

MARKETS AT A GLANCE

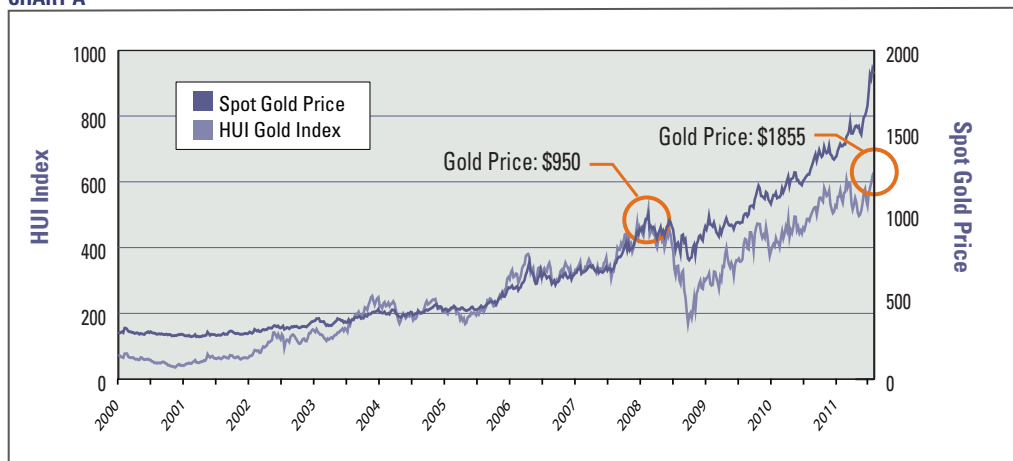
Sprott Asset Management^{LP}

Gold Stocks: Ready, Set,...

By: Eric Sprott & David Baker

Last week, the HUI Gold Index marked a new all-time high as it surpassed 600. Recent gold equity investors were undoubtedly happy with this move, but for longer-term holders, the recent strength is actually somewhat disappointing. If you review the chart below, you'll notice that while the gold price has almost *doubled* since early 2008, the HUI Index has appreciated by a mere 22% over the same period (see Chart A). If the HUI was justified at 500 in early '08, it should surely be justified at 1,000 today, given the appreciation of the gold price over that time. So why have the equities lagged?

CHART A



Source: Bloomberg

First and foremost: the sell-side's abysmal gold price estimates. Table 1 shows the average gold price that analysts are using to value gold equities today. While the futures market is comfortably forecasting a continuation of today's levels, the majority of sell-side analysts refuse to update their gold price estimates to reflect its recent strength. A rising gold price is normally a bad sign for the broader equity markets, and generally indicates a bearish trend. As bears ourselves, we're completely fine with this, and invest accordingly. But the sell-side has difficulty pairing bearishness with new underwriting opportunities. It doesn't mean you have to believe their price forecasts however.

TABLE 1

Sell-Side Analyst Gold Price Forecasts			
	2012	2013	2014
Median	1550	1392	1340
Mean	1602	1476	1340
High	2080	2200	1600
Low	1100	1000	1000
Current Forward Price	1866	1883	1909
Differentials (Median - Current)	-316	-491	-569

Source: Bloomberg

The second reason is gold's volatility. The amount of paper gold and silver contracts that trade on the futures and equities exchanges still dwarf the amount of actual physical trading that takes place. Paper markets continue to set price discovery – thereby allowing for dramatic volatility with little or no influence from actual physical fundamentals. In the LBMA market, for example, market participants traded an average 19.6 million ounces of gold PER DAY in July 2011.^{1,2} Keep in mind that the total gold mine production in 2010, globally, was approximately 86.5 million ounces. Global gold mine production is not expected to increase significantly year-over-year, so the LBMA is essentially trading a year's worth of production in less than a week. And this is just ONE market. When you add the COMEX futures and gold ETFs, the paper trading volume becomes absurdly high. When price discovery is dictated by levered paper contracts with no physical backing, it's extremely easy and relatively inexpensive to jostle the spot price around. The result for gold has been many days of extreme downside volatility, despite a strong and consistent overall upward trend. Investors don't like volatility – and the constant whipsawing has probably kept many of them away from the gold equity sector as a result.

Thirdly – investors still remember how badly gold equities got crushed in 2008. There was a reason they sold off so aggressively however – they were the most profitable positions investors owned going into the '08 crisis. Gold equities had enjoyed a strong bull trend going back to 2001, with the HUI Index appreciating by 980% from its November 2000 low through to August 2008. Investor behaviour is fairly consistent – when panic hits, you sell your winning positions first.

Something has changed recently, however. A new divergence has arisen in the precious metals equity market – a subtle, but plainly evident shift in recent daily performance. On Wednesday, August 10th, for example, the Dow dropped 4% while gold stocks rallied 3%, for a delta of 7% on the day. That is significant outperformance, and not what we have come to expect on an equity market down day. Gold stocks, as represented by the HUI Index, also seem to be breaking away from their traditional correlation with the spot gold price. On August 29th, spot gold dropped 2.16%, while the stocks fell by only 0.81%. On September 7th, gold fell by 3.09%, while gold stocks *rose* by 0.33%. These small differences indicate a new trend forming. While gold's daily volatility is expected to continue, we may be entering a new phase where the stocks react less harshly on gold down days, and outperform gold on days of strength.

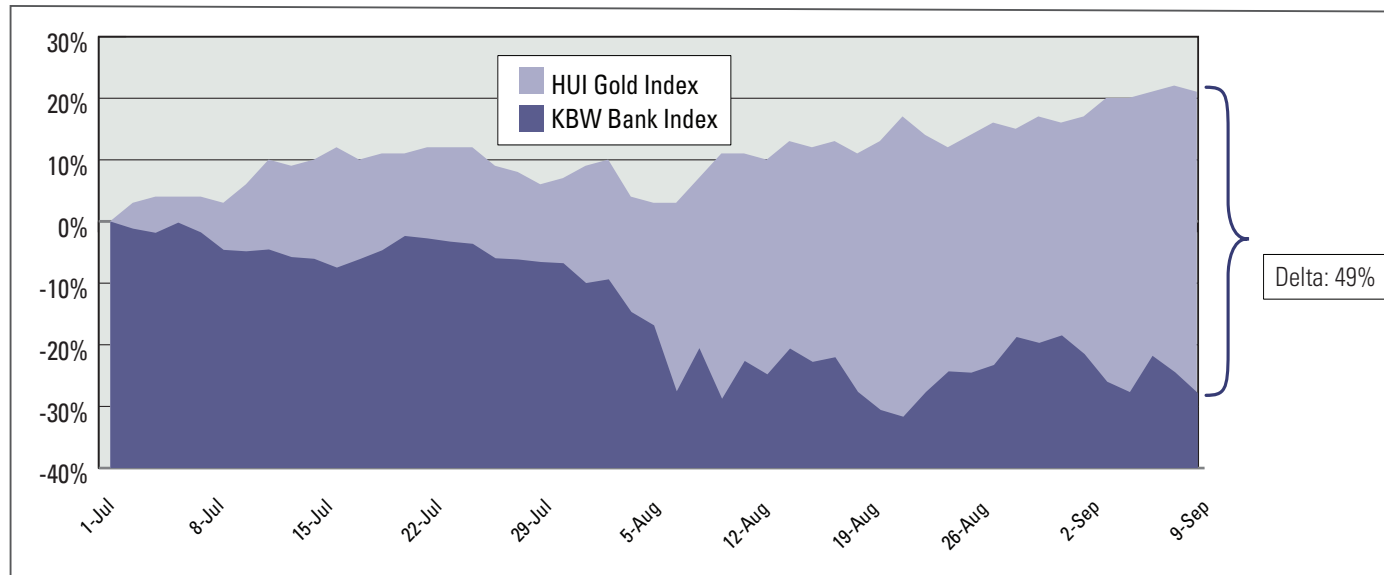
The gold equities' recent divergence has played itself out even more prominently against the financials, with the HUI Index outperforming financials by a stunning 49% since the beginning of July (see Chart B). As we wrote in "The Real Banking Crisis" two months ago, there appears to be a run on European banks, and financial stocks are reflecting that. IMF Managing Director, Christine Lagarde, recently confirmed as much in her Jackson Hole speech, where she warned about the banks' need for urgent recapitalization: "They must be strong enough to withstand the risks of

¹ http://www.lbma.org.uk/pages/index.cfm?page_id=50&title=clearing_-_statistical_table

² <http://uk.finance.yahoo.com/news/Gold-transfers-rise-July-LBMA-targetukfocus-2412619597.html?x=0>

sovereigns and weak growth. This is key to cutting the chains of contagion. If it is not addressed, we could easily see the further spread of economic weakness to core countries, or even a debilitating liquidity crisis.”³ Investors aren’t waiting around to see if they’ll pull it off, and as the chart below suggests, at least some of them have reinvested their former bank equity capital into the precious metals sector.

CHART B



Source: Bloomberg

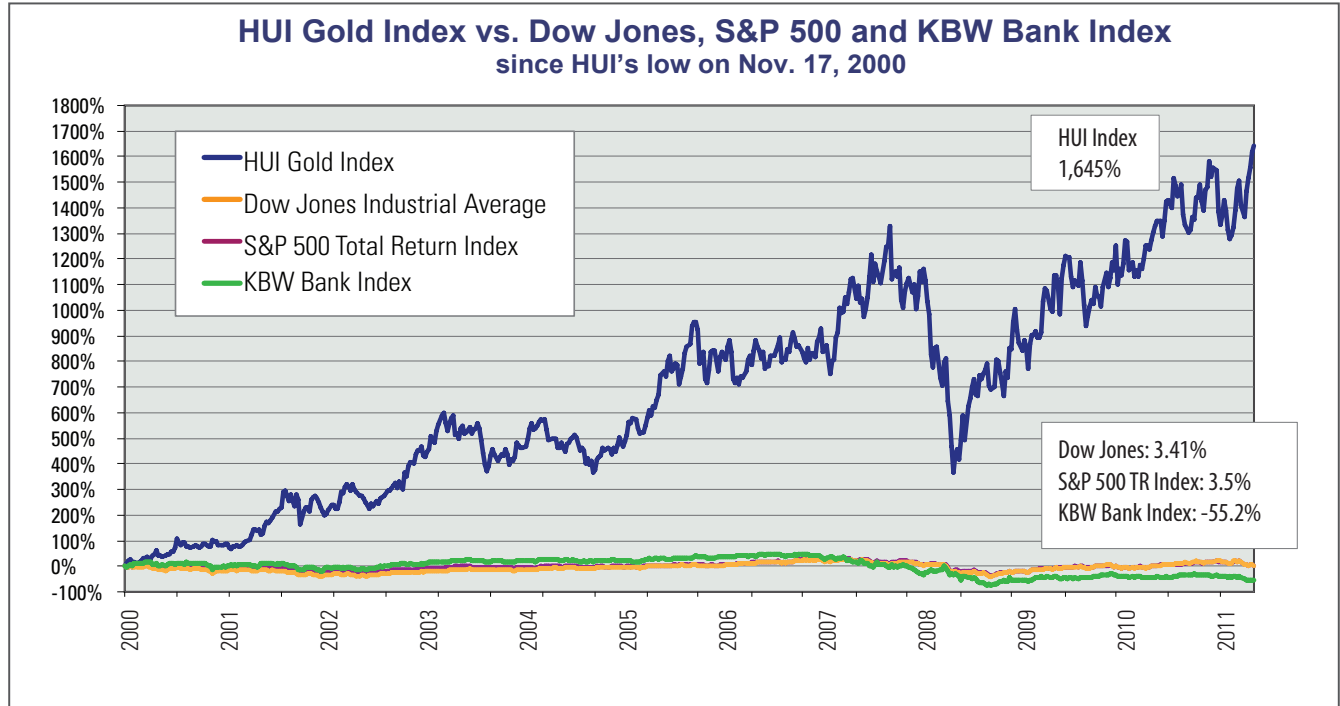
As a side note, Chart C symbolizes the great wealth redistribution that has taken place since 2000. Those investors who have owned precious metals equities have prospered, while those who have invested exclusively in the broader equity market or financials have little to show for it. We clearly see this trend continuing, and even accelerating, in the coming years.

In many of the funds we manage at Sprott, we’ve transitioned out of gold bullion and into gold equities to better participate in the continuation of the trend indicated above. As long-time investors in this space, we can assure you that the production growth rates will be significantly higher in the junior stocks. They continue to trade at discounted valuations, and we believe they offer the best opportunity to build exposure. Margin expansion is the key metric for this industry, and the market is now acknowledging the miners’ improvement in margin capture – which has occurred despite the increase in capital and operating costs (see Chart D). We meet with a large number of gold mining management teams on a weekly basis, and based on those meetings, it appears that the average cost of producing an ounce of gold today, all in, is now around \$800. At \$1,200 gold, these companies can capture roughly \$400 in EBITDA. At \$1800 gold, however, they’re now capturing \$1,000 per ounce in EBITDA - representing an **increase of 150%** in profit margin. That is significantly far above what any other equity sector has been able to generate over the past year.

Amazingly – despite this new reality for gold producers, we are still finding opportunities in select gold and silver mining companies that can be purchased today at 2-3 times their 2-year-out forecasted cash flow. These multiples are based on the current gold and silver spot price, and if these companies hit their production targets, and gold and silver continue their appreciation – we may discover that these stocks were trading at less than 1 times 2-year-out cash flow today. Having been in the business for many years, we can tell you that investing in a stock at 1 times 2-year-out cash flow tends to be a winning proposition – let alone in an industry that literally mines the world’s reserve currency out of the ground.

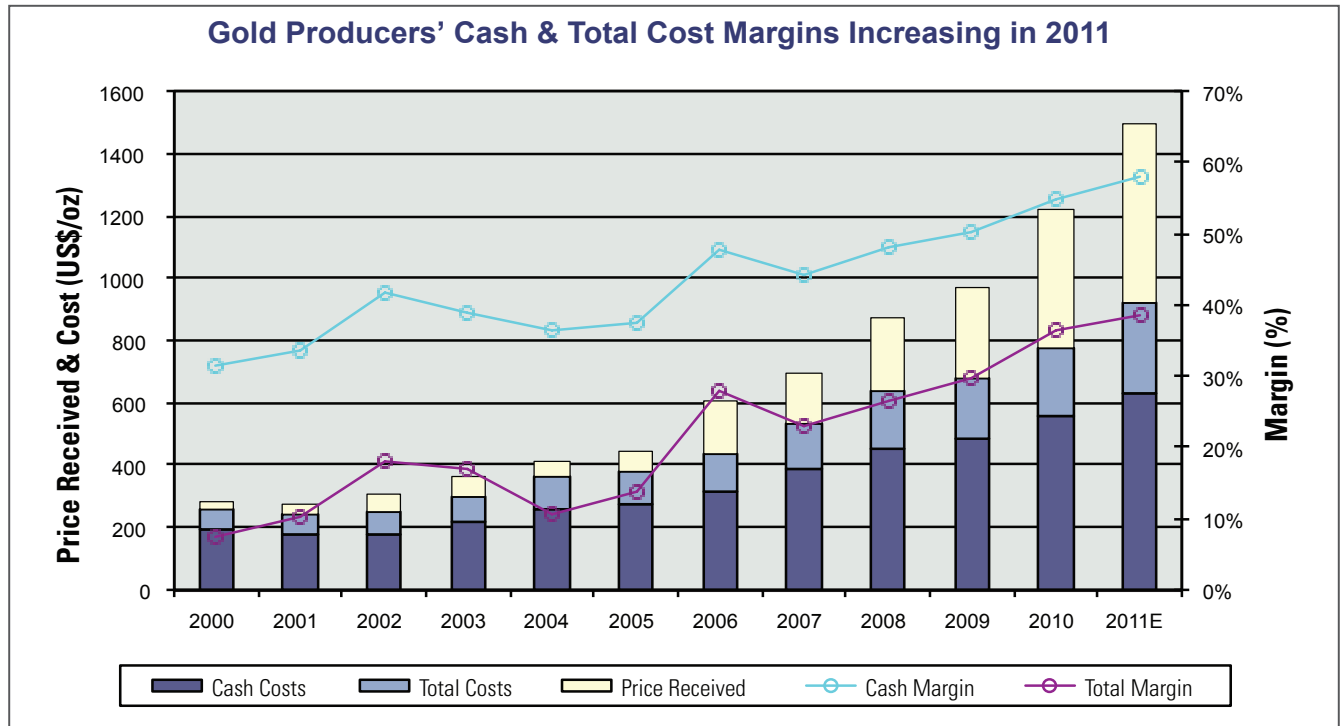
³ <http://www.imf.org/external/np/speeches/2011/082711.htm>

CHART C



Source: Bloomberg

CHART D



Source: BMO Capital Markets

In our view, gold stocks represent a bona fide growth sector in an otherwise dreadful equity market. All other equity sectors are weakening due to sovereign uncertainty and the reemergence of soundly weak economic data. The recent disconnect between gold equities and bullion isn't new either. We've seen it before over the past decade, and the returns generated after previous divergences have averaged around 26% (see Table 2). Given the recent performance correlations, the HUI's breakout above 600 and spot gold now firmly above \$1600, we expect this rebound in gold equities to be prolonged and much more significant in percentage terms.

S&P/TSX Gold Index performance (in USD) from previous peak divergences

TABLE 2

Peak	Date	1 mo.	3 mo.	6 mo.	12 mo.
1	00-03-29	5.7%	15.1%	2.0%	-4.2%
2	00-11-15	20.9%	7.0%	44.2%	39.1%
3	02-11-28	18.2%	11.2%	16.4%	70.2%
4	03-03-12	4.5%	20.1%	44.0%	52.9%
5	04-06-03	3.8%	5.5%	23.3%	3.5%
6	05-05-16	17.4%	30.8%	37.0%	103.6%
7	07-03-13	8.8%	0.4%	19.6%	72.3%
8	08-04-29	10.7%	8.4%	-53.7%	-27.1%
9	08-11-20	55.7%	79.7%	96.4%	140.0%
10	09-03-02	22.9%	35.1%	28.9%	44.3%
11	10-03-25	12.4%	20.3%	28.5%	39.0%
Average		16.4%	21.2%	26.1%	48.5%
Median		12.4%	15.1%	28.5%	44.3%

Source: Macquarie Research

Equity investors shouldn't let \$1800 gold dissuade them from participating in precious metals equities. The world is still dramatically underexposed to gold, and we firmly believe it should represent a higher percentage of investors' total portfolios today. The fact remains that both gold and silver continue to trade well below their inflation-adjusted highs in nominal terms, and the market is now beginning to acknowledge the profit potential that precious metals equities offer at today's bullion prices. We believe the equities will offer more upside than the bullion over time. Many of the smaller names are well priced and have momentum behind them. The prospects for gold stocks look extremely bright. 📈

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Sprott at a Glance

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