

This is the time to fight back

During my student times three good friends and myself happened to perform a wonderful hike into the wilderness of Yellowstone National Park in the US. After a multi hour walk we found a beautiful place for the night, many miles away from other human beings. In the area where we prepared for the night bears were seen a few days earlier. After raising the tents we once again read our camp guide, "how to behave in case of a direct confrontation with bears". Under the chapter "When the bear comes to the campground" we found a lot of useful information, for instance where to place the food and other stuff. A few sentences dealt with the matter, "when the bear is entering your tent". The main advice was, not to move and to play dead. And then we read through to the very last advice: "But if the bear is pulling your neighbor out of the sleeping bag ... this is the time to fight back".

I think this advice relates quite well with the state of the metal markets and the performance of miners, which are experiencing the last stages of a severe bear market. I am quite sure that the time to fight the bears back has arrived. But let's take a look at their main arguments first before this decision is made.

Factors behind the recent metals bear market

Argument #1: Oversupply and delayed supply cuts

There is some truth in the argument that a lot of metal markets are rattled with oversupply. In the last years we observed that China has emerged as an important metal consumer **and** as a dominant supplier for concentrate and refined metal. New Chinese refineries have battled for market share, driving prices well below production cost of Western producers (aluminum, nickel, steel components Iron ore and metallurgical coal). But also outside of China new supply (for instance the tin supply from Myanmar) or a resurrection of supply (of PGM production in South Africa after the end of the strike in summer 2014) which laid the foundation for sharply lower prices. For 2015/2016 most metal markets are believed to stay in a surplus market because intense competition among miners are preventing well needed production cuts. And indeed sharply lower energy cost and producer currencies have pushed down break even prices for metal producers. Only for three metals (Nickel, Zinc, Palladium) the consensus calls for a supply deficit, which seems hard to believe, when looking at the recent price slump. So, will the bear market for metal markets stay for longer?

I don't think so. Excess supply is relatively small compared to the market size. In most metal markets the estimated excess supply in 2015 and 2016 accounts for no more than 1%-2% of overall production. This leaves little room for unforeseeable supply shocks, which regularly arise from geopolitical conflicts, strikes or weather effects. Commodity bears are pricing in the best of all worlds without major supply disruptions. But if you take the copper market for instance, the forecast at the beginning of the year was always higher than the realized supply at the end of the year. Sudden supply disruptions could easily lead to a switch in market regime from pricing out supply to

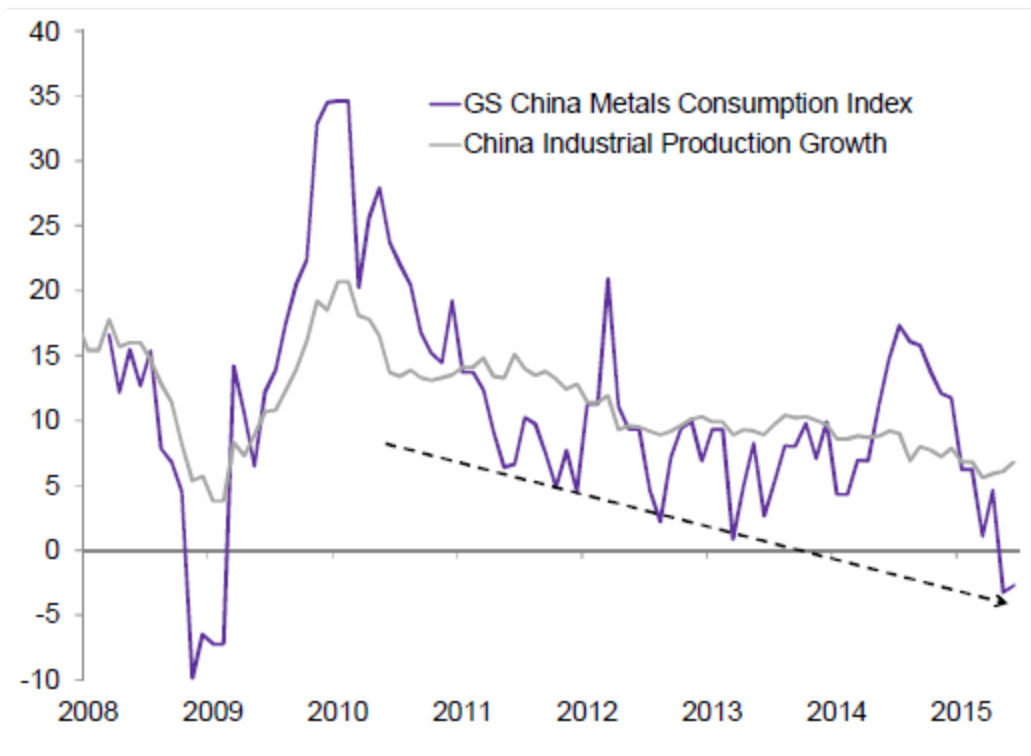
incentivizing additional supply. In many cases much higher prices are needed to incentive for additional supply, especially at a time when miners fight to survive by slashing capex budgets.

The bears might argue, that in this case ample stocks in reported and unreported warehouses will prevent any sustainable price spike. It is true that exchange stocks for quite a bunch of metals is high by historical standards, and there is enough anecdotic evidence that warehouses are filled to the brim. But that doesn't automatically mean that these stocks are available for consumers and traders, once a short squeeze has set in? The best example is the gold market where above ground stocks are equaling more than 30 times of yearly refined production. Gold from a physical perspective is never scarce. But the main question is: at which price are the stockholders willing to sell? The current oversupply in base metals is mopped up by stockholders, at prices which on average have halved from the top. From hindsight, the belief of the bears that current stockholders are forced to or intend to sell at even lower prices might prove silly. I have the impression that strong hands are taking over commodity stocks from investors who were buying late (2011-2013) during the last commodity boom.

Argument #2: China's economy is falling apart which leads to a slump of metals demand

The bets for a breakdown of the Chinese economy has grown substantially in the last years. The country is indeed facing various social, economic and environmental challenges. The Achilles heel of the Chinese economy is the architecture of the financial system. In the tradition of the Japanese growth model of the seventies and the eighties of the last century, Chinese government officials were dictating to the state owned banks, which sectors should receive what amount of credit. That yielded two unwelcome consequences. First, there was a misallocation of credit to in many cases to inefficient state owned enterprises (SOE) which inevitably leads to a big bad loan portfolio in the medium term. Second, this way of Chinese banking created a shadow banking system, which saw a tremendous growth in so called "asset management products", often tied to the property and commodity boom. The government efforts to cool down the shadow banking activities finally cracked the property and commodity boom.

Since mid 2014 the downturn of the China's industrial sector is more pronounced than in previous mini cycles. Property prices are, on average 5% lower than a year ago and industrial production have come down much more than official data wants us to believe. Most Chinese official data looks more like a smoothed moving average around government targets, which wouldn't be too surprising for a communist country. According to the National Bureau of Statistics of China GDP grew 7% YoY in the second quarter of 2015 and industrial production was up 6.8% YoY in June 2015. The reality is probably more a zero percent growth in China at present. Goldman Sachs Research made the effort to extract the metals consumption data from the industrial production output figures and came to the conclusion that the YoY growth rate of their Metals Consumption Index (MCI) was in negative territory in Q2 2015.

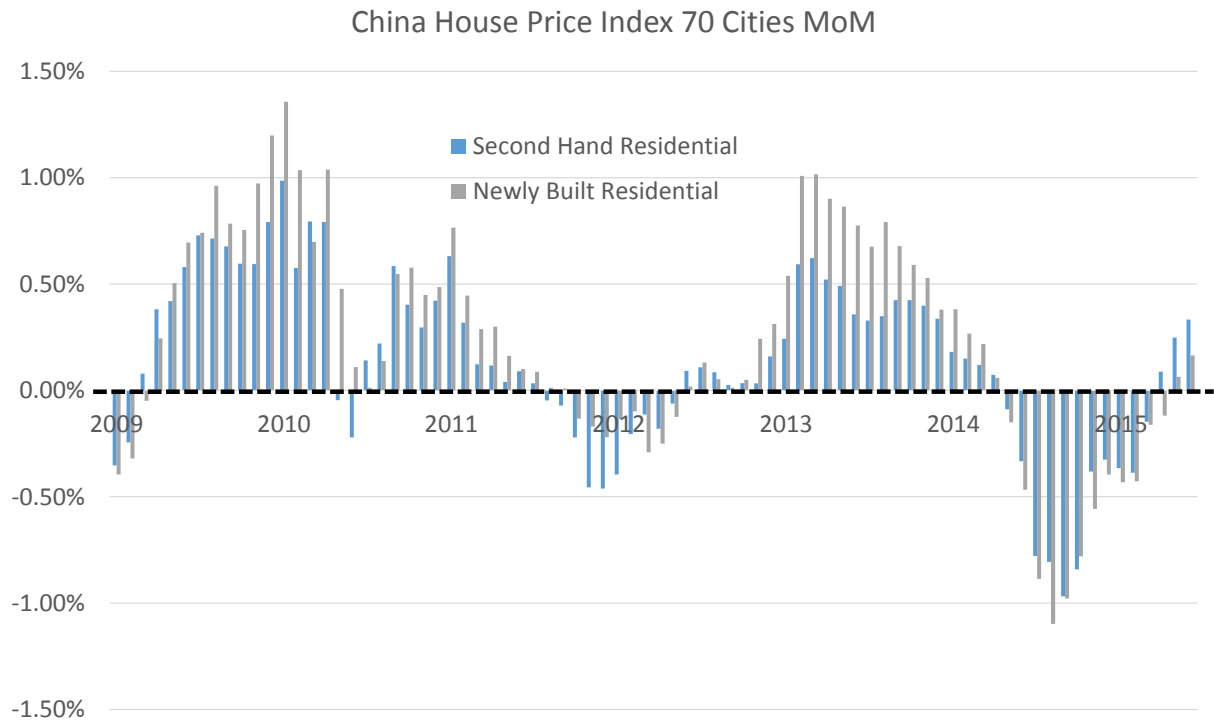


Sources: Goldman Sachs Global Investment Research, CEIC

But signs are increasing that the Chinese economy is poised for a much better second half. Monetary policy follows a more dovish approach after money M2 growth has fallen below intended growth levels. Beside several cuts of the Reserve Requirement Rate (RRR) the government abolished the 20 year old loan to deposit rule which capped bank credit to 75% of deposits. Since the state owned banks lost deposits to the shadow banking system this law was restricting new credit supply. The second monetary stimulus comes from the attempt to stabilize the crashing Chinese equity market. I don't think that massive government intervention in financial markets is a good idea, because it keeps asset prices at artificial levels and leaves funds with inefficient industries. But doesn't this sound familiar to Western investors? I personally fail to see, why the huge credit injections since the end of June 2015 (Central bank loan of 40 bln. USD to state owned banks, Central Bank capitals transfer of an undisclosed amount to the Chinese Securities Finance Corp, relaxation of regulation for equity investments and margin loans) should be bad news for nominal asset and metal prices at the same time, when it is the only mantra for investors in Western Capital markets. If the ECB or the Fed would have announced that kind of additional stimulus, markets would have probably responded with the advice "Don't fight the Central Bank". It looks like credit growth has already started to pick up again in May and June. I am convinced that we will see higher credit growth in H2 2015.

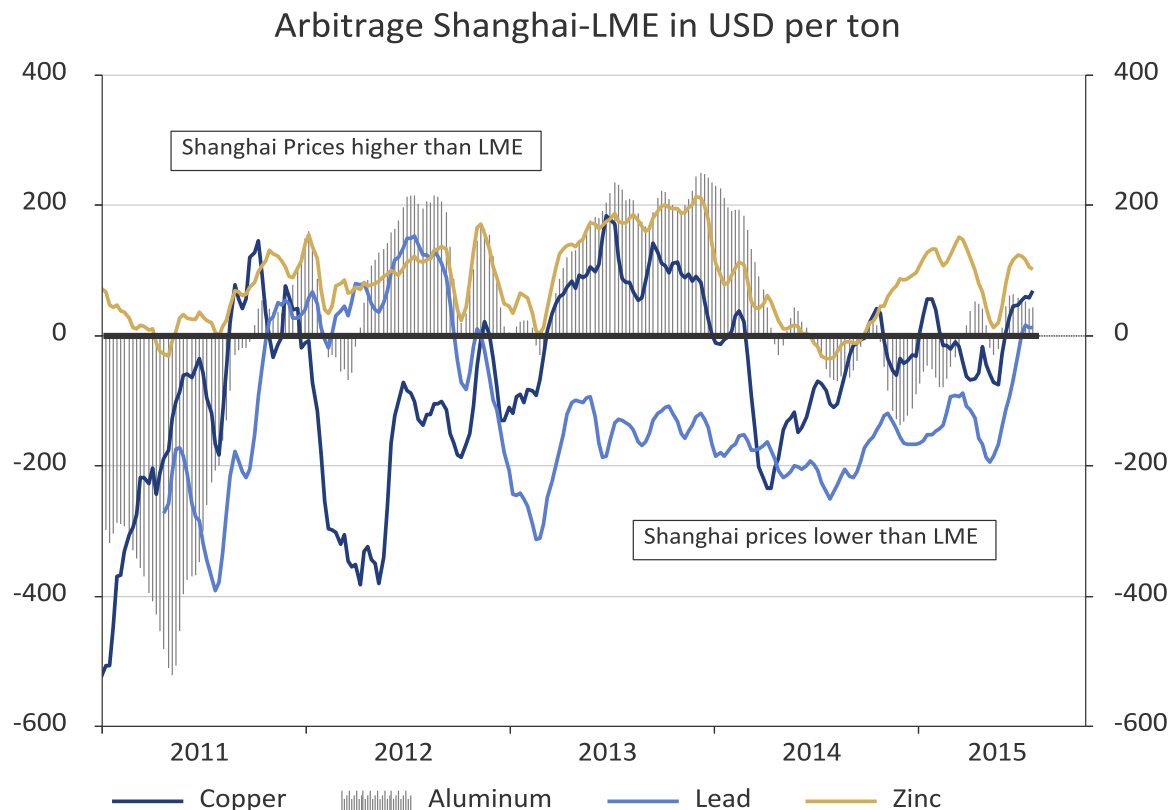


The second sign for a recovery of the Chinese economy is the turn of property prices to the upside. The National Statistics Bureau of China reported for June the second monthly increase for the 70 City House Price Index in a row. It seems that the heavy price fall from mid 2014 to spring 2015 has abated. The price increase is even more pronounced in the biggest Chinese cities. Presumably we just saw the start of a mini uptrend as in the years 2010, 2011 and 2013. In all of those years the investor's attitude towards China and industrial metals was similarly negative as today and base metals responded with an impressive bear market rally from oversold levels.



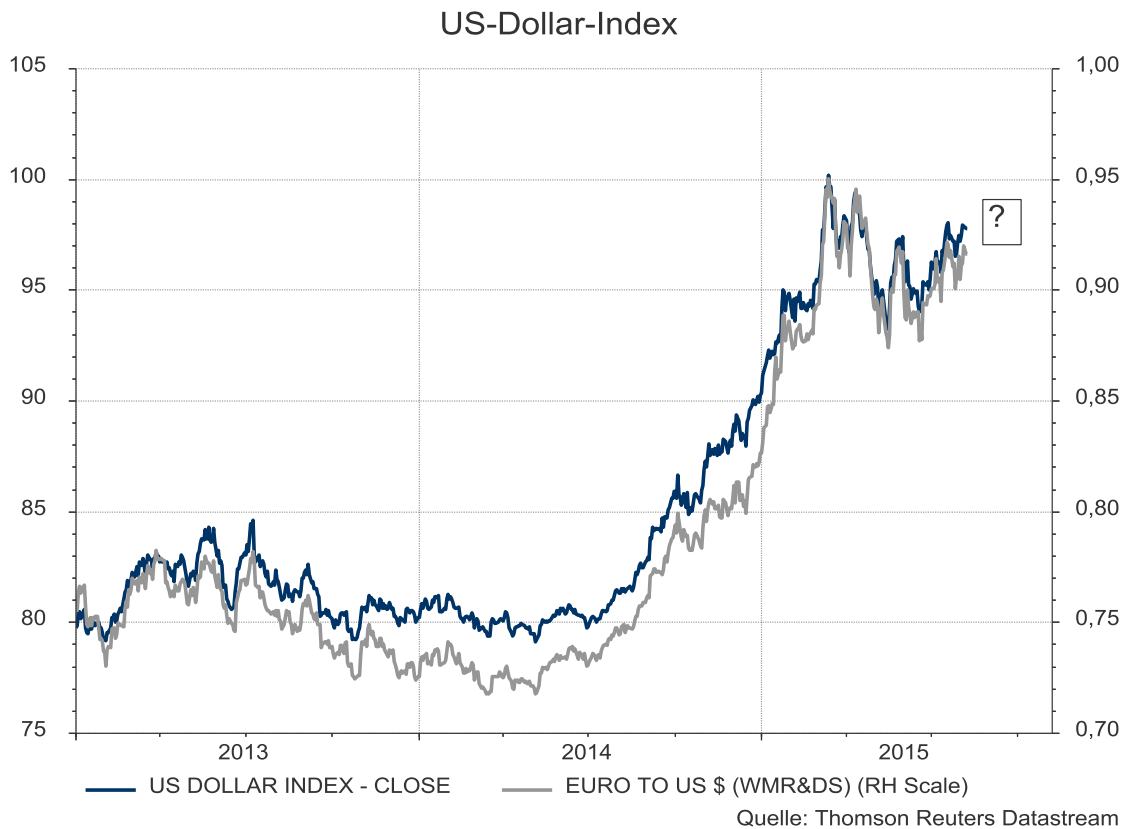
Source: Thomson Reuters Datastream, own calculations

The last point I want to emphasize is that Shanghai Futures Exchange metal prices are again offering a premium in comparison to the prices of the London Metal exchange. This gives the impression that Chinese metal destocking has come to an end. After accounting for taxes the arbitrage window is open for all of the metals (copper, aluminium, zinc, lead and the newly introduced nickel contract). This should result in steady outflows from LME warehouses to China in the coming months. Again, the situation is a reminder of the preceding years 2011-2014, when the bets for a shortfall of the Chinese economy (which reached their climax mostly at the end of the second quarter) were proven wrong. A sudden short covering rally is in the cards for Q3 2015.



Argument #3: A Dollar Bull in full

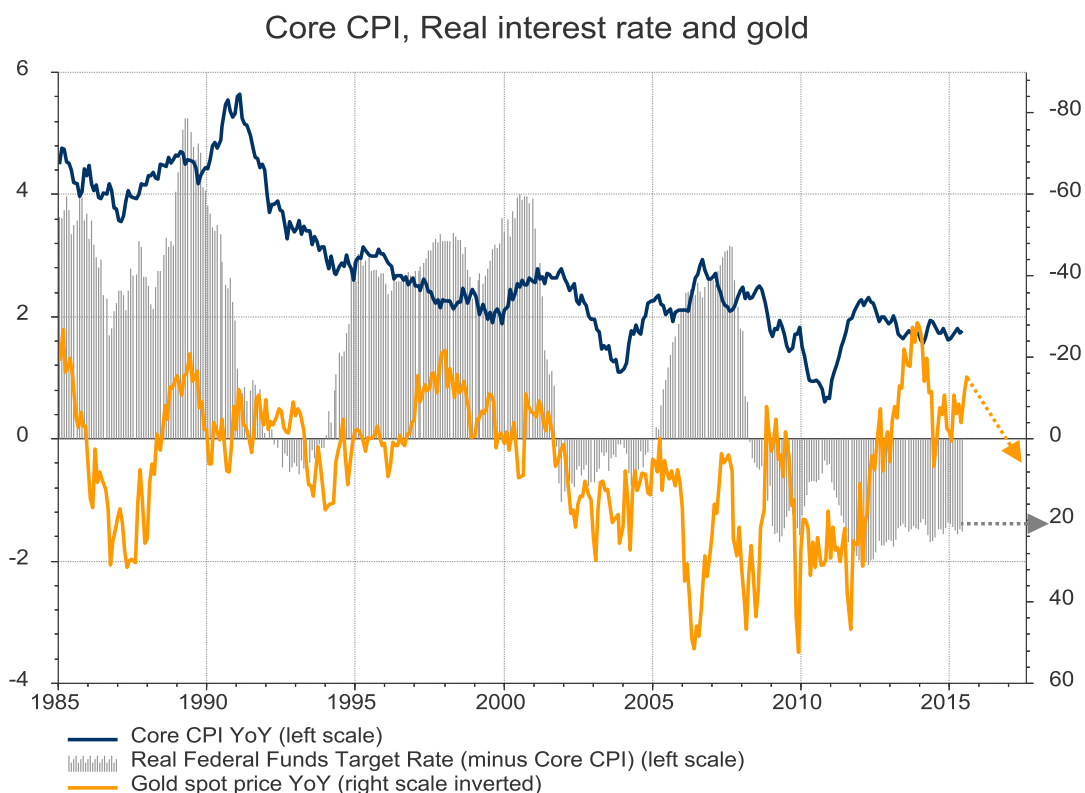
If not from dwindling demand from Emerging Markets, the metal markets will suffer from a further appreciation of the US-Dollar. That's the central argument of the commodity bears and indeed, history shows a negative correlation between the US-Dollar-Index, which represents the performance of the US currency against the Euro (~50%), the Japanese Yen (~25%) and the currencies of other major US trading partners (~25%), and metal prices in USD. The rationale for a Dollar long trade was quite appealing in mid 2014. The US monetary policy was just about to exit her Quantitative Easing (QE) programs. At the same time when the ECB felt more and more obliged to implement additional monetary stimulus and Japan remained trapped within the Abenomics type of monetary easing. In May 2014 the Euro was flying high against the USD (1.4 USD) and economic signals, especially credit data, from the Eurozone were quite disappointing. As a result interest rates have shifted in favor of the US-Dollar. The money markets are pricing in roughly a 2.0% Fed Funds target rate in 2017, whereas in Europe and Japan the environment of zero or even negative interest rates are believed to stay at least until the end of the current QE programs (autumn 2016). Ten Year government bonds are offering a yearly interest advantage of 1.5% against German 10 Year government bonds. The prospects of relatively higher interest rates have caused capital flows to Emerging Markets to reverse, leading to large devaluations of important commodity producer currencies (Brazilian Real, Russian Rouble, Canadian and Australian Dollar). With the first interest rate hike for the Fed Funds Rate expected either in September or in December 2015, the only direction for the US-Dollar is further up, isn't it?



I want to raise a question against this argument and the absolute target price of the US-Dollar or, in other words: How much is a shift of 2.5% in interest spread expectations worth? If a positive interest rate spread between the US and major trading partner currencies would be the only explainable variable, any US-Dollar appreciation is justified as long as the interest advantage of the greenback persists. When the Euro as a result of diverging monetary policies has fallen to 1.1 USD per Euro, why it should not fall to 0.9 USD or to 0.5 USD per Euro? Or why should the Yen not head for 250 Yen per US-Dollar? From my understanding it is evident that signals, which are derived from short term interest rate expectations are limited by some long term absolute (fair) values of currency exchange rates. I am not a friend of the Purchasing Power Parity (PPP) theory, because it tries to formulate target prices for currencies only from the spread in inflation rates. But the main logic behind it – the exchange rate as a barometer for the long term competitiveness of an economy – is valid in my opinion. To gauge the fair value of a currency takes in a lot of factors, for instance, labor and capital productivity, development of the trade balance, competitiveness of main industries, government debt and spending ratio, money supply and the importance of the currency in international currency reserves, all have to be considered. And if we take a look at these factors, it is obvious that the main trend for the US currency has been down for many decades. In principle the US-Dollar is devaluing since the failure of the Bretton Woods system of fixed currency rates in 1973. And there is some evidence that the recent US-Dollar strength is starting to hurt the US economy just as in the years 2000ff. Economic and industrial production growth in the US have undershot expectations. The US is not the engine of the World Economy as it was supposed to be by mostly US economists two years ago. The forecasted boom in (infrastructure) investments didn't materialize. US GDP growth is well below target for a third year in a row. As a consequence Fed officials guided down new equilibrium rates for the Fed funds target rate – from 3.75% in September 2014 to below 3% at the time of writing. And even that may prove as too optimistic, looking at the pricing of money market futures

and the resilience of 10 year rates to move up. Financial markets forecasted the first rate hike two years ago for autumn 2014, the best guess today stands for December 2015. Currency markets so far largely ignored the weak spots in the US economy.

If it comes to metal prices, by far most important factor for a strong currency is the ability of an economy to pay a positive *real* interest on bond and equity investments. In the last 15 years we witnessed an explosion of private and government debt and an equivalent (nominal) increase in private wealth in all major world economies as the other side of the coin. To bring this debt down to sustainable income levels there are two principle choices: First, debt defaults which could cause a deflationary spiral. Second, a long period of negative real interest rates. Policy makers around the world have opted for the second choice, not shying away from a more a less direct monetization of government debt. The whole discussion, whether Fed rate hikes would be harmful to gold and metal prices and beneficial to the US-Dollar is misleading as long as real interest rates have no prospects to rise from current depressed levels. A backtesting of changes of the Fed Funds target rate and metal price performance reveals, that metal prices do well in an environment of target rate hikes as long as nominal rates offer no protection against inflation. In comparison to incredibly inflated bond prices all metal prices are looking cheap. That said, core inflation in the US is slowly on the rise. The Fed will be intentionally behind the curve. Many more years with negative US real interest rates are at the horizon. At the same time the US-Dollar long trade seems very crowded and gold bulls in public media have almost disappeared.

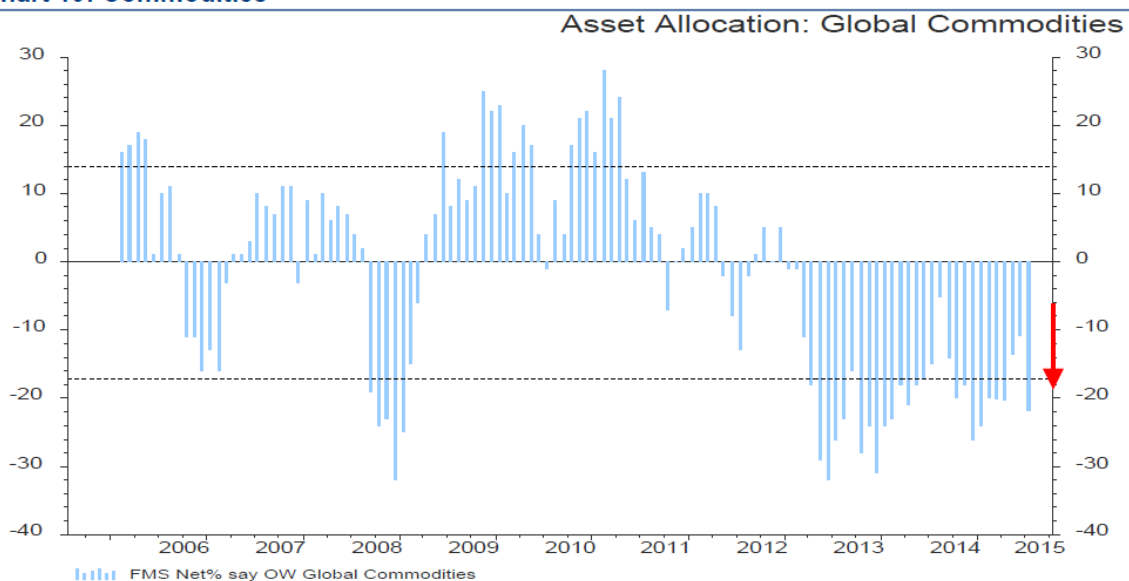


Quelle: Thomson Reuters Datastream

Argument #4: Technical downtrend in commodities firmly in place

I have traded commodities now for more than 20 years. I can hardly recall a time when sentiment towards commodities was as negative as today. The only comparable time frame was the late nineties, when commodities suffered from the aftermath of the Asian Crisis and the LTCM debacle. Equity markets posted stellar returns as a temporary loosening of monetary policy in the US in 1998/99 boosted an already inflated market bubble in TMT stocks. Click rates of internet companies were called “fundamental indicators”, whereas the “old economy” of miners and commodities was out of fashion. Gold had no more role to play in the “new era” of Tech stocks. Today the sky is the limit for the NASDAQ again. Valuations for equity markets are stretched, even when they have not yet reached the extremes of the year 2000. Internet companies have multibillion market caps, worth a few times the stock of big miners with thousands of workers. Since bonds offer no or only minor interest, a bunch of risk averse investors were talked into dividend stocks. The fund manager survey of Merrill Lynch shows equities as the most overowned and commodities are the most underowned asset class in the last 10 years. It looks like the investors who bought commodities too high in 2010-2012 are finally giving in.

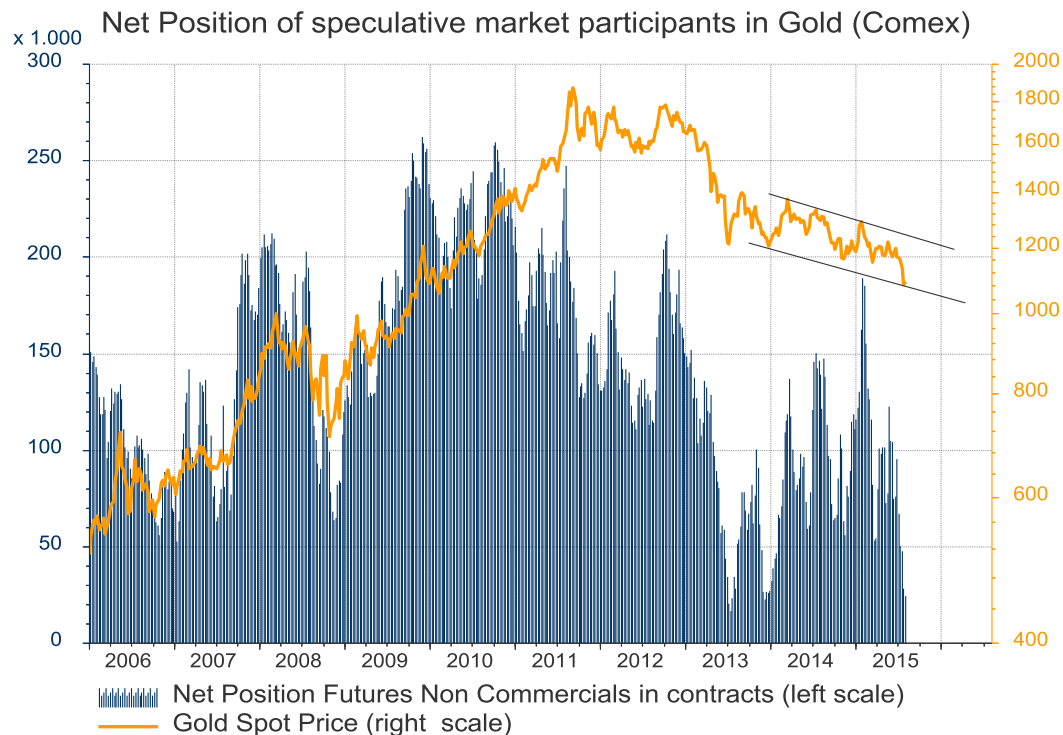
Chart 19: Commodities



Source: Bank of America Merrill Lynch, Global Fund Manager Survey, July 2015

With regard to Gold most market observers take it for granted that the price will fall further to at least to 1,000 USD per ounce. I reviewed hundreds of commentaries of brokers and investors and I didn't find one arguing for a short term turnaround above 1,200 USD per ounce. The consensus trade seems to be to sell into any short term strength. The one sided sentiment is mirrored within CFTC data, showing a record gross short position of large speculators (non commercials) in the Comex Gold contract. That doesn't necessarily mean that a short covering rally is imminent, since the net position is still 24,465 contracts long and I remember well the situation in 2000 when the paper gold market was characterized by a net speculative short position. If we take a look and the technical chart pattern, the short position seems vulnerable to a countertrend rally. Gold is hovering around the

support of the lower trend line. The window for strong seasonal demand from Asia is just opening up (August-October) and a short covering rally should be in the cards, given the fundamental situation described above.



Quelle: Thomson Reuters Datastream

Even more perplexing is the chart of Gold in Euro. The announcement of the 1,600 bln. € Quantitative Easing program of the ECB led to a sudden price spike from 920 € in November 2014 to 1,150 € in January 2015. Since then the price in € has retreated to just under 1,000 € per ounce, where it should find strong technical support. From a fundamental perspective it is difficult to imagine that a Eurozone with Greece can afford to suspend the current ultra expansionary setup. Both sides, Greece and the other Eurozone members missed a great opportunity to find a sustainable solution for Greece, which enjoys public support in all Eurozone member countries. This solution can only consist of an introduction of an own Greek currency. Any policy reforms and the urgently needed introduction of an in a more efficient state administration can hardly be implemented against the will of the majority of the Greek people and their representatives. If Greece has the will and the power to develop its own business model for the country - good. If not – the other Eurozone countries cannot help it. The lion share of the credits to the Greek government is lost anyhow. Financial markets are pricing in a 40% recovery rate of Greek government debt denominated in Euro– that's what you can hope to get back.

But the real surprise for me was that the Greek attempt to disunite the Eurozone was quite successful at second glance. During the negotiations for a new rescue package the same cacophony of voices was heard as at the beginning of the Eurozone crisis in spring 2010. The political leadership of France and Italy communicated very clearly that they would have preferred a less binding solution for Greece. Immediately after bilateral talks between France and Germany to work out a common approach for the negotiations with Greece French President Hollande told the press that Greece has

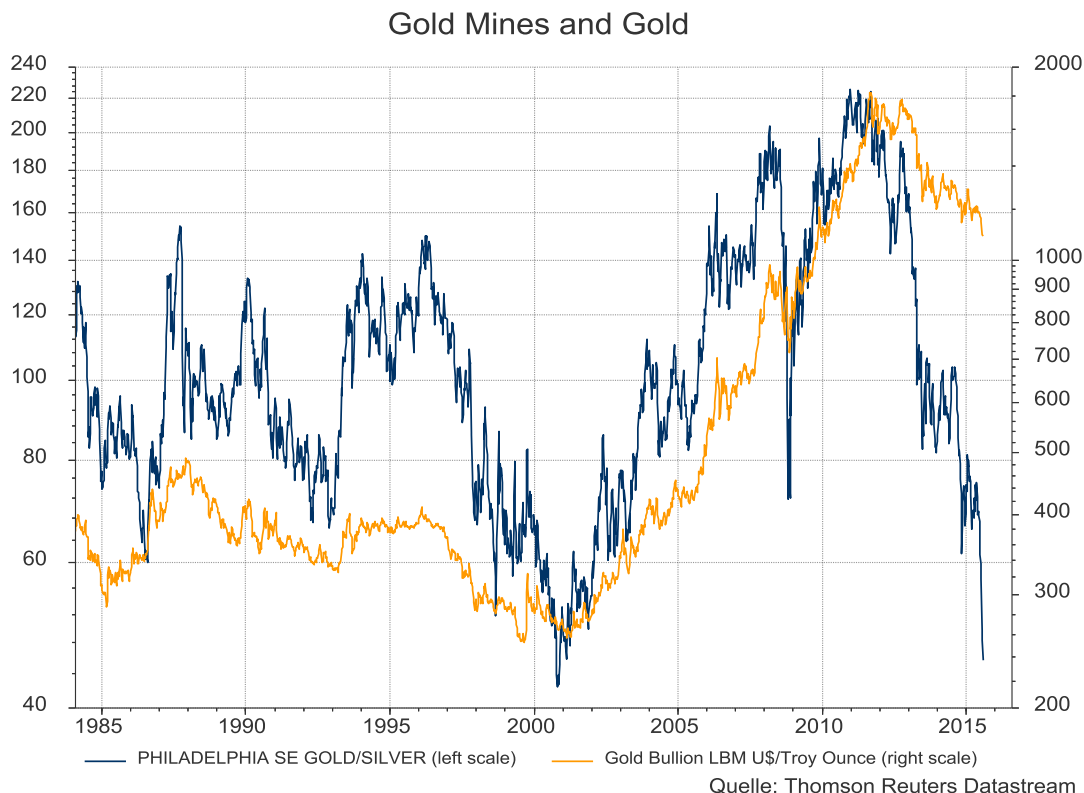
to be kept in the Eurozone in any case, thus undermining other possible alternatives. The central conflict lines at the core of the Eurozone broke up again. The idea to establish a common currency for European core countries was born in the aftermath of the 4+2 talks about a reunified Germany. From a French perspective it might have been seen as the ideal instrument to contain Germany and to break the dominance of the hawkish German Bundesbank. And indeed the whole Maastricht Treaty turned out to be only paper. Nearly all rules of the treaty were broken. Fiscal deficits were materially higher than the Maastricht limits and transfer payments became reality via huge credits between National central banks in the TARGET system. The German initiative to establish some fiscal discipline and limit government debt to GDP ratios was accepted some years ago, but barely any steps in that direction were taken by France during the presidency of Hollande. Clearly there is a common incentive for France, Italy and Greece to let fail the German policy approach of more fiscal disciplin. The Greek drama will pop up again as early as in autumn 2015. If the demanded reforms fail Germany will get the blame. The credibility of the German Chancellor Merkel could be seriously damaged. Socialist groups all over Europe will demand transfer payments and more fiscal deficit spending. All this is very bullish news for Gold, even more than some gold bugs would have dreamed of. It doesn't necessarily mean a complete failure of the Euro, since other paper currencies are experiencing the same problems as the Eurozone. But it will be a much weaker currency than initially intended. Gold is a great buy at 1,000 € per ounce. The metal has already completed a technical bottom. The trend is up from here with a first price target of 1,160 € per ounce at the end of this year.



Quelle: Thomson Reuters Datastream

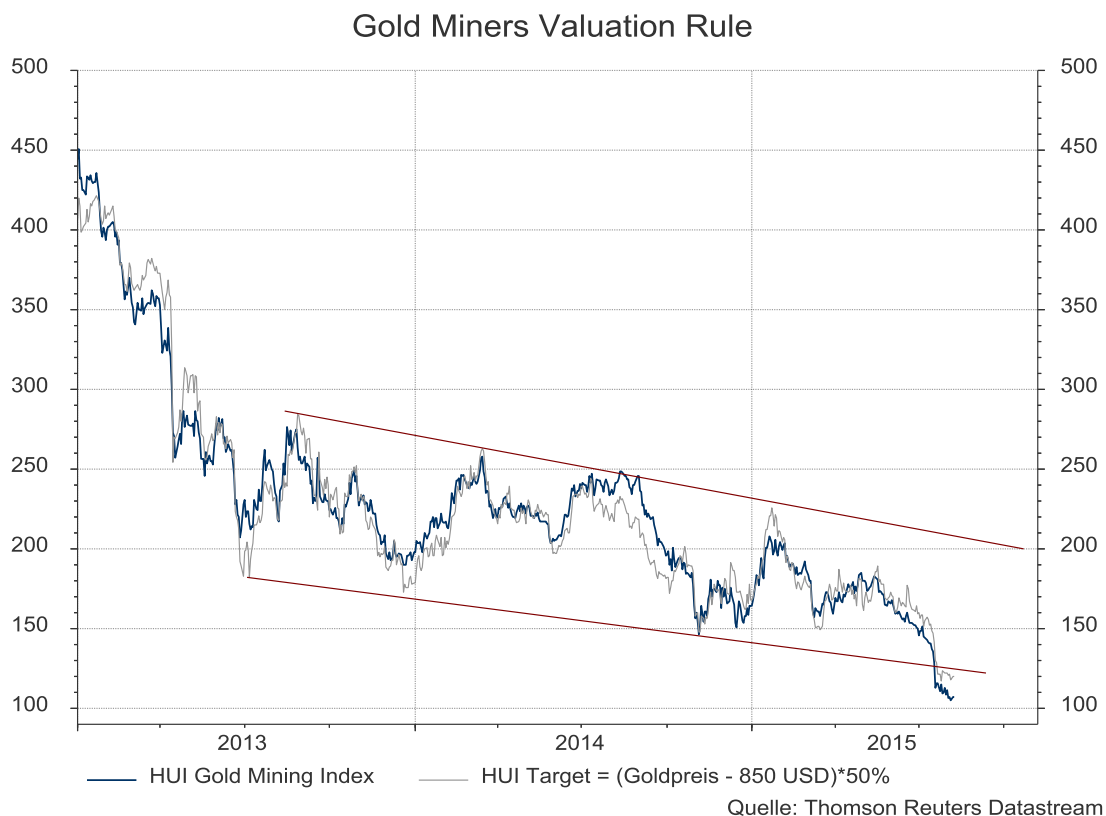
Argument #5: Don't catch a falling knife

Some readers might wonder, why a 10% drop of on average in metal prices in the last 8 weeks has caused me to write a 15 pager, titled "This is the time to fight back"? It is because true capitulation is going on in mining stocks. Gold miners have taken the biggest hit. The Philadelphia Gold & Silver Mining Index (XAU Index) topped out in December 2010 and has shed 80% in value since then. Relatively to the price of Gold miners exhibit a downtrend since the beginning of the year 2006. The ratio between the Gold Price and the XAU index stands at 0.041, the lowest level since data are available for the XAU-Index.

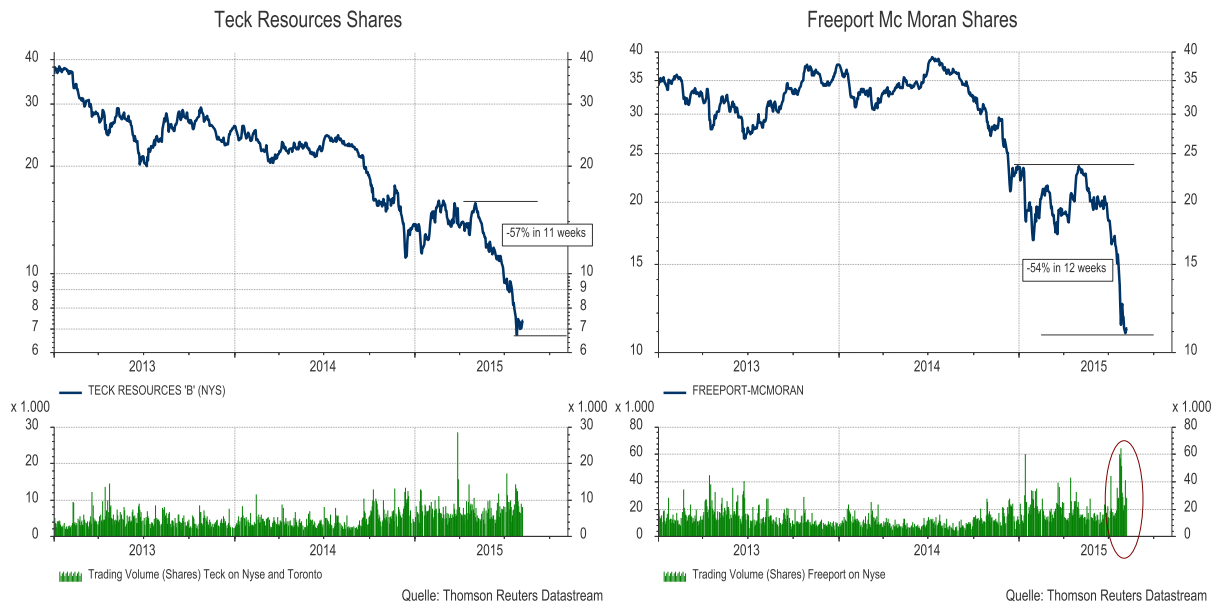


Gold mines are trading with huge discounts to their Net Asset Values (NAV). The NAV calculation is somehow questionable, because most analysts are using higher gold prices to evaluate the cash flows from 2016ff. But even if today's spot prices will stay for longer a pack gold miners could generate positive free cash flow, since costs in some cases have come down quicker than the gold price (devaluation of producer currencies, energy cost, slashing of Capex budgets). The fears for an Armageddon of gold miners are overdone. Some of the bears argue, that a wave of bankruptcies in the sector and severe supply cuts are the preconditions before a bottom in the gold price, can be found. But there is no historical evidence for that. It didn't happen in 2000-2002 when gold prices fell below production cost and it is unlikely for the coming years. Ironically the biggest default during the crisis of 2000-2002 was caused from a sudden price spike to the upside, when gold miner Ashanti was trapped with big losses from their gold price hedges. Of course highly leveraged gold miners with comparatively high debt and high production costs) suffered the most severe losses. And there is some logic to that, since gross profit margins are squeezed in percentage terms much more than the gold price. Gwyde Blogspot, (<http://gwyde.blogspot.de/2015/05/gold-and-miners-identifying-bear->

[market.html](#)) published a simple valuation rule for the Amex Gold Bugs Index (HUI Index). Assuming that at a Gold price of 850 USD per ounce all miners will go out of business the target value for the HUI-Index is defined as the current spot gold price minus 850 USD, multiplied with 50%. This valuation rule turned out to be quite accurate for the actual market behavior in the last 3 years. At a 850 USD gold price, the HUI-Index according to this logic represents a value of zero. But this approach largely ignores the option value of gold mining. Some companies have mine projects with a mine life of more than 15 years. They should be treated as an option which is slightly in the money (at current spot prices) or out of the money (at 850 gold). If investors acquire standard gold price calls, they have to pay huge premiums, because implied volatility is high for longer term options. We all know that if the gold price would start a new uptrend management of miners will find various ways to waste their money as they did in 2005-2012. So in the long run a gold price call and gold miner stocks are not the same thing. But at the moment miners can be bought with huge discounts to NAV whereas Gold option sellers demand big premiums.



Technical market capitulation was not limited to gold mining stocks. Mining stocks fell across the board on high turnover, no matter if the main product is Iron ore, copper or other industrial metals. As with gold miners the worst hit took miners with a comparatively high debt load and negative free cash flows at current commodity spot prices. I've plotted the stock price performance of two of them – Teck Resources and Freeport Mc Moran – just as an example of what was going on in mining stocks during the last 12 weeks.

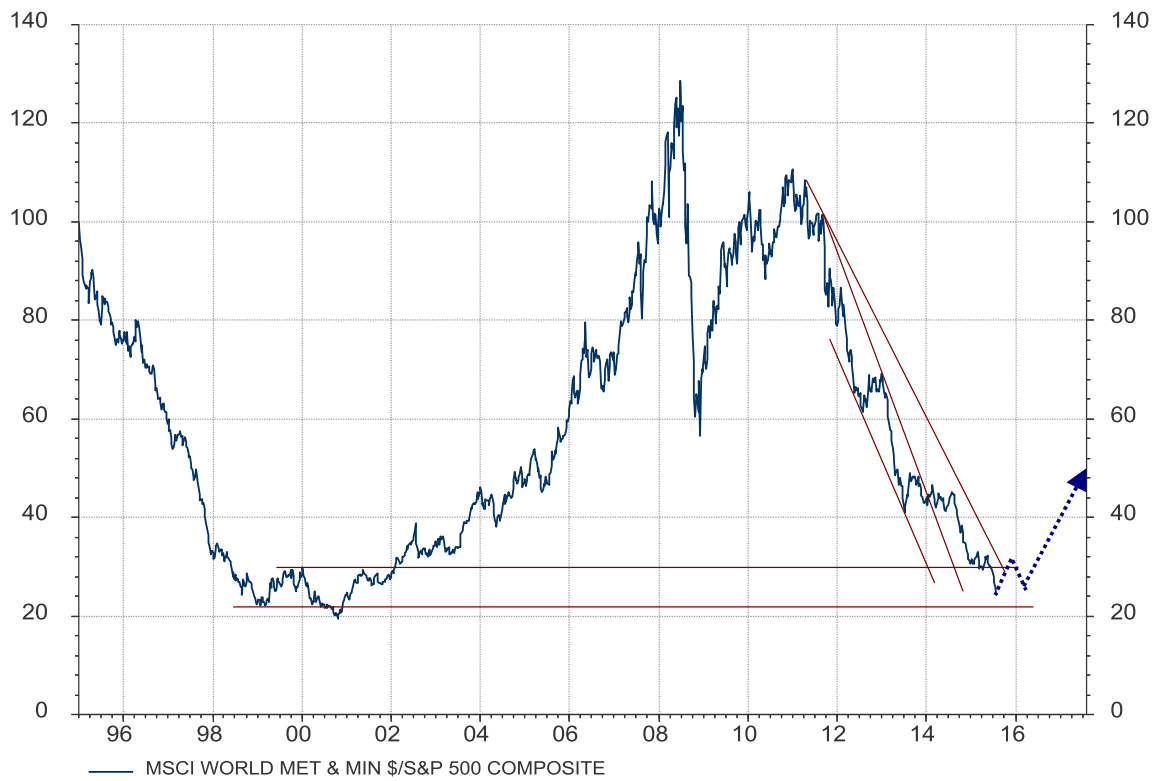


Again liquidity and financing lines are, in most cases, sufficient to survive a few years at current spot prices. As for gold mines the option values are disregarded. Mining stocks are traded as if there is no tomorrow. The main advice you hear in the street is not to catch the falling knife, even if some mining stocks are quoted at 30%-40% of NAV, which is, by the way, calculated applying a discount rate of 8%. Most investors are not able to buy countercyclical. Either they are procyclical by nature or they are restricted by performance reporting rules, risk managers or political behavior within their institutions. The dramatic price collapse coupled with a high turnover volume in mining stocks suggests to me that mining stocks are changing hands out of reported portfolios into not reported portfolios. Or in other words going from weak to strong hands.

Conclusion: A short term rally as the begin of multiyear bull trend

This is one of the rare opportunities where all ingredients for a good trade come together (**the Bears are in the tent**). Fundamental perspectives, which are better than the recent past, overextended negative sentiment and frustration of long standing bulls and a technical sell off, which bears all signs of a broad market capitulation. The time to buy metals and mining stocks is back. And I do not say that as a man, who was holding on to bullish forecasts, which have proven wrong. Some of you might remember the first piece I published about Gold in the year 2000 ("Gold – a new megatrend ?" BW-Bank special study). In 2011 when the Gold price had formed a short term bubble I warned about multi-year bear market in the precious metal (Gold – the end of a megatrend. Tiberius Asset Management special study). I am sure that this is the right time to be back on the long side of the commodity trade. What you can expect at least is a hefty short covering rally, which will last some months. I don't foresee a V-shaped bottom from where it is a one way street up. It is more likely from my point of view that this rally is part of a broader bottom formation. But it will mark the start of a multiyear outperformance of the MSCI Metals & Mining Index against traditional equity benchmarks like the S&P 500.

MSCI Metals & Mining relative to S&P 500



Quelle: Thomson Reuters Datastream

Schönaich, den 7.8.2015

Markus Mezger