

The Crisis in Japan and the Impact on the Precious Metal Markets

“The members of Craton Capital would like to express their deepest sympathy to all people affected by the Japanese earthquake and the aftermath tsunami. We salute the courage and the dignity shown by the Japanese people in this current crisis.”

Dear Investors,

Weakness is strength

Whilst the world and Japan are still coming to terms with the consequences of the earthquake and the following tsunami as well as the risk of a meltdown of nuclear power facilities, global equity and currency markets are starting to reflect concerns and increasing volatility.

We would like to focus our comment on the potential impact of the current situation on precious metals as an asset class as well as on precious metals equities.

The immediate reaction for physical gold and silver on the day the earthquake and the tsunami occurred (Friday, the 11th of March) was that of a strengthening of both metals. Since the beginning of week and at the time of writing, all precious metals are coming under considerable pressure. The selling pressure emerges for different reasons but the pattern is a rationale and explainable one. Gold's current weakness is its strength. It is a misperception to assume that gold's role in a time of uncertainty and crisis is that of an improving asset class. Its towering role is that of a source of immediate liquidity, 24 hours a day, 7 days a week. It is not a surprise that from the background of a rampant declining Japanese stock market and pressured global equities, the need for cash as a rapid source of liquidity is urgent. Gold fulfils this role perfectly - as it did during the financial crisis of 2008.

“In times of crisis gold is destined to be under pressure. That is why a lot of investors hold gold, as a source of reliable liquidity in times of dire need. A price under pressure in troubled times does nothing else than highlighting the true character of gold as an asset.”

The pressure on the physical metal may well continue – at least in the short term. With global markets under pressure, the need for margin calls for investors could further

increase. It is also realistic to expect that outflows of gold, silver, platinum and palladium in their ETF's could further accelerate the short term selling pressure on the metals. That pressure has the potential to persist as long as the visibility in global financial markets remains low. However, the underlying investment case for precious metals going forward remains strong and should be borne in mind by investors with a time horizon that exceeds a couple of weeks.

Precious metal equities will not escape the current selling pressure. While they produce a "safe haven" product such as gold, they are perceived as a risk asset being an equity investment and hence they will not be able to escape the general selling pressure on all "risk assets" as long as volatility and uncertainty in global financial markets (measured by the VIX and the MRI) are on the increase.

The cautious investor will always be aware that the valuation of a company is also a function of its (the company's) price and the number products it can produce (and sell) and the respective costs in doing so. In the particular case of gold equities it is also a function of its unhedged resources in the ground. Despite the very volatile market conditions it will be a fair assumption that no gold company in our investment universe will produce or sell a single ounce less than before the earthquake. It is also fair to expect that the costs in doing so will not accelerate exponentially. Hence it is also fair to assume that the economic value of the companies that we invest in is not impacted negatively. Market forces might well drive the prices of the equities down but not the intrinsic value of these companies. Valuations of gold equities were on numerous metrics highly attractive before the general market sell-off and they are even more so now.

We would also note that in comparison to equity markets, global credit markets remain relatively calm. A reliable indicator for risk perception on the inter banking market is the TED spread and the current level of 22.5 bps indicates that the credit flows and the (counter-party) risk perception in global credit markets remain at non-panic levels. This is a critical and often overlooked condition as global credit markets provide the cash to the real economy as well as indirectly to equity markets. Taking guidance from these indicators one can conclude that the current violent moves are of temporary nature and the volatile situation in financial markets will stabilize.

With regard to commodity markets and precious metals and gold equities in particular one can also take guidance from events and the established blue print of the financial crisis of 2008. We would highlight that at this stage the severity of the financial impact cannot be compared, but there are similarities: gold sells off in times of a crisis. Gold equities being risk assets follow through. But it should be also kept in mind that every crisis offers opportunities, meaning the chance to acquire mispriced assets. The cautious investor should be cogniscent of these opportunities whilst following the development in financial markets over the coming days. From that perspective the Craton Capital Precious Metal Fund must be on your radar screen, more than ever.

We receive a lot of enquiries regarding the commodity price outlook in the context of current events, both in the Middle East as well as in Japan. It is premature to predict to what extent the earthquake and the tsunami will impact the global economic recovery and hence commodity prices. Question is also if it will impact it at all. The devastating destructions directly impact some 20 % of Nippon's population and an estimated 17 % of GDP. We do not doubt for a moment that Japan will get back on its feet and despite its huge national debt burden and other challenges this great nation will rebuild what has been destroyed. Our esteemed colleagues from MRB partners summed it up by commenting that "natural disasters destroy existing wealth within a nation but can lead to a substantial increase in economic growth due to reconstruction efforts in months and years following."

Markus Bachmann

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