

THE CAPITAL OBSERVER

GOLD RESEARCH, MAY 2018



A DC&C publication,
featuring MJT's timing methodology



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THE CAPITAL OBSERVER

A Monthly Macro and Asset Review
Featuring MJT's Timing Methodology

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General Disclosure

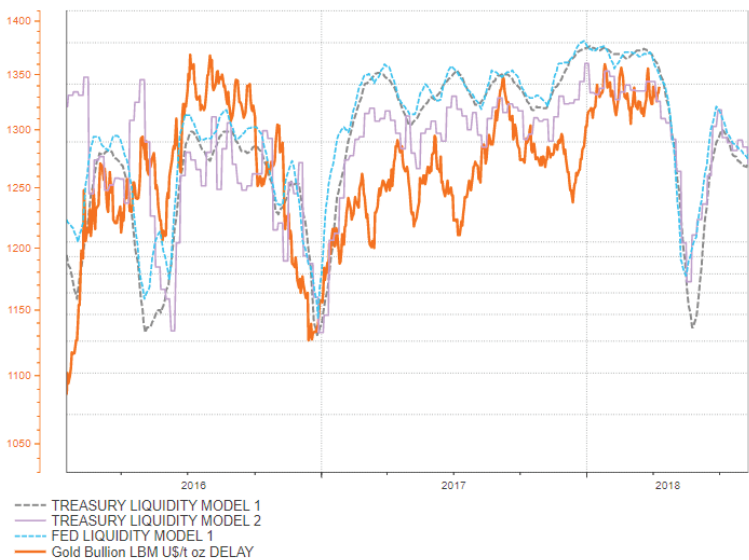
Gold set for one more rally to a new high before summer, but will likely come under extreme pressure later in the year in Q3 when the US Dollar takes off

The most popular attribute of Gold from the point of view of investors is that it can be a safe haven destination. In the not too distant history, gold had responded to geopolitical events out of the Korean Peninsula and had rallied as the rhetoric between US president Mr. Donald Tum and Korean dictator Kim Jong-un heated up. Conversely, the price of Gold deflated when the rhetoric calmed down. Gold had also responded to initiatives from the Federal Reserve, its price falling during the times that the central bank had raised rates and reduced its balance sheet – policy moves that tended to increase the allure of the US Dollar. That is why at the core, we call Gold the “anti-Dollar”.

What is clear is that Gold is not merely a pawn of geopolitical events. Gold is also bound to the vicissitudes of economic growth and activity, as much as equities or bonds are. For instance, we all know that gold is negatively correlated to GDP growth – which makes the yellow metal the perfect antithesis of equities. We have always maintained that this negative relationship is what makes Gold attractive as part of an asset allocation. This is, in fact, the best role for the yellow metal, in our opinion. Of course, gold is also considered by many as a hedge against inflation, a relationship that is very nuanced and deserves further discussion in the last part of the article.

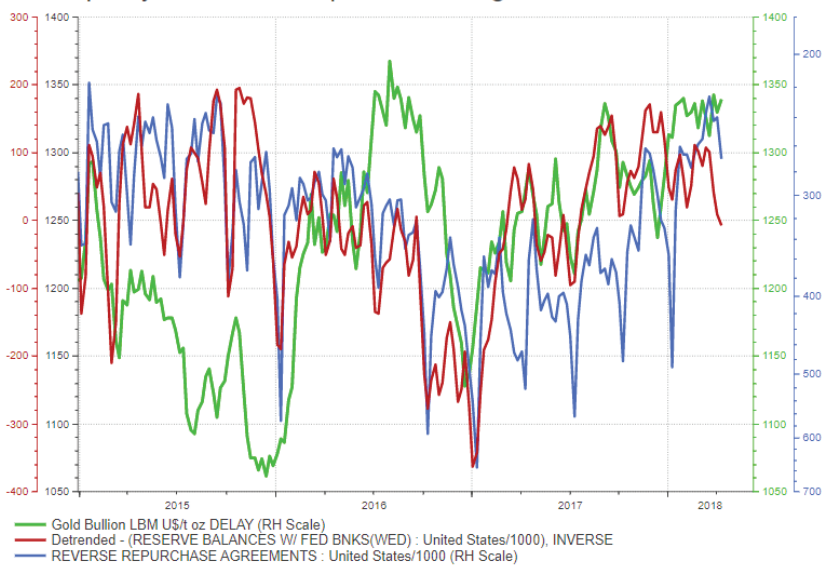
Our recent research also showed that systemic market liquidity has a huge impact on the valuation of Gold. Over the longer term, it is highly sensitive to the changes in the periodic liquidity infusions from the US Treasury and the Federal Reserve (see 1st chart on this page). It seems that increasing amounts of liquidity infusions support higher valuations of the yellow metal

TREASURY AND FEDERAL RESERVE LIQUIDITY MODELS vs GOLD



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

Liquidity factors that impact the changes in the value of Gold



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

(see 1st chart on this page). That makes sense, as tighter supply of systemic “money” tends to support the US Dollar (via the Quantity Theory of Money) which has an inverse impact on Gold.

One way to confirm that is to make a comparison between Gold and term market rates via a regression process. We find out that increasing bank reserves at the Fed (the most money-like of all financial instruments) tend to push up Gold prices, while Reverse Repo Rates (which the Fed use

to contract real money balances) have negative impacts on the changes in Gold price.

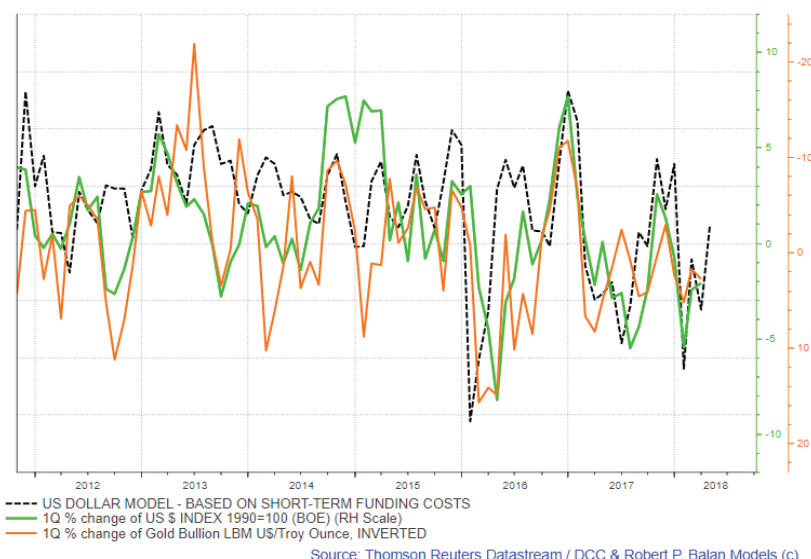
Using those liquidity-themed relationships, it is straightforward to make a combined model of the US Dollar and Gold. Using VAR extensions, we use term market rates to project the likely movements in Gold and US Dollar several weeks ahead. This model is telling us that a US Dollar rally is due and conversely, Gold is slated for a fall (see 1st graph on this page).

In all of these comparisons, something stands out: Gold is indeed the antithesis of the US Dollar -- when the Dollar weakens, gold strengthens and vice versa. Even the famous negative correlation of Gold with GDP growth stems from that relationship. The US Dollar is often positively correlated with growth, but it is not a consistent relationship. Too high a value of the US currency is often deleterious for GDP, as a strong dollar curtails exports. And exports are direct components of the US GDP. In the event of a growth recession, gold often shines due to the consequent infusion of liquidity from the central bank. That is also why the US Dollar often weakens into a growth recession.

Gold and the US Dollar are also linked via the Gold Volatility Index. For some reasons, the Gold Volatility Index leads changes in the Gold bullion. We have used this linkage before to accurately project the latest downturn in the gold bullion price (see 2nd graph on this page). It can also be used to monitor or forecast the end of the current gold correction. This tool could give you advance warning if used correctly.

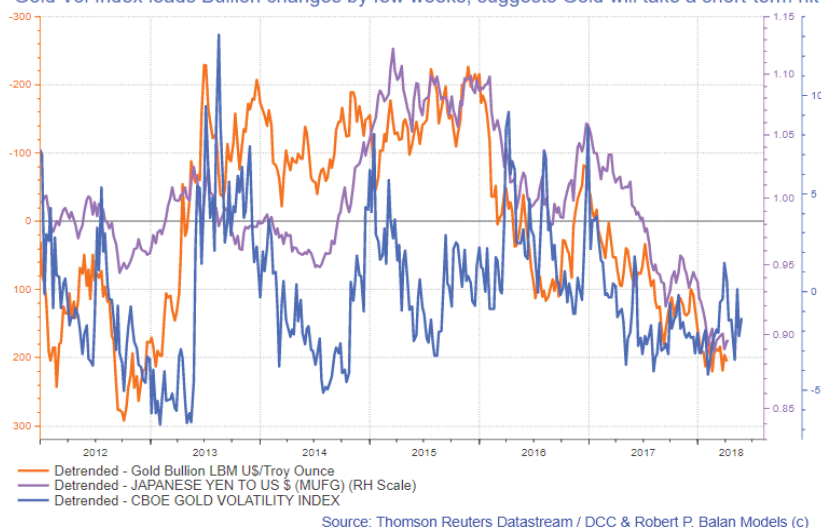
An instrument that responds to macro development, like gold, should have strong co-movements with other risk assets, or respond to instruments which are linked to money, or the cost of money, like interest rates. The link between yields and Gold runs through the US Dollar, as the domestic currency is thought to be driven in some degree by the cost of capital. What we found out was that the 10yr bond yield has a lead over the US Dollar and Gold by 6 months on average. We computed the second derivatives of the 10yr yield, the US Dollar and Gold to obtain those relationships. The second derivative process strips seasonality, the business cycle, and other idiosyncrasies of the instruments, which allows a comparison of their core values and trends (see 3rd graph on this page).

US DOLLAR/GOLD MODEL - BASED ON SHORT-TERM FUNDING COSTS

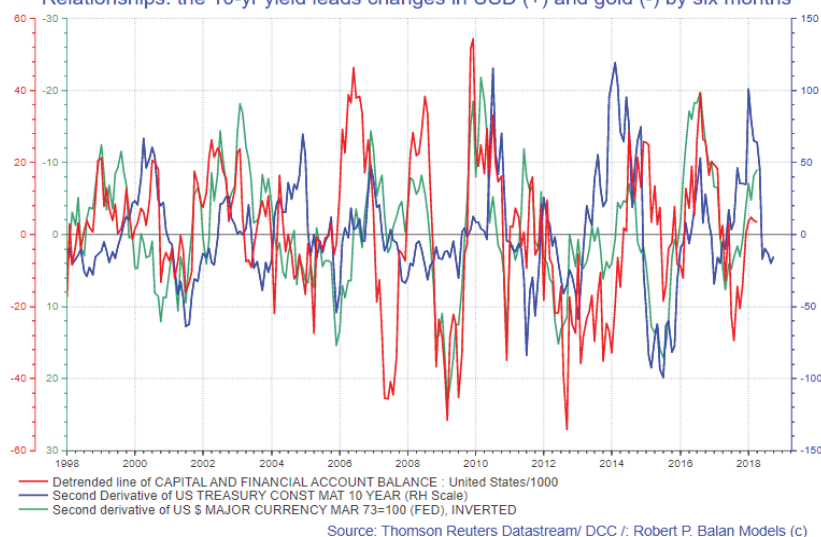


Gold Bullion price, Gold Volatility Index, US Dollar TWI

Gold Vol Index leads Bullion changes by few weeks; suggests Gold will take a short-term hit



The role the 10yr yield plays in the price discovery of US Dollar and Gold Relationships: the 10-yr yield leads changes in USD (+) and gold (-) by six months

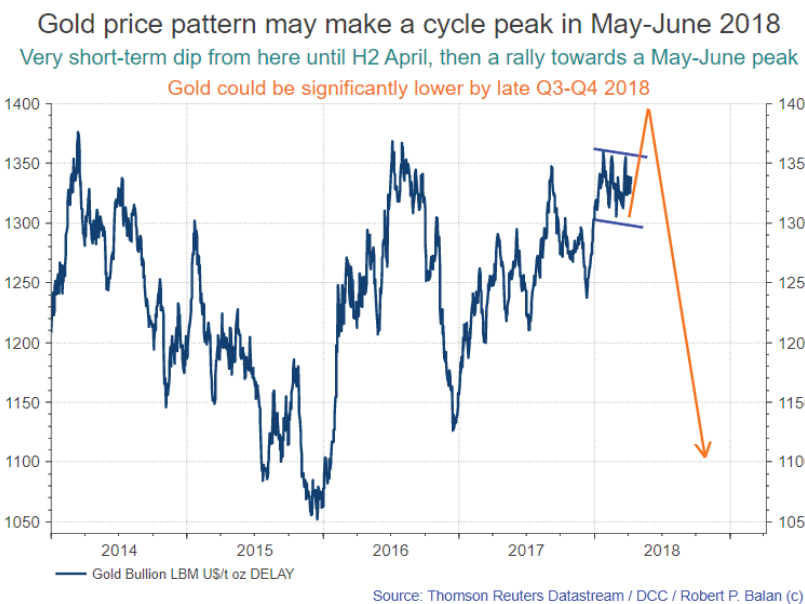
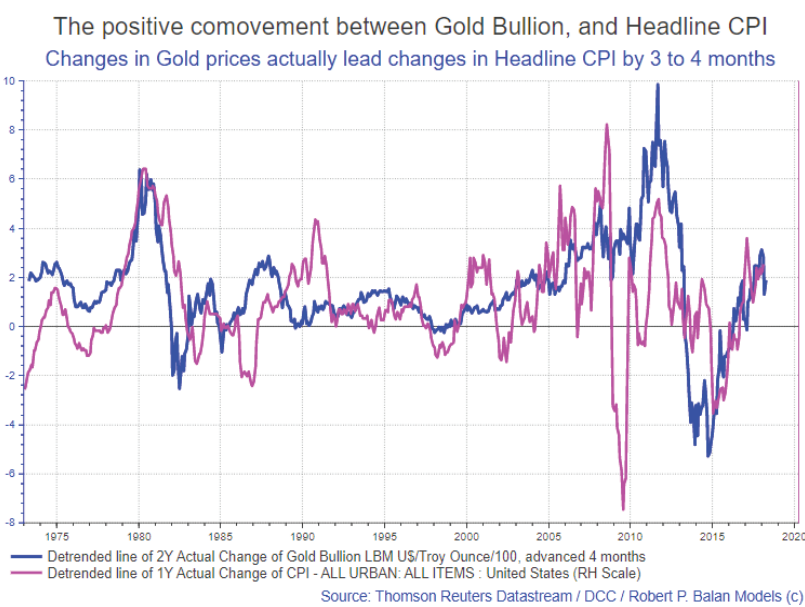


Gold and inflation:

Yield-less but credit-risk-free gold also becomes attractive to inventors as one means of hedging the possibility of an unexpected rise in inflation (see 1st chart on this page), which Gold can undertake very well, given its lead on inflation changes by 3 to 4 months. Given gold's "predictive" tendency over CPI, gold may be seen as a "predictive hedge" versus unwanted rise of inflation (see 1st chart on this page).

If Gold changes lead changes in inflation, and Gold is negatively correlated with GDP growth (and therefore with equities as well), we need to turn conventional wisdom on its head to place the yellow metal in a new light. We should start looking at gold as a possible inoculation to the ill-effects brought about by a business cycle or growth downturn. That is the new thrust of our research work in gold, and we will publish our findings accordingly when we are done., which should be soon.

Our liquidity models applied to the price of Gold provide a map of the distributed lag for as far as a year. We have shown examples of the Gold models in graphs shown earlier. But to fully illustrate the path Gold and Silver prices will likely take over the next 6 to 8 months, we provide the graphs shown below. We expect short term dips in Gold and Silver prices, followed by a rally into late May-June time frame. However, both precious metals will likely be under extreme pressure by late Q2, as the US Dollar takes off. We do not expect the pressure to ease off the precious metals until later in the year or even beyond. (see last 2 charts on this page).



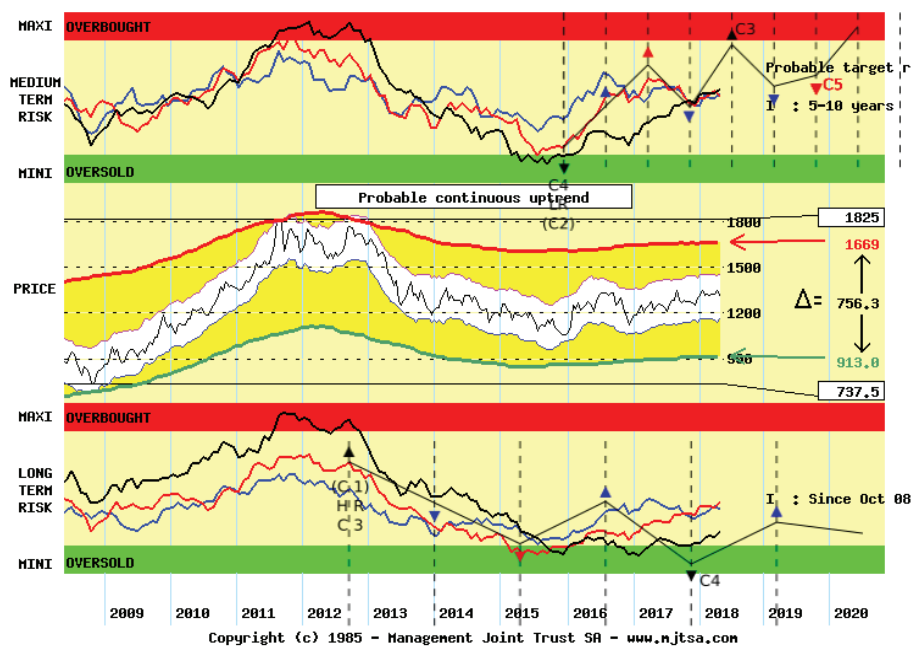
MJT - TIMING AND TACTICAL INSIGHT

Gold should break-out to the upside, before it retraces down on USD strength in H2 2018

While the overall context seems favourable for Gold, it has failed for now to break out to the upside above its 2016 highs. Worse, it recently retraced once again, this time due to the strong US Dollar rebound we have seen over the last few weeks. More generally, the cross-asset environment does look favourable for Gold over the next 12 to 18 months as the business cycle is maturing and risk assets seem quite overvalued. That said, for now, **Gold is still trapped cross-current between many factors, which range from political risks to rising inflation expectations, rising short term rates, a flattening yield curve, or a US Dollar, which may have just started to reverse up.** Given these multilateral influences, we believe that we are **probably in for some volatility on Gold prices as the transition period from economic expansion to deceleration takes place.** Below, we try to understand how these moves may articulate over the next 3 to 6 months, and then beyond.

Gold

Bi-monthly graph or the perspective over the next 1 to 2 years

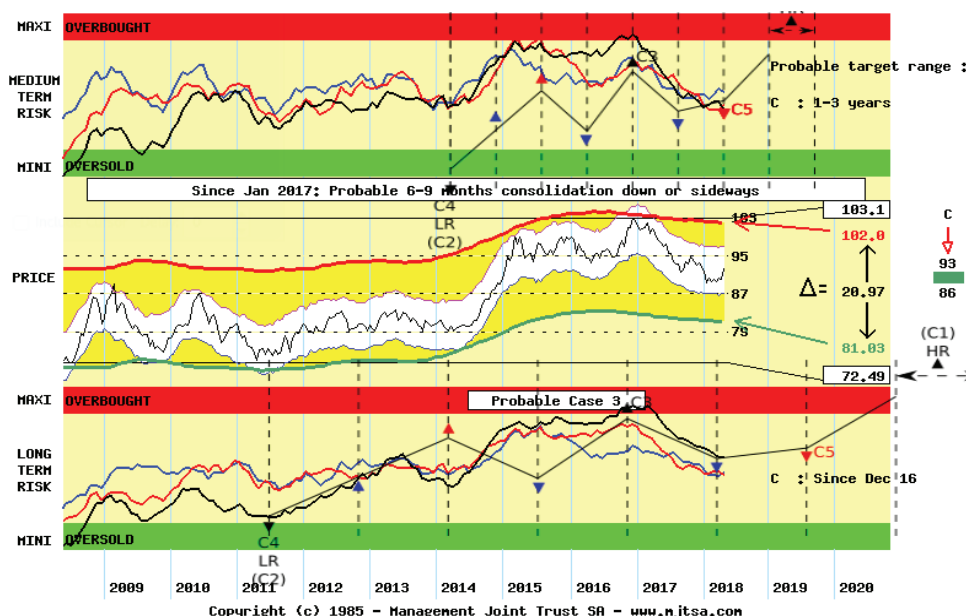


On this long term bi-monthly graph of Gold, our long term oscillators (lower rectangle) are still very much Oversold and slowly rising, i.e. Gold has built a strong base over the last 5 years. As for our medium term oscillators (upper rectangle), **they are now in an uptrend, and probably getting ready to break out above Gold's previous 2016 highs.** The sequence we show potentially leads Gold up towards mid-year, possibly the Summer in first instance. Following that, we would expect Gold to retrace during H2 2018, and then accelerate up again towards late 2019 / 2020. Our **I** Impulsive targets to the upside on this long term graph would suggest

that Gold could see new historical highs towards 2'000 USD/oz over the next 2 to 3 years (right-hand scale).

Dollar Index

Bi-Monthly graph or the perspective over the next 1 to 2 years

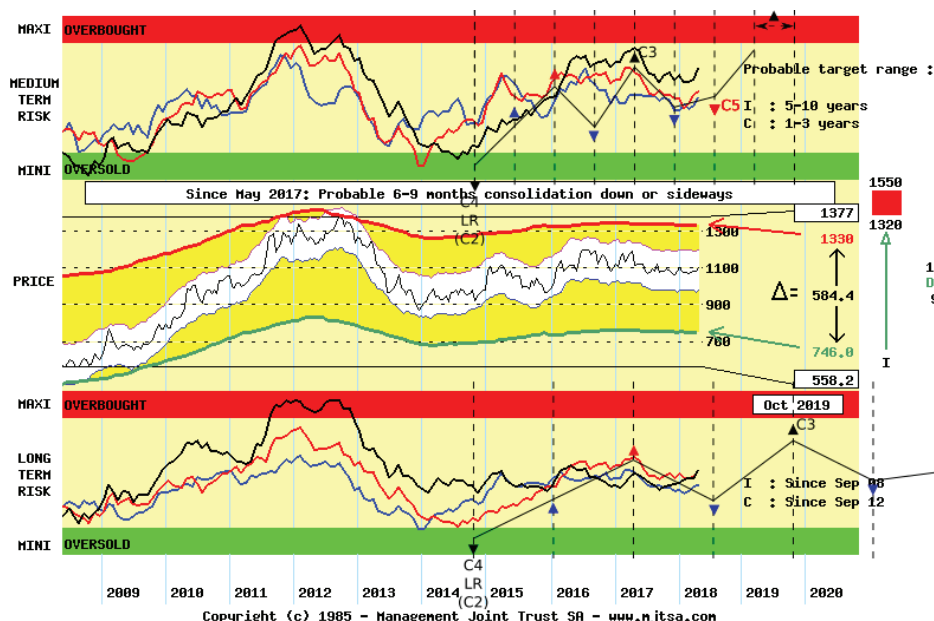


That said Gold is listed in US Dollars, and the Dollar has probably completed its move down since late 2016. It has held above the support of our C Corrective targets to the downside, above 86 (right-hand scale), and on both oscillator series (lower and upper rectangles), we would expect it to continue its recent reversal upwards, first into 2019 (upper rectangle), and then probably even into 2020 (lower rectangle). **Initially, at least, this return to US Dollar strength should weigh on Gold.** This would confirm the intermediate correction we expect on Gold during H2 2018 in the graph above. Following that, we

expect financial conditions to deteriorate during the Fall, and by year-end at the latest, Gold should start climbing vs most currencies and most assets.

Gold in Euro (Euro/oz)

Bi-Monthly graph or the perspective over the next 1 to 2 years

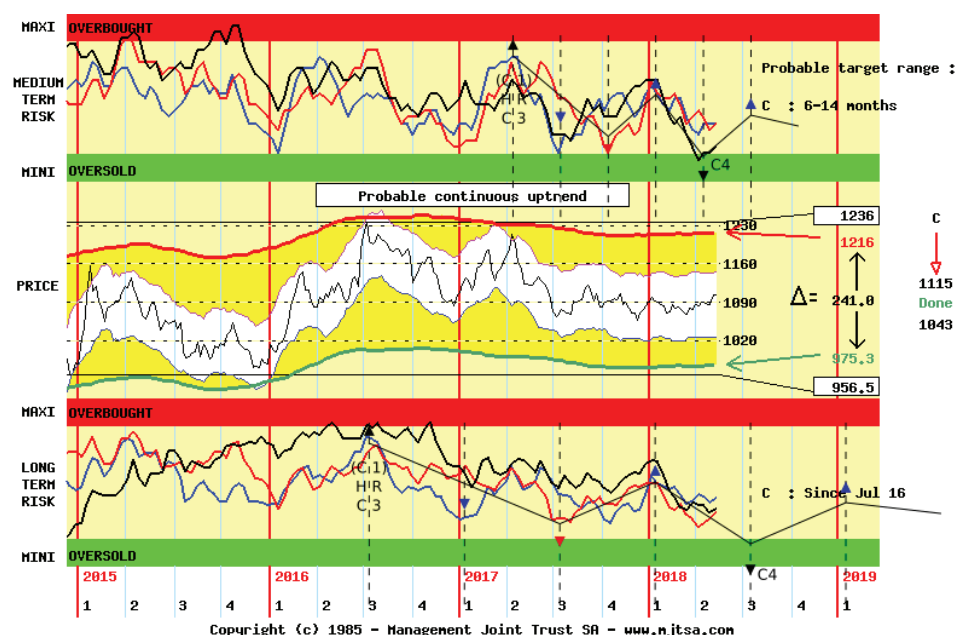


Nevertheless, Gold denominated in other currencies is also gathering momentum. Indeed, analyzing Gold in Euros, for example, strips out the US Dollar effect (i.e. its weakness since December 2016, and its possible reversal to the upside over the coming year). On both our oscillator series (lower and upper rectangles), the uptrend for Gold in Euros is already well engaged. It made an intermediate top in early 2017, has retraced since, yet could be getting ready to reaccelerate up again between now

and late Summer. As with Gold in USD, or the US Dollar itself, Gold in Euros should also be moving up towards late 2019, possibly reaching new historical highs (right-hand scale). Indeed we believe that we are very late in the business cycle, and that over the next 12 to 18 months, risk assets could suffer a substantial correction to the downside. Once the crisis starts to worsen, possibly towards late 2018, both Gold and the US Dollar should benefit from their Flight to Quality status. Gold could then start to outperform in both USD and Euro terms.

Gold in Euro (Euro/oz)

Weekly graph or the perspective over the next 2 to 4 quarters

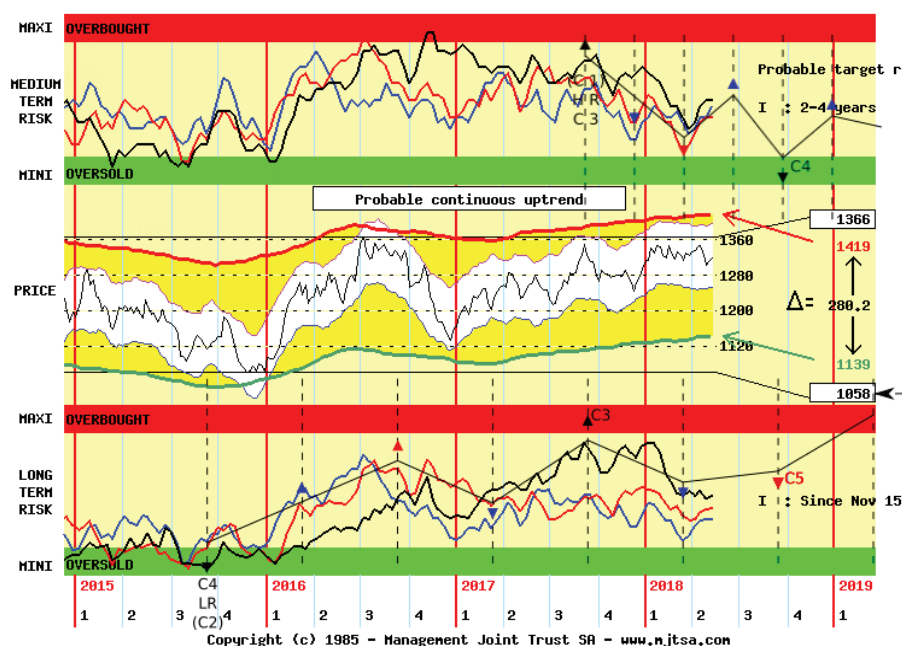


On the Weekly Graph, Gold in Euros has done nothing over the last 3 quarters. Previously, it had moved up on the early 2016 market sell-off, and then in the run-up towards the Brexit vote (i.e. on political and market risks). Again in early 2017, it moved up on fears about the French election. Both our oscillator series could now be bottoming out again. On our medium term oscillators (upper rectangle) a low point may have just been made (Middle East turmoil ?). Our long term oscillators (lower rectangle) would suggest another support point

around mid Summer, perhaps as it becomes apparent that the economy is on the verge of decelerating. Interestingly, over the last 2 years, Gold in Euros has held above the support of its C Corrective targets down (i.e. above 1'043; right-hand scale). This highlights the strength of the build-up towards the next move up.

Gold Spot (USD/oz)

Weekly graph or the perspective over the next 2 to 4 quarters

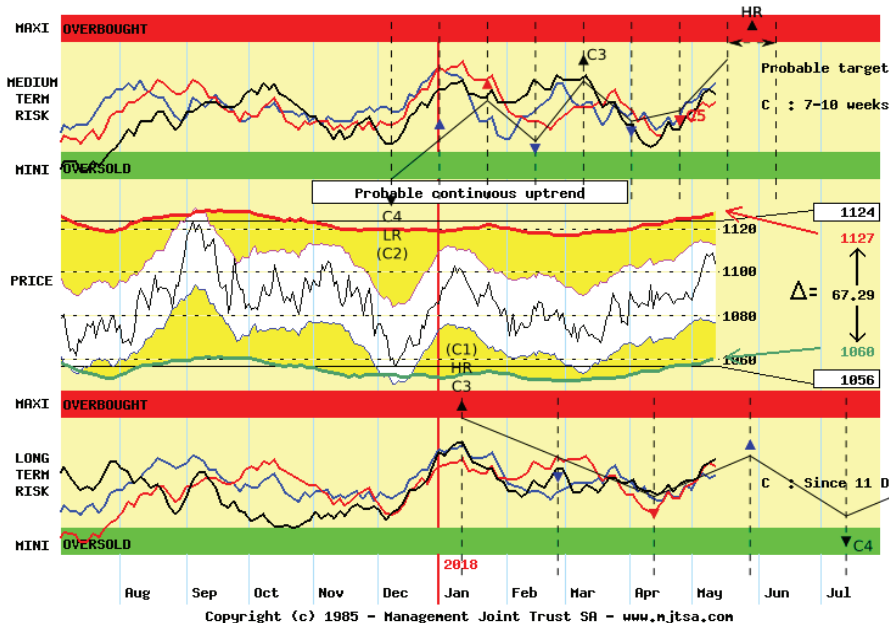


For Gold in US Dollar terms, we believe more patience is required. As we describe above, our view is that the US Dollar has probably turned up for this cycle, and that initially it should rise towards late Summer. Gold should suffer in this first US Dollar rally as economic conditions remains relatively benign. And indeed, our medium term oscillators (upper rectangle) would suggest a last push up between now and mid-year and then, a new period of weakness until end Q3. On our long term oscillators (lower rectangle), we

would also expect some consolidation work, probably towards late Q3, when Gold in USD could start accelerating up again. Until then, the downside risk could be as low as 1'200 USD/oz, or 0.5 times or historical volatility measure "Delta" (here at 280.2, middle rectangle, right-hand side), subtracted from the recent tops around 1'360. Following that, from late Q3 and into 2019, Gold could re-accelerate up again towards our I Impulsive targets to the upside towards the 1'420 – 1'540 range (right-hand scale).

Gold in Euros (EUR/oz)

Daily graph or the perspective over the 2 to 3 months

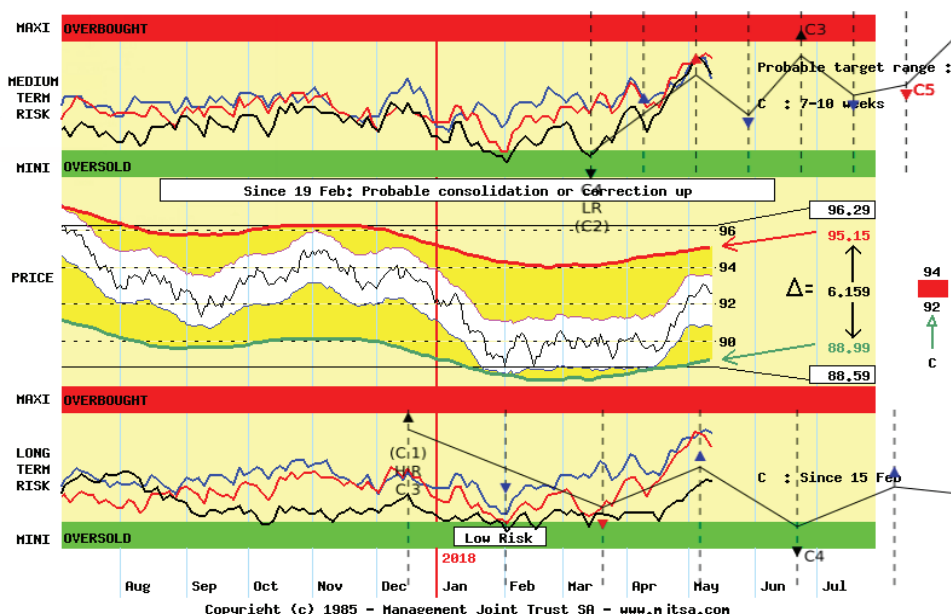


Again, before looking at Gold in US Dollars on a Daily basis, it is interesting to analyse Gold in Euros. It strips out the USD denomination effect, yet highlights Gold's profile in terms of Flight to Safety (against political risk and financial turmoil). Indeed, over the last few weeks, Gold in Euros has reacted strongly to the possibility of an escalation of the Syrian conflict. Both our oscillators series (upper and lower rectangles) would suggest that Gold in Euros may progress up a while longer, possibly until

late May, early June. Our C Corrective targets up (right-hand scale) are signaling some resistance though at current levels. Any move higher from here may hence kick-start a new acceleration to the upside above this resistance.

Dollar Index

Daily graph or the perspective over the next 2 to 3 months

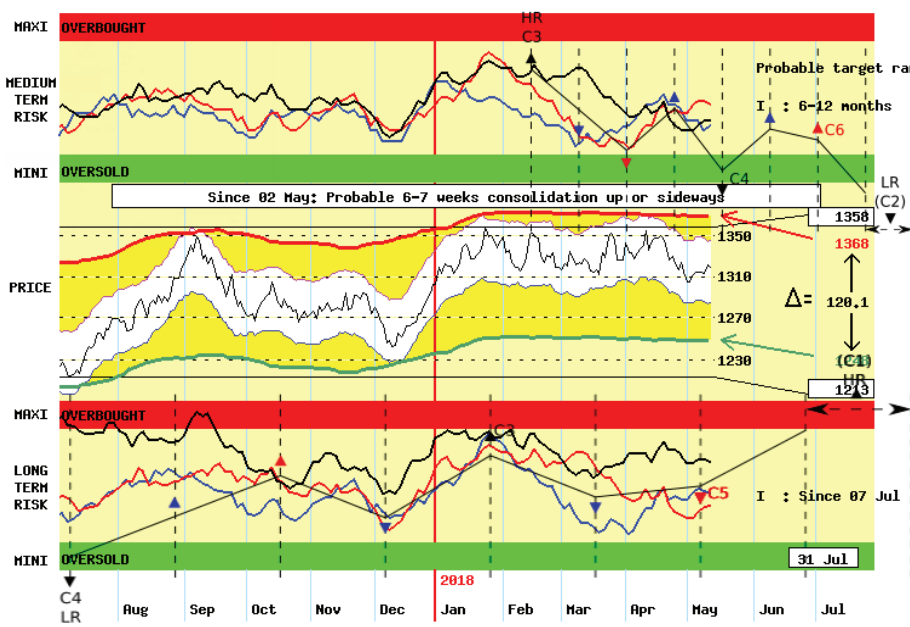


This graph is also very interesting to consider before we analyse the one of Gold in USD. On both our oscillators series (lower and upper rectangle), the Dollar Index could have started to retrace lower, probably towards late May / early June (upper rectangle), perhaps even until mid June (lower rectangle). **Both scenarios are negative for the US Dollar over the next 3 to 4 weeks, and hence positive for Gold.** In this forthcoming retracement, the Dollar Index could probably move lower

again by 2 to 3 figures.

Gold Spot (USD/oz)

Daily graph or the perspective over the next 2 to 3 months



Our analysis of the graphs above would suggest that the US Dollar may retrace some of its recent gains over the next few weeks. Concomitantly, we also expect Gold in Euro to remain bid for now, possibly into late May, early June in first instance. For Gold in USD, these positive effects should cumulate and we would probably expect a new rally into early, perhaps even late June. **The sequences we show on both oscillators series (lower and upper rectangles) confirm this view.** Our medium term oscillators (upper rectangle) which

are already in a downtrend, would suggest a weaker retest to the upside, while our longer term oscillators (lower rectangle) are more positive with Gold potentially reaching new highs during June towards the 1'369 - 1'417 USD/oz price range (right hand scale). Both scenarios are hence positive for Gold in USD from mid May to early June, we would probably favour the more aggressive one (i.e. "marginal new year-to-date highs").

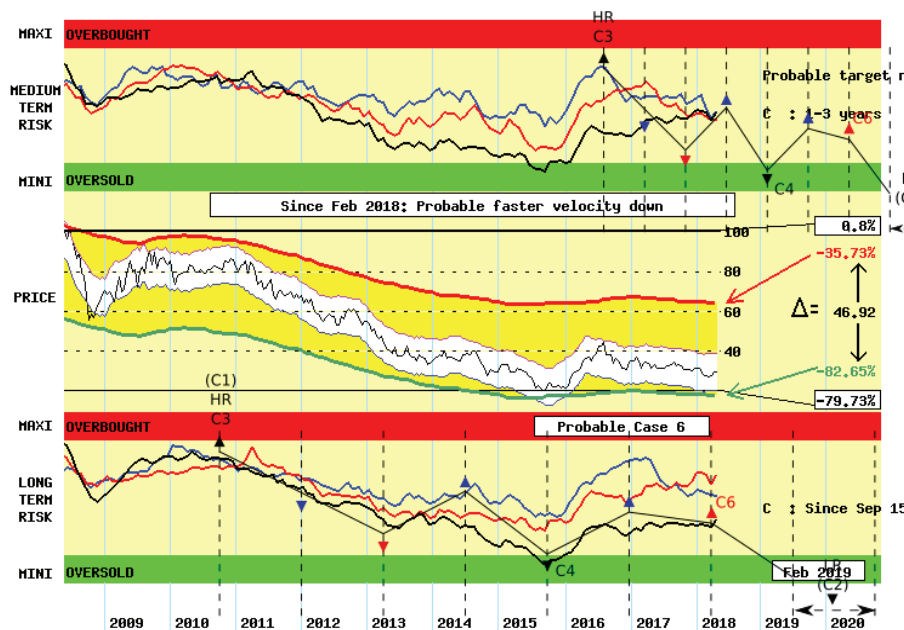
Concluding remarks

Over the next few weeks, we believe the US Dollar could retrace some of its recent rebound. It should allow Gold to finally break out above its 2016 highs, probably until early/mid June, and towards our targeted 1'369 - 1'417 USD/oz price range. The move may also be supported by persistent political risks around trade tensions and a possible contagion of the conflict in the Middle East. That said, this upside breakout may be short lived. Indeed, during Q3 2018, we expect Gold to retrace most of its recent gains and perhaps more, as the US Dollar starts to accelerate up again, probably from late June into September. Following that, towards year-end, Gold should start to turn up again vs all currencies and most assets as the downturn in the business cycle becomes more apparent and financial conditions start to deteriorate quite quickly. Gold could then rise well into 2019, perhaps even 2020 and possibly move back up to test its all-time highs.

10 / Splicing the markets – Intermarket perspectives relating to Gold

HUI - Gold Bugs Index (NYSE Arca) / Gold Spot (USD/Oz)

Bi-Monthly graph or the perspective over the next 1 to 2 years

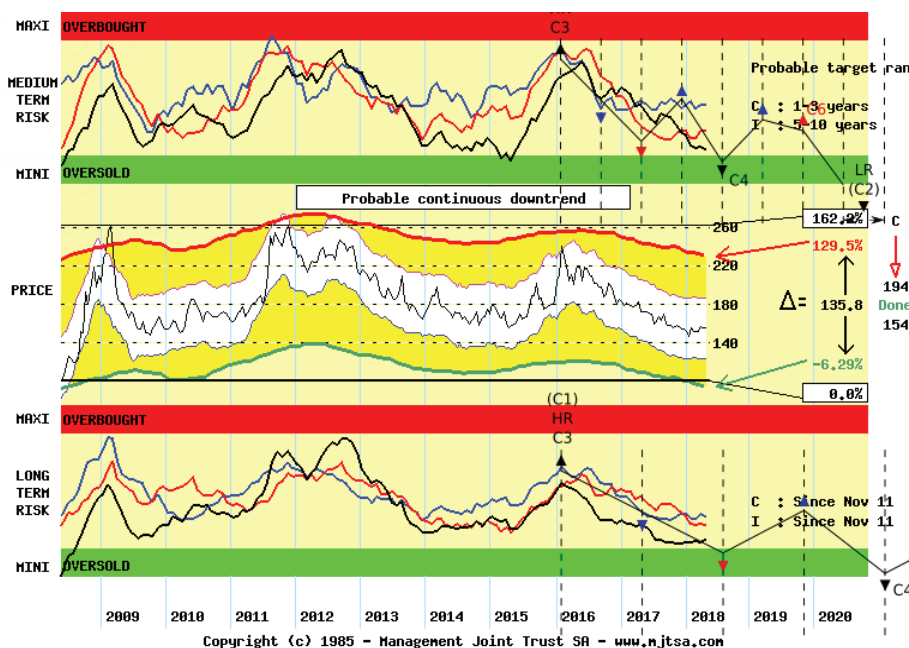


Long term, we would prefer holding Gold rather than Goldmines, at least over the next couple of years. Both oscillator series (lower and upper rectangles) on this bi-monthly ratio of Goldmines vs Gold are still downtrending. On our medium term oscillators (upper rectangle), a slight bounce may be warranted until mid-year, before Goldmines start to underperform the metal again, while on our long term oscillators (lower rectangle), the bounce of Goldmines vs Gold since 2016 is probably already

over, and the trend is getting ready to resume lower. Goldmines usually outperform Gold during recovery phases of the business cycle not during decelerations. Our view is that we are rather late in the cycle at the moment, and that Goldmines should underperform Gold into late 2019/2020.

Gold Spot (USD/Oz) / MSCI Emerging Markets

Bi-monthly graph or the perspective over the next 1 to 2 years



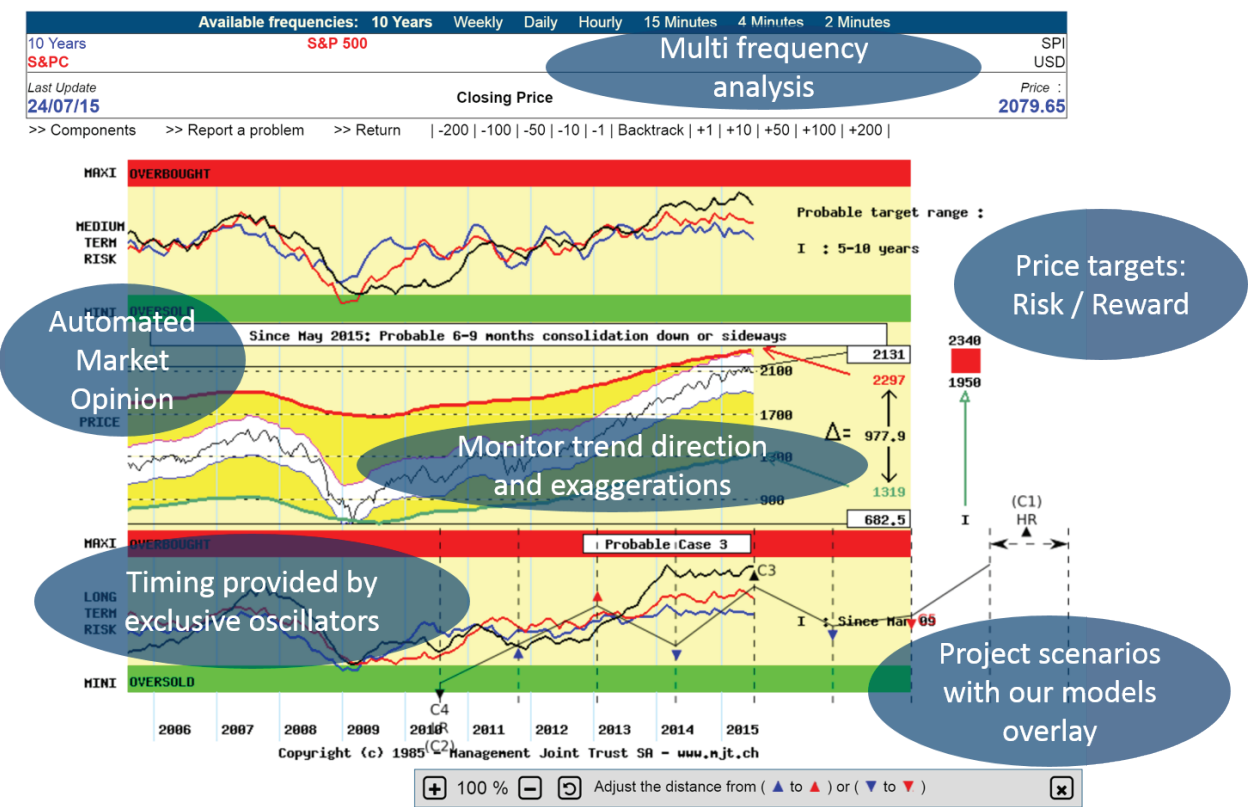
To corroborate this view, we also compare Gold to Emerging Markets. Indeed, while both are usually negatively correlated to the US Dollar, Emerging Markets are rather pro-cyclical, while Gold is clearly defensive. On this long term bi-monthly graph, the cyclicity is very clear with substantial Gold rallies vs Emerging markets in all previous recessions/slowdowns (2008, the 2011 Euro Crisis, and the 2014/2015 growth recession). On both our oscillator series (lower and upper rectangles), we would expect the ratio to bottom out again soon, probably during the Summer and start moving up again towards 2019.

Intermarket take-out

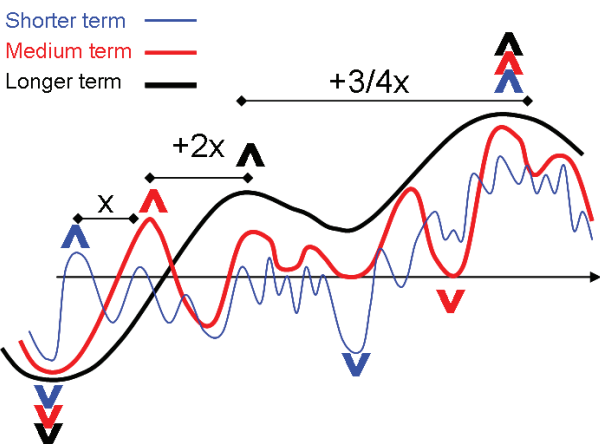
While Goldmines should continue to resume lower vs Gold, Gold itself also seems to be bottoming out vs many risk - assets (e.g. Emerging Markets). Both these graphs highlight the Defensive Shift we expect from the Summer of 2018 into late 2019-2020.

11/ METHODOLOGY

MJT's proprietary methodology uses Timing Oscillators to help investors position themselves either in an uptrend or downtrend. It will hence allow them to anticipate and project the future sequence of events. Coverage extends over 5'000 instruments, long term to intraday, across all asset classes. Relative charts, Opportunity filters, Multi charts monitoring screens and a Portfolio Simulation tool complete the functionality set. See below a description of What's on the Chart, a Methodological brief and an outline of the ideal Uptrend/Downtrend Models (read more on www.mjtsa.com)

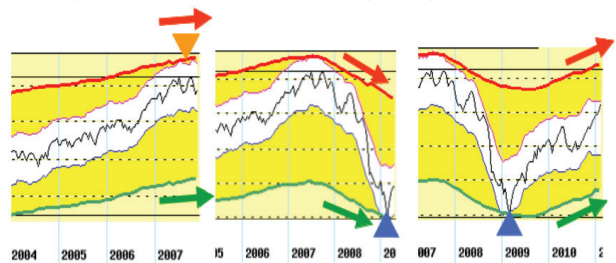


Timing oscillators: Different prices cycles are captured by our 3 Timing oscillators. Monitor how their relative positioning defines specific situations (Cases) to always know where you stand within the Trend (e.g. please see below the ideal Uptrend Case succession sequence)

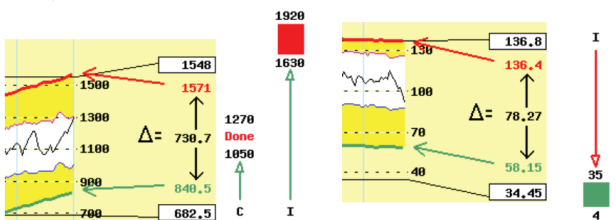


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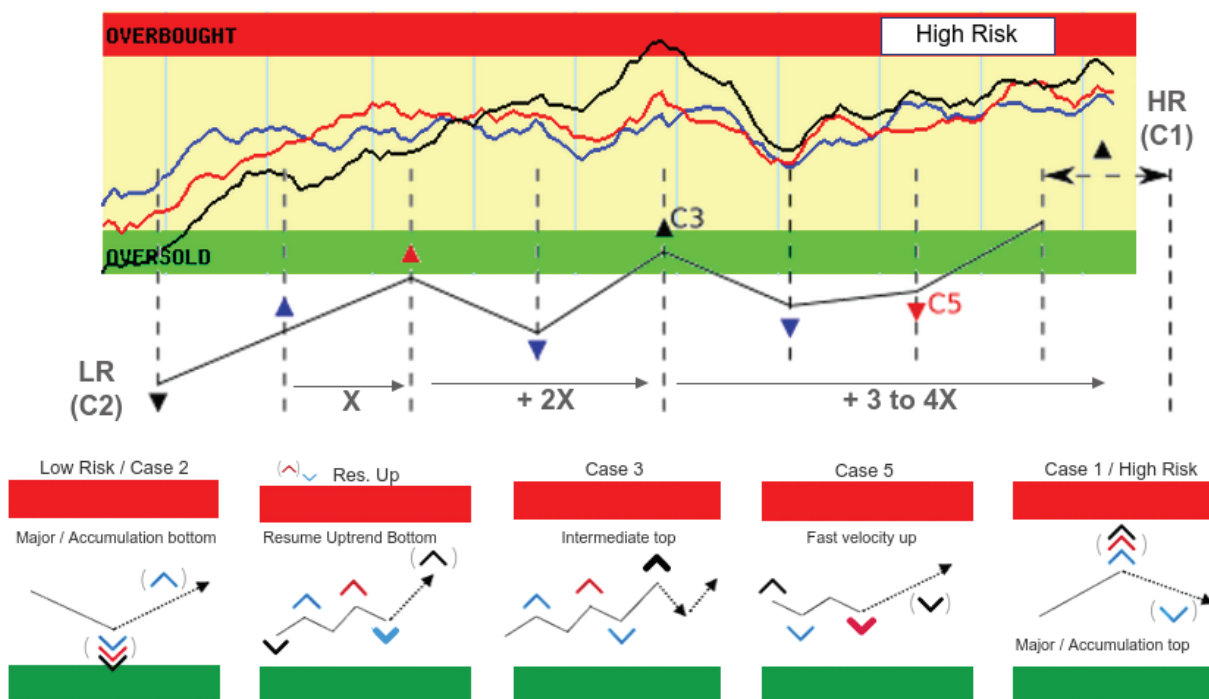
Trend direction: the direction of FinGraphs' large envelope will help you decide either to apply an uptrend or a downtrend model. Contacts between the wider and thinner envelopes will help you anticipate and confirm market turning points (e.g. S&P500 bi-monthly, extracts from the 2005-2011 period).



Price targets: based off historical volatility, they can highlight price potential or risk and, once achieved, define take profit or stop loss areas (e.g. below S&P500 in early 2011, Brent in October 2014).



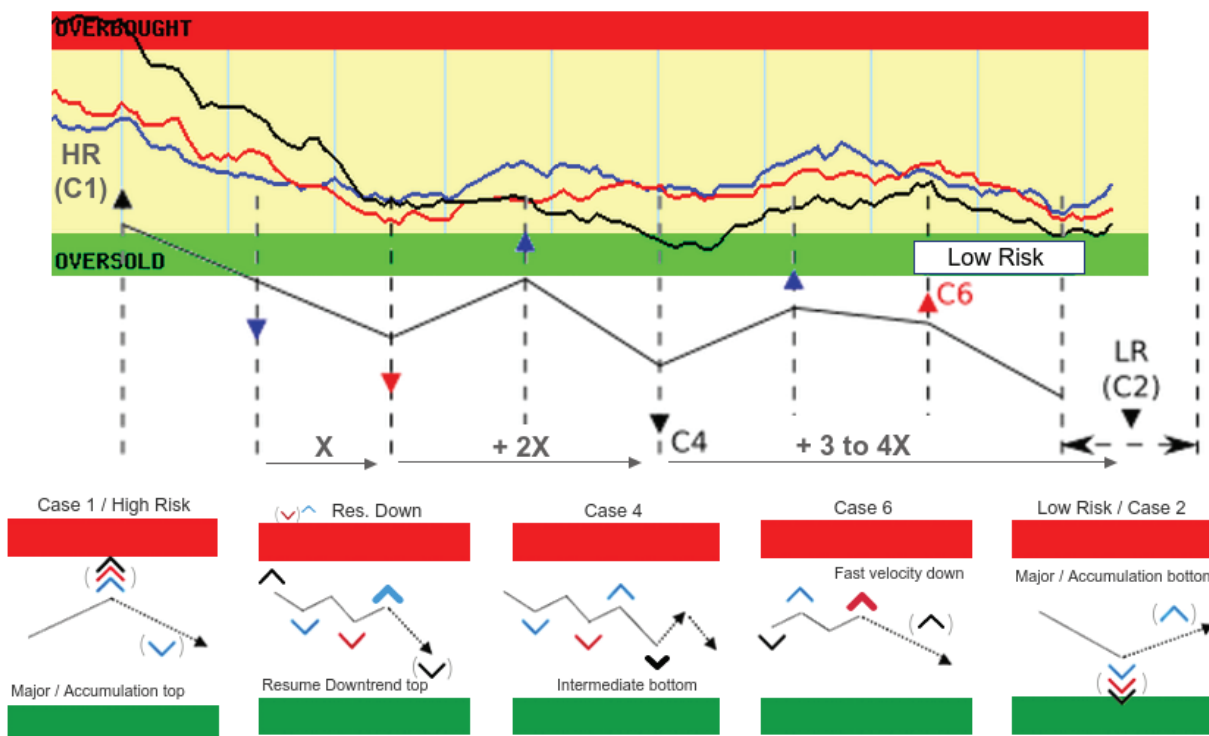
Ideal Uptrend Model



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(left to right) from an oscillator black bottom (usually a Low Risk or a Case 2), the oscillators and prices will start moving up. An uptrend is confirmed once a red top can be made above a blue one. The correction down that follows delivers a buying opportunity ("Resume Uptrend") followed by an intermediate top (Case 3). A new period of consolidation down or sideways then starts, ending with a Case 5 acceleration up towards an important top (usually a High Risk or a Case 1). For each time frame, a fixed time unit separates each timing incidence, so that the distance between a blue and red top is usually X, the distance from the red to the black top is then 2X and the distance between the first and second black top is 3 to 4X.

Ideal Downtrend Model



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(left to right) from an oscillator black top (usually a High Risk or a Case 1) the oscillators and prices will start moving down. A downtrend is confirmed once a red bottom can be made below a blue one. The correction up that follows delivers a selling opportunity ("Resume Downtrend") followed by an intermediate bottom (Case 4). A new period of consolidation up or sideways then starts, ending with a Case 6 acceleration down towards an important bottom (usually a Low Risk or a Case 2). For each time frame, a fixed time unit separates each timing incidence, so that the distance between a blue and red bottom is usually X, the distance from the red to the black bottom is then 2X and the distance between the first and second black bottom is 3 to 4X.

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