Gold: The Road to Hell is Paved with Good Intentions

There’s a whiff of the Thirties in the air. Global markets had their worst start ever. But the market is confusing coincidence with causation. In a déjà vu moment there are concerns that oil’s collapse is America’s next sub-prime disaster – after all, the big banks have healthy loan and derivative exposure. The other concern is about China’s stock market meltdown that after a 150 percent gain, somehow will trigger a global collapse. While pundits cite these factors in the panic, oil and China have been going down for months so the declines are nothing new or surprising.

The problem we believe is part economic. The main factor is that the US economy once thought to be most powerful, is collapsing under the weight of trillions of printed dollars. The market is adjusting to a “new norm” and finally catching up to reality. America’s policymakers are grappling with the exit from quantitative easing (QE) and a “return to normal”. At home and abroad, investors have lost faith in the markets, and fear that central banks have lost their grip on the economic levers, wasting the seven years not with reform but senseless money printing. During that period, the bull market was supported by free money and the belief that money had
value. However the collapse in oil, markets and currencies are indicators that the problem is not in China, emerging markets nor Europe. It’s in the U.S.

**Politicization of Policy**

Long ago, the world was based on good intentions. Politicians for example, in tackling poverty, raised taxes and closed tax loopholes to finance the programs that were good for us. Or, since guns kill people, gun laws must change and the outcome? More guns it seems. Those extravagant promises of hope, pronounced during every election, attracts votes but few recall that if the promises were so painless, that it would have happened already. So Mr. Rhetoric alone does not satisfy the electorate or investors, The problem of course is that politicians don’t have the power to deliver on those high expectations or even make needed changes, and instead, faced with the sober reality of governing, politicize their decisions to combat the falling esteem and diminished expectations. As such, every policy initiative has become more politicized, prompting policy makers to intervene in the economy –after all the polls can’t be wrong. Monetary and fiscal policies have become politicized whilst fundamental reforms like tax reform or in Canada, a single regulator are left aside.

Quantitative easing simply sowed the seeds of a worse financial problem than QE was to fix. Sooner or later investors will learn that this so-called money illusion and ideology can’t save the economy from its fundamental problems and that less intervention is needed to solve the very problems they were elected trying to solve.

With the ink barely dry on the historic Paris Climate Accord, the grandiose and inspirational announcements from our politicians saw nearly 200 countries signing on. Few recall that after the Kyoto Accord, US shale technology financed of course by Wall Street’s derivative gang allowed America to become an exporter of oil. As new technology replaced the old technology, Paris simply replaced new targets, in place of the old targets. Again our politicians took the easy way out. And sure Paris was a tiny step, but like closing tax loopholes and eliminating waste, it is not so painless.

The first rate increase in almost 10 years is another example of the politicization of monetary policy. After saving the Eurozone and Wall Street in 2008, with rounds and rounds of quantitative easing and zero interest rates, the consequences of the world central banks’ noble intentions are only just emerging against the backdrop of global market losses. Credit spreads have widened, sovereign defaults are on the rise and global markets have become addicted to the stimulus provided by zero rates and quantitative easing.

Good intentions aside, we believe our politicians won’t be able to evade the consequences of their politicized decisions. Politicians it seems are heading in different directions. In the Thirties, the failure of politicians resulted in an upsurge of support for the nationalistic right because democracy was seen as failing. And today, our democratic leaders seem to flail in the wind with old ideas. When politicians admit they can’t solve our problems and politicize economic policy, they invite the extreme as seen in France, the UK and the United States.

Plenty of problems are in evidence. There are spreading signs that Black Swans are everywhere, a consequence of this politicized era, from Britain going to the polls on Brexit this year, to America’s multi-billion presidential election, to China’s revamp of its economy, to Europe’s
stagflation, to the tide of refugees created by a sinking Middle East. All are signs of shifting tectonic plates in the global economy exacerbated by attempts to shift government led stimulus (QE) to private-sector led growth that only heightens investor risk.

Geopolitical Causation is Running the Other Way
This year we believe we are in the transitional phase of the geopolitical games of chance where rifts are exposed. Oil has dropped 18 percent since the start of the year to 13 year lows as Saudi Arabia racks up $100 billion deficits. OPEC’s defacto leader has introduced spending cuts to offset the impact of low oil prices. The 13 nation group while controlling more than a third of the world’s oil supplies over-produces in pursuit of a long term strategy to recapture market share. The consequences are disastrous. Today, Brazil the leader of the emerging economies must borrow just to pay interest while its public debt is at the third highest since records began. Standard & Poor’s cut Brazil’s sovereign credit rating to junk. Once a country that symbolized human rights and the fifth largest gold producer in the world, South Africa’s political uncertainty continues following the dismissal of another finance minister, only four days after President Zuma dumped another one sending the rand to record lows. And in Europe, all are weak under spending pressures and the growing refugee problem. Growth remains a major problem, particularly when so much debt overhangs the EU. Russia faces the prospect of a recession hit by collapsing oil prices, western sanctions and a sinking ruble. Puerto Rico, a ward of the United States, recently defaulted on debt payments on a debt load of $72 billion but the default has not yet had a ripple effect on Wall Street. As a legacy of 2008, debt keeps piling up proving equally consequential. Geopolitical games have become the new reality.

Lessons From the Arab Spring
The onslaught of Arab Spring brought much rhetoric of a new beginning, but five years later the consequences are only now being realized, with the Arab world worse off than in 2011. The wealthy Arab Gulf states are under pressure and sectarian divisions have deepened between Persian Iran and the Arab states. America sidestepped a geopolitical contest in the Middle East, by siding with Iran which led to the lifting of sanctions amidst a growing sectarian dispute between Iran and Saudi Arabia. The lifting of sanctions though allows Iran to increase oil production sending prices to 13 year lows, hurting even US shale producers. Saudi Arabia is a majority Sunni country and its dilemma is that they bought sectarian peace through generous public spending and welfare payments which are threatened by the collapse in oil prices. Even so, the execution of the highest ranking Shiite cleric reignited the long standing Sunni/Shiite rivalry but the problem is beyond sectarian differences. The rivalry is more about the domination of the Middle East, its trade routes and oil. For now, at least further pressure on oil prices is expected as Saudis overproduce to put pressure on Iran. However, the power vacuum created by Washington’s retreat exacerbated the rivalry, drawing in the world powers into a new and dangerous phase. Unfortunately, America having recently surrendered a 2,400 kilometer air corridor from the Baltic Sea to the Black Sea, to the Russians, are only just spectators here.

America’s politicians too must face the consequences of their good intentions and rhetoric past. Moscow, Tehran, Beijing and Riyadh has forced investors to face deteriorating choices. Needed of course is financial reform, long term investment and structural transformation but the US economy has become so addicted to credit bubbles that it has become debt-ridden, rooted not in economics, but in politics and ideology. What ballasts the US monetary system is debt, and it is
still growing. Debt to GDP is 100 percent and the system is so debt-clogged that the 0.25 percent rate increase caused a major correction. The Americans have become addicted to zero interest rates and quantitative easing which pushed up asset prices artificially, inflated valuations and depressed growth. And now the markets fear a return to normal which will cause even bigger defaults than 2008. Today, mammoth oil and gas defaults threaten Wall Street’s banks and private equity players in a repeat of 2008, aggravated again by derivatives. Unless these problems are addressed, geopolitical risk premiums can only grow. Gold will be a good thing to have.

**Great Circuit Breaker of China**

There is much concern over China’s large cap CSI 300 index sell-off, which triggered circuit breakers for the second time in a week sending financial shock waves around the world. Overlooked was that Chinese stocks are trading at 60 times forward earnings and after a 150 percent move fueled by leveraged retail speculators, everyone headed for the exits. China’s capital markets are thin and nascent lacking even the equivalent US Plunge Protection Team. Gambling investors simply discovered that trees don’t grow to the sky. Noteworthy is that the stock markets play a relatively small role in China’s GDP and are not an indicator of China’s health. Little Chinese wealth is actually stored in shares, particularly when compared to property and unlike western wealth management, they do not have RRSPs or 401 Ks. Noteworthy is that China’s stock market is still higher than last summer’s low. Nonetheless though, the sell-off in stocks spurred demand for a haven and gold stocks soared as equities swooned. What will happen when the Chinese stock market rallies and North American markets continue to woon. Who else can they blame?

Although China’s slowdown has been two years in the making, it will still grow at close to 7 percent. We believe concerns about the slowdown are much exaggerated. First, Alibaba’s “Single’s Day” sales reached $14.3 billion, smashing records and an indication of a vibrant and growing middle class. Auto sales were also at a record. Second, China’s infrastructure rollout is just beginning with 30 new regional airports being built and $120 billion of railway lines linking major centres. Indeed, China’s Silk Road initiative is a “Made in China” Marshall Plan. To be sure, what is slowing down is the ridiculous boom time expansion of expensive western capacity that was supposed to satisfy Chinese commodity demand growing to the sky. Much of that capacity was to be based where? The West. Third, China is the biggest beneficiary of the collapse in commodity prices, receiving a bonus windfall.

Fourth, China has shifted more to a domestic demand driven economy and less from an investment and manufacturing model. America’s economy is geared more towards debt-fueled consumption with the consumer accounting for almost 70 percent of economic activity. Ironically what the United States desperately needs, is more investment and less consumption. On the other hand, China’s growth hinges on all four drivers and that transition is confusing to the West. The West forgets that in less than three decades, China has grown from an impoverished agrarian country into a manufacturing powerhouse largely on infrastructure growth becoming one of the major superpowers in the world. That turnaround has come while its population exploded to 1.4 billion and changes were needed to lift the living standards of those people. Of course, debts have piled up but those debts are largely owed to the government, not
unlike the United States, where the Federal Reserve’s balance sheet was used to finance America’s growth over the past seven years.

Furthermore, President Xi Jinping’s policies and intentions are a conservative effort to eliminate self-serving corruption and reduce the huge bureaucracy – a supply-side approach. Here, there seems to be a true effort combining private and public works projects. Finally, devaluation jitters are intensifying. The renminbi sank eight percent to its lowest level since 2010, aiding the world’s biggest exporter. Although, China spent more than $100 billion in the summer to stabilize its currency, the lower renminbi will help out exporters who were badly hurt when China’s currency, pegged to the dollar jumped 60 percent as the superstrong greenback making exports particularly expensive with neighbouring “Asian Tigers”, South Korea, Singapore and Taiwan. Nonetheless, the renminbis’ sharp decline has caused angst among investors because the “stealth” competitive devaluation joins Switzerland, Brazil, Mexico, Sweden and soon Saudi Arabia. Of equal concern is what China does with its capital. Last year they ran down their trillion dollar foreign exchange reserves, selling US Treasuries. China still has $3.4 trillion of foreign exchange, but financing America’s profligacy by buying Treasuries has become passé.

**Gold – The Antidote To Our Problems**

Despite dropping 10 percent in US dollar terms last year, gold denominated in ten other currencies (eg ruble, SA rand, Brazilian real) have increased. In Canada and Australia, gold was up. In Russia, gold is at a record. Since 2010, central banks have become net buyers of gold, close to a fifty year high. These central banks also have repatriated their gold reserves from Fed and UK bank vaults. Historically and today, gold is still a currency. Russian and Chinese central banks are buying physical gold as a hedge and diversification move against a dollar debasement. The world’s largest bank ICBC recently bought a 1,500 tonnes storage facility in London to store Chinese gold. Do the banks know something we don’t know?

In the past few years, the main reason for gold’s drop was a superstrong dollar which acted as a refuge for the trillions created by a global easing monetary policy. However, gold is an alternative investment for central bankers and a hedge in a time of competitive devaluation. We believe faced with the consequences of rounds and rounds of quantitative easing, the avalanche of dollars will push its value down this year. On the other hand, Chinese gold demand approaching 50 tonnes a month has taken up nearly 85 percent of Western gold production last year. We believe the Chinese are following the age old prescription of purchasing tonnes of gold to protect themselves against a depreciating renminbi. History shows that gold always retains its value. And with the world’s assets largely denominated in a fiat paper currency, our view is that the US dollar’s days of acting as haven are limited by ironically, the upswing in interest rates and the growing concern among central banks of its value, particularly during an unpredictable election year.

In November, the Americans may elect another inflationist Democrat socialist or, the Donald? That will be good for gold, but bad for the dollar. Consequently, we believe that gold bottomed last year and expect a run to $1,170 an ounce in the near term but importantly, see a resumption of the bull market which will see gold topping $2,000 per ounce.
Recommendations
We also believe that gold equities have bottomed in correlation with the bottom bullion reached late last year. For much of last year, gold stocks underperformed the gold price but we expect this to change this year. Of interest is that gold stocks have outperformed bullion at this early start of the year, helped by the gold ETFs which became buyers again. And the fundamentals of the surviving gold miners have improved as the CEOs went “back to basics”, reducing costs, selling assets and focusing on cash flow per share. Investors meantime focused on the liquid big cap stocks particularly those producers with low cash cost which provided margin insulation. However, we also believe the market will focus this year on the growth pipelines of many producers. We believe that the markets will reward those producers with the highest growth rates, cheap in situ reserves and best quality assets with attractive multiples. *Barrick* and *Agnico Eagle* fall into that category. Among the mid-cap producers badly mauled *B2Gold* and *Eldorado* should be looked at down here. We also believe that some of the smaller gold producers and developments situations like *McEwen Mining* should be looked at because they are attractively priced in this nascent bull market. We note that the merger of *Kirkland Lake Gold* and *St. Andrews* will result in a medium sized producer, with a large Timmins footprint giving them long term development potential to be financed by Kirkland Lake’s cash cow Macassa.

Execution risk was a big problem in the last couple of years, but now the swamp has drained. We believe the massive share dilution, destruction of Alamos Gold’s balance sheet and healthy price tag are behind Alamos Gold trading at a lower price than when they merged with fellow producer AuRico. We would avoid the shares – one and one did not make two here. Not so lucky was Rubicon Minerals which slashed its gold resources by 90 percent and this was not even a fraud like Bre-X. Ironically, it was a badly flawed resource estimate and management’s incompetence which led to this potential bankruptcy. Rubicon’s collapse has cost metal streamer Royal Gold about $75 million and CPP was dinged for $50 million. The lesson here was not that $800 million plus was spent but was built without a feasibility study like San Gold and Colossus Minerals in Brazil which went into production prematurely. As a sidebar, we also believe that the metal streamers, the default bankers of the mining industry, in their chase for ounces are running a substantial risk. The streamers’ reply is that they are diversified but their portfolios are based on the premise that most of their investments will be in production. Impossible. Moreover, streamers also take the miners’ upside away and we believe the current enthusiasm will be tested this year.

Finally, we also like development situations, such as *Lundin Gold*, which just announced a fiscal arrangement with the Ecuadorian government for the rich undeveloped gold deposit, Fruta Del Norte which was acquired from Kinross for $240 million. The terms are liveable since Lundin will get its money back first and the royalty will be tied to the future gold price. Ecuador has opened its mining and we believe Lundin Gold has attractive upside here.

Companies

**B2Gold Corp.**
B2Gold shares have been under pressure due to missing guidance and the rumours of a stock issue which could flood the market with shares. We do not expect B2Gold to issue shares down here since the cash flow from El Limon, La Libertad, Masbate and newly opened Otjikoto in
Nambia are sufficient to build-out Fekola in Mali, the next producer. B2Gold has grown through astute acquisitions and execution. B2Gold produced almost 500,000 ounces and 131,000 ounces in the final quarter was on the low side of guidance due in part to permitting delays at La Libertad in Nicaragua. Despite the miss, cash costs were down reflecting the quality of assets. Otjikoto will produce a minimum 160,000 ounces in its first year of production at a cash cost of only $440 an ounce. Otijikoto was commissioned in September 2014, ahead of schedule and under budget.

The Fekola’s mine’s construction has been funded by cash flow and a line of credit but will require a top up before completion. The balance sheet is manageable since B2Gold has only drawn $150 million of the $350 million credit facility. Fekola will be Africa’s third largest gold producer with the final feasibility study filed in June last year. Fekola will be an open pit mine, with a mine production life of almost thirteen years and average over this period at 276,000 ounces per year at a cash cost of $550 an ounce (350,000 ounces per year for the first seven years). Access roads, airstrip, and construction of the camp pad is underway. Gold production is scheduled for the end of the fourth quarter 2017 at a cost of $400 million. B2Gold has $259 million of convertible debentures due September 2018. We like B2Gold down here, particularly on the current pullback.

**Centamin PLC.**

Egyptian based Centamin surprised the Street producing 440,000 ounces from open pit Sukari which began production in 2010. Centamin’s all-in costs are under $950 an ounce and output in the latest quarter was up 12 percent. Guidance this year is for an increase to 470,000 ounces at an AISC at $900 an ounce. Centamin has $213 million in cash and no debt. Centamin also has advanced exploration programs in Ethiopia, Ivory Coast and Burkina Faso, but the flagship Sukari is a cash generator. Centamin is also a large employer and the largest gold mine in Egypt. The stock is cheap and attractive down here.

**Centerra Gold Inc.**

Centerra exceeded its guidance producing 536,000 ounces, with most coming from the Kumtor mine located in the Kyrgyz Republic. At Kumtor, gold output this year is expected to be flat, at an all-in cost shy of $1,000 an ounce. Centerra again plans to spend $11 million on exploration, advancing the Oksut project in Turkey. Centerra is in need of diversification of its assets because of the ongoing battle with the Kyrgyz government over ownership. Capex for the year is estimated at $269 million including $85 million of sustaining capital. President and CEO Ian Atkinson retired and Scott Perry was elected CEO. At current levels, Centerra shares are cheap.

**Detour Gold Corp**

Detour produced a solid 506,000 ounces at an estimated AISC of $1,050 an ounce helped by the drop in the Canadian dollar as well as the decline in energy prices. A new “life of mine” update is expected soon to include plans for Block A, which has a slightly higher grade. Detour is a low grade open pit operation in northern Ontario that is leveraged to the gold price. At current levels the company is losing money and needs to boost throughput. Detour has $160 million of cash and an undrawn $85 million line, sufficient to finance capex plans. From an exploration point of view, only 20 percent of the Detour Lake property has been explored, so there is a lot of blue sky here. Detour currently has 5 rigs turning as part of a 40,000 metre program. Detour is a hold here.
Eldorado Gold Corp.
Notwithstanding spending $700 million in Greece since 1982, the company has suspended construction at Skouries because the leftist government has blocked the issuance of permits. Eldorado has been in a protracted fight after the energy minister revoked its permit. Eldorado responded by halting $1 billion of work and plans to halt work at Olympeias costing another 500 jobs should they not receive a permit by March. The suspension has hurt Eldorado’s share price as the Greek assets represent over a third of net asset value. We believe the market has overreacted and like the shares here. Eldorado is the largest foreign investor in Greece building two gold mines together with operating short-life Stratoni mine. Eldorado has almost $400 million of cash and a credit facility of $375 million. While Greece was to be a major part of Eldorado’s future, the Company has solid legs in Turkey and China. Buy.

Goldcorp Inc
Goldcorp’s newly minted CEO, David Garofalo, will have his hands full when he replaces Chuck Jeannes in April. Start-up Eleonore mine in Quebec and Cerro Negro in Argentina are still suffering teething problems. The recently announced joint venture with Teck to combine El Morro and Relinco in Chile will require big bucks and there are plans to optimize flagship Penasquito in Mexico. In Canada, its Ontario strategy needs fixing. Mr. Peter Thomas George, P. Geo, a Qualified Person (QP), recently admitted to unprofessional conduct in producing a substandard technical report for Barkerville Gold Mine and early Rubicon reports. He also authored the report for the Cochenour deposit. Cochenour has 12 rigs turning but Goldcorp’s $1.5 billion acquisition (Gold Eagle) of Cochenour may be problematic as the resource might be lower than anticipated. The Association of Professional Engineer and Geoscientists of British Columbia sanctioned Mr. George a paltry $15,000 and $20,000 in costs. We trust newly arrived Garofalo will scrutinize Cochenour more closely. Exploration drilling in the third quarter hinted of possible changes from original interpretation. Cochenour is supposed to be processed at Red Lake where flagship Campbell is winding down.

In fact, he should order another review at Borden, about 160 kilometre from Goldcorp’s Porcupine which was purchased for $500 million last year to provide feed to Porcupine and also a key part of Goldcorp’s Ontario Strategy. Goldcorp announced closure of the underground 100 year old Dome mine, part of the Porcupine Gold Mine complex at Timmins. It appears that there are problems here, maybe continuity or the model? Garofalo’s task is to optimize Goldcorp’s existing assets, salvage something from $2 billion of acquisitions, and make their development assets work. We believe there are further shoes to drop and prefer to sit on the sidelines.

IAMGold Corp.
IAMGold has lowered its guidance and still has not yet replaced reserves. The company is harvesting Sadiola in Mali, Rosebel in Suriname, and Essakane in Burkina Faso which has a ten year life. IAMGold has a strong balance sheet of almost $800 million in cash and bullion, against some $600 million of debt due 2020. IAMGold sold Niobec and has not been able to replace the cash cow. A revised mine plan is planned for problem prone Westwood shortly which was shutdown because of lack continuity. Westwood was brought into production in July 2014 but operations were shutdown due to ground conditions as well as operating problems. IAMGold has a modest joint venture at Monster Lake in Quebec, near Westwood but there seems nothing on the horizon of interest. IAMGold is still a harvest situation. Sell.
McEwen Mining Inc.

McEwen reported record production this year of 154,000 gold equivalent ounces with a major contribution from the El Gallo mine in Mexico, which produced at an all-in costs(gold equivalent) of $1,100 an ounce. Cash flow in the quarter was $8.5 million and McEwen sits with almost $36 million of cash and equivalents plus no debt. McEwen’s 49 percent owned San Jose mine in Argentina, remains on target and the turnaround in political climate in Argentina has made San Jose interesting again. McEwen also announced a positive feasibility study at the Gold Bar project in Nevada which calls for a capital expenditure of $60 million and an internal rate of return of 20 percent with annual gold production of 65,000 ounces a year. Permitting is advanced and McEwen has hired Colin Southerland as president who has strong operating experience, most recently in Indonesia. McEwen Mining has an attractive pipeline including El Gallo II development and the Los Azules in Argentina as well as Gold Bar. That pipeline, a strong balance sheet and Rob McEwen owning 25 percent of the company, makes the shares attractive down here.

John R. Ing
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<td>5.79</td>
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<td>2016</td>
<td>0.14</td>
<td>(0.10)</td>
<td>14.57</td>
<td>(20.40)</td>
<td>1,913</td>
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Rating: 5 – Strong Buy 4 – Buy 3 – Hold 2 – Sell 1 – Strong Sell

<table>
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<tr>
<th>Gold Price</th>
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<tr>
<td>2013 $1,410</td>
</tr>
<tr>
<td>2014 $1,200</td>
</tr>
<tr>
<td>2015 $1,200</td>
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<tr>
<td>2016E $1,300</td>
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John R. Ing
416-947-6040
Analyst Disclosure

Rating: 5 – Strong Buy  4 – Buy  3 – Hold  2 – Sell  1 – Strong Sell

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<tr>
<th>Company Name</th>
<th>Trading Symbol</th>
<th>*Exchange</th>
<th>Disclosure code</th>
<th>Rating</th>
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<tr>
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<td>ABX</td>
<td>T</td>
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<td>Centamin</td>
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