

## Gold Soars in August to Best S&P 500 YTD

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### Gold Climbs 18.55% YTD as Trade War Worsens

August was notably eventful for gold bullion. Gold added \$110 in August to close the month at \$1,524, gaining 7.8%. YTD gold is up 18.55%, ahead of the S&P 500 Index's rise of 15.34%. Gold equities have impressed even more, climbing 46.4% YTD as measured by Sprott Gold Miners ETF (SGDM).

### Month of August 2019

Indicator	8/31/19	7/31/19	Change	% Change	Analysis
Gold Bullion	\$1,524	\$1,414	\$109.79	7.8%	Next Resistance at \$1,580
Silver Bullion	\$18.36	\$16.26	\$2.10	12.9%	Another solid month, target \$20
Gold Equities (SGDM) <sup>1</sup>	\$25.66	\$23.00	\$2.66	11.56%	Strong advance for the month
DXY US Dollar Index <sup>2</sup>	98.81	98.52	0.29	0.30%	Steady up trend
U.S. Treasury 10 YR Yield	1.50%	2.01%	(0.51)%	(25.5)%	Very sharp drop, 1.36% target
German Bund 10 YR Yield	(0.70)%	(0.44)%	(0.26)%	(59.09)%	New lows, target -1.00%.
U.S. 10 YR Real Yield	(0.04)%	0.26%	(0.31)%	(119.23)%	Real yield now negative
Total Negative Debt (\$Trillion)	\$17.0	\$14.12	\$2.92	20.7%	Tracking model, target \$19 trillion
CFTC Gold Non-Comm Net Position <sup>3</sup> and ETFs (Millions of Oz)	115.0	103.6	11.40	11.0%	Another large increase in gold holdings, all-time high

Gold mining equities rose 11.6% in August, while broad equity markets fell 1.8% as the U.S.-China trade war escalated further, and signs of recession increased. To recap, at the July 31 FOMC (Federal Open Market Committee) meeting, the Fed cut interests rates (25 basis points) for the first time since 2008. One day later, President Trump announced a levy of 10% on an additional \$300 billion of Chinese imports into the U.S. The Yuan was allowed to be devalued past the critical 7.00 USD/CNY (one U.S. Dollar equals 7.00 Chinese Yuan) level immediately by China. In turn, the U.S. declared China a currency manipulator pushing the trade war into a more dangerous phase. The impact was immediate as bond yields plunged and equity markets and commodities sold off sharply. Gold, however, broke past the \$1,450 resistance level and traded up \$25 to close at \$1,458 that day.

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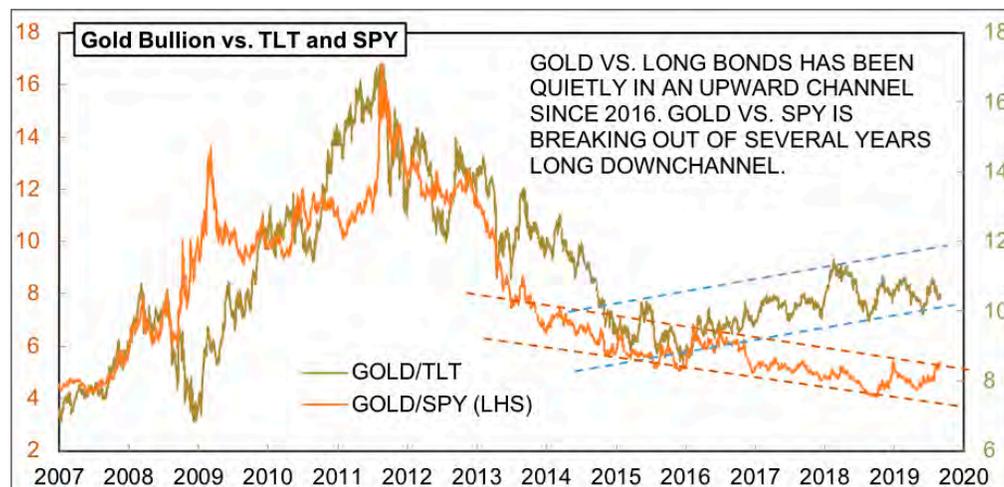
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Gold continued to rally throughout August as the market began to price in the negative consequences of a worsening trade war and a weaker Yuan. Shortly after, U.S. 2-year and 10-year yield curve inverted thus signaling the possibility of a recession coming to the U.S. Later in the month, China announced a \$75 billion tariff on U.S. oil, soybeans, cars and other goods. The U.S. responded that the 25% tariff on \$250 billion worth of Chinese previously-specified goods would increase to 30% and the 10% tariffs on the remaining \$300 billion would rise to 15%. The market's reaction was predictable: A continuation of the early August equity swoon and stronger support for gold.

## Gold Quietly Outperforms Major Asset Classes

With gold climbing to \$1,524 at the end of August, we see \$1,580 as the first meaningful resistance level from here. By all measures that we track, gold bullion is advancing in a very bullish manner. Like recent prior months, the accumulation of gold continues, yields are all lower and more tail risks are emerging as we will discuss further. U.S. 10-year yield has fallen below our 1.60% technical target without a pause. The 1.36% low of 2016 is now the likely target, but given the strength of this move, we would not be surprised it fell below this level as well. There are many forces at play and more being added.

Figure 1. Gold Bullion versus U.S. Equities/Treasuries



Source: Bloomberg as of September 1, 2019.

In Figure 1, we highlight that gold relative to the SPY ETF is breaking out of a multi-year down channel. Gold relative to TLT ETF has quietly been in an up-channel since 2016. Against these two main asset classes (U.S. equities and U.S. Treasuries), gold looks to begin another relative outperformance upcycle. In the past, this outperformance can be significant under the right conditions. We look at gold bullion versus the TLT ETF (+20 year U.S. Treasuries ETF). The long end of the bond market is the best performing part of the bond market. Even measured against the long bond market, which is having one of its most robust performance runs, gold has been quietly outperforming since 2016. The U.S. equity market (SPY ETF/S&P 500) is by far the best-performing equity index globally. After several years of underperforming in a well-defined down channel, gold versus SPY is now breaking to the upside of this channel. Note that in the prior gold upcycle, gold significantly outperformed bonds and equities. (And, yes, massive underperformance followed.)

Recent memory and the adverse bias effects of considerable losses are the last significant obstacles to gold sentiment remaining.

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## Gold Equities: To the Top of Quant Screens

The average price of gold price year to date as of May 31 was \$1,296. The average monthly price of gold for June, July and August were \$1,362, \$1,426, and \$1,503, respectively, representing significant month-over-month advances. The average price of gold in August versus the first five months of 2019 is up +16%. Gold companies in general terms have a fixed cost structure (unless there are dramatic changes to their production profiles) and are mostly unhedged. When September rolls around and analysts are back from the holidays, we should see dramatic revision increases in gold companies' earnings figures. Quant funds are dominating the equity markets.

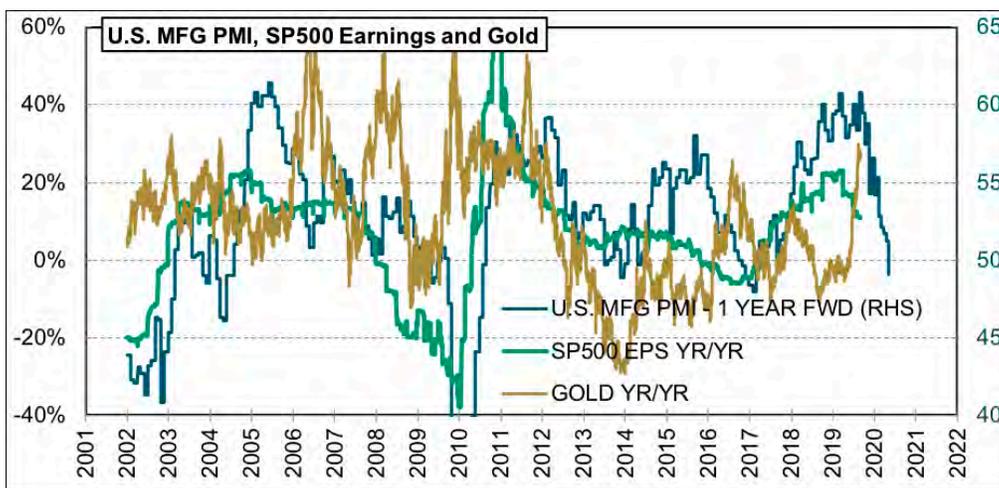
One of the primary quant drivers is EPS (earnings per share) revision and momentum. Given the sharp move in bullion prices, gold companies will begin to rank at the very top of quant screens. During a strong up move in gold prices, gold equities' earnings estimates consistently see upward revisions as analysts' price decks for modeling, typically lag gold futures prices. This continuous upward revision is another key screen for quant funds. Also, as the economy slows, broad market earnings will begin to roll over. Downward revisions are already dominating for one year forward consensus estimates. Lower interest rates usually boost P/E multiples but not when growth is slowing; and systemic market risk is rising as we discuss further.

Gold equities will be one of the few groups with significant positive earnings revisions, while the majority of companies will see downward earnings revisions.

## PMI Falls Below 50, Indicating Contraction

The U.S. ISM Manufacturing Purchasing Managers Index (PMI)<sup>4</sup> is a diffusion index that measures the primary direction of economic trends. A reading above 50 indicates expansion, while a reading below 50 indicates contraction. **The latest reading of 49.1 for August shows a marked contraction as the negative effects of the trade war are now quite evident.** The PMI is a great lead indicator for S&P 500 earnings year-over-year trends. Figure 2 shows that the PMI moved forward 12 months to indicate the direction earnings trends are headed. In this case, it is lower. Meanwhile, gold bullion is now up more than 30% year-over-year; gold companies' earnings will be revising higher.

Figure 2. The U.S. ISM Manufacturing Purchasing Managers Index (PMI) Falls Below 50



Source: Bloomberg as of September 1, 2019.

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Since peaking in 2011, gold equities have crashed (down more than 80% at the low) and have been in a recovery and repair mode since 2016. The reasons are many, but when falling gold prices meet poor capital allocation and overcapitalization, the results are predictably bad. After several years in the penalty box, the gold industry is highly limited in its ability and desire to repeat the mistakes of the prior cycle. This reticence is typical in all sectors with a higher capital spend that has gone from boom to bust. After the bust, the next boom usually arises from the ashes of the bust.

## Gold Equities are Breaking Out

Figure 3 shows the GDM Index (AMEX Gold Miners) relative to gold bullion. After over a decade of being in a significant decline (note the log scale), the ratio of gold miners to bullion has finally broken out of the downtrend. There is a last remaining resistance level before the market sentiment switches to all-out bullish. The introduction of the GLD ETF in late 2004 has taken market share away from gold equities. It allowed small investors a means of gaining exposure to gold without physical delivery and the operational risk of a gold miner. The primary reason to own gold miners versus gold bullion is leverage, gold miners in past cycles typically experience 2x to 3x the move in gold bullion. When the market becomes convinced of a higher and sustainable gold bullion pricing scenario, gold equities will transition out of recovery and repair to boom like prior cycles.

Gold equities relative to gold bullion have broken out of a plus decade long down channel, as shown in Figure 3. We would expect at the very least for this ratio to test this major resistance level (note this chart is formatted in a log scale). When this final resistance level is taken out, market sentiment on gold equities will see another positive rerate.

Figure 3. Gold Equities Relative to Gold Bullion



Source: Bloomberg as of September 1, 2019.

As with gold equities, the gold-silver ratio looks to be finally breaking the uptrend that has been in place since 2011. The trend break signals silver bullion outperformance versus gold bullion, another sign that we are entering the more bullish beta driven part of the precious metals equities cycle. Other indicators confirming this move are ETF gold buying ramping higher, EPS revisions favoring beta gold equities and gold equities outperforming gold bullion.

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Figure 4. The Gold-Silver Ratio Breaks its Uptrend



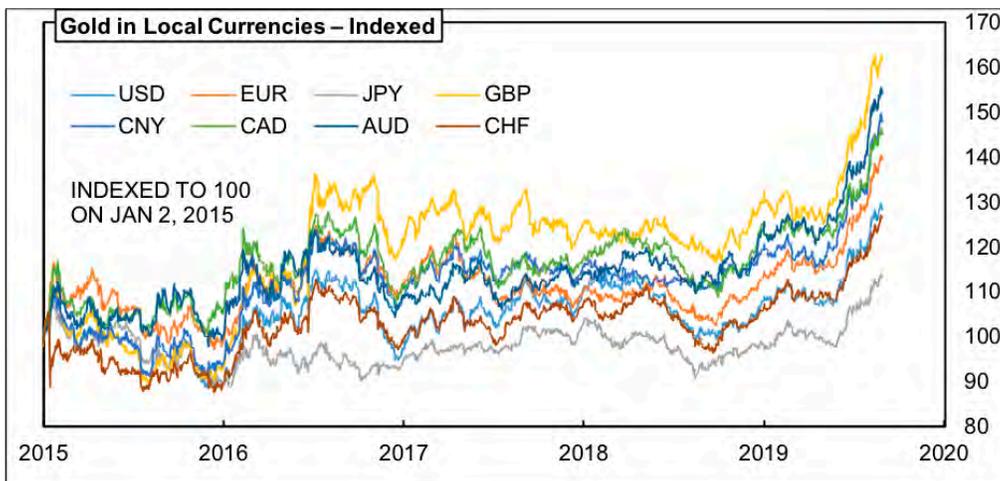
Source: Bloomberg as of September 1, 2019.

## Looking Closer at the Strengthening Support for Gold

From the perspective of multiple currencies, gold is strengthening. Gold in every currency has a bullish chart pattern. All have broken above the 2016 highs convincingly and all are spiking higher. Of the eight gold in local currencies listed, six have now made all-time highs.

Figure 5. Gold's Bullish Move in Local Currency Terms

(Indexed to 100 on Jan 2, 2015)



Source: Bloomberg as of September 1, 2019.

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## Competitive Currency Devaluation: A Growing Tail Risk

There are two immediate drivers for gold from the currency perspective. First, a Yuan devaluation runs the risk of competitive currency devaluation from other exporters, especially emerging market exporters. Emerging markets, as a group in general, have very high U.S. dollar-denominated debt. This U.S. dollar exposure puts the emerging markets in a terrible bind. If they weaken their currencies to stay competitive with China on the trade front, their debt in U.S. dollar rises, as does their U.S. dollar-based interest payments.

Emerging markets debt levels and servicing costs grow as the U.S. dollar increases, while their ability to service debt weakens as global growth slows further. Credit markets will price this in quickly and emerging market credit spreads will widen as we saw in 2015-16. The ultimate credit risk scenario is a liquidity squeeze and resultant contagion to the banking system, but we are far from that (for now). However, as the experience of the past decade has shown, things can move shockingly fast.

The second consideration is outright competitive currency devaluation not just from emerging market exporters but from developed countries. In a world where growth is becoming scarcer while trade barriers and tariffs are rising, it is hard to imagine a country that wants a robust currency. Manipulating currency pegs and sporadic interventions in the FX markets with limited currency reserves will not be enough as FX traders will outlast any short-term attempts. To maintain a weak currency will require a sustained lower yield relative to its peers.

## A Race to the Bottom in Yields...Look at History

In other words, a race to the bottom in yields is a real possibility to weaken currencies to offset the effects of tariffs. The impact on gold is direct. Gold priced in almost any currency is rising, some to significant chart breaking levels. We touched on gold's relationship to negative real yields in our July monthly.

There is a third possible but unlikely consideration, a Plaza Accord type agreement to weaken the U.S. dollar. A quick history: the Plaza Accord occurred on September 1985 when the U.S., UK, France, Germany and Japan all agreed to weaken the U.S. dollar, especially relative to the Yen. Within two years, the U.S. dollar fell almost 50% versus the Yen. During this period, gold gained 70% as the U.S. dollar fell.

In this current environment, a strong U.S. dollar is not only harmful to countries with significant amounts of U.S. dollar-denominated debt but also detrimental for the U.S. from a competitive point of view. A strong U.S. dollar in a weak global economy will also import disinflationary pressures, contrary to central bankers' goal of inflation targeting. There could come a time when U.S. dollar strength becomes destabilizing for the world.

A re-ordering of exchange rates similar to the Plaza Accord would provide a more stable path to relieve this stress. The caveat here is that such a multi-lateral accord would require significant cooperation among all main trading partners, which seems unlikely given the current discord. The U.S.-led globalization structures of the past several decades are seemingly unraveling as we speak. A disorderly go-it-alone competitive currency devaluation would be highly destabilizing for the world economy and markets, but extremely bullish for gold.

We have not seen a major discordant currency world since the 1930s and the 1970s. In the 1930s, the Great Depression forced many countries off the gold standard of the time, and the Smoot-Hawley Tariff Act of 1930 led to disastrous effects on global trade. The other period was in the 1970s when the Bretton Woods Agreement (post-WW2 fixed exchange rate system with the U.S. dollar pegged to gold) ended and by March 1973 most currencies were floated against each other.

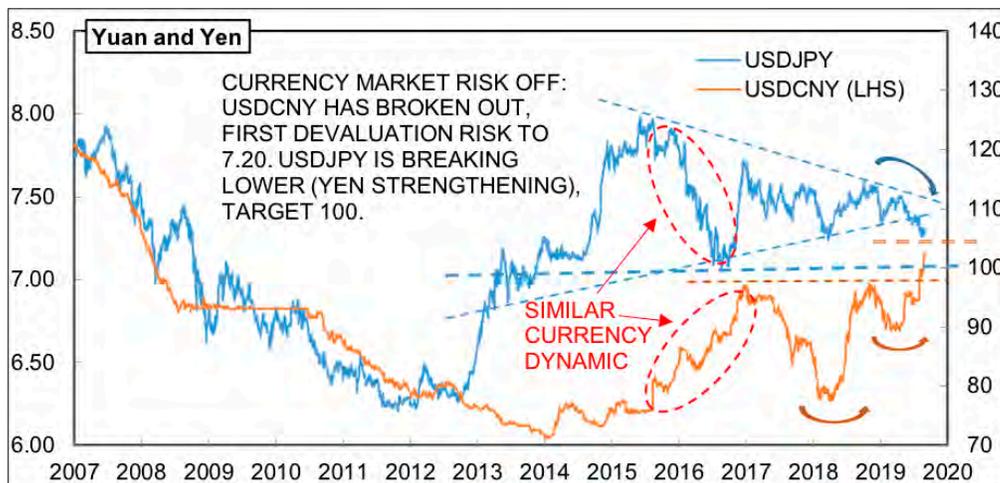
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A competitive currency devaluation event is challenging to assign a probability to, but its effects are not. This tail risk now joins the growing amount of negative-yielding bonds (currently \$17 trillion) and the potential negative real yield central bank policy as a critical driver for this gold cycle.

USD/CNY is staging a significant break out from a “cup & handle” pattern targeting the 7.20 level initially and then 7.40 on further weakness. We would expect risk-off action as the USD/CNY level rises (Yuan weakening). USD/JPY is confirming the move in USD/CNY as USD/JPY breaks lower (Yen strengthening) signaling risk-off from currencies. During 2016, the last time we saw China growth concerns and emerging market stress, we saw similar currency action. In 2019, due to the escalating trade war, this stress is expanding beyond the emerging markets to the developed markets.

**Figure 6. Dual Dynamic of Yen Strength and Yuan Weakness is Significant for Gold**



Source: Bloomberg as of September 1, 2019.

## The U.S. Yield Curve Inverts for the First Time Since 2007

On Wednesday, August 21, the U.S. Treasury 2-year and 10-year note yield curve inverted (i.e., the 2-year yield is higher than 10-year yield) for the first time since June 2007, signaling the possibility of the U.S. entering into a recession within the next two years. Markets sold off hard that day. The record of the 2s-10s yield curve is impressive and now widely communicated. It has accurately forecasted the last five successive U.S. recessions. This yield curve move was driven mainly by the dramatic fall in the 10-year yield.

The drop in yields, however, seems also to have a “negative gamma” buying quality to it. Given the lack of shockingly bad economic news and the absence of spiking credit stress accompanying the plunge in yields, this looks to be almost panic-buying driven. The amount of global negative-yielding bonds (now \$17 trillion) as a percentage of the Barclays Global Bond Aggregate has now climbed to about 30%, a shocking level. International insurance funds and pension funds are likely to try and lock in as much positive yield as they can to meet their actuarial requirements before the entire bond world drifts deeper into negative-yielding territory. Other factors such as convexity hedging and term premium collapse are adding to this move to lower yields. The U.S. 30-year Treasury yield closed at 1.97%, an all-time low.

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Although the yield curve certainly deserves attention, there are several other indicators flashing economic weakness ahead. Last month, we mentioned the 5y/5y inflation swaps as a sign of growth. The EUR 5y/5y broke below the 2016 lows months ago and looked to head lower. The U.S. 5y/5y has completed a significant top and will likely test the 2016 lows. U.S. 10-year break-even rate (growth expectations) has now broken from a chart top. U.S. 10-year real yields have now touched negative (see July monthly). CRB Futures and the CRB Raw Industrials (an excellent proxy for global growth) both look ready to break lower.

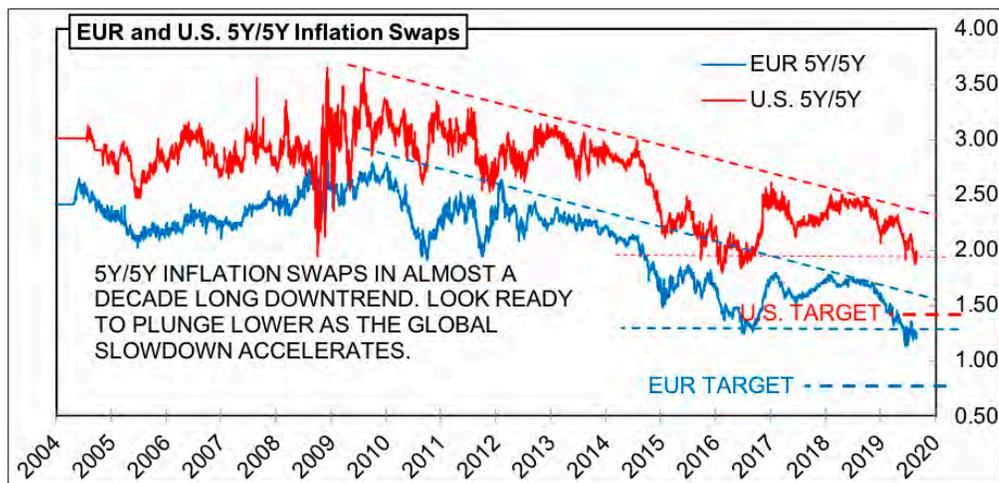
## Rising Systemic Risk

All this leads to rising systemic risk. There are many measures, but we focus on credit stress and the possible liquidity squeeze if credit stress gets bad enough. These are the lessons from 2008, 2011 and 2016, which were all positive for gold. For credit stress, we like to keep an eye on CDS spreads (credit default swaps; the cost of default insurance) for the prime brokers, corporates and sovereigns (in this case China, the center of the storm). All have now hooked up and are trending higher (i.e., credit risk is rising). For liquidity measures, we keep an eye on Libor-OIS spreads and Eurodollar Basis Swaps. Both are rising but well below levels that are coincidental with major market sell-offs.

In a world of massive debts and an interconnected banking system, being aware of credit conditions and credit liquidity cannot be underestimated.

The continuing downtrend in the 5y/5y inflation swaps (growth expectations) looks to accelerate lower led by Europe. Although the Eurozone is already deep into negative yields and trillions of dollars of QE/LTRO over the past several years, growth expectations and inflation targets continue to fall well below expectations. U.S. 5y/5y has now broken below the critical support level and looks to test, and then fall below the 2016 levels much like the EUR 5y/5y. If negative yields and QE continue to be as ineffective as they have been (a growing acknowledgment amongst central bankers), expect "helicopter money" to re-enter the lexicon. Helicopter money refers to giving money directly to individuals rather than central banks buying up bond issuances. We think Ben Bernanke should get the first cheque.

**Figure 7. Continuing Downtrend in the 5Y/5Y Inflation Swaps**



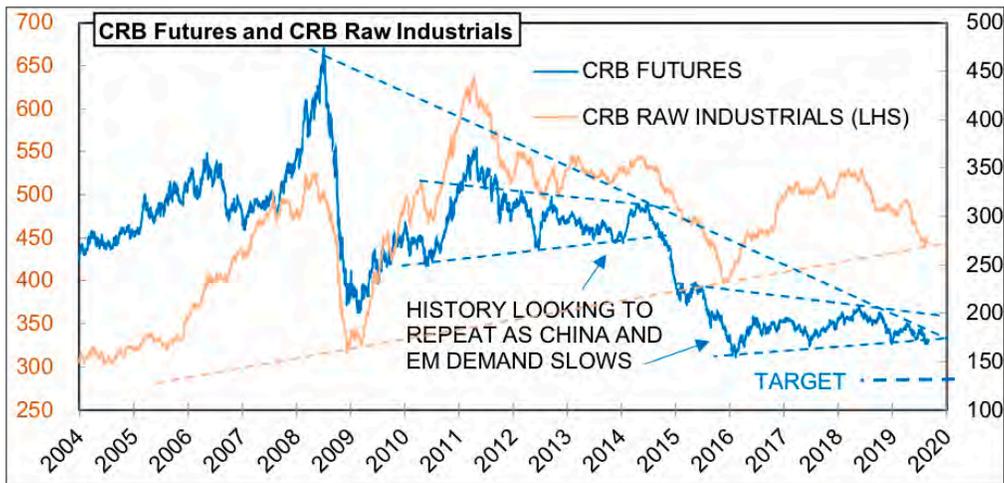
Source: Bloomberg as of September 1, 2019.

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The CRB Futures (commodities futures) have been weak for several years, reaffirming the weakness seen in the 5y/5y inflation swaps. The CRB Futures chart looks ready to break lower from a bearish wedge pattern similar to the bearish wedge pattern in 2012-15. Included is the CRB Raw Industrials which has a historically closer fit to global economic growth. The CRB Raw Industrials does not have financial buyers like the CRB Futures, so it is considered to be possibly less distorted. Either way, both measures look to be breaking lower, confirming real-world demand weakness. These are well-diversified commodity indices measured over several years. It is looking more and more like a deflationary bust if it follows the 2015 pattern.

**Figure 8. CRB Futures and CRB Raw Industrials Ready to Break Lower**



Source: Bloomberg as of September 1, 2019.

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<sup>1</sup> Sprott Gold Miners Exchange Traded Fund (NYSE: SGDM) seeks to deliver exposure to the Sprott Zacks Gold Miners Index (NYSE: ZAXSGDM). The Index aims to track the performance of large- to mid-capitalization gold companies whose stocks are listed on major U.S. exchanges.

<sup>2</sup> The U.S. Dollar Index (USDX, DXY, DX) is an index (or measure) of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies.

<sup>3</sup> Commodity Futures Trading Commission's (CFTC) Gold Non-Commercial Net Positions weekly report reflects the difference between the total volume of long and short gold positions existing in the market and opened by non-commercial (speculative) traders. The report only includes U.S. futures markets (Chicago and New York Exchanges). The indicator is a net volume of long gold positions in the United States.

<sup>4</sup> The Purchasing Managers Index (PMI) is a measure of the prevailing direction of economic trends in manufacturing. The purpose of the PMI is to provide information about current and future business conditions to company decision makers, analysts, and investors.

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