All that Glitters Isn't Gold…But it Might Be.

By: Dave Lavigne

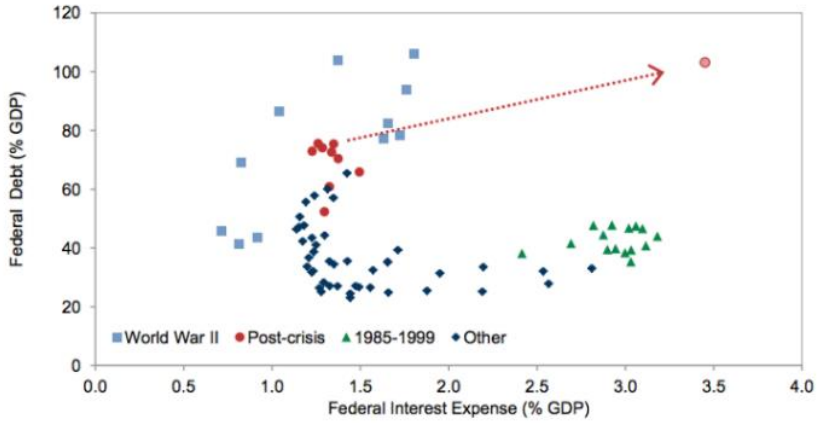
September 2018

For those who read this column even occasionally, it will be no surprise if I suggest (reiterate) that I have weary for some time now over the lengthy path the Fed and other central banks have taken to accommodate economic recovery, which is now being measured in *decades* rather than months or even years. Moreover, as industry titan Jeff Gundlach of Doubleline Capital has been noting of late, the US government's willingness to further relax fiscal policy (read: continue to increase the debt) seems counterintuitive to an environment where the Fed expects to continue to (albeit guardedly) raise rates.

Gundlach sums those thoughts as follows:

> *"…The US also appears to be headed into uncharted territory - at least for US fiscal policy - regarding the relationship between interest expense and the debt level. As shown in Exhibit 11, interest expense considerably exceeded the current level during the late 1980s and early 1990s, though the debt level was moderate. By contrast, the debt level was slightly higher during and just after World War II than it is today, while the level of interest expense was similar. However, we project that, if Congress continues to extend existing policies, including the recently enacted tax and spending legislation, federal debt will slightly exceed 100% of GDP and interest expense will rise to around 3.5% of GDP, putting the US in a worse fiscal position than the experience of the 1940s or 1990s…"*

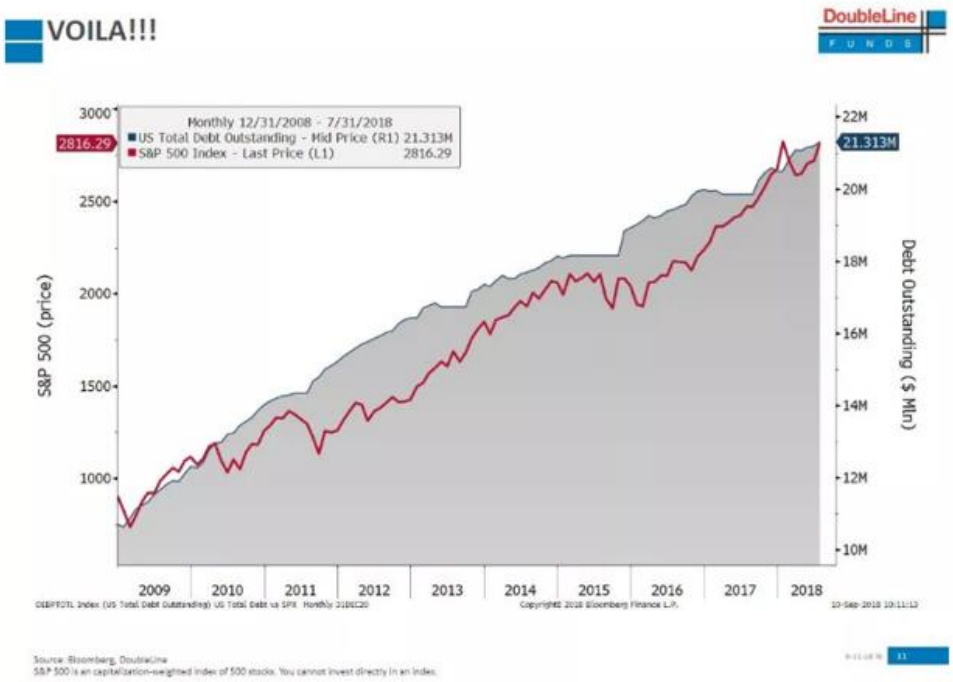
Exhibit 11: Heading Into Uncharted Territory



Source: Office of Management and Budget, Department of Commerce, Goldman Sachs Global Investment Research

A recent SeekingAlpha article (https://seekingalpha.com/article/4205991-maybe-listen-jeff-gundlach-says) by one of its more interesting contributors in my view ("The Heisenberg") expands on this point:

He (Gundlach) *went on to (again) criticize U.S. fiscal policy and question the relative wisdom of further juicing a late-cycle economy with stimulus. Recent economic gains catalyzed by the deficit-funded tax cuts are likely to prove ephemeral, Gundlach argued. Here's another chart he used that will probably serve as some fodder for good conversation in the comments thread of this post:*



This chart points out something I have been lamenting for some time and is the basis for my criticism of central bank policy, which is that if you really want to know what is driving the US equity markets you need look nor further than the mass of liquidity that has been pumped into the system. The chart above is quite telling in that regard. What is perhaps most amazing to me is some of the "rationale" that many of these stocks *belong* where they are trading. I understand "don't fight the tape", but in a world of normalized Fed/central bank policies, there is no way large mature companies with low single digit operating income growth trade at 20X to 25X for extended periods of time. These days, there are many of those. Valuations are extended to say the least, and the chart above is as good an explanation as to why as any. On the other hand, that is not point here.

What I DO want to touch on is another issue that Gundlach has raised, which is the recent strength of the U.S. Dollar. Like most of the environment today, the impact of recent dollar gains on a large portion of the world's assets is profound and frankly, complex. As an aside to that note, I tend to think one of the other negative implications of "too much" money is the tendency for that type of liquidity to lead to marked speculation, which is part of the dollar trade. As a topical example, Gundlach notes that the current short position in both the 10-year and the 30-year treasuries are at "all-time highs". As an additional example the chart below (also from Gundlach, via Seeking Alpha and "The Heisenberg") reflects the sharp divergence that has also developed between US equities and emerging market counterparts:

I think is again fair to suggest that a strong dollar has had considerable impact on this chart. I also tend to think some of that stems from the trade situation. In short, it looks to me like the markets are wagering that in an all-out trade war the U.S. may end up being the last man standing…which I assume must mean not better off, but less worse off. Further, as some have suggested, China's hammer in a trade war may be the influence it wields via its large treasury position. That by the way may tie into the large treasury short we are seeing.

Again, back to my point…which I have yet to make. Given some of the above, I think it is at least reasonable to argue that the recent surge in the dollar has shuffled the valuation deck across the planet, and I think much of that is about people speculating on the winners and losers of this current and/or impending trade war, and I use the term "winners" only for lack of a better word because I am confident that it will be a net negative, and perhaps overwhelmingly so. On the other hand, it may follow that net exporters might (might) be more negatively impacted than others. After all, export imbalances are what trade wars are all about right? To that end, beyond emerging markets, gold has also taken it on the chin as of late, which follows given its dollar denominated status. Certainly, some of gold's compression had been about the dollar trade and perhaps even much of it. That is, in a more "normal" environment, with the prospect of higher interest rates pushed presumably by a Fed becoming more guarded about inflation (which seems to be supported by recent wage data), shouldn't gold be going up…not down?

So now I have finally arrived at my point. To frame the above, I think the rattle of trade war sabers has bolstered the Dollar. That has in turn compressed gold prices, which has commensurately put pressure on gold miners. Don't misunderstand, if gold prices go down (especially if they are expected to stay there) that provides *a fundamental basis* for the value of miners who produce and sell to go down with it (assuming they were not undervalued before the fact). Conversely, if somewhere in here the dollar starts to experience some reversion to the mean, and retraces, I am assuming gold may get a bump from that, and the depressed gold miner shares will likely be an even larger beneficiary.

I currently provide research on two gold miners, New Jersey Mining (NJMC) and Gold Resource, Corp. (GORO), and I think each has recently been negatively affected by the dollars impact on gold prices. Granted, there are still reasons to believe that the dollar may get stronger yet (and gold and the gold miners weaker by extension). For instance, all other things remaining equal (which of course they never do) Fed moves to raise interest rates should make the dollar more attractive not less, although if the impetus for Fed moves is inflation, then one might expect gold to catch a bid as well. (Like I said this stuff is complex). However, I tend to lean toward the reversion to the mean theory, which would suggest that somewhere in here the Dollar could retrace and that should (might) be good for gold and the miners. In the case of my coverage stocks, in my view, New Jersey and Gold Resources may each represent compelling intrinsic propositions from *current levels* (assuming gold isn't going to $900 and staying there), which I think makes them even more attractive in terms of a potential falling dollar trade. Obviously, that might also apply to other miners such as Hecla Ming Co. (HL), Goldcorp., Inc. (GG), Barrick Gold (ABX), Newmont Mining Corp. (NEM) and several more …"all other things remaining equal…".

David Lavigne is long Hecla Mining Company CALL Options.
David Lavigne is long Goldcorp.