



Precious Metals Market Update

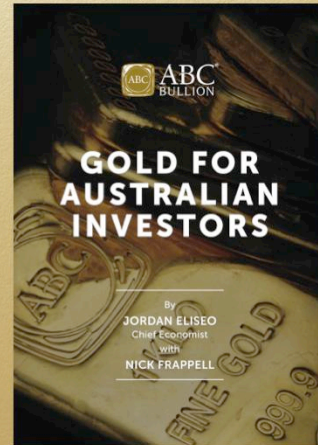
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Chief Economist
February 2018



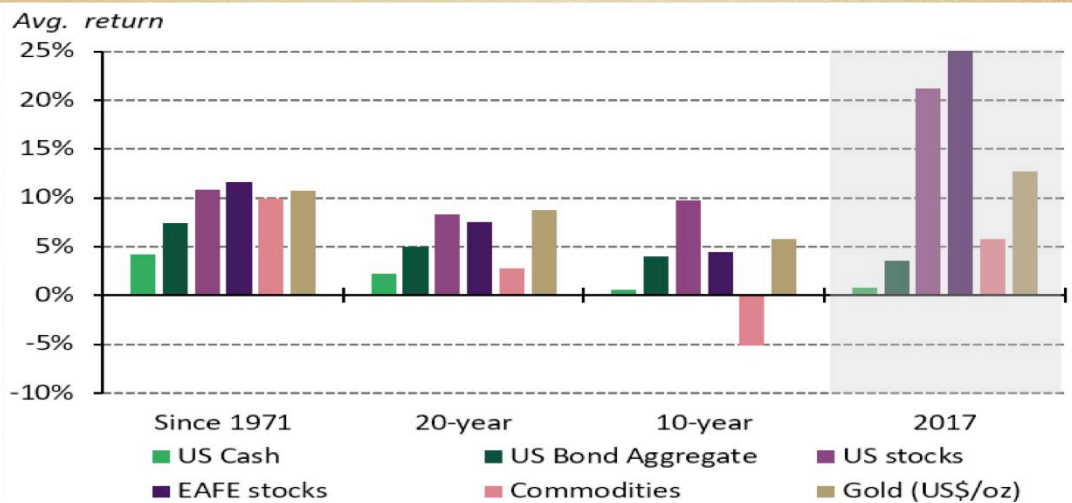
This presentation – which was delivered on 21st Feb 2018, delves into a range of topics.

Topics

- Key Reasons to Own Gold
- Financial Markets: A Time for Caution
- Australia: Housing, Interest Rates and the AUD
- Gold and Silver in 2018 and Beyond
- Bitcoin and Cryptocurrencies: Bubble Bursting?



Strong Returns over short – medium – long term

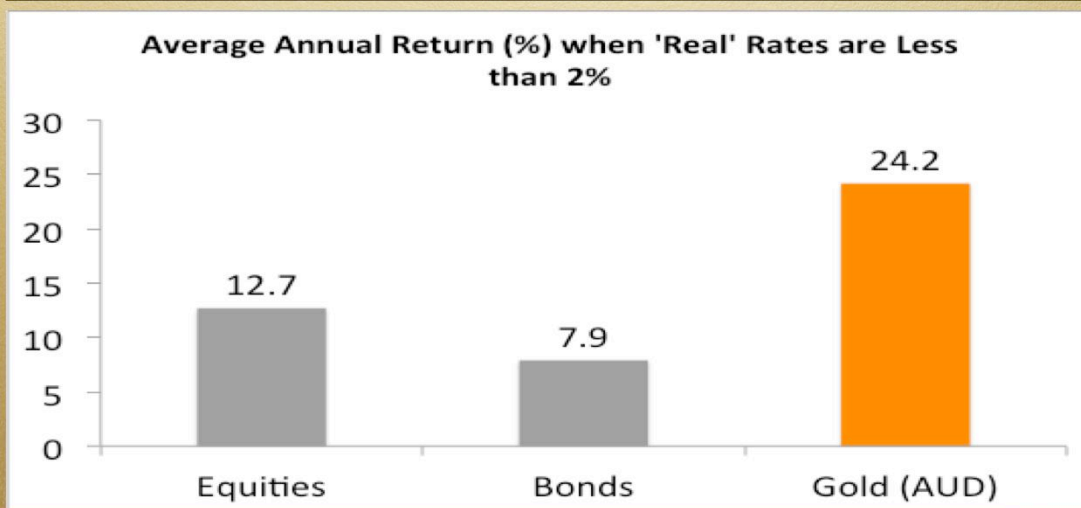


This chart shows the strong performance of gold in both 2017, as well as over a 10 year and 20 year period, and since 1971.

As you can see, over the long run – gold outperformed defensive assets like cash and bonds, and nearly matched the equity market, whilst over a 20 year period it was the best performing asset class.

This highlights why, even from a capital appreciation perspective alone, gold deserves a place in a well rounded portfolio.

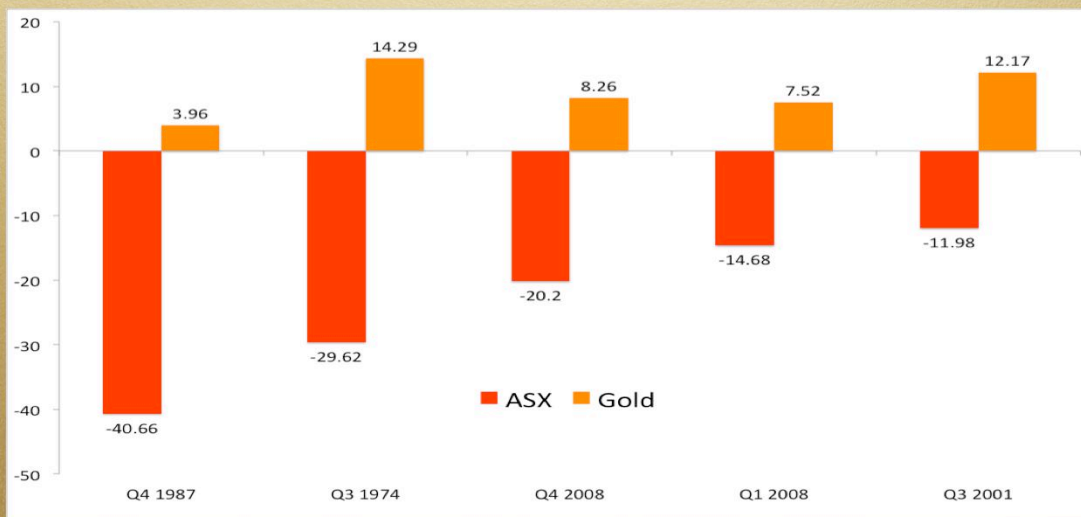
Outperforms whenever 'real' interest rates are low



One of the key reasons to invest in gold is that it typically outperforms shares and bonds in environments when 'real' interest rates are low.

The chart above shows that gold has been by far the best performing liquid asset in environments where the 'real' rate of interest is 2% or less, something highly relevant given the current RBA cash rate.

Simplest hedge against falling financial markets



Another great reason to own gold is that it typically performs best when equity markets fall hardest, as evident from the above chart. The chart shows the performance of the equity market during its 5 worst calendar quarters since the 1970s, as well as the performance of gold.

As you can see, gold has risen in every situation, balancing investor portfolios.

Financial Markets: A Time for Caution

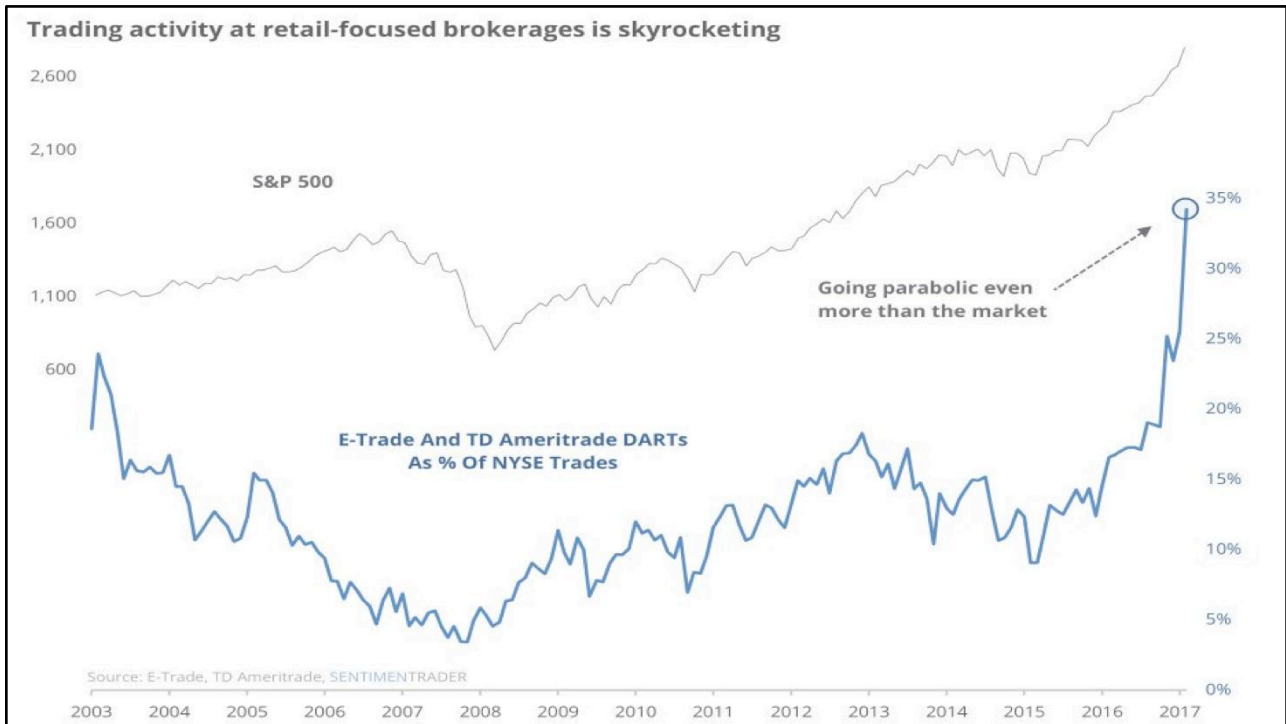


The next few slides explain why we think it's a time to be cautious about financial assets, looking at valuations, economic developments, and sentiment indicators.



This chart shows the percentage of Americans surveyed who think the stock market will be higher 12 months from now. The three orange circles you can see highlight where the sentiment reading was back in 1999, before the NASDAQ crashed, and in 2007, before the onset of the GFC.

As you can see, sentiment readings even higher today – a clear warning sign to investors.



Another warning sign is contained in the above chart, which shows the percentage of all trades on the NYSE that have been placed through E-Trade and TD Ameritrade, brokerage platforms popular with retail investors.

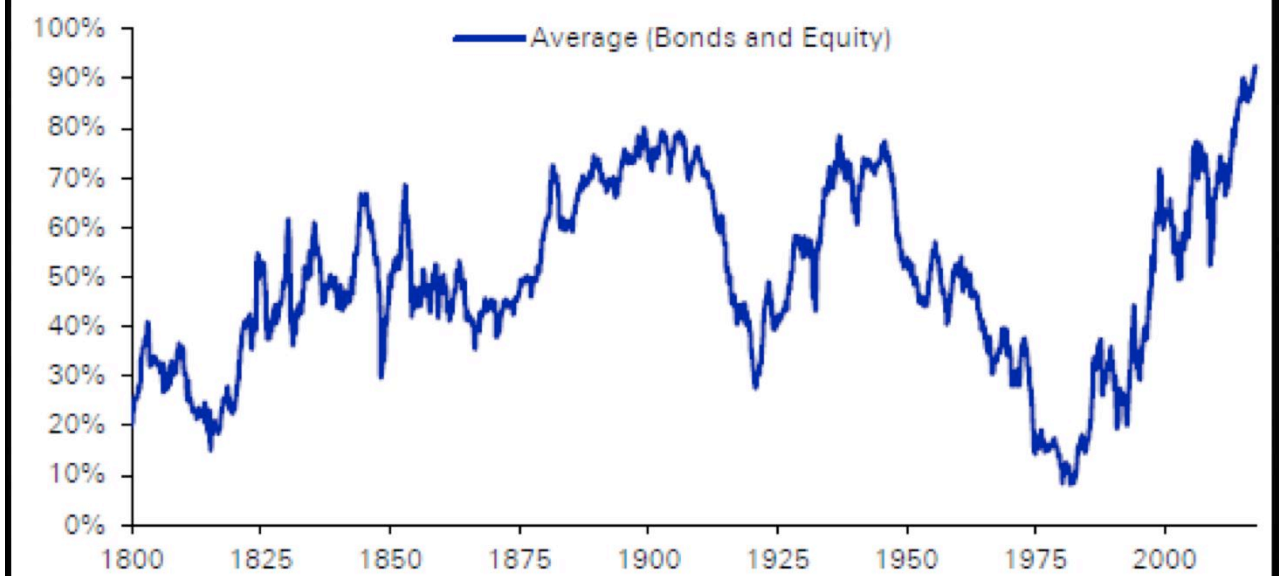
The numbers have skyrocketed lately, alongside the rally in the S&P500.



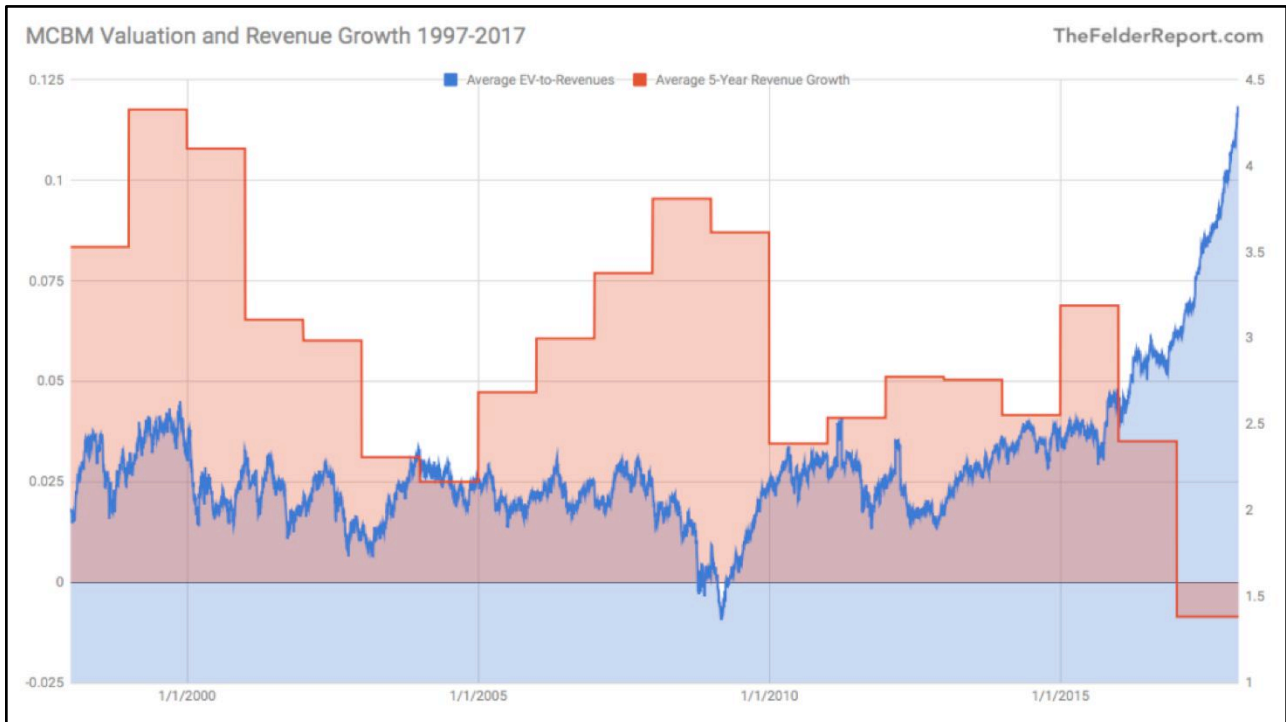
Another warning sign for financial markets is the headwind for risk assets that comes from a slowing of monetary largesse from the world's largest central banks. Note that whilst central banks are still providing stimulus, the pace of that stimulus has slowed meaningfully.

Given how highly correlated rising equity markets are with monetary stimulus – this is something investors should be paying attention to.

Figure 57: Aggregated 15 DM country average bond (nominal yields) and equity percentile valuations (100% = most expensive; 0% = cheapest)



Perhaps most worrying for financial market participants should be the valuation levels in broader equity and fixed income markets. The above chart, which dates back to the year 1800, was produced last year, and it suggests that, based on a composite of 15 developed country bond and equity markets, markets are at their most expensive levels on record.



This chart, which comes from a great analyst called Jesse Felder, is the early favourite for my chart of the year.

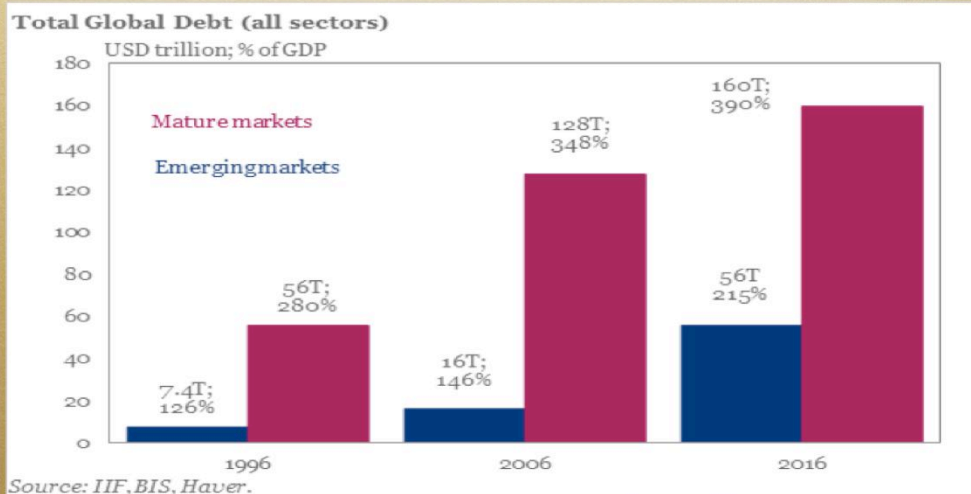
It shows the average 5 year revenue growth (the red line) for 4 well known stocks – McDonalds, Caterpillar, Boeing, and 3M. It also shows the average enterprise to revenue ratio (blue line) for the same stocks.

As you can see – despite tepid earnings growth, the price investors are willing to pay for a dollar of company sales has skyrocketed.

This is the impact of 10 years of QE and negative real interest rates, as well as the desperate search for yield.

It bodes poorly for future returns in risk assets.

Debt Levels are Higher than pre GFC

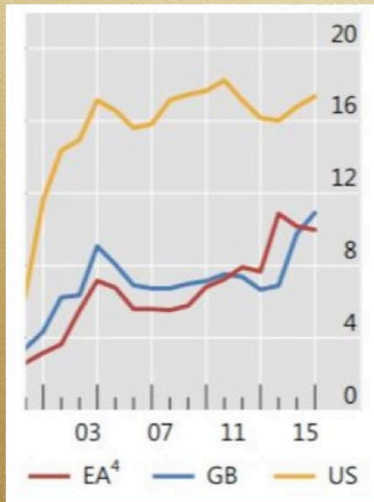


On top of expensive financial markets – we also have the unresolved debt challenge from the GFC.

This can be seen in the chart above – which shows debt levels both in USD value, as well as a percentage of GDP, in both mature, as well as emerging markets, and how these have changed between 1996, 2006 (just prior to onset of GFC), and again in 2016.

If you believe that excessive debt and poor capital allocation was a major cause of the GFC, then you can't help but be worried about the picture today, for the situation has clearly deteriorated since.

Zombies are on the March!



- Zombie firms are
 - At least 10 years old
 - Have earnings *insufficient* to cover interest on loans
- Share of firms classified as “zombies” risen notably over the last 15 years – from 2% to 12% in a decade
- Major reason why productivity, wages and growth remain weak
- Major risk to markets: they are unhealthy businesses



Another cause for concern is the growth of zombie businesses – which have grown from 2% of all companies to nearly 12% in a decade, with the problem particularly acute in the United States.

These businesses have earnings that don't even cover the interest on their loans, which is one of the reasons capital investment, productivity and wage growth remain so low.

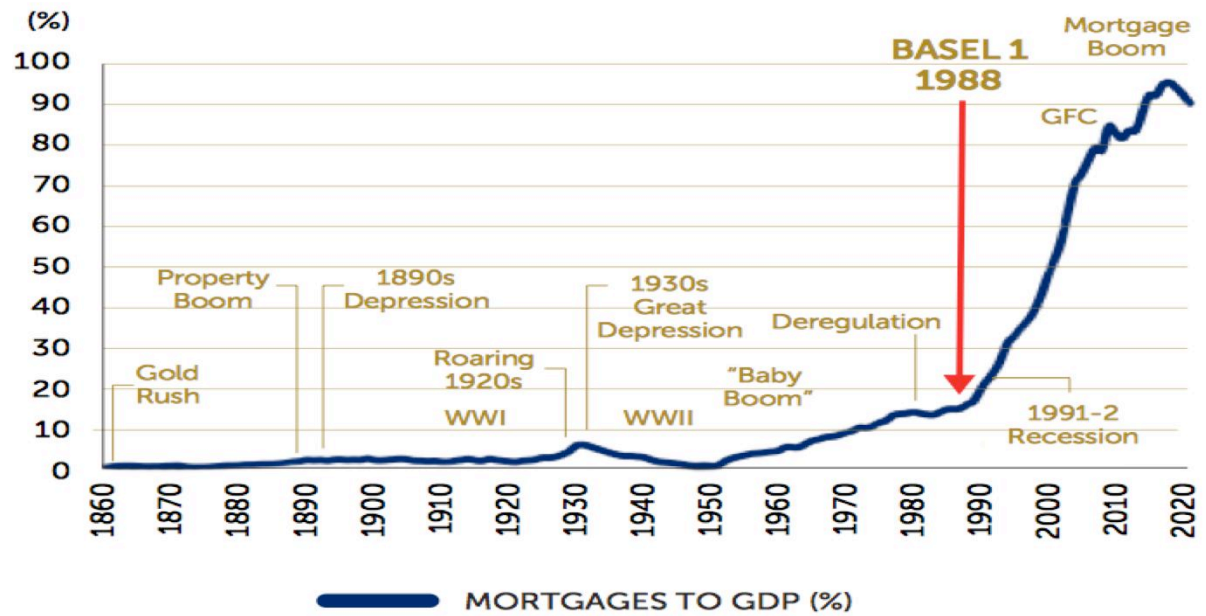
Millennial lows in interest rates have kept these companies alive, but in so doing, central banks have also stopped the much needed forces of creative destruction, which, painful though they may be, are critical to effective capital allocation over the long term.

Australia: Housing, Interest Rates and the AUD



Developments in Australian markets are always worth paying attention to, especially as they relate to our housing market, the AUD, and local interest rates.

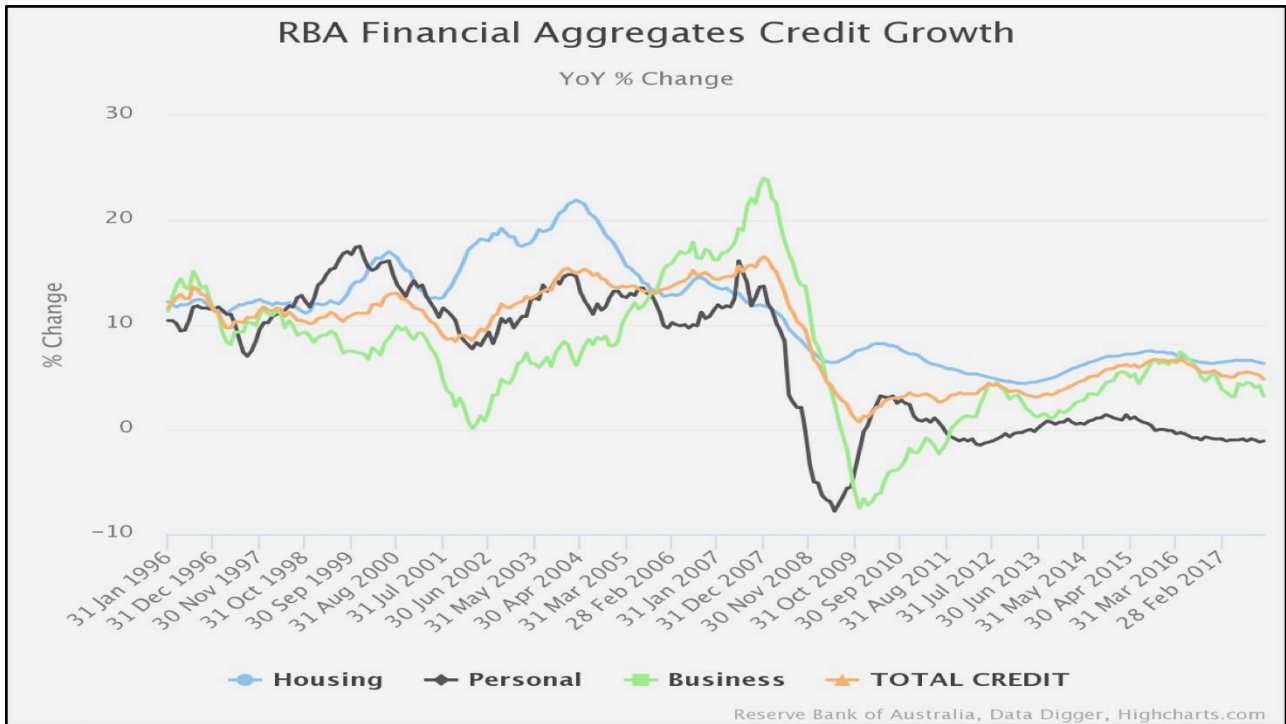
Fig. 4: ULTRA LONG TERM MORTGAGES TO GDP (%)



This chart highlights the growth in mortgages, relative to GDP, in Australia, and how this has exploded since the 1980s.

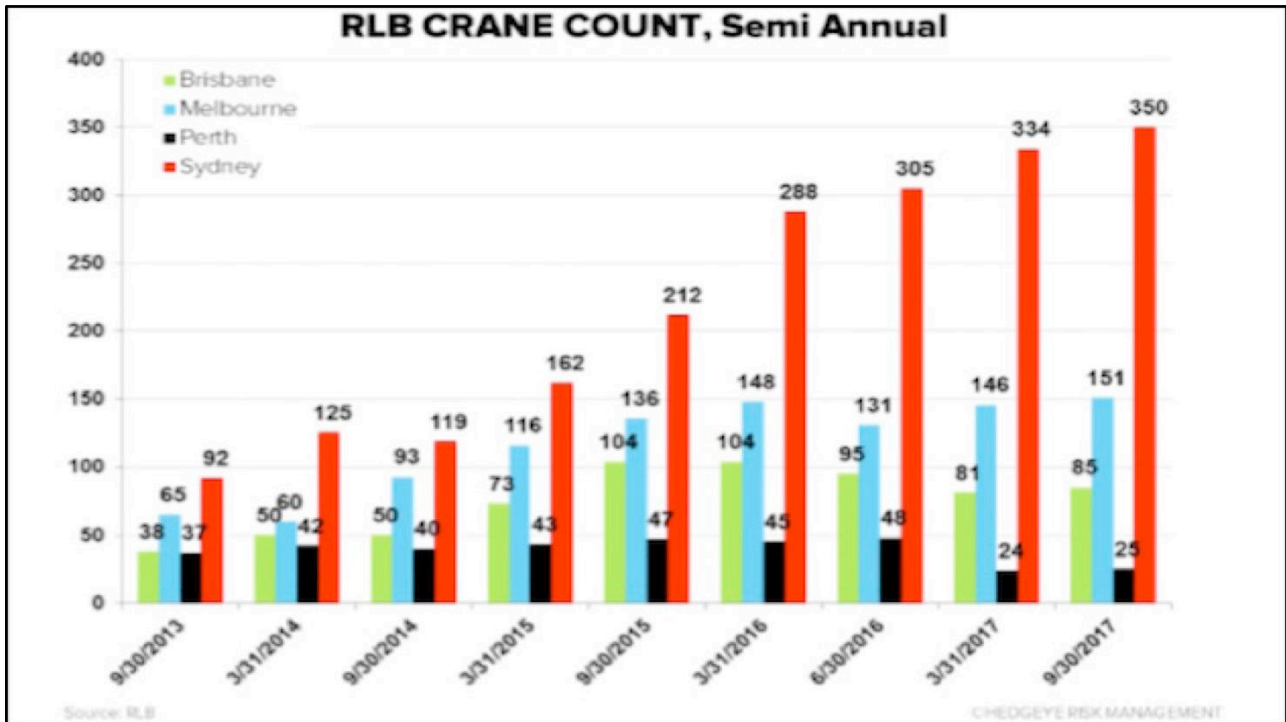
There are a number of other factors that explain our high house prices (tax rules, migration rates, bank lending preferences, etc.), but it's undeniable the secular decline in rates, and the explosion in household debt is one of it not the major factors that has driven house prices to the levels it has.

It's been a headwind for the nations wealth the least 25 years – but it may well prove a significant headwind going forward.



This chart shows year on year changes in the growth of housing, business and personal debt, and how this has changed since the mid 1990s.

As you can see, growth rates in debt are rolling over – which, given the importance of rising debt levels to rising house prices, and rising economic activity, portends slower growth for Australia in the years ahead.

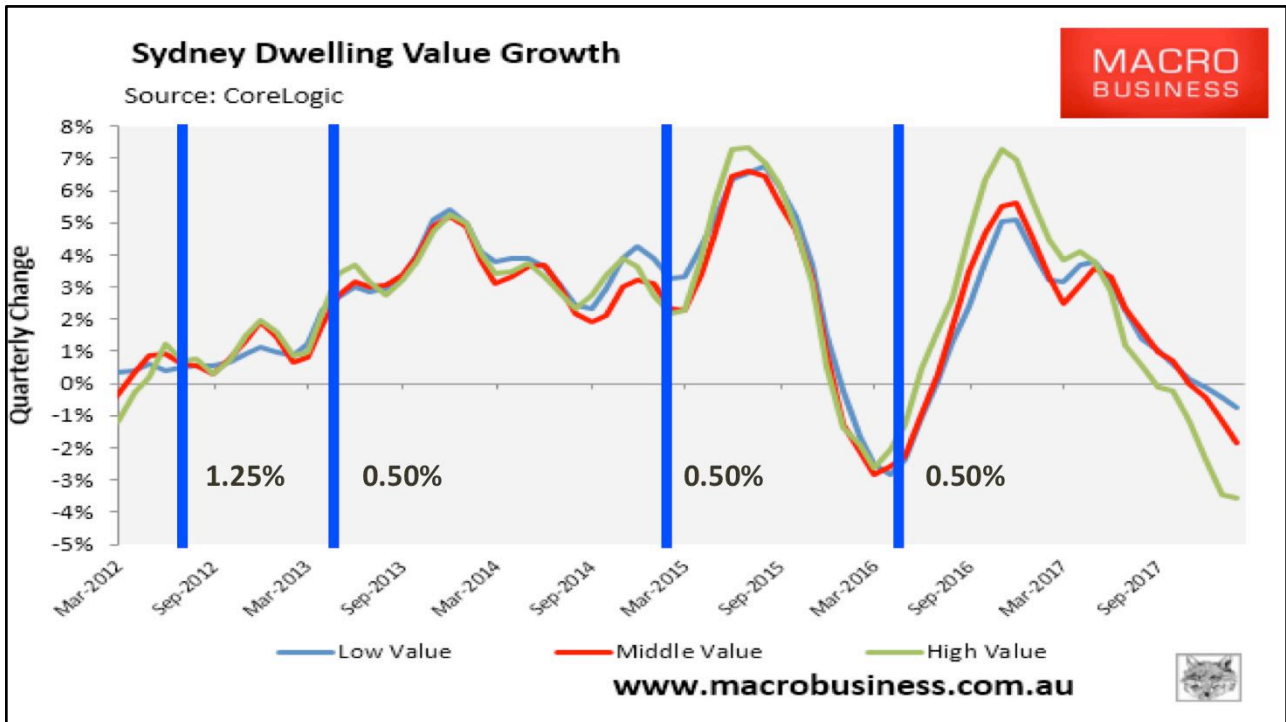


This chart above serves as a warning on both the potential for lower housing (and especially unit) prices, as well as a slowdown in Australian employment, especially on the East Coast.

It shows the number of cranes being used in Australia's East Coast cities, as well as Perth, and how this changed since 2013.

As you can see, the number of cranes being used in Sydney has gone from 92 to 350 over this time period, whilst it's more than doubled in Melbourne.

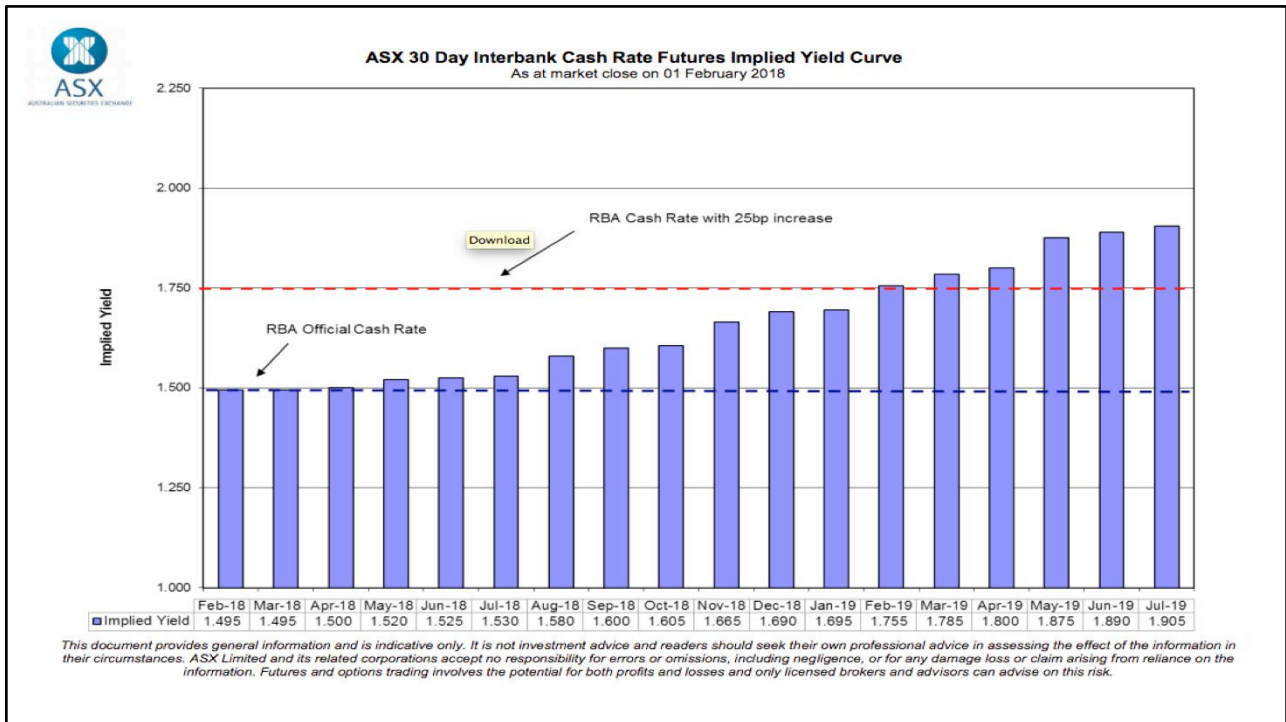
This huge increase in supply has helped employment the last few years, though we've likely past peak housing construction, whilst it will act as a headwind to higher property prices.



This chart shows quarterly changes in Sydney house prices over the last six years. The blue lines represent periods where the RBA cut interest rates – and the size of those cuts (not that they all occurred in one month periods).

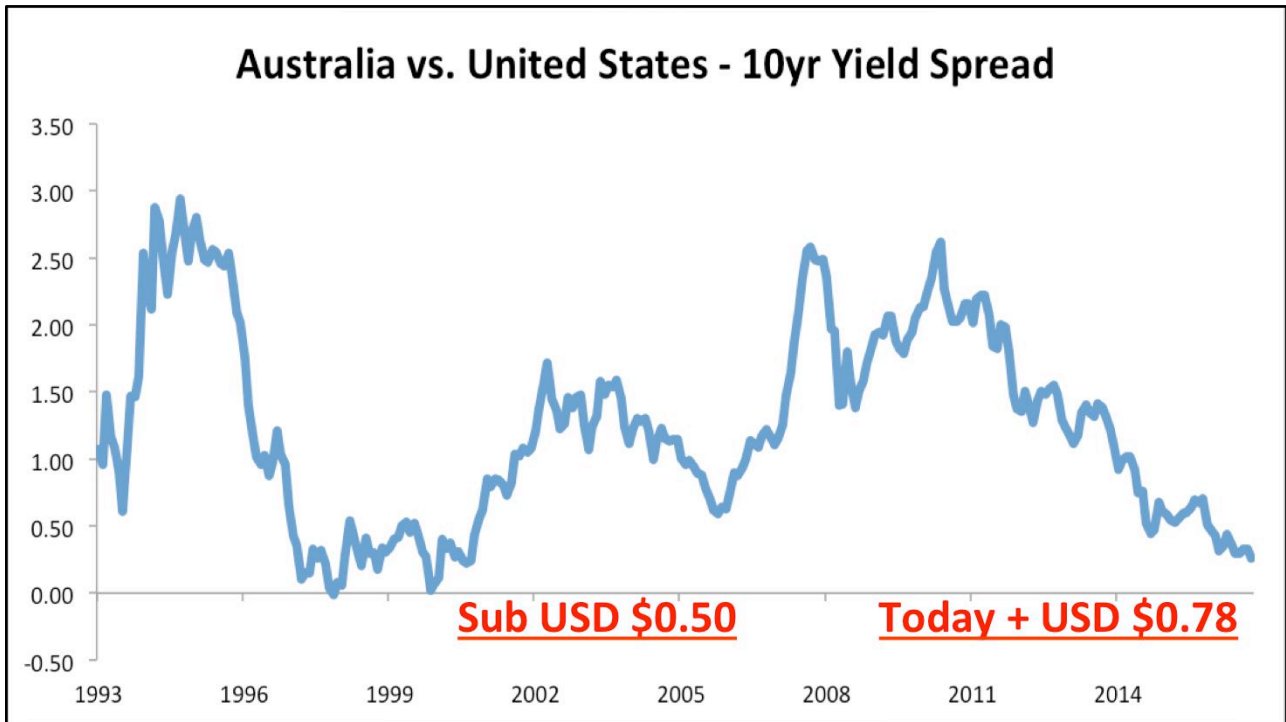
We included it because it highlights if the RBA were to hike rates in 2018 (as many expect) it would be very unusual, given East Coast property prices are already stagnant/falling.

Their normal course of action in such times is to ease rates. Our expectation is that they will be forced to do so again, with rates set to head below 1% in this cycle.



This chart shows current expectations for rates, as per the ASX. It suggests the market thinks rates have bottomed, and are set to increase – as per the United States, where the Fed is hiking.

Given our concerns re housing (as well as household debt, wage growth, low official inflation, etc.), we think the market is overly optimistic.



This final chart on Australia shows the yield spread (for 10 year government bonds) between the United States and Australia. It is actually fractionally out of date now, for there is now essentially no yield differential at all.

Last time the differential was as low as it is now, the Australian dollar could barely fetch USD \$0.50. Today it still gets you USD \$0.78.

There are a number of good reasons for this difference – but it is our view the AUD is at risk of a meaningful decline, helping bolster the case for gold in a portfolio.

Gold & Silver in 2018 and Beyond



This next section looks exclusively at gold and silver – looking at the charts for gold, the gold to silver ratio, inflation developments, physical bar and coin as well as ETF flows, and price projections based on historical bull markets.

Gold Chart Looking Constructive



The first point re gold is that the charts look healthy.

The above chart shows gold from the late 1990s to now – with the build up toward USD \$2000oz into 2011, and the subsequent decline easily viewable on the chart.

You can also see the large correction we've had in the years that followed, but also the fact that gold appeared to bottom in late 2015, with a reverse head and shoulders pattern now evident on the charts.

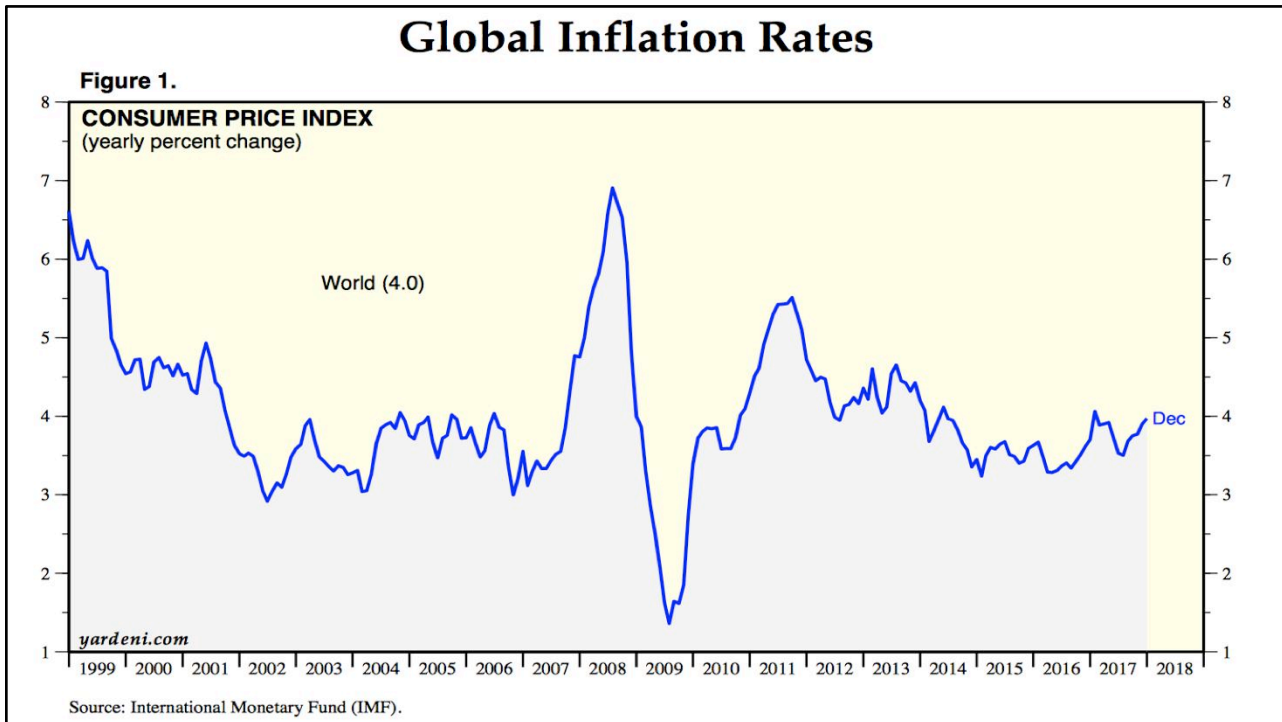
It bodes well for higher prices in the years ahead.



Silver also looks particularly attractive, with a current gold to silver (GSR) ratio of 80:1.

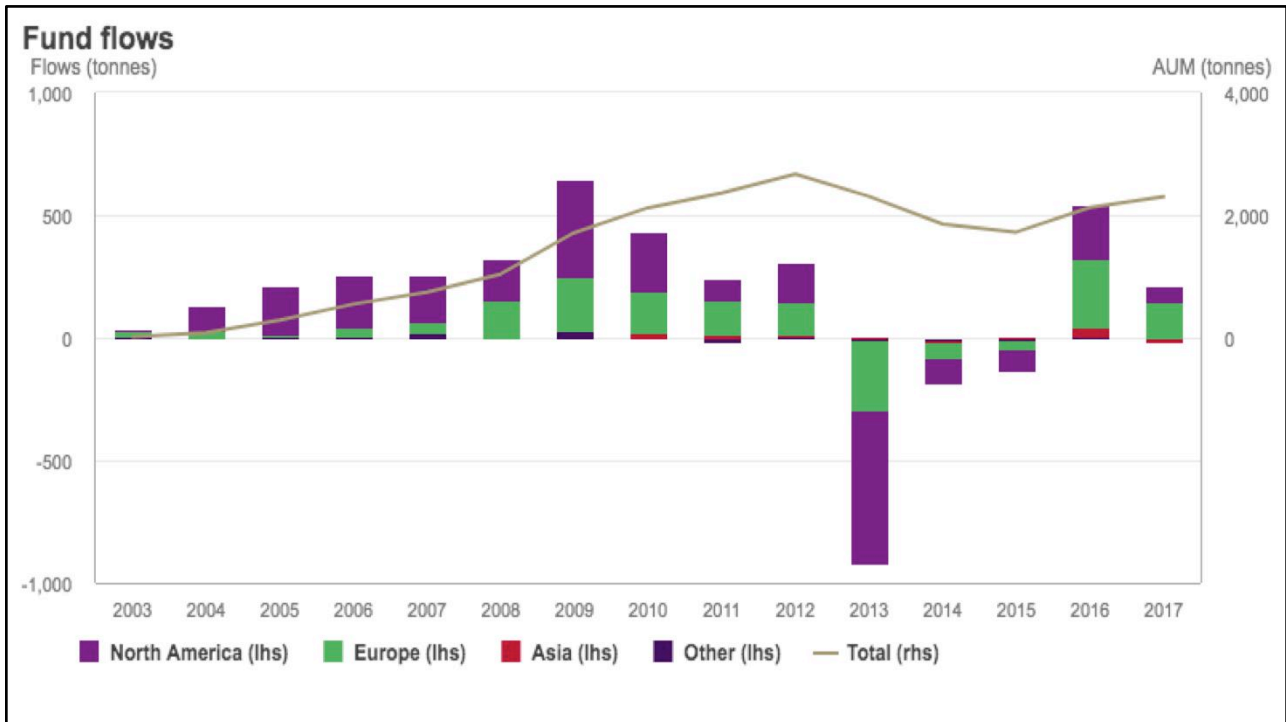
Based on the chart above, in the last 30 years, the GSR has only once gone higher than this – which suggests potential for significant silver outperformance in the years ahead, should the precious metal complex as a whole continue to rally.

Global Inflation Rates



Global inflation rates are starting to edge higher, as is evident on the chart above. From 2011 to late 2015, global inflation rates were declining, led by the developed world, where rates in some cases went negative.

Whilst they are hardly a problem right now, it is clear that inflation is on the move higher, which will no doubt support precious metals going forward, especially if the Fed, and other central banks, aren't able to tighten rates as fast as the market is expecting.



This chart shows annual gold ETF flows since 2003 – broken down across Europe, North America and Asia.

We can see the massive outflows in 2013, as well as smaller outflows in 2014 and 2015 – and then the turnaround in 2016.

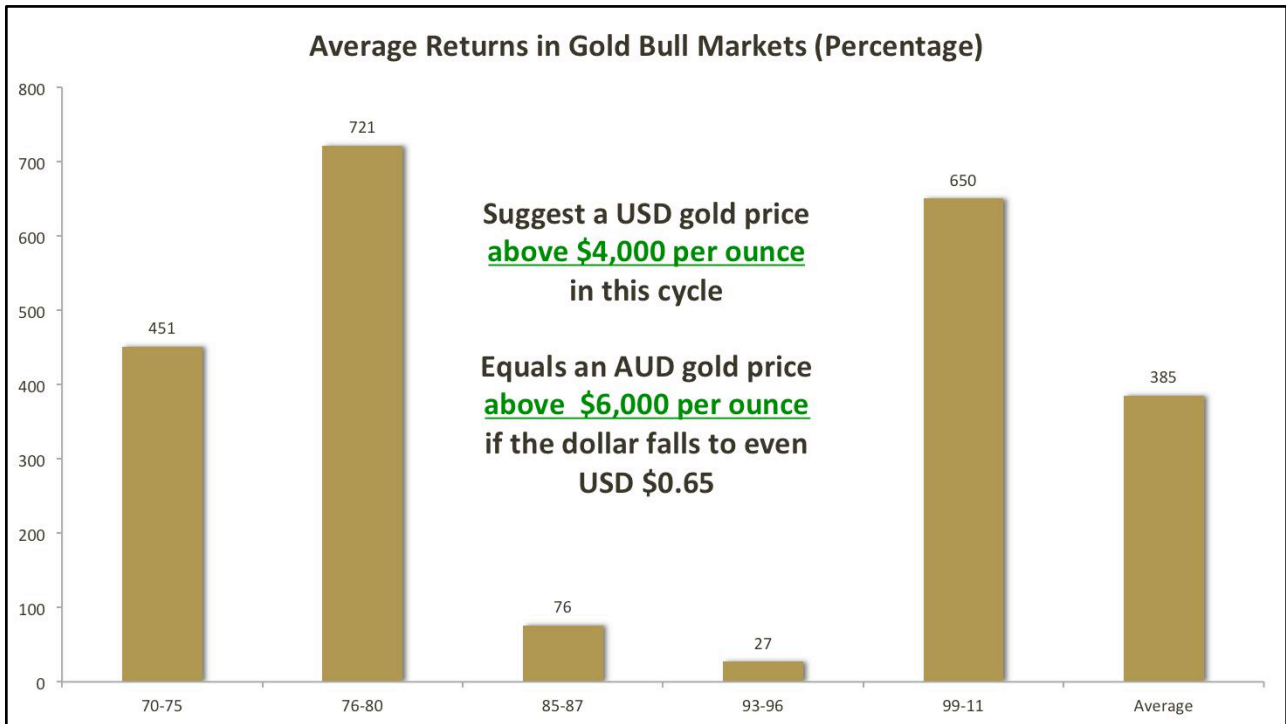
In 2017 we saw more inflows (though the pace was slower), though still indicative of support from this segment of the market.



The data in this chart shows US bar and coin demand every quarter since 2010.

The key takeaway from this is the significant decline in bar and coin demand in late 2017, as investors chased ever higher stock prices (and Bitcoin).

That gold performed so well in 2017 despite the relative lack of interest from physical investors in the Western World bodes well for future pricing, especially if financial assets start to experience more volatility and drawdowns.



This chart above highlights the percentage gains in previous bull markets, as highlighted by the World Gold Council in a 2016 study. The average of these gains was 385%.

If we assume that gold bottomed around USD \$1050oz in late 2015, then a return of similar magnitude would see gold head up toward the USD \$4,000 mark, which would likely be AUD \$6,000 or more, if the AUD weakens.

Note these are not ABC Bullion predictions, just an illustration based on historical returns applied to the current cycle.

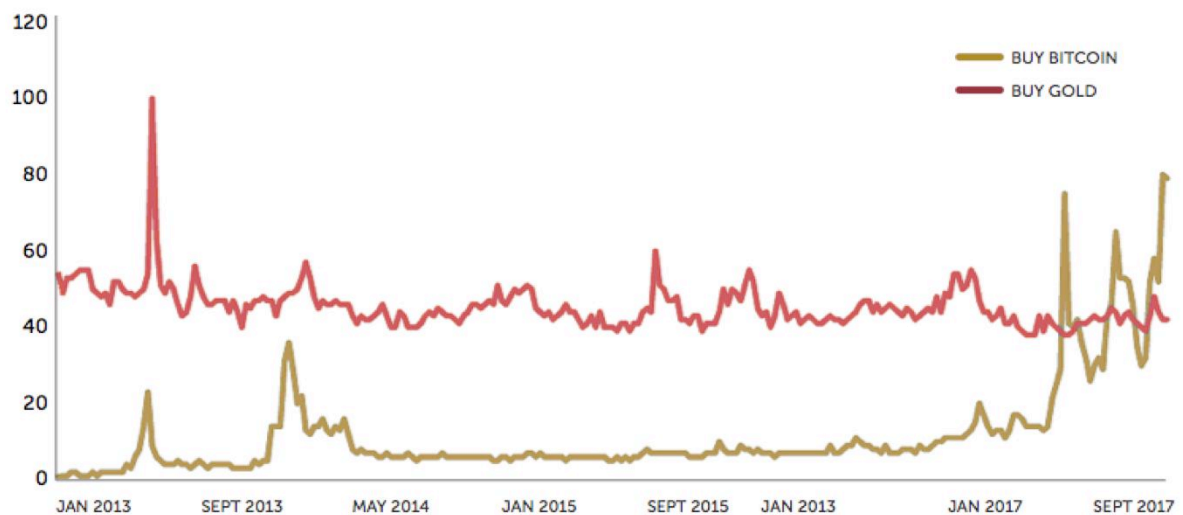


Fig. 13: Bitcoin image
Source: Shutterstock

This presentation finishes with a look at Bitcoin – the investment that dominated investment markets in 2017. We have written extensively about Bitcoin in the past, including in this key report at the following link:

<https://www.abcbullion.com.au/media/pdf/Bitcoin-Dollars-and-Gold-ABC-Bullion.pdf>

Fig. 1: SEARCH QUERIES FOR "BUY BITCOIN" SURGED PAST "BUY GOLD"



Source: Valuewalk

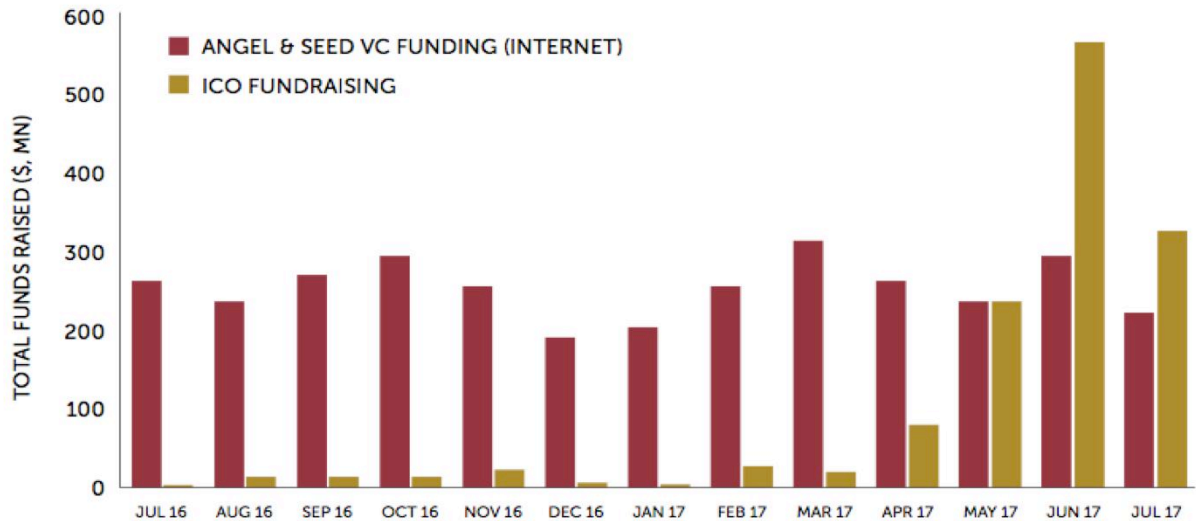
One way to highlight how popular Bitcoin became last year is seen in the chart above, which shows Google search queries for "Buy Bitcoin" vs "Buy Gold", and how these have changed since 2013.

As you can see, apart from a spike in 2013, queries for buying gold have been relatively static.

Queries for buying Bitcoin on the other hand exploded higher last year, actually surpassing that of gold.

We saw this evidence first hand at ABC Bullion in late 2017, with literally hundreds of enquiries about Bitcoin received by our sales team.

Fig. 9: FUNDRAISING: ICOS VS. VENTURE CAPITAL

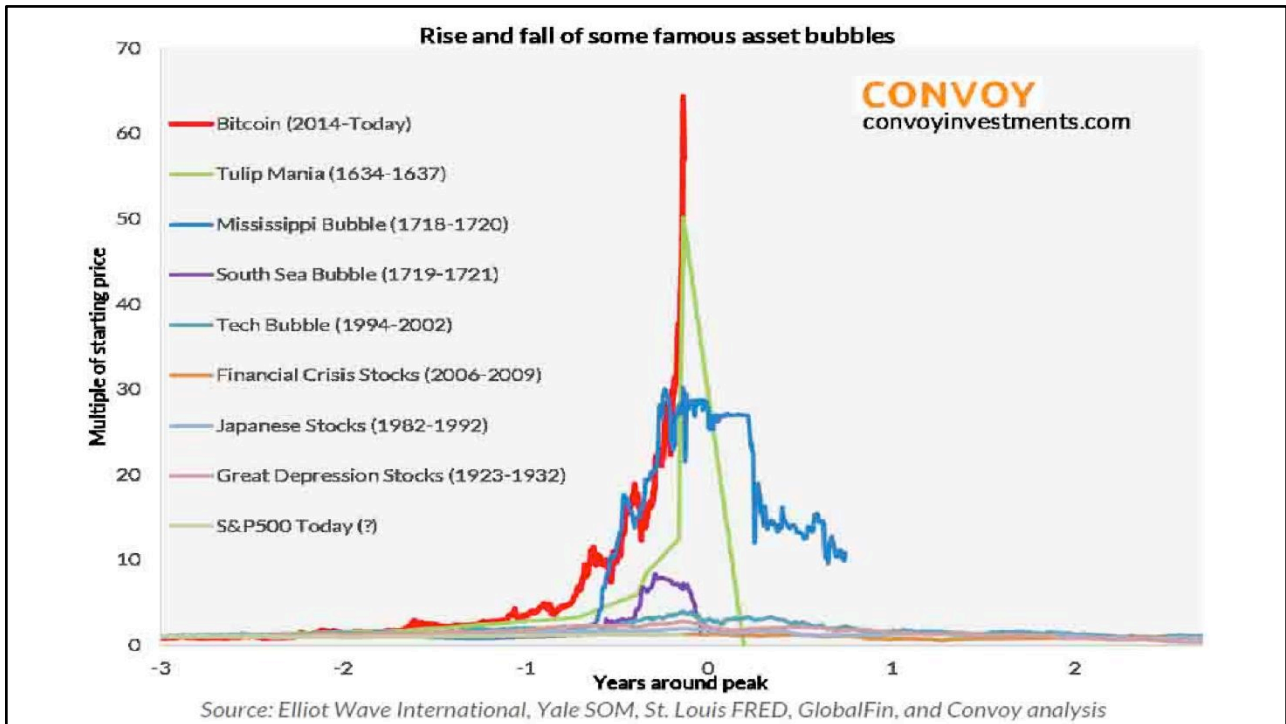


Source: Marketwatch

Another way of seeing how popular cryptocurrencies became last year is captured in the above chart. It shows the dollar value of funds raised from Angel and Seed venture capital funding (which has been relatively static the last two years), versus the explosion in Initial coin offering (ICO) fundraising.

It is another illustration that the very fastest of money was to be found in the crypto space.

Again, this was great for anyone who was already long this asset class, but it represents a major risk for anyone speculating in the space today.



This chart shows the price gain in Bitcoin (red line) and compares it to previous investment manias in history, including the South Sea Bubble, the Mississippi bubble, and the Japanese stock market boom of the late 1980s.

As you can see, Bitcoin has outdone them all – terrific for speculators on the way up, but likely devastating on the way down.

TABLE 1: CRYPTPO PRICING

	BTC	LTC	ETH
Living Room of Satoshi	21,317.51	348.50	875.40
BTC Markets	22,992.00	381.00	985.00
Coinspot	24,097.00	396.76	1,001.00
Difference (BTC - LROS) - \$	1,674.49	32.50	109.60
Difference (BTC - LROS) - %	8%	9%	13%
Difference (Coinspot - LROS) - \$	2,779.49	48.26	125.60
Difference (Coinspot - LROS) - %	13%	14%	14%

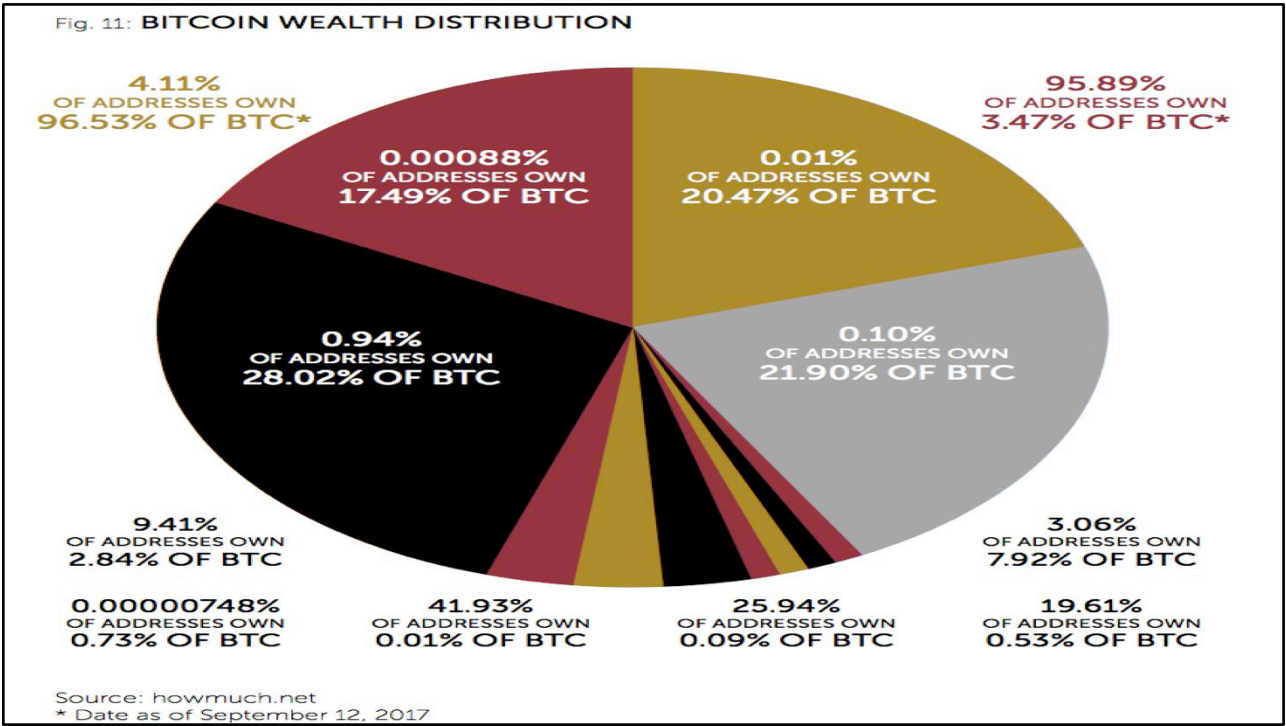
Source: Living Room of Satoshi, BTC markets, Coinspot

One major issue we see with Bitcoin is how expensive it is to actually use in day to day commerce.

To help visualize this – we looked at the following table, which shows the price of Bitcoin, Litecoin and Ethereum on two major exchanges (BTC Markets and Coinspot) as well as the price of these coins on Living Room of Satoshi, which will actually facilitate you using your Bitcoin to pay for a utility or a mobile phone bill, etc.

As you can see, there is in some cases an up to 14% spread between the supposed price of Bitcoin on an exchange, versus the actual price you can get when trying to use it for a commercial transaction.

Hardly efficient I think you'd agree.



A final concern we shared about Bitcoin is the extreme concentration of the ownership of Bitcoin, with barely 4% of all Bitcoin addresses owning over 95% of all Bitcoin.

This can be seen in the chart above.

Far from being a “money of the people” it would appear to be a “money of a very few people”, and this is one major final headwind (alongside its volatility, its clunkiness and the lack of regulation) to it ever getting widespread adoption as a monetary asset.

Final Thoughts

- Key reasons to own gold are highly relevant today
- Financial markets are stretched – tough to generate returns in years ahead
- No way to raise real interest rates without causing economic pain
- Australian property market weakening – implies lower rates and AUD
- Cryptocurrencies are a speculative investment – not a substitute for gold



The five final thoughts from this presentation are shared above.

If ABC Bullion can help in anyway with your precious metal investment needs, we'd be delighted to talk to you. We can be contacted via comms@abcbullion.com.au or via 1300 361 261.

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