Commentary for the fourth quarter of 2017

What could 2018 bring?

Review of 2017

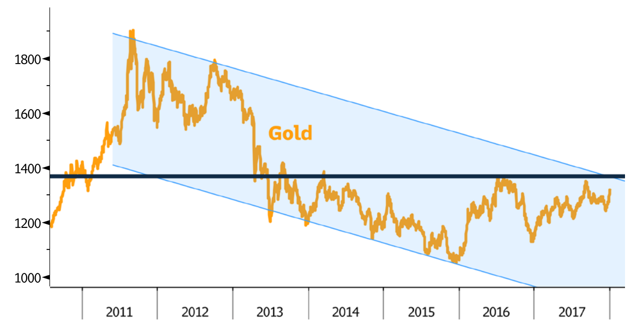
Before we give our forecast for 2018, first a brief comment on 2017. We saw the gold price only reaching our target range of $1300 to $1350 on the last day of the year. If we can claim to have predicted this one correctly, we were far off with our expectations about mining valuations.

Analyzing the causes of this delay in mining repricing, we see three factors worth mentioning.

First, the false – at least in our opinion – mantra, of higher rates being detrimental to gold, kept gold prices under pressure all throughout 2017. Every Fed rate hike has been preceded by gold going down, only to start a mini rally during the weeks after. As the third hike of 2017 came on 15 December, it was too late to boost the HUI and comparable indices (expressed in euros), into positive territory before yearend. Remember that the US dollar lost more than 12% against the euro in 2017.

Some observations on mining valuations and rate hikes.

- Gold prices went down before every rate hike, but formed higher bottoms successively. So we could say that precious metals had a positive undertone in US dollar all throughout 2017, even as gold was not able to break out of its downward channel, it is imprisoned in since the peak of 2011. Breaching the level of $1365-1372 is required to have a confirmed restart of the bull.



- As the balance sheet repair done by most mines since 2011 is coming to completion and a positive M&A cycle has started between juniors and small mid-tier companies, we saw cash flow growth in the sector, even amongst the majors. Free cash flow expansion will become noticed by the market more and more, with every dollar that gold goes up beyond the $1300 level. Hikes in dividends by miners will become more common.

- We expect a new Fed hike in March 2018, so the current runup may begin to stoke and correct in the second half of February 2018. A correction towards $1280 just before the March hike should not be seen as a lasting negative. It could be what the doctor ordered to alleviate a short-term-overbought miners market and create the energy to break through the resistance around $1365-1372.

Second, the distraction caused by ongoing bubbles in equity markets and some 'follies' in cryptocurrencies.

Tina pushed investors to the false presumption that they do not need protection. In our vision, the blow-up formation in equity markets has started in 2017. (We think that this will end after five or ultimately six more Fed hikes, which takes us to the summer of 2019, assuming 3, maybe 4 hikes in 2018.)

Smart money will only increase their investing to precious metals as they come to believe that the Fed will deliver on the promised hikes on time in the 2018-2019 time frame. We already saw a beginning of smart money accumulating royalty companies and the best quality miners in general. In brief, smart money was supportive for gold in 2017, but it was not yet a driving force to push the yellow metal through the heavy long term resistance at $1365-1372. And dumb money, well they overlooked the sector completely, and the most greedy ones even shorted or sold out precious metal positions at ridiculous valuations.

Third, the mysterious absence of inflation.

Indeed we stressed in our predictions for 2017 that we and you should watch for inflation trends obsessively throughout the whole year 2017. It was a bit like waiting for Godot. Even when statistically GDP growth became stronger worldwide and more synchronized (as Europe joined in), inflation remained stubbornly low. Even as continuously better employment figures were released, the renaissance of inflation stayed dubious. The Fed became shaky in its conviction on the relation between labor markets and wage inflation. Miss Yellen explained at great length in her last press conference as Fed chairman, that the Fed model is invalidated by what she called 'the mysterious absence of inflation'. But she concluded that she and her cohorts think – or is it hope – that this mystery is a temporal occurrence. We have less doubt, on one precondition: the Fed has to deliver

on the coming rate hikes! Why are we so strongly convinced? Answering this brings us to our 2018 scenario.

Scenario for 2018

Precious metal investors will become happy campers in 2018 as the business cycle, the inflation momentum, multiple Fed hikes and up trending money velocity will push gold up and above the precited resistance. We target $1400 to 1450 in bullion by the end of 2018 and a possible doubling in a lot of our mining holdings.

On the business cycle.

As the upward trend is already nine years old, we think it's very likely for the business cycle to continue for some 6 quarters more. Only a fifth or sixth additional hike will push the US economy into recession. Tax cuts and deficit spending will help the extension of the current economic cycle. Deregulation will also help: financial deregulation will liberate community banks, environmental deregulation will liberate business investments.

It takes time before capacity constraints settle in and certainly after coming off from the zero interest rates level. First hikes only feed 'the animal spirit' as it gives the market a feeling that they are hiking because the economy is healed and sane.

Every end of the business cycle is in se inflationary. No serious economist will doubt this point. As the cycle will be extended for some quarters beyond the normal cycle duration, logic dictates that the inflation momentum will also be above normal during the end of this cycle. So we say thanks to Trumponomics for making this extension plausible. Phew, the law on tax reduction is signed. Phew, the new Fed chief is a deregulation adept. Phew, coming congress reelections will help deficit spending in 2018.

On inflation momentum

After the Fed follies – pardon Fed unconventional policies – killed the zero lower bound and caused an ultimate collapse in money velocity, we see the downward trend in velocity halted in the last trimesters of 2017. The hike from December and the coming one in March will hopefully create enough momentum to start a reverse, a rising money velocity. By September we will know for sure.

Inflation momentum is more important for gold bullion than its absolute level. This factor can now be stronger than usual, to drive gold prices up. Indeed, absolute debt levels are so high worldwide, that the market takes it for granted, that the Fed will be very slow increasing interest rates (and thus be continuously behind the curve). The belief that robotics and 'Amazons' will forever be deflationary, coupled with Western demographics (declining labor forces) comfort the market. We think differently and believe that the Fed will be setting monetary policy more for Main Street than for Wall Street in a struggle for its proper survival. They fear of being accused of bubble blowing and working for the one percenters. They also want to have the renewed possibility to lower rates when the next recession hits.

We believe that the Fed will become powerless and that smart money will continue to anticipate progressively during 2018 that inflation is forcing the 'Fed put' to explode at some nearing instant, after five or six more rate hikes.

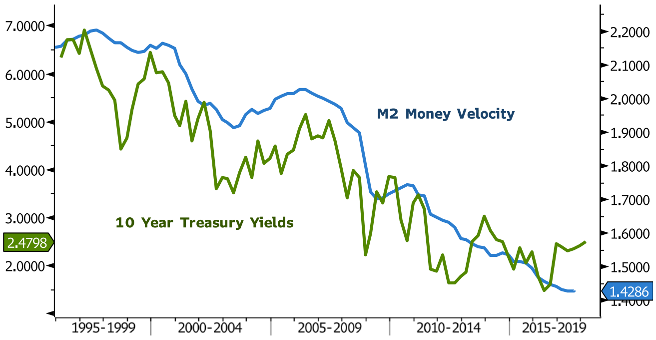
On multiple hikes in 2018-2019 and money velocity, its collateral brother

We expect the new Fed boss, Jerome Powell, to hike in March, independent of the economy in the first quarter of 2018. He will do this to stress continuity, as the Fed is an institution above personalities, and to make clear that he is not an extreme dove as some pundits say.

In a self-reflexivity process, as long as the market believes in the Fed put, the equity blow-up can continue. So the Fed continues hiking to stop the bull run.

If we are right, that inflation will start up for real in 2018, then every hike will create more inflation. Remember what Greenspan has recently repeated again: "the banking reserves on the Fed balance sheet are like a tinder box, waiting for a match". Rate hikes of course being the figurative match. Hence our insistence on Bank of America as a canary for this phenomenon. We are happy to see a new high at $30 for BAC at the end of December 2017.

The surprise could be to see the 'dove' Powell hike 4 times in 2018.



<u>Implications for precious metals</u>

If inflation momentum is important for bullion, its absolute level is even more important for gold mining. We explained in earlier writings that this sector has a gamma that works negatively for returns in a lowering interest environment. Suffice to say that the contrary will happen once rates rise continuously higher and higher, and continue to do so even when growth begins to falter somewhere in 2019. Can you imagine gold mines becoming dividend anchors for pension funds in 2020?

It is this mechanism that makes us believe that some mines will rise tenfold in price in the coming years from their depressed December 2017 levels. Happy campers in 2018 should stay the course and continue camping in 2019.

Target $1400-1450 for gold bullion

Even a big bushfire starts slowly. Give the reflation some time to become undeniable during 2018. Just breaking out of the negative trench for 2018, above $1372, is enough confirmation for the happy camper to sleep well at night. Accept that during early parts of 2018, general equity bulls can still surpass the returns of mines, notwithstanding a possible short lived equity correction.

Further, specifically for gold bullion, we see another correction possible during the weeks before the March Fed hike.

Further hikes, if the March one is also followed by a run-up in gold, could see the market anticipating future hikes instead of selling gold down going into the event.

For the equity blow-up we do see short lived corrections in 2018, but not the big crash. The big crash will come only after the blow-up top is completed.

Normalization of physical buying in India with sustained growth in Chinese demand should help gold in 2018.

Already in 2017, India imported more than 800 tonnes, 70% more than in 2016.

Fear trade demand will be more a trade for 2019. Smart money will hedge the fear of the equity bubble popping as the equity markets rise ever more to the exuberance territory during 2018.

A dollar counter rally in 2018 at some point, also risks to pressure gold. A steep rising dollar in a stagflation environment is expected more for 2019. As that rise of the dollar would express a scarcity and a liquidity problem, such a dollar rise would no longer be a hinderance for gold prices.

So if our expectations for 2018 are good, those for 2019 risk to be more heavy loaded with gold flirting with all-time highs.

Happy new year and a fruitful precious metal mining's return

for iW Partners,

the fund manager