Sprott Silver Equities Class

February 2018 Commentary

The calm of the equity markets across the world was rudely interrupted by a sudden spike in volatility, which impacted virtually every asset class. Volatility across equities, bonds, currencies and commodities all rose sharply in February and remain elevated into March. For the month of February, the Sprott Silver Equities Fund lost 3.65% versus the MSCI Silver Select Index, which declined 4.36% in the same period. Precious metals and gold bullion in particular, measured in U.S Dollar terms, remained surprisingly resilient through February, losing only 1.22% of its value over the course of the month. Due to the high degree of correlation between gold and silver, the lack of volatility in gold merits further discussion and we will touch on this topic later in our commentary.

Investment Team

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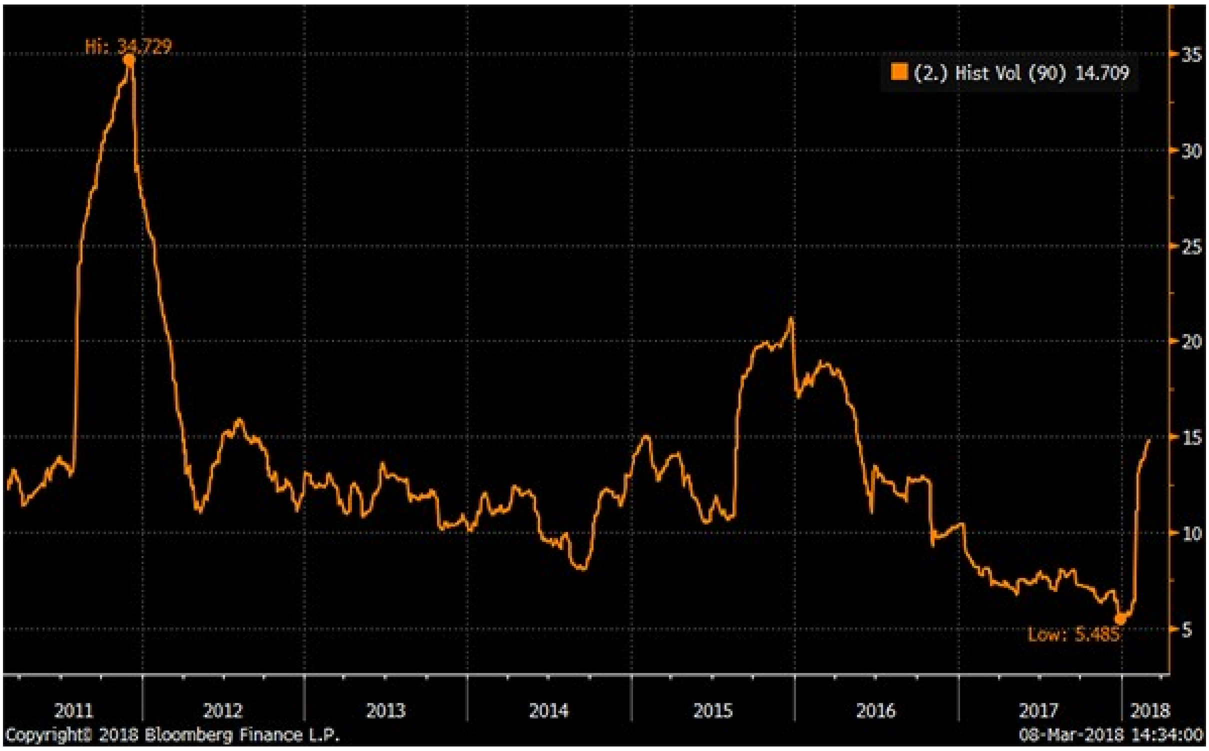
The three largest contributors to February fund performance were Silvercrest Metals, Tahoe Resources and Cia de Minas Buenaventura. Silvercrest announced a maiden resource estimate on its high-grade Las Chispas project in Mexico. The resource estimate focused on an estimated 3.5km of a known 12km of cumulative vein strike length in the district. Four additional veins have only been partially drill tested and were not included in the maiden estimate, plus ten other veins are still to be drill tested.   Tahoe rallied on the back of increased market expectations that the Company will be able to re-open its Escobal silver mine soon. However, Tahoe suffered a setback in March announcing that they received a request from the Constitutional Court of Guatemala for additional information in the legal case regarding Minera San Rafael's Escobal mining license. Buenaventura reported 2017 earnings and a strong 2018 outlook - the Company is forecasting growth in gold and silver production at its mines.

The three largest detractors from February performance were Wheaton Precious Metals, Industrias Penoles and Fresnillo Plc. Wheaton Precious underperformed despite First Majestic acquiring Primero Mining and its Mexican San Dimas mine. The deal removed the overhang on Wheaton Precious from Primero's potential bankruptcy and restructured silver stream on San Dimas. Penoles reported strong Q4 results, but corrected after performing well in December and January. Fresnillo reported solid fiscal 2017 results with strong cash flow, but disappointed the market with capex deferrals and downgrades to its medium-term production growth profile. Fresnillo is a very good operator and, in our view, is being prudent by controlling its expenditures at the expense of growth.

The month of February provided a wake-up call to the markets as the period of historically low volatility came to an abrupt end. Investors had grown accustomed to the lack of volatility in equity markets over the course of the past 15 months. The chart below illustrates the realized volatility on the S&P 500. Realized volatility (using a 90 day running average) in the S&P 500 has averaged 13.4% since 2011. The December 2017 low of 5.49 was one for the history books and to put this into context, equities were acting as benignly as investment grade bonds!

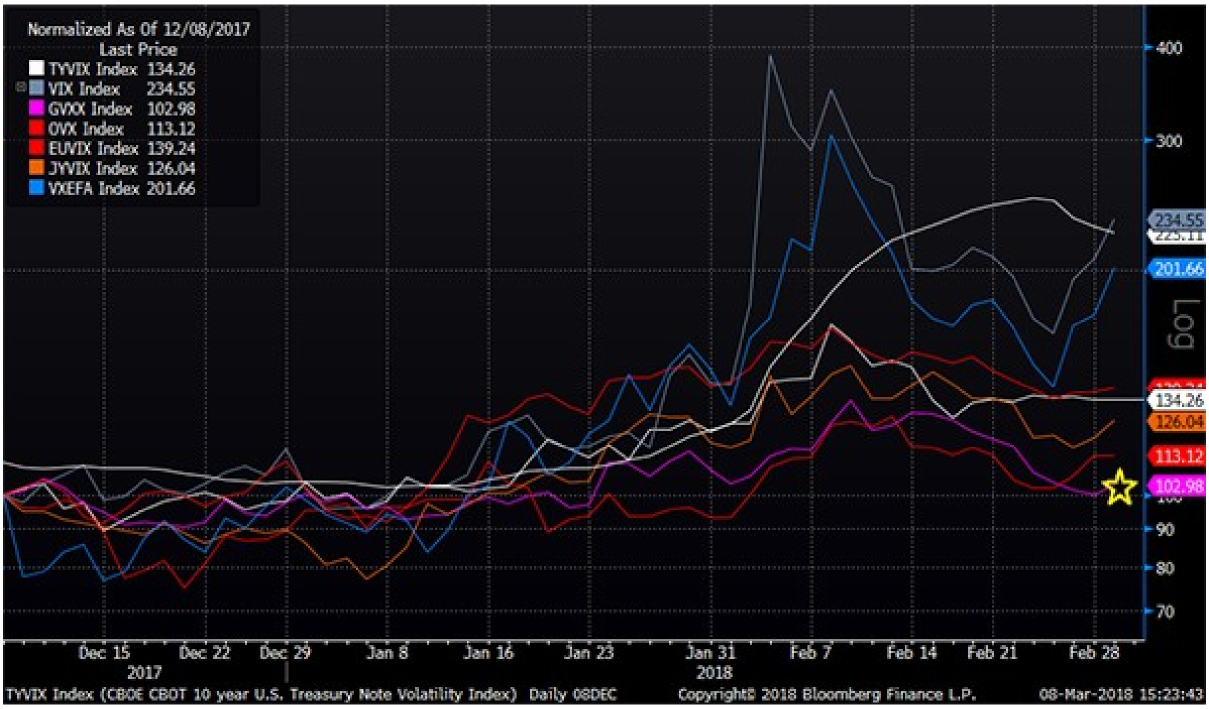


Source: Bloomberg

Since 2011, the widely followed VIX index has averaged 16.3. As central banks begin to reduce their balance sheet holdings and raise short-term interest rates, risk premiums across asset classes should normalize and so will volatility. At the time of writing, it sits at 16.9. Volatility has simply reverted back to its mean while the environment of exceptionally low volatility is likely behind us.

At Sprott, we have long been proponents of holding precious metal bullion and equities as a portfolio hedge against general market volatility and the events which transpired in February underscore our point even further. Volatility across many asset classes, including North American equities, global equities, treasuries and currencies rose in February and remain elevated today, with the single exception being gold bullion, which saw its volatility move by just under 3%. In the same time-frame other asset classes saw their volatility increase by as much as 235%.

Precious metals equities were affected by the general equity volatility and sold off in February. This was to be expected. However, the profitability of precious metals equities is predicated on bullion prices, and with bullion prices remaining firm and maintaining their uptrend there has been no change in the fundamentals of gold equities. In fact, we have pointed out in our previous notes that while gold bullion has continued to climb, the vast majority of precious metals equities have lagged the metal. Indeed, gold equity valuations sit at levels we have not seen in our careers and we posit that it is a matter of time that these valuations normalize.



Source: Bloomberg

As market volatility rises, investor complacency falls. As complacency falls, investors begin paying attention to developments, especially those which have the potential to have an impact on the economy and on the markets, both positive and negative. We would argue that the weight of negative factors which can lead to further market declines over the medium term continues to rise. Our colleague, Trey Reik, who writes with much more eloquence than I ever can, just published a note titled, "Oopsie Daisy! Equity Markets Stumble in Early February". We would strongly encourage our clients to read his note as it does a wonderful job of summarizing the build-up of factors which are negative for both the equity and bond markets including rising consumer stress, rising equity market stress from higher rates and last but not the least, the ballooning U.S. fiscal debt.

The declining U.S dollar and rising inflationary pressures continue to provide a favorable tailwind for gold. Gold's relative lack of volatility has not gone unnoticed by investors and this has begun to attract investors into the space. While large ETFs such as SPY and EFA have seen billions in outflows over the past few weeks, money has begun flowing back not only into the SPDR Gold ETF (GLD) and VanEck Vectors Gold Miners ETF (GDX) but also the iShares Silver ETF (SLV). We would encourage others to look into precious metals equities space. You would be surprised at how profitable some of these companies are with gold above $1250/oz and silver above $16/oz.

[1] All returns and fund details are a) based on Series F units; b) net of fees; c) annualized if period is greater than one year; d) as at February 28, 2018; e) 2012 annual returns are from 02/28/12 to 12/31/12. The index is 100% MSCI ACWI Select Silver Miners IMI (CAD) Index and is computed by Ninepoint Partners LP based on publicly available index information.

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