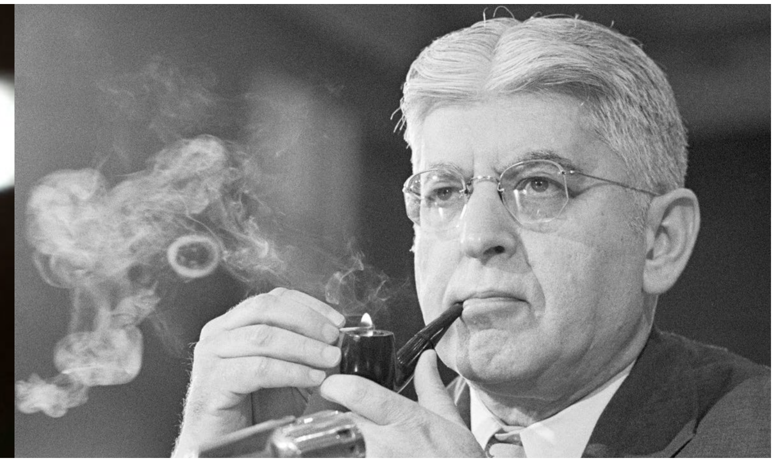
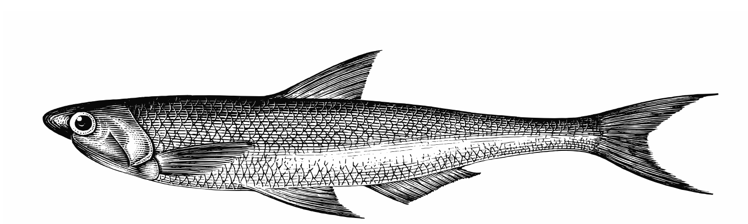
Inflation, the Financial Markets and Gold

John Hathaway - Strong Symposium 2022

What do Jay Powell, Arthur Burns, Anchovies and a Dead Horse Have in Common?





Transitory Inflation!

Burns

1972

- Decimation of anchovies by El Nino drove fertilizer and feedstock prices higher in turn driving up meat prices. Food = 25% of CPI. Disregard food as a component of inflation. The forerunner of "core CPI"

1972-1975

- Removed mobile homes, used cars, gold jewelry, home ownership 16% = of CPI

1975

- Burns had removed 65% of CPI items to "normalize" inflation. Finally conceded the U.S. had an inflation problem. –Stephen S. Roach, The Ghost of Arthur Burns, 5/25/2021

Powell

Until recently, Powell insisted increases in the prices of food, construction materials, used cars, personal health products, gasoline, car rentals, and appliances reflect transitory factors that will quickly fade with post-pandemic normalization. Scattered labor shortages and surging home prices are supposedly also transitory. –Steven Roach, 5/5/2021

"The characterization of inflation as transitory is probably the worst inflation call in the history of the Federal Reserve, and it results in a high probability of a policy mistake." –El Erian

"Because they started so late, the window for action is very small. What they need to do (at the January FOMC meeting) is announce an immediate stop to QE, announce plans for QT, and explain why they got the inflation call so wrong….I don't expect that to happen."[1] –El Erian

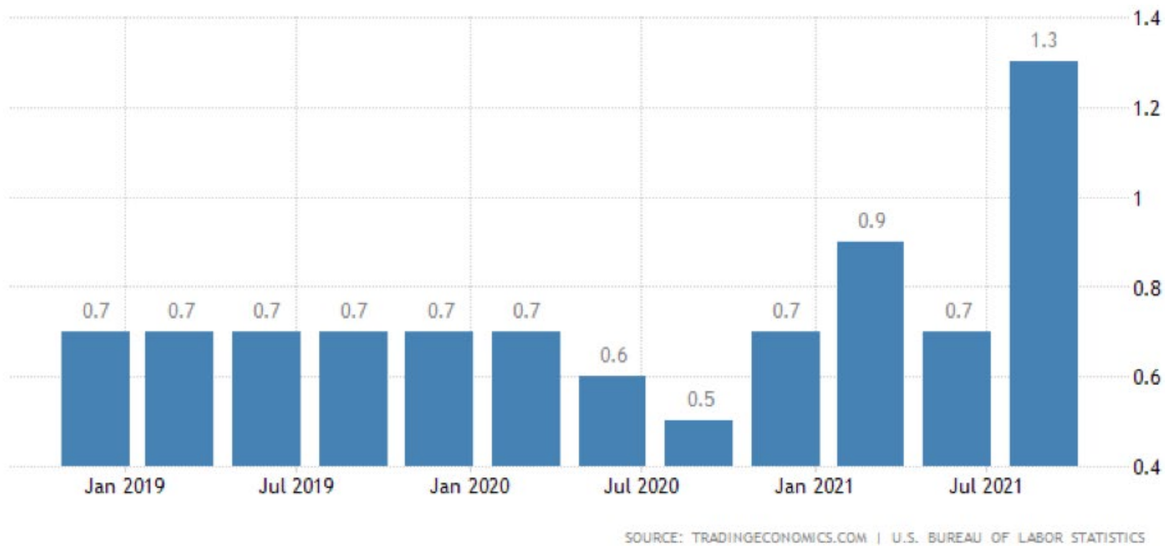
"This [supply chain bottlenecks] is a description of the state of affairs, not its [inflation's] source." –Kevin Warsh, former Fed Governor

[1] https://www.bloomberg.com/news/videos/2022-01-20/el-erian-says-fed-needs-to-be-bold-at-january-meeting-video

Higher Wages will Affect CPI with a Lag

- 60% or so of all cost inputs
- Very sticky compared to commodity cost inputs
- Q4 ECEC to be announced March 18, 2022

Employment Cost Index QoQ



Economic Slowdown or Recession will not stop embedded inflation

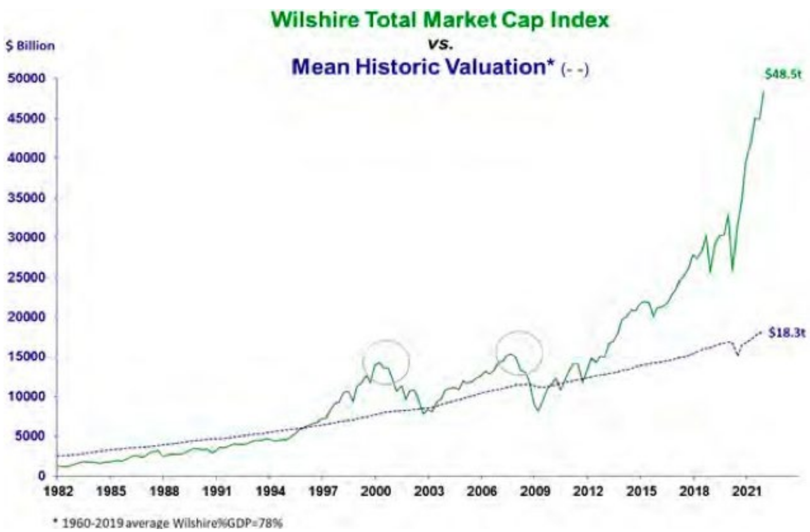
High Unemployment and Inflation

- Assumption that high unemployment and inflation are binary is suspect based on 1970s precedent

	GDP (% change)	Unemployment	CPI
1973	5.64	4.9%	6.2%
1974	(.541)	7.2%	11.1%
1975	(.205)	8.2	9.1%
1976	5.33	7.8	5.7%
1977	4.62	6.4	6.5
1978	5.55	6.0	7.6

Equity Markets Poised to Falter?

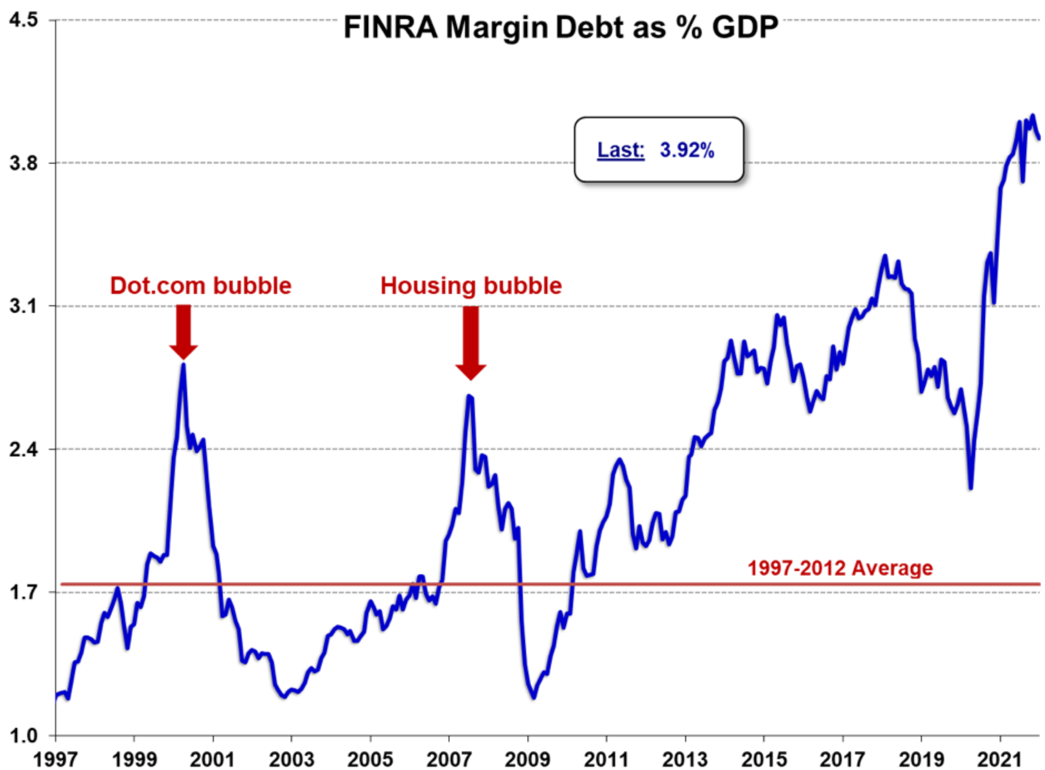
Market Priced for Perfection



Source: Stephanie Pomboy, MacroMavens as of 12/31/2021.

Fed Accommodation = Financial Asset Bubble

Bear Markets…



"Exponentially rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways." –Robert Farrell, 10 Rules of Investing, rule #4.

"Bear markets have three stages—sharp down, reflexive rebound, and a drawn-out fundamental downtrend." –Robert Farrell, 10 Rules of Investing, rule #8

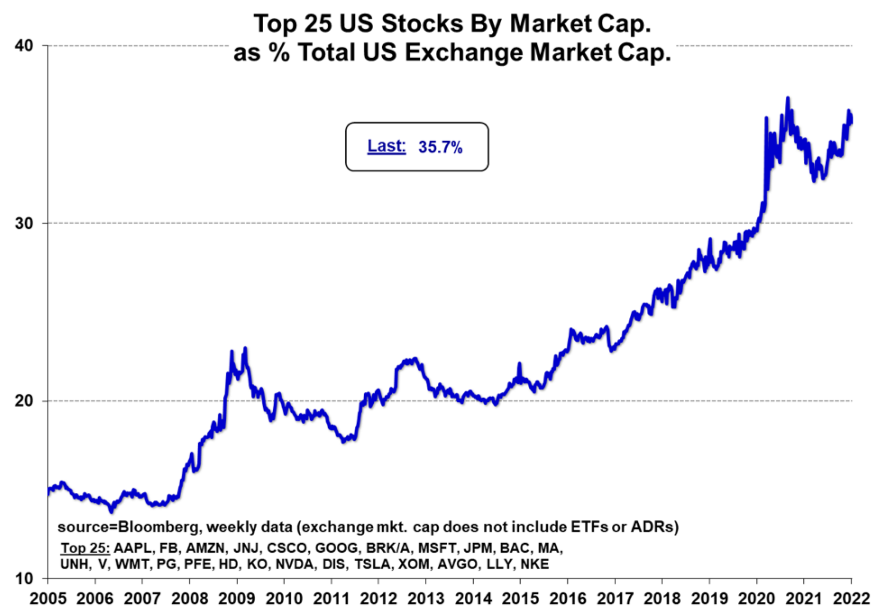
"Bear markets do not have neat beginnings. They often have inauspicious starts, taking hold much earlier than when they become an acknowledged reality." –Michael Solomon, Marlin Sams Fund, 1/1/2022

- The S&P 500 Index has traded above its current valuation of 23 times forward P/E (price/earnings ratio) only 10% of the time, prior to the 2000 dot-com crash and now in the current market. (Waiting for the Pivot)

Add S&P 500 footnote here. See word file for reference… footnote 3 placed in text above.

The Powell Pivot

- With Fed policy taking a more hawkish turn, the fire hose of liquidity that has fueled the mania is being turned off. Should the Fed not flinch (a major assumption), bubble days would seem to be numbered. A deflation of financial assets would very likely trigger a downturn in economic activity, even more unacceptable politically than the current high rate of inflation. For that reason, another "Powell Pivot" is still very much in the cards. It may just take longer and create more damage than the 2018 pivot. We believe that CPI inflation will not respond to restrictive monetary policy in the absence of a market reversal that disrupts manic psychology. (Waiting for the Pivot)
- Former U.S. Secretary of the Treasury Lawrence Summers recently warned of the possibility of a market crash. At the December 14, 2021, American Council for Capital Formation (ACCF) webinar, Summers stated that there is a risk of "spontaneous deflation of capital markets". He added that "The Fed will have a very difficult time of organizing a soft landing…. All the efforts at disinflation we have had historically, where it was clearly established that inflation has been too high and the Fed acted, have ended in recession."



Add CPI inflation footnote here. See word file for reference… footnote 9 placed in text above.

"Markets are strongest when they are broad and weakest when they narrow to a handful of blue chip names."

– Robert Farrell, 10 Rules of Investing, Rule #7

60 year veteran market analyst sees a bear market ahead

- There's *much* more that's a problem with this trend. And this is what so confuses so many of the fundamentalists who expect these oversold rallies to turn into "A+" moves that will give them a chance to sell their negatively-rated Stage 3 & 4 stocks at *much* higher prices. But what they don't "get" is that when the technicals are so weak, history shows that these bear market rallies aren't long-lasting and, in addition, as I wrote in my book many years ago, they also don't realize that "in a bear market, stocks that appear 'cheap' as the months go by, get *cheaper*!!"
– Weinstein, 2/22/2022
- First, and most important of all, it reinforces that our long-term call that the market saw its high for this cycle several weeks ago is spot on and, even more importantly, that the aggressive growth stocks, which we felt were destined to be *disasters,* is also on target. And the second short term insight is that such negative reversal action has the potential to lead to a further "mini-crash." – Weinstein, 1/20/2022

Russell 3000 Index… 2009-2022 Channel

- A selloff by June 30th to the midpoint of the 2009-2022 channel would represent a **20% +/- peak-to-trough decline.**
- A selloff by December 30th to the lower band of the 2009-2022 channel would represent a **37% +/- peak-to-trough decline.**

Source: Carter Braxton Worth.

Catalyst for Gold = Bear Market + Loss of Confidence in the Fed

- Confidence in the Fed and attraction to gold at the moment appear to be binary. We stand by our comments from our July 2021 *You Gotta Have Faith* report, "Faith in the Fed's omniscience is convenient to the investment consensus because it underpins the extraordinary overvaluation of financial assets. Let's face it, despite pious subservience to the goals of full employment and price stability, the Fed's real mandate is to keep financial markets from coming unglued. 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. (Waiting for the Pivot)
- We worry that today's situation is the flip side of the Volcker experience. Forty years of price stability have given breathing room to today's Federal Reserve, but U.S. interest rates could again provide erroneous forecasts of inflation. Most market participants have apparently played down the possibility that we are in a new monetary and fiscal regime, one in which policy makers don't worry enough about large deficits and excessive money creation and new purposes like addressing climate change distract the Fed from inflation. We hope our fears are misplaced, but if they aren't, the new reality of higher inflation will eventually take hold, and the 10-year rate will jump to reflect that regime. History teaches that central bank credibility usually moves slowly in both directions. –Thomas Sargent & William Silber, "The Market Is Too Serene About Inflation" WSJ, 1/11/2022
- What is even more bizarre is that as wrong as the Fed has been in predicting inflation over the last year, financial markets continue to signal extreme confidence in the Fed and other central banks—with investors paying a historically high price for the privilege of lending their money to the U.S. Treasury and other governments around the world. –James Freeman, "Bond Bubble Bigger" WSJ, 12/17/2021

Q. What Nominal Rate is Necessary to Provide a 2% Real Return?

A. 7.27%

- Back in the mid-to-late 1970’s, when the FOMC raised the Fed Funds rate from 6.5% t0 10.5%, the CPI increased from 6.0% to 13.0%....the “real rate”, the nominal rate less inflation, was minus 2.5%. The inflation was finally stopped-and-declined when the 10-year T-Bond rate increased to 14.5% in 1981 and 15.4% in 1982 that ran over the 13.5% CPI. The CPI was back down to 3.5% within a year. To get the positive 2% real rate at this time, the 10-year T-Bond rate has to advance from the current 1.77% to 8.00% - 9.00%....and quickly. The longer-the-time, the chances of a higher rise in the CPI. That’s the history. Lots-of-Luck! – Fred Kalkstein, January 2022

Accelerating Maturities of Speculative Grade Debt

U.S. Maturing Debt By Year

(Bil. $)		2021	2022	2023	2024	2025
Financial services		220.0	247.7	255.2	205.3	229.9
	IG	212.2	228.4	231.3	186.8	184.6
	SG	7.8	19.2	23.8	18.5	45.3
Nonfinancial		484.6	667.0	812.1	885.2	1,004.1
	IG	362.3	428.0	474.2	396.2	445.8
	SG	122.3	239.0	337.9	489.0	558.4
Total IG		574.5	656.4	705.6	583.0	630.4
Total SG		130.1	258.2	361.7	507.5	603.7
Total		704.6	914.7	1,067.3	1,090.5	1,234.1

Source: Macro Mavens, LLC. Stephanie Pomboy;

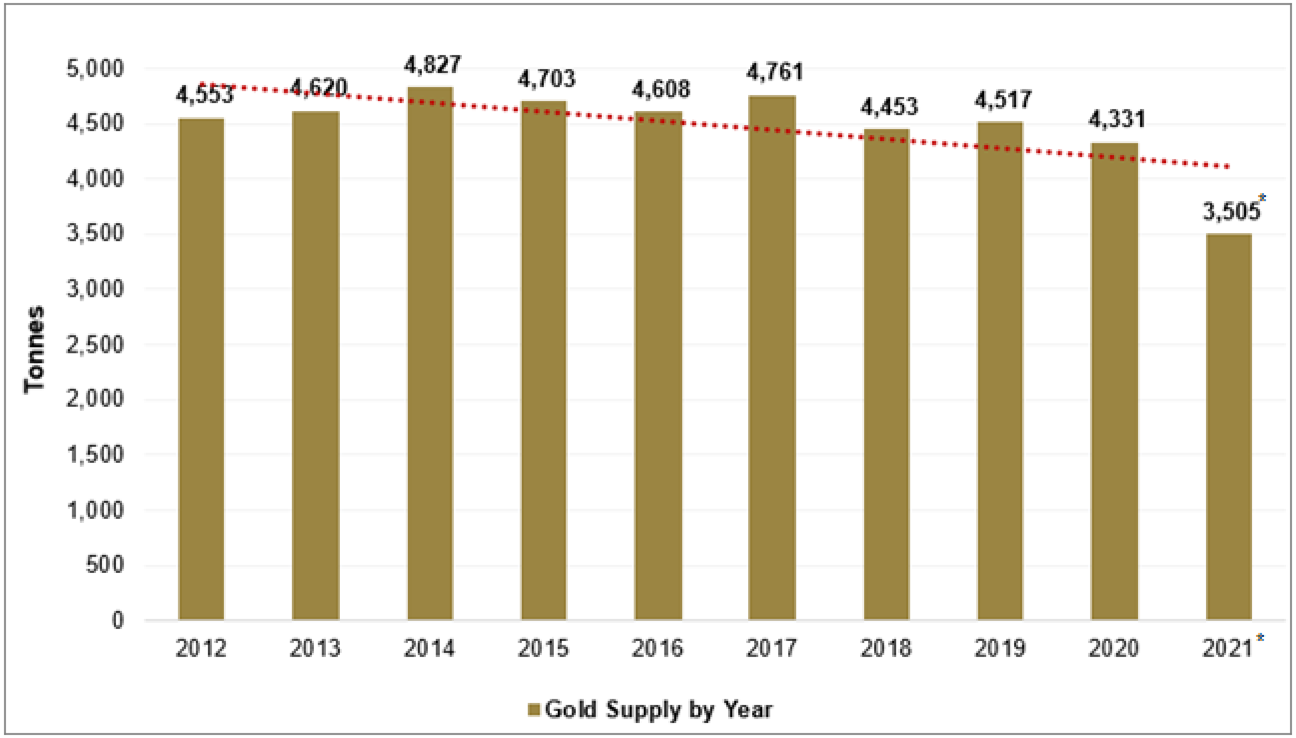
In other words, expectations of the Fed orchestrating a return to positive real rates is a fantasy

Relevance of Intransigent Inflation to Asset Valuations and Gold

- It would be a mistake to position gold narrowly as an inflation hedge. While gold performed well during the inflationary 1970s, it also did so from 1999-2011 when inflation wasn't on the front page. Gold is a hedge against systemic risks, including inflation, deflation, monetary regime change, or just plain monetary malpractice. "Waiting for the Pivot"
- *"The real danger comes from the Fed encouraging or inadvertently tolerating rising inflation and its close cousin of extreme speculation and risk taking, in effect standing by while bubbles and excess threaten financial markets."* –Paul Volcker
- The investment consensus that financial assets are reasonably valued is dependent on the view that inflation will go away on its own. If inflation remains stubborn and is difficult to stamp out, financial asset valuations will need a major rethink. The market cannot handle the prospect of a Volcker Redux.
- *"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."*

Gold Bullish Supply & Demand Setup

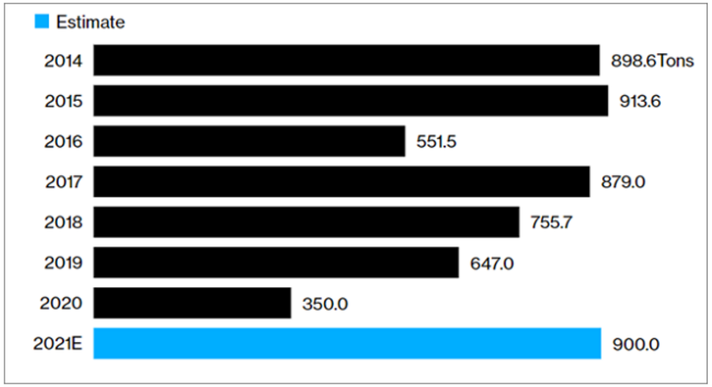
Gold Mine Supply



Indian Imports – Highest In 5 Years

Asian Demand for Physical Gold has Surged

India's 2021 Gold Imports Hit Six-Year High



Chinese Investment Strongest In Three Years

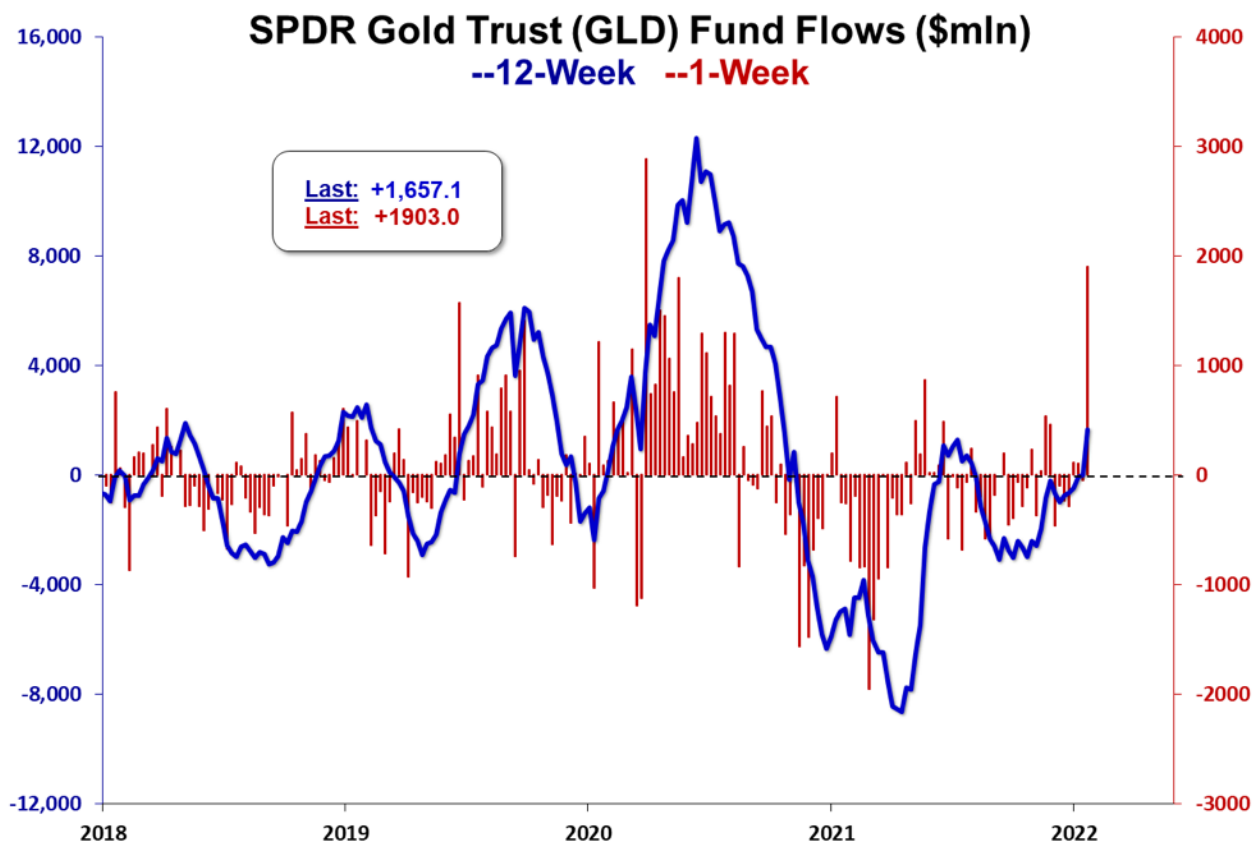
Shanghai Gold Exchange: Gold Withdrawals (Tonnes)
Source=Shanghai Gold Exchange

	2022	2021	2020	2019	2018	2017	2016	2015
JANUARY	0.000	159.489	110.871	218.54	223.58	184.41	225.08	255.42
FEBRUARY	0.000	92.392	28.990	99.76	118.42	148.24	107.60	156.36
MARCH	0.000	167.743	82.270	218.02	192.61	192.25	183.24	213.35
APRIL	0.000	148.404	95.796	151.89	212.64	165.78	171.40	195.45
MAY	0.000	105.061	69.179	123.11	150.58	138.08	147.28	162.15
JUNE	0.000	132.803	85.711	107.449	140.58	155.51	138.51	195.67
JULY	0.000	110.612	82.938	129.332	137.41	144.71	117.58	285.50
AUGUST	0.000	149.951	111.370	107.727	190.59	161.41	144.44	265.27
SEPTEMBER	0.000	190.869	153.977	117.084	188.12	214.24	170.90	259.98
OCTOBER	0.000	136.624	94.277	91.15	142.94	151.54	153.25	176.29
NOVEMBER	0.000	158.308	127.645	119.426	179.08	189.10	214.72	202.71
DECEMBER	0.000	193.437	162.298	158.501	178.04	185.21	196.37	228.21
YTD	0	1745.693	1205.322	1,642.0	2,054.6	2,030.5	1,970.4	2,596.4
Y/Y CHANGE		+44.83%	-26.59%	-20.08%	+1.19%	+3.05%	-24.11%	+23.50%

Gold-Backed ETF Flows

Source: World Gold Council Gold Hub as of 12/31/2021. Included for illustrative purposes only.

GLD Fund Flows



Gold Mining Shares are Inexpensive…

In Absolute and Relative Terms

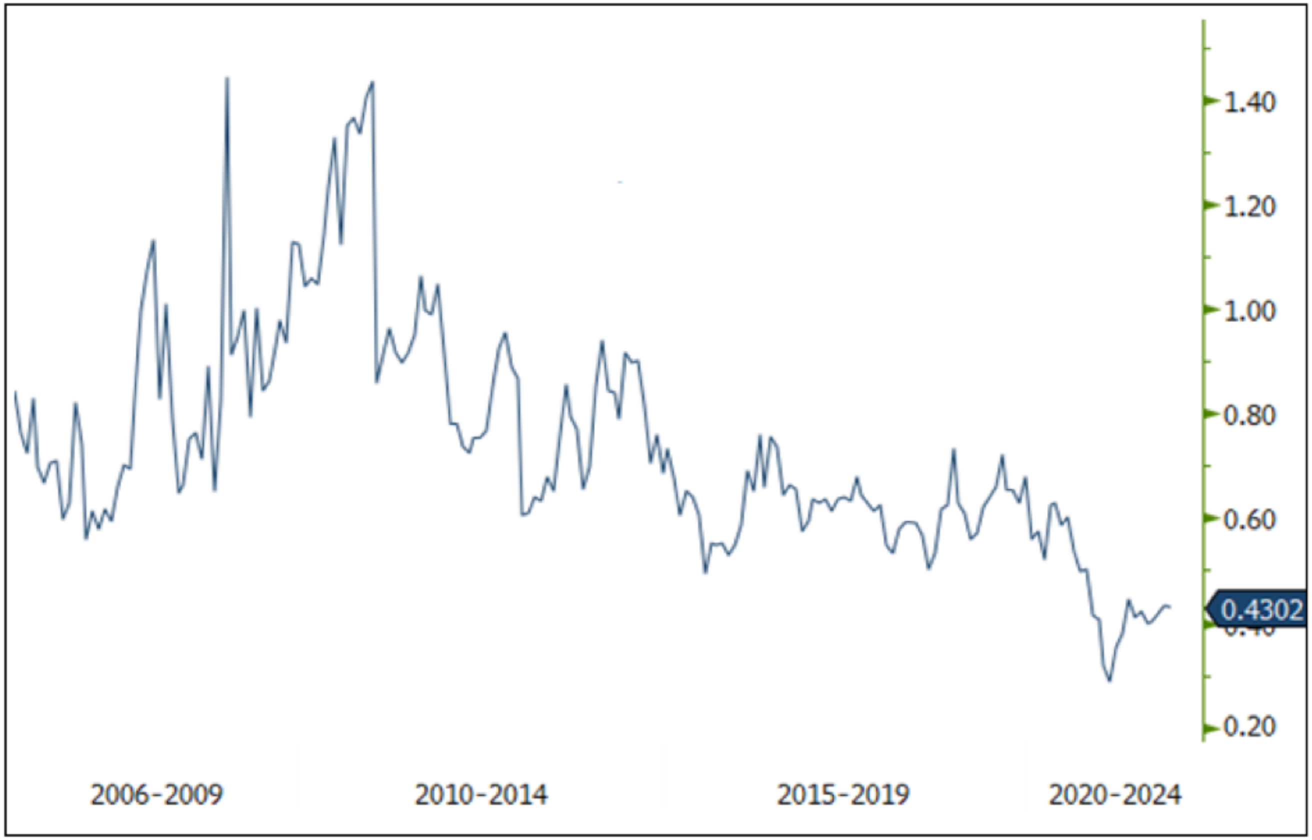
Relative Valuations of Gold Mining Equities (GDM)[11] vs. S&P 500 Index

	Gold Mining Equities (GDM)	S&P 500	GDM vs. S&P 500	Since 2006 16 YR %-tile	Comment
EV/EBITDA	6.43	14.65	0.44	0.06	Lowest 6%-tile
P/E Ratio	15.56	21.81	0.71	0.08	Lowest 8%-tile
Free Cash Flow Yield	5.41%	3.31%	1.64	0.06	Highest 6%-tile
Dividend Yield	2.09%	1.39%	1.50	0.03	Highest 3%-tile
Return on Assets	6.08%	3.73%	1.63	0.29	Top 1/3 relative active ROA*
Profit Margins	17.00%	12.01%	1.42	0.34	Top 1/3 relative margins
Net Debt to EBITDA Ratio	0.17	1.02	0.16	0.34	Small relative fraction
Total Debt to Total Assets Ratio	13.23	24.06	0.55	0.42	

Source: Sprott Asset Management, Bloomberg. Data as of 12/31/2021. WHAT is the * for above "ROA"???

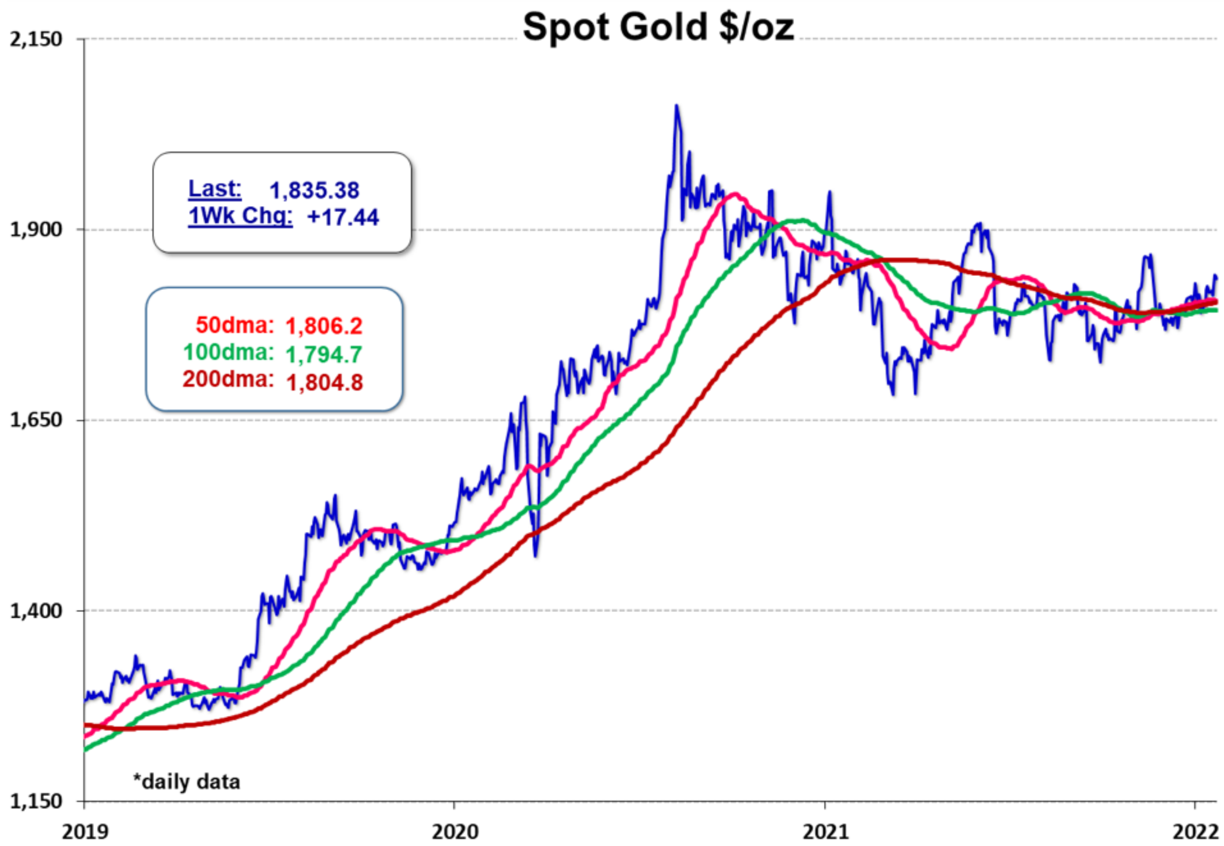
Gold Miners vs. S&P 500: EV/EBITDA

Gold Mining Equities (GDM)[11] EV/EBITDA Relative to S&P 500 Index EV/EBITDA (2006-2021)



Source: Sprott Asset Management, Bloomberg. Data as of 12/31/2020. DO WE HAVE ONE THAT IS UPDATED AS OF 2021?? What is footnote 11?

A Promising Chart



John Hathaway

John Hathaway, CFA, Senior Portfolio Manager

John Hathaway joined Sprott Asset Management in January 2020. Mr. Hathaway is a Portfolio Manager of Sprott Hathaway Special Situations Strategy and Co-Portfolio Manager of the Sprott Gold Equity Fund. Previously, Mr. Hathaway joined Tocqueville Asset Management L.P. in 1997 where he was a Co-Portfolio Manager of the Tocqueville Gold Fund as well as other investment vehicles in the Tocqueville Gold Equity Strategy. He was also the Portfolio Manager of private funds. Prior to joining Tocqueville, Mr. Hathaway co-founded and managed Hudson Capital Advisors followed by seven years with Oak Hall Advisors as the Chief Investment Officer in 1986. In 1976, he joined the investment advisory firm David J. Greene and Company, where he became a Partner. Mr. Hathaway began his career in 1970 as an Equity Analyst with Spencer Trask & Co. Mr. Hathaway earned a B.A. from Harvard College and an MBA from the University of Virginia. Mr. Hathaway was also the Chairman of Tocqueville Management Corporation, the General Partner of Tocqueville. He also holds the CFA® designation.

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