Sprott | Monthly Report
December 4, 2019

Gold's Pullback is Just a Pause

Authored by Paul Wong, CFA

Special Contributor; Paul was formerly a Senior Portfolio Manager at Sprott Asset Management and has more than 20 years of investment experience, specializing in investment analysis for natural resources investments. He is a trained geologist and CFA holder.

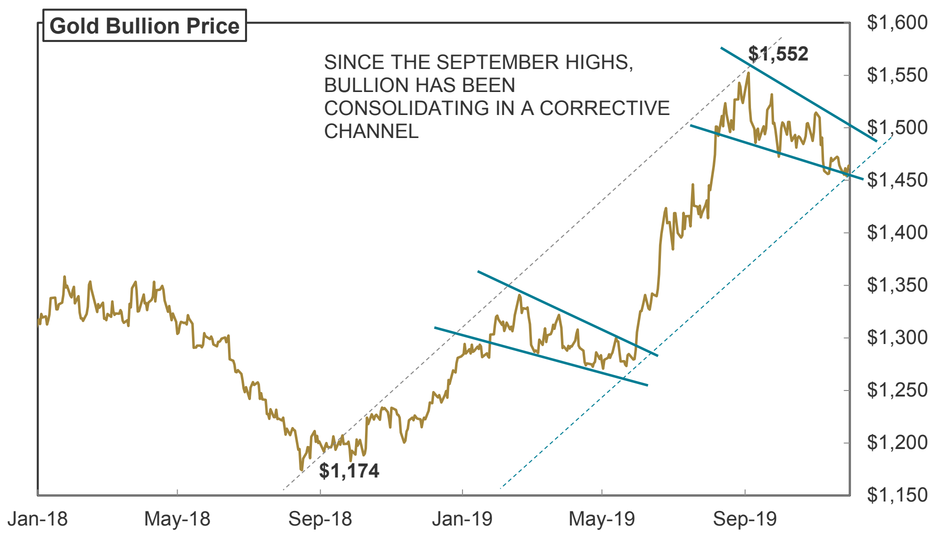
November marked the third month of consolidation for gold bullion and gold equities. Gold bullion closed the month at \$1,464, holding above the \$1,450 support level (and is up 12.69% YTD through 11/30). Silver closed the month at \$17.03, holding above the \$16 breakout level, though it continues to trade in a volatile manner (up 9.64% YTD). The gold/silver ratio closed at 86x below the up-channel broken in August (which indicates a bullish reading). Gold equities lost 3.3% for the month, and are up 33.35% YTD as measured by Sprott Gold Miners ETF (SGDM).[1]

Month of November 2019

Indicator	11/30/19	10/31/19	Change	% Change	*Analysis*
Gold Bullion	**\$1,464**	**\$1,513**	**(\$48.97)**	**(3.2)%**	**Consolidating in short-term range; \$1,450 support**
Silver Bullion	**\$17.03**	**\$18.11**	**(\$1.08)**	**(6.0)%**	**\$17 base held; carving out a base**
Gold Equities (SGDM)[1]	**\$23.34**	**\$24.13**	**(\$0.79)**	**(3.3)%**	**Nearing the end of the consolidation**
DXY US Dollar Index[2]	98.27	97.32	0.95	1.0%	Sideways grinding up
U.S. 10-YR Treasury Yield	1.78%	1.69%	0.08%	5.0%	Consolidating in short-term range
German Bund 10-YR Yield	(0.36)%	(0.41)%	0.05%	12.2%	Consolidating; major downtrend in place
U.S. 10-YR Treasury Real Yield	0.15%	0.14%	0.01%	7.1%	Consolidating in short-term range
Total Negative Debt (\$Trillion)	\$12.40	\$12.80	(\$0.40)	(3.4)%	Pull back inline with yields
CFTC Gold Non-Comm Net Position[3] and ETFs (Millions of Oz)	111.16	111.24	(\$0.08)	(0.1)%	Minor pullback in CFTC position

As we see in Figure 1, the gold price pattern and trading action continue to confirm a corrective pause in a long-term bullish pattern.

Figure 1. Gold Bullion Consolidates within a Longer-Term Bullish Advance



Source: Bloomberg as of November 30, 2019.

Gold equities continue to consolidate in a descending wedge pattern (a bullish pattern) and have held above key support levels. As gold equities traded down to near support levels several times in this correction, selling disappeared as volumes failed to confirm a breakdown. The key overhead resistance on GDX[4] is the August 2016 highs of $31.79; through that level, there is little overhead resistance until the $39 level. This target level is the 50% Fibonacci retracement of the entire 2011 to 2016 secular bear market and is also a major chart level resistance. As this correction winds down and we head into seasonal strength, the $31.79 level will be a key measure to watch.

Figure 2. Gold Equities Consolidate in a Bullish Pattern

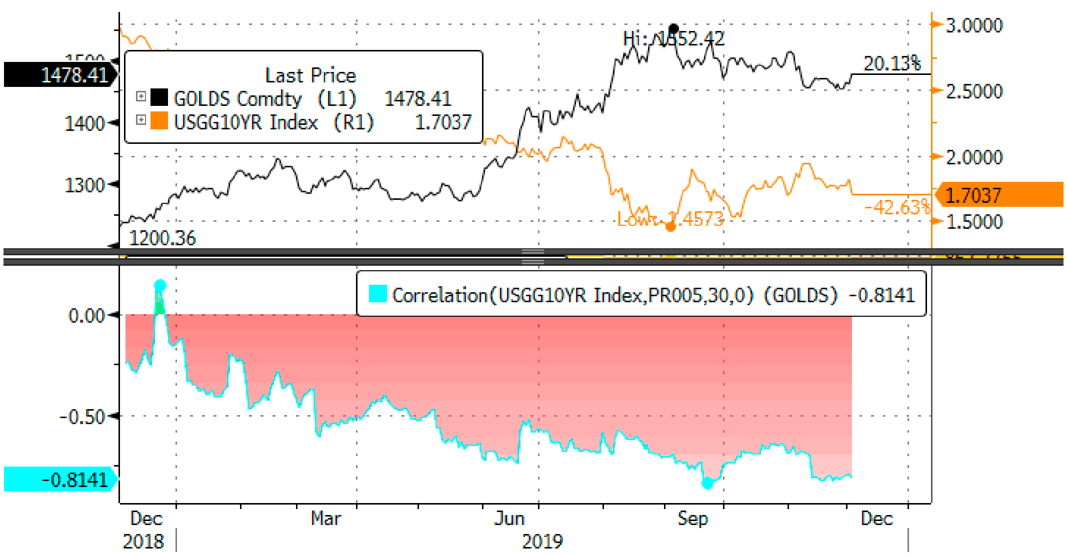
Source: Bloomberg as of November 30, 2019.

In 2019, the high inverse correlation between gold and bonds has been noteworthy. Recently bond yields have been driven by the hope that the current U.S.-China trade negotiations will spark an improving economic outlook, coupled with the support of large global stimulus programs launched over the past year. On September 3, U.S. 10-YR Treasury yields bottomed at 1.46%, near their 2016 lows, as gold bullion and gold equities peaked. The upward turn in yields was not driven by an inflection of better economic data but by potential trade talks, declining recession risk, and the avoidance of a hard Brexit event. Thus far, the economic data remains soft at best.

We wrote that the dramatic plunge in U.S. yields in the summer was likely exacerbated by convexity hedging and panicky overseas funds trying to lock in positive yielding bonds as negative yields surged elsewhere (see our August Gold Report). Another factor that we learned later was that CTAs (Commodity Trading Advisors, i.e., quant funds, an investment fund that selects securities using advanced quantitative analysis) had built an enormous long position in the bond market peak. The sharp snap back in yields from 1.46% to 1.94% since September was mainly due to CTAs bringing down their long positions dramatically as dictated by their models. We have seen analysis that shows CTAs have now likely eliminated three-quarters (75%) of their long positions. The sharp sell-off in bonds had a knock-on effect of causing a significant unwind of very crowded trades (i.e., long momentum short value, long low volatility short cyclical, etc.). The commonality of these trades was the correction in the long duration theme, which includes gold.

> "The broader equity market is not making new highs on typical fundamental drivers. If this sounds unsustainable, it probably is."

Figure 3. Gold Bullion and U.S. 10-YR Treasuries: Strong Inverse Correlation



Source: Bloomberg as of November 30, 2019.

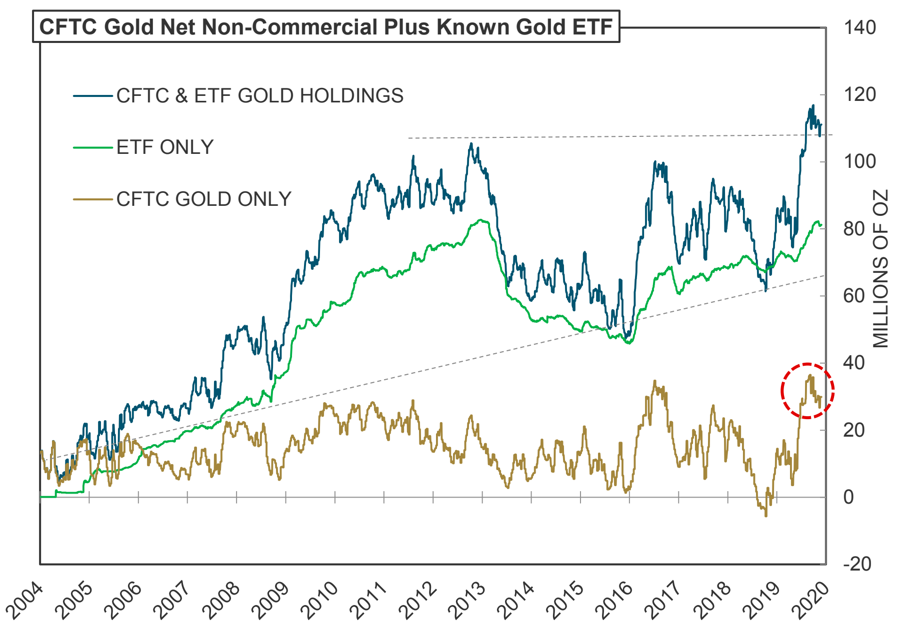
Gold Equities Set to Outperform

Other measures of growth that do not have market positioning influence (i.e., CRB Raw Industrials Spot Price Index,[5] and EU/U.S. 5Y/5Y inflation swaps[6]) have not shown any meaningful improvement, and remain consistent with the weak economic data. At the very least, slowing global growth and disinflationary macro forces will make it very difficult for market cyclicals to establish leadership. The corollary to this is that gold equities will likely outperform. Net CFTC gold holdings and ETF holdings in bullion are off by only 5% from their early September peaks, mostly via reduced CFTC longs. ETF holdings, the sticky money, has seen less than 2% selling.

Even though CTAs have unwound the majority of their massive bonds holdings, they appear to have left their gold long positions intact. We have often made the argument for gold as a potential portfolio allocation due to its low to negative correlation to equities, protection against negative yields, and its effect as a portfolio diversifier. This may be the first significant example we have seen so far in this cycle. Unfortunately, there is not enough transparency in CTA holdings to make a definitive statement, but the sizeable relative magnitude in selling is telling. One of the signs we usually see at gold trading lows is speculative longs being eliminated as a sign of washout selling. CTAs or quants are model-driven and are not trading gold as just another bond proxy or simple long-duration trade as they were selling those positions aggressively. Gold is the likely reason in our view, due to its high correlation to bonds while still having a diversification effect in the face of a high-risk environment. It is still early in this gold cycle, but we will keep watch of this dynamic.

Figure 4. Very Little Selling in Gold Bullion Positions, Despite Pause

Despite the great unwind in CTA long bond position and other long-duration assets, there has been very little selling in gold bullion positions. Hard to see, but the low in CFTC positions was October 15.



Source: Bloomberg as of November 30, 2019.

Gold Equity Valuation Metrics: Earnings Growth Stands Out…

In our October report, we highlighted the robust strength of 2020E upward earnings revision for gold stocks through 2019. We observed that the average of the top-10 gold mining stocks by market capitalization had seen their 2020E earnings per share increased by 50% since the beginning of the year, while the top 20 names in the S&P 500[7] by market capitalization, saw a downward revision of 2020E earnings by 9%.

Looking at 2020 estimates for other valuation metrics, gold mining equities compare quite well despite being at the early stages of their recovery and advance. Price-to-earnings is reasonably close, price-to-cash flow is the same, but the earnings growth for gold mining stocks stands out. Price-to-book value has gold mining equities at a small fraction of the S&P 500 multiple, and free cash flow yield is much higher for gold miners. Return on capital is higher for the top 20 S&P 500 companies, but one could argue that the S&P 500 companies are at peak cycle returns while gold miners are just beginning their cycle and are far away from hitting full earnings potential. Debt to total asset ratios also show that gold stocks have cleaner balance sheets. Gold mining companies' debt has been brought down considerably from cycle highs several years ago.

In all, **we believe that the considerable 2020E earnings revision momentum is one of two standout factor variables for gold stocks going forward**. The fact that the other comparable valuation multiples for gold stocks are either in-line or more favorable for 2020 provides another layer of support.

…As Does Gold's Negative Correlation to the S&P 500

The second standout factor is the low to negative correlation of gold mining stocks to the S&P 500 over any period. With the S&P 500 making all-time highs on non-fundamental drivers (and arguably unsustainable factors), a non-correlated hedge with favorable valuation metrics and a better growth outlook is worth exploring. The general equities market is in the descending part of their late cycle with record debt levels and record rising deficits. Central banks are using unsustainable and generally ineffective monetary policies as a band-aid for a breakdown of the multilateral global trade system that has been in place since the Second World War. It is an excellent time to look at gold stocks. We mentioned that gold stocks were hitting the sweet spot of their equity cycle from an earnings momentum perspective in our last note, and we are seeing even more that makes them attractive right now.

Figure 5. Gold Equities vs. the S&P 500

Gold stocks offer a superior growth profile, in-line or better valuations metrics, and non-correlated returns. Gold stocks are in the early part of their cycle, while the general market is in the descending part of their late cycle.

BLOOMBERG CONSENSUS DATA	Avg. Top 10 Gold Mining Stocks	Avg. Top 20 S&P 500 Stocks
2020E P/E	**25.0**	20.1
2020E EPS GROWTH	**37.4%**	12.8%
2020E P/CF	**14.8**	14.4
2020E FREE CASH FLOW YIELD	**5.0%**	2.9%
2020E RETURN ON CAPITAL	**11.2%**	14.9%
PRICE TO BOOK	**2.7**	9.4
DEBT TO ASSET	**17.0**	24.2

Correlation Between Gold Mining Stocks and S&P 500	
1-YR Correlation	-0.16
2-YR Correlation	-0.03
3-YR Correlation	-0.03
5-YR Correlation	0.05
10-YR Correlation	0.18

Source: Bloomberg as of November 30, 2019.

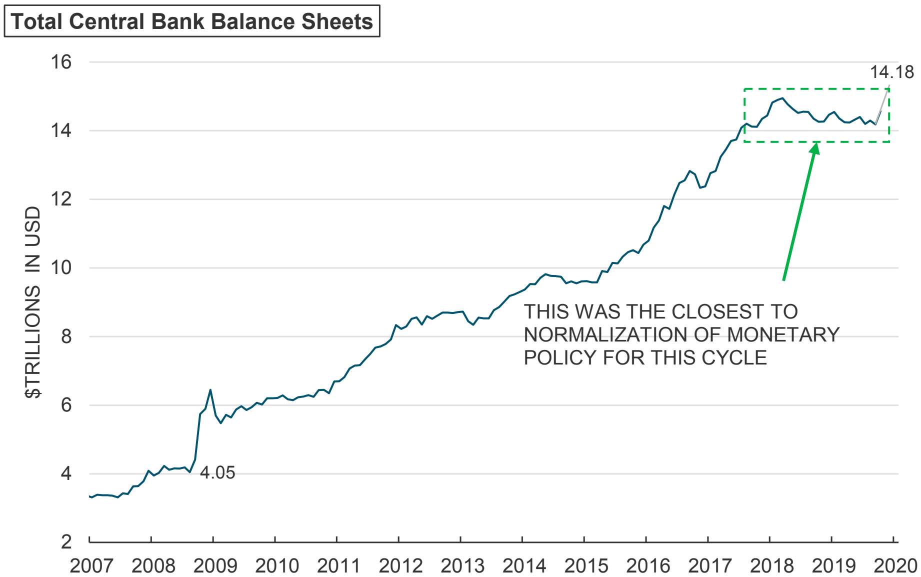
Central Banks are Expanding their Balance Sheets, Again

Central Bank balance sheets are now expanding again. That brief flattening of the balance sheet in the past couple of years was as close to "normalization" as central banks got. The quantitative easing (QE) that began in early 2009 as a short-term unorthodox monetary response to the aftermath of the Great Financial Crisis is now the new normal. The numbers speak for itself. In 10 years, central bank balance sheets have more than tripled despite the recovery and growth in the global economy.

With signs of a worldwide slowdown emerging in Q4 2018, by mid-2019, central banks started to cut interest rates aggressively and by September launched QE programs (we include the U.S. Fed's "Not QE" QE program). The big difference between today and 2009 is that in 2009, the global economy was already late into a deep recession and was therefore in a much better condition to respond to massive monetary stimulus. That and debt levels were a fraction of what they are today.

Figure 6. Central Bank Balance Sheets Have Tripled Since the Great Financial Crisis

From the peak in 2018, central banks managed to shrink their balance sheets by 3%, but this will reverse as balance sheets are expanding again.



Source: Bloomberg as of November 30, 2019.

Our Mounting Debt Burden

Currently, we see massive monetary stimulus to try to engineer a soft landing scenario to extend what is already the longest U.S. economic expansion on record. Meanwhile, debt continues to grow at alarming rates in the U.S. and globally. Since 2009 U.S. total Treasuries have climbed from $10.7 Trillion to $23.1 Trillion or about a +7.4% annualized rate, far more than U.S. GDP growth of 3.7% over the same period. That is the definition of leveraged growth. Debt to GDP is now sitting at 103% (highest since right after World War II), up from 77% in Q1 2009. And that is only using Treasuries.

We are well past the peak in the global economy, earnings momentum and interest rates. We are now firmly at the end of a cycle down leg as GDP, though still positive, has seen its highs for this cycle. Interest rates fell as the global economic slowdown accelerated and are likely now staying low as global inflation expectations remain low. The still unresolved U.S.-China war, weak European economy and continuing U.S. dollar strength remain negative near-term risk factors for growth. Further, low growth runs the risk of becoming negative growth and precipitating an earnings recession. Meanwhile, equity markets are making new highs as central banks lower rates and QE provides a liquidity lift. Corporates, in turn, are leveraging up their balance sheets to buy back their stock at even higher multiples.

The broader equity market is not making new highs on typical fundamental drivers. If this sounds unsustainable, it probably is.

We have now reached the point where a slowing economy is now enough for central banks to cut rates and launch QE programs. Whether we see continuing low growth or a recession, debt levels will rise. The massive U.S. deficit alone guarantees a 4.5% increase in U.S. debt annually at a minimum. Low growth alone will raise the risk of a systemic financial crisis in an overindebted world. Judging by central bank reactions, a recession would be an existential risk event. Even without a crisis, the ability to service an ever-growing debt load while growth is very low and slowing will put growing pressure on central banks to revert to negative real interest rates (U.S.) or more negative interest rates (Europe, etc.) sooner rather than later.

Sprott Monthly Report

December 4, 2019

About Sprott

Sprott is a global alternative asset manager with a defining focus on precious metals and real assets investments. Through our subsidiaries in Canada, the U.S. and Asia, Sprott is dedicated to providing investors with world-class investment strategies that include exchange-listed products, active equity strategies and highly-specialized real asset investments. Our deep sector expertise creates investment and financing solutions unparalleled in the industry. For more information, please visit **sprott.com**

Sprott

sprott.com

1. Sprott Gold Miners Exchange Traded Fund (NYSE Arca: SGDM) seeks investment results that correspond (before fees and expenses) generally to the performance of its underlying index, the Solactive Gold Miners Custom Factors Index (Index Ticker: SOLGMCFT). The Index aims to track the performance of larger-sized gold companies whose stocks are listed on Canadian and major U.S. exchanges.
2. 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.
3. Commodity Futures Trading Commission's (CFTC) Gold Non-Commercial Net Positions weekly report reflects the difference between the total volume of long and short gold positions existing in the market and opened by non-commercial (speculative) traders. The report only includes U.S. futures markets (Chicago and New York Exchanges). The indicator is a net volume of long gold positions in the United States.
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.
5. The Bridge/CRB Spot Market Price Index is a measure of price movements of 22 sensitive basic commodities whose markets are presumed to be among the first to be influenced by changes in economic conditions. As such, it serves as one early indication of impending changes in business activity.
6. An inflation swap is a contract used to transfer inflation risk from one party to another through an exchange of fixed cash flows.
7. 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.

1219466 12/19_ART_SMR