RESOURCES POISED FOR GROWTH AMIDST INCREASING UNCERTAINTY

By Lowell Resources Funds Management August 2018

…Global commodity markets are volatile at the best of times but are more so at present

At Lowell Resources Funds Management, we remain optimistic that the early signs of a bull market in the resource sector are unfolding, notwithstanding the recent pullback in base and precious metals.

For example, despite strong supply-demand fundamentals, August 2018 saw net shorts in the bellwether metal copper reach extreme levels, near the highest ever. Bearish traders are increasing short positions *despite* the strong outlook for the red metal.

Crude Oil

Crude Oil has been the standout performer in 2018 and we expect oil prices to remain firm based on renewed global growth prospects and after the current pullback in global oil prices. The oil price will influence perceptions of economic health and inflation, with flow-on effects impacting other resource prices. Niche metals in batteries and electronics were temporarily overbought, but are expected to appreciate over the longer term, with increasing development and use of electric vehicles and stationary power storage applications.

Gold

The price of gold is currently being held down by a monetary tightening in the US, a stronger US dollar, and a slowdown in global money supply. However, rising global tensions and heightened risk in world markets are pointing to a higher gold price, something which has unfolded in the past and may well do so again.

Impacts on Minerals demand

The current level of economic and political uncertainty is also suggestive of a wider than normal range of possible outcomes. US earnings reports are indicating that the combined impacts of tax cuts, funds repatriation, and deregulation are bearing fruit and will restore the upward trajectory of US stocks, with knock-on benefits to other markets. Anything less may be viewed as a significant setback.

Resumption of growth in China, and especially a vigorous expansion of the One Belt One Road (OBOR) megaprojects, can only provide a stimulus to the resources sector. Economic cohesion in Europe, particularly with regard to immigration issues, intractable debts, and other north-south economic disparities, will also be important to minerals demand. Another factor is the resolution of potentially crippling currency and debt issues in the larger emerging economies such as Turkey, South Africa and Argentina. Overriding all of this is the extent to which trade conflicts escalate or are resolved with only modest impact.

Four positive scenarios for Gold

We foresee four scenarios which could lead to a better gold price in the back half of 2018.

Scenario 1

- ✓ An evolving bull market in mineral resources in an expanding, moderate inflation world economy.

    - ➢ In this scenario Base metals would be expected to outperform along with niche new-technology materials, crude oil, LNG, and bulk commodities. Gold might appreciate at a more modest rate.

Scenario 2

- ✓ We have Inflationary world growth that is led by crude oil, declining dollar hegemony, currency degradation, and especially influenced by pent-up US wage increases in response to growing shortages of skilled labour.

    - ➢ The resource sector in general would prosper, with accelerated economic growth in China, India, and the smaller South East Asian nations. Gold would be expected to outperform.

Scenario 3

- ✓ Here we have a world beset with dysfunctional government, heightened trade conflict, military confrontations, European discord, a global debt crisis, and falling demand for Australian commodity exports. The sale of even some of the US$1.2 trillion worth of US treasury bonds held by China could trigger a bond market collapse and soaring interest rates.

- A modest flight to US safe-haven assets would be tempered by a relative decline in the value and international relevance of the US dollar. The gold price might escalate as never before.

Scenario 4

- ✓ Secular stagnation. Tepid world growth, a return to quantitative easing, loan defaults, disinflation, falling bond yields, rising unemployment, failed pension programs, social unrest, and sideways trading markets.

  - Government infrastructure spending might support base metal demand, especially in China. Gold would appreciate in value as a result of monetary stimulus and declining faith in currencies, central banks and the democratic system.

Various permutations of the above scenarios are quite possible, as unfolding events will determine.

Are we in a major "supercycle"?

Independent researchers, including historians, fund managers and Wall Street professionals, conclude that the final stage of a major supercycle may have commenced[1], which is typically a period of upheaval, conflict, social disorder, nationalism, authoritarianism, and economic stress. Politics assume a dominant role in such circumstances.

Comparisons between the present cycle and the decades leading up to World War II have been noted. For example, Ray Dalio, Chairman of Bridgewater Associates, ominously asserts that *"politics will probably play a greater role in affecting markets than we have experienced any time before in our lifetimes but in a manner that is broadly similar to 1937."* Political issues have superseded economic fundamentals[2].

Neil Howe[3] too notes parallels with the 1930s, a time when iconoclastic populists reigned, *"beggar thy neighbour"* attitudes prevailed, and multinational organizations were assailed (as are the World Trade Organization and U.N. today).

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[1] Edelson Institute, Weiss Research

[2] Luke Gromen, FFTT, LLC

[3] Neil Howe, 2017, The Fourth Turning: Why American Crisis May Last Until 2030. *Theburningplatform.com*

Unprecedented possibilities

As the *"Fourth Turning"* of Strauss & Howe[4] evolves there is increasing scope for unforeseen *"black swan"* events triggering tumult and crisis. Howe observes that benign complacency, such as has been prevalent up to present, typically precedes a regime shift.

Should this process of social and economic unravelling eventuate it will present unprecedented opportunities for investment in precious metals and other resources, as long predicted by the late Larry Edelson[5] and other experts in social and economic cycles.

Forecasts are necessarily subjective and based on unpredictably evolving events and changing assumptions. Quantitative modelling has proved futile according to Taleb[6]. Markets are mathematically complex systems based on unquantifiable investor emotions and involve multiple non-linear variables. This accounts for the inability of numerically disposed economists to predict market directions and timing.

Looking through uncertainty

Further clouding the picture is distortion arising from the *"information economy"*. According to Niall Ferguson[7], connectedness via social media has created *"huge monopolistic networks"* that reinforce confirmation bias with no foundation in fact. George Friedman[8] notes that public opinion is easily manipulated and *"truth has become irrelevant"*. This adds another layer of uncertainty to the already confused geopolitical milieu.

In such circumstances, cycle analysis may provide the clearest guide to the future, but fall short with regard to timing of near-term events. [There are repetitive patterns, e.g. the *Edelson Wave,* that signal trend changes, but the dominant waves comprise multiple sub-cycles that either interfere or reinforce one another. Directional changes may take place overnight when least expected, or may evolve slowly.]

[4] Strauss & Neil Howe, 1997, The Fourth Turning

[5] Larry Edelson, Real Wealth Report, Money & Markets, Weiss Research

[6] Nassim Taleb, 2016, Incerto: Fooled by Randomness

[7] Niall Ferguson, 2014, The Great Degeneration

[8] George Friedman, Geopolitical Futures

US leads the way

What happens in the US still to a large extent determines the course of events in other parts of the world. As waves of excess liquidity scour the globe for returns the US remains the "*cleanest dirty shirt*", as was the case in the mid-1930s. This monetary inflow may have extended the bull market, which is almost a decade old.

In due course, the negative impact of slower world monetary growth will be felt, but this may still be a year or two in the future. The flattening yield curve paints a similar picture.

Towards a US recession

Recession is inevitable in the US. It could be imminent, but that appears unlikely[9]. It may be a year or two ahead, possibly with the most profitable- albeit risky- blowoff phase in the S&P still to come, as in the period 1932-37 when the Dow appreciated several-fold and was matched by a rise in major gold stocks. As other currencies decline, the influx into safe-haven dollars is likely to support US financial assets and constrain commodity prices.

Resources Rally

Beyond the short term, we believe that the conditions are in place for a substantial rally in the resource sector. Elevated risk and deteriorating geopolitical scenarios are conducive to unpredictable high-impact black swans capable of changing the course of events

Lowell Resources Funds Management is prepared for an impending lift in mining & energy stocks and believes that with this there is likely to be a shifting commodity focus. To exploit this the LRF Investment Committee has been expanded to enhance expertise in stock selection ahead of what we ultimately expect to be a rewarding, albeit volatile, period in the resource sector.

In such volatile or "interesting" times, flexibility is vital to take advantages of threats an opportunities which present themselves in dynamic resource share markets.

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[9] Sean Brodrick, Wealth Supercycle, Weiss Ratings, May 2018

Getting yourself set

Overall we would say the microcap resource sector is looking good but "D-I-Y" investors who have stock exposure should ensure to keep a close eye on all of their positions.

There will absolutely be some stocks that become big winners, but sector and stock volatility may be too much for most people to want to manage until the winners identify themselves. In the meantime investors may be better suited to have the bulk of their micro-resources allocation through a diversified fund.

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Lowell Resources Funds Management Ltd ('LRFM') is manager of the Lowell Resources Fund, a junior-resources focused fund that is listed on the ASX (ASX: LRT). LRFM management continuously reviews global economic conditions as they impact the resources sector and manage their portfolios accordingly.

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