 months, SAM LP and/or its affiliates may have received remuneration other than normal course investment advisory or trade execution services from the issuers mentioned in this report.

11211075 11/21_ART_SMR