Renewed risks driving a new regime: outlook for base & precious metals

Nicky Shiels, Metals Strategist

August 2019
2019 and the macro backdrop
The macro backdrop: A tale of two halves

- **1H 2019:**
  - Low volatility
  - Complacent regime
  - Risk assets trend

- Summer 2019 -- macro inflection point
  - Trade, geopolitics & the Fed change course

- **2H 2019:**
  - Higher volatility
  - An anxious regime
  - Havens continue to trend
The summer marked several major turning points in trade, geopolitics/politics & monetary policy:

- **TRADE TENSIONS (cold war) May 2019**: last minute collapse of US/China trade deal; post-FOMC tariffs
- **GEOPOLITICAL TENSIONS (hot war) June 2019**: Iran / North Korea / Middle Eastern tensions, HK protests
- **CURRENCY WAR (cold war) July/Aug 2019**: yuan breach of 7-threshold marks a new front; threat of FX intervention
- **MONETARY POLICY WAR Aug 2019**: the ‘first responders’ to the Fed cut by more than expected
**2019 and the Short-Term Precious Outlook**

**DESPITE a resiliently strong & compressed US$, Gold makes a statement breakout - RESPECT**

- Gold hits record highs in 73 currencies indicating a global macro regime shift
- Gold’s price in the majors (AUD, CAD, JPY, GBP, EUR) at peak, indicating a DM currency war against fiat
- Technical Gold break aligns with shift in Fed policy → entering new bull market
Gold is a rate cut hedge and more….

- Gold is very dependent on the pace of Fed easing cycle

- Pricing not only a hedge to a ~3 Fed cuts within 6 months, but also incorporates the threat of core “fear” (trade, political and geopolitical) drivers re-emerging

- Given current real rates & US$, Gold’s “fear premium” is $185. Peak “fear premium” was $700 (in 2011)

- Political risk is underpriced into 2020

### 2009 - 2019 (current)

<table>
<thead>
<tr>
<th></th>
<th>Real US 10 Yields*</th>
<th>DXY</th>
<th>Nominal Yields</th>
</tr>
</thead>
<tbody>
<tr>
<td>10year monthly Correlation with Gold</td>
<td>-0.71</td>
<td>-0.45</td>
<td>-0.43</td>
</tr>
<tr>
<td>Gold with real yields at -0.01 (current)</td>
<td>$1,435</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gold with DXY at 97.64 (current)</td>
<td>$1,215</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Weights</td>
<td>0.61</td>
<td>0.39</td>
<td></td>
</tr>
<tr>
<td>Gold with DXY/10yr weighted (40% DXY, 60% real)</td>
<td>$1,350</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fear premium*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current Gold price</td>
<td>$185</td>
<td>$1,535</td>
<td></td>
</tr>
</tbody>
</table>

*10yr US Treasuries - 10yr Breakevens

Source: Scotiabank Commodities Strategy
With late cycle getting long, a strong disconnect between havens and risk

- US Treasury yields (and the yield curve) pricing in an imminent recession
- US equities pricing in easier monetary policy, relative US outperformance & reflation
- Commodities – especially Gold – remains relatively underpriced vs risk
- The pool of negatively yielding debt is ~$16tn, double that of above ground Gold stocks
- Without sustained growth, low and falling global yields expected; US yields are (still) too high vs the ROW
Known Gold Flows: Western investors & CBs adding vs Asia dehoarding

- Strong physical selling from Asian Gold hubs
- New Central Banks – especially EM CBs - looking to “de-dollarize / re-commodidize”
- Investors turned net bullish in 2019 *; sentiment improving from underweight base
- Without equity market volatility and an unwind of the bull run, the larger equity / generalist investor is quite underweight Gold (holdings only 0.61% of SPX market cap, vs peak of >1.6%)

* CB flows as of June 2019; investor flows as of August 21 2019
** Investor Flows defined as net Global ETF flows + net CFTC COT paper flows

Source: IMF, Bloomberg, Scotiabank Commodities Strategy, CFTC
Gold Outperformance → Only 2/4 drivers “on”

1. *Sustained* equity market volatility (✗)
2. A negative U.S. Dollar catalyst (-)
3. Lower yields for longer (✓)
4. A dovish Fed (✓)

(✓) Achieved. (-) Undecided; TBD. (✗) Not achieved

Short-term Gold outlook:

- $1,450 is the new hard floor; $1500 is the soft floor; $1600 soft ceiling into 2H’2019

- Upside Risk ($1500-1700): increasingly dependent on 1) U.S. politics/geopolitics and trade, 2) Fed outlook, 3) the US$.

- Key downside risk (~$1400): reflation risk
Outlook for Copper
Macro (usually) always trumps micros: demand double-whammy

Escalating trade war

- A new & unpredictable multi-front trade/economic war
- More tariffs now, than before summer ($550 bn)
- Aggressive paper shorts, not coincidentally, correlated to pickup in trade headlines/rhetoric

Global manufacturing mini-recession

- Collective rollover in manufacturing PMIs for 18 months
- The US is (barely) holding the ROW up

"Trade War" search terms vs Copper shorts

* Google Trend interest over time represent numbers where worldwide search interest is relative to the highest point on the chart. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular.

Source: Scotiabank Commodity Strategy, Bloomberg, CFTC Commitment of traders

Source: Scotiabank Commodity Strategy, Bloomberg, IHS Markit
Base Metals more sensitive to EM growth

- Softer EM growth profiles, weaker currencies
- Relative EM Equities underperformance weighing on industrial metals pricing
- Correlation between Base metals Index & EM/DM equities proxy is ~0.60

New $5800 Copper ceiling

- Weakening of the yuan through 7 was/is a game changer for base
- A weaker yuan sours sentiment, lowers Chinas purchasing power for all goods, provides negative tailwinds for EM assets/markets
- However:
  - Potential US currency intervention (targeting the yuan), is upside risk for Copper
  - Major negative trade headlines (#1-3) resulted in shallower dips; diminishing effect of impact on traditional trade war proxies (yuan, copper)
The short-medium term fundamentals: Copper outlook

Trade war and demand impact hasn’t given supply a chance to matter

- Negative supply growth in 2019
- YTD disruptions have totaled ~480K mt
- Global inventories building from cyclical lows, signaling weaker demand
- Forecast 2019-2021 average net deficits 173k mt despite weaker demand outlook
- BUT, weak correlation between historically accepted balances and annual price performances
The medium term fundamentals: contending with cycles

- Current commodity capex 1/5th of peak; Peak commodity capex was $100bn (2012), dwindled to $20bn in 2019, as 2012-2016 bear market resulted in large underinvestment by the capital-constrained mining sector

- Copper net deficit position over the next few years to drive upside price pressures & thus reinvestment, within this capex cycle

- But need to contend with very late business cycle, and commodities broadly in a supercycle downswing that peaked in 2011*

*BCPI is the BoCs Commodity Price Index is an index of 26 commodities including minerals/metals, agricultural products, livestock and oil

<table>
<thead>
<tr>
<th>COMMODITY SUPERCYCLES - 4 cycles since the early 1900s</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) The industrialization of the US in late 1800s</td>
</tr>
<tr>
<td>Peak Year</td>
</tr>
<tr>
<td>Length of cycle (peak-trough, years)</td>
</tr>
<tr>
<td>Upswing (years)</td>
</tr>
<tr>
<td>Downswing (years)</td>
</tr>
<tr>
<td>Supercycle peak (%) from long-term trend</td>
</tr>
</tbody>
</table>

Base: A tactical rally (within a structural decline) requires:

1. Easing of trade tensions enough to boost Chinese confidence and deter paper shorts (✗)
2. A weaker U.S. Dollar (-)
3. Collectively dovish global CBs (✔), especially the PBOC, giving EM assets a chance to outperform & putting recession fears on hold (✗)
4. Bottoming out in global manufacturing sectors (✗)

Short-term Copper outlook:

- New lower range $5500-$5800 due to trade escalation, renewed tariffs threatening a ‘manufacturing recession’ and Rmb 7 per US$ the new macro/currency floor
- Upside risk ($6000): Reflation trade in 2H’19, short covering
- Downside risk ($5300): tendency to trade to pain levels, rising inventories.
Appendix
<table>
<thead>
<tr>
<th><strong>Tailwinds</strong></th>
<th><strong>Neutral</strong></th>
<th><strong>Headwinds</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Feds</strong> reaction function shifts, pre-emptively cutting rates due to trade/geopolitical risks &amp; slower growth. Likely global central bank policies follow suit</td>
<td>A stubbornly perky US$. Outlook on whether the $ extends into cyclical weakness is mixed, given its reserve currency status &amp; historical resilience</td>
<td>Lack of sustained macro fear/equity volatility (VIX &lt;25) given the inbred resilience of US equities to bounce.</td>
</tr>
<tr>
<td><strong>Geopolitics</strong>: an unpredictable &amp; escalating multi-front trade/cold war. Outlook increasingly uncertain with formal US/China trade deal unlikely before US 2020 elections</td>
<td>Higher pace of Central Bank gold buying, diversifying against fiat and US$ in 1H'19; risk of CB demand slowing due to significantly higher prices in 2H'19</td>
<td>Muted physical support from India &amp; China as higher prices in local terms defer purchases; XAUINR near record highs &amp; XAUCNH at 6 year highs deterring jewelry consumption</td>
</tr>
<tr>
<td>Expanding pool of negative yielding debt securities &amp; lower for longer global bond yields; talk of the threat of negative rates in the US in the medium term</td>
<td>Positioning and sentiment flipped from peak bearish (2018) to bullish; while fast money (COT) own peak holdings, the generalist investor is largely underweight</td>
<td>Large dishoarding from traditional physical Gold countries given price surge</td>
</tr>
<tr>
<td>Fiat currencies politicized with markets in a cold currency war: growing risk of US currency intervention to weaken the $ as yuan devalues through 7 per-US$</td>
<td>Gold Producer consolidation / M&amp;A driving “peak gold” supply calls; (bullish sentiment theme in the short-term; negligent in the longer-term)</td>
<td>Higher yielding Gold ‘detractors’ like alternative currencies (Bitcoin) or assets compete for similar flows, especially in EM markets where currencies are depreciating</td>
</tr>
<tr>
<td>Growing talk around alternative CB tools (MMT, QE+, negative interest rates globally) more relevant as rate cuts arrive earlier</td>
<td></td>
<td>2H reflation risk or fear on US data outperformance and / or trade ceasefire promoting a “one-&amp;-done” Fed cut</td>
</tr>
<tr>
<td>The independence of CBs increasingly under threat from populist governments; skepticism growing around power of CBs s to remove volatility &amp; pump up asset prices amidst trade tensions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unsustainable US debt/fiscal path with swelling twin deficits; Structural theme, and one which has taken a backseat to trade/politics</td>
<td></td>
<td></td>
</tr>
<tr>
<td>A pickup in socialist rhetoric and policies with social pendulum swinging left in US (democratic nominees) and abroad</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Summary: A list of macro uncertainties

Potential catalysts for Gold to reprice above $1,600:

- **3 known** core macro uncertainties:
  - Shaky Banks in Europe
  - Debt mountain in China
  - Corporate Leverage in the U.S

- **Potential lesser known macro uncertainties:**
  - Global growth falters further (√)
  - A Central Bank policy mistake
  - Escalating geopolitical or trade tensions (√)
  - Official currency intervention
  - Credit event
  - A dollar-yuan break through 7-handle (√)
  - 2020 U.S. election race
  - Threat of a US debt default
  - Problems sourcing market liquidity


**WSJ:** “Behind the broad, swift (stock) market slide of 2018 is an underlying new reality: roughly 85% of all trading is on autopilot—controlled by machines, models or passive investing formulas, creating an unprecedented trading heard that moves in unison and is blazingly fast” (Dec, 2018)

“It is also a good time to ask what will be the next-best currency or storehold of wealth to have when most reserve currency central bankers want to devalue their currencies in a fiat currency system” Ray Dalio, Founder Bridgewater Associates

“We have probably the riskiest credit market that we have ever had. We see it in the buildup in corporate leverage, the decline in credit quality, and declining underwriting standards—we all this late-cycle credit behavior we began to see in 2005 and 2006.” Scott Mather, CIO of U.S. core strategies at Pimco.

“[Democratic socialism] puts the word democratic in front of the word socialism, but you know, socialism is not a very good way of building wealth, as shown by... hundreds of years of history, most recently down in Venezuela. That’s all you have to look at” Jeffrey Gundlach, DoubleLine Capital
The information contained in the confidential presentation (the “Presentation”) is proprietary and may not be copied, excerpted or otherwise reproduced and may not be distributed, transmitted, disseminated or otherwise made available to any other person or entity without the prior written consent of The Bank of Nova Scotia or its affiliates (collectively, “Scotia”). The information contained in this Presentation is indicative only and is subject to change without notice. Information other than indicative terms (including market data and statistical information) has been obtained from various sources. We do not represent that it is complete or accurate. Any analysis presented herein that indicates a range of outcomes that may result from changes in market parameters, is not comprehensive, is not intended to suggest that outcome is more likely than another and may have been derived using proprietary models developed by Scotia, historic data and subjective interpretation. Nothing in this Presentation shall be construed as constituting an offer or an agreement, or a solicitation of an offer or an agreement, to enter into any transaction. No assurance is given that any transaction on the terms indicated in this Presentation can or will be arranged or agreed. Transactions of the sort described herein contain complex characteristics and risk factors. Transactions incorporating derivatives may create additional risks and exposures. Before entering into any transaction, you should consider the suitability of the transaction to your particular circumstances and independently review (with your professional advisers as necessary) the specific financial risks as well as the legal, regulatory, credit, tax and accounting consequences. Scotia does not act as an adviser or fiduciary to its counterparties or their clients and takes no responsibility for assessing the suitability of this product for you except where written agreement expressly provides otherwise. Nothing in the Presentation shall be construed as constituting legal, business or tax advice by Scotia to any person or entity. Scotia, its respective officers, directors, partners and employees, including persons involved in the preparation or issuance of this Presentation, may from time to time (1) have banking or other commercial relationships with the with the issuers of the products contemplated by this Presentation or the issuers of the investments, securities or related derivatives underlying such products, (2) may engage in proprietary trading in the products contemplated by this Presentation or the investments, securities or related derivatives underlying such products, (3) perform services in connection with or be an issuer of the products contemplated herein, and (4) engage in transactions similar to those contemplated by this Presentation with other market participants, all or some of which may negatively impact or reduce the return expected or anticipated by you in connection with the products or transactions contemplated hereby.

™ Trademarks of The Bank of Nova Scotia Used under license, where applicable Scotiabank, together with “Global Banking and Markets”, is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including Scotia Capital Inc, Scotia Capital (USA) Inc, Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat SA, Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa SA de CV, Scotia Inverlat Derivados SA de CV, Scotiabank Colombia SA, Scotiabank Brasil SA Banco Multiplio – all members of the Scotiabank group and authorized users of the mark The Bank of Nova Scotia is incorporated in Canada with limited liability Scotia Capital Inc is a Member of the Canadian Investor Protection Fund Scotia Capital (USA) Inc is a registered broker-dealer with the SEC and is a member of FINRA, the NYSE and SIPC The Bank of Nova Scotia, Scotiabank Europe plc, and Scotia Capital Inc are each authorized and regulated by the Financial Services Authority (FSA) in the UK Scotiabank Inverlat, SA, Scotia Inverlat Casa de Bolsa, SA de CV, and Scotia Derivados, SA de CV, are each authorized and regulated by the Mexican financial authorities Activities are subject to the local law The products and services described herein may not be available in all jurisdictions, and are offered by different legal entities authorized to use the SCOTIABANK trademark.

The ScotiaMocatta trademark is used in association with the precious and base metals businesses of The Bank of Nova Scotia. The Scotia Waterous trademark is used in association with the oil and gas M&A advisory businesses of The Bank of Nova Scotia and some of its subsidiaries, including Scotia Waterous Inc, Scotia Waterous (USA) Inc, Scotia Waterous (UK) Limited and Scotia Capital Inc - all members of the Scotiabank group and authorized users of the mark.

Scotia Capital Inc owns or controls an equity interest in the TMX Group Limited (TMX) and has a nominee director serving on its board. As such, Scotia Capital Inc may be considered to have an economic interest in the listing of securities on an exchange owned or operated by TMX, including the Toronto Stock Exchange, the TSX Venture Exchange and the Alpha Exchange (each, an Exchange) No person or company is required to obtain products or services from TMX or its affiliates as a condition of Scotia Capital Inc supplying or continuing to supply a product or service. Scotia Capital Inc does not require issuers or selling shareholders to list securities on any of the Exchanges as a condition of supplying or continuing to supply underwriting and/or any other services.