# Gold Stock Fortunes

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# Buy when others are fearful

Eoin Treacy, Investment Director

I'll buy an 8% yield, from a growing company, any day. That's what the share I am recommending this month pays. It is exactly the kind of opportunity I want to pick up at the end of a correction. That's where we are right now. Let me explain why.

In a zero-interest rate world, yield is at a premium. In fact, the global economy is drowning in debt and no government has a plan for how to pay it down, so gold remains a very good place to be. I started this letter because it is possible to achieve both income and growth at this stage of the precious metals bull market.

So that begs the question, "Why isn't gold doing better right now then?" Afterall, the peak to trough contraction was 16.19% before the recent rebound.

It's a great question that I'll be talking about here.

There are three things every gold investor should remember.

**1.Gold is volatile**

That's a good news/bad news story. One of the reasons I like trading gold is because when it moves, it can really move a lot. That's exactly what we saw during the initial breakout in 2015/16, the sustained jump to about £1,000 in 2019 and the pandemic-driven surge during the first seven months of 2020.

But on the flip side, when gold pulls back it can be unsettling. We're in this game for the strong gains gold and gold miners are capable of. It's difficult to sit through months of underperformance. That's particularly true when the price pulls back faster and farther than we were willing to consider was possible.

The risk of a contraction was why I skipped making a recommendation a few months ago. However, I'm becoming progressively more bullish again. It's taken me years of conditioning but I have now become more excited the further gold prices fall, as this presents an attractive entry point for buying into the metal.

**2. Volatility generates strong emotions**

This is one of the most important lessons. When prices rise strongly for months at a time, it is very easy to think a long-term bull market is going to be fulfilled all at once. There is an old Wall Street saying: "There is no fever like gold fever". When the bulls are running, gold investors tend to become very confident and plough money into the asset class.

The opposite tends to be the case when prices correct. The emotional response to prices swings around. Investors tend to become apocalyptic and paranoid about the prospects of the sector. The reality is that no asset class or share price goes up in a straight line. Consolidations can be deeper and longer than we might wish.

However, it is very important to remember that in a secular bull market patience will be rewarded with higher prices later. As you know, I believe that we are in a secular bull market for gold so I am not worried.

**3. When everyone is bearish, it's time to buy**

Volatility is a natural part of the commodities sector. We have to expect it. Therefore, the best strategy is always to be greedy when others are fearful and fearful when others are greedy.

Back in August, there was a lot of enthusiasm about the outlook for gold and gold miners. When the media latches on to a theme it generally tells us more about what people have already done – than what they are going to do. After a big rise, all people with long positions want to hear is good news, so that's what the media delivers.

Gold hit a medium peak (as in multi-month) in August. Since then, sentiment has corrected significantly. There are now plenty of bearish arguments about the outlook for precious metals. Some are even questioning whether we have already seen the end of this bull market. But the key point to remember is that, in spite of the bearish headlines, the price gold price rebounded last week.

That kind of signal is a gift for investors. When sentiment says one thing and prices say something else, that's our chance to put faith in prices.

Let's examine some of those bearish arguments.

## "'Massive ETF selling' is hurting gold price, say analysts" – Kitco

This was a recent headline on a gold news site from November. I'm on the record as saying that by the end of this bull market, ETF holdings of gold will be larger than those of any central bank. That would signal Investor demand for gold exceeds that of all central banks because of the clear intention of governments to devalue their currencies.

My view has not changed. In a correction it is logical for investors to take profits. ETFs are now one of the primary vehicles for investors to take a position in gold. When prices fall, I expect to see ETF holdings come down too.

However, we should also bear in mind that gold ETF holdings have contracted by a total of 3.92%. So this tells us that although there may have been some hot money in gold ETFs, the vast majority is in it for the long haul. ETF holdings of gold rose persistently from the lows in 2016 and have only pulled back modestly relative to the gold price of late.

Something we should also be aware of is that gold ETF holdings are not a reliable indicator of the metal's current price. ETF gold holdings peaked in October, even though the gold price peaked in August – so there has been a significantly delayed reaction to the correction.

If anything, the recent pick up in ETF selling is a good thing as it tells us that sentiment is not as bullish as it was before. It tells us some of the hot money has come out of the market.

## Central banks are now net sellers of gold

Last week, the World Gold Council reported that central banks were net sellers of gold in Q3 2020 for the first time since Q4 2010. Generally, countries buy gold to maintain the weighting in their reserves as their economies expand, so the rare occasions when central banks sell gold tend to make headlines.

When we dig a little deeper, two central banks accounted for most of the selling: Turkey and Uzbekistan. The former has been

by far the most aggressive buyer of gold this year, accumulating 148.7 tonnes of the metal year to date, before the selling of 22.3 tonnes.

Turkey's economy is under a great deal of pressure. The Erdogan government has been unwilling to raise interest rates enough to get a handle on inflation. That has taken a very heavy toll on the Turkish lira. Even after the rebound that accompanied the gold sales, it is still down 23.6% this year.

Turkey is disaster prone. The populist authoritarian government has been spending far beyond its means for a long time. The bills are now coming due. The central bank is already buying all of the domestic gold supply and that is not about to change.

To support the currency, the bank needs access to a domestic resource that can be sold when prices are high. So Turkey is likely to remain a net buyer, even if it will occasionally sell off parts of its reserves to bolster the currency.

The other big seller was Uzbekistan. It sold 34.9 tonnes of gold in Q3. That still leaves it with a total of 307 tonnes. Uzbekistan had for years been largely cut off from the world economy because of an authoritarian and insular government.

However, it is also home to the world's largest open pit mine, Muruntau. As the country has begun to liberalise its economy, it has attempted to draw significant investment to the project in order to expand the nation's production, so we can expect a great deal more gold to be produced over the coming years.

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At present, production in Uzbekistan is estimated to be around 100 tonnes this year and will likely climb in the years to come. Since all of the companies producing the metal are state owned or controlled by the ruling oligarchy. There is clear scope for the continued sale of gold in Uzbekistan. However, the recent sell-off was likely an exception as the government tried to plug the funding gap opened by the pandemic.

Meanwhile, it is also worth remembering that most other central banks were net purchasers in Q3. Here is a section from the World Gold Council's report listing net buyers of more than 1 tonne. "United Arab Emirates (7.4t), India (6.8t), Qatar (6.2t), Kyrgyz Republic (5t), Kazakhstan (4.9t), and Cambodia (1t)"

There has also been some commentary, particularly from JP Morgan, that there is a generational divide between the people looking to hedge their exposure to the depreciation of fiat currencies. I think there is some weight to that argument. People over 40 tend to favour gold while younger people tend to favour digital assets.

These are not mutually exclusive groups. It is possible for people to own both but bitcoin has been performing better recently.

The one thing that I would like to point out, which I don't believe many people understand, is that bitcoin and other cryptocurrencies tend to trade in the same manner as gold and precious metals. They are both monetary instruments but not currencies. Both sit on the fringes of the global financial system and they also tend to be much less liquid that conventional currencies.

In many other respects, they are very different assets but their similarities mean that they trade in similar ways. Bitcoin is also best bought when no one else wants it and is susceptible to big pullbacks when it is very popular.

## So why is now the time to buy?

Reasons not to buy emerge in every correction. This more than three-month hiatus is no different. None of these reasons does anything to challenge the overall bullish argument.

To be clear: we live in a time of financial repression.

Governments are spending money they don't have and are being enabled by central banks.

Spending is climbing but central banks are intent on holding interest rates down regardless of inflationary pressure.

Market-based inflation rates in the US are at 2.14% but the ten-year Treasury yield is 0.96% and the fed funds rate is 0.1%. That is the kind of negative real interest rate environment gold does best in.

The difference is even wider in the UK where the market-based inflation rate is 3.59% and interest rates are 0.1%.

The implication is that by doing nothing with one's money, it will lose more than 3% of its value annually. Historically, gold is the best answer for how to protect ourselves from governments' tendency to rob us via stealth. After a mild correction and some exiting by leveraged investors we are now back in a buying range. The region of the 200-day MA is often a solid entry point in a medium-term uptrend and the price is steadying from that area at the time of writing.

So, what about Brexit?

The clock is ticking down to the end of negotiations and direct talks between Boris Johnson and the EU were inevitable. That always looked likely so here we are.

The stakes are high and there are competing narratives on both sides. The official line is an agreement needs to be reached before the end of the year so parliaments have time to ratify it. That may or may not prove to be the case. The EU has a record of pushing right up against deadlines and occasionally overstepping them.

If there is a deal, it will be limited in nature and the impact on the pound will be probably be positive. It is currently trading at €1.1084, which is the lower side of the range posted since 2016. Traders are therefore not willing to bet there will be a benign outcome, but they are not convinced it will be a bad outcome either.

I believe it is likely there will be a deal of some sort. Ultimately, it is only a question of when a deal gets done. Politicians might not want to drag negotiations into a post-Brexit world but that is what will happen if they fail to reach agreement now.

In fact, it might be better for the UK to negotiate after an exit. That way everyone will have had a taste of what life is like outside the EU. Then it will be easier to figure out what the real priorities are.

That suggests some near-term pound volatility is possible. Buying gold now ahead of that eventuality makes sense since a weaker currency would boost the price of gold in the UK.

The pound has traded up to test $1.35 against the US dollar over the last couple of months. Back in March it was trading closer to $1.15. The big story in the currency markets, over the last week, has been the dollar's weakness. That has contributed to the rebound in gold prices but it is also part of a much wider tapestry.

The Dollar Index is the primary tool used to plot the outlook for the dollar. It has tended to move in a very cyclical manner over the last 30 years. The most important thing to remember about currencies is no country wants a strong one, but some need a weak one more than others.

The primary factors supporting the dollar over the last four years were the strength of the economy, higher interest rates than most other developed countries and the Federal Reserve's quantitative tightening. That increased the cost and reduced the supply of dollars so they increased in value.

The pandemic erased all of those factors. Instead, China has strong growth, higher interest rates and a government that has resisted the temptation to print with abandon. The dollar is falling and the renminbi is rising.

If we look at the Dollar Index's performance, there are three examples of 5/6-year uptrends. Each time, when the bull market ended, the currency fell to new lows.

The big bull market between 1980 and 1985 was more than reversed. The uptrend from 1995 to 2001 took a while to put in a top formation but ultimately made a new low. The uptrend from 2011 to 2016 has taken four years to put in a top formation but now looks likely to break and trend lower.

If we turn our attention to what has been normal in terms of

downtrends, the average peak-to-trough move has been seven years: 1985 to 1992 and 2001 to 2008. If that consistency is repeated, we would be looking at a new low for the index and a terminal value sometime between 2024 and 2027 depending on how much weighting one is willing to give the euro cross rate.

2020 and the pandemic panic ushered in helicopter money. That's very difficult to unwind. Ten-year yields are trending higher and testing the 1% level. Given the quantity of debt and the need to continue to run deficits next year, the Fed is inevitably going to have to control the long end of the yield curve. Even a modest wobble on the stock market is likely to usher in that eventuality. With it, the medium-term bullish outlook for gold will be confirmed.

## The end of the current bear market is in sight

Let me summarise where we are with gold. There has been a correction in the price underway since August. I believe it is close to ending so this is a good time to get into the market if you have been waiting for a pullback to buy.

The obstacles to rising prices are generally consistent with short-term rather than medium-term weakness. Meanwhile, the demise of the dollar is a secular trend which will act as a tailwind for gold for years to come.

That brings me to my recommendation this month.

## Trans-Siberian Gold

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Russia is the world's second largest gold producer and a number of its most prolific miners are listed in the UK. In the past, subscribers have expressed some resistance to investing in Russian miners because of the low standards of governance in the country and its rather taut relationship with the UK government. I am fully aware of these objections but I also believe we are being more than adequately compensated for them with the share's 8.21% yield.

The share has a market cap of £86 million ($113 million) and generates $17.4 million in free cash flow from that valuation. The interim dividend jumped 250% over H1 2019 on the back of that performance. Like I said at the outset, I'll buy an 8% yield all day if I think it can be sustained.

The fact the company was able to reduce debt by 19.92% while growing the dividend is exactly what I look for in a mining company. It speaks to a willingness to put the interests of shareholders in first position.

This was achieved despite the fact the production fell in the 12-month reporting period. Gold production was 18,278 oz versus 21,889 oz in 2019 and silver production was 47,466 oz versus 59,787 oz in 2019.

The big difference was in the average selling price for the metals which was $1,691/oz for gold versus $1,312/oz in 2019 but the all-in sustaining cost has risen from $850/oz to $1,021/oz. Cash costs of production are $941/oz.

The company's five-year plan is to become a 100,000 oz multi asset producer. That suggests there is ample scope for growth and new mines will be built. The comfortable margins on production mean the dividend can continue to increase, while the debt load will remain manageable.

The nature of epithermal systems that arise from volcanos is gold deposition tends to be in fits and starts. The lower production was in part due to lower grades being mined. Starting in Q2 higher grades are once more being mined.

The wholly owned Asacha is not a new facility. It has been producing gold for years already. The company is in the process of developing the East Zone for mine expansion. A 25,000-metre drilling programme has been completed, which is expected to deliver additional significant higher-grade production and will be completed ahead of schedule. The company also released an independently produced report in February covering the Rodnikova deposit which confirmed estimates of over 1 million oz of gold.

The official line on dividends is the company aims to pay out approximately $3 million per annum. With much improved realised prices for both gold and silver this year, they have already paid out $7 million. The second half of the year is likely to have generated even better prices for production so there may be an additional increase in the dividend but there is also likely to be clearer messaging on a commitment to increase the base dividend beyond the $3 million figure.

Trans-Siberian Gold provides us with a clear route to significant leverage to the gold price. The all-in sustaining cost, which is the most conservative metric for assessing mine profitability, is conservative and production is likely to increase substantially over the coming years. Meanwhile, management have shown a clear willingness to reward shareholders which is very encouraging.

UFG Asset Management owns 43.59% of the outstanding shares and employees of the asset manager like Charles Ryan, Florian Fenner and Vadim Ogneshchikov own another combined 14.26%. CEO Alexander Dorogov owns 0.26% while non-executive director Eugene Antonov owns 0.09%. Hargreaves Lansdown holds 4.18%. Antonov spent 11 years with Kinross. He was pivotal in driving efficiencies at its East Russia Kupol mine which produced the largest cash flow and lowest operating cost in all of Kinross' operations. He is a substantial asset in the management team for Trans-Siberian Gold.

The company is a low-cost, high-grade producer in an historically prolific area which is tightly held by well-connected asset managers who hold seats on the board. That's a solid foundation for the shareholders' interests to be respected, which is foundational when investing in emerging markets.

The company paid a $1,987,000 settlement in the Q1. There has been a legal dispute going back and forth in the courts since 2016 about the cost of disposing of waste materials. The Federal Service for Supervision of Use of Natural Resources, Rosprirodnadzor ("RPN"), appealed a decision in favour of Trans-Siberian Gold in 2019 and won a settlement.

Every miner is at risk of regional or national governments coming for a pound of flesh on occasion. That risk increases in places like Russia unfortunately but I do not believe it materially influences the investment decision.

## Risks

The biggest risk in my view is in the seismic activity of the Kamchatka Peninsula. It is one of the most active volcanic regions in the world. That is also why it is host to so many attractive mining locations but volcanic eruptions can impact production from time to time. That is something every investor should be aware of.

As a reasonably small company with a market cap of only £86 million it is likely to be more volatile than larger companies. Trading volumes are therefore smaller than one might find with larger cap companies. That generally means it is easier to buy than sell such shares.

The share surged higher in 2019 when gold initially broke out. It gave up all of the advance during the initial pandemic lockdowns. The price has been consolidating between 80p and 110p since June and is currently firming in the region of the trend mean.

**I rate it a buy up to 115p. My 12-month target is 200p and my five-year target is 1,000p**. That is based on the assumption that the dollar will trend lower for another five years, the gold price responds as I expect and the company reaches its 100,000 oz per annum goal.

Full buying instructions can be found on page 7.

All the best,

Eoin Treacy
Investment Director, *Gold Stock Fortunes*

| **Action to take:** | **Buy Trans-Siberian Gold Plc** |
|---|---|
| Ticker: | TSG LN |
| Price as of 11.12.20: | 98.25GBp |
| Market cap: | £85.94 million |
| 52-week high/low: | 110.9p/37p |
| Buy up to: | 115p |

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Investment Director: Eoin Treacy and Nick Hubble. Editors or contributors may have an interest in shares recommended. Information and opinions expressed do not necessarily reflect the views of other editors/contributors of Southbank Investment Research Limited. Full details of our complaints procedure and terms and conditions can be found at, www.southbankresearch.com.

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Contact Us

To contact customer services, please call us on 0203 966 4580, Monday to Friday, 9.00 am - 5.30pm.

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