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LOWELL RESOURCES FUND ("LRF")

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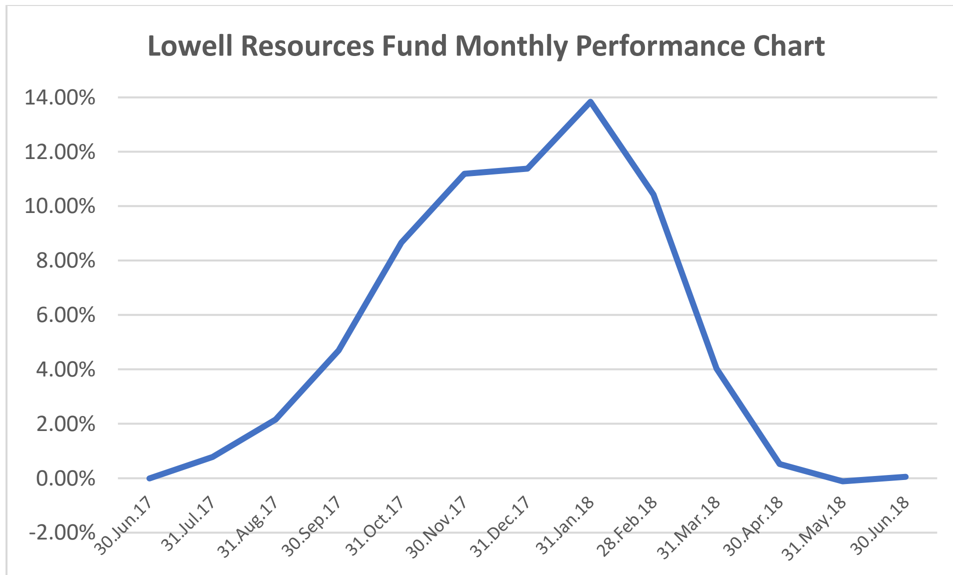
Report prepared for the Responsible Entity Cremorne Capital Limited ABN 60 006 844 588 (AFSL: 241175) by the Investment Manager of the Fund ("Lowell Resources Funds Management Limited")

June 30, 2018 End of Financial Year Report to Unitholders

The performance of the LRF over the year to 30 June 2018 is shown in the chart below.



Overview

The LRF portfolio eked out a small gain over FY18, with the unit price ending the year at $7.9347. It was a turbulent twelve months for the Fund, buffeted by unfolding events in the United States and China, the two dominant economies affecting the resource sector.

The gigantic S&P500 equity market is has become the *de facto* US economy in its own right, with worldwide impact as it directed currency flows. China, Australia's largest trading partner, has dominated the global market for mineral resources. Geopolitical factors have been paramount with multinational giant cult stocks dominating proceedings and little interest in junior resource companies.

Runaway performance by the S&P500 index of major US companies was the prime focus over the first half as index funds returned almost 40 percent in 2017, compared with around 12% for gold and oil. Passive investment in giant blue-chip technology companies such as Amazon, Apple and Facebook and corresponding index funds eclipsed active management strategies.

Speculative investments were drawn to cryptocurrencies such as bitcoin, which appreciated by over 3,000 percent for the calendar year before collapsing, and along with marijuana stocks further detracted from the appeal of the resource sector, and particularly junior mineral explorers.

The steady upward momentum in US megastocks was checked during Q1 2018 by a sharp 12% drop in the S&P, followed by a 1,000-point falls in March in response to Trump's trade tariff announcements. The subsequent erratic sideways drift in share prices has owed much to disjointed presidential tweets and policy statements relating to trade, regional hostilities, and political alignments.

Higher interest rates in the US reflect an uptick in growth and inflationary expectations, accentuated by lower taxes and repatriation of offshore dollars coupled with capital flight to safe haven US assets. The resulting strong US dollar weighs on commodity prices and investor sentiment. On the other hand, most minerals have increased in terms of local currencies.

A number of market experts are extremely bullish on resources. Jeff Gundlach, the "*Bond King"*, notes that at this late stage in the business cycle, with a recession on the horizon, there is elevated risk as all five recessions since 1970 were preceded by a commodity price rally.

Synchronous global economic expansion in evidence early in 2018 was tested in recent months by trade tensions, problems in Europe, and suggestions of a slowdown in China with a heavy decline on the Shanghai Stock Exchange. In addition, the strong US dollar has proved problematic to highly indebted smaller nations such as South Africa, Brazil and Turkey.

A recession is certainly overdue, possibly starting in Europe or the US, where the bull market approaching the longest on record is driven by global liquidity creation in excess of US$20 trillion by central banks, accompanied by low to negative interest rates. Leading indicators suggest that there is not much recession risk over the remainder of 2018, but the probability and potential severity of a downturn will increase the longer the cycle persists. Much mention has been made of the flattening yield curve as an advance warning, but far more serious in our mind is the pronounced reduction in global money supply growth. Should such as slowdown eventuate the negative implications to certain industrial minerals could be more than offset by appreciation in gold and precious metals.

Mining & energy

The resource sector was boosted by global growth expectations, with commodity prices increasing across the board. Among the major metals, copper increased by 9% for FY18, zinc 3.5%, gold 2.2% and silver by 1%. Among the niche metals, lithium rose 17%. But energy was the star performer with crude oil up 56% and even long-dormant uranium rising by 10%.

The CRB commodity index has trended upward since 2016, suggesting the early stages of a bull market in resource stocks. Resource company shares have lagged commodity prices by a large margin however, and most junior mining & energy stocks languished, especially those without significant news flow.

Figure 1: Dow Jones Commodity Price Index, 12 months to June 30, 2018

Resource companies represent a leveraged proxy over commodity prices, which had been rising over the 12 months, but with some weakness towards yearend. Selected LRF portfolio juniors are reporting strong results in niche metals, for example Kidman Resources and Kalium Lakes, along with Tinka Resources among the multimetal miners,

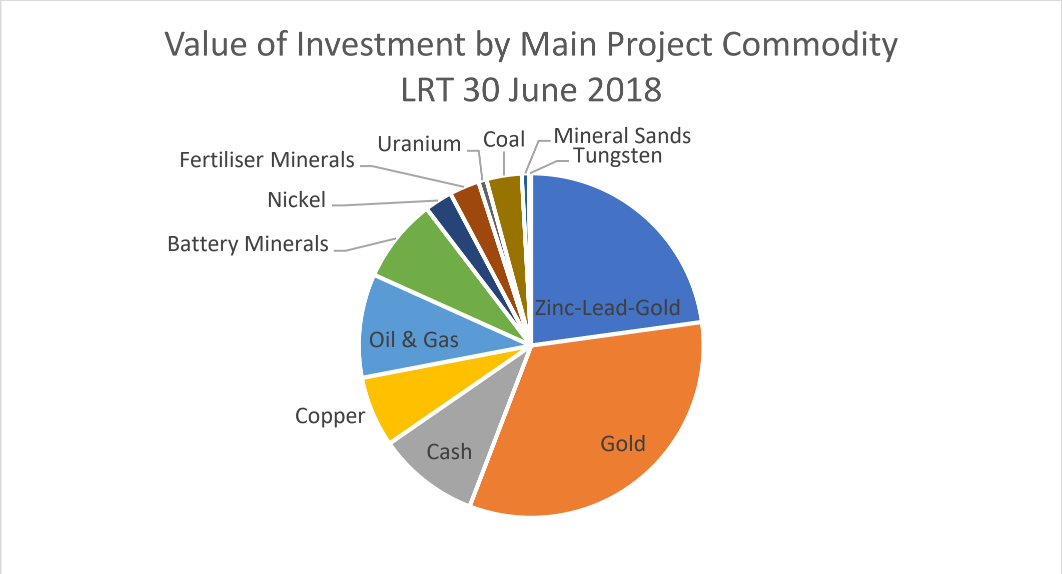
and Gold Road Resources the standout among pre-development gold stocks together with a number of exploration-stage gold juniors. Adriatic and Oklo reported excellent gold intersections towards yearend. Generally speaking, however, small resource stocks attracted very little attention.

The environmental focus on electric vehicle (EV) production, stationary energy storage, robotics and advanced electronics has spurred interest in nickel, tin, lithium, cobalt, graphite, high-purity aluminum and vanadium, all of which are represented in the LRF portfolio in Battery Minerals Ltd, Pioneer Resources, Altech Chemicals and Corazon Mining, along with aforementioned Kidman and Kalium Lakes.

Oil and natural gas exposure was increased as crude oil prices rose and as new opportunities arose in natural gas. Afton Energy, an unlisted company in which the LRF holds a significant stake, drilled two prospects in Texas, both successful, with strong oil & gas production underway. The Fund's largest petroleum exposure is in Indago Energy which holds a proprietary technology that lowers the viscosity of heavy crude oil, enhancing production and transportation of relatively immobile asphaltic or paraffinic crudes. Investments in Cooper Energy, High Peak Royalties and Real Energy Ltd are designed to capitalize on the emerging imbalance between LNG export commitments and domestic gas demand in the eastern States of Australia.

Large metal and energy producers have experienced a rundown in reserves over the past few years because of cutbacks in mineral exploration and capital expenditure. Coupled with growing cash balances this is expected to increased corporate acquisitions and the price premium for junior pre-development companies with significant reserves, exploration upside and manageable costs. The LRF has therefore increased its exposure to small companies that meet these criteria.

Most of the stocks in the LRF portfolio are ASX-listed, with projects in various parts of the world, but with a major focus on Australia. Australia's terms of trade are positive, reflecting its pre-eminent exposure to growing resource demand from an expanding global economy (*Morrow Money Morning,* 4th May 2018). Minerals and energy account for almost half of the nation's exports. Australia is a "*trading counter surrogate for China*", with its gargantuan infrastructure projects including China's multinational *Belt & Road* Initiative megaproject already underway, together with growing raw materials demand from South East Asia and an expanding US economy.



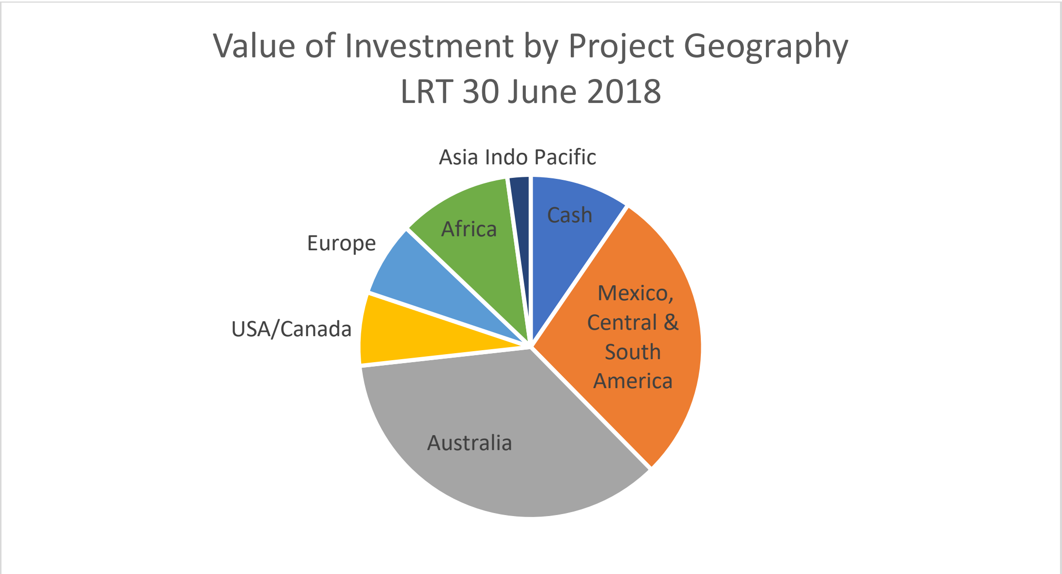


Figure 2: Commodity exposure & Geographic distribution

Resource sector performance over the medium term will remain hostage to unfolding geopolitical machinations and thus encompasses a range of possible outcomes. Risks abound, but so do opportunities in minerals and energy.

Nassim Taleb[1] notes that share markets are fragile and highly vulnerable to negative forces. On the other hand, gold and other precious metals in particular are "*antifragile*" and typically appreciate in value under stress. Sublime investor complacency is gradually giving way to a recognition of mounting uncertainty, but this is yet to be reflected in the price of gold.

Global risk

Broad equity markets during FY18 were dominated by investor optimism while the negative implications of adverse global developments were brushed aside in the bullish stampede in the first half.

Apart from military tensions, mass migration, deficits, quantitative tightening and deteriorating international trade, the staggering levels of global debt and unfunded liabilities are out of control and growing. The longer-term impact of demographic ageing and automation will transform the workplace and require increased taxes to service monumental debt and prop up failing social spending obligations, as detailed by *Mauldin Economics, Agora Financial & Weiss Ratings*, among other credible market researchers.

Trade

Having raised over half a billion people from abject poverty and maximized the benefits of international trade to the advanced economies, globalization has given way to an inwardly focused, nationalistic perspective commencing in the US and Europe. Celebrated author Niall Ferguson[2] notes that globalization peaked in 2007 and international trade is now declining, with ominous implications.

Protectionist trade barriers and tariffs have ended badly in the past, as detailed by author Douglas Irwin[3] who notes the egregious impact of the protectionist US Smoot-Hawley tariff of 1930. This act was magnified globally by retaliatory measures, just as is taking place today. Other financial crises, for example in the 1870s, were responsible for earlier waves of stifling protectionism.

The impact of the opening salvos of the current imposts are already being felt. *Bloomberg News* reports that on June 25th the Dutch Bureau for Economic Policy Analysis published its latest *Trade Monitor* showing that world trade momentum has fallen from a seven-year high in early 2018 to the lowest point since 2015.

Quantitative tightening

Quantitative tightening, and a sell-down of the US Federal Reserve Bank's bond holdings threaten to reverse the stimulative impact of liquidity injection following the 2008 financial crisis.

With the massive increase in the value of financial assets ascribed to quantitative easing, steps towards quantitative tightening might be expected to reverse the process. Despite the current economic slowdown, Europe has signaled a reduction in stimulus measures during the remainder of 2018.

Debt

Debt is an overriding problem in Europe, Japan and the US. Global debt (government, corporate, household and financial sector) totaled US$238 trillion as of 2017 according to the IIF *Global Debt Monitor* and is growing fast. This amount excludes the even more onerous unfunded government expenditure obligations, or entitlements, which according to *Mauldin Economics*[4] will alone consume the *total amount* of US tax revenues by 2045. Many other countries will be in an even worse position with their social spending commitments on health and welfare, particularly in Europe. Emerging economies with the loans denominated in US dollars are at risk as the debt burden in local currency terms escalates in line with the rising dollar.

As debt continues to mount it will eventually become unserviceable, the "*Minsky moment*" alluded to in previous LRF reports. At that critical tipping point, economic growth is impaired leaving default or devaluation as the only available options. Asset values plummet in such situations.

China's debt is less quantifiable but involves massive "shadow bank" loans and highly leveraged real estate. According to *Global Debt Monitor* China's debt from all sector amounted to US$36t in 2017, almost double its level in 2012, but still only half that of the US.

Bond market risk

According to *bondvigilantes.com* central banks worldwide now hold some US$15 trillion on their balance sheets from QE, which is starting to unwind, with corresponding contraction in liquidity.

Corporate debt in the US totals $US14.5t, equivalent to 72% of GDP, and this excludes financial debt which is even larger. Corporate debt repayments are currently estimated at $3.8t a year according to John Mauldin[4,5].

The risk of a US government bond market collapse is perhaps mitigated by the difficulty of the US to meet its debt servicing obligations at rates much higher than a 3% yield, suggesting that the Federal Reserve might intervene. For example, the Bank of Japan is by far the dominant holder of Japanese bonds, and aggressive ongoing BOJ purchases maintain high demand and a corresponding suppressed yield[6].

Leverage

Margin lending on major exchanges is reportedly at an all-time high, adding to downside risk. And derivatives exposure is estimated to have reached US$172 trillion, some 90% of which is held by four large commercial banks, with foreign banks holding even larger amounts according to *Weiss Ratings*.

Currency concerns

Escalation of trade restrictions would impact currency exchange values to the extent that a lower US trade deficit would lead to a reduction in the US capital account and presumably a lower US dollar and reduced global liquidity.

Currently, however, the US dollar is still viewed as the ultimate safe haven, and continued inflow of funds could propel the dollar far higher. The adverse impact on the US economy as well as on debt-laden foreign countries would have potentially serious consequences for world trade and commodity demand.

Moves are underway to reduce the dominance of the US dollar in world trade. The petrodollar agreement with Saudi Arabia in 1973 established the US dollar as the *de facto* global reserve currency. This situation is being challenged by China, which as the largest oil-consuming nation is reportedly paying for crude oil imports from Saudi Arabia in Chinese yuan, backed by Shanghai gold futures contracts. Russia, Iran, Syria and Venezuela are also said to be trading crude oil in currencies other than the petrodollar.

Special drawing rights (SDRs) issued by the International Monetary Fund (IMF) are predicted to play a growing role in international transactions according to James Rickards[7]. Rickards believes that a global monetary reset is already underway, which will further reduce US dollar hegemony. Rickards has widely predicted that the IMF will utilize Distributed Ledger technology to facilitate SDR trades, perhaps commencing during the next 12 months. SRD bonds would provide an alternative to US treasury bonds, eroding US dollar value. This would imply higher resource prices.

The strong US dollar has created a downdraft for gold, but *Incrementum* fund manager RP Stoeferle notes that a short squeeze in the dollar is almost complete, which should provide relief for gold. Furthermore, Trump's stated strategy for US growth will necessitate a lower dollar which will therefore benefit the resource sector.

Inflation

Inflation is a monetary phenomenon according to Milton Friedman[8] but tends to be expressed in terms of consumer prices or CPI. Counteracting forces are underway, but despite economic growth and upward momentum to 2.8% annualized inflation for the US, sparked to some degree by higher oil prices, disinflationary pressures persist. Extremely low US unemployment has triggered fears of wage inflation (the *Phillips Curve*), hence the implementation of monetary tightening. New employment opportunities are reportedly paying low wages or increasingly in part-time positions.

Inflation should be far higher than it is, given the prodigious monetary creation since the 2007-09 financial crisis, but central banks have intervened to keep inflation in the major economies at very low levels. Yield spreads on 10 and 30-year US bonds suggest low inflationary expectations for decades to come, but there are many other forces at work.

Demographics and global debt have kept inflation expectations in check. Technological advances and automation have been disinflationary, while industrial consolidation has reduced competition and dampened wage increases.

Increased shipping costs related to stricter environmental measures, discussed below, will also flow through to all products subject to marine transport, and this is also expected to boost inflation (*Oil & Gas Investments Bulletin*). The imposition of trade tariffs on US$50 bn of Chinese goods will provide another inflationary boost.

We anticipate staged inflationary pressures impacting different sectors, starting with energy. Higher energy prices will translate into a rise in practically all sectors where transport is involved, as well as into the cost of power generation, petrochemicals and a range of manufactured goods. Wage inflation has been suppressed to date, but the shortage of skilled labour coupled with high company profits suggest significant salary increases in the offing which will translate into broader inflationary pressures. In due course, however, automation and job replacement are likely to be disinflationary.

On the other hand, Warren Buffett is quoted as saying recently that "*if you throw money out of helicopters you must eventually get inflation"*. Dilution diminishes currency value, the ultimate response to monetary inflation. Monetary inflation leads to higher nominal prices for hard assets such as mineral resources.

Demographics

Neil Howe[9] points to increasing intergenerational tension resulting from the marked discrepancy between the wealth of the older population that has reaped the rewards of the secular bull market in financial assets relative to younger generations with disproportionately low real wealth.

This does not bode well, given the soaring social spending commitments occasioned by demographic aging. According to Patrick Cox in a *Tech Digest* report ***"**most developed nations have failed to plan for the day when the shrinking taxpayer base would no longer provide the funds to deliver on promises made to a growing population of retired dependents."*

The insidious information economy

In the words of John Mauldin[4] *"We're entering a period of volatility and instability unlike anything any of us have experienced"* The *"information economy"* may therefore be characterized by disorder and chaos rather than the comfortable equilibrium postulated by cornucopian economists.

According to historian Niall Ferguson[2] an interconnected world such as at present poses formidable risks. The impact of the Trump tweets is a prime example. Given the newfound ability to mold public opinion, coupled with the speed and effectiveness of social media in promoting incendiary ideologies, "*totally unpredictable outcomes become more and more*

likely". Ferguson states that the 2007 financial crisis was partly a consequence of this interconnectivity and suggests that the same phenomenon may trigger the next crisis.

Global networking also elevates the risk of cyberattacks, which are viewed by the Pentagon, among others, as another mounting threat to energy distribution, banking, communications, and hence the functioning of modern society.

Convergent cycles

As remarked in previous reports to unitholders, the ominous convergence of cycles points to change, with prominent historians and market researchers such as Strauss & Howe[10], Larry Edelson[11], John Mauldin[4], George Friedman[12], and Jim Rickards[7] all foreseeing transformation and global turbulence.

As put forward in a previous LRF report: "Economic cycles are well documented in a number of authoritative reports from *Mauldin Economics*, *Edelson Wave*, and others. Major cycles of varying duration are made up of shorter-term cycles which may reinforce or cancel one another out, but which converge from time to time with potentially severe repercussions."

These economic supercycles correspond well with the repetitive patterns in human society recognized by historians, for example the *"generational cycle"* of Strauss & Howe[10], as well as the periodic resurgence of nationalist sentiment documented by Niall Ferguson[2].

Dominant Macroeconomies

The United States

The world economy is strongly influenced by US growth, which is currently benefiting from foreign capital inflows, reduced taxes, a strong housing sector, retail sales growth, improved corporate earnings, unprecedented share buybacks, and a cautious approach by the Federal Reserve Bank to interest rate increases. Unemployment is close to a 50-year low. Positive news releases in June relating to the business outlook were tempered by the scarcity of qualified workers to fill key positions. Federal Reserve minutes for June 2018 foresaw a "*very strong economy*" but noted "*clouds looming on the horizon*" and growing risk of a recession. The impact of tax cuts will only become apparent in the upcoming earnings season.

Trading has been concentrated in a very narrow, overpriced subsector comprising multinational giants. Furthermore, Lance Roberts[13] shows that the much-publicized growth in corporate profits since the financial crisis owes far more to drastic cost cutting, creative accounting and share buybacks than to revenue growth, which has been tepid at best. *Weiss Ratings*[14] draws attention to the recent surge in very poor-quality IPOs in the technology sector, reminiscent of year 2000 ahead of the Nasdaq crash.

The immediate future looks promising, the key *National Federation of Independent Business* (NFIB) Survey is still positive, as are most other short to medium term leading indicators. But not so beyond that. The Shiller price/earnings ratio is double the historical average, indicating that the major US indices are grossly overpriced, while margin debt is at the highest level ever, adding to downside risk. The flattish yield curve implies low inflation expectations in years to come that are not consistent with significant growth. However, the attraction of US treasury bonds may continue to exert downward pressure on long-term yields. Furthermore, the already onerous government debt servicing costs would soar commensurately with higher bond rates, which may call for measures such as renewed purchases of US treasury bonds by the Federal Reserve to constrain rate increases.

Money supply growth rates provide another leading indicator of economic health. Steve Saville[15] notes that a precipitous decline in money supply such as occurred in the US during 2017 tends to be followed within a year or two by a severe downturn.

US is facing an increasingly insurmountable debt burden. Mauldin[4,5] notes that on top of the existing national debt of US$21t, the *"US Treasury Department is expected to issue over $1t of debt in each of the next four years",* which is double the forecast rate of economic growth. Corporate debt amounts to 46% of GDP, much of it low-quality. Consumer debt too is at dangerous levels with car loans, student loans and credit card debt all at record levels around US$1 trillion, as defaults escalate.

Europe

This Week in Geopolitics[12] notes that the European economy defied the odds over the year and showed modest improvement, especially in the Eastern Bloc and Germany. Political cracks have appeared of late, however, centred on immigration issues, with crises in Italy and Spain and threats to Merkel's coalition in Germany.

Austerity measures have improved the debt/GDP situation within the Eurozone, but the viability of monetary union in the context of vast fiscal disparity between the prosperous northern states and the struggling Mediterranean economies is questionable. The populist coalition in Italy has outlined increased welfare expenditures, lower taxes and universal income while already burdened with well over 2 trillion euros in national debt. This apparently extremist populism may further threaten the fragile unity of the Eurozone.

Even the robust, export-reliant German economy would suffer in the event of waning European demand, which is reportedly faltering. Threats of US trade embargoes on imports of cars from Europe could be the final straw to the cornerstone of the European economy

China

China accounts for more that one-half of total world consumption of steel, copper, nickel and coal and is the dominant consumer of half a dozen other mineral resources according to *Bloomberg*, with the nation's GDP of US$13.2 trillion now ahead of the 19 Eurozone countries combined.

More than 3500 under-regulated financial institutions (*"shadow banks"*) had emerged in China, providing an array of riskier financial products outside the state-controlled banking system. Shadow banks in China reportedly account for 45% of credit on issue. But the central government is aware of these imbalances and is currently embarking on measures to address the situation.

Apart from tightening banking regulations, China continues to reduce pollution, improve living conditions in the impoverished interior, and limit spending, indicating a willingness to sacrifice a little growth to achieve longer-term objectives. The ongoing commitment to infrastructure spending and upgrading of manufacturing facilities through the use of high-quality raw materials is an encouragement for Australian exports.

Of greater concern is the potential impact of US$50 bn worth of US trade sanctions coupled with retaliatory measures by China. These measures may not have major impact on the Chinese economy, given that exports have declined to less than 20% of GDP as internal consumption spending has expanded. But as pointed out by Malcolm Wood in a *Baillieu Research Report* June 30, 2018, escalation of the trade war to US$250 bn of Chinese exports would disrupt the Asian supply chain, especially from Taiwan and Japan, with negative implications for Australian exports.

Reduction in China's trade surplus with the US coupled with slower growth projections would necessitate stimulus measures by the Chinese government and a closer alliance with other Pacific Basin partners such as South Korea, Japan and ultimately from the Belt and Road megaproject. The latter will effectively expand China's trade links through Asia and into Europe. Recent yuan devaluation should provide a further stimulus to Chinese exports.

China has demonstrated a unique ability to mitigate risk and deal with uncertainty, and the government has taken strong steps to accommodate the range of issue confronting the nation at present.

The Resource Sector

Until mid-June the prospects for the resource sector were negatively impacted by an escalating trade war that threatened to reduce China's demand for base metals and other raw materials, and also blunted gold's investment appeal in light of slower growth expectations. Modest monetary tightening in the US was reinforced by a statement from the *European Central Bank* (ECB) that their aggressive policy of quantitative easing would be phased out.

Provided that the incipient growth momentum is maintained, the resource sector appeared primed for a sustained revival but recent weakness in copper, the bellwether commodity, has injected a degree of uncertainty. Based on continued expansion in China we anticipate resumption in demand growth for industrial minerals, a trend underway for much of 2017-18. Producers are cashed-up, and in many cases are positioned to expand.

Estimates from the *Massachusetts Institute of Technology* (MIT) predict significantly increased demand for many metals arising from new technologies such as electric vehicles, robotics, renewable energy generation, energy storage, IT, and petroleum industry applications. While much has been made of the battery metals lithium, cobalt and graphite, discussed below, tin ranks first on the critical list compiled by MIT based on its diverse applications and especially its dominance as an electrical contact material in electronics.

Energy

Regardless of the focus on renewable resources and demonization of fossil fuels in the populist media, crude oil supply remains central to the world economy. Curtailed production from OPEC and Russia augmented by reduced supply from Venezuela and Iran saw a significant price rise over the half-year period. World oil supply increased to over 98MMbod with China and India leading the way while global consumption increased to the extent that inventories were run down. Saudi Arabia, desperately in need of higher oil prices to accomplish its vision for a more powerful and diversified economy, and to maximize value of the previously mooted gargantuan Saudi Aramco listing, withdrew supply. Along with the US, Saudi Arabia is one of the few countries capable of significantly increasing output.

The US appears set to dominate global energy supply as oil exports expand and imports decline, and rapidly growing LNG exports likely to compete with Qatar and Australia given the competitive advantage of inexpensive US natural gas production from hydraulic fracturing of shale reservoirs in horizontal wells. Australian onshore gas production is relatively high cost in comparison.

- Oil

While US shale oil production continues to soar to record levels, this did not compensate for cutbacks by other nations, leading to supply concerns. Excess world oil demand is illustrated in the chart below. The futures curves for crude oil, gasoline, gasoil and heating oil were all in backwardation in anticipation of a supply shortage. Global inventory levels fell, leading to a 2 MMbod deficit (*Keith Schaefer, Oil &Gas Investor Bulletin, June 3, 2018*). Temporary reductions in Libyan oil shipments and technical problems with Canadian synfuel production added to ongoing issues in Venezuela to curtail supply.

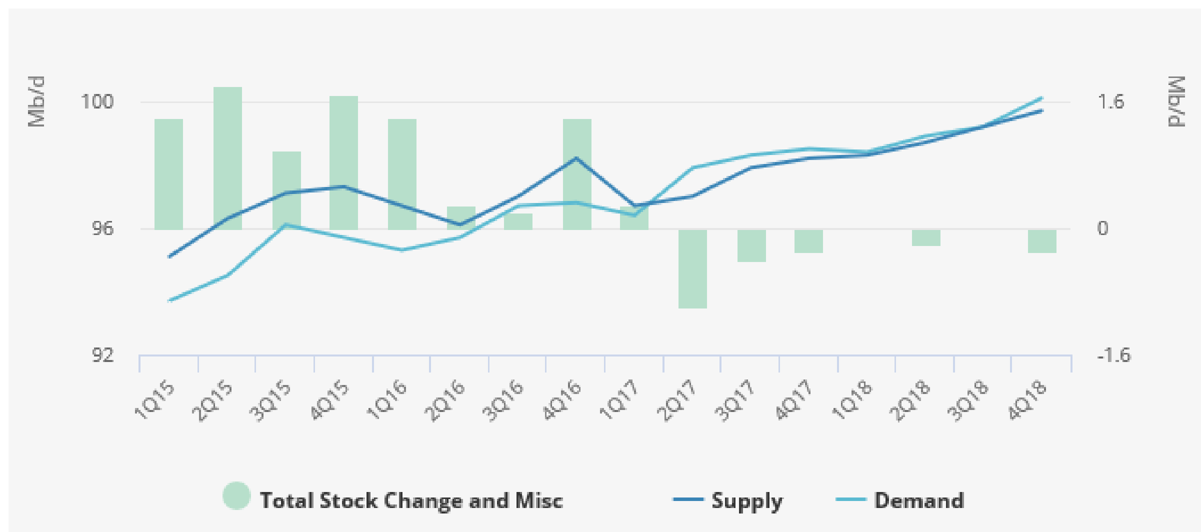


Figure 3: Global supply/demand balance for oil. International Energy Agency

Optimistic production forecasts for the Permian Basin of West Texas were tempered in recent months by large pricing discounts of up to US$12/bbl, a situation that is expected to persist for as long as 20 months (*Oil & Gas Investments Bulletin op. cit.)* while new pipelines are being constructed.

Surging supplies of light, unconventional oil from shale wells differ in grade from the heavier crudes for which most refineries are designed. Demand is therefore increasing for heavier Brent crude oil with more diverse industrial uses and contributes to the price premium for Brent relative to WTI pricing.

Deep-water exploration declined precipitously with oil price but is now experiencing a revival. Subject to sufficiently high crude oil prices, the more attractive economics of large offshore fields would be expected to supersede shale oil in years to come.

New International Maritime Organization regulation due to take effect late next year relating to bunker fuel is expected to impact end-product demand. The far lower sulphur content requirement will increase bunker fuel costs by as much as 25% according to Schaefer. Bunker fuel accounting for some 5% of world oil consumption, and very few refineries are currently able to accommodate these new fuel quality requirements.

- Natural Gas

Increasing focus on natural gas production, coupled with the propensity for the proportion of gas to increase as oilfields age, has accompanied increased gas demand as a substitute for coal in power generation, as well to supply expanding LNG facilities have secured future gas requirements. *Bloomberg News* sees Asia becoming the main driver of LNG imports, with global demand rising from the current level of around 300 million tonnes (m.t.) in 2018 to almost 500 m.t. by 2030.

Europe is heavily dependent on Russian gas supplies, with Germany to benefit most from the Nord Stream 2 pipeline, but with other European nations expressing greater interest in LNG imports, particularly from the US. The LRF holds a strong position in Petrel Energy which holds a significant interest in a large gas prospect in southern Spain in close proximity to a major gas pipeline with excess capacity, a high risk but potentially very high reward venture.

Fears of an LNG glut based on the multiplicity of proposed processing and export facilities worldwide have abated, and Deutsche Bank, among others, have focused on potential shortages, spurred by demand in the Pacific Basin.

Media hostility and political prevarication have stood in the way of local gasfield development in Victoria and NSW, making these States particularly vulnerable as supply from aging Bass Strait fields and the Cooper Basin declines. Queensland gas is largely dedicated to LNG exports. However, supplies from the Northern Gas Pipeline and from a number of gas exploration programs in several parts of southeastern Australia are expected to augment gas delivery. Whereas the emphasis to date has been on LNG exports, several LNG *import* facilities are proposed for gas shipped from offshore Western Australia and elsewhere.

Matt Chambers in *The Australian* June 18, 2018 reported that three proposed regasification projects in Victoria and NSW with development costs in the $100-$300m range and operating costs in the $1-1.30/Gj range could be in production within 2-4 years. Given existing pipeline infrastructure and the commitment of most Queensland gas production to existing LNG exports, Australian East Coast gas prices will be keyed to international levels and thereby iron out disparities in local price levels.

- Coal

Despite strong opposition, world coal consumption increased slightly during 2017. Coal remains the most abundant, inexpensive, and efficient energy resources and an essential component in the production of steel, along with a wide variety of industrial end uses. Thermal coal demand in the Asian region is growing rapidly, especially for high-quality black coal from Australia. The *BP Statistical Review of World Energy* showed that coal-fired power generation increased in the Asia-Pacific region by a massive 330 terawatt hours over the past year.

Clean coal technology has reduced toxic emissions and greenhouse gases, but government regulations and subsidies have encouraged a switch to gas-fired power generation and renewable energy. An unintended consequence of anti-coal sentiment aimed at counteracting climate change has been to increase the profitability of coal mining by eliminating poorer quality and less-competitive supplies. Seaborne coal prices have surged, with thermal coal prices doubling and the landed price of metallurgical coal in China being highly volatile and increasing threefold over the last two years. Forecasts by BMO Capital Markets of supply deficits within three years are likely to provide further upward price

pressure. Australian exporters are the primary beneficiaries, including the LRF's seed investment in Bounty Mining.

- Uranium

The two exceptions to the resource price revival of 2017-18 had been uranium and silver, but uranium has picked up off a low base and may be embarking on a longer-term uptrend after languishing for many years, in many cases below the cost of production.

The *World Nuclear Association* points to soaring nuclear power generation capacity led by China, which is expanding its 36 nuclear power plants currently in operation by a further 21 plants, and with Japan bringing reactors back on line following the post-Fukushima shutdown.

Production cutbacks by Kazakhstan, the dominant uranium producer, accompanied by suspended production by the giant Cameco Corporation.

Gold

For thousands of years gold has been the ultimate store of value as currencies have consistently lost value, but over the past year the gold price has traded sideways to slightly down. History suggests that it will eventually break out to a far higher level before pausing or retracing some percentage of the gain.

Incrementum points out that since1971, when the new monetary era commenced, the US dollar gold price has appreciated at an average annualized rate of 8%.

Gold has been negatively impacted by the strong US dollar; another factor has been market complacency based on expectations of further upside in US share markets. Gold has temporarily lost its safe haven status as more rapid gains have been accrued on US share markets.

Apart from the moribund bullion price, gold equities have lagged even further. Junior explorers and developers have been particularly hard hit, and many are very underpriced, particularly on the TSX. This presents an opportunity. Over the past three months the LRF has invested in six very small companies with significant gold potential, skilled management and access to funding.

Geopolitical upheaval and declining confidence in governments, central banks and other assets is raising the profile of gold. Leading gold expert Rick Rule[16] observes that over a period of 36 years, precious metals as a percentage of world investable assets have fallen by 75%, so a reversion to mean would imply a massive increase in precious metals demand.

Although there is a moderate inverse correlation between gold and the US dollar, Steve Saville[15] comments that under conditions of international stress it is not unusual for gold

and the dollar to rise in unison. Neither are higher US interest rates necessarily an impediment to gold price, as they rose strongly in unison during the late 1970s.

Government deficits and increasing national debt have exercised significant longer-term influence on gold price, as illustrated in the chart below. Ballooning US government deficit spending augurs particularly well for significantly higher gold prices.

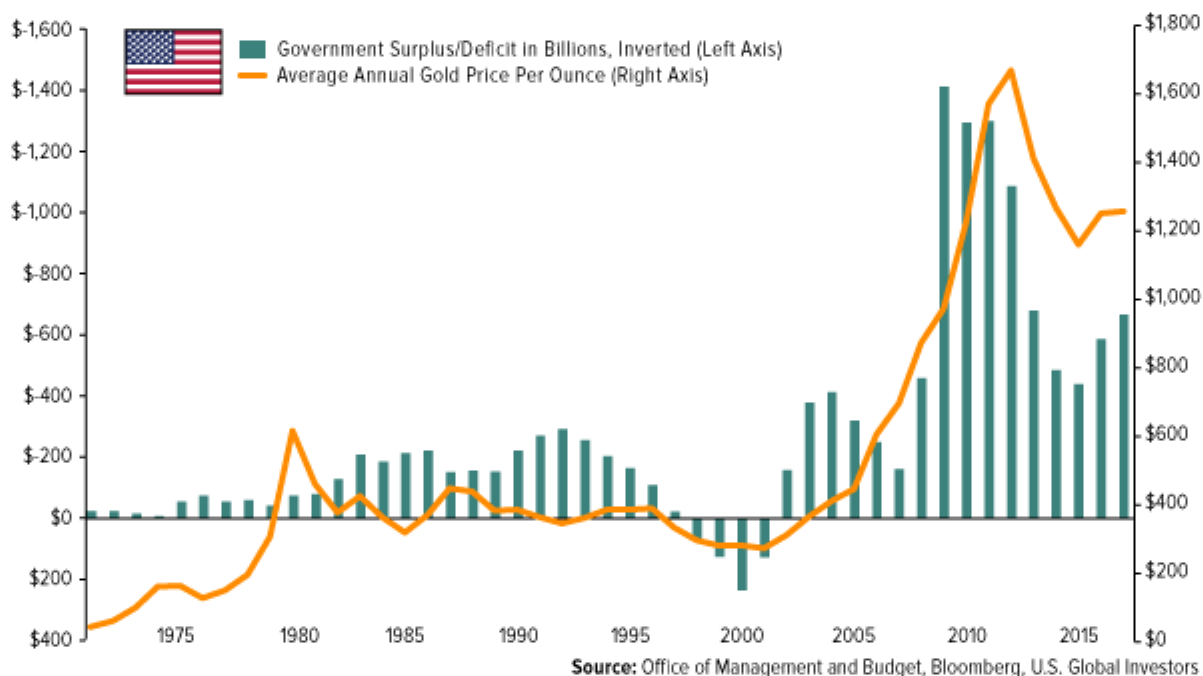


Figure 4: Gold price relative to US deficit spending. OMB, Bloomberg, US Global Investors

According to the *World Gold Council*, gold production peaked in 2016 and economic gold resources are declining worldwide. New discoveries are smaller and lower grade and reserves are depleting. As prices rise, however, currently sub-economic grades will become economically viable, supplementing gold resources and perhaps stemming the production decline. As reported by *Mining News,* new gold discoveries over the past decade were significantly lower than in the past.

Central banks have been adding to gold reserves for the past decade, with emerging economies almost doubling their gold purchases. As pointed out by *Incrementum,* China, Turkey and Russia have increased their central bank gold holdings more than threefold. China is the world's largest gold producer and gold bullion importer and has introduced yuan-denominated gold pricing on the Shanghai Gold Exchange. This launched a new benchmark price for gold, to complement the London Exchange.

The market for silver is small, volatile and prone to manipulation, but small silver stocks can achieve spectacular gains. The LRF has modest holdings in silver production as a byproduct and is reviewing several highly leveraged junior silver explorers.

Base metals

For much of FY18, copper and zinc were the standouts among the major industrial metals, with significant price increases followed by a decline towards financial yearend which erased most of the gains. Copper in particular is an indicator of economic growth, strengthening in response to positive indications of synchronous global expansion. Zinc flowed suit. Contentious trade issues and negative data on European and Chinese growth rates resulted in the overall decline in base metal prices late in the year.

Battery metals

Attention focused on the niche metals used in energy storage as interest in electric vehicles (EV) soared. EVs held less than 2% market share over the past year, with estimates of future EV penetration varying widely. The greatest increase is expected from Asia, with the volume of new EV sales in China likely to be more than three times the rate in the US. Although manufacturers are reportedly experiencing heavy losses on each vehicle sold, *Bloomberg New Energy Finance* predicts that by 2040 at least half of all new cars sold will be electric, numbering around 60 million at that stage, up from around 1 million in 2017. An even larger proportion of heavy transport vehicles will be electric.

As pointed out by Sean Brodrick[16] battery composition varies from one manufacturer to another. For example, the nickel-manganese-cobalt (NMC) battery contains more or less equal proportions of these elements in one case, or as much as 60% nickel in some newer generation versions. Nickel also dominates in Ni-Co-Al (NCA) batteries.

Lithium prices fluctuated over the 12-month period in response to growing supply in the face of demand uncertainties. Although lithium carbonate demand may double from 2017 to 2022 *Wood Mackenzie* expects that prices may have peaked in 2018. China is expected to dominate lithium demand, with the price likely to reflect supply growth from the many evaporite and hard-rock lithium projects currently underway. A large proportion of these projects are expected to fall by the wayside.

Cobalt faces a similar challenge, with *Wood Mackenzie* anticipating battery demand for the metal more or less doubling by 2022, when it would represent 60% of the cobalt market. Incremental supply is expected to be dominated by the DRC, an inherently unstable regime that is susceptible to sovereign risk disruption.

Vanadium batteries are suited to large, stationary energy storage. Vanadium prices have soared to their highest in nearly nine years due to shortages created by China's anti-pollution drive, which has led to increased vanadium imports. Further, Chinese regulations requiring higher vanadium content in rebar steel has increased demand. The tightening supplies of vanadium are resulting in a global shortage, with prices appreciating dramatically since mid-2017, with reports indicating that vanadium pentoxide prices have rallied further in 2018 to in excess of US$15/lb V2O5 from less than US$4 in early 2017.

Nickel demand is still predominantly used in the production of stainless steel and alloys, electroplating, but Canaccord reports that EVs will require as much as 50 kg of nickel per vehicle, which will add to demand particularly from limited sulphide production which has reduced supply response capability.

High-purity aluminum is a high-value product used in the manufacture of resistant glass screens, LED diodes, and semiconductors, with growing demand in lithium ion batteries. The LRF holds shares in Altech Chemicals, the most advanced HPA developer on the ASX.

Graphite is a highly conductive non-metal that is a key component in lithium batteries. The scramble for graphite triggered by the construction of battery megafactories in China and the US led to a multiplicity of graphite projects, some of which have reached production stage. Syrah was a profitable investment for the LRF, with expanding reserves and major graphite production set to commence. The investment was sold once the rapid growth phase was complete, but LRT retains exposure to the sector through an earlier stage graphite developer.

The Future

We are optimistic that the early signs of a bull market in the resource sector will bear fruit notwithstanding the modest retreat in the copper price and hesitancy in the precious metals. World growth rates outside the US have deteriorated in 2018.

Crude oil has been the standout performer and may resume its ascent after the current pullback. The oil price will influence perceptions of growth and inflation, with flow-on effects on other resource prices. Niche metals in batteries and electronics may have been temporarily overbought but are expected to appreciate over the longer term, depending on supply response, with increasing EV and stationary power storage applications. The price of gold is being held down by a monetary tightening in the US and a slowdown in global money supply.

Elevated levels of global uncertainty in world markets suggest a wider than normal range of possible outcomes. Upcoming US earnings reports will indicate whether the combined impacts of tax cuts, funds repatriation, and deregulation bear fruit and 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 *Belt & Road* megaproject will reinforce the resources sector. Economic cohesion in Europe, particularly with regard to immigration issues, intractable debts, and other north-south economic disparities there will also be important, along with resolution of potentially crippling currency and debt issues in the larger emerging economies. Overriding all of this is the extent to which trade conflicts escalate or are resolved with only modest impact.

We foresee four possible scenarios.

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

- Inflationary world growth led by crude oil, declining dollar hegemony, currency degradation, and especially by pent-up US wage increases in response to growing shortages of skilled labour. The resource sector in general would prosper, with economic growth in China, India, and the smaller South East Asian nations. Gold would be expected to outperform.

- 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.

- 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.

Independent researchers, including historians, fund managers and Wall Street professionals, conclude that the final stage of a major supercycle may have commenced[18], which is typically a period of upheaval, conflict, social disorder, nationalism, authoritarianism, and economic stress. Politics assumes a dominant role.

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[19].

Neil Howe[9] too notes parallels with the 1930s, a time when iconoclastic populists reigned, *"beggar thy neighbor"* attitudes prevailed, and multinational organizations were assailed (as are the World Trade Organization and U.N. today). As the *"Fourth Turning"* of Strauss & Howe[10] evolves there is increasing scope for unforeseen *"black swan"* events triggering tumult and crisis. Howe observes that benign complacency such as the present typically preceded 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[11,18] and other experts in social and economic cycles.

Forecasts are necessarily subjective and based on unpredictably evolving events and changing assumptions. Quantitative modeling has proved futile according to Taleb[1]. Markets are mathematically complex systems based on unquantifiable investor emotions and involve multiple non-linear variables. This accounts for the inability of economists to predict market directions and timing.

Further clouding the picture is distortion arising from the *"information economy"*. According to Niall Ferguson[2], connectedness via social media has created *"huge monopolistic networks"* that reinforce confirmation bias with no foundation in fact. George Friedman[12] 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 falls short with regard to timing of near-term events. There are repetitive patterns, e.g. the *Edelson Wave*[11,18] that signal trend changes, but the dominant waves comprise multiple subcycles that either interfere or reinforce one another. Directional changes may take place overnight when least expected, or may evolve slowly.

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.

Recession is inevitable in the US. It could be imminent, but that appears unlikely[17]. 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. On the other hand, given recent sideways trading, it may have passed.

As elaborated above, the conditions are in place for a substantial rally in the resource sector, but elevated risk and evolving geopolitical scenarios are conducive to unpredictable, high-impact *black swans* capable of changing the course of events[1].

The LRF management is prepared for a lift in mining & energy stocks but are aware that there is likely to be a shifting commodity focus. The LRF Investment Committee has been expanded to enhance expertise in stock selection ahead of what we expect to be a rewarding, albeit volatile, period in the resource sector.

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