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February 11, 2020

Why Gold Stocks Should Be Owned

- **We are in the middle of an incredulous financial environment**
- **Central banks are buying gold for their reserves**
- **The gold price made a spectacular breakout in mid-2019**
- **Gold mining shares are undervalued at the current price of gold**
- **Gold mining shares have substantial upside leverage at the present time**

We are in the middle of an incredulous financial environment

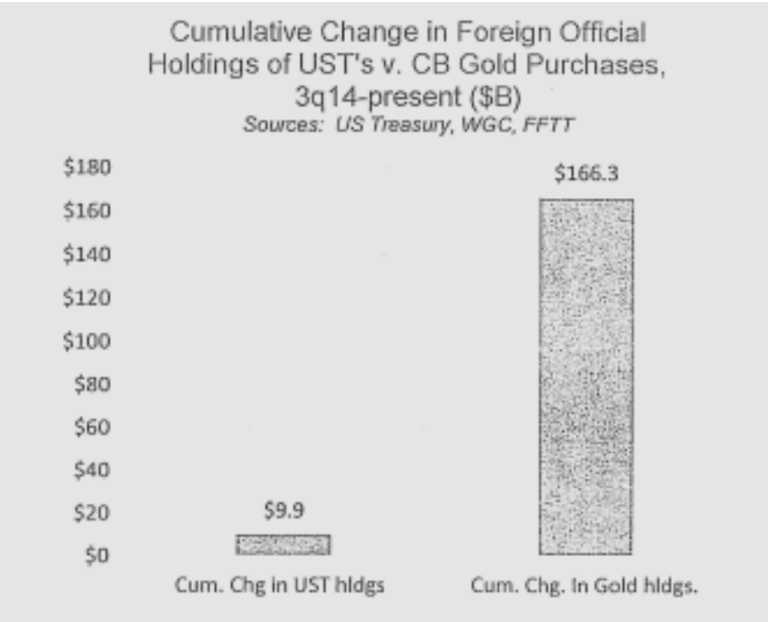
The world has been in a distorted financial environment since the financial crisis in the fall of 2008. We won't recap the details because they are well known, other than to suggest that experiencing 11+ years of these distortions can cause one to begin to believe they are normal.

Historically most Federal Reserve Board (FRB) aggressive credit easing has come once signs of a recession have appeared. Since 1998 with the intervention to provide an orderly liquidation of the hedge fund, Long-Term Capital, aggressive credit easing has increasingly been the result of fears of serious financial stress.

However the truly incredulous aspect of the current financial environment occurred last fall when the Federal Reserve Board (FRB) responded to the surge in repo rates. The economy was at full employment and no rumors of a banking crisis were apparent. In late September 2019 the FRB announced that they would begin buying Treasury bills to whatever degree necessary, to calm the repo market and keep interest rates within their desired range. They indicated that they would buy billions of T-bills through approximately April of 2020. The FRB also told the market that they would not tell the world for two years who needed the funding. At first, speculation assumed that a bank, possibly a foreign bank was in trouble.

However shortly after the funding began, the Bank for International Settlements (BIS), the central banks' bank in Switzerland, issued a paper stating that the problem stemmed from borrowing by three giant hedge funds, which were engaging in a leveraged strategy. The leveraged strategy involved buying Treasury bonds, and selling derivatives against the bonds. To continue to leverage these positions they had to borrow against their bonds, creating huge demands for loans that the banks were either unwilling or unable to continue to provide. In effect there were three major hedge funds with a problem bigger than the Long Term Capital hedge fund problem in the fall of 1998. In addition to these hedge funds there appear to have been other funds, including those aimed at the retail market, that had stepped up their leveraging.

Let us back up for a moment and examine some of the key financial conditions that existed. The U.S. is faced with an ever increasing need to finance a growing deficit. Unlike the past, foreigners are no longer buying the percentage of our debt that they did in the past. This could be a combination of unattractive interest rates, especially of the buyer wishes to hedge the currency risk. It could also be due to a lower preference for U.S. debt for either portfolio diversification or geopolitical considerations.



Without foreign buyers taking their previous percentage of the debt, the onus falls back on domestic buyers. However with interest rates pegged at unattractive levels, demand may be suppressed from traditional buyers. This leaves leveraged fund strategies or the FRB itself. With the current repo policy the FRB is close to practicing Modern Monetary Theory, or direct buying of Treasury debt from the Treasury. Instead, what appears to be happening is that approved bond dealers buy T-bills from the Treasury, hold them for a week or two and then sell them to the FRB with a modest fee attached. Between bailing out hedge funds and providing a guaranteed buyer of T-bills for government bond dealers, we appear to be witnessing financial welfare for Wall Street.

It will be interesting to see when April arrives if the FRB is able to extricate itself from the repo market, or, like a junkie, are the financial markets too dependent on FRB actions. The stock market's aggressive advance since October is clearly a result of FRB policy. In addition M2 money supply is now rising at over 12% annually, a rate sufficient to lead to goods and services inflation within several months. The FRB wants higher inflation and it may finally get its wish in terms of goods and services inflation. The FRB is also working on revised language that will justify allowing inflation to exceed their 2% target.

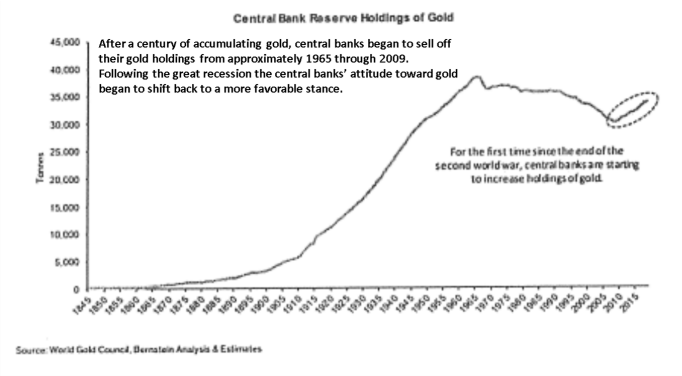
The FRB may have backed itself into a corner. To cease money injections into the repo market could send interest rates rising once again along with stock prices cratering. If

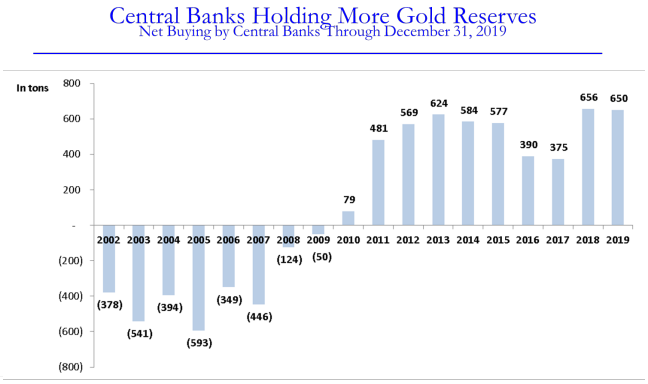
they keep up this policy, it is increasingly likely that we could be entering into accelerating inflation which would also not be good for either the dollar or for stock prices.

Gold's price strength over the last 17 months is probably equivalent to the canary in the coal mine, signaling that all is not well in our financial markets. As we continue down the road of increasing debt leverage and abnormal and extreme central bank policies, gold's price rise may be signaling that market interventions have their negative consequences.

Central banks are buying gold for their reserves

Governments were net sellers of gold from the late 1960s through 2009. Over the previous decades gold had lost status as an integral component of many central banks assets. Especially after the U.S. closed its gold window to other countries in 1971, there was a growing attitude that gold served no purpose and earned no interest. U.S. Treasury debt on the other hand was sound and earned interest. Thus there was a general move on the part of many governments to increase U.S. Treasury debt as a reserve asset, while at the same time selling off a portion of their gold holdings. A major seller of gold was the U.K. which sold off half of its gold holdings between 1999 and 2001 which turned out to be a major low in the gold price at approximately $ 254 an ounce.





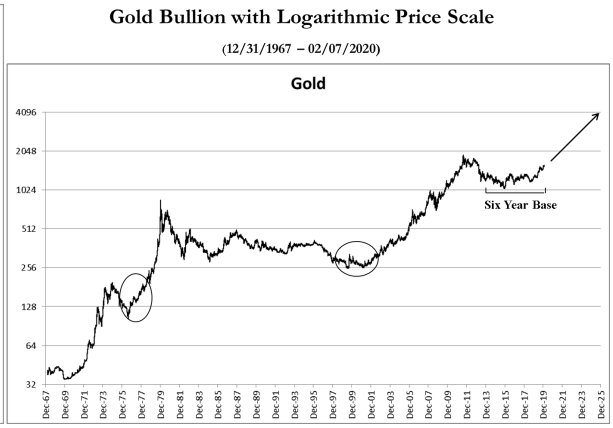
However, a major change of attitude toward gold began to develop after the Great Recession of 2007-2008. This change of attitude appears to have developed both due to the significant decline in interest rates, making U.S. Treasury debt less attractive, and the realization on the part of central bankers that in a serious crisis gold was a universal asset not subject to another government's default. The changing geopolitical environment with increasing challenges to U.S. hegemony has also been a factor. Specifically the economic and political challenges from China, Russia, Iran have also increasingly created questions about the U.S. dollar's role as the international reserve currency. Add to this the increasing realization that the U.S. budget deficit is forecast to grow indefinitely into the future, with little or no political will to reverse the situation.

Whatever the reasons, central banks have steadily increased their acquisition of gold to the point where their purchases are equivalent to approximately 20 percent of new gold

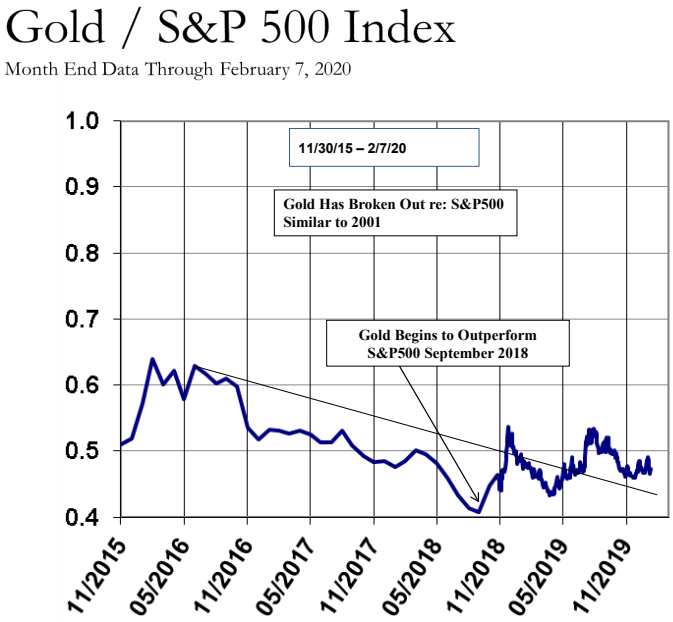
production. We do not expect a return to the gold standard due to its automatic restraints on politicians. However it is increasingly likely that gold will play some type of a more central role in supporting international transactions. As the dollar's role as the world's reserve currency comes under increasing scrutiny, demand for gold by the world's central banks and governments is likely to trend much higher.

The gold price made a spectacular breakout in mid-2019

Gold's price advance in 2019 was a significant event. While gold has not made a new all-time high in U.S. dollar terms, it has done so in many of the other world's important currencies. Only because the dollar has been strong in the last year, gold has not yet made a new all-time high in dollar terms. However the fact that gold could advance when the dollar was strong is unusual and significant.

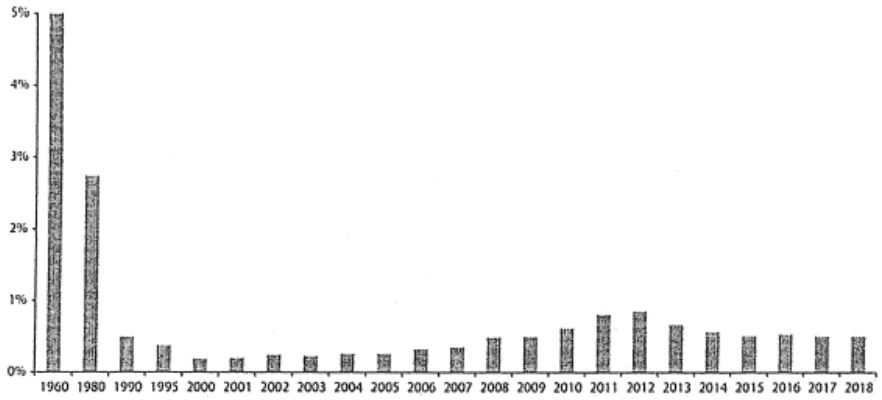


It is also interesting to note that since the end of the third quarter of 2018, the gold price has performed better than the S&P500. This is in spite of the strong performance of equities since that time. This relative price strength also occurred in the 2000-2001 period when gold commenced a ten year advance.



The ability of gold to break above the 1370 level which had contained it for six years is a significant event. Gold's price strength strongly suggests that it represents the early stages of a multi-year price advance. The power with which it advanced through 1370, and the distance it has traveled since the breakout, is strongly suggestive of the early stages of a major price move. Given the miniscule value of the world's gold supply relative to the world's financial assets and liabilities, even a small percentage shift in gold ownership by either the private sector, or governments, or both, gold's price will likely surprise by a wide margin how far it may advance in price.

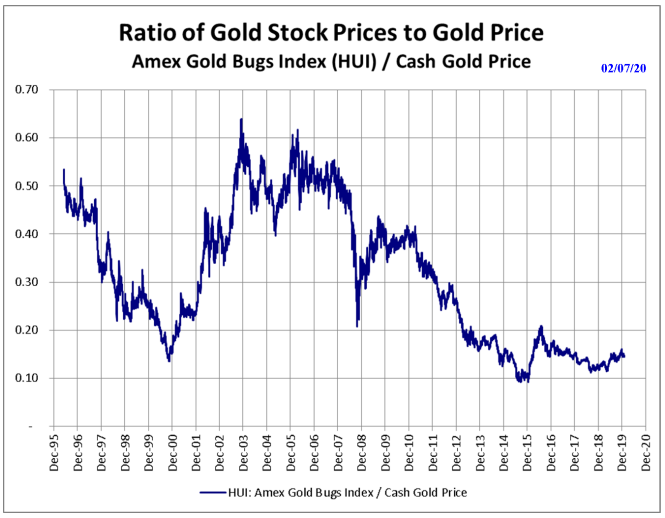
Gold Percentage of Global Financial Assets

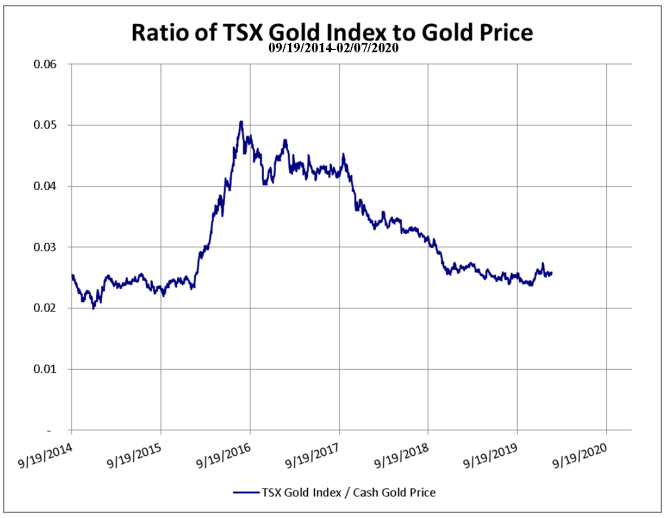


Source: CPM Group

Gold mining shares are undervalued at the current price of gold

While there has been a modest pickup in buying interest in the gold ETFs beginning in 2019, this has not been the case with the gold stock ETFs. For all of 2019 the largest gold stock ETF, GDX, saw significant outflows as the number of GDX shares outstanding declined from 502 million to 441 million, a 12 percent decline. This occurred in spite of the GDX being up 39.73% in 2019. For comparison, the AIS Gold Fund advanced 61.47% after all fees and expenses.





Although gold mining shares performed well in 2019, their shares remain extremely undervalued to the price of gold. This can be seen in the chart (previous page) of the relative price of large gold miners (HUI Index) relative to the price of gold. This index reached an all-time low at the end of 2015 and is barely above that level. This compressed state of the gold miners is even more apparent in looking at the ratio of the small gold exploration stage miners (TSX Venture Index) relative to the price of gold (previous page). These depressed relative price levels can only be explained by a combination of disinterest in the sector and/or a disbelief that gold prices will remain at these levels. We believe that these price levels will disappear once investors focus on the opportunity, and begin developing concern about the general stock market.

Gold mining shares have substantial upside leverage at the present time

There is no such thing as a sure investment opportunity. However there are times when a confluence of factors point to a significant potential profit opportunity. We believe such a time currently exists in the gold miners, especially the intermediate sized producers and the exploration/ development stage companies.

The gold price made a powerful move in 2019 which reminds us of the price move that the general stock market made in mid-1982, which led to a multi-year price advance. A

breakout such as gold made in 2019 is more characteristic of the early stage of a major move than the end of a move.

Economic /financial conditions argue for higher gold prices. Central banks are major buyers of gold once again.

The U.S. FRB is engaged in extreme funding activities as the U.S. Government deficit appears to be expanding indefinitely.

The U.S. dollar's reserve status is increasingly questioned by foreign governments.

Gold is very under owned by private portfolios.

Gold stocks are severely under owned by investors and are languishing at depressed fundamental valuations, even as their fundamental earning power is improving.