Struthers Report V21 # 18.0 Fed, Rates, Gold Kinross, K Dec 14 2015

Know when to hold-em!
Know when to fold-em!
Know where to set stops!
Know when to run!
Never count your portfolio
Until the sells are done..

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Why an Interest Rate hike will hurt stocks and benefit Gold

This is a follow up to my September article why the Fed would not raise rates back then

This goes against the conventional rhetoric you hear in the main stream, so lets get into detail

- Talking about a rate hike
- Announcing a rate hike
- Implementing a rate hike

Those are all 3 different things

Don't forget the Fed was created by the banks and for the banks. Their main purpose is to maintain stability in financial markets and promote U.S. financial assets and the US$. A strong dollar draws in funds from around the world to support U.S. stock markets and most important U.S. bonds and the astronomical Government Debt.

What the Fed has done historically and is the most effect way for them to manage their mandate is to talk about it. The Fed puts great effort in what message they want in the market and managing the media to promote that message.

While many complain the Fed and US government are manipulating economic data, I like to say they are the Masters of Economic Data. And to go further - use that to support and promote their message.

This cannot be more obvious with what we have witnessed in the past year or more with all the talk about a rate hike and all the focus on the monthly jobs data. It has been instrumental in driving the US$ to multi year highs, stock markets to new record highs and commodities to multi year lows.

The main m**essage has been the U.S. economy is doing great and steadily improving. Interest rates should move back to more normal levels.**

Most important, always remember the Fed's message and reality can be two different things. Their jaw boning is what they want the world to hear not necessarily what is real.

The Fed intervenes in the Banking System and Bond Markets to influence the level of interest rates, doing this with their jaw boning and adding or withdrawing reserves from the Banking System.

The Fed has historically always intervened in the currency markets, meaning influencing the price of major currencies against the US$ that includes mostly Gold, Euros, Yen, Pounds and Francs. The Chinese Yuan has seen a lot of jaw boning as well in the past decade.

Since the early to mid 2000s the **Fed has added to their mandate intervening in stock markets and mortgage markets. Corporate bail outs too!**

Some market watchers have commented there are no markets anymore just intervention. And this holds a lot of truth as the Fed is intervening every where these days. It is a natural tendency for any Central Planning System to continue to grow and expand. Because of this the Fed is credited with creating many bubbles resulting in the crashes that follow.

I am not getting into the detail of past and current bubbles, but the main ones now are Debt, Paper Gold and Stock bubbles.

For the Fed to be effective with their jaw boning they have to have credibility and back up their talk now and then with action and that brings us to where we are today. **The Fed has painted themselves into a corner where they are losing credibility** and they must act and raise rates so I believe it will happen this week. They must be beating themselves in the head for not acting sooner because in reality the economy is deteriorating badly so they have been manipulating the jobs data to give them the reason to raise rates. Last month it was a huge increase in the Birth/death rate model http://www.bls.gov/web/empsit/cesbd.htm and recently this last report was a big increase in part time jobs of 319,000 http://www.bls.gov/news.release/empsit.nr0.htm to more than make up for losses in Full time jobs. A lot of these are temporary involving retail for the Holiday season and the good old seasonal adjustments.

The real reason the Fed is raising rates is to reload their interest rate gun. Moving rates to zero, they basically used up their most important tool (rate reductions) to influence markets and the economy. The Fed would love to get rates up to a ½ or 1 percent and give themselves some wiggle room. A few bullets in the gun!

Now if you read the main stream message that has been put out there, everywhere you will see that the recent robust jobs data ensures a rate hike in December at this weeks FOMC meeting.

I believe they will announce a rate hike after this meeting

Now the next step is to implement it and the way the markets have evolved over the years – it is going to make this interesting.

They could sell their U. S. Treasury/Debt holdings or Mortgage Backed Securities to push rates higher there, but they have been holding these in pretty steady amounts and the Fed believes they have to influence the repo (repurchase agreements) market as well. The Fed has been experimenting in the repo market and I think that is where they will intervene to push rates higher.

NY Fed report estimates the repo market now around $4 to 5 trillion
https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr740.pdf

Bloomberg did a good article on this http://www.bloombergview.com/quicktake/the-repo-market

Basically the repo market is short term excess cash looking to buy liquid assets for the short term. New regulations are pushing the Banks to hold onto their safest investments like Treasuries so there is fewer homes for this cash. The Fed is likely to come into this market and offer to make loans for this cash at higher levels thus pushing these rates higher, competing with the Banks and Dealers forcing them to pay more and these higher rates paid by the Banks is expected to filter through the system

When I read documents about the repo market they don't seem clear or easy to understand, so I thought using my own experience would make the job easier

My personal REPO Trade

I did my own repo (repurchase agreement) trade about a decade before this repo market came about - back in the early 1980s when I was only around 25 years old. Interest rates were heading to 20%. I invested in Canada Savings Bonds, the year they had their highest interest rate ever. I believe it was 16% or 18% and guaranteed for a full year. I thought this was great to be locked in for a year because I was sure rates would decline - these levels were punishing, especially home mortgages

Not happy with only this return, I took the Bonds to the Bank for collateral and they loaned me 100% of the value at a prime floating interest rate because this was the best collateral you could provide. The bank agreed to hold the Bonds to pay back the loan in 1 year, so it was a 1 year term repo. I basically traded the Savings Bonds for cash in the form of a loan.

Since I thought rates would come down, the Saving Bond interest would more than pay for the loan interest.

I took the loan money and bought a high yielding dividend stock which was Bell Canada, but at the time they went by another name, Bell Enterprise, not sure it is faded in the memory now but the stock was safe and yielding something like 16% to 19% - again can't remember the exact rate but it was high and similar to bonds.

In those days markets were normal and dividend stocks moved inverse to interest rates so if rates came down as I expected, the dividend yield on Bell would fall, meaning the stock price would rise and I would also make a capital gain.

My bet proved correct and after a years time Interest rates declined to about 13%.

My return to use round numbers was 17% on my savings bonds
plus 17% on my yield holding Bell stock
My cost on the loan came down so averaged about -14%

Just on interest income I made about 20%

But with rates declining I made about 60% capital gain on the Bell stock.

So my total return ended up about 80% instead of just the 17% if I simply held the Savings Bonds only and a few points more if I just bought the dividend stock. That was a nice repo trade.

The same thing is happening today in the repo market. Dealers are using mostly Treasuries to trade for cash and buy other investments with higher yields. Since interest rates are so low they are getting this repo cash for not much over 0% interest. **This has been major fuel for the stock market.**

The net effect of these REPO contracts are inventory flows, which result in either long or short positions in securities, or equivalently, short or long positions in cash. Data published by the Federal Reserve Bank of New York shows repo trades are mostly collateralize d by U.S. Treasuries and agency Mortgage Backed Securities.

So if the Fed intervenes here it should influence Treasury rates as well - and Bingo! should do the job to move rates higher

But here in lies the Achilles' heel

The cash the Security dealers got from these repo contracts would go into higher yielding assets and a lot of cases that is the Stock Market.

If the Fed intervenes here by offering higher loan rates for this cash - **in essence they will be taking cash out of the system that would have went to Security dealers and the Stock Market.**

I have seen estimates of up to $800 Billion that would have to be sucked out of the repo market to push rates up ¼ point. That is a lot and a good portion will end up coming out of the Stock Market.

With the economy in decline, fundamentals falling, a deflation wave sweeping the Globe and another $500 billion or so sucked out of the Stock Market – it is going down and probably testing or taking out the September low.

As I write this today, the S&P 500 has just bounced up off the support area that is around 2000. **The best case scenario is this holds and goes back up and we get a Santa Claus rally.** If the Fed ends up sucking a lot of money out of the system to go up a ¼ point, perhaps this does not hold, a drop below 1975 probably means a retest of 1875 area.

- Gold most often moves contrary to the Stock market and is the prime reason I see Gold rising with this interest rate rise.

- Plus Gold is way oversold so the timing of this rate hike is perfect for a bigger effect on Gold than at other times.
- Gold will capture some of the flight to safety out of the Stock Market as Bonds may not look attractive if they are falling because of the rate increase.

Ironically if more money flows to short term Treasuries driving their price up and Interest rate down, the Fed will have to suck out more money out of the System. The Fed can also use the cash they take out of the repo market and buy stocks, sort of compensating the Dealer selling.

This is going to be a real tight rope balancing act. The market has been use to zero rates for 7 or 8 years, can a transition go smoothly? Again another new experiment and interesting times.

I am betting on volatility but not where most expect.

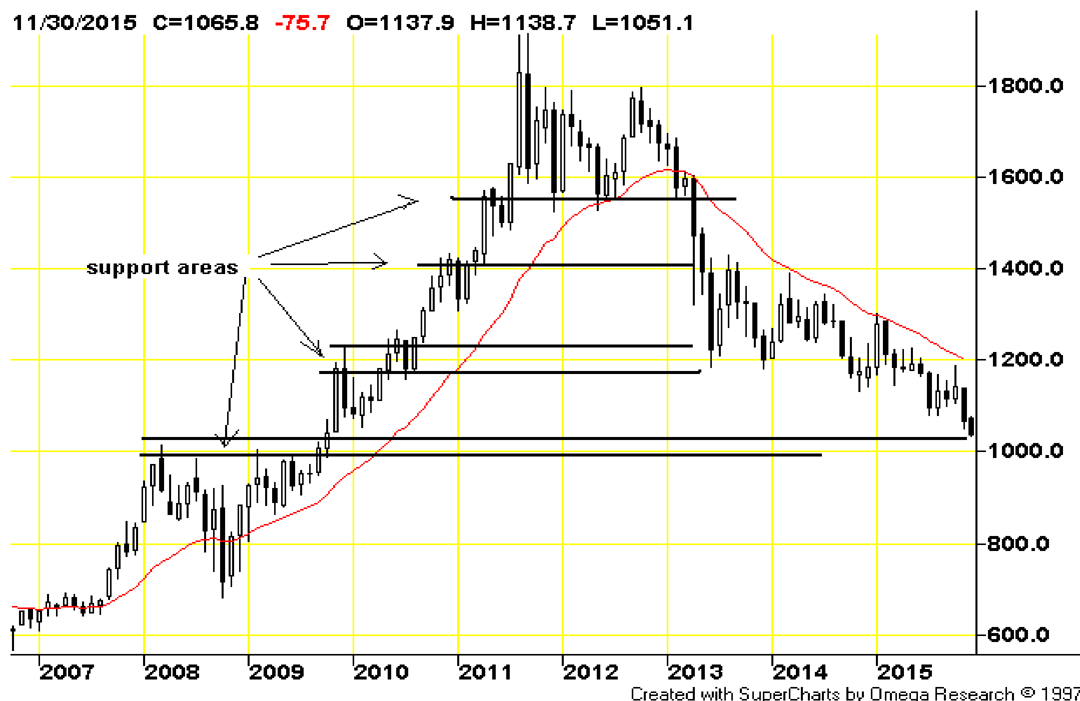
The message that has been hammered so much in the past year by the main stream media -is higher interest rates boost the value of the dollar and makes gold less attractive as an investment because the metal is not yield-producing.

And for the record - no financial instruments gives a yield until you deposit your cash some where. If it is with a Bank or with Government treasuries your yield is close to zero. I highly doubt investors are going to consider Treasuries over Gold for the sake of a ¼ point yield. And further more Gold does have a yield, known as the Lease Rate which pretty much moves up and down with market interest rates.

But regardless this message of higher rates = a stronger dollar and weaker Gold has been driven so hard it is already a self full filling prophecy. The trade and profit is already done. Hedge funds have now dumped more than 150,000 lots or the equivalent of some 425 tonnes of gold since the beginning of November.

Managed Money at 1.74 million ounces short a little less than the almost 1.8 million ounces short the week before, shows the market is now in its biggest net short position ever, surpassing bearish positions entered into in July and early August. That was the first time hedge funds were net negative since at least 2009, when the Commodity Futures Trading Commission first began tracking the data.

As soon as the Fed gets this rate hike out of the way – I **guarantee they will become very dovish and hold off quite some time before another rate hike, because the economy is far weaker than portrayed.** We might see one final bump down for Gold with the rate announcement but I think this would be short lived or not at all. The market is close enough to major support for a bounce off of it



I show the failed and current support levels for Gold. The $1200 area was considerable support and it held a long time. **This area just around $1000 is much more stronger, a price level that contained Gold for almost 2 years, so I have no doubt we will see a bounce higher off of this.** The above chart is a monthly one and I drew in the last candle showing early December going a bit lower. We are close enough to bounce now or as mentioned above maybe one final bump lower.

The Gold stocks have been telegraphing a move higher for the last couple weeks as they have not gone to new lows with Gold but have been edging higher. The 105 area on the HUI looks very solid with numerous tests of this support.

I believe it is a great time to be buying more Gold stocks and my favorite senior now is Kinross

One man's loss another man's gain. That is why I decided to add Kinross back to the Selection List. With the downturn in Gold, Barrick has struggled with it's $13 billion debt load and vowed to reduce that debt this year. While Kinross had a strong balance sheet of just under $1B in debt and just over $1B in cash with $1.5 Billion in credit facility

Kinross Gold   TSX:K   Recent Price C$2.63

Kinross cut a deal with Barrick to buy their Bald Mountain Mine and the 50% of the Round Mountain mine they did not own for US$610 million cash.

As at Dec. 31, 2014, Bald Mountain had proven and probable gold reserves of 1.36 million ounces based on 60 million tonnes at 0.70 g/t, and additional measured and indicated gold resources of 4.16 million ounces based on 207 million tonnes at 0.63 g/t.

As at Dec. 31, 2014, on a 50-per-cent basis, Round Mountain had proven and probable gold reserves of 690,000 ounces based on 27 million tonnes at 0.79 g/t, and additional measured and indicated gold resources of 440,000 ounces based on 24 million tonnes at 0.58 g/t.

That is a total Measured and indicated resource of 6.65 million ounces for $610 or just under $92 per ounce for a quality producing assets that will add about 335,000 to 515,000 ounces per year of production over the next 3 years.

I believe this is a very good price and will also help lower Kinross's over all costs

Bald Mountain to be a low-cost producer going forward. The mine is expected to have an annual production range of 175,000 to 300,000 Au equivalent ounces with an annual cost of sales range of $450 to $1,000 per Au equivalent ounce and an annual all-in sustaining cost (3) range of $700 to $1,130 per Au equivalent ounce over the three-year period from 2016 through 2018.

Round Mountain (on a 100-per-cent basis) is expected to have an annual production range of 340,000 to 430,000 Au equivalent ounces with an annual cost of sales range of $820 to $900 per Au equivalent ounce and an annual all-in sustaining cost (3) range of $850 to $1,000 per Au equivalent ounce over the three-year period from 2016 through 2018.

Outlook: Kinross expects to be within its updated 2015 guidance range for production (2.5 million to 2.6 million gold-equivalent ounces), all-in sustaining cost ($975 to $1,025 per gold-equivalent ounce) and cost of sales ($690 to $730 per gold-equivalent ounces); the company expects to be below its updated capital expenditure guidance ($650-million) and below its overhead guidance ($205-million), which excludes one-time restructuring charges;

http://s2.q4cdn.com/496390694/files/doc_presentations/2015/111715-rbc-london-pitchbook.pdf

The link above to the presentation is worth a look and RBC Capital Markets estimates Kinross' Enterpriseeee value based on 2.5 M ounces of production for 2016 is lowest among the majors Goldcorp value is 4 times Kinross, Newmont 5 times and Barrick 6.6 times. Agnico is 2.2 times and Yamana is about the same at 1.1 Eldorado is a bit lower at 0.9 times

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