Tocqueville Gold Strategy

Second Quarter 2016 Investor Letter

Weeks Where Decades Happen

The precious metals markets have clearly turned the corner, becoming flat-out bullish following the extensive and painful correction from August 2011 to year-end 2015. Year-to-date through June 30, the US dollar gold price has increased 24.57 percent, while the XAU (Philadelphia index of gold and silver stocks) benchmark has increased 116.16 percent. Positive gold cycles have historically lasted for at least three to five years, and some longer. Despite the impressive year-to-date advance, we believe this cycle is still in its infancy, and that it promises to be extremely powerful.

We believe that fiscal and monetary policy in all developed countries has reached a dead end, and is all but bankrupt. More important, we maintain that the persistent application of and adherence to idiotic/unproductive public policies have substantially ramped up systemic risk. Investors are beginning to look to gold, fearing that the purchasing power of all paper currency – including the US dollar – is imperiled. The three-decade low in the pound sterling following the Brexit vote is a warning that the practice of central-bank-managed currency exchange rates is unravelling. Mainstream economists are beginning to express concern:

- Brexit is a shock to an already fragile system…. The situation is extremely unstable and if not taken seriously quickly enough could end up setting the European recovery back substantially, threatening the political sustainability of the single currency project. (Note by Torsten Slok, chief economist, Deutsche Bank Securities, 7/5/16)

According to a June 25, 2016, Financial Times commentary, "The Fed is fast becoming a sideshow as forces work against a rate rise." In our view, interest rates will rise, and cannot be normalized without another financial crisis that would mirror or exceed the intensity of the 2008 global credit meltdown. Super-easy money has, in our opinion, reached the end of the road as a credible palliative for economic underperformance. What comes next is anybody's guess, but under almost any imaginable scenario, gold benefits.

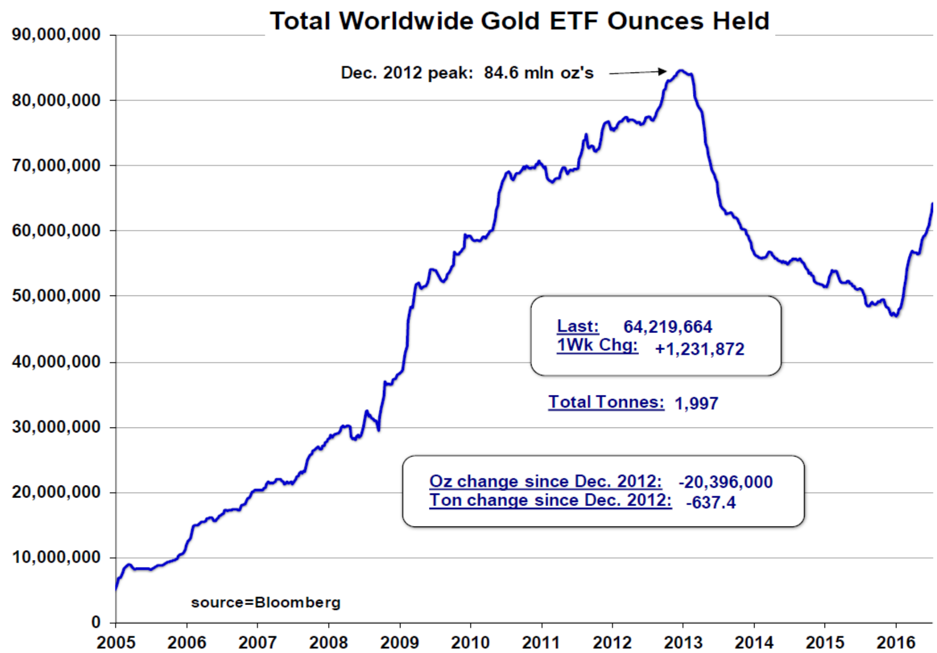
With popular market averages hovering near all-time highs, complacency seems to rule the financial markets. Confidence seems to rest on the belief that a return to a normal interest-rate structure is achievable, and that the exit from radical monetary policy can be painless. However, ultralow interest rates – the lowest in 5,000 years, according to Bank of America Merrill Lynch's Michael Hartnett (MarketWatch, 6/14/16) – have inflated asset values while failing to trigger economic growth. A return to normal interest rates cannot in our opinion occur without damage to financial markets. According to Citibank, negative rates are "poison to the financial system," threatening the viability of the capital-formation process and institutions at the core of the financial system.

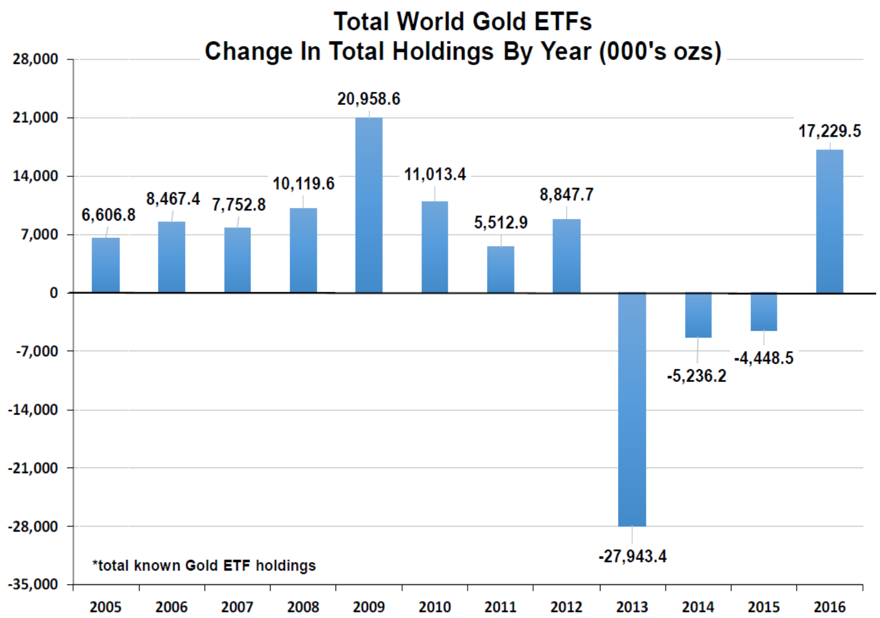
We agree with Stephanie Pomboy of MacroMavens that the lesson of Brexit is that political and financial elites are clueless as to fundamental realities: "The markets never could truly embrace polls suggesting a possibility of a vote to leave because they see no problem with the status quo in the first place." However, she concludes, "Things aren't nearly as good as non-GAAP earnings and sell-side assurances would have them believe." For example, consumer goods orders have had negative comparisons in 21 of the last 22 months; orders ex transportation have been down 17 months in a row on a year-over-year basis; factory orders have been down 10 months in a row on a year-over-year basis.

It is difficult to square these and other economic reports with market averages hovering near all-time highs, unless one were to hypothesize central-bank manipulation of these averages for optical purposes to affect consumer and business behavior.

It is impossible to know what headlines, and when, will drive more investors to acquire gold. We believe that the market situation for precious metals is identical to the 1999 bottom, which preceded a 12-year advance of 615 percent. Apparent then, and again at year-end 2015, was nearly universal negativity for gold's prospects. To pinpoint future reasons for a reversal of sentiment is analogous to guessing which snowflake will trigger the avalanche. What should be obvious to the residents in the valley below is the buildup of the cornice (systemic risk). As Lenin said, "There are decades when nothing happens, and there are weeks where decades happen." It is the nature of bull markets to leave most investors on the sidelines, scratching their heads as to what has changed. The upsurge in gold could be a warning of seismic shifts in financial markets.

As we have noted in Paper Gold: Utopia for Alchemists and our Fourth Quarter 2015 Investor Letter, physical gold is in extremely short supply relative to the potential demand that could be activated by a shift in sentiment. That is because 99 percent of the gold traded is in the form of paper contracts (futures, ETFs, derivatives, etc.) that are settled for cash instead of for physical metal. In a financial crisis, counterparty risk is likely to become a paramount concern, leading to a run on the credit-based, cash-settled system of gold trading. Flows into gold ETFs, which must translate inflows into physical holdings, are likely to trigger an outsized gain in the gold price because of the scarcity of physical gold.





Mining stocks are likely to outpace gains in the metal in the years ahead. Since December 2015, they have done so by a factor of 4 to 1. The mining industry has cut costs, focused on cash generation, and observed financial discipline that was lacking preceding the 2011 market top. The XAU index of gold and silver mining equities was launched 37 years ago at a value of 100. As of June 30, 2016, it printed at 97.64, which suggests to us that there is ample upside potential. According to the 6/27/16 Belkin Report, "Gold assets are long-term depressed, negatively correlated to the stock market, and have completed a bear market; while stock indexes have entered a bear market….switch out of overvalued equities as global economies contract – into gold-mining equities."

Gold, having been written out of the monetary script in the years following President Nixon's closing of the gold window in 1971, appears set to return to center stage. It has recently received serious consideration from noteworthy academic and policy thought-leaders. In a May 3 commentary ("Emerging Markets Should Go For The Gold"), Harvard economics professor Kenneth Rogoff argued that emerging-market central banks should allocate as much as 10 percent of their reserves to gold and away from sovereign debt of wealthy nations:

> Why would the system work better with a larger share of gold reserves? The problem with the *status quo* is that emerging markets as a group are competing for rich-country bonds, which is helping to drive down the interest rates they receive. With interest rates stuck near zero, rich-country bond prices cannot drop much more than they already have, while the supply of advanced-country debt is limited by tax capacity and risk tolerance.
>
> Gold, despite being in nearly fixed supply, does not have this problem, because there is no limit on its price. Moreover, there is a case to be made that gold is an extremely low-risk asset with average real returns comparable to very short-term debt. And, because gold is a highly liquid asset – a key criterion for a reserve asset – central banks can afford to look past its short-term volatility to longer-run average returns.

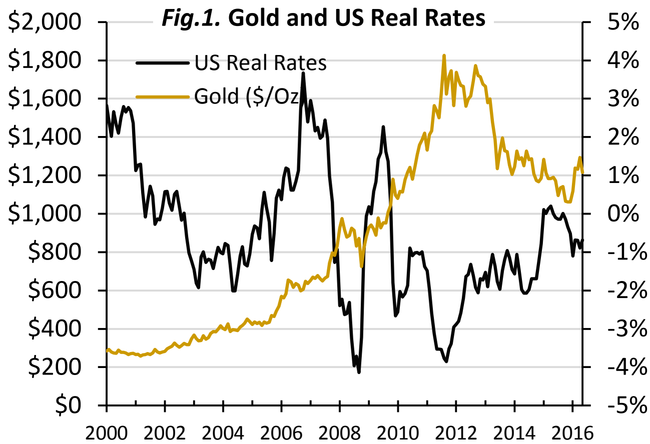
In a June 27, 2016 Bloomberg interview, Alan Greenspan stated that as a result of Brexit, "we are in the early days of a crisis which has got a way to go," and that the best solution would be a return to the gold standard that was the basis for international finance from 1870 to 1913. The former Fed chairman (1987-2006) was, in our opinion, an architect and intellectual predecessor for current radical central-banking activism. For him to make such a statement is an eye-opener, suggesting that this former policy insider no longer believes that the dollar-centric fiat currency system is workable.

It seems to us that we have entered a momentous period for gold: "weeks where decades happen." The rewards of gold exposure, in our opinion, promise to be of historic magnitude. At such a moment, it would be counterproductive for investors to dwell upon issues of market timing. Gold is extremely under-owned, and therefore likely to react dynamically to even modest inflows. Despite strong recent gains, we believe that the current alignment of political and economic factors is unusually compelling. In our view, substantial gains lie ahead.

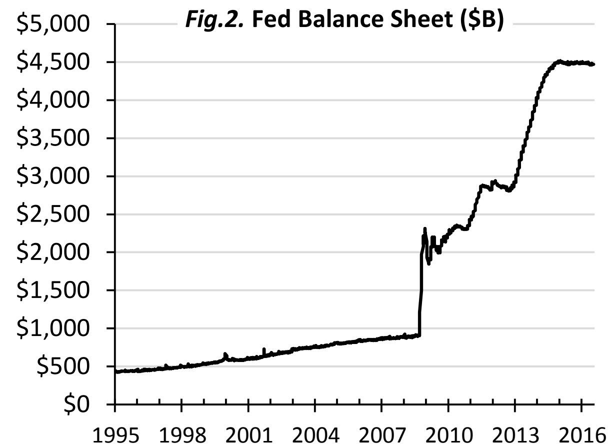
John Hathaway
Senior Portfolio Manager

July 12, 2016

Section I. Macro



Source: Bloomberg



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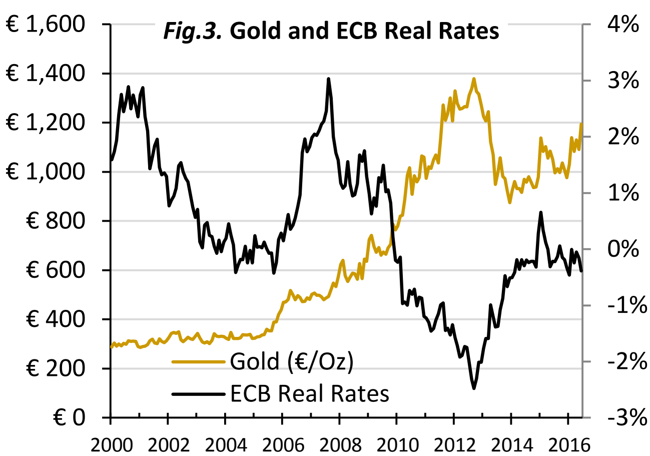

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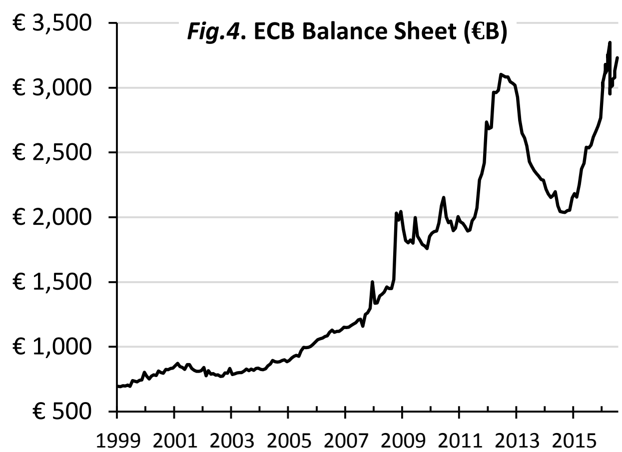

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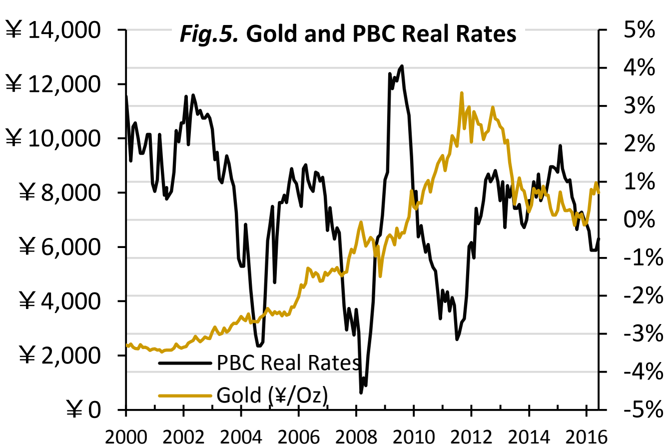

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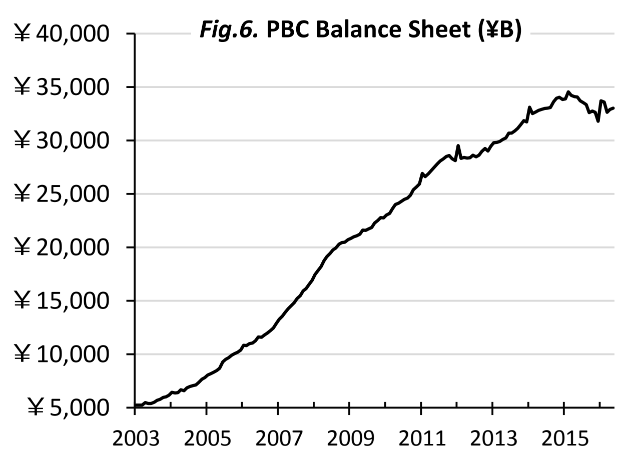
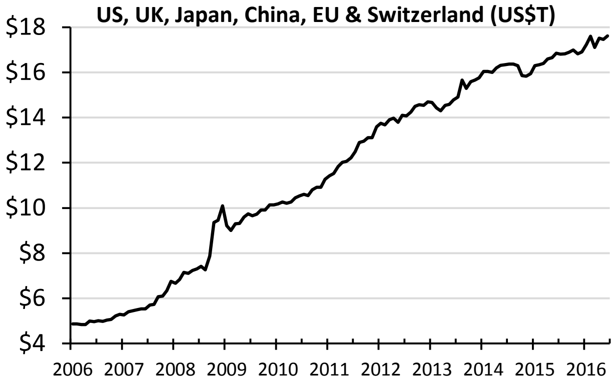


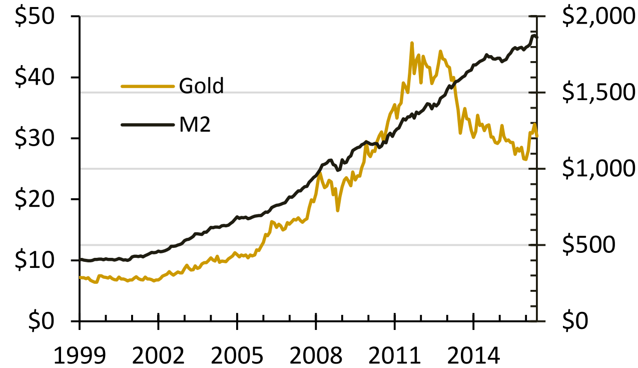
Source: Bloomberg

***Fig.7.* The Biggest 6 Central Bank Balance Sheets US, UK, Japan, China, EU & Switzerland (US$T)**



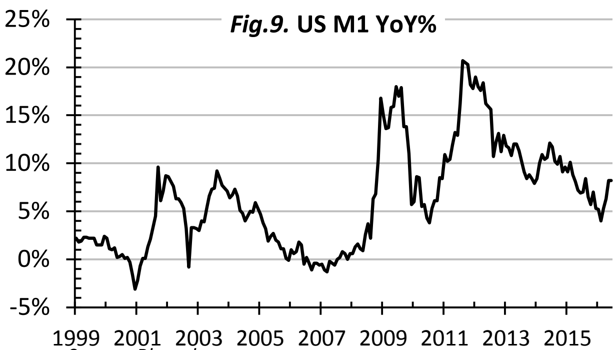
Source: Bloomberg

***Fig.8.* Gold and M2 (US$B, Fed, ECB & PBC)**



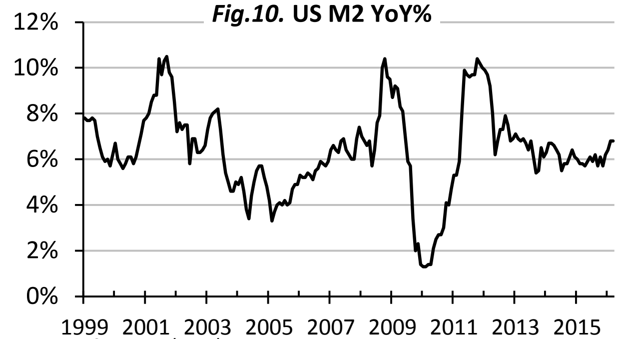
Source: Bloomberg

***Fig.9.* US M1 YoY%**



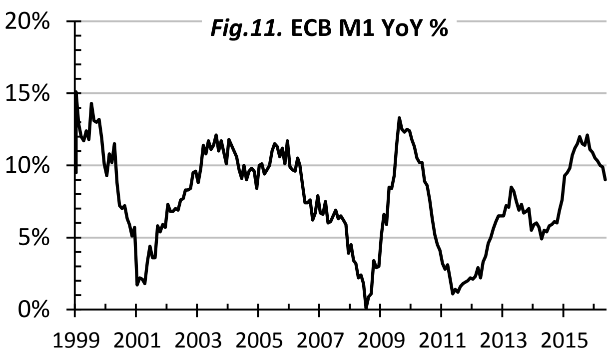
Source: Bloomberg

***Fig.10.* US M2 YoY%**



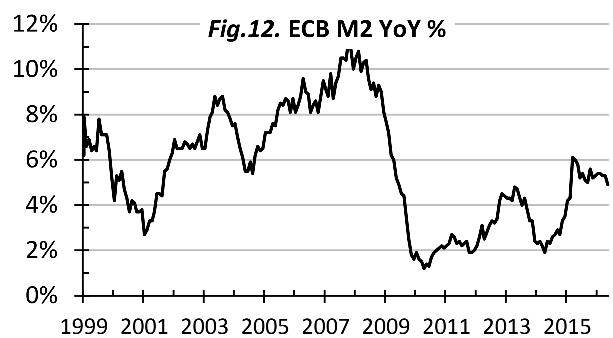
Source: Bloomberg

***Fig.11.* ECB M1 YoY %**



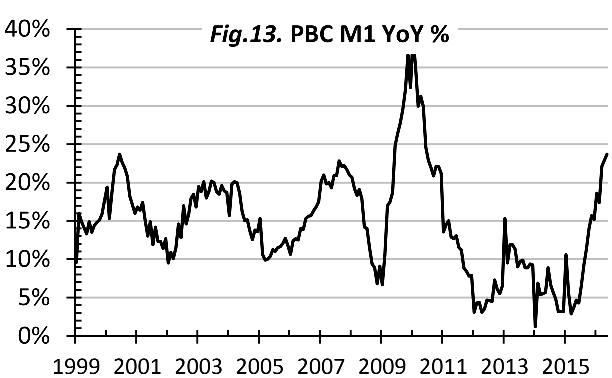
Source: Bloomberg

***Fig.12.* ECB M2 YoY %**



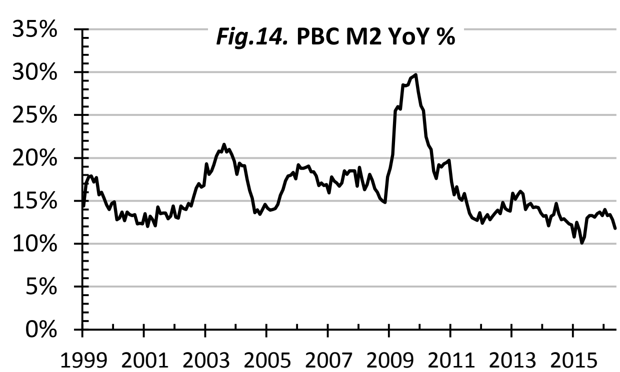
Source: Bloomberg

***Fig.13.* PBC M1 YoY %**



Source: Bloomberg

***Fig.14.* PBC M2 YoY %**



Source: Bloomberg

Fig.15. Inflation May 2016			
	US	Euro Area	China
Headline CPI	1.0	0.1	1.9
Core CPI	2.2	0.8	n/a
Shadowstats	8.1	n/a	n/a

Source: Bloomberg, Shadow Government Statistics.

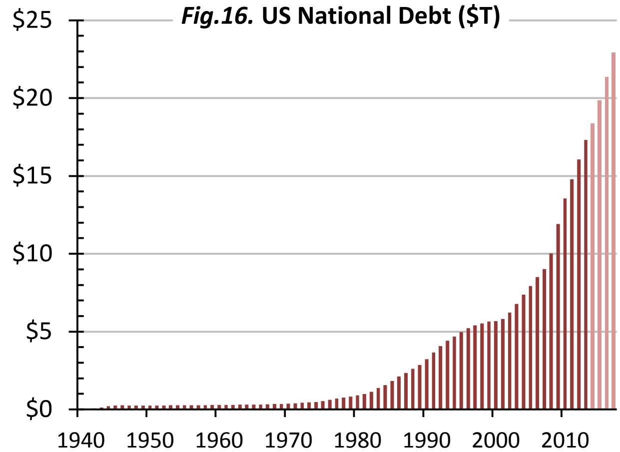


Fig.16. **US National Debt ($T)**

Source: TreasuryDirect.gov, USDebtClock.org

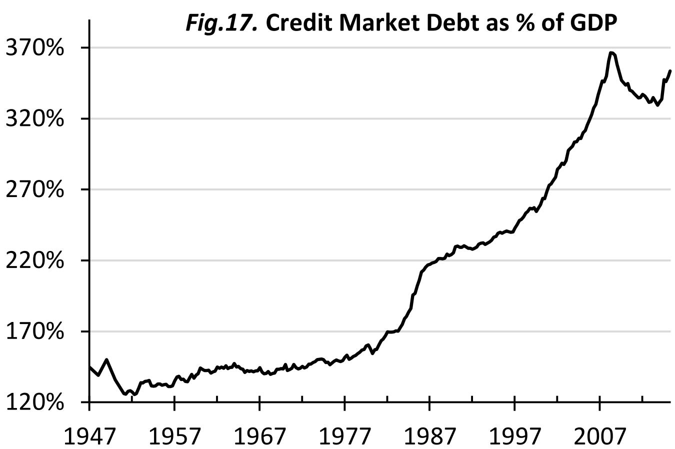


Fig.17. **Credit Market Debt as % of GDP**

Source: Stlouisfed.org

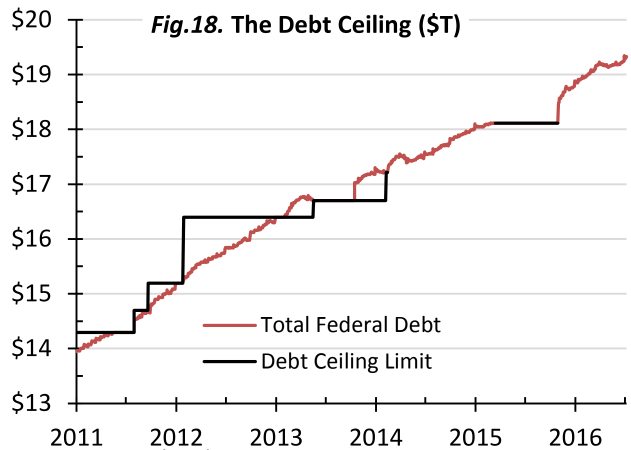


Fig.18. **The Debt Ceiling ($T)**

Source: Bloomberg

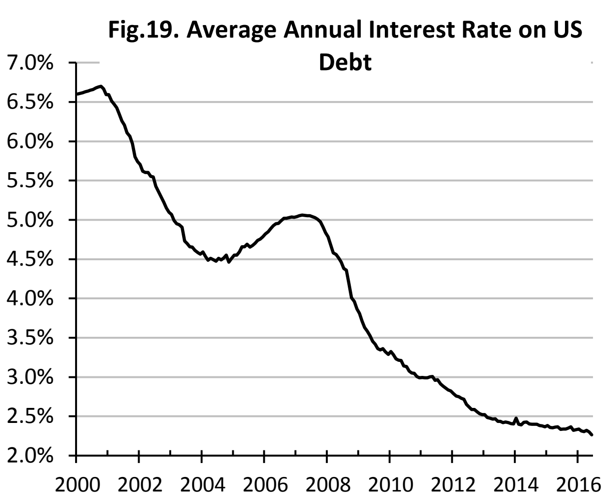


Fig.19. Average Annual Interest Rate on US Debt

Source: US Treasury, Meridian Macro.

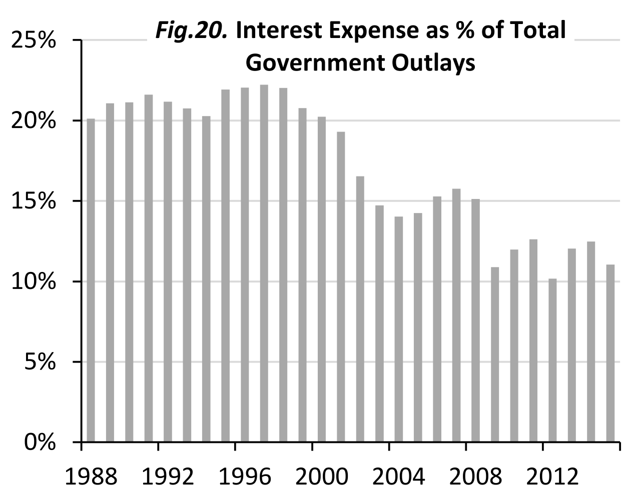
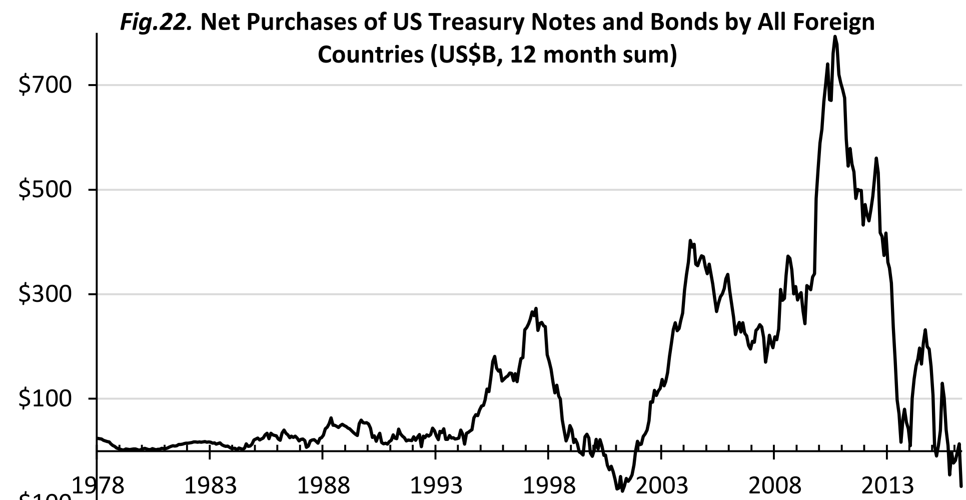


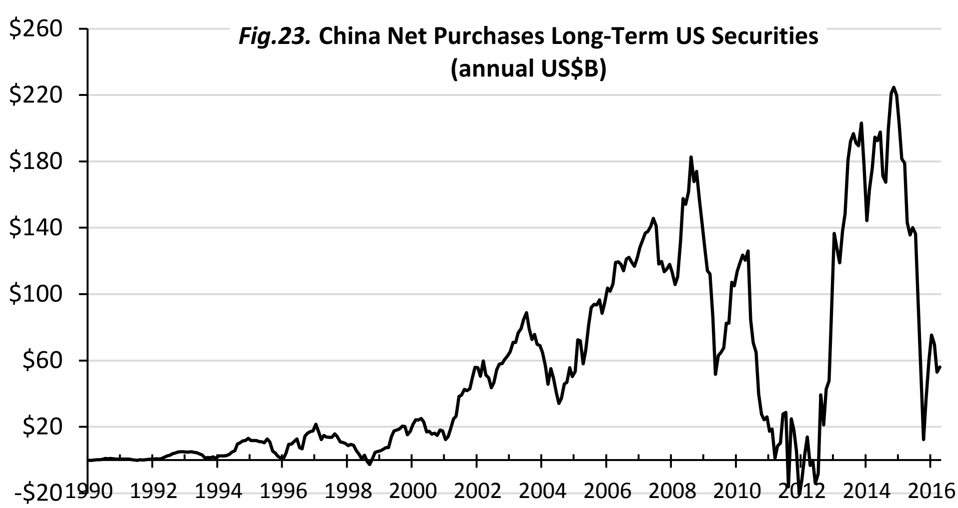
Fig.20. **Interest Expense as % of Total Government Outlays**

Source: Bloomberg; US Treasury

Source: Bloomberg; MacroMavens, LLC



Source: US Treasury; MacroMavens, LLC



Source: US Treasury; MacroMavens, LLC

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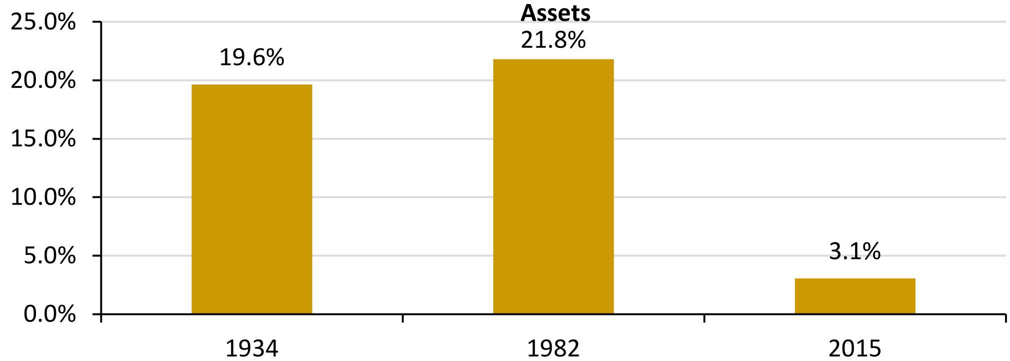
Section II. Gold

Fig.24. **Gold Supply and Demand (tonnes)**

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	1Q 2016
Supply															
Mine production	2,591	2,592	2,478	2,550	2,481	2,476	2,409	2,584	2,739	2,827	2,848	3,019	3,114	3,186	734
Old gold scrap	835	944	829	886	1,107	956	1,217	1,672	1,723	1,669	1,626	1,371	1,122	1,093	361
Traditional supply	**3,426**	**3,536**	**3,307**	**3,436**	**3,588**	**3,432**	**3,626**	**4,257**	**4,463**	**4,495**	**4,473**	**4,390**	**4,236**	**4,279**	**1,095**
Net producer hedging	-412	-279	-445	-86	-373	-444	-349	-252	-108	10	-20	-50	42	-21	40
Official sector sales	545	617	497	662	367	484	236	30	-	-	-	-	-		
Total supply	**3,559**	**3,874**	**3,359**	**4,012**	**3,582**	**3,472**	**3,513**	**4,034**	**4,355**	**4,505**	**4,453**	**4,340**	**4,278**	**4,258**	**1,135**
Demand															
Jewellery	2,680	2,522	2,673	2,707	2,283	2,405	2,187	1,760	2,017	1,972	1,908	2,198	2,153	2,455	479
Other	360	385	416	431	458	462	436	373	466	453	428	409	389	331	81
Total fabrication	**3,040**	**2,907**	**3,089**	**3,138**	**2,741**	**2,867**	**2,623**	**2,134**	**2,483**	**2,425**	**2,336**	**2,603**	**2,542**	**2,786**	**559**
Bar & coin retail investment	373	314	396	412	421	446	649	743	1,205	1,519	1,256	1,654	1,064	1,012	254
Official sector purchases	-	-	-	-	-	-	-	-	77	457	535	369	477	588	109
ETFs & similar	3	39	133	208	260	253	321	617	382	185	279	-881	-159	-133	364
Implied net investment	143	614	-259	254	160	-94	-80	541	207	-81	47	595	354	5	-152
Total demand	**3,559**	**3,874**	**3,359**	**4,012**	**3,582**	**3,472**	**3,513**	**4,034**	**4,355**	**4,505**	**4,453**	**4,340**	**4,278**	**4,258**	**1,135**

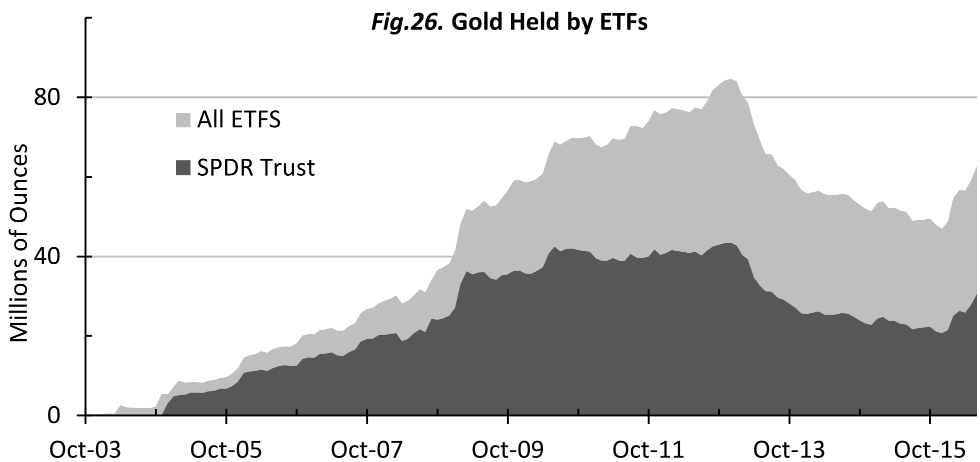
Source: World Gold Council

Fig.25. **Market Value of Above Ground Gold as % of Total US Financial Assets**



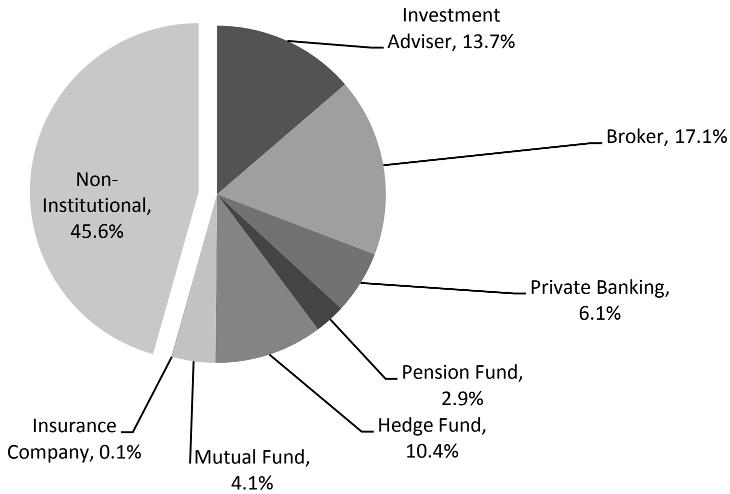
Source: Federal Reserve, World Gold Council

Fig.26. **Gold Held by ETFs**



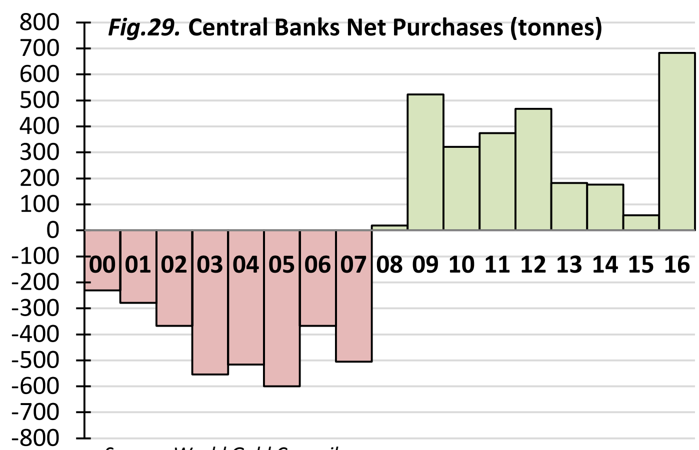
Source: Bloomberg, Company Filings.

Fig.27. SPDR Gold Trust Ownership by Type



Source: FactSet

***Fig.29.* Central Banks Net Purchases (tonnes)**



Source: World Gold Council

***Fig.28.* Notable Transaction in May 2016 (YTD)**

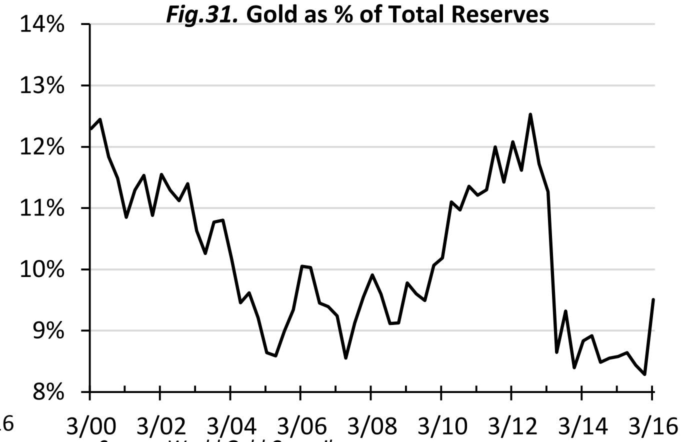
Country	Tonnes	Transaction
Russia	66.9	Purchase
Turkey	51.4	Decrease
China	46.0	Purchase

Source: World Gold Council

***Fig.30* Central Banks Holdings of Gold (tonnes)**

Source: World Gold Council

***Fig.31.* Gold as % of Total Reserves**



Source: World Gold Council

Section II. Gold

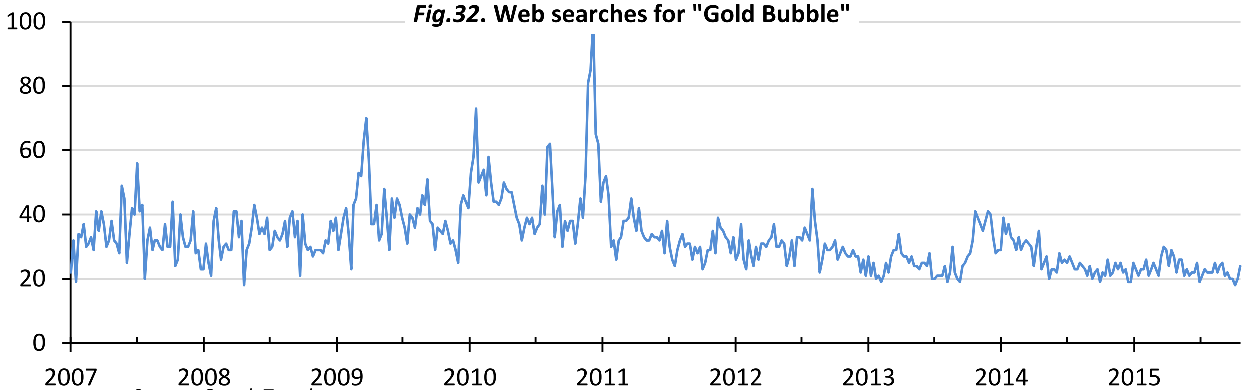


Fig.32. **Web searches for "Gold Bubble"**

Source: GoogleTrends

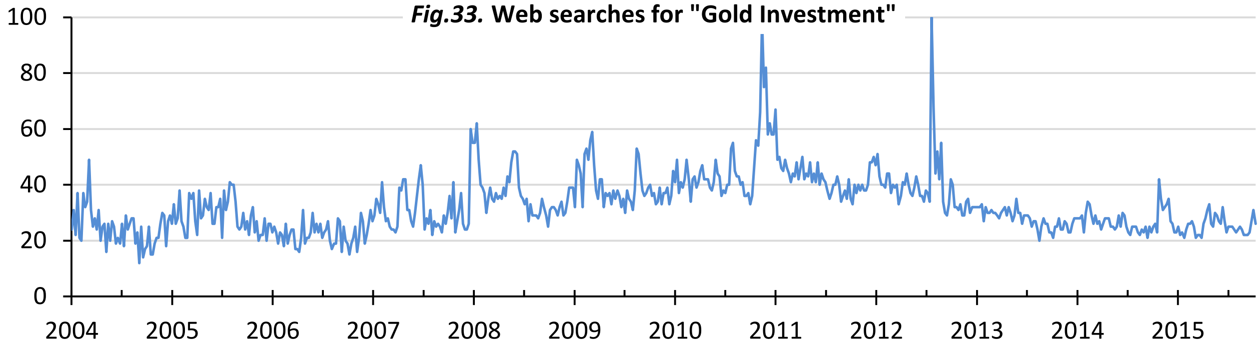


Fig.33. **Web searches for "Gold Investment"**

Source: GoogleTrends

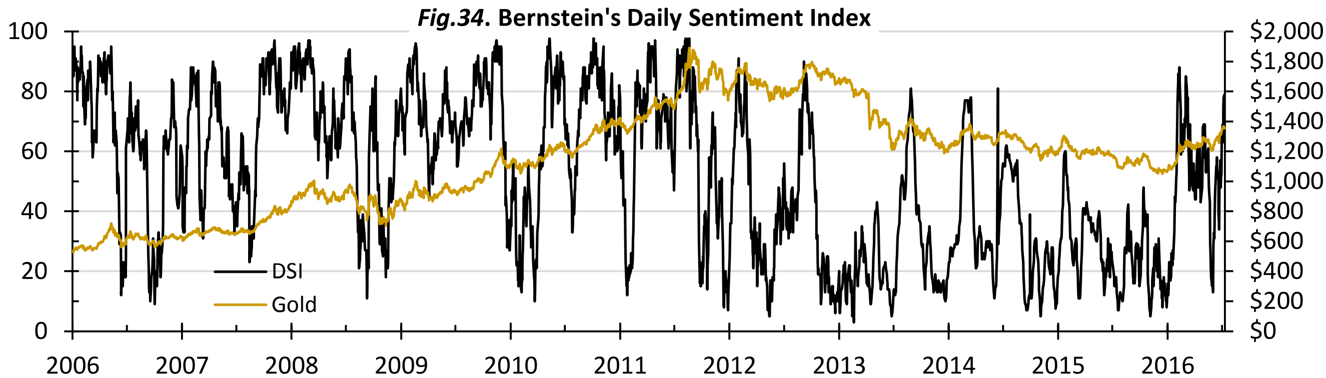


Fig.34. **Bernstein's Daily Sentiment Index**

Source Bloomberg, Bernstein's DSI

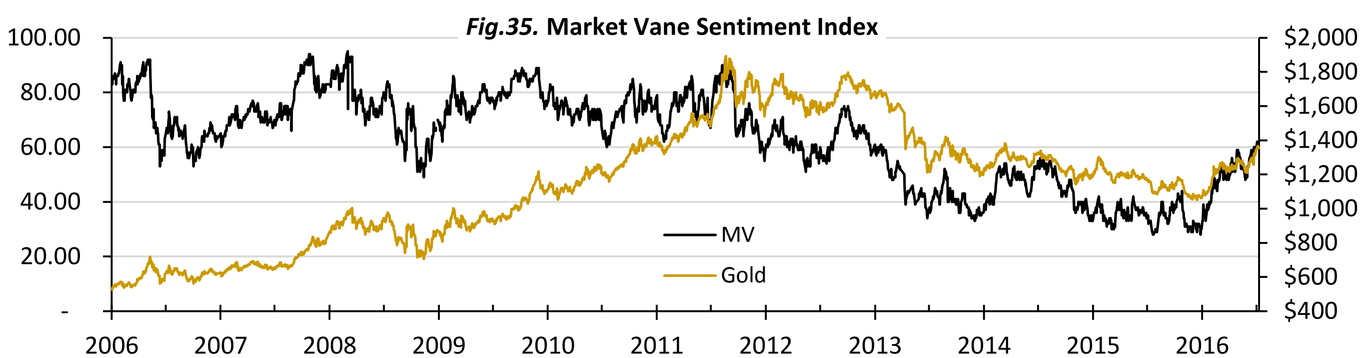
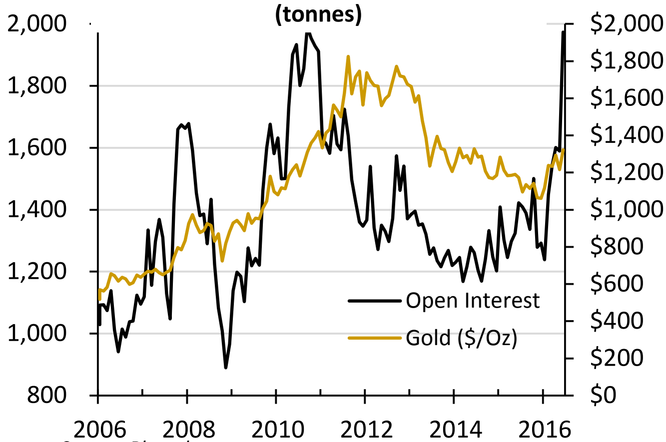


Fig.35. **Market Vane Sentiment Index**

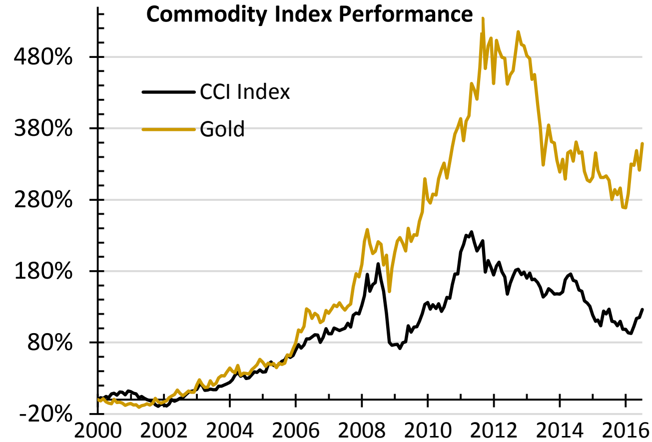
Source Bloomberg, Market Vane

***Fig.36.* Comex Gold Futures Open Interest (tonnes)**



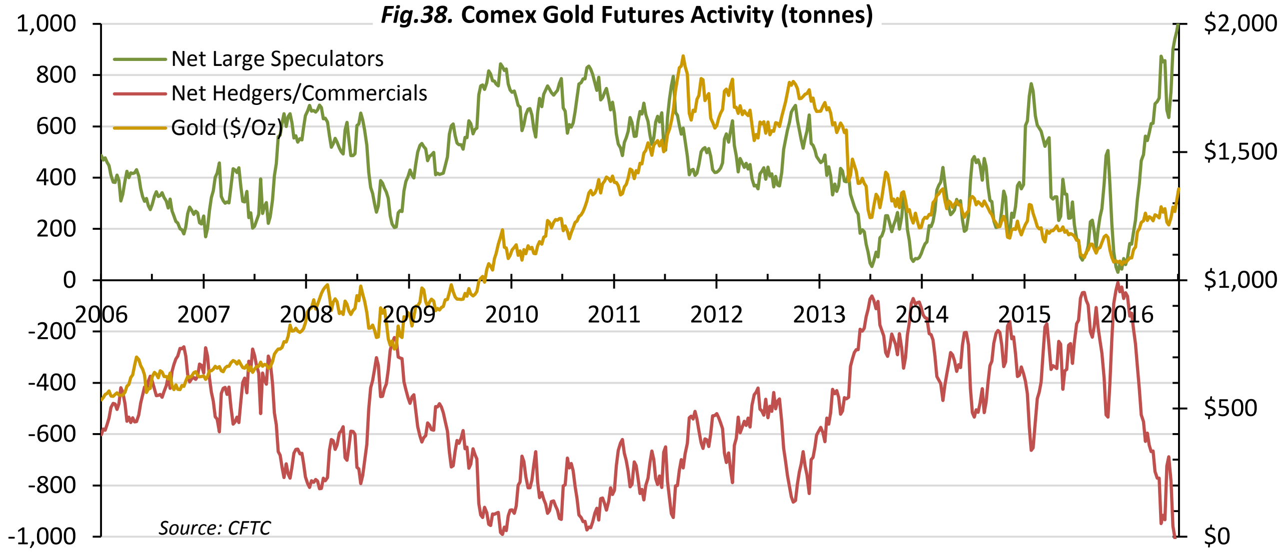
Source: Bloomberg

***Fig.37.* Gold vs Continuous Commodity Index Performance**



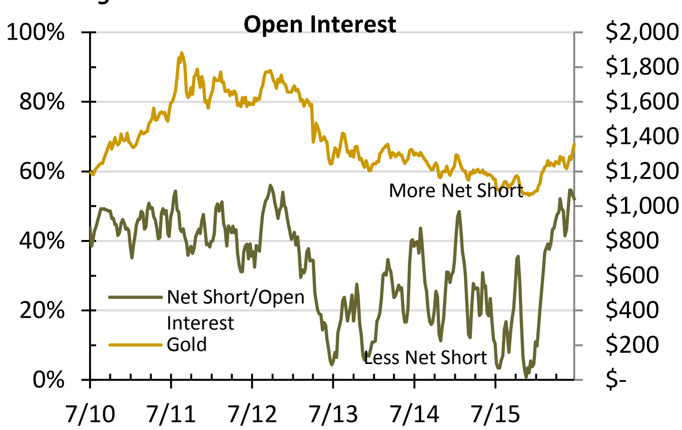
Source: Bloomberg

***Fig.38.* Comex Gold Futures Activity (tonnes)**



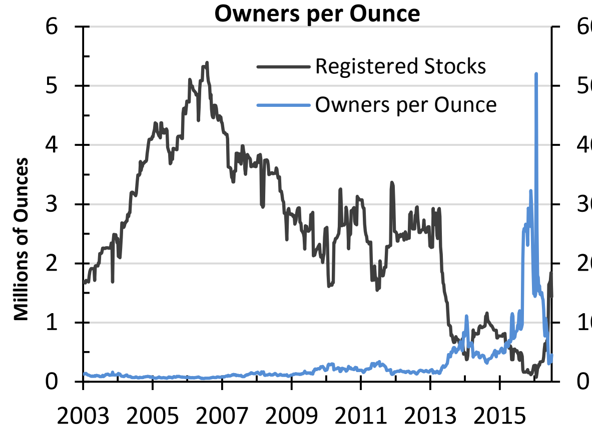
Source: CFTC

***Fig.39.* Commercial Net Shorts as % of Total Open Interest**



Source: Bloomberg; The McClellan Market Report

***Fig. 40.* Registered COMEX Gold Stocks vs. Owners per Ounce**



Source: Bloomberg

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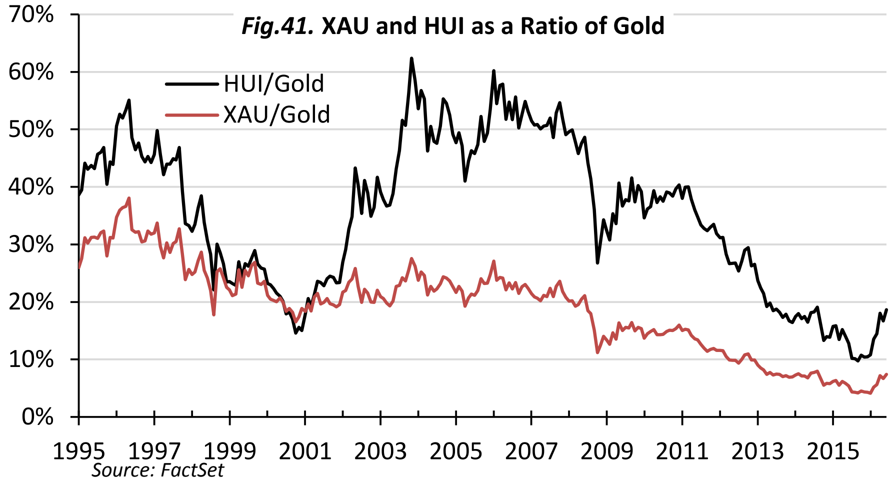

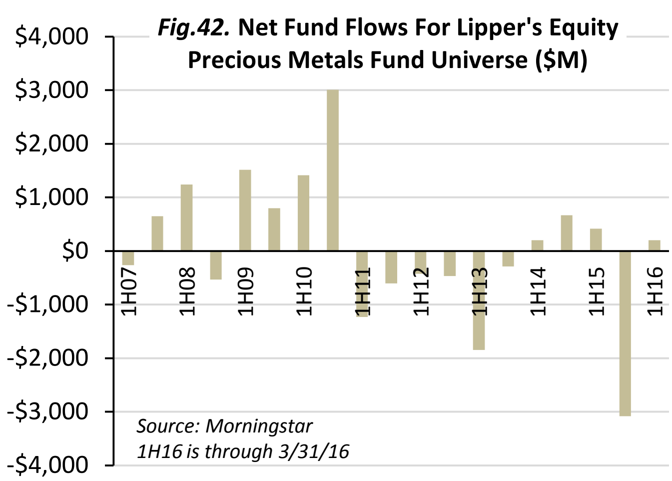

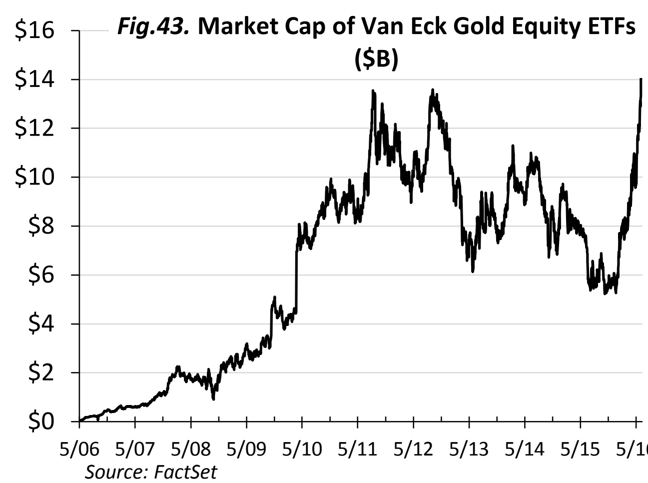

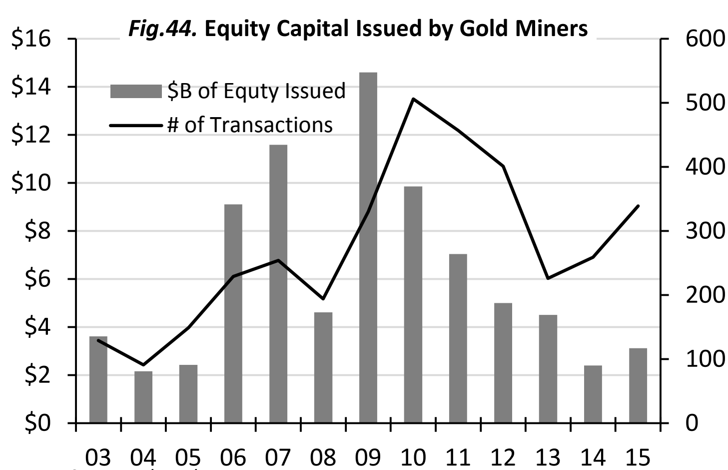

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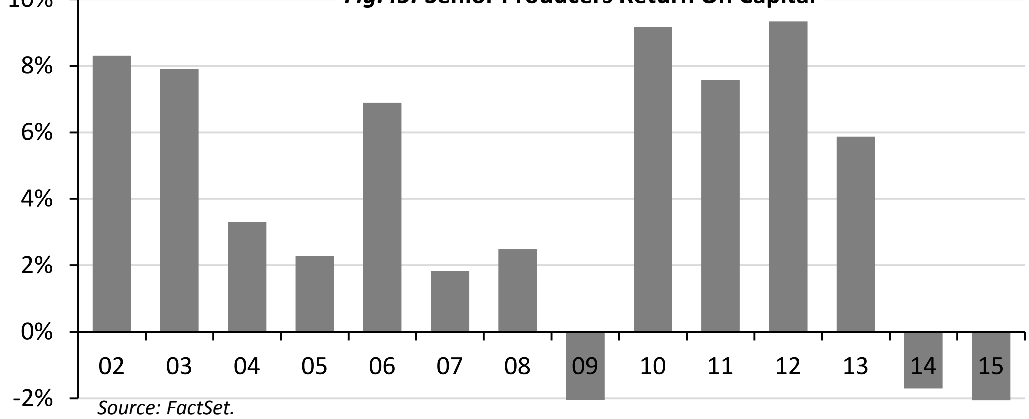
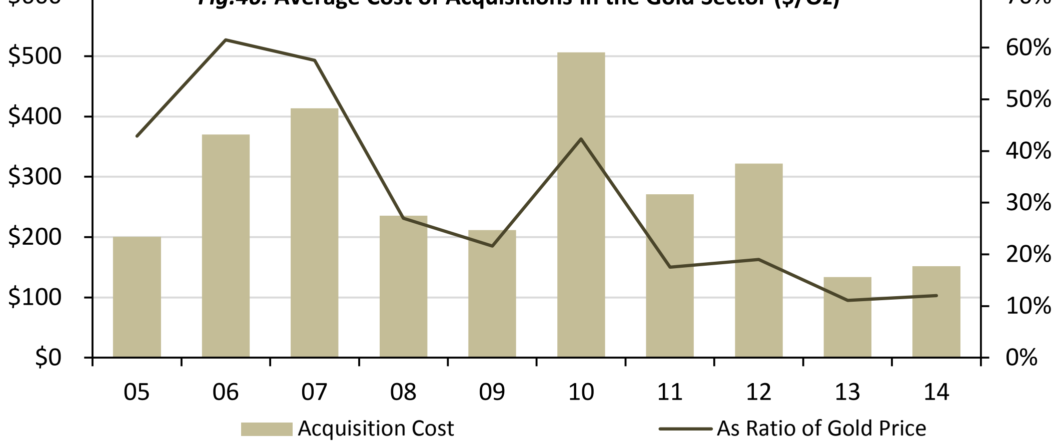
Fig.45. **Senior Producers Return On Capital**



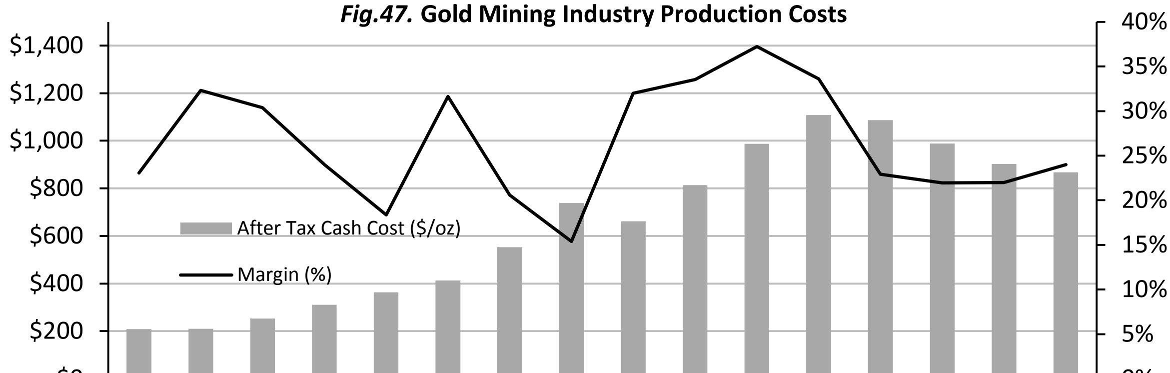
Source: FactSet.
Universe: NEM, ABX, GG, KGC, AUY, NCM, AU, GFI, HMY

Fig.46. **Average Cost of Acquisitions in the Gold Sector ($/Oz)**



Source: RBC Capital Markets, Bloomberg.

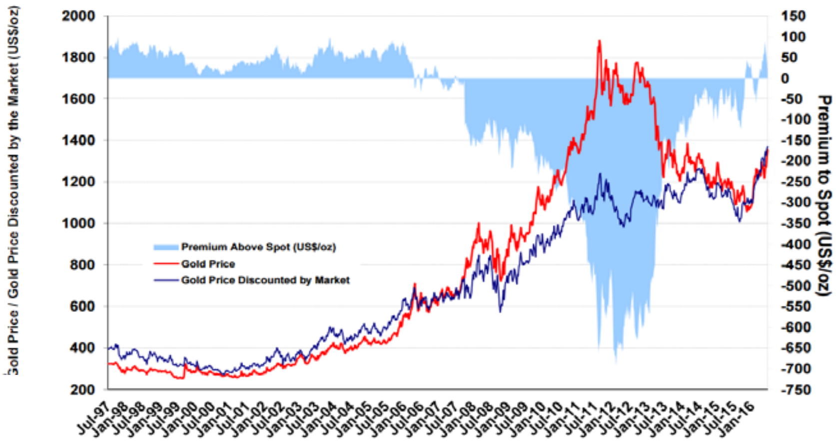
Fig.47. **Gold Mining Industry Production Costs**



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016 E
After Tax Cash Cost ($/oz)	209	210	253	311	363	413	552	738	661	814	987	1,108	1,087	988	903	868
Margin (%)	23%	32%	30%	24%	18%	32%	21%	15%	32%	34%	37%	34%	23%	22%	22%	24%

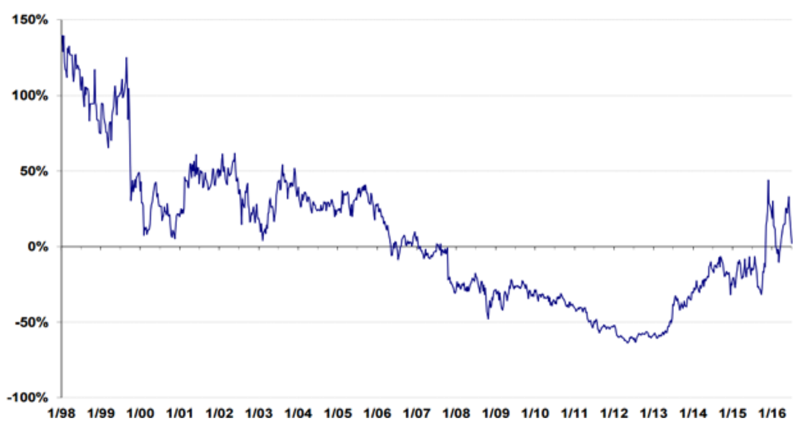
Source: Tocqueville Asset Management, FactSet.

Fig.48. **Gold Price Discounted by Market ($/Oz)**



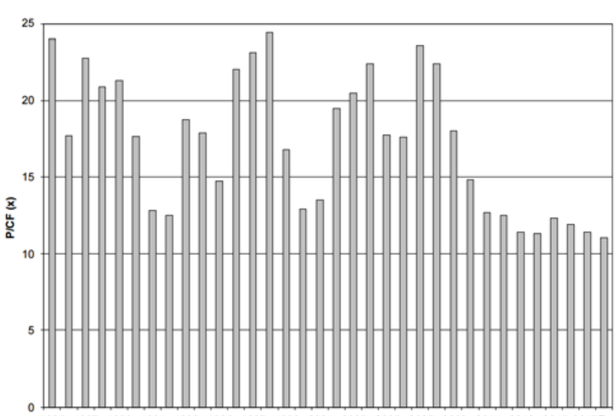
Source: BMO Capital Markets

Fig.49. **NAV Premiums – Senior & Intermediate Producers (N.A.)**



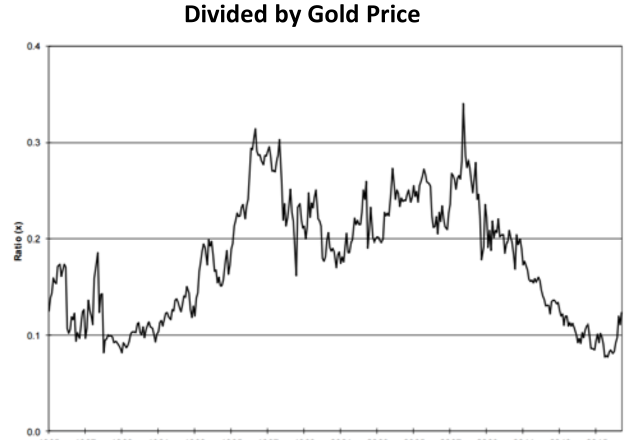
Source: BMO Capital Markets

Fig.50. **P/CF – Universe of Coverage Average**



Source: Scotiabank

Fig.51. **Adjusted Market Cap per Oz of Resource Divided by Gold Price**



Source: Scotiabank