Sprott | Gold Report
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Tariff Tension

Authored by Trey Reik, Senior Portfolio Manager, Sprott Asset Management USA, Inc.

All of a sudden, the leading question with respect to precious metals has become, "Why isn't gold doing better?" After trading in a bullish consolidation pattern for the past 18 months, gold appears to have lost its mojo and is flirting with technical breakdown. Given daily Trump-tariff headlines, shouldn't gold be reacting more positively? In this report, we offer a few thoughts on gold's recent performance.

Why Isn't Gold Doing Better?

Perhaps because the gold price is influenced by so many simultaneous variables, the gold conversation is frequently punctuated by protests from one contingent or another that gold is failing to perform as advertised. In recent weeks, apprehensions over an accelerating global trade war have unsettled traditional asset classes. Knee-jerk reasoning suggests any variable so disruptive to broad markets should be lighting a fire under the gold price, right?

Well, it's just not that simple. Without question, the asset class most negatively impacted by President Trump's developing skirmish with China has been commodities. As shown in Figure 1, the Bloomberg Commodity Index (BCI) has been under heavy pressure ever since the Trump administration imposed its steel and aluminum tariffs on June 1 (red arrow). Then, when the Treasury Department announced late on July 10 that an additional $200 billion of Chinese imports were being slated for 10% tariffs, commodities rolled off the cliff (red circle).

Figure 1: Bloomberg Commodity Index (5/1/17-7/16/18)

Source: Bloomberg.

Specifically, the BCI suffered on 7/11/18 its worst trading session since 2014, plummeting 2.70% on the ***day***. Among leading component declines (measured by spot performances), WTI (West Texas Intermediate crude oil) fell 5.03%, zinc tumbled 3.12% and copper slid 3.02% (bringing copper's five-week selloff to a sharp 16.4%). Bloomberg (7/11/18) summarized:

> "'Plunge, tumble and rout' are overused by the financial media to describe a market in decline, but such superlatives would not be out of place to describe what's happening to commodities....Metals were among the hardest hit on Wednesday after the Trump administration said Tuesday that it would impose a new round of 10 percent tariffs on $200 billion of Chinese goods....Copper prices plunged as much as 4 percent in London, while zinc, nickel, lead and tin also slid on the London Metal Exchange."

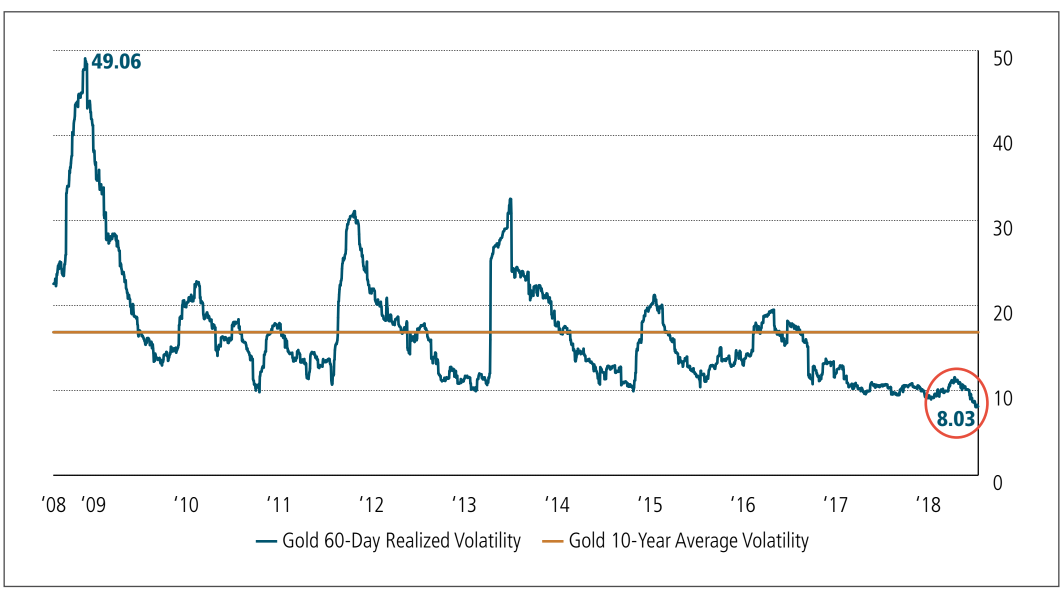
Gold's Price Stability Has Been Unique Among Asset Classes

While gold's commodity function (jewelry) is not central to our monetary investment thesis, the fact remains that gold *is* a key component of most commodity indices. In fact, gold is currently ***the single largest weighting*** in the BCI, at 9.32%. In the very short run, therefore, gold is not immune to the magnetic pull of displacements in the commodity complex. In the context of 3%-plus declines in base metal prices on 7/11/18, gold's comparatively modest 1.09% dip serves as testament to gold's non-correlating profile. In fact, we view gold's early summer performance as incremental evidence of bullion's true portfolio utility. Gold is ***not*** a magical elixir, but it ***is*** a fiercely reliable store of value.

Widening the lens of analysis a bit further, spot gold's YTD decline, so puzzling to the financial press, stood at a mere 4.76% as of 7/16/18, hardly a notable move over a six-and-a-half month span, especially following gold's consecutive advances of 8.56% in 2016 and 13.09% in 2017, (counter-intuitive strength during two years in which total-return for the S&P 500 Index measured a sparkling 36.38%). Come to think of it, amid near continuous geopolitical turbulence and resurgent market volatility during 2017 and 2018, gold's price ***stability*** has been fairly unique among asset classes.

By way of example, during 2017, there was not a single trading day on which change in the gold price exceeded 2.5% (first year since 1996). As shown in Figure 2, gold's 60-day realized volatility has collapsed to a fresh decade low of 8.03%, versus a 10-year average of 16.83% (orange line). Of course, this type of price action is precisely how an effective store of value ***should*** behave.

Figure 2: Spot Gold 60-Day Realized Volatility (7/16/08-7/16/18)



Source: Bloomberg.

Gold is Heavily Influenced by the U.S. Dollar

Over the short run, gold can display measurable correlation to a variety of assets, but over the long run, the only asset to which gold maintains lasting correlation is gold's inverse correlation to the U.S. dollar. Therefore, gold's prospects for the balance of 2018 and beyond will be heavily influenced by relative strength of the U.S. dollar. After declining 9.87% during 2017 (worst annual performance since 2001), the DXY Dollar Index was off to an equally inauspicious start in early 2018, declining an additional 3.14% through 4/17/18 (intra-day low of 89.23). Since that mid-April nadir, the DXY Index has rallied a crisp 5.92% to its 7/16 close of 94.51.

What changed in mid-April? Well, 10-year Treasury yields printed above 3% for the first time since January 2014, Fed jawboning assumed its most hawkish stance in decades, and Fed policies of simultaneous rate hikes and balance sheet reduction, especially against the backdrop of accelerated Treasury issuance, have crimped overseas dollar liquidity. For gold, the operative question has become whether the dollar's rally is likely to continue? With the Bernstein Daily Sentiment Index for the DXY Index now registering 79% bullish (7/16/18), the overwhelming majority of futures traders appear to believe so.

Growing Signs of Fed Induced Stress

The dollar's bullish case rests on two interrelated fundamentals. The first is the virtuous circle of solid U.S. economic growth allowing the Fed to tighten monetary policy. The second is the strain on overseas dollar liquidity caused by Fed policy divergence (versus looser global CB peers). In our June report, we chronicled Fed-induced stress now appearing in peripheral segments of emerging markets, global financial institutions, and U.S. consumer and corporate credits. In the latest sign that the Fed's dual policy agenda is already introducing unforeseen strains on global liquidity, the Fed took the unprecedented step at its June Federal Open Market Committee (FOMC) meeting of increasing the interest rate the Fed pays on excess commercial banking reserves (IOER) by only 20 basis points, versus a 25-basis-point increase in the fed funds target range. In essence, the $179 billion reduction in the Fed's balance sheet since QT (quantitative tightening) began has already placed such a premium on the declining stock of commercial bank reserves that banks are bidding-up the fed funds rate (cost of reserves) significantly above the Fed's preferred target range midpoint. During June, the ***effective*** fed funds rate came within a mere 5 basis points of the top of the Fed's targeted range.

For the effective fed funds rate to exceed the FOMC's targeted ceiling would be a significant embarrassment for the Fed. In an effort to cool commercial bank competition for shrinking reserves, the Fed is experimenting by raising the IOER at a slower pace than the fed funds target range itself. This policy can serve only as a temporary patch, however, and leaves the Fed with few palatable options as slated balance sheet reduction continues to diminish the stock of reserves. One option would be to abandon the target range approach (to setting fed funds rates) and return to the Fed's historical practice of daily intervention to maintain a ***specific target rate***. The only other possibility we can envision would be for the Fed to curtail balance sheet reduction a whole lot sooner than currently projected. ***Our expectations rest firmly on option # 2!***

Cornerstone Macro (7/2/18) attributes the U.S. dollar's recent surge to four variables distinguishing the U.S. economy from the rest of the world. Briefly, comparative prospects for growth, inflation, monetary policy and ability to withstand trade frictions have all lent relative support to the U.S. dollar. While Cornerstone is not forecasting significant F/X (Forex trading) volatility for the balance of 2018, we find it telling that the firm's proprietary macroeconomic models suggest the U.S. dollar is ***already overvalued by an average 6.8% against the currencies of all seven of the largest U.S. trading partners.*** In Figure 3, Cornerstone highlights percentages by which the top seven currencies in the trade-weighted U.S. dollar index are undervalued versus their model-implied values. Will the U.S. dollar expand (or even maintain) its premium valuation in future quarters?

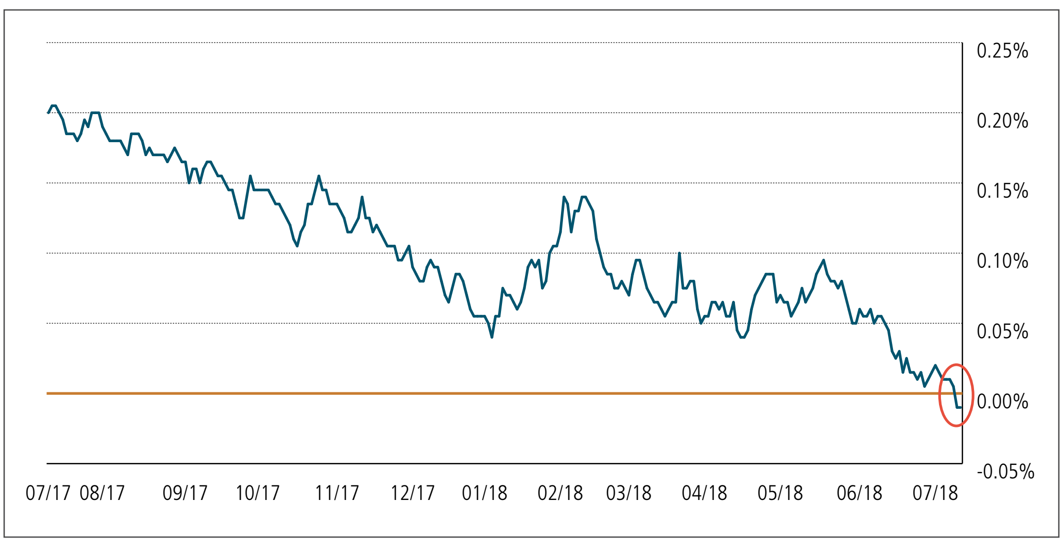
Figure 3: Percentage Undervaluation of Seven U.S. Trading Partner Currencies versus Cornerstone Macro Proprietary Macroeconomic Models (7/2/18)

	Weight In Trade-Weighted Dollar	Current Value	Model Value	% Over/Under Valued
CNY	21.6%	6.67	6.39	-4.1%
EUR	17.2%	1.16	1.17	-0.3%
MXN	12.8%	20.06	14.76	-26.4%
CAD	11.9%	1.32	1.12	-14.8%
JPY	6.5%	110.72	108.93	-1.6%
KRW	3.9%	1120.01	1031.00	-7.9%
GBP	3.6%	1.31	1.42	-7.6%
	77.5% (Total)			**-6.8%** (Average)

Source: Cornerstone Macro.

In our view, prospects for protracted U.S. dollar strength depend directly on the scope of ongoing Fed policy divergence. As we had anticipated, consensus over future Fed tightening is beginning to slip. On 7/12/18, Bloomberg reported (Figure 4) that the spread between December 2019 and December 2020 eurodollar contracts had fallen below zero for the first time, indicating traders no longer anticipate ***any*** rate hikes after next year. Indeed, despite FOMC dot-plot consensus for one-or-two 2020 rate hikes, eurodollar traders now give a 2020 rate ***cut*** higher odds than a 2020 rate ***hike***.

Figure 4: Eurodollar December 2019/December 2020 Spread (7/12/17-7/12/18)



Source: Bloomberg.

Looking Forward: U.S. Dollar Strength Likely to Dissipate in Second Half

We expect the U.S. dollar strength which has weighed on gold's performance in recent months to dissipate during the second half of 2018. Fed tightening is already pinching global liquidity and projections for a year-over-year $300 billion increase in second-half Treasury issuance will refocus consensus on grim realities of the deteriorating U.S. fiscal position. The domestic economy is not all it is cracked up to be. David Rosenberg calculates that U.S. real GDP growth has historically improved on the order of 3.5% in quarters following large fiscal stimulus (Kennedy, Reagan, Bush 43 twice, and Obama), so 2018 Q2 GDP growth should be humming along close to ***5.5%***. It is telling that the Atlanta Fed's GDPNow forecast for Q2 has fallen from a February high of 5.4% to just 4.5% by 7/16/18.

Gold Presents an Undervalued Opportunity

Internal equity market dynamics continue to deteriorate. First, as predicted, Trump tax cuts are funding runaway levels of share repurchase. Share buybacks in Q2 totaled $436.6 billion, 80% higher than the previous quarterly record of $242.1 billion, ***set in Q1***. The annualized rate of first-half buybacks now amounts to a patently absurd $1.35 trillion, or 9.5% of M2 money supply and 6.8% of nominal GDP. Second, market breadth is increasingly narrow, with CNBC reporting on 7/10/18 that 71% of YTD returns for the S&P 500 accrue from just three stocks: Amazon, Netflix and Microsoft. While imbalances and fragilities continue to mount in traditional asset markets, gold's portfolio insurance value is being priced remarkably cheaply. This is frequently a signal that market dynamics are about to change.

Timing a gold purchase is always a bit of an existential challenge. When gold is rising rapidly, a natural reaction is, "I missed it." Alternately, when gold is falling, an easy rationalization becomes, "See, I told you so." And when gold is flat for long periods, urgency is lost. To us, the U.S. dollar's counter-trend spring rally has provided a particularly fortuitous entry point for portfolio allocations to gold. Given the array of fundamental challenges in the contemporary investment landscape, we are confident today's gold price will soon prove to have been an especially prudent investment proposition.

Trey Reik
Senior Portfolio Manager
Sprott Asset Management USA, Inc.
203.656.2400

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