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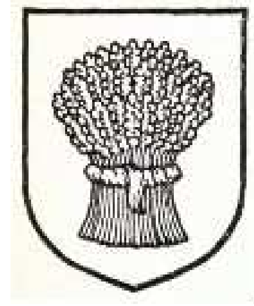

Hallgarten & Company

Macro Strategy

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Metal & Macro Musings:
Peak Gold (Price)

Metal & Macro Musings

Peak Gold – and we mean price

- + Zinc and lead have been rallying slowly but surely with both breaking through the 95 cts per lb level in recent weeks
- + The Euro crisis is losing steam and the currency is stabilized with the focus now turning back to the lackluster US economy. This has dampened inflation fears
- + Copper seems to be rangebound with the Chinese unwilling to see it break much above the $3 per lb level
- + The Australian resource tax proposal has been watered down after the fall of the Australian PM. Now an election could sweep out the government and remove even the diluted proposal
- + The announcement by the Chinese that 2010 export quotas for REE would be 40% lower than 2009 electrified the space. The quotas for 2010 total 30,250 t REO compared with ROW forecast demand of 50-55,000 t. Dudley Kingsnorth estimates total ROW production capacity is currently 10-12,000 t at best, which indicates a shortfall this year 10-15,000 t.
- ✘ Despite this the Molycorp IPO remains a prisoner of global market sentiment (especially the S&P500) rather than REE specific bullishness
- ✘ The Baltic Dry Index has been extraordinarily weak but rallying commodity prices might imply that this is due to oversupply of ships rather than some impending metals demand slump
- ✘ Gold's fade removes one of the brighter spots of the financing space with even gold juniors (and some smaller producers) finding fund raising a hard slog

Golden Peaks

Not unsurprisingly, at least for us, gold has run out of puff. The signs were clearly there when it struggled to get above $1250 and now it has seriously turned southwards without the tailwinds of either inflation or Euro-crisis to keep up its momentum.

Our view on the Euro crisis is that ultimately Greece and maybe Portugal will be ejected however the key to whether this will be a traumatic event or merely a damp squib depends on how long this eventuality takes to play out. Measures have been taken to shore up Spain and we suspect that Spain is where the "generals" at the EU have decided to dig their trenches. Portugal and Greece are regarded as lost but just serve as a no-man's-land now between the EU and its financial Big Berthas and the massed hordes of shorters, mostly at the Satanic hedge funds. Staving off the evil day means that shorters will

get tired and eventually close positions taking winnings or small losses off the table. A blow-up in Greece or Portugal before year-end might produce the dreaded domino effect, however after the end of 2010, the banks and other holders of the sovereign debt of these two "victims" will have distanced themselves and fastened their lifebelts and seatbelts for a bumpy ride. Already bank mergers are taking place in Greece to prepare the lifeboats for their probable launch. If Greece and Portugal can eventually be shown the door with minimum trauma a prime thesis of the gold bugs will have lost it figleaf.

So gold's fate is hostage to some peripheral European states coming to grief sooner rather than later. Big firepower has moved in to make sure that the event is later. Who are gold bugs to walk into that withering hail of bullets? Thus gold is going to slide… $1,100 here we come and after that $1,000 could even be tested if some of the liquidity wave is scooped back up by Central Banks. The Canadians, Australians, Chinese and many emerging nations are tightening, the Europeans are vigilant and yet the US stands almost alone with Uncle Ben cranking the printing presses to keep financial community in the comfort to which they have become accustomed (because they certainly aren't on-lending to the Great Unwashed of the public or small business. So on most fronts inflation, if not under control, is being actively assailed by Central bankers who are intent upon stamping it out even at the risk of enfeebling the recovery. Again, not good for gold (or silver)..

In short, a weak recovery is the worst-case scenario for gold bugs, as it will leave most of their theses without any props to sustain the price at record levels.

Heckle & Jekyll

At an event recently we were bemoaning the lack of a popular groundswell for mining investment to a group of institutional investors (and a few waifs & strays). We noted that unlike the great emerging markets boom of the 1990s when first Telmex and then Telebras were the most traded stocks on the NYSE and new launches of LatAm funds by mutual fund companies had the public surging into the space. And this was right from the start of that boom in 1992. We are now eight years into the commodity (and most particularly metals) reflation and there has not even been something vaguely like the popular upwelling of retail interest in the mining space that there was in emerging markets in the 1990s.

This statement clearly rubbed one of the non-institutional "roll- grabbers" at the lunch up the wrong way. He launched into the question time with the ferocity of a Rottweiler on the Berlin Wall. His claim was that the ETFs represented the modern manifestation of retail's interest in the mining space…. Hmmmm. Well we had been talking about the junior mining space and lamenting the lack of funds because they would have been the underpinning for financing and moving projects towards production and being properly funded. The "heckler" was obviously confusing $50bn in the gold ETF with funding of junior miners. There is no evidence that even one dollar invested in the Gold ETF (GLD) makes its way into the coffers of junior miners. Hence the disconnect we were pointing out. Then he launched into a paean to the Gold Miners ETF (GDX) and its junior version GDXJ. The former does not invest in juniors and, as we recently pointed out in a specific note on the GDXJ, its erratic construction and deviations from what it purports to be mean that trickle-down to anything but the enchanted circle of chosen companies is non-existent. Broad based mining booms should be made of sterner stuff.

As yet the move in the mining ETFs has been a relatively one-way street. There was the brief plunge in October 2008 and then it was business as usual. A prolonged down period in the gold price would see

the physical ETF dumping gold. We have already had brief foretastes of the effect of the GDX selling off gold stocks, which meant that they outperformed (and not in a good way) the GLD on the way down. These were only brief spurts but prolonged selling and downsizing of the ETFs (we suspect our heckler didn't know ETFs have to sell as they get "redemptions") could leave to massive selling pressure on the relatively small universe of stocks contained therein. Even worse for the gold bugs would be havingt eh gold ETF shrink by a mere 20% which would tip $10bn of gold into the marketplace which is extraordinarily thin. These ETF-lovers should be careful what they wish for the ETF concept in mining may go swiftly from one-way street to two-edged sword.. to mix some metaphors…

Conclusion

How long can a commodity super-cycle run if it does not have a strong motor of growth? This is a key question that should now be asked. China has clearly been the medium for soaking up excess supply over the last decade. It was a net exporter of minerals in the 1990s then switched to the opposite stance. Without this sea change demand and supply might have been in equilibrium and prices would have been substantially lower. If China moves to less rollicking growth it will still be a major metals importer but low Western growth might just mean the Chinese are compensating for lack of demand elsewhere rather than being an incremental demand growth source as they were up until 2008. In any case they now have the whip-hand.

Thus it looks like the coming months will be more tranquil on the demand front and that is not a bad thing. Copper producers in particular need to get used to the idea that $3 per lb might be as good as it gets and that is pretty good. The other base metals need to see their prices back at pre-Euro crisis levels (i.e. above $1 for lead and zinc) while nickel below $10 is workable the repeated spikes and dumps in this metal make it a wild ride for users and producers.

Gold losing some of its shine might help refocus minds on the broader metals space with benefits for the base metals from a less mono-focused market.

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