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The Southbank

Private Briefing

Beta

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- **What "misery" hath the EU brought**
- **The Bank of England digging a deeper hole**
- **British banks are lending less, but deposits steady**
- **China sends silver higher**
- **The future of robots is people**
- **The Filipino 'Donal Trump' trade**
- **Expert: How to profit in gold stocks**

Henry Bonner

In this week's edition of the *Southbank Private Briefing*, we'll be introducing one of the newest analysts in our *MoneyWeek* team. His name is Eoin Treacy, and he's the investment director of *Frontier Tech Investor* and *Trigger Point Trader*.

Eoin Treacy lives in the San Francisco Bay Area, California, where he keeps in close personal contact with technology startups and entrepreneurs who are working on breakthrough innovations…

As a long-time account manager at Bloomberg, he became deeply involved in market data and analysis… leading to his co-authoring the book *Crowd Money*, which describes how to use data in order to study markets.

Today's briefing contains Eoin's take on the new robotics revolution, followed by an opportunity he sees in one small Asian market today.

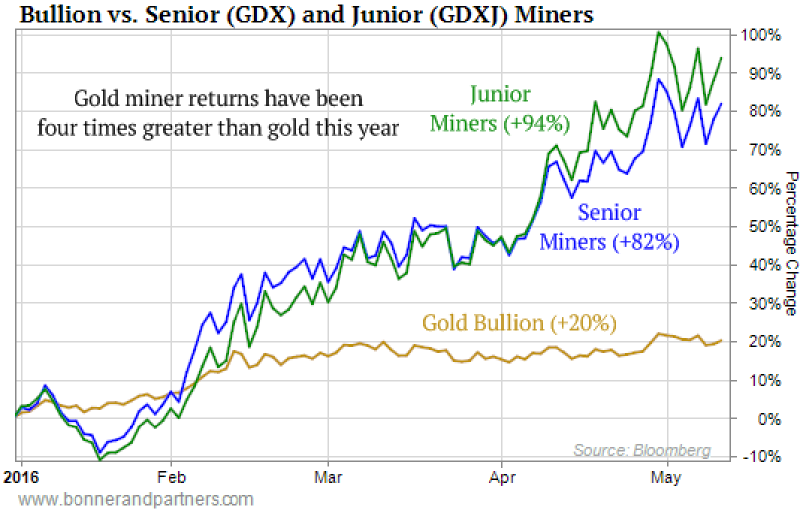
But first, we'll share with you a few choice questions and answers from Boris Johnson's *MoneyWeek* interview. The departing London mayor gave a special interview for magazine subscribers, which was published last week. He gave us a fairly in-depth take on Brexit, which we've supported.

One commenter said the interview made Boris seem more likeable… while others cursed us for taking sides in the political battle. Tell us what you think by emailing me at henry.bonner@moneyweek.com.

We've included excerpts from this week's *London Investment Alert* and *The Fleet Street Letter*. You might see some competing ideas between our two lead experts… Tim Price believes that markets in stocks and bonds are fundamentally overpriced – and that we are approaching a correction.

Charlie Morris, on the other hand, is beginning to see stability. As he reveals in today's update, "my research shows that UK banks are largely fixed."

Bullion vs. Senior (GDX) and Junior (GDXJ) Miners



He goes on to show how bank loans outstanding have dramatically decreased and deposits have held steady – making bank balance sheets more secure.

We'll end this edition with a timely interview with a gold stock analyst from our global network. Louis James is an investment strategist with Casey Research. Louis has recently logged gains of 164%, 131%, 85%, and 91% on precious metals recommendations…

The following chart, courtesy of our friends at Bonner & Partners, shows how junior gold stocks are beating gold bullion by an astonishing 74% so far this year. Louis James tells us how you make money with gold stocks in this special interview.

Read on for this week's full issue… and please send us your feedback. Tell us what you like – and what we should change.

Boris Johnson: "economic misery" and "division" brought by EU…

Charlie Morris, *Fleet Street Letter*

London ex-mayor Boris Johnson sat down with Merryn Somerset Webb, *MoneyWeek*'s editor-in-chief, for a full interview, which appeared in last week's issue. Here are some of the most important answers he gave…

What's the biggest downside for UK companies, and hence investors, if we vote to leave the EU?

I can think of only two British industries that may suffer a significant loss of business if we leave – lobbyists and lawyers. Brussels is a goldmine for them. But they are fields where Britain leads the world and I am sure they will find new clients easily. Most businesses in this country will thrive. We will be free to run our worldwide trade policy rather than having to subcontract it to the EU. We will be able to reclaim our £350m-a-week membership fee to spend on our own priorities. The City will be free of the ever-present threat of hostile financial regulation. I am tempted to say that the only thing British companies will have to fear is fear itself.

Is the eurozone doomed regardless of our vote?

Just when you think there is light at the end of the eurozone tunnel, the single currency always turns into a tunnel-building machine. We are now facing another blow-up of the never-ending Greek disaster along with an Italian banking crisis. I am not going to forecast how and when the eurozone crisis will end and if the single currency will survive in its current form. But some things are clear.

We know the euro has brought crushing economic misery, resentment and division to wide swathes of Europe. And we also know very clearly how the EU wants to get out of the crisis – by the same old discredited methods of centralisation, with full economic, fiscal and political union of the eurozone. It is impervious to calls for a change of direction.

If we stay in, we will be outside the new eurozone pseudo-state where the key EU decisions will be taken. We may have some powers to block the most damaging proposals, but we will have little opportunity to influence positive change and will remain subject to all the strictures of the EU.

How hysterical should the City be about Brexit?

The hysteria comes from the people who do the City down. They are the people who told us that if we stayed out of the euro, it would be decimated and we would hear the giant sucking sound of jobs going down the plughole from London to Frankfurt. Of course, they had said the same thing earlier about our membership of the exchange-rate mechanism. When we crashed out of that we had our longest-ever period of economic growth. Now they are at it again. We should ignore them.

I have every confidence that London will thrive outside the EU. It is the financial capital of Europe, if not the world, with an unrivalled concentration of talent, firms and markets, together with a business-friendly tax, legal and regulatory environment. No European country would cut its firms off from this astonishing resource. Look at the letter signed by more than 100 heavyweights in the City who said that outside the EU London would be "most likely to strengthen its lead as the world's largest international finance centre".

For the City as for the rest of Britain, staying in is the risky option. As those City heavyweights say, Brussels "represents a genuine threat to our financial services industry". The safe option is to Vote Leave.

There is no endgame

Tim Price, *London Investment Alert*

With hindsight, 1981 was the best of times to be an investor… Less than two years earlier, BusinessWeek had published its infamous “The Death of Equities” front cover. With hindsight, that cover should have read “The Birth of the Strongest Bull Market in History”.

In 1981, five-year US Treasury bonds yielded 15%. (They now yield 1.2%.) Stocks were reviled. You couldn’t give them away. It was a great time to be an investor. You just didn’t realise it at the time.

The legendary investor Sir John Templeton once observed: “The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell.”

1981 was that time of maximum pessimism. Almost anybody with the constitution to buy either stocks or bonds enjoyed some of the best returns in market history… But right now, we’re living in a “mirror image” of 1981 (see fig. 1). And if 1981 was the “best of times”, how could 2016 be a good time to invest?

That’s how Stanley Druckenmiller, lead portfolio manager for the legendary Quantum Fund alongside George Soros, recently explained his view at a swanky investment conference in New York:

“[In 1981] we were setting up for one of the greatest bull markets in financial history as assets were priced incredibly cheaply to compete with risk-free rates… the 15% hurdle rate forced corporations to invest their capital wisely and engage in their own structural reform.

“If this led to one of the greatest investment environments ever, how can the mirror of it, which is where we are today, also be a great investment environment?”

Fig. 1: 5-year Treasury yields (grey) and the S&P stockmarket index (blue) since 1966

Druckenmiller was merciless towards the Federal Reserve (emphasis added):

> “**The [US Federal Reserve] has no end game. The Fed’s objective seems to be getting by another 6 months without a 20% decline in the S&P and avoiding a recession over the near term.** In doing so, they are enabling the opposite of needed reform and <u>increasing</u>, not lowering, the odds of the economic tail risk they are trying to avoid. **At the government level, the impeding of market signals has allowed politicians to continue to ignore badly-needed entitlement and tax reform.**”

I agree with Druckenmiller.

Central banks today have no endgame. They lurch from one failed experiment in stimulus to another. All objective evidence suggests that this stimulus has

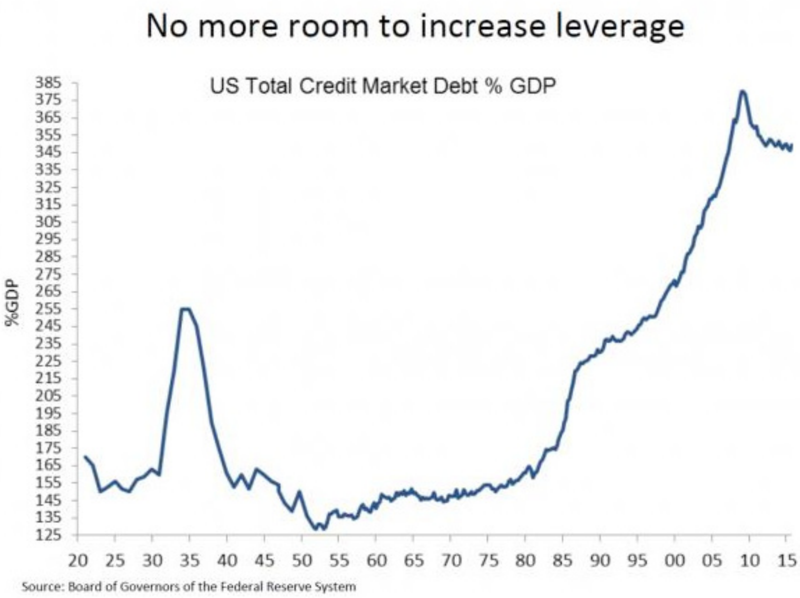


Fig. 2: Total US credit market debt as a percentage of GDP since 1920

a very short-lived impact on the financial markets and none whatsoever on the productive economy.

Western companies are borrowing money just so they can buy back their own stock. This desperate exercise in financial engineering isn't limited just to the US… Here in the UK, GlaxoSmithKline made £1.9 billion in cash from operations in 2015 but paid out £3.8 billion in dividends.

The scale of the borrowing is so extreme that our central bankers are now running out of road (see fig. 2).

This means, for savers, pensioners and those living on fixed incomes, that if interest rates go lower, their propensity to save more actually rises – because their existing savings aren't yielding them enough.

What should you do in the face of this warning? Here's Druckenmiller again (emphasis added):

> "On a final note, what was the one asset you did not want to own when I started Duquesne in 1981? Hint… **it has traded for 5000 years and for the first time has a positive carry in many parts of the globe as bankers are now experimenting with the absurd notion of negative interest rates. Some regard it as a metal, we regard it as a currency and it remains our largest currency allocation."**

Druckenmiller is talking about gold.

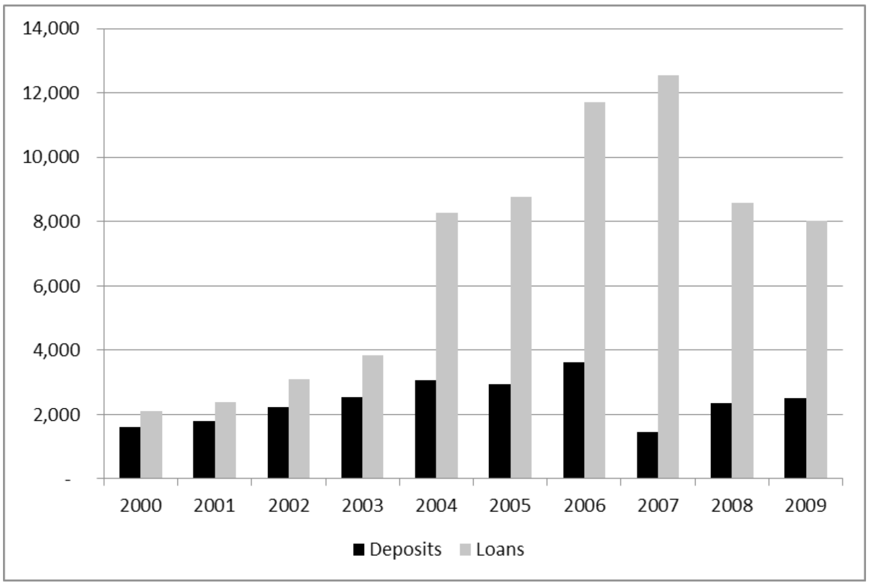
I completely agree with Druckenmiller about the merits of owning bullion today. The savings that I don't hold in my fund are invested in gold.

Nobody rings a bell at the top of the market. Or do they?

British banks are safer than you think…

Charlie Morris, *Fleet Street Letter*

Northern Rock lent money it didn't have



Source: Bloomberg

British banks collapsed in 2008. They were lending aggressively in the run up and have paid the price since. They've spent the last eight years repairing the damage.

You might be surprised to hear this… especially since all the news that you read about British banks is negative.

By my research shows that UK banks are largely fixed. Their balance sheets have been repaired.

I'll now show you Northern Rock. In 2000 its loan book extended to 130% of deposits. Then it discovered the art of the impossible. It grew its loan book with disregard for its deposit base.

You'll see that Northern Rock grew its loan book by nearly six fold between 2000 and 2006 while its deposits only doubled. At the end of 2006 its loans were 324% of its deposits.

This is possible because the banks were able to take advantage of wholesale funding. That is cheap money that was available to the banks on a short-term basis. It worked well until the money markets dried up.

As customers lost confidence, there was a run on the bank in 2007. Loans didn't grow much that year. However, at the depths of the crisis, deposits collapsed. That resulted in its loans peaking at 857% of its deposits. Since no credible buyer could be found, a government bailout was the only option.

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The money markets

Northern Rock faced a liquidity crisis because its business model relied on wholesale funding. You simply can't lend multiples of your deposit base, as it did, without the money coming from somewhere. It came from the money markets – a source of short-term cheap financing that was available to the banks. Had the money markets continued to function, Northern Rock might have carried on trading to this day.

But they did dry up. The model of lending over the long term, and borrowing over the short term, was unsustainable.

From 2007, a liquidity crisis began. Week by week, you could see the value of these securities fall. The system was slow to react because it was unknown by most people, including the regulators, just how vast this new world of low quality lending had become.

Life after a banking crisis

Once it's over, it's over. The banks went into a sharp reversal of strategy from 2009.

In the case of RBS, assets and liabilities grew rapidly until 2007. It had expanded its loan book by four-fold. At its peak, RBS had a balance sheet that was greater than Britain's GDP.

Notice that since 2014, deposits have once again exceeded loans. That's the first time since 2001 that we have seen the return of old fashioned banking.

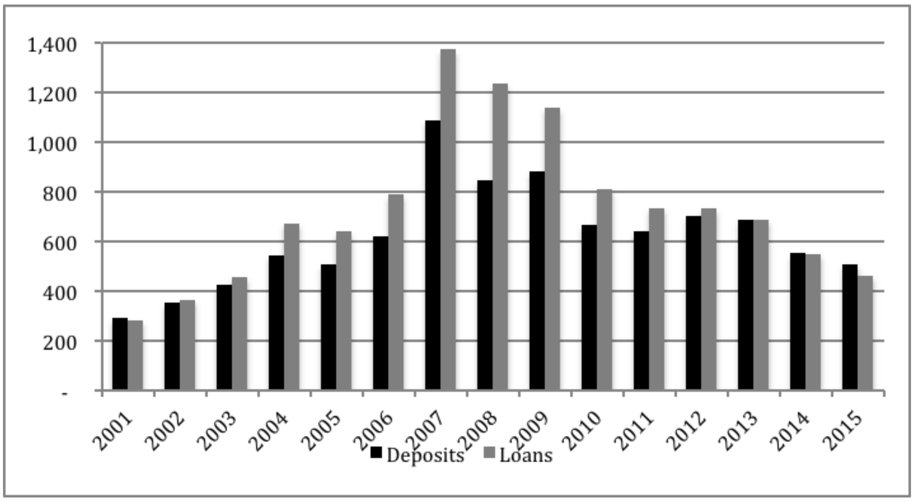
This is a strong indication that the bank is on a much more stable footing than it was eight years ago.

A quick way to determine the strength of the banks is to look at the credit markets. They show you how much it costs to insure a bond against default. A low reading implies good credit worthiness and vice versa. Here are the credit risk readings for the biggest banks in the UK:

HSBC	0.92%
Lloyds	0.93%
Barclays	1.14%
RBS	1.16%

In Britain today, HSBC and Lloyds are deemed to be the safest. RBS and Barclays are deemed riskier. To put the banks' creditworthiness into context, Vodafone has a CDS of 1.00%, BT 0.86% and Rio Tinto 2.03%. Pre-crisis the banks were priced as if they were risk free. Post-crisis they rank alongside traditional blue chip stocks.

It's back to 2003 for RBS



Source: Bloomberg

Why silver is flying higher

Simon Popple, *Metals and Miners*

In a word – China.

Fig. 3 is a graph depicting the massive growth in Shanghai Futures Exchange silver stocks.

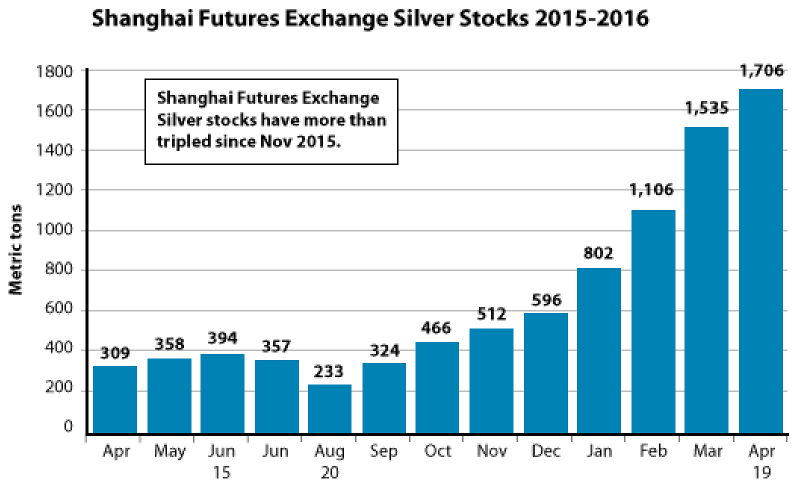


Fig. 3: Shanghai Futures Exchange Silver Stocks since April 2015
Data sourced from: Steve St. Angelo and the SRSrocco Report

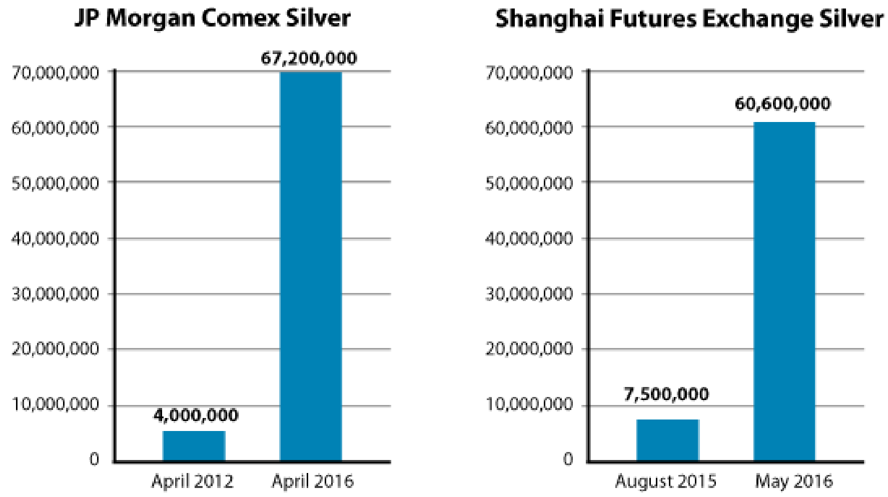


Fig. 4: JP Morgan Comex silver inventory in April 2012 and April 2016; Shanghai Futures Exchange silver inventories in August 2015 and April 2016
Data sourced from: Steve St. Angelo and the SRSrocco Report

Shanghai Futures Exchange (SHFE) silver inventories bottomed on 20 August 2015 at 233 metric tonnes (mt), or 7.5 million ounces (Moz). This was a sign of low buying appetite for silver.

The silver price bottomed around six months later at around $13.80 per ounce. It's risen to around $17.50, a 27% move since January.

Silver inventories at the SHFE began to pick up in 2016 as they surged to 802 mt in January from 596 mt in December. This snowballed to 1,706 mt by 19 April – that's huge growth over a very short period of time. Inventories tripled in less than six months.

To put this into perspective let's compare it to JP Morgan, which is the largest bullion bank in the Comex futures exchange.

JP Morgan is a major player in the bullion market. In April 2012, JP Morgan had about 4 Moz of silver inventories in Comex warehouses. Today, that figure is around 67.2 Moz.

As you can see (fig. 4), it took four years for JP Morgan to build its silver inventories from 4 Moz in 2012 to 67.2 Moz today.

In contrast, SHFE silver stocks jumped from 7.5 Moz to 60.6 Moz in **only eight months**.

If this demand continues for much longer and since the silver supply is relatively inelastic, I would expect the silver price to continue on its upward trajectory.

When people and technology merge

Eoin Treacy, *Frontier Tech Investor*

The robots of the future will work with us, not replace us altogether.

Human and machine collaboration is something we've taken for granted since we first discovered how to make fire. For instance, a computer can beat a grand master at chess. But pair a machine and a human together on the same team and they'll beat a computer operating alone.

The same principle is true across the board. It's known loosely as assistive technology – using robotics to work with us, to integrate with our lives and help us do things that are impossible for us alone.

Assistive technology helps us to do things we might not otherwise be able to do. In that regard it might be a robot, but it is not that different than a vacuum cleaner or car.

It is simply a tool that allows us to be more productive. In much the same way that a car can be used to run people over, it is primarily used as an indispensable mode of transport. The vast majority of robots will be the same.

Robots are beginning to walk out of the lab and into our homes, and with scale prices will come down. They will always be a premium product, but right now costs are in the area of $750 to $2,500 which is not beyond the means of most middle income consumers. Right now these kinds of robots are handy gadgets only the most technologically addicted are likely to pay for. Their utility will improve, however, as they become health companions; monitoring not only facial features but our vital signs too. As early as 2013 Microsoft's Kinect sensor could read your heart rate from four feet away.

It's not much of a leap to expect companion robots to be able to do the same thing in the not too distant future.

Filipino "Donald Trump" creates a rare opportunity

Eoin Treacy, *Trigger Point Trader*

[Ed Note: This article is just for Premium subscribers. Trigger-point Trader is a service that looks for short-term trades with a specific 'trigger' to drive a stock or a market higher].

Most people's first interaction with the Philippines is when they visit the hospital and their nurse or radiologist is Filipino. If you take a cruise, the chances are a solid proportion of the crew will be Filipino. If you visit the Middle East many of the people in the service sector are Filipino. Many of these people work hard all over the world and send money back home. As a result, the Philippines are one of the biggest beneficiaries of remittances in the world. It's worth over $25 billion a year, which represents more than 9% of annual GDP.

In many respects, the Philippines are like Ireland before it quickly evolved into a developed country. It has a large overseas diaspora sending money home. It is one of the few countries in the region with a large, young English-speaking population. It has been developing a manufacturing sector and has benefitted from the offshoring of call centres and other services. Governance has always been an issue, and that has held the economy back while its regional neighbours took off.

The last decade represented a boom for the market as commodity prices took off and domestic incomes rose, which allowed consumer spending to rise. The popping of the commodity bubble in 2013 saw the peso lose 13% of its value, which is a substantial devaluation but modest compared to the havoc it played on neighbouring currencies. Remittances play an important role in the resilience of Filipino consumer spending and help to fund education.

The challenge has been to stop the brain drain. The Philippines spends so much money to educate nurses and healthcare workers, only for them to emigrate. Improving standards of governance, which would allow people to realise their productive capacity at home, rather than abroad, was the missing ingredient for a long time.

The aftermath of the Marcos dictatorship 30 years ago left the country in the grip of a powerful oligarchy and one of the highest poverty rates in Asia. The country has made progress since but not quick enough for the electorate who has been clamouring for change.

Enter Rodrigo Duterte. He's a relative political outsider. And he stood in recent elections on the promise of improving governance and egalitarianism in what is one of the most unequal societies in Asia.

Last weekend, Duterte was elected.

Duterte has been compared to Donald Trump for throwing out the rule book in the rhetoric he used to get elected, but that is where the comparison stops. Duterte is a seasoned politician, and more importantly he is stuffing his cabinet with technocrats.

Their challenge? Well, the Philippines' biggest foreign policy issue is China's claim to a substantial portion of the South China Sea, which happens to fall inside the archipelago's 200-mile box. The issue is expected to go before the UN over the summer; so the Chinese are eager to get a deal done, and Duterte has already said he wants to improve relations and potentially exploit energy resources in the area jointly with China.

The Philippines need strong government to tackle bureaucratic inefficiency and to clamp down on crime. The potential for Rodrigo Duterte to deliver on at least some of his election promises has sparked renewed interest in the Philippines and the currency is now strengthening. It is looking increasingly likely this is going to be the catalyst to revitalise interest in the country.

The entire Filipino stockmarket has a market cap of around $157 billion – less than half the value of Microsoft. So a small change can have big results.

Louis James: how to profit in gold stocks

Chris Lowe, *Bonner & Partners*

Chris Lowe: Gold stocks are now leading physical gold higher. This hasn't happened for a while. Can you explain why that's important?

Louis James: There are two things that we shouldn't confuse…

The first is that gold stocks give investors leverage to the gold price. In other words, they move much more than the underlying commodity.

One reason for that is that small changes in the gold prices can create large changes in profit margins for the miners. Say you're a gold miner, and you're making $100 an ounce when gold is selling for $1,000 per ounce. Now, suppose that gold goes up by $100. That's a 10% rise in gold. But now, you're making $200 per ounce in profits. That's a 100% rise in your profit margin. Your stock responds to that.

The second thing is gold stocks moving first… as a leading indicator for gold.

Right now, we're seeing gold stocks offer leverage to gold, for sure. The question is: are gold stocks a leading indicator? Casey Research founder Doug Casey believes they are. If he's right, what happens next is going to be absolutely spectacular.

What's the best way to play the rally in gold? Buy gold bullion? Gold ETFs? Stocks?

L: You invest in physical gold for prudence. Physical gold is money. It is value in your hand. And it has been for much of human history, come hell or high water. In a *Mad Max* scenario, if you needed something, and you had gold, somebody would probably take it.

In that sense, gold bullion is not an investment. It's a form of savings. If gold happens to go up relative to fiat currencies, great. But that's not why you buy it. You buy it because it is gold and it protects you.

Precious metals stocks are different. You buy them as a speculation because you think gold is going to go in a certain direction. Precious metals stocks offer leverage to the underlying commodity, as we've discussed.

That's where a lot of people go wrong. The precious metals stocks shouldn't be called "investments", in the traditional sense. They are not subject to your traditional Graham-and-Dodd-type investment securities analysis. [Benjamin Graham and David Dodd laid out the intellectual framework for value investing in their seminal 1934 book, *Security Analysis*.]

In a market where the biggest company – Barrick Gold, in our case – doubles in just a few months, you can see that the entire sector is speculative.

What does that mean for readers?

L: To succeed in this sector, you need to understand that you will lose money on some of your investments. Nobody wins them all. This is an even more important consideration if you are investing in smaller precious metals miners – the so-called juniors. [The junior miners are small companies developing or seeking to develop a natural resource deposit or field.]

Mathematically, there is more potential for extreme gains and losses in companies that have a smaller market capitalisation [the total value of a company's outstanding shares]. It's hard to move a $20 billion company five times. But with a $20 million company, it's easy. You make a significant high-grade discovery, and that can happen in a few months.

It's astounding if a big company such as Barrick doubles. It's never going to be a 10-bagger, at least not in less than decades. Whereas a junior that goes from having nothing but prospects to a significant discovery can double overnight… and then go on to be a 10-bagger within weeks or months.

But you have to understand that this is a higher-risk proposition. People think they grasp that, but they are rarely prepared for the reality. If you're going to hunt for 10-baggers, you have to be able to honestly look yourself in the mirror and say, "I'm going to have more losers than winners."

But it's worth it because your 20% losses, 40% losses – even the rare complete write-offs – will be more than offset by the doubles, triples, 5-baggers, and 10-baggers.

That may sound scary to a lot of people.

L: It does… at first. But the most you can lose when you buy a stock is 100%. On the other hand, there is no "most you can win." You can win 500%. You can win 1,000%. And that actually happens.

A 1,000% gain sounds like hype. But our track record at Casey Research is full of them. As resource investing legend Rick Rule likes to say, "You expect to lose more often than you win. But you expect the wins to amortize your losses… and then some."

For folks reading this who want to participate in the bull market in gold, what specific advice do you have?

L: There are two important things…

First, it's not too late. People see what's happening and they think, "Oh, I missed out!" But if things play out as we were discussing earlier – if we are seeing a trigger in the gold market that brings a lot of money off the sidelines – this is still just the beginning. A precious metals stock may have doubled… even tripled. But if it has 10-bagger potential, we're still just on the beginning of the runway.

Second, it's a big mistake to feel you must buy everything now or you'll miss out. That will leave you paying more than you need to. It reduces your potential gains. Precious metals stocks are, as Doug likes to say, the "most volatile stocks on Earth." Whenever possible, you want to buy on a day where gold is spooking the market and stocks are retreating. Hit the low end of the bid-ask spread, in other words.

[The bid-ask spread is the difference between the highest price a buyer is willing to pay for an asset and the lowest price a seller is willing to sell it for. For example, if the bid price is $10 and the ask price is $10.50, the bid-ask spread is $0.50. The higher the spread, the higher your buying cost.]

If you're truly disciplined, what you want is a big move lower in price. And after a big move higher, there's almost always some kind of correction.