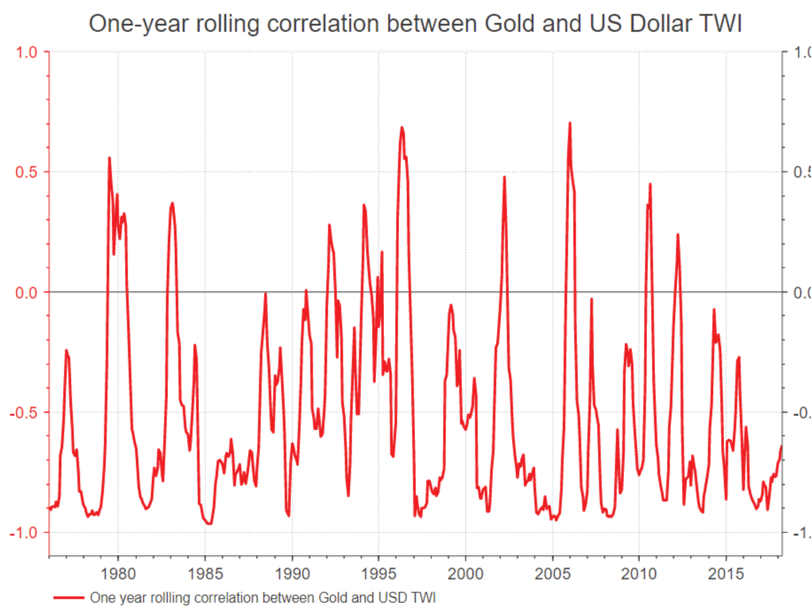
32 / Medium-term prospects for Gold, Silver and Gold Miner Equities : Q1 should not be supportive for the precious metal sector

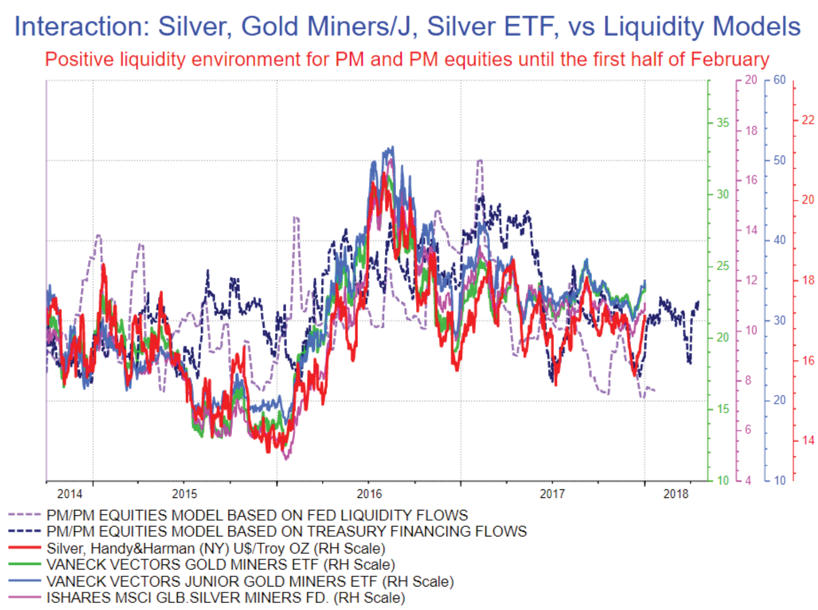
The precious metals sector rose 5.23% in Q4 2017. Precious metals rallied 13.4% higher in 2017 (DCI Precious Metal index), thereby posting its second consecutive annual gain -- precious metals gained 11.50 % in 2016. **It was also the best yearly performance for gold since 2010**. The precious metals sector has generally moved inversely to the changes in the US Dollar TWI. The USD has been falling steadily lower throughout the year, providing the positive bias for Gold, Silver and the rest of the precious metals sector, enabling the sector to perform well despite generally low inflationary pressures during last year. But that relationship will likely become negative from here, so we will have to look for other primary determinants of the gold price *(see 1st chart on this page)* in the near-term. .

The US Dollar and precious metals (as well as a host of other cyclical assets) have also been very responsive to the changes in liquidity funding measures being provided by the Federal Reserve and the US Treasury. Although the impact of liquidity on asset prices is short-lived (from 3 to 6 months), the distributed, lagged effect could sometimes be profound, and could be a determinant of the high-frequency changes in precious metals and some cyclical assets. In graph two and three provided on this page, we show the impact of these measures of liquidity funding from the Fed and Treasury on Silver, Gold and the Gold/Silver Miner equities and ETFs.

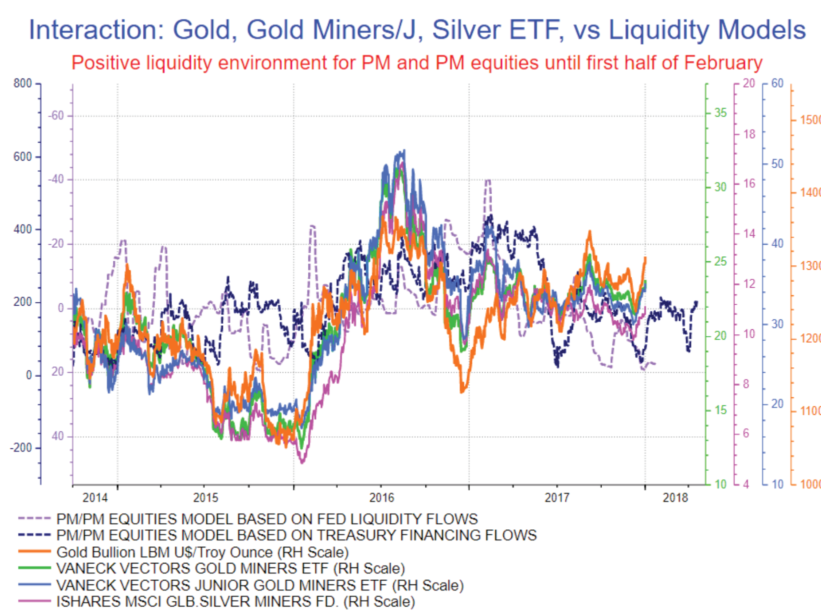
Based on the distributed and lagged effect of the liquidity funding, silver has risen in the past several weeks, but could enter into a consolidation phase soon. A brief pause of a week or so, however, may give way to another sequential upmove which could top shortly. Following the trajectory of the liquidity funding model, a top in January early February should be followed by a PM sector sell off until the early Q2 *(see 2nd graph on this page)*.



Source: Thomson Reuters Datastream / DCC & Robert P, Balan Models (c)



Source: Thomson Reuters Datastream / DCC & Robert P. Balan Models (c)

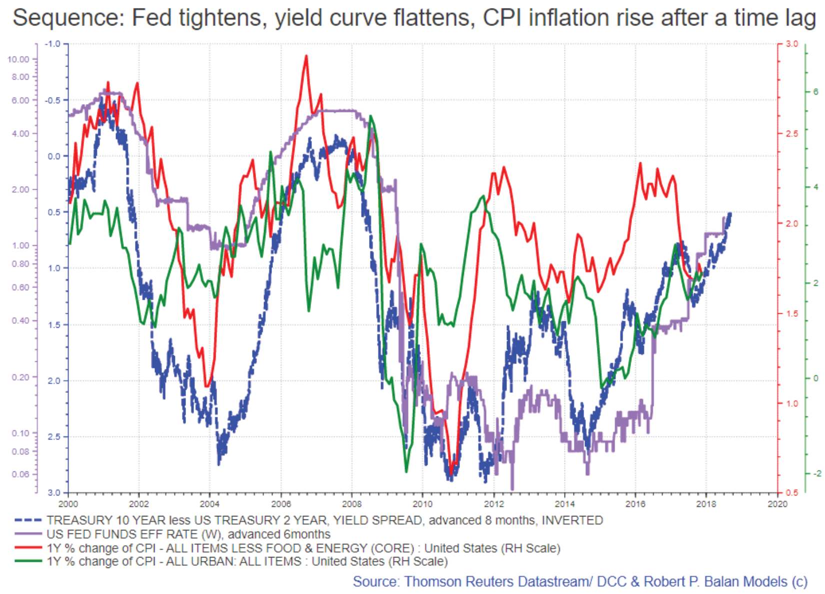


Source: Thomson Reuters Datastream / DCC & Robert P. Balan Models (c)

That should hold true for Gold and the various Gold Miner equities and ETFs as well. The sequential move for Gold is exactly the same as that for Silver, but Gold is skewed higher – which has been the source of Gold's outperformance relative to Silver *(see last graph on previous page)*. Political instability in Asia as a result of North Korea's nuclear ambitions, and the brewing tension between Saudi Arabia and Iran continue to be positive factors for precious metals. Now, we have the Iran uprising as well to contend with. These issues have the potential to foster fear and uncertainty in markets across all asset classes. That may benefit Gold especially among the precious metals – but we have no way of knowing whether these issues will come to a head this year or the next.

Gold has been buoyant last year even in the absence of CPI inflation, and it is intriguing to think how much better the yellow metal can perform in the actual presence of CPI inflation. And by some measures which we have been tracking, there is potential for CPI inflation (both Core and Headline) to rise this year, at least during H1 2018. **The Quantitative Easing program and balance sheet stimulus coming from the Fed during the last several years have skewed many of the relationships between macro factors and monetary data, or amplified the relationships. One such example is the inverse relationship between the Fed Funds rate and the bond yield curve (the 2Y/10Y spread as proxy).**

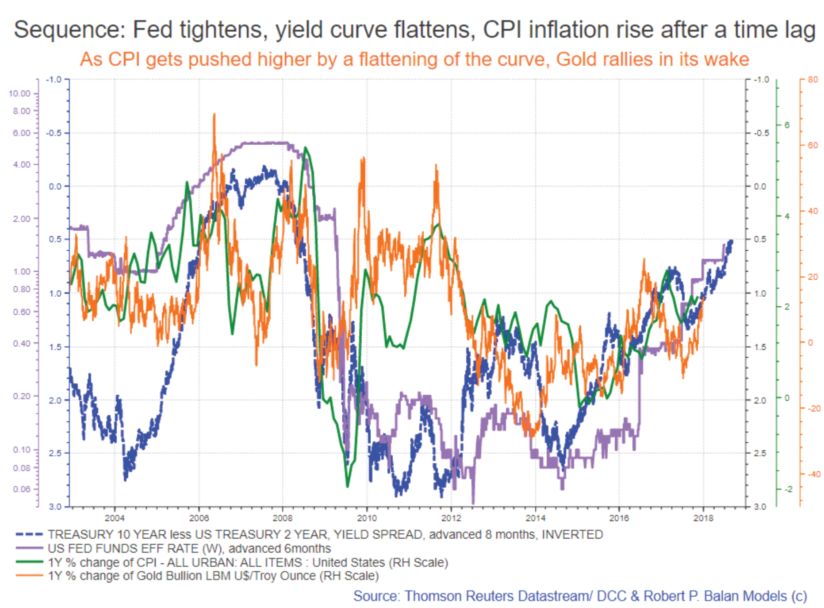
Tighter monetary policy has always flattened the yield curve, but in this cycle of Fed tightening, the relationship has become even starker. The flattening of the curve intensified when the Fed made clear of their intention to tighten policy regardless of tepid inflationary pressures and modest progress on US GDP growth. The short end of the curve is being pushed up by the Fed tight stance, while the long end of the curve has been falling in fear of consequences the tightening has on asset prices and growth.



Interestingly, the dynamics of yield curve flattening/steepening of the past few years has also driven the CPI inflation trajectory. Falling long term yields have driven inflationary tendencies higher along with actual CPI measures (both headline and CPI). So we now have a counter-intuitive situation where higher FFR driven by the Fed, results in a flatter yield curve, which in turn provokes a rise in CPI inflation after about 3 quarters *(see graph above)* time lag. This has deep implications for the medium-term outlook in Gold and precious metals, as we expect both CPI inflation measures to rise from here until the middle of the year at least. Gold should derive some measure of strength from rising CPI inflation during Q2 of 2018 *(see graph below)*.

Gold and crude oil are classified as commodities, but in reality both assets have been so heavily financialized that monetary and interest rate developments have inevitably impacted their pricing mechanisms. Pursuing the negative correlation of precious metals and the slope of the yield curve, we find that the relationship is sufficient, per se, to be a determinant of gold prices.

For instance, flattening of the yield curve today is enough to impart positive impulse on the gold price over a distributed lag of 30 days – the optimal impact coming at the end of that 30 day lag. Gold is not alone in this situation, which basically tells us that the inverse relationship between a cyclical commodity and the yield curve is not spurious. We find the



same inverse relationship between the yield curve and crude oil prices.

This crude oil-yield curve inverse relationship provides another added value in the sense that it lags behind the gold-yield curve inverse correlation by 5 months. Put simply, how gold behaved in the relationship 5 months ago provides strong clues as to how crude oil will perform over the next 5 months vis-a-vis the yield curve *(see graph on this page)*.

Our liquidity funding models (derived from Fed and Treasury provided financing flows) suggest that precious metals (especially Silver and Gold) are still getting some support on the very short term, then it should be followed by a likely decline in the price of those assets until the first half of April. These projections have been provided by the evolution of our liquidity funding models which were based on Fed market liquidity flows and Treasury financing outflows. We also get a sense of strength for gold prices later in 2018 based on the lagged, inverse relationship between gold prices and the currently strong flattening of the yield curve. As bonus, we also derived a basis for an outlook of firmer crude oil prices during the first half of the 2018 year. Since these relationships are not perfectly deterministic, those relationships need to be watched closely as there could be needed adjustments as the price determination dynamic of these commodities evolve.