The Tortoise and the Hare

NOVAGOLD's director, Dr. Marc Faber, publishes *The Gloom, Boom & Doom Report*, a monthly investment newsletter that highlights unusual investment opportunities around the world. Based on economic, social, and historical trends, the report aims to warn investors when investment themes have become widely accepted – and are therefore highly priced and risky – while continuously searching for opportunities in unloved and depressed markets. The January 2016 issue features the following article by NOVAGOLD chairman Dr. Thomas Kaplan, who, in providing an in-depth overview of the gold market, details why he's so confident on the renewal of gold's long-term uptrend, and why NOVAGOLD is his vehicle of choice for exposure to gold.

The most common association of John Maynard Keynes with gold is his use of the expression "barbarous relic" to describe the metal, an oft-quoted quip adored by gold's detractors. Apparently, however, Keynes' relationship with gold was more nuanced than this remark would suggest. Richard Hurowitz, in an illuminating piece in the *Wall Street Journal* this past September 15th entitled "What Keynes Would Think of 'Neo-Keynesians,'" revealed that the famous economist had been misunderstood and that, "unlike his acolytes, he understood the value of gold and the dangers of currency debasement." To those who would claim this to be revisionism, think again. When Keynes described his optimal postwar monetary system in December 1941, he recognized that gold had been valued as money for thousands of years. As a consequence of its universal appeal, he acknowledged that it was necessary that gold be part of any new global monetary system. *"We do not take any action injurious to the position of gold,"* he said in 1943. Relating the ideas that would bear fruit at the Bretton Woods conference in 1944 he observed, *"The world being what it is, it is likely the confidence gold gives can still play a useful part."*

"The world being what it is. . . ." These are words too seldom spoken. Those who have a firm grounding in the past are not fazed by the sentiment that history at its core is human psychology played out on a broad canvas. And, if history doesn't quite repeat itself, it certainly rhymes. In today's zeitgeist, however, where universal notions are viewed as indiscriminate, old-fashioned, deterministic or, even worse, politically incorrect, one takes a risk expressing the pragmatism of "the world being what it is." It implies that experience may yet trump our generation's enormous solipsism. Too few college presidents today would exhibit such a didactic approach in prefacing a concept lest it offend somebody somewhere. As a consequence, we continue to find that, the world being what it is, *"le sens commun est fort rare,"* or as Voltaire's maxim is most commonly translated, "common sense is not so common."

That's not to say that it no longer exists. It was only recently that Bridgewater's Ray Dalio, a man who possesses more than a passing acquaintance with financial history, remarked at the Council on Foreign Relations: *"Gold is a currency. We have dollars, we have euros, we have yen and we have gold. If you don't have [10% of your assets in] gold, there is no sensible reason other than that you don't know history or you don't know the economics of it. As a hedge . . . as a diversifier . . . there should be a piece of that in gold."* There you have it from a man widely considered to be eminently rational . . . if not actually hyper-rational. With no fuss or muss, and without an atavistic appeal to Druid rituals or the End of Times, Ray Dalio observed simply that gold is an under-owned currency that enjoys a well-earned place in global finance. I would personally add, to the vast majority who can't bear the idea of gold still being reckoned to be anything approaching an asset class: as Keynes implied, *just get over it.*

Ray Dalio's comment about gold being a hedge or diversifier seems reasonable enough. In an economic landscape bubbling with all sorts of distortions, even the central banks' most ardent advocates should find it comforting to know that there is a financial asset that doesn't represent someone else's obligation. To repeat: *"The world being what it is, it is likely the confidence gold gives can still play a useful part."* Considering that gold multiplied in value as much as 50-fold since it was allowed to trade freely, Keynes seems to have been right at the time. Yet, it's hard to argue that his comment should not resonate as much in today's environment as it did with Keynes' contemporaries.

While one could perhaps see gold sell off to $900 before it vaults beyond $1900, the outlook for gold is a much higher price. What makes me so confident on the eventual outcome besides the fact that it has the whiff of inevitability about it? It is a variation on the answer that I give to the question that I am most frequently asked: "What will be the trigger for gold's revival?" My response is usually found to be disappointing: "It will just happen one day and that will be that." A "that's it?" stare invariably meets my rejoinder. But, in truth, most successful traders will tell you that the move that occurs on no news is often the strongest.

The reason, I presume, is that fundamentals take time to gestate and usually reveal themselves when they are least expected. After all, they don't ring a bell to say it's time to buy or sell.

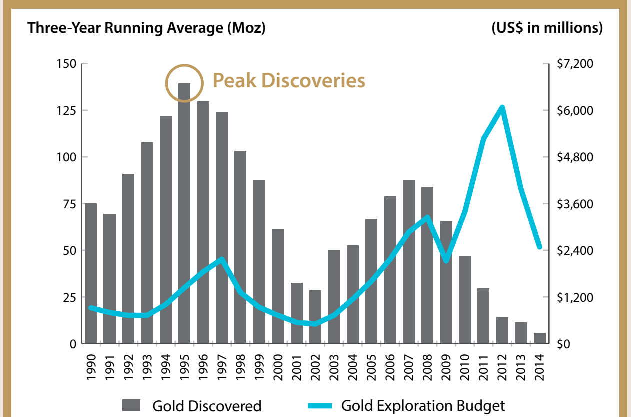
The renewal of gold's long-term uptrend doesn't require any specific event to happen. That is not to acknowledge that there are plenty of triggers that would favor gold over almost any other asset class, as happened during the last financial crisis. Indeed, if one needs an example of how well gold has shown it can perform as a diversifier, we needn't look back very far. When my company, Leor Energy, exited energy in 2007, oil was trading over $100 a barrel and gold was $600 or so an ounce. What followed has been quite an amazing performance for a financial asset that is often miscast as a commodity. Moreover, as a currency itself, who can gainsay the performance of gold since then against practically all other currencies including the dollar? Astonishingly, gold's naysayers will argue that equities have outperformed gold. But that's not correct. If you bought gold before the financial crisis, you've made more money on the metal than in the broad market. When the Dow peaked in 2007 at 14,000, gold had a six-handle. Imagine that: since the onset of the financial crisis, gold has outperformed commodities, the dollar and even equities. How can a fiduciary, or "prudent man," not own some of that for his clients … especially when one remembers that the expression "prudent man rule" itself was originally defined as a means to assess the risk of an investment against the most prudent of assets: gold? I dare say he will … assuming he can buy enough of it when he needs it.

What is so interesting about gold, however, is that none of the black swans which darken our skies need to alight for precious metals to resume their uptrend. What's necessary for that to happen is already underway, and in a fashion that does not appear to have to disturb the life, liberty or happiness of anyone other than a few miners … and perhaps those who have intemperately eschewed diversification and prudence. The best case for gold, and investing in gold miners, is indeed that the industry's most gaping wounds are extrinsic to the gold price. Really well-managed gold companies can perform admirably. Mark Bristow's Randgold, for example, has returned 19% annually over the last decade, far outpacing the broader market. Most of its peers have not delivered, however, due to the misallocation of capital, ill-considered acquisitions and a series of crippling compromises and false assumptions on jurisdictional risk and mine quality. And most will continue to not deliver … though, as with the oil industry earlier in this century, higher prices for their products or an increase in demand could well bail them out before the day of reckoning.

What follows are four charts with which everyone should become familiar as they show that peak gold production is becoming very much a reality. The first two charts are straightforward: despite a marked increase in exploration spending over the past decade, new discoveries have been increasingly rare and size and production are set to decline (fig. #1 and fig. #2). This is going to worsen as expenditures on exploration collapse … from the "Majors" on down to the bombed out "Juniors" that most often incubated the pipeline.

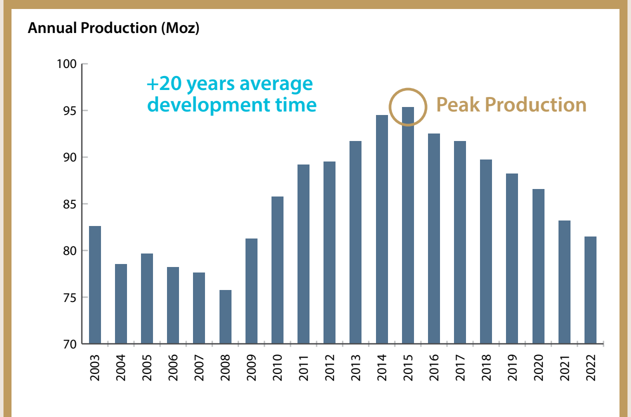
At a time when the "Majors" are producing gold faster than they can replace reserves, and when projects in exotic jurisdictions are finding it particularly hard to raise development

Discoveries fig. #1



Goldcorp corporate presentation, 11/14 (SNL Metals & Mining, CPM Group, GFMS, and Metals Focus)

Production fig. #2



Goldcorp corporate presentation, 11/14 (SNL Metals & Mining, CPM Group, GFMS, and Metals Focus) capital – a trend we believe is long term in nature – the supply of gold from mines is likely to decline faster than conventional wisdom believes.

In addition to quantity, quality is plunging. The current generation of operating mines is well past its prime. The best ore has already been mined and remaining reserves will cost more to produce. We see no relief in sight; the average grade of all producing mines is 32.6% higher than the average of all development-stage projects (fig. #3). This latter number is going to continue to fall.

Finally, to reinforce the fact that we have passed a tipping point, even if the mother lode of mother lodes were found today, which is highly doubtful, it will take as many as 20 years to get it into production (fig. #4). This is not shale energy, which can be explored and exploited in a matter of months. The barriers to entry in gold are incredibly high and the steps necessary to develop a project are many, time-consuming and complex.

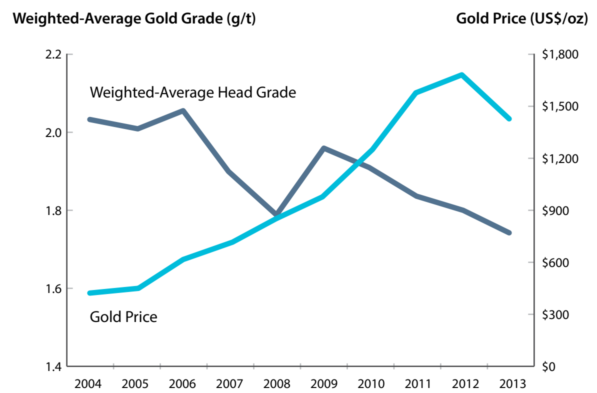
Whether or not mine supply has peaked, there is also very interesting news on the demand side. In a fine piece written by metals analysts CPM Group entitled "The PBOC Changes Everything," CPM opined that two announcements from the People's Bank of China, in July and August, *"dramatically and fundamentally changed the outlook for central bank gold buying patterns for the foreseeable future, and consequently the outlook for the gold price."* As they note: "The PBOC has fundamentally reversed its position toward gold, from seeing it as not likely to play a significant role as a monetary reserve asset to seeing it as playing a minor but on-going role in its monetary reserves."

The first announcement came on 17 July, when the PBOC revealed that it had added 19.4 million ounces of gold to its official monetary reserves in June. The second announcement came on 14 August, when the PBOC released its July statistics showing that it had added another 610,000 ounces of gold. Gold as a percentage of China's official monetary reserves therefore has risen from 1.1% to around 1.6% as a result of these moves.

When I saw the PBOC's increase in gold reserves, I initially was surprised that the amount added wasn't larger. My assumption had been that the lion's share of gold moving into China was for the official sector and that the private sector demand infrastructure was a work-in-progress. Assuming the Central Bank isn't fibbing or masking wider official sector purchases, it may well be that China's investment sector interest in gold is broader and deeper than anyone had expected. This is encouraging to anyone who believes, as do I, that the Chinese investor will be an ever-increasing buyer of gold. CPM's analysis opened my mind to another, equally interesting observation: While few central banks take their monetary policy cues from the central banks of Russia, Venezuela or similar countries which have been gold buyers, the same can't be said for China. *"While they may be loath to admit it, central banking authorities around the world will take more notice of, and place more emphasis on, such a major shift in the Chinese central bank's policy stance toward gold. As a result, not only may the gold market expect on-going gold purchases by the PBOC, it also may see other central banks revisiting the role of gold in their monetary reserves."* At the very least, it is likely to continue to suppress any urge by central banks – admittedly non-existent at present – to sell their reserves for a very, very long time.

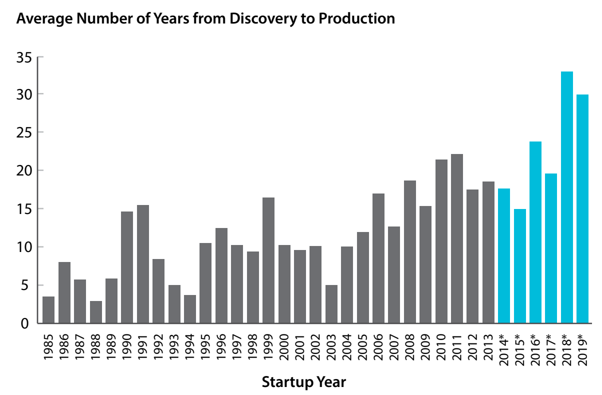
Clearly, the supply and demand forces at work make owning

Declining Gold Head Grades fig. #3



Data sourced from SNL Metals & Mining.
Based on 72 mines with 25% of 2013 world gold production.

Time from Discovery to Production fig. #4



Data sourced from SNL Metals & Mining. *Projected.

gold at some level eminently rational. For those with a more aggressive bent, the miners are providing leverage at historically low prices. The key, we at Electrum believe, is to build positions in the few companies that have great assets in safe places, and ensure that they have the balance sheet to weather the current storm. For such assets, we are buyers here even if lower prices are yet to come. Whether or not we get lower prices that enable us to deploy our capital on an even more efficient basis is not within our control. That being said, the universe in which we're engaged is already quite modest. In light of the gold industry having already passed a tipping point, we do not need to witness black swans landing on a pond to see significant upside and experience significant up-moves. The market is now so small that one could theoretically buy all of the world's publicly-traded precious metals producers for the modest sum of ~$150 billion. Of course, at the first sign of a shift in sentiment, that market capitalization will multiply rapidly.

Our group's vehicle of choice remains NOVAGOLD, of which I am chairman, largest shareholder, and an unsubtle advocate. Natural resource assets have been my livelihood for over two decades. By focusing on the rare "category killers," it has been a good living. When we entered NOVAGOLD as a white knight at the end of 2008, we felt Donlin Gold, the Alaskan gold deposit which the company shares with Barrick Gold, was likely the best single development asset in the world. To some, our investment may have seemed long-dated. Now, more than half-way through permitting, it doesn't look long-dated any longer. Indeed, as other less attractive mining projects around the world have been cancelled at an accelerating rate, Donlin has continued progressing at its natural pace. We refer to this phenomenon as "The Tortoise and the Hare." The passage of time has only reinforced our appreciation for Donlin. We now believe that industry fundamentals are rendering it unique. Certainly, the superlatives are quite remarkable. Starting at nearly 1.5 million ounces per year, Donlin will be the largest single pure gold mine in the world when it begins production. Over a million ounces a year will be produced over a mine life that begins with 27 years of reserves. There is no other producer that has started with 39 million ounces of resources (inclusive of its 34 million ounces of reserves) … and that is only from the 3-kilometer portion of an explored mineralized belt 8 kilometers long. This belt in itself is only a small portion of the property package. In other words, in an era of declining reserves and precious few new discoveries, Donlin's size will very likely increase along strike as well as to depth … perhaps significantly. In addition to quantity, there is extraordinary quality. Though the project will begin by processing 2.5 grams of gold per tonne, the mine life average of 2.1 grams per tonne is over *double* the grade of other large open pit projects. *Size and grade matter.* The consequence of Donlin's scale renders the economics unusually attractive, with life-of-mine cash costs of $585 per ounce. In terms of Donlin's combined attributes of size, grade, exploration upside, forecast production profile, mine life, low cost structure and community support, there's really nothing like it anywhere … and it is that rare "unicorn" that is located in a safe part of the world where an investor can tread without fear. As such, Donlin represents for us the optimal way to invest in the space: that is, to seek the maximum leverage to gold in a jurisdiction that will allow investors to keep the fruits of that leverage.

This safety premium creates an exceptional risk-to-reward ratio, based on the leverage to higher gold prices enjoyed by Donlin Gold. Its after-tax Net Present Value ("NPV") using US$1,200 per ounce-gold and a 5% discount rate, was estimated in the Donlin Gold Second Updated Feasibility Study at US$547 million. This number rises to $6.2 billion if undiscounted. Importantly, the resultant NPV sensitivity analysis shows a more than eightfold increase in value to US$4.6 billion at US$1,700 per ounce of gold ($14.6 billion if undiscounted), and then nearly a 50% further increase in NPV to US$6.7 billion at US$2,000 per ounce of gold. At the zero discount rate at which we believe North American assets may once again be rated, as they were not so long ago, that number rises to more than $19 billion. *And that is solely based on existing reserves.*

In today's market, NOVAGOLD is exceptional from a risk/reward standpoint. Debt-free and laden with $127 million in cash, it has a balance sheet that could last for a decade without additional capital. This attribute, rendering it the profile of an unexpiring call option not simply on its proven reserves, but also its larger resources, is accentuated by the fact that under CEO Greg Lang's leadership, the stewards of NOVAGOLD's fortunes are best-in-breed when it comes to management. They have their eye on the ball, manage the company's money frugally, care deeply about their shareholders and their partnerships, and are not remotely tempted to do stupid stuff. Being Chairman is such a pleasant gig that I give my remuneration to Donlin's unique alliance with the National Fish and Wildlife Federation, an agency of the US federal government with which NOVAGOLD has a partnership in wildlife conservation in Alaska. When gold turns I fully expect a bull market in Donlin that will affect not only NOVAGOLD as a "pure play" on what will be the largest pure gold project in the world, but that will materially affect our partner Barrick's valuation as well.

In 2010, gold equities experienced a blistering bull run. NOVAGOLD was a star performer, multiplying several-fold in short order. It did so despite significant headwinds, including that its long-anticipated Feasibility Study on Donlin Gold was still a work-in-progress; the Pebble project raised an Alaskan question mark regarding permitting; the company's balance sheet was modest; new senior management had not yet been hired; and prior missteps had created environmental and legal issues that had yet to be sorted out. Despite these uncertainties, NOVAGOLD's equity surged from $5 to $16 within a matter of weeks. The winds have since reversed. The headwinds no longer exist and the company is now poised to benefit from multiple tailwinds: from the robustness of its management, the exceptional technical attributes and quality of its resources, community support, solid balance sheet and jurisdictional safety, the company checks all the boxes and is among the very best positioned to profit mightily from any hint of sentiment change.

An additional headwind when we acquired our interest in NOVAGOLD and which increased several years later as NOVAGOLD's partner, Barrick, underwent an internal upheaval, was the attitude that Barrick publicly exhibited towards Donlin Gold. The two companies had some history. In 2006, Barrick had coveted Donlin Gold so much that it launched a $1.6 billion hostile takeover bid. The attempt failed when NOVAGOLD's shareholders rejected the bid and NOVAGOLD's shares soared into the $20s. I was not a shareholder at the time and bought in a couple of years later after the company had fallen from grace and needed rescuing. Yet I had seen that Barrick knew precisely what it was doing. After all, Donlin Gold's reserves have more than doubled since the failed bid and NOVAGOLD's other major asset, Galore Creek, has shown almost the same level of resource growth. In the aftermath of the bid, however, there was a lot of broken glass between the management teams, with Barrick smarting from its failure and yet still desirous of acquiring the 50% of Donlin Gold it did not own.

Very recently, Barrick's message has changed as chairman John Thornton has adopted a no-nonsense approach to value creation and asset pruning. While in no more of a rush to build than we are, Barrick's ambivalence has given way to a simple and positive approach to Donlin. Though now is not the time for either Barrick or NOVAGOLD to build what will be the biggest pure gold producer in the world, when the time is right and gold prices are higher Donlin will be as good as it gets. With NOVAGOLD's senior management team having previously led Barrick's North American operations, the trust-connection between Barrick and NOVAGOLD is as strong as can be. In addition, Donlin will initially add 50% of 1.5 million ounces per year of production to Barrick's pipeline, more than enough to replace production from the multiple assets Barrick is selling. The fact that Donlin is in North America, which has historically been home to the jewels in Barrick's crown, has not gone unnoticed either. Indeed, in Barrick's most recent disclosures, its narrative sounds substantially like NOVAGOLD's … so much so that NOVAGOLD reprinted Barrick's disclosure in its entirety in its own presentation under the headline "Perfect Alignment Between Partners." This extraordinary solidarity was in full display in the November 30, 2015 Barrick-NOVAGOLD joint press release, in which the partners declared that they had reached a major permitting milestone through the filing of the draft Environmental Impact Statement for Donlin Gold. In that press release, the Calista Corporation, owner of the minerals, and The Kuskokwim Corporation, owner of the surface lands, also expressed their strong support for the successful development of the project as a profitable business capable of providing much needed socio-economic benefits to many villages within the broader Yukon-Kuskokwim community and, through the facilities of the Alaska Native Claims Settlement Act (ANCSA), far beyond that. This alignment of partners at the local, state and federal government levels is a beautiful thing to behold.

If gold is positioning itself for better times, and quality equities are cheap, it stands to reason that open-minded investors should be looking closely at the space, however reviled it may be at present. The way I would put it is like this: In the aftermath of the tech bust fifteen years ago, many technology stocks evaporated into oblivion. Even the "good stocks" were down by over 90%. Yet imagine if you could go back, sift through the survivors of the tech bust and pick the winners. The Amazons and Pricelines of the world are up hundreds of times off their lows. Not all of us are smart enough to know how to evaluate a tech company's business plan. But we do not even have to possess much of Voltaire's common sense to understand that, in an industry characterized by enormous barriers to entry – nobody can recreate a unique asset like Donlin in a garage – there will be a few star performers when "maximum pessimism" yields to reason. Therein is the opportunity amidst the rubble of the precious metals equities. Having a second bite of the apple is not reserved just for those who bought Apple. It can be had by carefully selecting an equity in an unpopular asset class with a global brand recognition greater even than Apple itself: gold.

Note: Certain technical information has been changed to be consistent with the Donlin Gold Second Updated Feasibility Study effective November 18, 2011, as amended January 20, 2012.