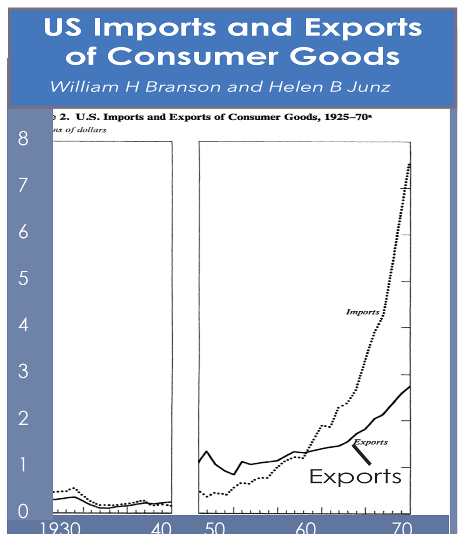
Here come the 70s

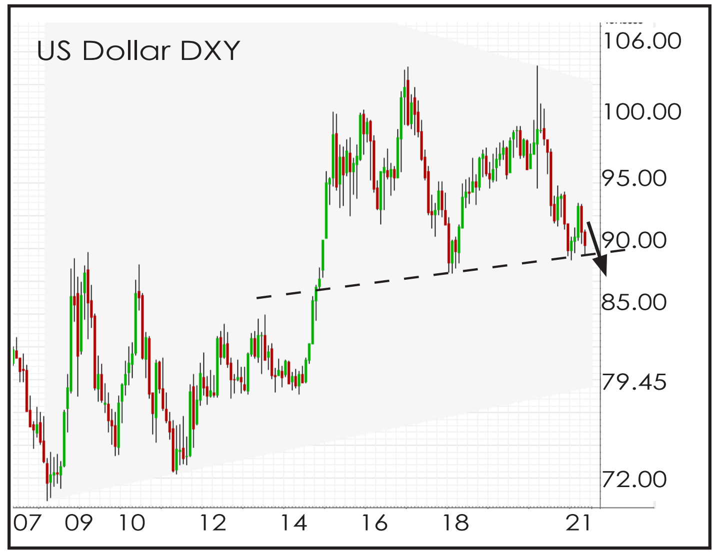
In 1959 a Belgium American economist, named Robert Triffin, testified before America's congress that under the Bretton Woods system, in order for the world economy to grow, the US would need to run deficits on the current account of its balance of payments in order to supply the world an increasing amount of dollar reserves required for the expanding volume of international trade.



Running continuing deficits on the current account resulted in an ever-increasing stock of dollars held overseas and, by the mid-1960s, it became obvious that the number of dollars would soon vastly exceed the amount backed by gold. Triffin predicted that the dollar system would not be able to maintain indefinately both the liquidity the world economy required if it was to continue growing, together with the confidence of dollar holders, that it would maintain its value.

Triffin's warning was ignored until 1968 when the first global panic to get out of the dollar occurred. At the time, America's continuing balance of payments deficit was made worse by the ballooning costs of the Vietnam war and President Johnson's Great Society programs which were intended to alleviate poverty and racial discrimination. By the late 1960s, key partners in the system, such as the West Germans, were complaining that the US deficit was exporting inflation to surplus countries, while France also resented US financial dominance and the seigniorage the US in effect received from its offshore dollar liabilities – most famously described by French Finance Minister, Valéry Giscard d'Estaing, as giving the US an "exorbitant privilege".

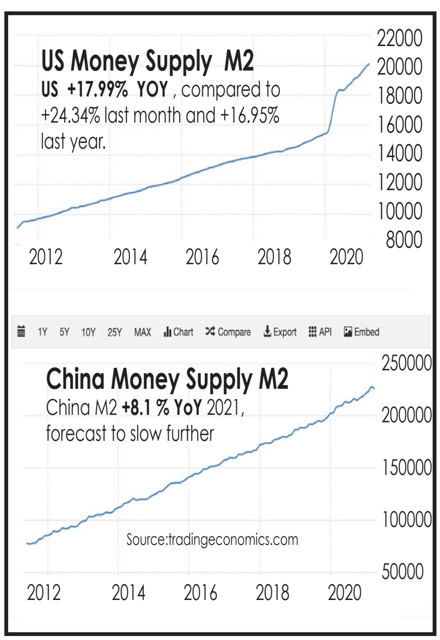
A panic in 1968 to convert dollars into gold marked the beginning of the end of the American post war boom and the abandonment of the dollar's gold backing three years later. Compared to now, America's 1960s profilicacy seems quaint. The country's trade deficit in 1967 was just $3.6 billion or 0.3 % of its GDP, while its net international investment position (NIIP) (US-owned foreign financial assets less US liabilities to residents of other countries) was a respectable plus $68 billion – roughly 8% of GDP. The Federal Budget Deficit ranged from between 0.5% and 2.7% of GDP and of what was spent, two of every three dollars was discretionary, allowing far more flexibility to adjust spending in the future. In total, the Federal debt was $336 billion an amount equal to 37% of the country's GDP.



Fast forward to today and it is a wonder the dollar exchange rate has held up this long. America's trade balance reached a record negative $74 billion in May and is on track for this year to easily exceed 2020's $678 billion total – at $700 billion, it will work out to around 3.5% of GDP, more than ten times the 1967 number. US Federal (pre-COVID) 2019 deficit spending was 4.6% of GDP, more than double the late 1960s average. In 2020, the cost of the COVID-related government support programs caused a tripling of the deficit to a post war record of 17.9% of GDP.

This year's budget deficit is on track to exceed 10% of GDP, likely taking the total federal debt past $30 trillion. Of this, roughly $7 trillion is foreign owned and just over $5 trillion is held by the NY Federal Reserve which continues to mop up excess supply at a rate of up to $120 billion per month. Its treasury buying program is a principle reason that in the face of a 4% inflation rate (compared to a 1967 3.05%), the current real yields on treasuries from 5 to 30 years duration are negative.

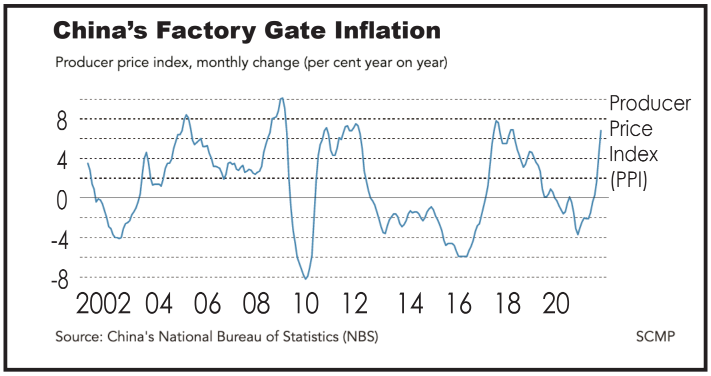
As one would expect, getting foreign investors to buy negative yielding US treasuries is a hard sell. Unless the dollar exchange is devalued significantly. America's NIIP at a negative 63% or $14 trillion is unlikely to change.

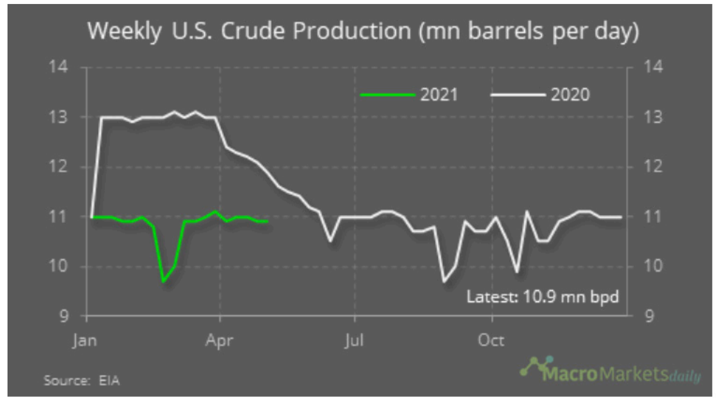


The Coming Dollar Devaluation

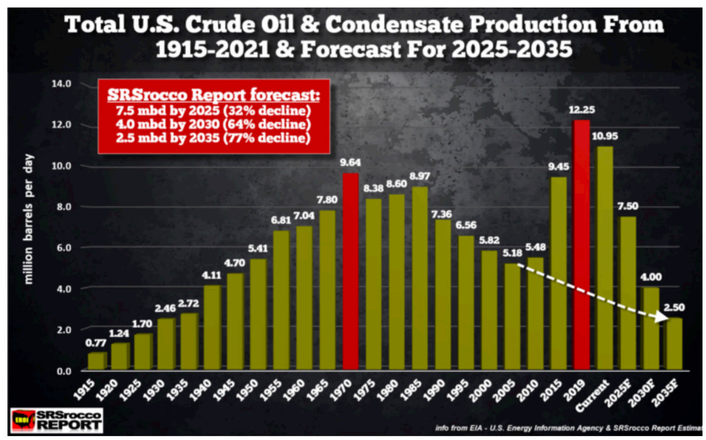
Since 2001, when China joined the World Trade Organization, western consumers benefited from its low-cost exports which in turn provided a deflationary tailwind for America's 40year bond bull market. At the same time, China's middle class grew from 9.1 million people (3.1% of the population) in 2000 to more than 700 million (50.8% of the population) in 2019.

Similar to many Germans, most Chinese are prodigious savers, something the Chinese Communist Party would like to change. Its latest five year plan aims to stimulate private consumption in order to shift from an export-based economy to a more advanced consumption-based one. As it does, those 700 million (and growing) middle-class consumers are more likely to become competitors with the western shoppers for everything from gold to gas, and the effect is likely to be anything but deflationary. We are already seeing it happen. Factory gate inflation in China is near 20 year highs. Industrial metals from copper to cobalt are on a tear. As these commodities get more expensive, manufacturing input costs are increased which, in turn, may translate to more expensive exports which can only exacerbate inflation in America. Many of the basic commodities we take for granted will continue becoming harder to find and more expensive to produce.





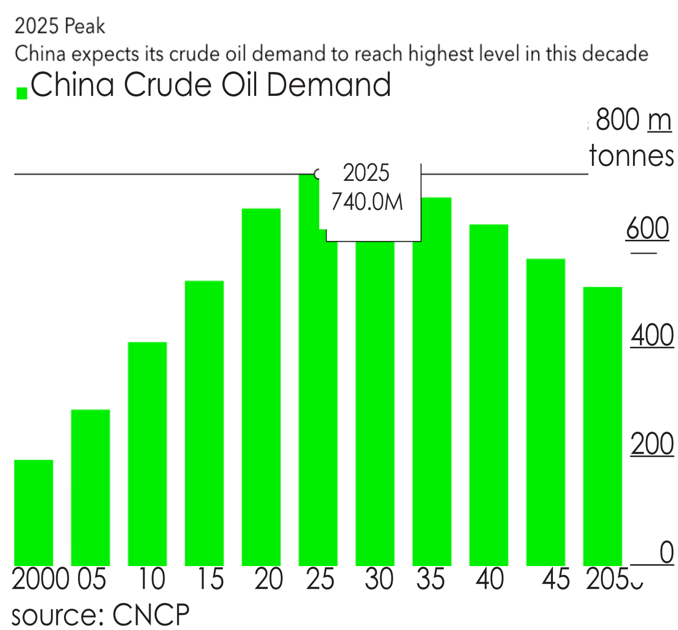
As production flatlines there is no sign of a recovery



Shale well's production decline rates overwhelm any new drilling as the most productive locations dwindle

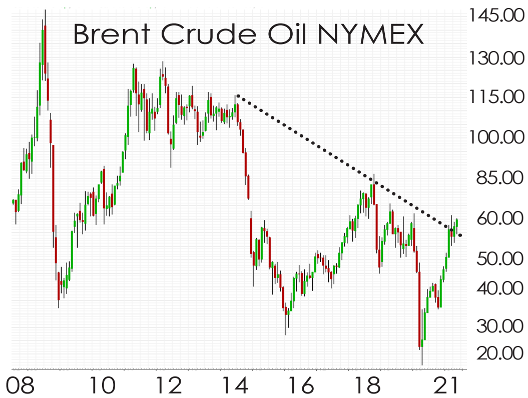
Reading the news it seems the West is intent on putting OPEC back in the drivers seat. Super major Exxon was just forced to admit two activist investors who pledged to steer the company 'away' from producing oil and gas. Shell Oil has just lost a lawsuit in Holland because the judge agreed that its petroleum products contribute to climate change and, as a consequence, the company violates the concept of duty of care to those affected by it. The company has been ordered to reduce its carbon emissions and those of its suppliers and customers. London-based British Petroleum gives us some idea as to how Shell might do it. BP is halting all oil and gas exploration in new countries, while it slashes oil and gas production by 40 percent.

In America, shale oil production has peaked. The shale industry's breathtaking decline rates always meant that just maintaining a field's production was a Sisyphean task of drilling new wells. After its peak at 8.47m BOPD late 2019, production plunged to 6.7m BOPD. As the chart upper right shows, there is little sign of recovery. The SRSrocco Report expects further reductions in tight oil production to take America's total oil production down to 7.5m BOPD by 2025. Texas-based resource specialists, Goehring & Rozencwajg, are as pessimistic and warn that we are "on the cusp of a global energy crisis".



Source: CNPC

America's shale boom had all but eliminated the country's need to import oil creating jobs and reducing the deficit. It was a dollar and economy-supporting tailwind which looks set to disappear. Using $50 oil, every million BOPD decline in domestic production adds $18.25 billion annually to the country's import bill.



oil breaks out to the upside adding to America's trade deficit and inflation...

And in case you are wondering what the effect of electric vehicle additions are on oil consumption, the chart, in the preceding page is China National Petroleum Corporation's estimate of the country's crude oil demand which factors in its booming electric vehicle market. A meaningful decline in petroleum consumption is a decade away.

The New Green Metal

A gas-powered car can require up to 49 pounds of copper, while plug-in hybrid electric vehicles (PHEV) use 132 pounds. Tesla's and other wholly battery electric vehicles (BEVs) on average contain 183 pounds. Copper, with its use in electric cars and the renewable energy grid, is the new green metal.

Critically while the stage is set for continued consumption growth, there have been no major new sources of copper mine supply coming online. The last period of significant growth was 2010 and 2016 when several giant deposits were developed in Zambia, Peru, Kazakh and the DRC, adding some 27% to the copper supply. There has been no appreciable growth in supply since. Most reserve additions have been achieved by lowering cutoff grades so that what was once considered waste rock is instead re-classified as part of the reserves. Between 2001 and 2014, 80% of new reserves were created this way. As a result, average grades are rock bottom. Cut-off grades at the world's porphyry deposits (which are responsible for about 80% of global mined supply) have dropped from 0.3% to 0.4%.

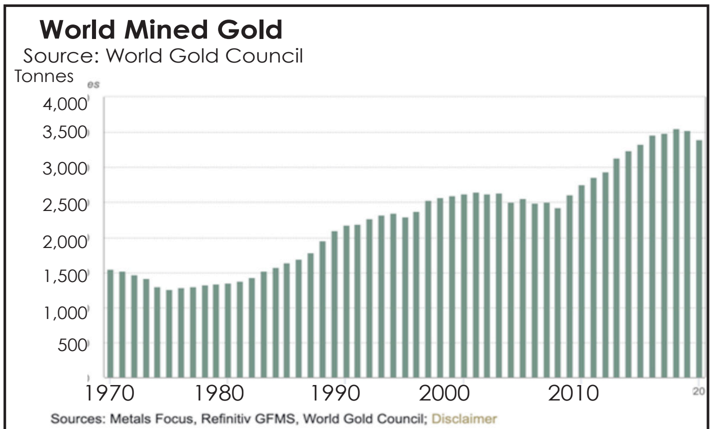
Except the Kamoa/Kakula in the DRC and tentatively, Oyu Tolgai in Mongolia, there are no new major additions to copper supply on the horizon. And analysts calculate that these two will only offset depletion at existing copper deposits rather than increasing mined supply.

CRU, a consultancy, says the industry needs to spend $100 billion to close the annual 4.7 million ton supply deficit it forecasts for 2030. S&P Global Markets warns that the current copper deficit will deepen' over the next several years. expects the current copper deficit to 'deepen' over the next several years.
The bigger the supply deficit becomes the higher the copper prices will go.

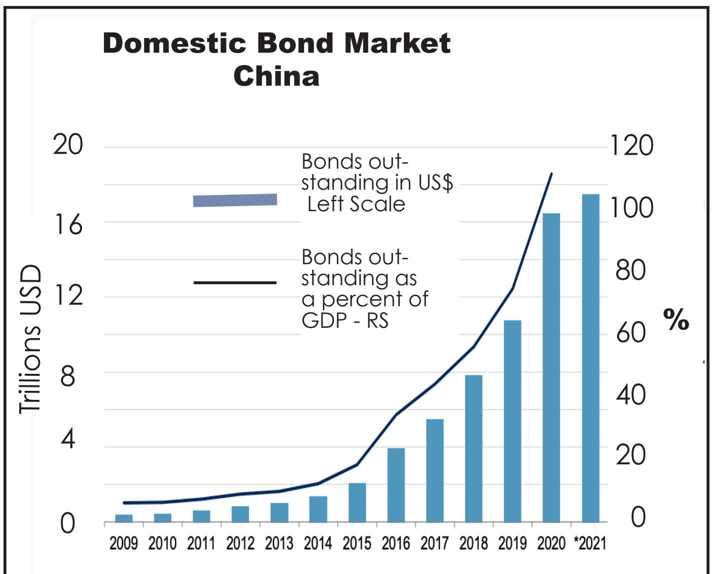
A Stronger Yuan?

Higher commodity prices will not speed China's transition to a more consumption-based economy. The inflation it causes, works through supply chains, and makes the cost of living higher. With less discretionary income, consumers buy less and often feel compelled to work more. This makes the current basic materials inflation an unhelpful trend when the CCP is trying to encourage the development of a consumption-based economy.

One way to minimize the commodity inflation is to allow the yuan's exchange rate to go higher. It would be the flipside of the past two decades of China exporting deflation to the US while financing America's deficit spending. A stronger Yuan would, for example, make metals which are



World mined gold production. Source: World Gold Council



priced in dollars cheaper. The cost of making metals-containing products in China would then be less. A stronger yuan would increase its consumers spending power and with a larger disposable income, an increased level of consumption seems likely.

Underpinning yuan strength is China's $3.198 trillion, FX war chest, the result of 20 years of trade surpluses. A growing flow of foreign investment into the Middle Kingdom's $9 trillion domestic bond market – the world's second largest adds to the yuan's strength. And unlike America's negative yielding securities, Chinese sovereign bonds pay interest with real yields above 3% which may explain why 9% of Chinese government bonds are currently foreign owned. An added incentive is that a strong yuan makes these bonds worth more and investing their even more attractive.

China's recently introduced digital Yuan could benefit too. As it looks set to provide a convenient way for consumers to shop both inside and outside of China – thus creating another way to trade that does not depend or SWIFT or the US dollar. Some worry that users will never be far from the prying eyes of the CCP if they use it. A counter argument is that 2.85 billion Facebook users provide ample evidence that privacy concerns are unlikely to discourage its adoption.

America, on the other hand, will see little benefit as the digital yuan chips away at dollar hegemony, while a strengthening conventional yuan adds to America's inflationary pressures. As the US dollar declines inflation will make America's import addiction more expensive, just its decline causes a growing number of foreign investors to flee its debt markets. It is a downward spiral which could end in crisis. American officials have long complained about the Yuan being too weak. Now it looks set to be strong. Be careful what you wish for.

Buy Gold

One of gold's attributes is that it is likely to benefit from a weak US dollar. Going back to the 1970s, it's not hard to see the correlation between rising energy and commodity costs and a weak dollar, which then feed through the economy increasing inflationary pressures, while gold rallies in response. A key element is that central banks, the Federal government and critically, America's Federal Reserve, accommodate higher energy prices by increasing the money supply, while at the same time keeping treasury yields lower than the inflation rate.

These conditions have been more than met. In reaction to Covid crisis, America's Central Bank reduced the fed funds rate to a range of 0 to 0.25%; subsequently enacted more than $4 trillion worth of support schemes, while continue monthly purchases of at least $120 billion worth of Treasury bonds and mortgage-backed securities. At the same time Congress appropriated $3.1 trillion in emergency assistance for people, businesses, the health care system, and state and local governments.

We have been recommending gold since 2019 (when gold was around $1350). It has broken out of a nine month consolidation and is in the beginning of what should be a sustained and powerful bull leg which over the next year could take it's price to as high as $3,000 per ounce. We will hold our positions in **Newmont** (NYS:NEM), **Polyus** (UK:PLZL) and **Franco Nevada** (NYS:FNV). Of our speculative positions, **Sonoro Gold** (CA:SGO) is a standout. Next month, SGO is expected to release a PEA for its Cerro Caliche Project in Sonora State Mexico. If the results are similar to deposits in the area, such as Argonaut Gold's San Agustin Mine, it should be an exceptionally profitable operation. Argonaut bought Sonoro VP of Exploration Mel Herdrick's last successful mine development: Pediment Gold. When Herdrick got started, Pedimen shares were trading about the same price as Sonoro's – $0.30. Around a year later, Argonaut took over Pediment at just over $2.56 a share.)

All indications are that the Cerro Caliche economics should be exceptional with a very short construction time and payback on CAPEX. Basically, it looks increasingly like we are on track for another Pediment-like near ten times our money or better, performance.

I went through the math in a previous issue based on Sonoro building the 15,000 ton per day operation and found that using the net 0.5 g/t Au Eq and

a conservative (high for the area $1200 cost) and 330 working days, it should easily produce around 80,000 ounces of gold annually. At gold's current $1900, that means EBITDA of just over US $56 million for a (fully diluted) cash flow of $0.34 per share. Comparable companies typically trade around 4 times cash flow which gives us a share price target of around $1.40 per share. Key is that Sonoro is a development play, so it's considered a very low risk opportunity.

While the mine is being built, they will be drilling to expand the 18 known shallow oxide gold zones while drilling some very good high-grade gold targets. The shallow drilling is much lower risk and according to the company's 2020 Development Report, its a reasonable assumption that they can define another million ounces of mineable gold. These kinds of deposits will also often have high grade gold containing feeder systems which provided the plumbing for the gold rich fluids to get to the surface mineralization. When they are encountered, they can be game changers in terms of a deposit's size, economics and even the type of mine. Mel Herdrick has already idenitifed several areas to drill with this kind of potential – but they will wait until theCerro Caliche is cash flowing.

As an aside, Argonaut just reported an exceptional high-grade gold discovery at its Colorada mine which was originally acquired and developed by Mel Herdrick on behalf of Pediment. Herdrick had previously identified the area as a very prospective high grade gold target, where the high-grade discovery was made, but Pediment was bought by Argonaut before he could get to it.

The discovery is just below one of the pits that was mining the Colorada's original shallow ore. One hole intersected 12.2 meters at 98.9 g/t Au and 30.3 g/t Ag, including 3.0 meters of 383.0 g/t Au and 113.5 g/t Ag and another intersected 21.3 meters at 44.6 g/t Au and 274.9 g/t Ag, including 3.0 meters of 283.1 g/t Au and 858.0 g/t Ag. The targeted area had been known at least since Mel managed its development. Like Pediment Sonoro's initial focus is to first mine the low-risk areas that are capable of generating multi-million dollar revenues.

As the Cerro Caliche gets closer to generating revenues it should become increasingly leveraged gold's ongoing bull market. To approximate what the leverage might be we can first start by assuming Sonoro's cash costs are $1200 and it will produce 80,000 ounces per year and that gold's price has increased 12% from $1900 to $2128. Based on this Sonoro's cash flow would then increase from the original $700 per ounce by the extra $228 or 32%. Because high growth juniors, which Sonoro is definitely shaping up to be, usually trade at least 4 times cash flow we then multiply the 32% cash flow increase amount by the 4 times multiple and then add the result to the previous share price target. This amount adds roughly 128% to the original upside share price target. So if the original was originally $1.40 the new share price based on the higher gold price becomes $3.19. This rough calculation may also explain why gold producers shares rally so explosively during gold bull markets.

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