

## Why Gold and Gold Equities Can Thrive in 2018

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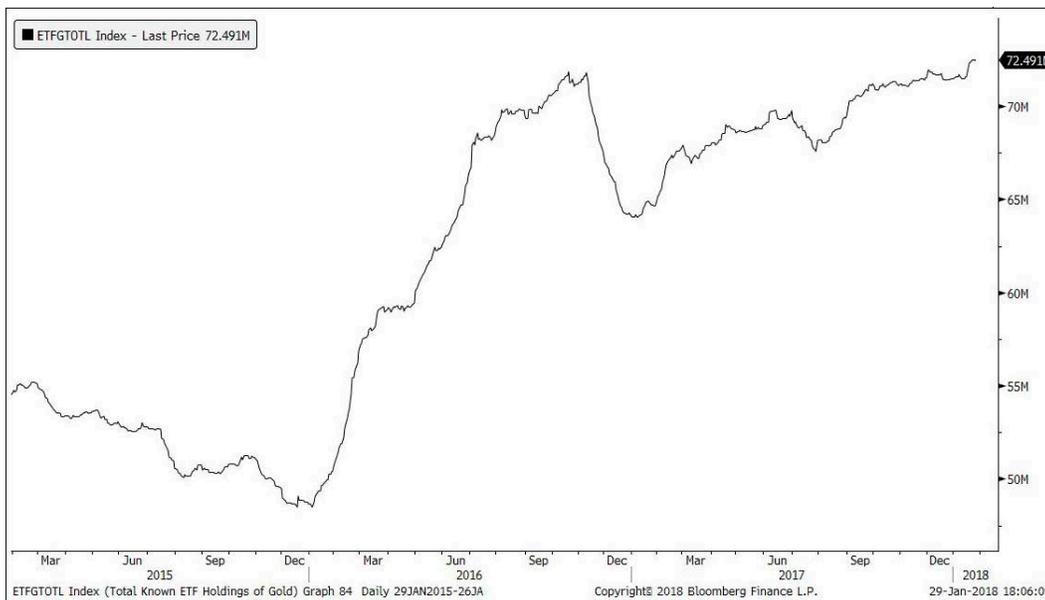
### Gold Bullion Gained 3.23% in January

With the beginning of the new year, we have entered a seasonally strong period for gold bullion and gold equities. Gold bullion posted a strong gain of 3.23% in January, ending the month at \$1,345.15 per ounce. While sentiment towards gold has improved from frigid to lukewarm, sentiment towards precious metals equities remains downright bearish.

We view this as a positive sign for precious metals equity investors with a long-term horizon because a shift in sentiment towards an asset class is usually followed by robust gains, which are primarily driven by re-rating of its valuation multiples. In the case of precious metals equities, multiples have continued to trend lower, making stocks cheaper while gold bullion has appreciated in price. We track investor positioning using a number of metrics including fund flows, gold futures trading and ETF flows. Gold bullion ETF flows serve as a good proxy for investor positioning, and options trading on GLD<sup>1</sup> helps us to gauge sentiment. As shown in Figure 1, the shares outstanding in gold bullion ETFs are currently at a three-year high. When seen against the backdrop of rising asset prices, the increase in gold bullion holdings, is merely par for the course.

**Figure 1: Total Known ETF Holdings of Gold (Oz)**

(1/2015 – 1/2018)



Source: Bloomberg. Data as of 1/26/2018.

Curiously, the shares outstanding in GDX,<sup>2</sup> which is the largest gold mining ETF, remain near their three-year low, reinforcing our thinking that North American investor positioning in the precious metals mining space remains relatively lean. On the same note, silver, which has often acted as a high beta cousin to gold bullion, has not attracted much investor attention of late. Total silver bullion ETF holdings have continued to languish over the past 18 months. This serves to inform us that while

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investors have continued buying bullion as an insurance policy for their portfolios, investors are not currently seeking leverage to their gains from the potential rise in the price of gold, which gold and silver mining equities have typically provided. Similarly, we see relatively neutral levels of participation by investors and speculators in the gold futures market.

## 2018: Not Likely to be a “Normal” Year

Normally, these developments might indicate that we are in for a “normal” year for gold. 2018, however, is not likely to be a normal year in our estimation. With the passage of the Tax Cuts and Jobs Act in the U.S. at the end of 2017, the Republican Party signaled its willingness to dive deeper into debt during a time of economic expansion. The cost of this bill is expected to top \$1.5 trillion over the coming decade (see Trey Reik’s commentary: [Just Get Tax Reform Done!](#)). On top of this colossal debt burden, there is signaling for further additions to the deficit as the House and Senate try to put together an infrastructure plan which would cost upwards of \$1 trillion. The lack of fiscal restraint was well telegraphed by the incoming Trump administration in 2016, at a time when the economy was gaining steam and monetary expansion was firmly in place.

## Signs of Inflation are Materializing

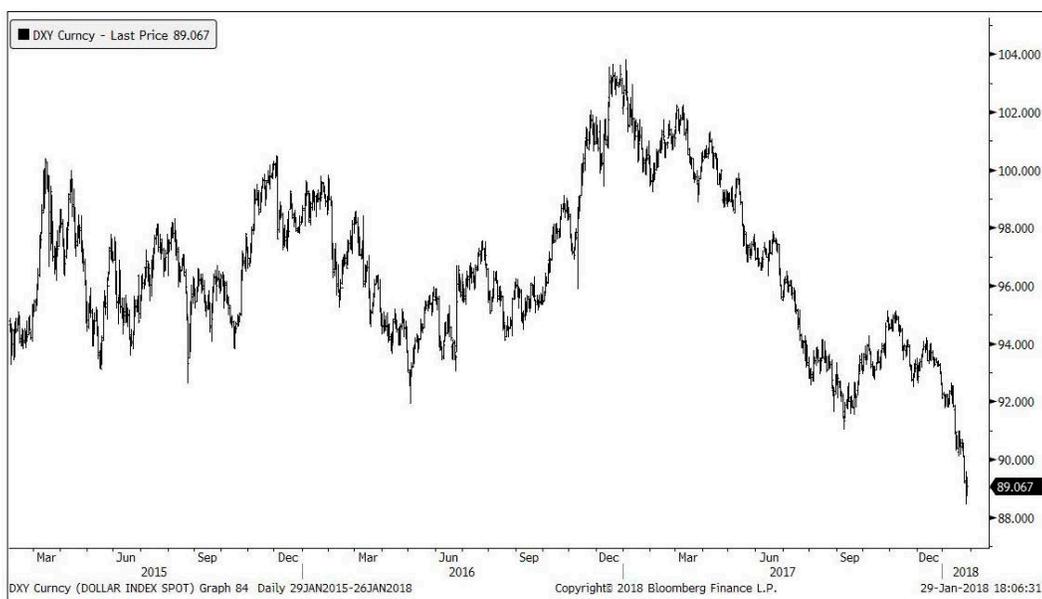
Fast forward a year, and we now have a situation where the U.S. Federal Government’s balance sheet continues to expand, the Federal Reserve remains dovish, the fiscal deficit is set to rise quickly and the U.S. economy continues to hum. Has anyone mentioned inflation yet? We are beginning to see inflation materialize. Energy prices are up, producer prices are on the rise and against all odds, wages are finally beginning to increase. It is no wonder that the combined effect of the factors above are weighing heavily on the U.S. dollar.

## The Almighty U.S. Dollar?

Indeed, in our estimation, one of the most significant developments of 2017 was the decline of the U.S. dollar, which lost almost 9.87% (DXY<sup>3</sup>) of its value when measured against a basket of other major currencies.

## Figure 2: The Declining U.S. Dollar

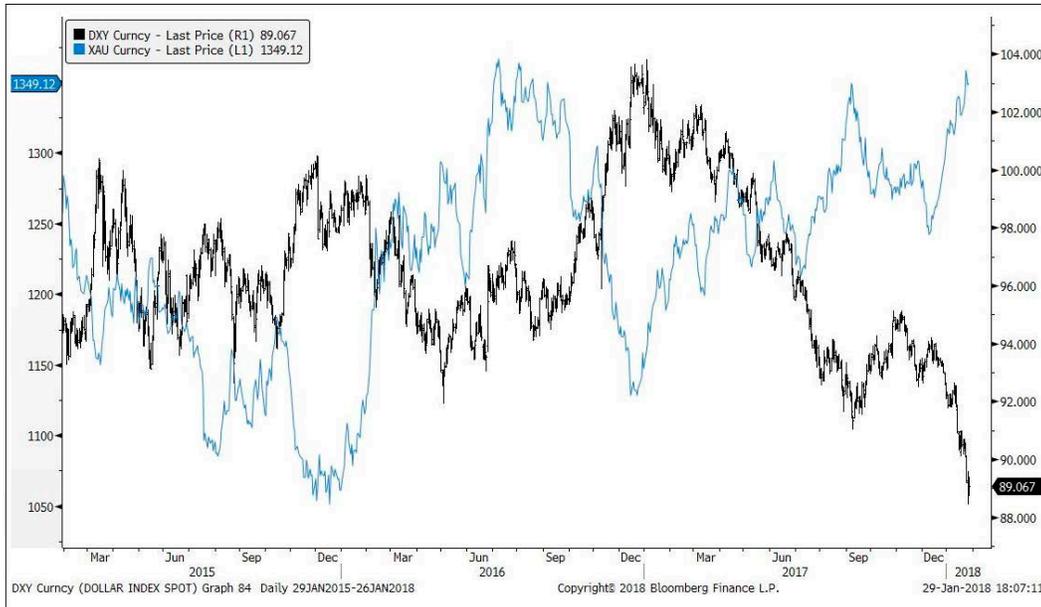
DXY Index Measured Daily



Source: Bloomberg. Data as of 1/26/2018.

**Figure 3: U.S. Dollar (DXY) vs. Gold (XAU<sup>4</sup>)**

(1/2015-1/2018)



Source: Bloomberg. Data as of 1/26/2018.

As you can see from Figure 3, a declining U.S. dollar benefits gold prices. We believe that 2018 will see pressure on the U.S. dollar continue on the back of increasing inflationary pressures, non-existent fiscal restraint and a dovish incoming Fed Chair (Jerome Powell). In January, the U.S. dollar broke below the important 90 threshold, and declined 3.25% (from 92.124 to 89.133 based on the DXY).

When the currency of a nation declines from increasing debt in an environment of easy money policies and artificially low interest rates, the perfect environment is created for gold to thrive. This is what we are facing today, in a repeat to what we saw between January 2003 and December 2006 which saw gold prices climb more than 80%, from \$350 to \$635 per ounce, while the U.S. Dollar Index (DXY) lost 18% of its value. It is no surprise that the rapid appreciation in gold also attracted speculative interest in gold equities, which saw the widely followed HUI Gold Index rise 142% in the same period.

As my colleague Trey Reik explained last month in [Sprott Gold Report: 2017 Redux](#):

*"Of all the combinations of market fundamentals which can prove supportive of gold prices, none are more potent than a slumping U.S. dollar amid concern for a deteriorating U.S. fiscal position. **This is total nirvana for gold.**"*

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<sup>1</sup> SPDR Gold Shares (GLD) is an exchange-traded fund and is used as a benchmark to measure gold bullion prices.

<sup>2</sup> VanEck Vectors Gold Miners ETF (GDX) tracks the overall performance of companies involved in the gold mining industry.

<sup>3</sup> The U.S. Dollar Index (USDIX, DXY) is an index of the value of the U.S. dollar relative to a basket of foreign currencies.

<sup>4</sup> XAU is an index of precious metal mining company stocks that are traded on the Philadelphia Stock Exchange.

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