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PAY DIRT

**Markets at
Crossroads Again
Gold equities on
the Cusp of a Bull
Market**

At Crossroads Again

Markus Bachmann & Douglas Orsmond | 7th February 2020



“Non-QE”
The US Fed’s new
easing program
boosted financial
markets in late 2019

In June of last year, the US Fed hinted at an imminent end to its Quantitative Tightening program. Some weeks before that, we published a [video cast](#) referring to markets being at a crossroads. In spring 2019 equity markets were stuttering, the bond market signalled a US recession and economic fears were widespread. At crossroads the markets were indeed. The US Reserve Bank saved the day and embarked on a rate-cutting cycle. As from September, the Fed abandoned its Quantitative Tightening policy in earnest and commenced aggressively expanding its balance sheet again. These easing financial conditions were a bait that equity markets eagerly swallowed. They rallied relentlessly following the Fed’s “repo facility”.

Gold & Miners:
bottoming phase
completed but not in
bull market - yet

In these conditions, gold’s price pattern is noteworthy. Bullion finally broke decisively out of its 6-year bottoming phase by the middle of last year ([see market comment of 25 June 2019](#)) and has consolidated firmly above its support levels ever since. This price pattern, in our view, is building a strong foundation for the first leg of a sustainable up-cycle with much higher price targets for all precious metals and mining companies. The latter performed well in 2019, a bit short of a 50% return. We don’t regard the miners (or gold for that matter) as in a bull market environment yet. However, it was a curtain raiser for things to come.

In 2020, debt and
external risks may
trigger further
stimulus by central
banks

Into 2020, investors find themselves at a crossroads again. The outbreak of the Coronavirus is exposing the fragile state of financial markets. The pandemic caught most investors off guard. From the backdrop of record high levels in nearly all leading equity indices, widespread nervousness is tangible. At this stage, it is impossible to gauge the impacts of the pandemic but investors will be reminded that previous

outbreaks (SARS pandemic in 2003, H7N9 pandemic in 2013) left their marks on economic growth. Corporate debt levels are at an all-time high and vulnerable to the slightest deterioration of the business cycle. It is a condition that could trigger a pre-emptive response by Central Banks, once again providing excess liquidity and further rate cuts. We don't know how it will play out but it is an environment where many paths lead to gold in investors' asset allocation.

Gold, as well as gold equities, have a low correlation with equities and improve portfolio diversification

Nowadays, gold's position in a well-diversified portfolio is becoming more accepted. The role of gold miners is still often misunderstood and it takes most investors by surprise when they learn about the very low correlation of gold equities to general equities. Similar to gold metal, gold miners play a critical role in a diversified portfolio. The correlation of 0.28¹ to overall equities is amongst the lowest of all sub-sectors in the equity universe. An exposure to gold miners may thus assist in increasing investment returns, improving the Sharpe Ratio and reducing the maximum drawdown of a multi-asset portfolio².

Our [presentation](#) published today revisits the role of gold mining equities in a diversified portfolio. Further, it takes a deeper look at the anatomy of this new cycle in precious metals and miners and explains how the Craton Capital Precious Metal Fund is positioned in this environment. The path into a new up-cycle won't be a straight line but the stage is set.

Dangerous Undercurrents

Paradox of Price Finding

While the Coronavirus understandably is increasing the nervousness of market participants, there are some deeper undercurrents evolving in financial markets that deserve investors' attention. We address these developments in this short market comment. Entering a new decade, financial markets are priced for perfection. Some seasoned market observers describe it as the "Everything Bubble". In our opinion, equity and credit markets are flying too close to the sun.

Markets seem to be ignoring fundamentals in the pricing of equities and credit risk

On the surface and obvious to all, equity markets are on a roll, led by North American key indices. Credit markets continue attracting massive flows in investors' desperate scramble for yields. Given the late stage of the business cycle and a now-tightening credit cycle, extreme caution should be the order of the day. The paradox that started to emerge over the course of recent years is twofold: with regard to equities it is the **finding of the "right price"** by the market and in credit markets it is the **right pricing for the risk purchased**. The two factors are, of course, interlinked and have created a paradox that investors are struggling to come to terms with. But, to put it in simple terms, instead of dealing with the paradox, the markets have decided conveniently to ignore it.

... driven by liquidity injections, low interest rates, ...

Equity and credit markets appear to have strongly delinked themselves from the real world. That delusion is strongly facilitated by two factors: firstly, liquidity injections and artificially low interest rates, provided and set by global central banks; and secondly, market penetration by passive investment. That said this is NOT a call

... and the rising market share of passive investments

¹ Craton Capital calculation, based on Bloomberg data, using weekly returns since 1995 of the MSCI World (and sub-indices) and the Philadelphia Gold and Silver Index (XAU)

² Source: State Street Advisors, 30th of October 2019

alerting to an upcoming possible crash. This would be a frivolous endeavour. But it might be a timely reminder that some deep undercurrent changes are underway. It is impossible to say when they will surface and once they are in play, how exactly they will impact the financial markets. But one senses that markets will, sooner or later, approach a decisive crossroads. In our opinion, equity and credit markets are flying too close to the sun - a risk which any investor should consider in their respective asset allocation.

No Happy Ending

This heading was chosen very reluctantly but alas, with high conviction. Equity markets do not reflect the underlying economic reality any longer. Still, they are priced for perfection. The VIX trades at highly suppressed levels, signalling to investors that everything is perfectly fine. It is not at all. Nevertheless, US Equities and their European brethren move from record high to record high, despite lacklustre profit growth, margin erosion and declining free cash flows. US equity indices in particular, or at least the top level they represent³, are an utter mockery of the guidelines of every valuation rulebook. Yet the market has decided to throw that rulebook away.

Equity markets are priced for perfection, giving a sense of déjà vu for those who remember 1999.

As equities continue higher, the risks of deep disruption rise

All the imbalances, headwinds and risks are well known and still they do not deter investors from chasing equities and yields. The markets are deeply addicted to low interest rates and excess liquidity. Any sober minded investor with some sense and knowledge of history knows that this will not end well. With a view on equities, flows are re-directed to the most liquid and sizeable names in US markets and the rest follow in its path. Those that were involved with financial markets in 1999 and 2007 must be feeling a strong sense of déjà vu, but the associated risks are now participating on steroids.

That said, would it be advisable to short equities at this stage? It would be a complete vanity trade and the answer is a firm "NO". Is it advisable to deploy fresh capital and chase general equities or fixed income investments? Again, the answer is probably a "No". In all likelihood equity markets have not reached peak levels yet and the prospects of further declining interest rates will attract additional flows into fixed income market. The evolving undercurrents are becoming more and more dangerous and the risks of deep disruption are on the rise exponentially.

The Lesser of two Evils

In the current environment, "price finding" in equity markets is no longer working. That is, to some extent, the lesser of two evils. Far more worrying is the lack of "appropriate risk pricing" in global credit markets. Investors will be reminded that all major financial disruptions in recent decades had their origins in debt or to be more precise, too much debt. Government debt as well as corporate debt worldwide continue to accelerate at a rapid pace and the levels are reaching a point where higher interest rates would put servicing the debt in jeopardy. Eventually, the debt will have to be repaid - or at least one would think so.⁴ Given the circumstances it appears highly

While a lack of appropriate risk pricing of the ballooning corporate and government debt is potentially even more worrying

³ 70% of the increase of the Nasdaq Composite since early October is driven by its top 10 holdings.

⁴ There is an increasing mentioning about the possibility of a "debt jubilee". One way to "make" government debt "to go away" would involve some accounting magic by central banks. They could take the outstanding debt on their books and "forget" about it. A significant currency debasement might be the consequence.

unlikely that interest rates will be on the rise anytime soon and the debt bubble will continue to inflate.

The Fire Accelerant – Passive Investments

A nasty fire accelerant to both equity and credit markets is the rise of passive investment. Market observers often point to striking parallels between the market environment in 1999/2000 and today. But there are also significant differences and these are mirrored in the unprecedented penetration of passive investment. During the market crash at the beginning of the new millennium passive investment was still in its infancy. Even during the Great Financial Crisis in 2008 the number of passively managed products was below 2'000. At the end of 2019, that number had increased to close to 7'000 funds, which have penetrated both equity and bond markets globally.

The growth of passive investment has added momentum to markets and exacerbated the mispricing of risk

While there are undisputed advantages of a passively managed fund (low fees) there is also a distinct difference to actively managed mandates. ETF's or Exchange Trades Funds are based on the simplest of all algorithms: investors provide the fund manager with the cash, the fund allocates it across a chosen index. The difference to active management is fundamental. An investment decision is not based on fair value assumption or on future return expectations of a respective company. The quality of the underlying purchase is not scrutinized by a vigorous analysis, it doesn't matter. To put it plainly, the portfolio of an ETF could be executed by a *Drosophila Melanogaster*, more commonly known as fruit fly. The comparison is not far-fetched: over 60% of human genes are fundamentally the same as in these little cute insects.⁵ Concerning fixed income: the fundamental question if an issuer of credit will be able to service the debt, or even more importantly to settle it, is not of major significance. The mispricing of risk is becoming a reality. The market starts to suffer from inattention.

The passive penetration in fixed income markets results leads to inattention to the mispricing of risk....

This would not be a concerning issue if the market share of passive were at a level where the important functions of financial markets, like checks and balances, price finding and the determination of credit risk, still operated effectively. Once passive investment takes over, these mechanisms become less efficient. In the 4th quarter of 2019 this tipping point was reached, in our view.

Tipping Point Reached

The tipping point could be defined as passive investment exceeding 50% of market share. Over 50% passive, the market starts to become discontinuous. In September 2019, this mark was surpassed. Nowadays, 90% of all transactions in US equity markets involve a passive entity.⁶ As a percentage of managed assets, over half is now controlled by passive mandates. As ETF's continue attracting massive inflows (and active managers lose assets under management) markets, propelled by large caps, will move higher. It is not the economy that matters, it is not the profit outlook that defines an investment decision - it is a simple liquidity game. As long as the liquidity keeps on coming, equity markets will go up and bond markets will thrive.

Passively managed assets now outweigh actively managed assets in many markets, notably in US equities...

Brakes Untested

So why worry? Because one should and there are too many warning signs to be ignored. The passive penetration will not pass, but the concentration of a massive

... which could accelerate selling pressure when markets turn downwards

⁵ To the disappointment of many, humans are closely related to fruit and vegetables as well. About half of the functions that take place in a banana are fundamentally the same as the chemical functions that take place in a human body – we digress....

⁶ Mike Green, Logica Capital Advisors

share of managed assets in the hands of mainly 3 major providers (USA) should put every compliance department and every regulator on red alert. A big unknown is how the market will react to possible outflows from passive funds. Ten years of a bull market and a meteoric rise in assets under management haven't tested the brakes of indexed funds. Some market observers offer a stern warning, where outflows could trigger a snowball effect that turns into an avalanche of selling. Who will be the marginal buyer IF passive funds have to sell, now that they risk becoming The Market, due to their increased market share? Investors also have to be aware of multiple crossholdings that will accelerate the potential selling pressure: Microsoft (and many other stocks) forms part of multiple strategies, parcelled into layers of passive vehicles. Microsoft is included not only in a plain vanilla index tracker, it is also an integral part of tech ETF's, dividend yielding ETF's, value ETF's, growth ETF's and the list goes on. It resembles adultery, where the more affairs the delinquent enjoys the bigger the risk of being caught – with the consequences that come with the territory.

A further danger looms from short sellers that could function as a massive fire accelerant to the market. The size and the positioning of each ETF is public information. The flows – subscriptions and redemptions - can be established instantly and if the trend changes into net outflows, it won't escape the attention of short sellers and hedge funds. Many investors believe that they are making a safe choice by choosing an index fund. But there is an increasing possibility that passive funds will face the full brunt in an accelerated downturn. The ballroom floor is becoming very crowded and the exit doors have not increased in size or numbers.⁷

The Orchestra Still Plays

Global equity markets were relentless in their advance since the beginning of September. The rally coincided with the well documented problems in the US Repo market. The US Fed tried to tame any potential negative fallout by accommodating the market with a sizeable facility, also resulting in a significant increase in its balance sheet. The Fed refuses to call it QE but the market does. Via mechanisms rather opaque to most, the proceeds of the facility seem to have found their way into Wall Street's prime brokerage houses (hedge funds are regarded by the Fed as a systematic risk). That seemed to have initiated the "risk-on" trade that propelled many of the go-to stocks to new all-time highs. Hedge funds buying lead the way and general money followed.

Removed from Reality, But Dangerous Going Short - Yet

Apple is probably the most represented "ETF stock" and its share price increased by 52% from the beginning of September to February 4th - notably in absence of any significant catalysts. Tesla is a company that many investors love to "hate" and has a fair amount of outspoken short sellers going after it. The period between September and now won't be fondly remembered by those holding a grunge against Mr Elon Musk, as the share price "exploded" by over 290%.⁸ On the other hand, we understand some of the rationale why investors shorted the company: it is an enterprise that hasn't made yet a profit, although it trades at a market cap of over \$100 bn. Its market capitalisation per car sold is over \$420'000 per vehicle, around 32 times that of Volkswagen at \$13'000, while VW also produces electric vehicles. Rio Tinto is one of the world's largest mining companies and does some of Tesla's "dirty" work by

The central bank fuelled liquidity mispricing is evident in Q4 2019's surge in some high-profile shares, such as Apple and Tesla

⁷ To further illustrate the risk: it has never happened in history before, but the S&P 500 had 3 down days in that past 15 months where ALL of its components were negative!

⁸ Short covering has been a contributor to Tesla's meteoric rise

producing critical metals required for the fabrication of electric vehicles. It is trading at a bit more than half of the to the market capitalisation⁹ of Tesla but actually makes money. RIO generates a Free Cash Flow of 5.4 billion dollars and a similar amount of dividends to shareholders. In 2019 it also transferred a not insignificant amount of tax payment to the respective receiver of revenues. The example of Tesla shows the perils of shorting a company on perceived fundamentals whilst the market is washed with liquidity.

Parallels to 1999?

The liquidity-propelled freight train might derail any short selling attempts until it hits significant resistance. Exactly that happened in March 2000. In a notable parallel to today, the Fed provided the market with a “Y2K” facility, increasing its balance sheet by 13% in the second half of 1999. The market at the time appeared less concerned and aggressively bought any risk asset they could get their hands on. The Nasdaq Composite rose 83% between October 1999 and early March 2000, before moving into meltdown mode. The Fed pulled the rug, the Y2K facility had to be paid back by mid-February 2000. Once the liquidity was withdrawn from the market, the end of the bull market was near.

Similar Fed fuelled liquidity saw the late 1999 rally – which did not end well when the liquidity was withdrawn in early 2000

Consider Insurance: Gold & Miners

It is impossible to predict how this is going to end. There are many potential catalysts that could turn into game changers and rapidly deteriorating conditions in financial markets. There will be attempts by Central Banks to keep the show going. However, equity markets and bond markets are priced for perfection and the resilience of the markets will be tested in earnest in the months ahead. It is imperative for an investor to consider portfolio protection and diversification into low correlated assets.

Portfolio diversification is imperative, now that equities are priced for perfection.

An asset that offers all the necessary attributes is physical gold. Its role is tested and proven. Its attributes are the perfect complement to a well-diversified portfolio. Undoubtedly bullion has its up -and down days, but gold in its unique function assists to stabilize (sometimes even to increase) investment returns, it helps to improve the Sharpe Ratio of a portfolio and contributes to reduce the maximum drawdown. Historically, gold has a low or even negative correlation with most other asset classes. We would like to add that we currently like all white metals as well: silver, platinum, palladium and rhodium, although that view is based more on fundamental, supply-demand considerations rather than long-term macro-economic or portfolio construction aspects.

Gold's low correlation with equities provides useful portfolio diversification

We note that gold mining shares provide similar portfolio diversification benefits as physical gold. Their correlation with equity indices, while not as low as gold's, is still well below most other equity sectors. Gold mining shares thus offer both the advantage of equities (business growth, cashflow, dividends etc) but also some of the low correlation benefits to portfolios which gold brings. Investing in the sector is like buying insurance against market and macroeconomic downside (ie gold) but also keeping some of the upside of the market, business growth etc (equities). In addition, the sector currently offers a compelling investment case on its own, with strong arguments that it is cheaply priced against historical values and the indications of a new up-cycle for gold developing.

Gold equities also have low correlations, offering similar diversification benefits as gold

⁹ At the writing of the first draft of this comment, Rio's and Tesla's market capitalisation were similar....

We have also published a presentation today. In it we illustrate the important role that gold and gold equities have in portfolio construction, where we are in the current cycle for the sector, the return potential of gold miners in an up-cycle and how the Craton Capital Precious Metal Fund is positioned to benefit from that move.

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