Ahead of the Herd Newsletter - 2018 Issue Thirty Three

Saturday July 21st

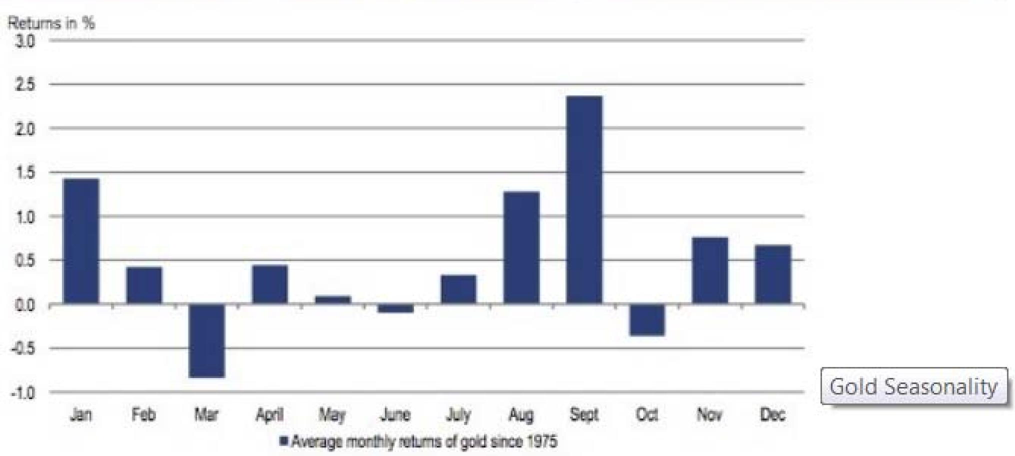
AheadOfTheHerd.com
Telling you things everyone else doesn't already know.

The road to war: Buying fear - Part 3

As a general rule, the most successful man in life is the man who has the best information

Gold has been dropping like a stone over the last several months, and getting no relief as the summer doldrums for precious metals meander along. Historically gold's worst month is March, with January and September the next best months to look for a rally. September is when gold demand spikes in India due to the buying of jewelry for weddings to correspond with the Diwali festival in October-November. April to July is when gold usually drops below its average monthly return.

Figure 1: Gold seasonality – average monthly returns since 1975



Source: the BLOOMBERG PROFESSIONAL ™ service, Credit Suisse estimates

As well, the US dollar has been climbing, which has worsened the price of the precious metal.

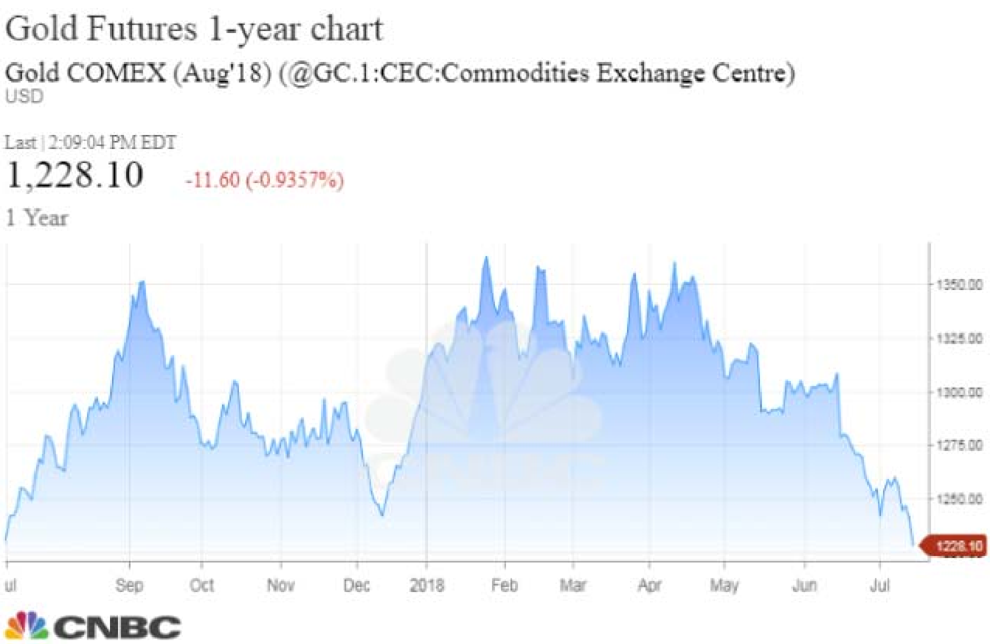
That's because all the bluster about trade wars and tariffs has pushed investors into the arms of the dollar - one of only a few safe-haven instruments that usually gain in times of economic turmoil - along with the Japanese yen, Swiss franc, sovereign bonds and gold.

Last week the greenback was up against most of its currency rivals, chiefly [against the yen, the highest the dollar-yen rate has reached in 11 weeks], immediately following Trump's threat to add another $200 billion in tariffs to China, which is currently dealing with $36B in tariffs as of July 6. China has retaliated with countervailing duties against the US of the same amount.

As expected, the dollar's rise has been at the expense of gold. The US dollar index has gained 6% over the last three months, while the three-month spot price for gold has lost 10%. For the last month gold has stayed under $1300 an ounce.

Historical Gold Price Performance in USD		
Period	Change ($)	Change %
30 Days	-39.40	-3.11%
6 Months	-102.40	-7.70%
1 Year	-15.80	-1.27%
5 Years	-68.50	-5.28%
Since 2000	+940.40	+326.75%

Futures aren't doing any better, from around $1310 an ounce the second week of June to the current $1226.30, as of Wednesday.



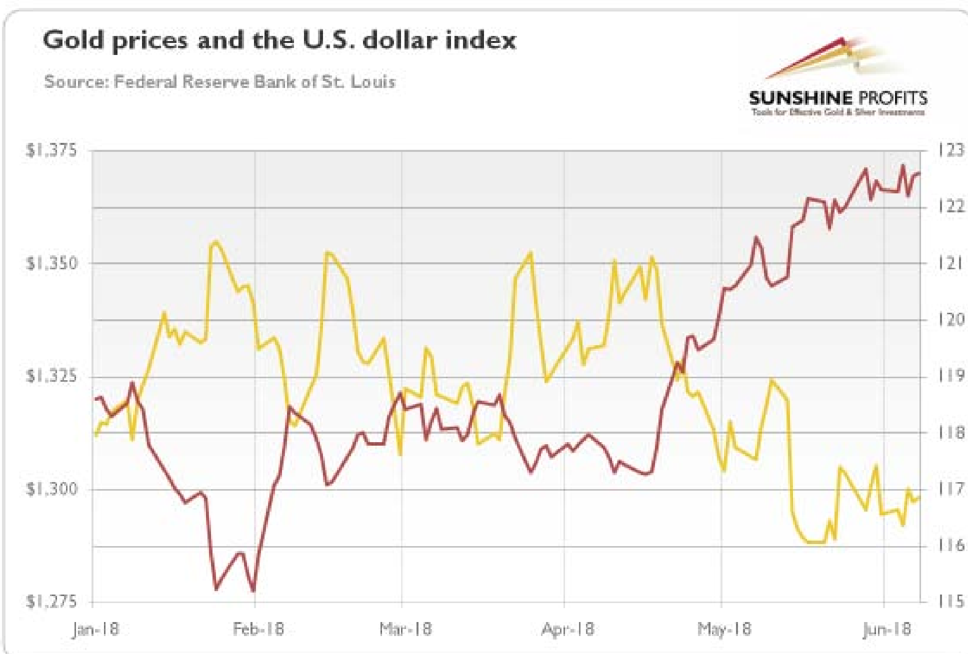
Along with the usual turnaround we expect to see when gold buying picks up again in September, there are other indications on the horizon for a major bullish period for gold. These are mostly due to fresh safe haven demand caused by widespread global tensions, along with the fallout from the US-led trade war which is likely to mean higher prices, aka inflation. Gold's natural hedge against inflation makes it an ideal safe-haven asset to benefit from current geopolitical tensions - along with the "road to war" between the US and China we detailed in the last two articles:

The road to war: China vs the US - Part 1
The road to war: China's kryptonite - Part 2

This article will focus on the bullish case for gold, right now. But first, why own gold?

Gold as store of value, inflation hedge

Investors love gold because it tends to hold its value through time. They see gold as a way to preserve their wealth, unlike paper or "fiat" currencies which are subject to inflationary pressures and over time, lose their value. In the US there was an increase in inflation for every decade except the Depression when prices shrunk nearly 20%. The Bureau of Labor Statistics' Consumer Price Index indicates that between 1860 and 2015, the dollar experienced 2.6% inflation every year, meaning that US$1 in 1860 was equivalent to $27.80 in 2015. This also means that prices in 2015 were 2,828% higher than they were in 1860.



When the dollar falls, investors flock to gold, hence the inverse relationship between the two.

When the dollar slumped between 1998 and 2008, gold prices nearly tripled, reaching $1,000 an ounce in early 2008 and nearly doubling between 2008 and November 2011, when gold hit $1,903 on the risk of the U.S. defaulting on its debt. Gold has since fallen due to the perception that the US economy is in better shape, judged partly by the current strength in North American stock markets.

Gold is seen as a hedge against inflation, because its price generally rises as the cost of living increases. As Investopedia points out, "Over the past 50 years investors have seen gold prices soar and the stock market plunge during high-inflation years."

Gold as safe haven

Gold investors love nothing more than a war, economic crisis or any type of geopolitical instability to watch the value of their bullion grow. Heightened global tensions such as terrorist attacks, border skirmishes or civil wars scare investors into putting their funds into safe havens like gold and stable, high-yield sovereign debt. Geopolitical tensions also drive more government spending (eg. on arms), which brings inflation, leading investors to look at precious metals as a place to park their money, short term.

For example during the 1970s, which saw a number of upheavals in the Middle East including the Iranian Revolution, the Iran-Iraq War, and the Soviet invasion of Afghanistan, gold rose 23% in 1977, 37% in 1978, and 126% in 1979, the year of the Iranian hostage crisis.

Gold also spiked when the US bombed Libya in 1986, right after the Gulf War in 1990, and more recently, when ISIS attacks put oil supplies in the Middle East at risk. However it is interesting to note that the price of gold "tends to rise in anticipation of a conflict," such as the current tensions between the United States and North Korea, "but often falls when tensions turn into a full-blown war," writes Simona Gambarini, an analyst with Capital Economics. For gold investors, this means timing is crucial in making a gold trade in the lead-up to a war. Staying in too long could mean losing out to other competing assets.

North Korea

After months of tough talk between Donald Trump and Kim Jong-un, the two leaders of diametrically opposed nations sat down for a historic meeting in Singapore. The world was transfixed as Trump and Kim agreed to de-escalate tensions in the Korean peninsula by the US agreeing to halt joint South Korea-US military exercises and Kim promising to wind down his nuclear program. Skeptics said it was all optics and no substance.

Turns out they may be right. A month after Trump declared the nuclear threat from North Korea over, things are murky again. The confusion started when Secretary of State Mike Pompeo went to Pyongyang to try to get some details out of North Korea as to the de-nuclearization promise. But after he left, the DPRK accused Pompeo of making “gangster-like demands” focused solely on North Korea giving up its nukes, and nothing on officially ending the Korean War and establishing a peace regime.

Then North Korea snubbed the US. A planned meeting between officials at the demilitarized zone just outside of Seoul did not take place; the North Koreans postponed the meeting, about repatriating the remains of US soldiers who died during the Korean War, the same day it was supposed to take place. Not good. We all know how badly Trump takes to being slighted. Being made a fool over North Korea is probably the most likely and most dangerous scenario that could trigger an escalation between the two nations.

Meanwhile China is poking the bear, with indications that sanctions the UN imposed on North Korean coal exports last September might be getting flouted. According to Reuters, while official data shows China hasn’t imported any North Korean coal, “North Korean traders are offering cheap coal to Chinese buyers who are stockpiling it at ports inside the isolated country, hoping recent diplomatic moves lead to an easing of sanctions barring purchases of North Korean coal,” the news outlet stated.

The offers surged after Kim Jong-un made a surprise visit to Beijing in March.

North Korean traders are willing to sell their coal for less than a quarter the price of similar-quality Chinese coal. If sanctions are lifted, the coal would be used to feed steel mills in China. The US has made the lifting of sanctions contingent on North Korea ending its nuclear program. The sanctions are aimed at cutting off up to 90% of North Korea's foreign exchange earnings.

South China Sea

We have written extensively on the escalating tensions between the US and China in the South China Sea, where China holds historical claims despite international treaties to the contrary (ie. the UN Convention on the Law of the Sea). Ongoing maneuvers in the South China Sea demonstrate that Beijing is willing to flex its muscles in a region it sees as strategically and economically important.

The latest kerfuffle ensued during the first weekend of July when two US Navy vessels went through the Taiwan Strait, the body of water separating China and Taiwan, a US ally. ABC News confirmed the two ships were the *USS Mustin* and *USS Benfold*. It's the first time a US Navy ship transited the Strait since 2017; no American aircraft carrier has gone through since 2007.

The United States supplies weapons to Taiwan despite not having diplomatic relations with the island and its government. China sees Taiwan as a breakaway territory that must be re-united with the Chinese Mainland; its independence is not recognized by Beijing.

A forced reunification between China and Taiwan would almost certainly cause a war between China and the US; the Americans would never allow Taiwan, a key tentacle of US influence, to be overtaken by the Chinese.

The Middle East

The Middle East has always been a region in turmoil considering its importance for oil and gas, but a tour of the area reveals things are getting considerably worse.

The horrors of a chemical weapons attack on the city of Douha in April were manifest in photos of dead bodies and half-clothed children struggling to breathe through oxygen masks. While the Syrian government denied the attack on the rebel-held town, which was followed up by a NATO counter-strike against chemical weapons depots, a report by the Organization for the Prohibition of Chemical Weapons (OPCW) said “various chlorinated organic chemicals” had been found, the BBC reported earlier this month.

The five-year siege of Eastern Ghouta, an agricultural region outside Damascus, was the longest in modern history. It finally ended in April after a two-month offensive by pro-government forces that left over 1,700 people dead, said BBC. Now the tide in the bloody conflict appears to be turning against the rebels. Last week government forces entered Deraa city, where the Arab Spring revolt started, and is poised to take over the rest of Deraa province, The Independent said. Army units, backed by Russia, raised the national flag in the main square. Fighting between the rebels and the regime led by President Bashar al Assad caused the displacement of 320,000 residents, the most in the seven-year civil war.

Iraq, the country of late dictator Saddam Hussein, was back in the headlines on the weekend amid violent protests that broke out. Despite attempts to shut down the Internet and social media, the protests in southern Iraq went ahead. Demonstrators demanded jobs and improved public services, while denouncing the influence of Iran in the region. According to a report by Kurdistan 24, protests led by local tribal leaders started in Basra and spread to five other provinces.

Back in May Donald Trump sent his daughter Ivanka to officially open the new US embassy in Jerusalem. Moving the embassy from Tel Aviv to Jerusalem is controversial and has been resisted by all US presidents up until Trump. West Jerusalem was among the areas captured and annexed by Israel during the 1948 Arab-Israeli War. East Jerusalem including the Old City was captured and later claimed by Jordan. On May 14, the day of the ceremony, at least 58 Palestinians were killed and more than 2,700 were injured in Gaza, making it the deadliest day since the 2014 war in Gaza, said CNN.

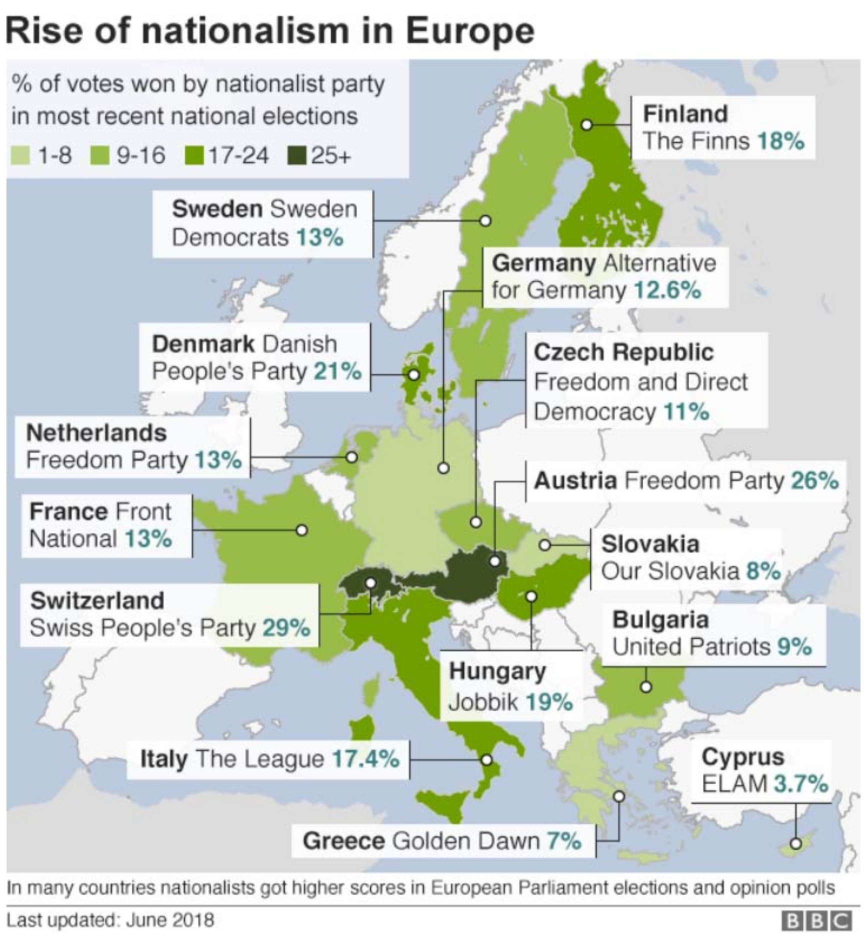
And then there's Iran. Trump made it a campaign promise to rip up the nuclear deal with Iran signed by former President Obama and six major powers in 2015. In May he made good on that promise, refusing to waive sanctions on Iran that were in place before the agreement - due to Iran's refusal to give up its nuclear weapons program. That left the other signatories wondering where the deal stood, but at the end of June the Trump Administration applied pressure on them, saying they must stop buying Iranian oil after November 2018. It softened its stance a few days later, saying some countries could be exempted (but not the EU) in an attempt to reassure the oil market and US allies. India and China are Iran's two biggest customers.

The likelihood of a confrontation between Iran and the United States over the re-start of its nuclear program has increased. On Wednesday it was reported that Iran has just built a factory that can produce rotors for up to 60 centrifuges a day. Centrifuges are used in the uranium enrichment process that creates nuclear energy or weapons.

Migrant crisis

The idea of creating the European Union (the successor to the European Economic Community) was to bury the nationalistic fervor that started two world wars and bind together the chief combatants - Britain, France, West Germany and Italy - in common economic goals. The free-trade zone began in 1957 with the Treaty of Rome, then deepened through monetary union with the euro as common currency, common citizenship, and the development of executive, parliamentary and judicial branches. Originally comprised of six member states, the EU now has 28.

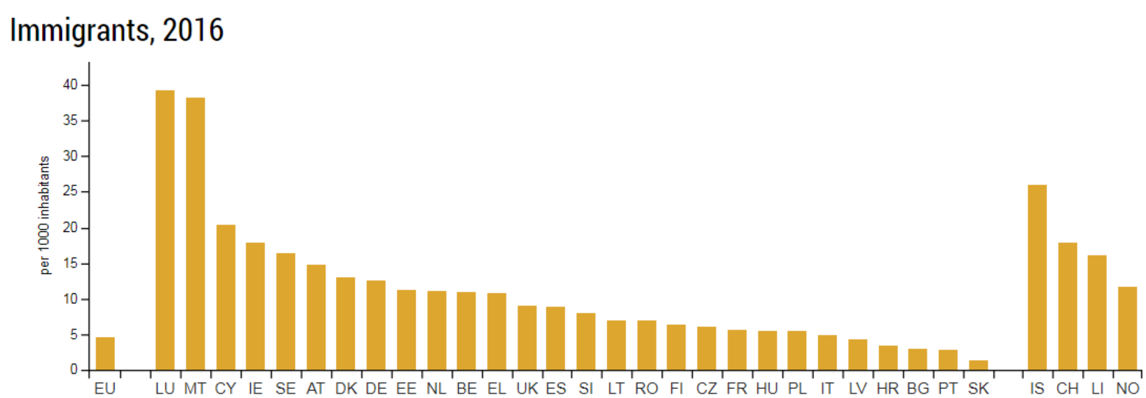
The very fabric of the EU however is ripping, due to a migrant crisis that has pitted left against right and is partially responsible for the rise of populist movements including Brexit and the election of Donald Trump. The BBC drew a good map of the way far-right parties are changing the European political landscape.



In Europe much of the discontentment, and fuel for the right, is directed towards migrants, mostly from war-torn Syria but also Iraq, Afghanistan, Lebanon and

African countries. Europeans feel their countries are being changed, and their national identities diluted by global forces beyond their control, without their consent, and they don't like it.

Whatever your position on immigration, the numbers are pretty shocking. In 2015-16 over a million migrants made the perilous journey overland or by boat to European shores. While that is only .002% of Europe's total population of 500 million, the load is being unfairly shouldered. Munich for example took 20,000 migrants in one weekend, as much as the UK agreed to take in five years.



The number of refugees in Germany has caused tensions among Chancellor Angela Merkel's coalition government. Interior minister Horst Seehofer, of the Christian Social Union party, has said he would block asylum seekers at the Bavarian border if some kind of immigration deal can't be struck. That could mean putting an end to the government and would threaten Merkel's 13-year run as Germany's leader, [notes the Washington Post.]

Immigration of course played a significant role in the "Brexit" referendum that amounted to a decision by Britain to exit the EU. The outline of an EU plan on migration was recently agreed to, but there are all kinds of questions around it. Reluctant signatories include front-line states like Italy, as well as Austria, Poland and Hungary whose anti-immigration leaders have described a migrant "invasion".

The number of migrants is down from 2015-16 but that isn't stopping the pushback. "The Vicegrad Group" composed of the Czech Republic, Hungary, Poland and Slovakia is calling for a force to defend European borders.

The conservative Heritage Foundation states:

"*Almost 1,000 people have been injured or killed in terrorist attacks featuring asylum seekers or refugees since 2014. Over the past four years, 16 percent of Islamist plots in Europe featured asylum seekers or refugees. ISIS has direct connections to the majority of plots, with Germany targeted most often, and Syrians more frequently involved than any other nationality. Nearly three-quarters of plotters carry out, or have their plans thwarted, within two years of arrival in Europe.*

...

"*Since January 2014, 44 refugees or asylum seekers have been involved in 32 Islamist terror plots in Europe. These plots led to 814 injuries and 182 deaths."*

Controversially, there is also the fear of being of being subsumed by Africans. According to *The Rush to Europe: Young Africa on the Way to the Old Continent*, written by Stephen Smith and quoted by ZeroHedge, currently there are 510 million Europeans and 1.3 billion Africans.

"In thirty-five years, 450 million Europeans will face some 2.5 billion Africans, five times as many," Smith predicts. If the Africans follow the example of other parts of the developing world, such as the Mexicans in the US, "in thirty years" according to Smith, "Europe will have between 150 and 200 million Afro-Europeans, compared with 9 million today." Smith called this scenario "Eurafrique".

The Zero Hedge article also quotes Stanford historian and author Niall Ferguson writing that, "Far from leading to fusion, Europe's migration crisis is leading to fission. Increasingly, I believe that the issue of migration will be seen by future historians as the fatal solvent of the EU."

US tensions with its allies

This week the headlines and Twitter were captivated by the meeting between Donald Trump and Vladimir Putin. The brief sit-down in Helsinki happened immediately after the NATO summit which by all accounts went very badly for the decades-old military alliance. Trump, no fan of international organizations, threatened to withdraw from NATO if member countries didn't double their defense spending commitments. The US paid for 72% of NATO's budget in 2017.

Trump at the summit also criticized Germany as being "captive to Moscow" due to its reliance on a planned 800-mile-long gas pipeline that would run under the Baltic Sea, complemented UK Prime Minister Theresa May's top rival Boris Johnson, who has called her Brexit plan "a big turd", and suggested meeting with Putin might be easier than talking with his Western allies.

Vanity Fair analyzed Trump's behavior as causing surprise and consternation, and sowing divisions which could play into the Russian president's hands:

"*I think to have him immediately launch into this attack on Germany specifically really took the NATO secretary general by surprise," said Julianne Smith, who led NATO policy at the Pentagon and served as national security adviser to Vice President Joe Biden. "I guess they didn't expect it to happen so early, right at the breakfast with the secretary general. But there's a level of frustration there, and particularly given the fact that he's about to go see Putin," she continued. "Putin would love nothing more than to have a divided alliance."*

From Russia with love

Indeed the coup de grace happened in Helsinki. Holding a press conference with Putin standing beside him, Trump told the media that they discussed accusations of Russian meddling in the US election - for which 12 Russian nationals were indicted just days before meeting Putin. Incredibly, Trump said he believed Putin that Russia had nothing to do with hacking Democratic Party emails and computer networks, effectively throwing his own intelligence aides under the bus for saying the opposite.

“They think it’s Russia,” he said. “I have President Putin — he just said it’s not Russia. I don’t see any reason why it would be.”

The statement was quickly rebuked by members of his own Republican Party, including Senator and former presidential candidate John McCain, who was vicious in his condemnation of Trump. “The damage inflicted by President Trump’s naiveté, egotism, false equivalence, and sympathy for autocrats is difficult to calculate,” McCain, who is also chairman of the Senate Armed Services Committee, said in a statement, adding: “No prior president has ever abased himself more abjectly before a tyrant.” Some are calling Trump’s actions treasonous and are calling for his impeachment.

Trade war fallout and gold

The import tariffs on goods exported by both China and the United States have just taken effect, so it’s a little early to say how they will play out in the US economy. So far as noted at the top, the US dollar is holding steady, and that has meant no love for gold, as investors funnel funds into dollars instead of gold amid the uncertainty of a trade war. According to Reuters, US investors pulled $1 billion from commodity funds, including those invested in gold - the largest withdrawal since July 2017.

However the good news for gold is that when higher prices start to trickle through the economy (imported steel and aluminum are already more expensive), the inflationary effects will benefit gold. “As the tariffs take hold and the market adjusts to the effects, we expect inflationary pressures to increase, which will benefit holders of gold and commodities,” Reuters quoted the CEO at fund manager GraniteShares Inc. Or it could get much worse than that.

Last week John Doody, founder of Gold Stock Analyst, warned that the trade war could bring the world to the brink of an economic collapse on par with the Great Depression. “We’re going to get a replay, to some extent, of the 1930s episode where the U.S. put the Smoot-Hawley Tariff Act, imposed taxes on 20,000 imports, and basically made what was going to be a recession into a depression,” Doody told Kitco News. However he also said that scenario probably won’t happen anytime soon because the US Federal Reserve will cut interest rates to avoid economic catastrophe. In June the Fed raised the federal funds rate to 2% - it’s the seventh interest rate increase since the financial crisis of 2007-08. A dovish signal on rates or the reversal of the current trend (ie. a rate cut) would be good for gold.

Other bullish signals

While the brewing and now real trade war has punished commodities including gold there are other less obvious signals that gold is poised for a rally. On July 3 MINING.com reported that hedge funds and large-scale speculators cut their long positions on gold by 82% - the equivalent of selling 700 tonnes of gold. The site quotes Ross Norman of Sharps Pixley, London’s top bullion broker, saying in a blog post that “the market is now at least clear for a rally.” A similar pattern appeared in 2015, when gold hit a six-year low in December but then speculators ran it up by over $300 the following July.

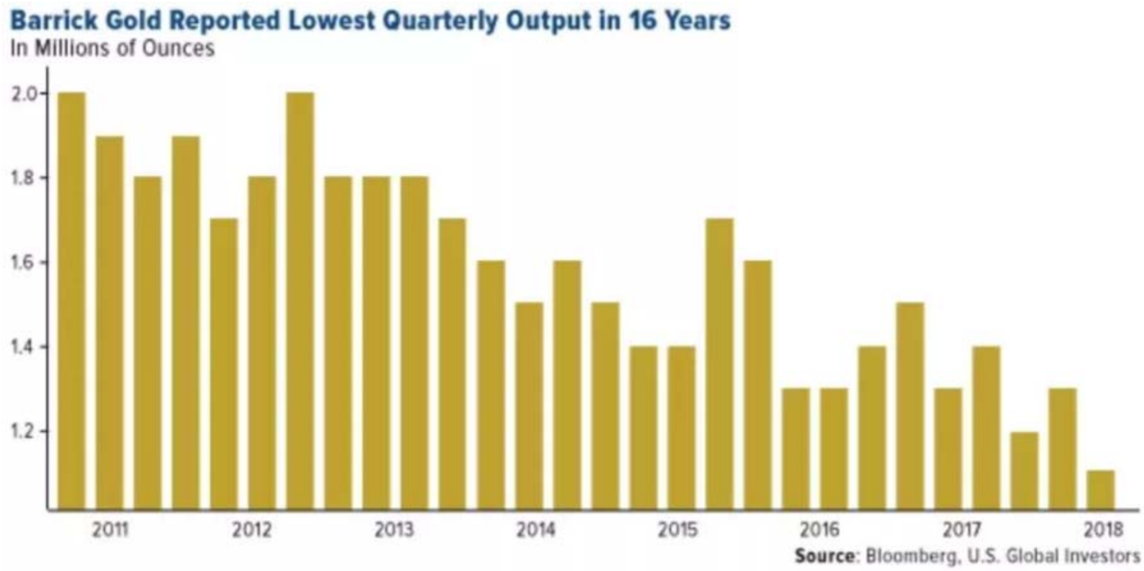
There are also more voices in the industry saying that we have reached “peak gold”, which is the point in time when the gold mined every year will shrink. Up to 2016, it increased continually, with discovery of new reserves happening each year despite the dips in the gold price. 2016 was the first year the gold mine output fell by 3%, or 22 tonnes.

South African gold production has plummeted below 250 tonnes compared to 1,000 tonnes in the 1970s, and China, the leading gold producer, is the only country to increase production in recent years, notes Goldcore via ZeroHedge.

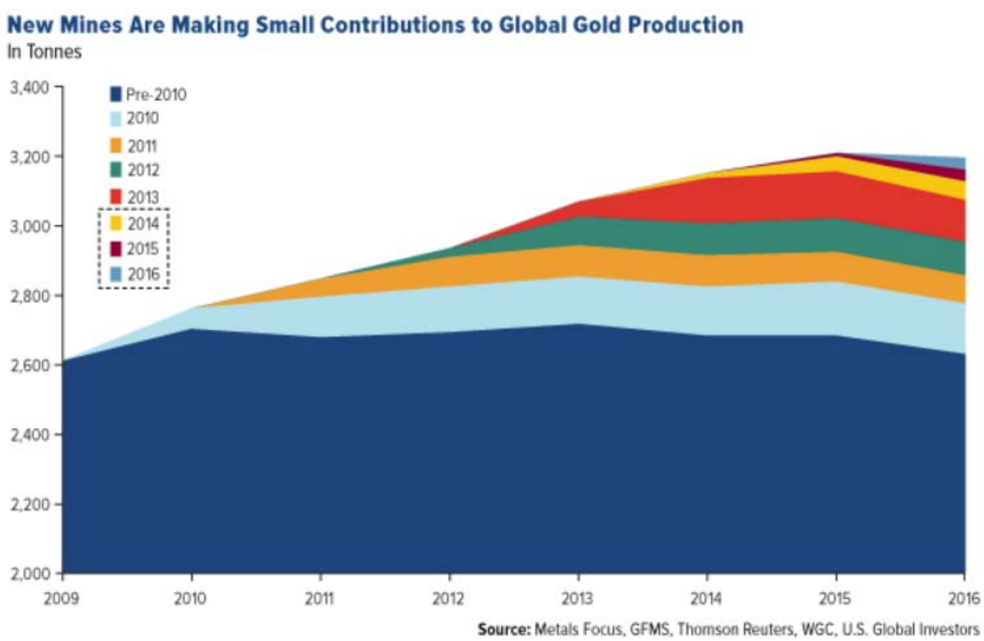
As for new gold mines, the bear market of 2012 to 2016 meant most large gold companies slashed exploration budgets and small explorers had an extremely tough time raising cash. The experts agree the industry is seeing a significant slowdown in the number of large deposits being discovered. Franco-Nevada co-founder Pierre Lassonde said he doesn't know how we'll replace the massive deposits found over the last 130 years:

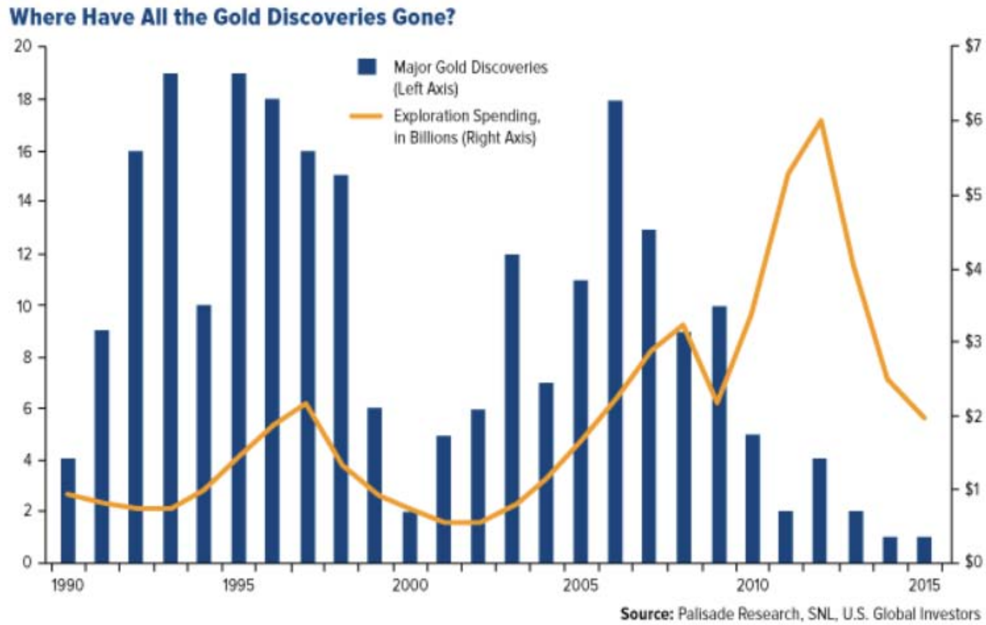
"*If you look back to the 70s, 80s and 90s, in every one of those decades, the industry found at least one 50+ million ounce gold deposit, at least ten 30+ million ounce deposits and countless 5 to 10 million ounce deposits. But if you look at the last 15 years, we found no 50 million ounce deposit, no 30 million ounce deposit and only very few 15 million ounce deposits,"* states Lassonde.

Goldcorp CEO Ian Telfer has said that peak gold is already here, Seabridge Gold chairman Rudy Frink says that gold reserves are shrinking fast, and Barrick Gold's Kevin Dushnisky notes that ore grades and production levels continue to deteriorate as discovery of new mines falls off, reports Safehaven.



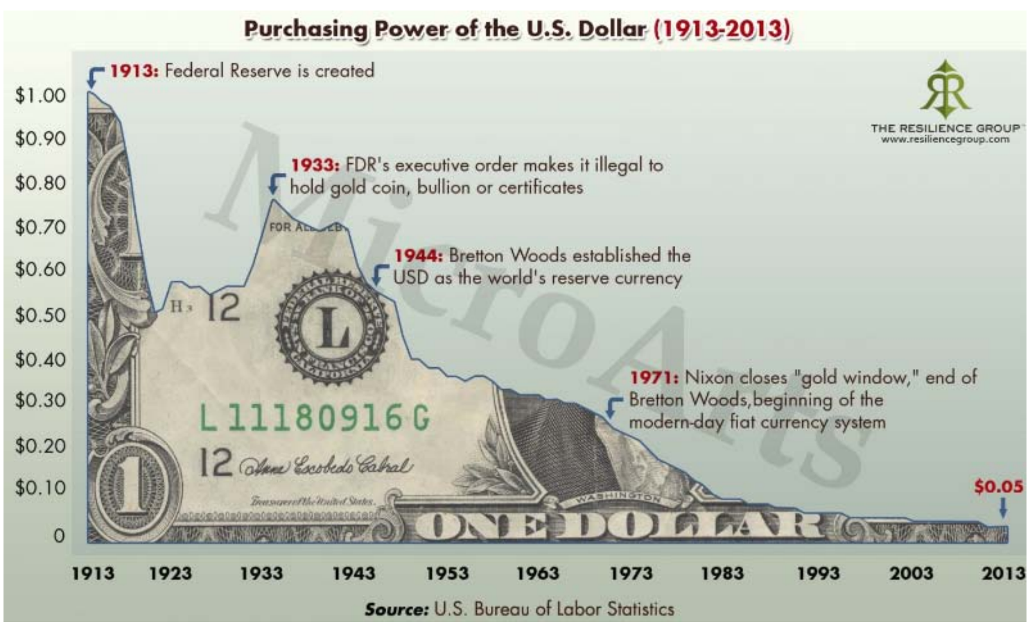
Goldman Sachs analyst Eugene King estimated we have only "20 years of known mineable reserves of gold."



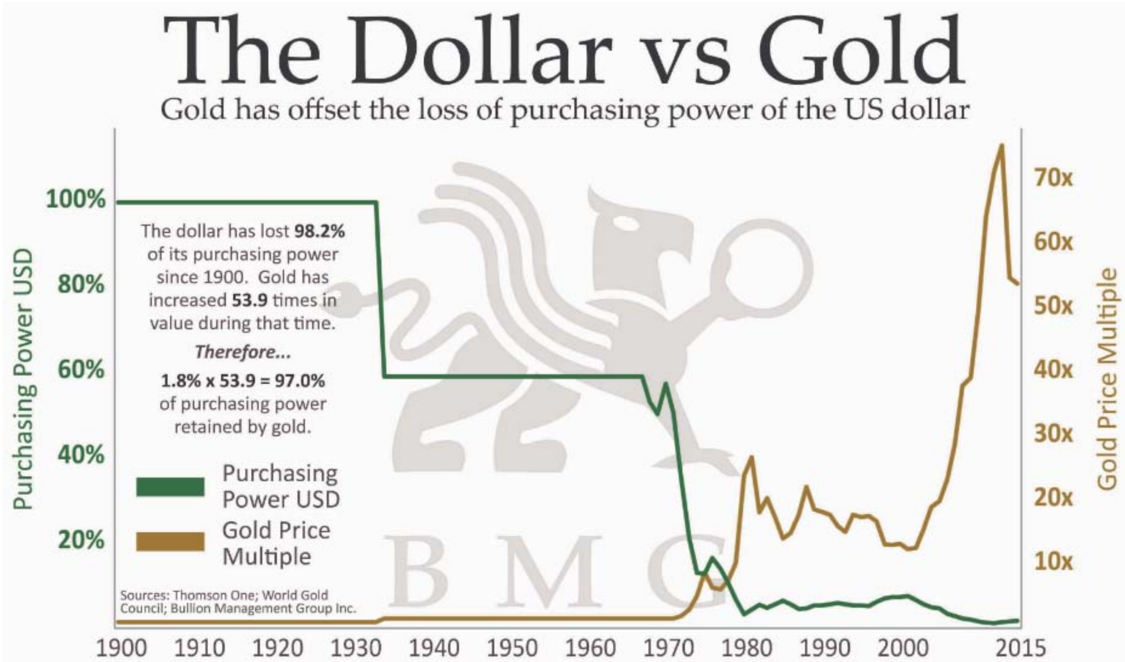


Loss of purchasing power

One thing remains a constant and has for over a century. The loss of purchasing power of the US$. Below is a chart showing the loss of purchasing power of the US$.



This second chart shows quite clearly the preservation of purchasing power that gold gives.



Conclusion

As we explained in the first two articles of this series, the current trade dispute between the United States and China is the first sign of a larger confrontation between the first and second-largest economies, that might even lead to a shooting war if international events were to run a certain course. This could include a naval battle in the South China Sea or a war over Taiwan should China insist on taking the island back. Relations between the States and North Korea appeared to be improving but now the situation is murky. It wouldn't be at all surprising if the one-on-one deal Trump reached with Kim Jong-un fell apart, and the North continued its nuclear weapons testing program.

Across the world, geopolitical tensions are adding to economic stand-offs. We have listed the main ones: North Korea, the Middle East, the migrant crisis in Europe, and the continuing tensions between the US and its allies. The odd dalliance between Trump and Putin has put America off-side, pulling it away from its usual leadership role and weakening decades-old alliances like NATO.

For gold, this means the return of safe-haven demand. While the dollar has so far been the safe harbor, this could change, especially as the billions in tariffs - real and threatened - begin to bite. Why? Because as prices increase, inflation will become a factor. While that strengthens the case for raising interest rates short-term, if prices move so high that they affect consumer spending, economic growth and employment, that could cause the Fed to change course and lower rates again. Could another quantitative easing program be far away? This would be extremely bullish for gold.

Seasonal demand for gold is low and commodity traders are on holiday. Add to this the structural market factor of peak gold, pile on safe haven demand as world events continue to run a more dangerous course, trade wars, climate change, a potential stock-market meltdown due to deteriorating political conditions in the US, and, in your author's opinion, we have the makings of a new bull market for gold.

I've got all kinds of drama, seasonal lows, purchasing power and gold on my radar screen. Something else that's on my radar screen is the undisputable fact that historically gold focused junior resource companies have offered the greatest leverage to a rising gold price.

Richard (Rick) Mills
aheadoftheherd.com

Just read, or participate in if you wish, our free Investors forums.

Ahead of the Herd is now on Twitter.

Newsletter Archives.

Legal Notice / Disclaimer

This document is not and should not be construed as an offer to sell or the solicitation of an offer to purchase or subscribe for any investment.