Sprott | **Monthly Report**
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March Roars in Like a Lion

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Gold continued to deliver strong relative performance and was up 3.95% on a year-to-date basis through March 31, 2020. This compares to a -19.60% first-quarter return for the S&P 500 Total Return Index.

Month of March 2020

Indicator	3/31/2020	2/29/2020	Change	% Change	*Analysis*
Gold Bullion	**$1,577**	**$1,586**	**($8.51)**	**(0.54)%**	**Gold flat in market chaos**
Silver Bullion	**$13.97**	**$16.67**	**($2.69)**	**(16.15)%**	**Silver more economic sensitive**
Gold Equities (SGDM)[1]	**$19.86**	**$22.66**	**($2.80)**	**(12.36)%**	**Gold equities in market storm**
Gold Equities (GDX)[2]	$23.04	$26.22	($3.18)	(12.13)%	same as above
DXY US Dollar Index[3]	99.05	98.13	0.92	0.01%	U.S. dollar funding stress & hoarding
U.S. Treasury 10 YR Yield	0.67%	1.15%	(0.48)%	(47.71)%	U.S. Fed goes to zero rate policy
German Bund 10 YR Yield	(0.47)%	(0.61)%	0.14%	18.03%	Choppy but long-term direction is lower
U.S. Treasury 10 YR *Real* Yield	(0.26)%	(0.29)%	0.03%	10.34%	Choppy but long-term direction is deep negative
Total Negative Debt ($Trillion)	$10.56	$14.57	($4.01)	(27.51)%	Backup in yields – bond tsunami
CFTC Gold Non-Comm Net Position[4] and ETFs (Millions of Oz)	121.81	125.53	(3.72)	(2.96)%	Buying led by ETFs; ETFs at all-time high

One for the History Books: The COVID-19 Global Pandemic

March 2020 will go down in history as one of the most tumultuous ever for capital markets. For the first time in over 100 years, a global pandemic has struck with devastating results. The COVID-19 coronavirus global outbreak has resulted in a public health crisis that has forced a lockdown of economies around the world and has morphed into a worldwide financial crisis reminiscent of 2008. In a matter of weeks, the broad market fell more than 30%, the fastest sharpest fall outside of a single day crash.

Like 2008, a series of cascading events led to a full-blown liquidity crisis that saw the U.S. Federal Reserve ("Fed") finally arrive at zero interest rates, QE (quantitative easing) Infinity, and re-opening virtually every emergency credit and swap facility last seen during the 2008/09 Global Financial Crisis (GFC). The fiscal response has been stunning as well, with a +$2 trillion stimulus package from the U.S. alone.

How Did We Get Here?

> "Gold, as a haven, continues to do its job in one of the worst financial shock environments ever."

Throughout February and early March, market stress was ramping up day by day. Systematic funds (CTAs,[5] volatility control funds, risk parity funds, etc.) began the year with the highest market exposure going back a decade with highly leveraged positions. As the news worsened, the systematic funds were forced to deleverage aggressively and selling intensified. Gamma positioning (an options hedge structure) flipped negative, amplifying the selling waves creating wild price swings and driving volatility to levels unseen since 2008. As volatility spiked, market depth vaporized, resulting in one of the fastest, deepest drops equity markets have ever recorded. Though the enormity of the pandemic may mask many market dynamics, we were struck by the degree of fragility and lack of depth in the broad equity market.

The Oil Floodgates Open

To make matters much worse, Saudi Arabia initiated an all-out oil price war with Russia, causing disastrous consequences. The first immediate impact was the risk to the high-yield credit market due to the significant exposure to the energy sector, coupled with the sudden fall-off in economic activity. The second is adding to the deflationary pressure already unleashed by the financial fall-out of the COVID-19 pandemic. The U.S. corporate sector is overleveraged. With the coming recession and oil price destruction, downgrades, credit events and bankruptcy feedback loops will occur. The sheer size of debt issuances will overrun any capacity that securities dealers will have in terms of warehousing the debt. Triple-B (BBB) debt (one notch above junk) is at a very high percentage of investment grade, and many funds cannot own junk-rated bonds. The high-yield market will provide the Fed with a test of its capacity to absorb this bad debt. Credit stress will be ongoing due to the unprecedented hit to the U.S. economy and the degree of overleverage.

On March 9, the high-yield debt market began to crater after Saudi Arabia announced its oil price war over the weekend. All through the following week, there was an alarming build-up in liquidity stress. Yields fell dramatically, and credit default spreads (CDS) all spiked. Finally, the largest and most leveraged of the systematic funds — the risk parity funds blew up and were forced into mass liquidation. Already bending from the stress of the pandemic and imploding credit market, even the U.S. Treasury market, by far the largest and most liquid market at $17 trillion, began to malfunction. Treasury bids fell away, and the ensuing liquidity crunch triggered a financial system-wide margin call that likely even surpassed the one witnessed back in 2008.

All through the week of March 9-13, the Fed desperately tried to plug the holes with ever-increasing daily repurchase agreement (repo) facility expansions, and even an emergency bond purchase of $37 billion (yes, QE). By Sunday, March 15, seeing the deteriorating landscape, the Fed had an emergency meeting and cut rates by 100 basis points down to 0 - 0.25% (zero interest rates), launched a $700 billion QE program and re-opened many 2008 era credit and swap facilities.

Still Not Enough to Meet Liquidity Crunch

On Monday, March 16, the S&P 500[6] closed down more than 12% in one of the worst daily sell-offs ever. To punctuate the selling action, the VIX "Fear Gauge" (CBOE Volatility Index)[7] had its highest close ever at 83, even surpassing the 2008 high. Despite Fed action, the liquidity crunch intensified, and a global U.S. dollar ($USD) funding shortage exploded.

Global trade and economic flows are transacted mainly in $USD — the world's reserve currency. With a sudden stop in global activity due to shutdowns to contain the coronavirus and falling oil prices, the global flow of $USD collapsed. Other parts of the world, such as the emerging markets economies with their high levels of $USD-denominated debt, began to hoard dollars pushing the funding shortage to an outright $USD shortage. As the U.S. economy dived, the commercial paper market froze up, threatening the ability of businesses to access short-term funding. Margin call pressure continued to worsen as the lack of liquidity impaired market functioning. The markets were now in a full-blown liquidity crisis. And to cap off the week, the major banks began to release revised Q2 GDP (gross domestic product) estimates that can only be described as "depression level."

Finally, after the horrible and dangerous spiral of the previous two weeks, on Monday, March 23, the Fed announced open-ended quantitative easing (QE Infinity), allowing the Fed to buy almost everything (Treasuries, corporate paper, mortgage-backed securities, asset-backed securities leases, exchange traded funds, etc.) and in unlimited amounts. The same day, an enormous $2 trillion fiscal stimulus bill was tabled but was shortly passed by the end of the week. Along with this massive one-two stimulus move, and one of the largest options expiries[8] ever (rolling over and removing much of the negative gamma effect[9] on the market), the broad markets finally found a footing. A short squeeze into a quarter-end rebalancing prevented a truly horrible market close for the quarter, with the S&P 500 down only 20% rather than 30%.

Gold Bullion and Memories of 2008

Gold bullion touched an intraday high of $1,703 an ounce on March 9 before falling sharply to just above the $1,450 level on March 20; it then bounced back to $1,632, and then closed the month at $1,577. Prior to March 9, gold was working well as a hedge in times of financial stress before quickly falling. What happened? The same thing back in 2008: A liquidity crisis so severe that it forced selling of gold to meet margin calls and collateral obligations. Gold bullion peaked at over $1,000 before selling off to eventually reach the $700 level by autumn. At the time, it made no sense; it should have been the time for gold to perform. Why would anyone dump gold in the middle of a financial crisis? It turned out it was due to liquidity conditions deteriorating to the point where not only gold holders were forced to sell gold, it was also one of the few financial assets creditors were willing to accept. Once enough credit and swap facilities were implemented, gold rallied to $1,900 eventually.

Figure 1. 2008 Experience: Liquidity Stress and Gold Bullion
(Measured using the one-month interest rate swap rate)

Source: Bloomberg. Data as of 3/31/2020.

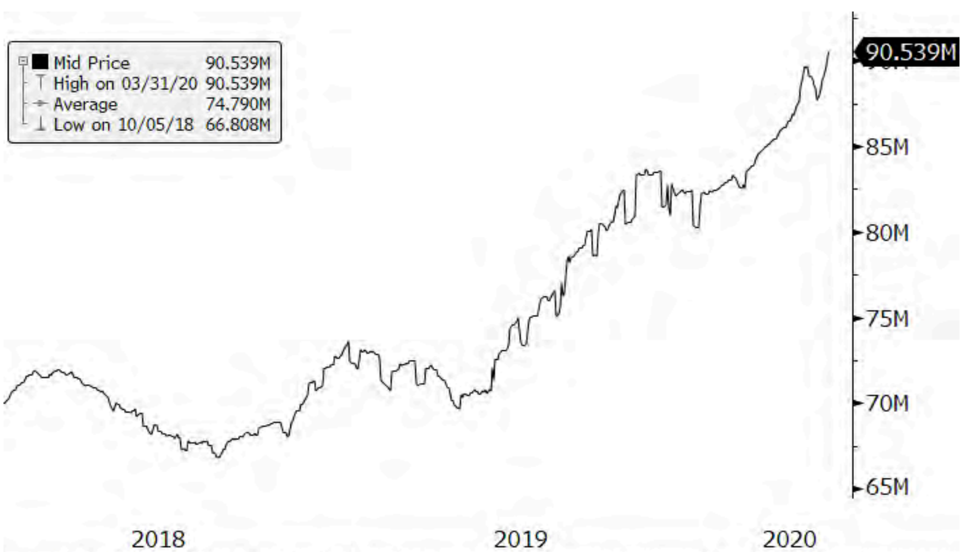
This time around, gold, as quickly as it fell, bounced back the day that the Fed announced QE Infinity (March 23). Along with QE, there were other announcements. The most impactful for the gold market was the expansion of global U.S. dollar swap lines[10] with multiple countries and the Credit Facility for Primary Dealers. The dollar swap lines should reduce the U.S. dollar funding stress and hoarding while the dealer credit facility should reduce the margin call pressure. Once this source of margin selling pressure was relieved, gold rallied to close above $1,550 that day. In time, the liquidity stress effect on gold should diminish. In 2008, the Fed took many months to initiate the credit and swap facilities, and ultimately QE. Today, it took the Fed a couple of weeks.

Physical Gold Bullion Shortage

Lost in the fog of the market chaos was a growing demand for physical gold as investors began to factor in what QE Infinity everywhere and multi-trillion dollar stimulus programs would mean. There are three primary gold centers in the west: London, Switzerland and New York. The coronavirus shutdowns have closed gold refineries, which has disrupted the production of refined gold bars. Commercial air flights are also restricted, preventing gold from being shipped. For now, gold futures are in contango (longer-dated contracts are more expensive), indicating supply tightness. All of Sprott's channel checks confirm this physical gold shortage. Online gold dealers are showing substantial premiums for physical gold (coin or bar).

Gold bullion held in ETFs has continued to climb to all-time highs. Typically, gold ETFs are owned by relatively steady holders representing mainly retail and smaller funds. ETFs are also much less exposed to the type of margin call pressures we saw in mid-March. Over time, we would expect gold bullion to continue to migrate to steadier, long-term holders.

Figure 2. Total Gold Held in ETFs Continues to Climb to Record Levels



Source: Bloomberg. Data as of 3/31/2020.

A Changed World?

The world economic outlook has, in less than a quarter, been upended, and the outlook for bond prices and equity prices reordered. The COVID-19 coronavirus is still raging, and analysts have barely begun to revise earnings estimates given the incredible uncertainty and complete lack of visibility. Many companies have suspended guidance; such is the state of affairs. Earnings forecasts will likely keep falling as they are growing stale by the day. The degree of economic uncertainty and downside potential is numbing.

In the past few years, one of the major push backs to owning gold was the belief it was simply not needed. Equities and bonds kept rising, and volatility kept falling to incredibly low levels, all the while, there was a belief in the "Fed Put." This condition created an era of borrowing, speculation and market euphoria that is now over. The U.S. Treasury bond-based risk mitigation and risk reduction portfolio strategies did indeed provide remarkable day-to-day low volatility portfolio returns for years. The flaw was that these strategies were fully exposed to tail risk events (i.e., the chance that an investment will post returns either much higher or much lower than analysts expected), as witnessed in March. The backbone of the hedging component, U.S. Treasuries, failed when it was needed the most. When volatility spiked, U.S. Treasury and equity prices became positively correlated. Worse, the daily changes in correlations increased in magnitude, exacerbating portfolio downside capture.

Broad equities will see a flow of funds headwind once the quarter-end rebalancing of pension funds and balanced funds is complete. One of the primary sources of positive inflows was corporate share buybacks. Barron's had estimated the size of the corporate share repurchases at about $800 billion in 2018 and about $725 billion in 2019. The coronavirus impact has forced corporates to conserve cash to protect their working capital. After years of adding leverage to balance sheets and using the benefit of the tax cuts to buyback shares, many companies have announced a halt to their buyback programs. Another significant source of positive flows was the sovereign wealth funds. With the looming economic crunch and funding shortfalls, there are expectations of massive net redemptions. The sovereign wealth funds that are also oil producers will be under even greater pressure to repatriate their funds. The early numbers we are seeing are in the $225 billion range, which will increase.

The Coming Bond Tsunami

Bonds are facing a tsunami of sovereign bond issuance from all corners of the globe. At last count, there is about $12 trillion in global stimulus announced so far ($7 trillion in QE, $4-5 trillion of fiscal stimulus), and we have barely finished the first quarter. The $12 trillion (and counting) of the global stimulus should give a sense of the scale of the coming bond tsunami. With bond yields so low and duration so high, even a small move in yields will cause significant price swings in bond yields.

We would expect bond volatility to stay high until it is evident the bond issuances can be absorbed either by investors or QE operations. In the second half of March, we saw a stunning $220 billion of outflows from bond funds. Many investors are not waiting.

The U.S. Debt and Deficit Picture Gets Even Worse

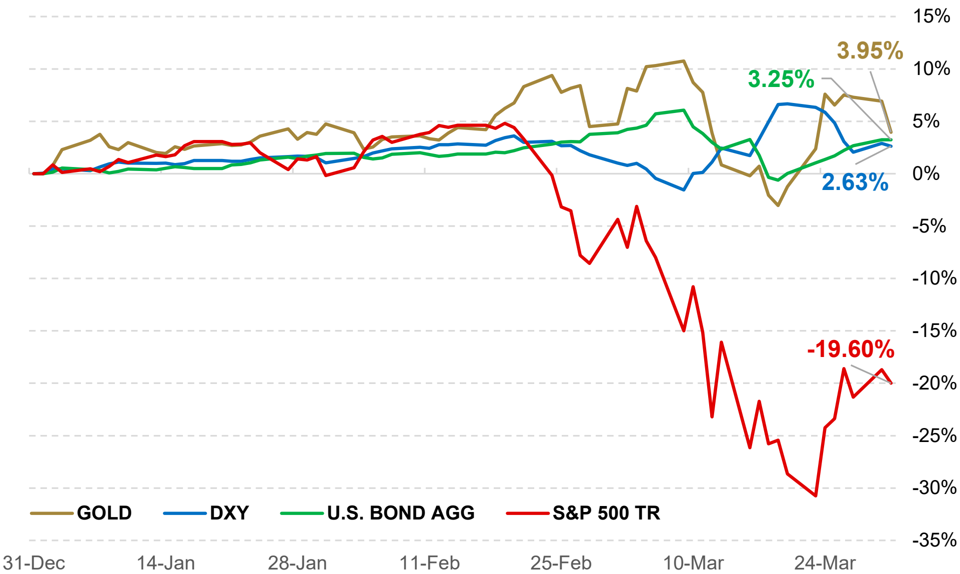
The U.S. budget deficit is now expected to be over $3 trillion this year. The number before the coronavirus outbreak was $1.1 trillion and the announced $2 trillion stimulus program pushes it above $3 trillion, even if one assumes a flat 2020 GDP number (next to impossible). The deficit number is a moving target. A $2 trillion program, as massive as it is, is estimated to provide only a few months of relief. If the coronavirus continues to shut down the economy beyond the next few months, another stimulus package will be needed.

A $3 trillion deficit would equate to 15% of GDP (a record), and a debt-to-GDP ratio of more than 120% (World War II peak was 122%). The Fed Balance Sheet has expanded to $5.25 trillion, well surpassing the prior highs, and growing rapidly. Frighteningly, the same situation is occurring across the globe to a varying degree. This all assumes the pandemic eases by summer.

Gold Performance and Outlook is Positive

Gold, as a haven, continues to do its job in one of the worst financial shock environments ever, and that includes the GFC. Figure 3 highlights the performance of the major asset classes and shows gold's resilience.

Figure 3. YTD Gold Remains Resilient and Out Performs Stocks, Bonds and the Dollar



Source: Bloomberg. Data for the period 12/31/2019 - 3/31/2020.

Many funds will reassess gold as an asset class in portfolios after the events and results of the March market crash. We still do not know what the earnings picture will look like, so we cannot value the equity market. Many unknown variables remain unanswered. In an economy still free-falling, equity markets will have more periods of resetting expectations. The bond market has many challenges as well. The tsunami of global bond issuances, the state of the corporate and high-yield bond markets look precarious even with a QE backing. How will the representation of bonds as a portfolio hedge be viewed? U.S. Treasuries failed as a hedge when they were needed most.

The dynamics for gold were positive before the coronavirus pandemic induced market and economy mayhem. We now have QE Infinity across the globe and this is likely just the beginning. Helicopter money[11] is here. The economic and social consequences of the pandemic will stress markets and societies to levels not seen in generations. Central banks have long delayed the credit default cycle. There will be more credit events leading to bankruptcies, leading to more credit. The need for a safe haven asset like gold and other precious metals, that represent a store of value during crises has never been greater.

At Sprott, we have held the view that the policies of the central banks and the ever-increasing levels of debt were not sustainable. What we thought would take a few more years to realize has been realized in a month, accelerated by the global pandemic.

Unfortunately for investors, March did no leave like a "lamb." **We have arrived at the end game.**

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[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. You cannot invest directly in an index.

[2] 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. You cannot invest directly in an index. You cannot invest directly in an index.

[3] 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. You cannot invest directly in an index.

[4] 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.

[5] Commodity Trading Advisors, i.e., quant funds, an investment fund that selects securities using advanced quantitative analysis repositioning were the main drivers of this price action.

[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. You cannot invest directly in an index.

[7] The CBOE Volatility Index, or VIX, is a real-time market index representing the market's expectations for volatility over the coming 30 days. You cannot invest directly in an index.

[8] Options are contracts that give the buyer the right to buy or sell an asset at a pre-specified time and price. The "expiry" date is the date at which the contract is settled, and payments are made.

[9] The gamma of an option is its "acceleration." Gamma decreases, approaching zero, as an option gets deeper in the money and delta approaches one. (Source: Investopedia)

[10] The Fed's dollar swap lines are designed to improve liquidity conditions in dollar funding markets in the U.S. and abroad by providing foreign central banks with the capacity to deliver U.S. dollar funding to institutions in their jurisdictions during times of market stress.

[11] Helicopter money refers to giving money directly to individuals rather than central banks buying up bond issuances.

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