Gold Stock Fortunes

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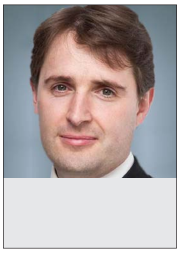
In this issue:

- China's over looked gold price boom
- A new Cold War
- Your latest *Gold Stock Fortunes* recommendation

Silver's time to shine

Eoin Treacy, Investment Director



It's a pleasure to write this month's letter because pieces of the market puzzle I anticipated are falling into place.

But before I go any further, I want to thank you for your patience. Believe me, I know what it feels like when you pick one asset to concentrate on and it doesn't do what you were anticipating right away.

I started this letter because I believe gold is on the cusp of great things. However, that does not mean it is going to happen all at once. This is a bull market with years to run and we are still only in the foothills.

That means all the possibilities are ahead of us – and I hope you find that as exciting as I do.

What I can assure you of is as an early subscriber you are getting in at the lowest possible price for this publication. When gold is double the price it is today, we will be able to sell it for a lot more, even though a big gain will have already occurred. That's just how people behave.

Most people need to see evidence before they can have faith. As early subscribers you are relying on my guidance and have exhibited faith in my ability to read the straws in the wind. I find that humbling and I again want to thank you for your support.

Now that's out of the way, let's dive into the gold markets. Two events happened last week that are of pivotal importance to the impending explosion in the gold price.

China's overlooked gold price boom

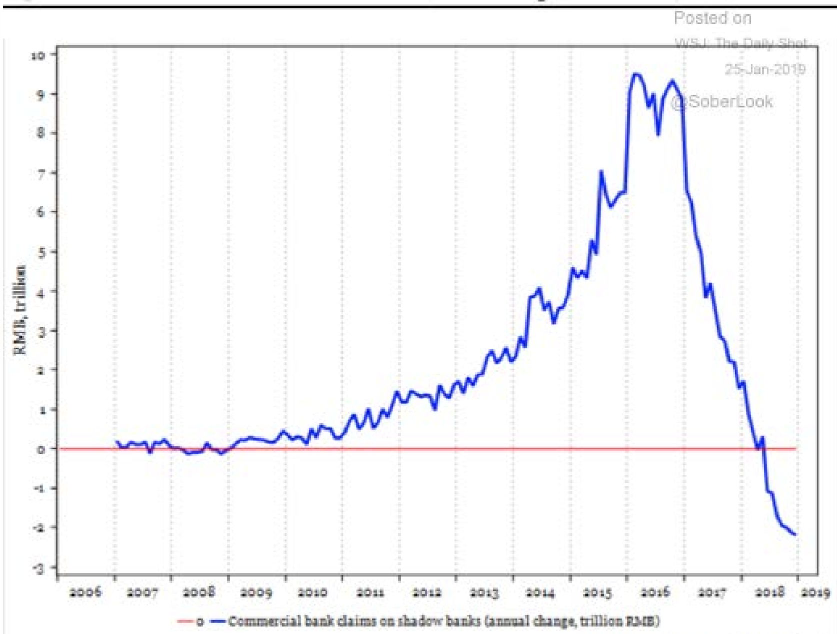
The first is that gold is breaking out when quoted in renminbi. That's big news in China, which tells a story of capital flight and demand for uncorrelated assets that is not making it into mainstream headlines.

The big issue in China is that regional banks are broke, but most of them are not listed on the stockmarket. Therefore the issue does not get the attention of the financial media.

The problem lies at the root of China's massive infrastructure build over the last few decades. The local governments do not get enough money from the central government to fund their operations. To raise capital, they sell land to property developers for infrastructure projects.

In turn the developers borrow the requisite funds from the regional banks. The regional banks then go to the local government to help source the deposits against which to make the loans.

Fig 1: Commercial bank claims on shadow banks (annual change, trillion RMB)



Source: Longview Economics, Macrobond

It's a circular argument and it is 100% dependent on the regional banks being able to continually source new funds to make loans.

Another problem is China has about 50 million vacant apartments and is still building more. It has all the infrastructure it needs but it is still building more and leverage ratios have risen considerably since the global financial crisis.

Basically, it is no exaggeration to state that China's growth of the last decade has been bought with massive quantities of debt.

Special purpose vehicles have over $3 trillion in debt, which is based on infrastructure and housing projects, many of which are surplus to requirement. That total scared the central government a couple of years ago so it cut off funding to the regional banks.

It immediately turned to the shadow banking sector and by 2016 the sector had risen to about CNY9.5 trillion ($1.5 trillion). That number scared the central government so it excised the shadow banking sector and it is now running a negative balance.

The absence of shadow banking left the regional banks in a bind so they began to issue US dollar-denominated debt. By 2017 they had issued $450 billion in debt, in less than three years. That scared the central government so it banned companies from issuing US dollar-denominated debt.

The numbers I'm quoting here are large but they demonstrate how large the demand for capital is. China ran a deficit of $552 billion in 2018. That money was spent to try and keep the banking sector from going bust.

However, it is impossible for the country to run that deficit indefinitely. Some of the banks have to be allowed to go under. That is now happening and that is why I am bringing it to your attention today.

Two weeks ago, Baoshang Bank was seized by authorities for "serious" credit risks. It's the first bank to be seized by the authorities in 20 years.

Last week, Bank of Jinzhou's shares were suspended in Hong Kong following the resignation of its auditors Ernst and Young. Things have to be pretty bad for auditors to decline a book of business and it is looking likely that Jinzhou is going under.

Nobody knows, or can know, what the natural default rate is for Chinese corporate defaults. We have a figure of about 4% for the US market, which can jump to about 12% in times of severe market stress. Since China has never allowed defaults before, it is impossible to know what the natural default rate is.

However, I believe it is reasonable to expect that the figure is a lot higher than that of the US. The scale of the malinvestment is epic and the no one ever had an incentive to be prudent, because they always assumed they would be bailed out.

I know if I was in China, I'd want to own gold and with the price breaking higher this week, there is now an urgency to that buying decision which is likely to have people racing to buy before prices rise further. That's important because China is both the largest consumer and producer of gold in the world.

As if the debt issue were not enough, the trade war is a major concern because of the risk of food inflation. China is dealing with a massive outbreak of African swine fever. It has already culled 1.1 million hogs but could be forced to cull millions more as China tries to control the disease.

Pork is the staple meat protein in the Chinese diet and it rising in price. Food inflation is up 6.1% year over year so there is a legitimate case for thinking inflation is also stoking Chinese demand for gold.

All of these considerations are manifesting themselves before we even begin to think about the outlook for the Chinese currency, the renminbi.

A new Cold War

The US dollar has been trading below CNY7 for three years. China has a lot of outstanding debt, slowing growth and a trade war to contend with. It also has massive foreign currency reserves and trillions of renminbi sitting in savings accounts at its banks and post offices.

As long as those reserves continue to sit in the banks, it has a solid chance of being able to manage the debt risk. However, if capital flight picks up either because of inflation, defaults or a property bust, then China risks a crash of epic proportions.

That's why China is supporting the currency right now. Given the challenges I have detailed above, the natural trajectory for the currency is lower. China is constrained from acting because it needs to demonstrate confidence in the currency to avoid capital flight.

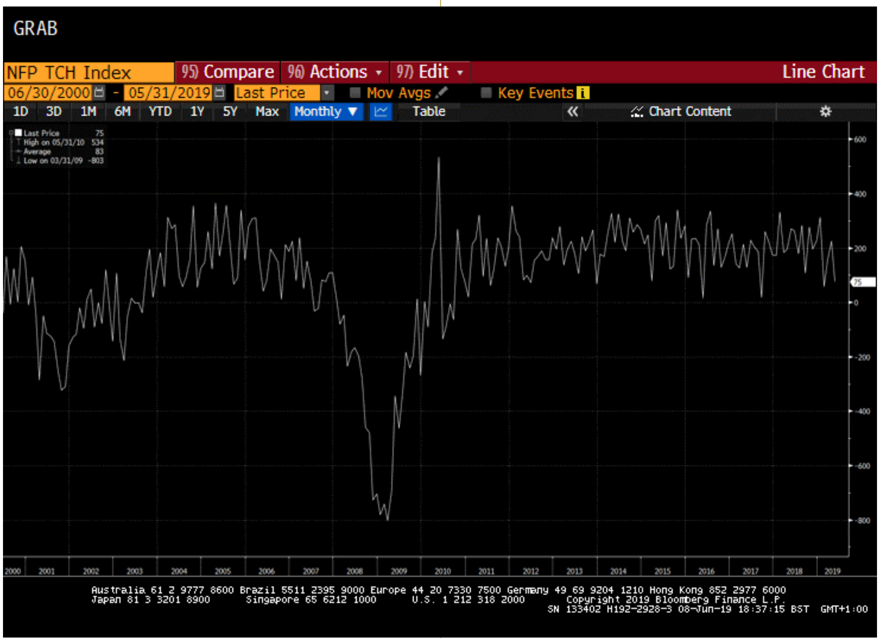
Nevertheless, strength of both bitcoin and gold suggest Chinese investors are not hanging around. Money is already being moved out of the financial system.

I know this is speculation but I have a strong feeling that we are dealing with a new Cold War rather than a Trade War. The big difference is the last Cold War was won by crashing the USSR's economy. We have to at least consider that the ultimate aim of the trade war is to do the same to China.

If that is even close to true, then it represents a true black swan bolt from the blue for the global economy and it would be particularly bullish for gold. That is because of the effect it would have on the Chinese renminbi and the massive money printing that would be required to stem the decline.

The Fed – spitting in the wind to avoid a recession

The second thing that happened this week was the Federal Reserve rode to the rescue of the stockmarket... again. However, this time gold rallied on consecutive days to retest the upper side of the evolving seven-year base formation.



So, what's going on?

The global economy is slowing. It's that simple. One of the most watched indicators of economic health globally are purchasing managers' indices. When companies are buying more stuff, they are generally producing more stuff because there is demand for more stuff.

That's a handy metric for the trajectory of economic growth. However, when companies are buying fewer materials it is generally because there is less demand for their products and that is bad news for the economy.

Purchasing managers' indices are already contracting in Japan, South Korea, China, Germany, the UK, Italy and France. The US has been the clear standout performer but the most recent figure, while still positive, surprised on the downside.

So, we know companies are planning for slower activity but the new hires figures that came out last week were also surprisingly weak. For example, the US nonfarm payrolls employment total fell from 225,000 new jobs created in April to 75,000 in May.

Companies are buying less stuff and hiring fewer people. The next step in that progression is to start firing people. If that happens, we are looking at a US recession. Again, there are straws in the wind.

Ford is firing 7,000 workers by August with 900 going in the last week. That follows on from substantial job cuts at General Motors at the end of last year.

Jobless claims have been trending downwards for the last decade and you can't have a recession without people losing their jobs. That's a truism but it makes the jobless claims figure an important one to monitor.

The only way is down (for rates, the dollar)

That's a summary of what is happening out there in the real world. So, what are central banks and governments going to do about it? The odds of the Fed cutting rates have jumped higher on this news and there is a lot of speculation that the cut will come in July.

Here is a chart of 12-month yields on the US notes. At the end of last year, market expectations were for one more hike this year. Since then the yield has dropped 75 basis points.

balance sheet slated to end in September, the bullish argument for the dollar is losing steam at a quicker rate. The dollar's bull market is ending and it is likely to be one of the primary victims of the drive to both support the economy and score points in the evolving trade/cold war.

With the fed funds rate still at 2.5%, the market now expects two interest rate cuts in the next 12 months. Until ten days ago the yield was only pricing in one cut but the massive move in the bond market last week quickly priced in another.

That is why gold is doing better. The one thing that has been supporting the dollar over the last few years has been the interest rate differential it has enjoyed versus other countries. That fact alone has helped to support the currency even though the US government has been running record deficits.

Since early last year the Fed has been reducing the size of its balance sheet. It has so far shrunk it from $4.4 trillion to $3.85 trillion. Quite apart from the impact that has had on global liquidity, the most immediate effect was to reduce the number of dollars in circulation. That represented a significant reason for the dollar's strength over the last 18 months.

With rate cuts now being priced in and the contraction of the

The foolish rise of MMT

The much bigger picture is that while financial media pundits are still debating the merits, or otherwise, of Modern Monetary Theory (MMT), we are already seeing clear examples of how it is being implemented.

The basic premise of the theory is government and central banks should work together to fund projects which enhance economic wellbeing and growth potential. Deficits don't matter, regardless of how large they are in service of these goals. The quantity of money being spent can rise, indefinitely, provided inflation remains contained.

It's a waste of time to express the emotional revulsion I feel at the thought of money printing to serve no useful purpose other than political gain. The reality is we already have evidence of MMT in action in the US. It is now reality rather than theory so rather than rebel against it, we need to turn our attention to figuring out how to make money from it. That was the reason I launched this letter.

Gold is the answer

Think about it this way. The Fed is sitting there watching the government spend way beyond it means and everyone knows that the unfunded liabilities represented by Social Security and Medicare are like icebergs about to hit the government's balance sheet as more people hit retirement age.

The Fed tried to raise rates and reduce the size of the balance sheet but that has slowed the economy and risks a recession. Without recourse to inflation as a way of justifying its actions, it has no choice but to fall into line, giving the government what it wants.

To refuse to act, against slowing economic fundamentals, would be to invite a recession for no good reason. Moreover, if the Fed were to refuse to act, it would be accused of political bias and ignoring the economic fundamentals. That would greatly endanger the central bank's independence, which is already under threat.

Here is where the big question arises...

Stockmarkets generally continue to rally while the Fed pauses rates following a hiking cycle. It isn't usually until it starts to cut rates that the stockmarket sells off. It stops raising rates because the risk of overheating has abated but it only cut rates because it is truly worried about a slowdown.

Economic figures lag by definition, since they are reported quarterly in arrears, so by the time interest rates are cut it is often too late to avoid a recession. The big question right now is whether the Fed is already too late in its attempts to support the economy.

The stockmarket seems to think a recession can be avoided. The jump on the upside last week by the primary Wall Street indices and most of Europe's indices suggests investors are back on a risk-on footing.

I believe we are on the cusp of a significant period of outperformance for both the stockmarket and the gold market which will be bought at the expense of the US dollar.

Of the two alternatives, gold is cheap relative to stocks and therefore has greater potential to outperform over the coming year. Gold stocks therefore hold out significant potential to outperform the wider stockmarket over the same timeframe. Every one of the shares in our portfolio rallied last week.

A month too early is better than a day too late

I received this email about a week ago and I thought I would reproduce it in this month's issue because I believe it encapsulates the frustration investors feel when the instrument they own is ranging and now performing in as timely a manner as they had hoped.

Here it is:

I am somewhat disappointed with the service to date and I am beginning to wonder whether I have paid just for the right to be enticed into buying yet further subscriptions. I am interested in gold and that is why I subscribed.

We have a peculiar market situation where, notwithstanding the weakness of the GBP because of the Brexit fiasco, 10-year UK gilts are being sold by the DMO at a negative real yield exceeding 1%. The backdrop to this situation is a US equity market valued at in excess of 140% of US GDP (it was last time that I saw figures) in a situation where there is a pretty negative global economic outlook.

Previous recent crashes of the US markets have involved falls of around 40% or more; the UK often follows; there is little in the way of good news in Europe; China is certainly not going to boom etc.

Gold, in the meantime, is staggering around in a trading range more than 30% below its high reached in the last bull market. So, what is the feeling amongst money managers? Are they waiting like sheep for the shepherd to show the lead? Are they waiting for the dogs to send them running in a stampede? I do not have those insights: that was why I paid for what I thought would be comment from someone with contacts with money managers and the relevant experience. Best wishes

> "Markets can stay irrational longer than you can stay solvent."

One of the most important and difficult lessons to learn is to refrain from telling the market what to do. I agree that there are some perverse leverage ratios outstanding in the global economy and that they will eventually result in a significant correction for asset prices.

However, as John Maynard Keynes said, "Markets can stay irrational longer than you can stay solvent." We have to foster the humility to only deal with the reality provided by the market.

This bull market from the lows in late 2008 and early 2009 has been fuelled by liquidity. The indicator I created for measuring global central bank liquidity peaked in January and trended down until the end of May. That coincided with rising fears of a global economic slowdown.

The recent weakness of the dollar has caused it to rally enough to break the downtrend. That is a significant development, which suggests the asset price inflation that has driven the stockmarket higher over the last decade is still in with a chance for another leg on the upside.

I spent the first three days of last week at an invitation-only investment conference, at the Ritz-Carlton in Palm Springs, aimed at hedge funds, private equity firms, alternative strategists and asset managers. It was very illuminating from a number of perspectives, and my wife and daughters also enjoyed their time by the pool.

I want to share an important takeaway from the conference. It was painfully obvious how the trendiness of investments tends to trump just about all over considerations. For example, there was one panel discussion where the topic was on liquid alternatives. It's a relatively new asset class that sprung up as a response to demand for instant liquidity in the aftermath of the credit crisis.

As its popularity surged, the instruments have become highly correlated to both bonds and equities, which negates their usefulness as supposedly uncorrelated assets. That has become painfully obvious over the last six months as bonds and equities rallied together. The consensus was that liquid alternatives are now useless and one should only own bonds as a hedge against equities.

That's a very easy conclusion to draw because bonds have been on a tear, globally, all year. However, it completely misses the point of owning an alternative asset in the first place, which is to provide a hedge against a situation when other assets turn down.

What I found most interesting about the conversation is there was only a passing mention of the fact commodity trading adviser (CTA) funds do tend to perform and there was no mention of gold as a liquid uncorrelated asset. That tells us the vast majority of asset managers do not hold gold because it is not yet trending in a verifiable fashion.

It all comes down to how money managers get paid. They need to beat their benchmarks and can only hedge long exposure for so long before they start to underperform. At that point they have to abandon hedges or risk losing customers.

The longer a trend persists the fewer hedges are in place. That's why so many money managers underperform when the cycle eventually does turn. This situation creates the closet tracking mentality, which the active investment management sector has often been accused of.

The time when money managers start to rediscover gold as an alternative asset will be when it has already broken out and is trending. The risk for them of anticipating the move is too high to do otherwise. That is the beauty of acting to manage your own wealth. You do not have to submit to the pressures of the market but can tailor your strategy to fit the reality provided by the market.

Let's also consider the idiosyncrasy of the UK market. It is one of the only countries in the world where inflation is coming in around the central bank's target. That puts the Bank of England in a conundrum. It would really like to raise rates but can't do that because of the uncertainty about Brexit.

The best any new Conservative leader can hope for is to wring a concession from the EU on the Northern Ireland border issue. However, the price is they have to display a willingness to walk away from the negotiations and push for no deal. That is negotiation 101!

> "Since the UK exhibits more inflation than other countries, it is potentially where we will see some of the greatest demand for a gold hedge."

You have to be able to walk away but it is a big risk if the EU is not willing to deal.

That is likely to contain any particularly bullish outcome for the pound in the short term because investors are unlikely to want to take big positions with such a lopsided set of outcomes. Meanwhile, gold cruised through £1,000 last week and is back testing the region of the 2016 peak. We may see a pause around this level but the £1,000 level should now offer support if the medium-term bullish outlook is to remain credible.

With central banks the world over getting ready to cut rates and the prospect of a currency war emerging as more countries explore the reality of MMT there is a clear risk the Bank of England will be in no position to raise rates and may even have to cut them if the economy takes a shock from Brexit. Since the UK exhibits more inflation than other countries, it is potentially where we will see some of the greatest demand for a gold hedge.

This brings me to where I think is currently most opportune to open a new position.

Time for a silver play

President Donald Trump put the cat among the pigeons last week when he suggested he was going to impose tariffs on Mexico. With little to show for his border wall initiative, much less his claim Mexico would pay for it, he has turned to the next best thing – which is to get Mexico to police the border.

Mexico is a major manufacturing centre for US companies so tariffs would be a major headache, but that also reduces the probability of them being imposed. In fact, over the weekend it was announced that the tariffs have been avoided because the US and Mexico have reached an agreement on controlling migration.

However, tariffs are not the primary risk from investing in Mexico. Instead it is the new left-leaning president who has a distinctly ambivalent attitude towards the country's corporate sector and particularly the resources sector.

Andrés Manuel López Obrador (known as AMLO) is a left-wing populist who is all about clamping down on crime and graft and getting more for the regular worker by taking money from the corporate sector. He is already talking about nationalisations and increasing the role of the government in corporate affairs.

Admittedly, the first 100 days of his administration have been blessedly free of fiery rhetoric but there is a clear risk that when he gets around to mining, there are going to be new royalty taxes. I want to open a position in Fresnillo but the risk of a surprise new mining tax is deterring me.

The reason I am attracted to Fresnillo is because silver is cheap. There has only been one other occasion since the early 1970s that silver was this cheap relative to gold. That was in 1991 when, for a brief time, gold traded at 102 times the price of silver. Right now, it is close to 90 times.

That tells us the price is cheap and worthy of our interest. However, the same argument was used about platinum about a decade ago and today it is still falling to fresh lows against gold. Therefore, while the relative charts give us a clue as to potentially important inflection points, we need to have confirmation from the absolute price before we can put faith in the above chart. That arrived last week.

Silver has been bouncing from around the $15 area since bottoming in 2014. Every time it has traded below that number over the last five years it has steadied and that same pattern now appears to be underway.

The price popped on the upside last week to confirm near-term support but more importantly to break the five-month downtrend. That suggests silver is on the cusp of a recovery run.

An additional reason for thinking that is because of gold. Silver has long been thought of as high-beta gold, meaning it is more volatile on both the upside and the downside relative to gold. If gold can manage to push through the $1,350 area over the coming couple of months, then we can anticipate demand for silver as a leveraged play on gold to increase. That's good news for the silver mining sector.

One important point about silver miners is they are now almost all producing gold in significant quantities. It is the only way they have been able to survive against a background where the prices of industrial resources and silver have been trending down. Therefore, they are already benefitting from the bounce in gold but are being priced as if they are only producing silver.

That is one of the beauties of investing in precious metal mining shares at this stage in the cycle. These kinds of inefficiencies will not be available when prices are trending higher and there is more competition for cheap assets.

If we are to avoid Mexico, one of the world's largest producers of silver, then where do we invest?

My answer is Peru and Argentina, with Hochschild Mining.

Action to take: Buy Hochschild Mining

Peru saw mining investment rise by 31.2% between January and April, mostly in the copper sector. The country has definitely had its brushes with left-wing populists but that is in the past rather than the future and is therefore already in the price. Argentina needs all the foreign income it can get and the government knows it has to look after all its foreign currency earners.

Hochschild Mining has an all-in sustaining cost of silver of between $11.8 and $12.3 per ounce and $960-$1,000 per ounce of gold. One thing that is important to understand about valuing silver mines is silver is very seldom the only mineral extracted. It is often a by-product of lead and zinc mining.

That is not the case with Hochschild where the primary assets are majority silver resources. The above quoted cost of production represents a significant achievement for the company because as recently as 2012, the all-in sustaining costs of production was $21.7.

That's exaggerated cost of production which is common to so many miners and is a reflection of just how much money they were spending on developing new operations during the last bull market. What we are looking for at this stage of the cycle are companies with low debt levels that are controlling spending because they will offer the best leverage to any move in the underlying metal prices.

That is what we have with Hochschild. The company has cash of $88 million and net debt of $68 million. That's a nice position to be in assuming the price of silver and gold continue to move upwards. It does have additional loans that need to be serviced over the balance of the year but these are on a revolving basis with local banks and therefore do not pose a risk in terms of having to pay off the balance in a hurry.

The company incurred a one-off charge for closing one of its mines, Arcata, in Peru. The original estimate for the cost of putting the mine into maintenance was $18 million but the company now expects that cost to be between $12 million and $13 million.

Having to close a higher cost production facility goes with the territory during a bear market for metals and that Hochschild is not the only company that has had to take the decision to slow production to conserve cash.

The benefit of having a mine ready to ramp up if prices improve is that a mine on maintenance can be brought back into production quite quickly so the company can benefit from increasing production in a higher environment without incurring additional costs. Importantly, this cost of maintenance is already in the price and is one of the primary reasons the share has been weak over the balance of this year.

Hochschild does not fall into that category and is primarily focused on silver and gold production. The company's prime asset is the Inmaculada mine in southern Peru. It represents both its largest production base as well as its lowest cost of production site with an all-in sustaining cost of $731 an ounce.

On the recent earnings call, the CEO states that grades can expected to be around 4.2 grams per tonne for gold and 150 grams per tonne for silver. At its next largest mine, Pallancata, grades are likely to be in order of 1.1 grams per tonne for gold and 295 grams per tonne for silver.

The biggest news from the company over the last year was the discovery of promising new veins at Inmaculada which are now being proved up. At the same time, it is also continuing to explore in the same region and is also conducting a brownfield operation.

This latter category is the equivalent of following the oil drillers maxim that you find oil where you've found oil before. Brownfield drilling in the areas around previous successful mining areas generally have a higher probability of success than greenfield sites.

One of the most attractive characteristics of Hochschild is its commitment to pay dividends when it has free cash flow. It paid a total of $14 million in 2016, $17 million in 2017 and $20 million in 2018. The company anticipated having a free cash flow yield of 7% in 2019 and 10% in 2020, which will be supportive of dividends increasing over the coming couple of years. The last dividend of 1.965¢ was paid in February and the next payment is due in August. At today's price the share is yielding 1.71%.

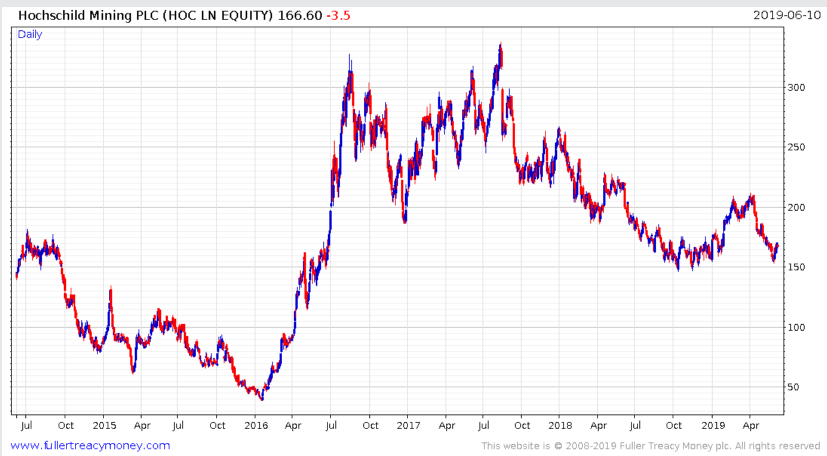
One point worth mentioning is that while the company is listed in the UK and in pounds, the dividends are paid in US dollars.

I recommend buying Hochschild Mining up to 190p. My target is closely linked to my view on both silver and gold. I strongly believe we are going to see gold break above $1,350 over the summer and to take silver with it to at least a $20 handle.

If I am correct in that assumption, I expect Hochschild Mining to trade up to 210p by the end of the year. Over the coming three years I believe there is ample scope for the share to trade up to 500p, assuming we get the bull market in silver I am anticipating in response to gold's breakout.

This is a London-listed stock, so no special instruction will be necessary – you will be able

Action to take:	**Buy Hochschild Mining**
Ticker:	**HOC:LN**
Market cap:	**£842.92 Million**
52-week high/low:	**£211.60/£146.65**
Price as of 11/06/2019:	**168.20p**
Buy up to:	**190p**



to pick it up from your regular online broker.

The risk is that we are investing in a primary silver miner and it is therefore likely to be more volatile than other shares, as is silver. The risk to the share can be either political or resource focused. Argentina in particular is in a state of flux and that could have an effect on its operations in San Jose.

There are always going to be risks with exploration. Perhaps the greatest risk is the end of the trade war and quiet returning to international affairs. However, while I believe that is a very unlikely prospect, it is a risk.

All the best,

Eoin Treacy
Investment Director, *Gold Stock Fortunes*

The Gold Stock Fortunes Portfolio

Gold plays					
Company	**Ticker**	**Rec Date**	**Price Then**	**Price Now**	**Gain/loss %**
Polymetal Intl	POLY-L	28/02/2019	866.60p	874.40p	9.13%
Shanta Gold	SHG-L	12/03/2019	5.30p	6.50p	22.64%
Newcrest Mining	NCM AU	14/05/2019	A$26.05	A$28.57	9.67%

Precious Metal plays					
Company	**Ticker**	**Rec Date**	**Price Then**	**Price Now**	**Gain/loss %**
Lonmin	LMI LN	09/04/2019	84.20p	75.50p	-8.60%
Hochschild Mining	HOC:LN	11/06/2019	168.20p	168.20p	N/A

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