Sprott | Gold Report
January 23, 2019

Catalyst for Gold Locked and Loaded?

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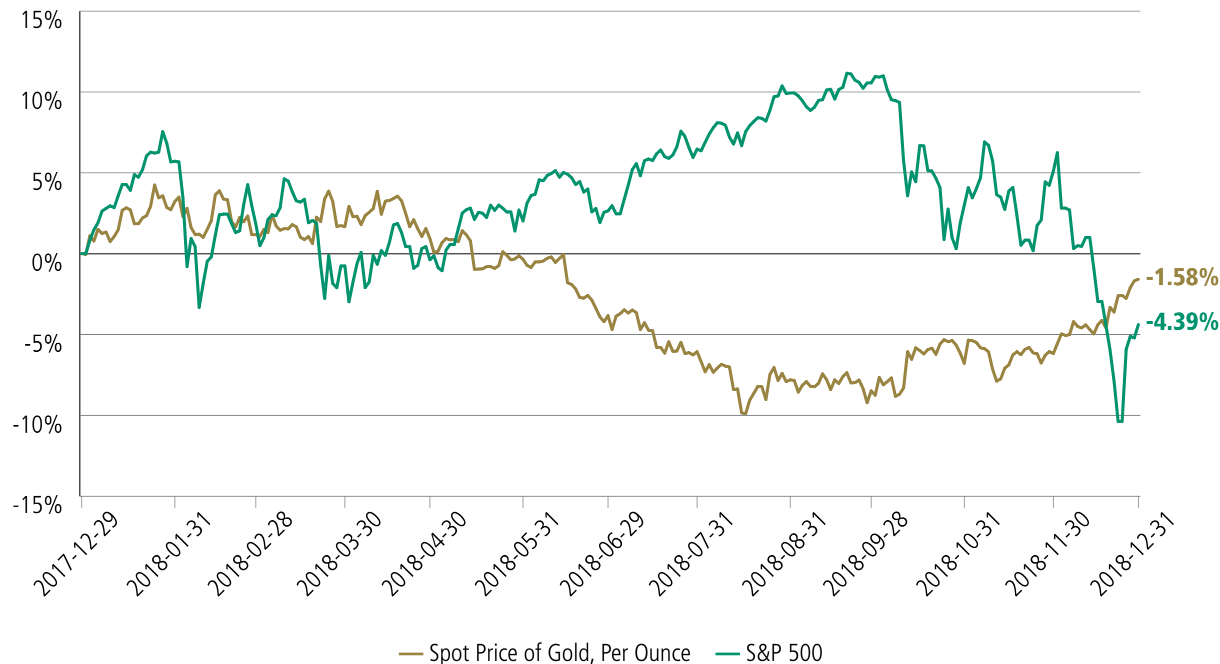
Gold Outshines the S&P 500 in 2018

We believe that gold bullion and gold mining equities may be poised for a multi-year uptrend. Gold bullion beat U.S. equities for the month of December, the fourth quarter, and the full calendar year of 2018. Spot gold[1] declined 1.58% versus the 4.39% drop in the S&P 500 Total Return Index[2] in 2018 (Figure 1). Gold also outperformed most currencies last year, with the exception of the Swiss franc and the Japanese yen.

The bulk of gold's 2018 outperformance came in the fourth quarter, on the back of the steep fall of the S&P 500 after it hit a high in late September, as shown in Figure 2. Gold rallied 7.54% in the fourth quarter, while the S&P 500 lost 13.52%. The rise in gold mining equities was also impressive in Q4, with Sprott Gold Miners ETF (SGDM)[3] gaining 12.63%. (See page 7 for full performance numbers).

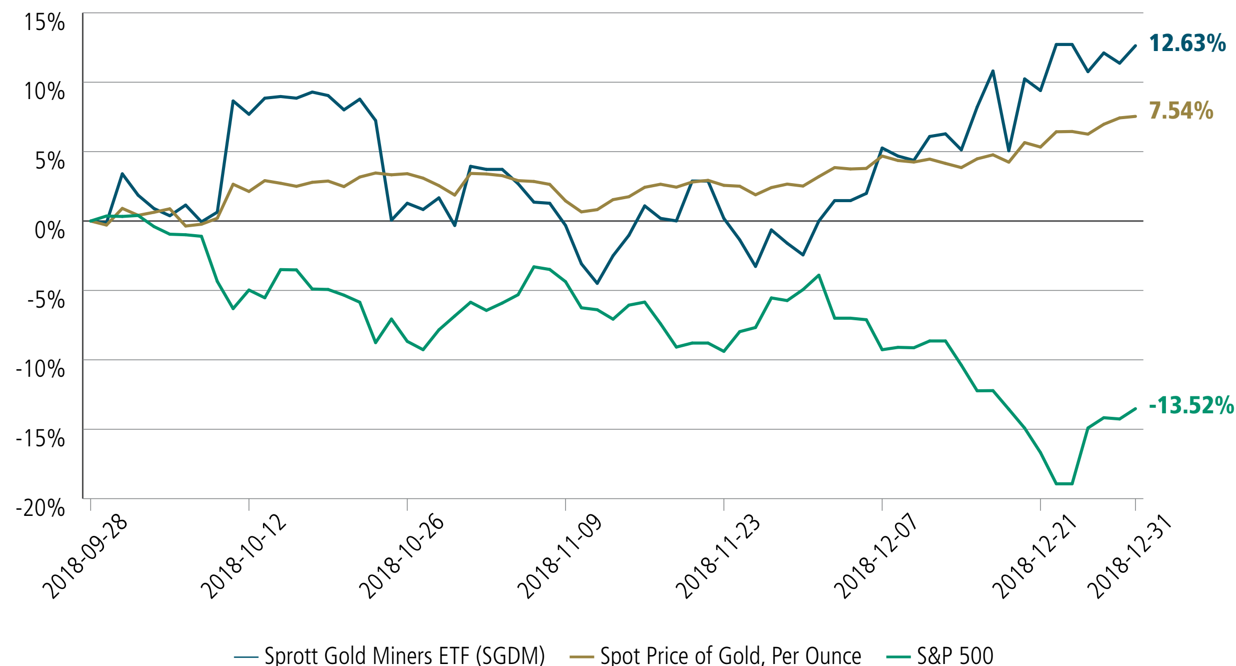
We suggested throughout 2018 that the catalyst for **gold's next important rally would be growing recognition that the Fed's current tightening cycle was reaching a conclusion**. This crucial trigger appears to now be locked and loaded, as we discuss in this report. History overwhelmingly suggests the Fed will be easing policy within three-to-six months. Once this inflection in Fed policy officially hits the tape, gold should have already commenced what we expect to be a significant and sustained advance.

Figure 1: Gold Beat the S&P 500 Index in 2018
(12/29/2017 – 12/31/2018)



Source: Bloomberg.

Figure 2: Gold Bullion and Gold Equities Beat the S&P 500 Index in the Fourth Quarter
(9/28/2018 – 12/31/2018)



Source: Bloomberg.

Fed U-Turn

During 2018, we suggested the Fed's dual policy agenda of simultaneous rate hikes and balance sheet reduction was crimping dollar liquidity to the significant peril of reigning financial asset prices. Throughout the year, we documented signs of mounting financial stress in both peripheral and mainstream asset classes, ranging from emerging markets and subprime U.S. consumer credits all the way to mammoth U.S. markets for residential housing and corporate debt.

By yearend, Fed-induced liquidity strains materialized in broad equity averages, **with the S&P 500 posting a 13.52% fourth-quarter decline**. True to form, Fed stewards took quick note of slumping U.S. equities and have since softened the Fed's party line. Indeed, an onslaught of Fed jawboning in recent weeks has virtually extinguished market expectations for additional rate hikes.

January Turnaround

On 10/3/18, the date of Fed Chairman Powell's now infamous "long way from neutral" comment, the S&P 500 closed at 2,925.51. By Christmas Eve, the S&P had declined a startling 19.63%, and on 12/24 alone, the Dow Jones Industrial Average plunged 653 points, its worst-ever Christmas Eve decline. Fueling market uncertainty, the Federal government shutdown commenced at midnight on 12/22, the same day Bloomberg reported President Trump was considering firing Fed Chairman Jerome Powell.

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In a curious attempt to calm markets, Treasury Secretary Mnuchin tweeted on 12/23/18 that he had phoned the top six U.S. banking executives to confirm that, despite the government shutdown, there was "ample liquidity" in the financial system. Since investors hadn't been concerned about bank liquidity before Mnuchin's tweet, markets accelerated to the downside on 12/24/18. Secretary Mnuchin then made the exceedingly rare ***public*** announcement that he had scheduled a meeting of the President's Working Group on Financial Markets for the morning of 12/24/18. Nicknamed the Plunge Protection Team (PPT), the Working Group was formed after the 1987 market crash and is composed of top officials from the Federal Reserve, the Securities and Exchange Commission and the Commodity Futures Trading Commission.

Fanning conspiratorial flames, the S&P 500 abruptly reversed course from its 2,351.10 close on 12/24 and rallied 11.02% through a 1/15/19 close of 2,610.30. What could account for such sudden resilience of previously slumping equity averages? As enjoyable as the Hollywood optics of a Christmas Eve PPT thriller might be, we would attribute the bounce in equities to a far more ordinary narrative — more like a late night re-run of an old sitcom. In recent weeks, global central banks have orchestrated significant and coordinated liquidity provision to provide Chairman Powell and his colleagues sufficient cover to stable their high-horses of monetary restraint.

In tracking the aggregate size of the balance sheets of the world's Big 4 central banks (U.S. Fed; European Central Bank, ECB; Bank of Japan, BOJ; and People's Bank of China, PBOC), we rely on the considered work of Andy Lees (Macro Strategy). Andy maintains a proprietary formula which tracks the ***daily U.S. dollar value*** of publically reported updates in Big 4 balance sheet composition. Importantly, despite a US$1.219 trillion collective reduction in Big 4 balance sheets between 3/26/18 and 12/24/18, the U.S. dollar value of the Big 4 balance sheets reversed on a dime (or command) on Christmas Eve and surged an eye-opening $428 billion during the three weeks ended 1/15/19.

Figure 3: U.S. Dollar Value of Big 4 Central Bank Balance Sheets

[Fed, ECB, BOJ and PBOC] (1/31/18 – 1/15/19)

Source: Bloomberg.

Global Central Banks are Reversing Course

While the majority of this climb was due to exchange-rate movements, the surging delta included $45 billion in asset purchases by the ECB (after officially terminating its QE program in early December), and $35 billion was in purchases from the BOJ (after remaining relatively stable for eight months). Point being, global central banks are already reversing course from their fleeting posture of removing accommodation.

We cannot stress enough how one-dimensional global asset markets have become. On 1/15/19, the Institute of International Finance (IIF) updated its longstanding study of global debt levels. As of Q3 2018, the IIF estimates total global debt now stands at $244 trillion, or over 318% of global GDP. With this much debt in the financial system, the only variables truly relevant for financial-asset valuations are the policies and behaviors of global central banks. It really is that simple — reigning financial asset valuations are now completely dependent on sustained central bank liquidity. For example, despite Chair Powell's bravado, it is now patently clear that the Fed cannot raise fed funds to 2.5% and reduce its balance sheet below $4.1 trillion without pressuring U.S. equity markets.

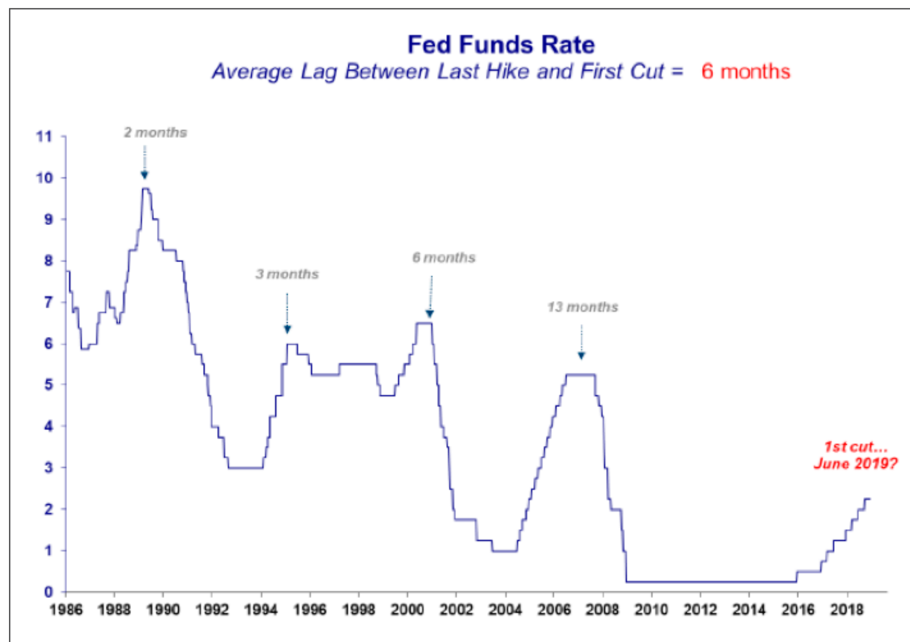
Fed Pause on Rate Hikes

By unanimous decision at its 12/19/18 meeting, the Federal Open Market Committee (FOMC) hiked the fed funds rate by 25 basis points. In his post-meeting press conference, Chair Powell telegraphed two additional rate hikes during 2019 and characterized the Fed's balance sheet runoff as being on autopilot and not subject to change. By January 9, however, Fed Presidents Bullard, Evans and Rosengren (coincidentally, all 2019 FOMC voters) had weighed in against the necessity for further rate hikes. By 1/14/19, even Janet Yellen had surfaced to suggest, "It's very possible we may have seen the last interest rate hike of this cycle." On 1/15/19, the Fed's most ardent hawk (and final 2019 rotating FOMC voter), Kansas City Fed President Esther George, made it official, "It might be a good time to pause our interest rate normalization."

Waiting for Scales to Tip on Gold

There you have it. The Fed has all but admitted in the three weeks following its December rate hike that that hike may have been misguided. As gold investors, we have anticipated just such a Fed denouement for much of 2018. In classic irony, market reaction-to-date from abrupt reversal in Fed policy-guidance has largely been limited to equity ebullience. The 11% post-Christmas rally in the S&P 500 has been matched by a negligible $20 rally in the Spot Price of Gold (1.6%). **Needless to say, we expect more reasoned analysis to tip the scales dramatically in gold's favor in coming periods**.

Figure 4: Upper Bound of Fed Funds Target Rate
(1986 – 2018)



Source: Federal Reserve; MacroMavens.

Typical of late bull market cognitive dissonance, we believe consensus is misreading the significance of the Fed's evolving pause in rate hikes. On the surface, suspension of further tightening might equate to a back-in-the-pool signal, right? Actually, no it doesn't. The history of Fed pauses during the past three decades has been to signal significant economic slowdown. At least in 1989, 2000 and 2007, the first Fed pause signaled imminent recession. Indeed, as shown in Figure 4, since 1986, the length of time between first Fed pause and first Fed ease has averaged roughly six months.

With all due respect to equity markets, we would suggest the evolving about-face in Fed policy holds unequivocally positive implications for precious metals. Stay tuned!

Sincerely,

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Sprott Asset Management USA, Inc.

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[1] Spot gold is measured by the XAU: The ISO 4217 standard code for one troy ounce of gold, considered as a currency.
[2] S&P 500® Total Return Index represents 505 stocks issued by 500 large companies with market capitalizations of at least $6.1 billion, and reflects reinvestment of dividends. This Index is viewed as a leading indicator of U.S. equities and a reflection of the performance of the large-cap universe. The TR Index represents dividends reinvested.
[3] Sprott Gold Miners ETF (NYSE: SGDM) seeks to deliver exposure to the Sprott Zacks Gold Miners Index (NYSE: ZAXSGDM). The Index aims to track the performance of large to mid-capitalization gold companies whose stocks are listed on major U.S. exchanges.

Two Unique ETFs to Invest in Gold Stocks

Each Index:

- Seeks to outperform purely passive representations of the gold and silver mining industry
- Uses transparent, rules-based methodology designed to overweight gold stocks with attractive investment merits relative to the other stocks in the index
- The stock selection and index weighting criteria were co-developed by Sprott Asset Management, a leading, long-time gold sector investor, and Zacks Index Services

SGDM
NYSE ARCA
Sprott Gold Miners ETF

- Stocks weighted in the index based on quarterly revenue growth and long-term debt to equity
- Reconstituted quarterly

SGDJ
NYSE ARCA
Sprott Junior Gold Miners ETF

- Stocks weighted in the index based on revenue growth and price momentum
- Reconstituted semi-annually

SPROTT ETFs

Sprott ETFs provide investors with access to innovative and unique indexes that are designed to outperform passive market cap-weighted offerings. Each Index is designed using specific **FACTORS** *that* **MATTER**™ for a particular strategy. These customized factors are selected because they have historically shown correlation to stock performance.

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Sprott Gold Miners Exchange Traded Fund

Quarterly Performance as of 12/31/2018

	Cumulative				Annualized		
TOTAL RETURNS	1 Month	3 Month	YTD	Since Inception[2]	1 Year	3 Year	Since Inception[2]
Sprott Gold Miners ETF (Net Asset Value)	15.45%	12.79%	-15.01%	-27.88%	-15.01%	11.69%	-7.06%
Sprott Gold Miners ETF (Market Price)[1]	15.49%	12.25%	-15.12%	-28.04%	-15.12%	11.64%	-7.10%
Sprott Zacks Gold Miners Index (Benchmark)[3]	15.55%	13.05%	-14.36%	-25.50%	-14.36%	12.50%	-6.38%

Expenses as of 03/31/2017

Management Fee	0.57%
Other Expenses[4]	0.00%
Total Operating Expenses	**0.57%**

Sprott Junior Gold Miners Exchange Traded Fund

Quarterly Performance as of 12/31/2018

	Cumulative				Annualized	
TOTAL RETURNS	1 Month	3 Month	YTD	Since Inception[5]	1 Year	Since Inception[5]
Sprott Junior Gold Miners ETF (Net Asset Value)	15.03%	3.80%	-25.66%	5.66%	-25.66%	1.48%
Sprott Junior Gold Miners ETF (Market Price)[1]	15.38%	3.75%	-25.67%	5.74%	-25.67%	1.50%
Sprott Zacks Junior Gold Miners Index (Benchmark)[6]	15.06%	3.98%	-25.20%	9.04%	-25.20%	2.33%

Expenses as of 03/31/2017

Management Fee	0.57%
Other Expenses[4]	0.00%
Total Operating Expenses	**0.57%**

Performance data quoted represents past performance. Past performance is no guarantee of future results so that shares, when redeemed may be worth more or less than their original cost. The investment return and principal value will fluctuate. Current performance may be higher or lower than the performance quoted. Call 866.675.2639 for current month end performance.

1 Market Price is based on the midpoint of the bid/ask spread at 4 p.m. ET and does not represent the returns an investor would receive if shares were traded at other times.
2 Inception date of 07/15/2014.
3 The Underlying Index was created by Zacks Index Services ("Index Provider") to provide a means of generally tracking the performance of gold and silver mining companies whose stocks are traded on major U.S. exchanges. An investory cannot invest directly in an index.
4 Other expenses are based on estimated amounts for the current fiscal year and are calculated as a percentage of the Fund's net assets.
5 Inception date of 03/31/2015.
6 This factor-based Index aims to track the performance of small-capitalization gold companies whose stocks are listed on major U.S. and Canadian exchanges.

IMPORTANT DISCLOSURES & DEFINITIONS

An investor should consider the investment objectives, risks, charges and expenses carefully before investing. To obtain a Statutory Prospectus, which contains this and other information please contact your financial professional or call 1.855.215.1425. Read the Statutory Prospectus carefully before investing.

Sprott Gold Miners ETF and Sprott Junior Gold Miners ETF shares are not individually redeemable. Investors buy and sell shares of the Sprott Gold Miners ETF on a secondary market. Only market makers or "authorized participants" may trade directly with the Fund, typically in blocks of 50,000 shares.

The Funds are not suitable for all investors. There are risks involved with investing in ETFs including the loss of money. The Funds are considered nondiversified and can invest a greater portion of assets in securities of individual issuers than diversified funds. As a result, changes in the market value of a single investment could cause greater fluctuations in share price than would occur in diversified funds.

Micro-cap stocks involve substantially greater risks of loss and price fluctuations because their earnings and revenues tend to be less predictable. These companies may be newly formed or in the early stages of development, with limited product lines, markets or financial resources and may lack management depth.

The Funds will be concentrated in the gold and silver mining industry. As a result, the Funds will be sensitive to changes in, and its performance will depend to a greater extent on, the overall condition of the gold and silver mining industry. Also, gold and silver mining companies are highly dependent on the price of gold and silver bullion. These prices may fluctuate substantially over short periods of time so the Fund's Share price may be more volatile than other types of investments.

Funds that emphasize investments in small/mid cap companies will generally experience greater price volatility.

Funds investing in foreign and emerging markets will also generally experience greater price volatility.

There are risks involved with investing in ETFs including the loss of money.

Diversification does not eliminate the risk of experiencing investment losses.

ETFs are considered to have continuous liquidity because they allow for an individual to trade throughout the day.

ALPS Portfolio Solutions Distributor, Inc. is the Distributor for the Sprott Gold Miners ETF and the Sprott Junior Gold Miners ETF.

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