Strategic Intelligence Report

MACRO VIEW: Goldfinger Blows Out

In the third James Bond film – 1964's *Goldfinger* – there is a villain who tries to irradiate all the gold in Fort Knox. The bad guy in the James Bond movie wanted to drive the price of gold much higher. In real life, however, gold now has a bad guy (or guys plural) who want to drive the price much lower.

We do not believe in the popular gold conspiracy theories. When someone tells us JP Morgan is holding back the price of gold (and that their manipulation will explosively fail), we remark that the exact same theory was being passed around in the 1990s. When a conspiracy theory doesn't change in 20 years and has no way to be falsified, you know it's a doozy.

Conspiratorial selling in gold's current bloodbath, however, looks all too real. Between the Comex futures exchange and the Shanghai Gold Exchange, more than $1.7 billion worth of bullion was dumped on Monday's market in just three to four minutes. David Govett, head of precious metals at Marex Spectron in London, tells the FT there is *"no coincidence this happened in the quietest, thinnest period of the week,"* meaning that the sellers timed their sale for maximum damage. Nobody doubts it was a hit job… When the Comex selling started, the selling in Shanghai began moments later – a synchronization of efforts some 7,000 miles apart.

To add insult to injury, more selling kicked in via the Chinese derivatives market… and all this came shortly after China's central bank (whose gold reserves had long been a state secret) publicly announced a tonnage level much smaller than the market had anticipated. The question now is: Was China's central bank "in on" the maneuver? Is this the work of China-based traders conducting a speculative raid, as with their hit on the copper market earlier this year? Or does the market have even trickier forces at work? (A truly dedicated gold bug could argue China is deliberately driving down the gold price to set the stage for massive buy orders on the cheap – not unlike the Rothschild's legendary maneuver of selling prior to buying on news of Napoleon's defeat.)

Gold stocks were absolutely destroyed as the price of gold hit five-year lows. GDX and GDXJ, the popular gold ETFs, fell roughly 11% each in a single trading session. Newmont, the bluest of gold blue chips, has plummeted back to its lows. Barrick Gold, another gold blue chip, is plumbing new depths. For those who have considered themselves "true believers" in gold stocks, this blowout has been incredibly painful. For those who "backed up the truck" on gold stocks without any kind of stop loss (reasoning that valuations couldn't go any lower), this move could end money management careers and vaporize retirement nest eggs. Gold stocks are now the all time classic example of the "value trap:" An asset that looks attractive because its price is super-cheap, which then inflicts pain on all who buy it via falling much, much lower.

At what point does the carnage stop? This is not a guessing game we care to play (with real funds anyway). If a stock can decline fifty percent, e.g. from $24 to $12, then it can fall another fifty (from, say, $12 down to $6). If the gold price stays depressed – or far worse, falls back into triple digits – the favorable economics for many gold mining projects will turn negative. And given that gold was at $250 per ounce circa 1999, nobody knows how much farther it could fall. The last time gold got whacked, it was Britain doing the heavy selling, with Prime Minister Gordon Brown ordering massive gold sales below $300 per ounce. (Talk about a rotten trade.)

Let us say the Chinese government is involved in this latest blowout. The bullish theory is that they are selling in order to be tricky and buy cheap. But this smells more like hope than logic. If China's central bank was keen to amass large quantities, wouldn't they have done so already? Why is their stash so much smaller than anticipated… given that theories of China gold hoarding have been rampant for years?

The extremely bearish take on potential China involvement is frank assessment of what broad-based slowdown could do to the global economy. If China slows markedly… and then steps up currency war to try and support flagging exports… the result is stepped-up deflationary pressure for the rest of the world. Falling prices for China goods, even as emerging market demand continues to fall and developed demand stagnates, could mean a global deflation scare that lends new strength to the US dollar. And the USD is likely to gain ground in the event of a "risk off" event regardless, as US investor capital flows home with waning risk appetite. Add to this the potential "short squeeze" unwinding of the multi-trillion USD carry trade – via which governments and large institutions are short the dollar by debt proxy – and you have the makings of a further huge run-up in USD, which would likely send the price of gold down into the mid-hundreds per ounce. **We may yet see gold stocks transition from value trap, to super value trap, to epic and incredible mother of all value traps.** If the Chinese government (or whoever triggered the recent selling) knows all this is coming, they could now be positioning for a further extreme drop …

Some argue gold was crushed by news that Janet Yellen is still ready to hike interest rates before the year ends. But this does not make a lot of sense. The gold price has more linkage to the rate of inflation than the trajectory of interest rates. Just imagine, for example, an environment where the Fed is hiking rates while inflation runs rampant. Interest rates would then be going up… and the gold price would likely be going up even faster, on perception that the world's most powerful central bank has lost control of monetary policy.

There is an argument to "buy gold because central banks will create inflation." This argument actually has merit… **but not on a near-term or even medium-term timeframe.** If the Fed succeeds in stoking the fires of inflation, it might be a good solid year or two (or three) before the numbers start getting frisky. One could say inflation is a very hard fire to put out… but also a very hard fire to get started. The road to rampant inflation may well pass through a period of "benign" inflation or even "good" inflation before hand, where there is just enough price appreciation for the inflation to feel positive. In the meantime, gold has to hang out and wait.. or sell off…

Investors who decided to prematurely load the boat on gold (or gold stocks) are thus out of luck. If they are counting on central banks to create inflation, it may take a while. If they were counting on buyers like China to stoke sentiment with news of mass gold hoarding, the disappointing data from China's central bank has had the opposite impact. And if they were hoping that a crisis situation or "risk off" event would make gold perk up, those hopes have been dashed too. With the Grexit drama and China market meltdown occurring in tandem these past few weeks, one might have logically expected a wave of safe haven gold buying. And yet this hasn't happened at all. One also has to wonder whether this move has led to full capitulation on the part of gold bulls, or whether the real capitulation is yet to come. There are many investors and money managers who do not believe in risk points. Instead, they hold onto losing positions until brutal price action forces their hand (or investor redemptions force them to sell). These sellers are the ones who tend to accelerate the blowoff portion of a move, by dint of waiting and waiting to get rid of their losing positions until a maximum pain point forces the hold-outs to give up hope.

There is a scenario in which the gold price rises dramatically, without the need to wait a few years for inflation's slow-but-steady return. It is the one in which the entire world sees an economic slump – including the United States – and central banks are forced to confront the prospect of a new recession with rates still near the zero level. If this happens, there is a possibility that central bankers panic, or try increasingly radical experiments like deeply negative interest rates (e.g. minus 2 or 3 percent instead of just a few basis points).

In that type of scenario, gold becomes a proxy for cash (and the only form of cash not subject to a printing press). So if you are in a hurry to see gold hit $5,000 an ounce, you want to see a scenario where the global economy gets so bad, all major paper currencies get proverbially shredded all at once.

In the opposite camp from gold bugs, there are those who see gold as a "pet rock" (as a WSJ columnist recently dubbed the yellow metal). This camp cannot see the point or purpose of gold in virtually any circumstance. They note that gold has no yield, and thus can't really be considered an investment. There is nothing to benchmark it against, they add. The price seems to rise or fall based on sentiment as much as anything.

We view gold as a sort of insurance contract – a kind of credit default swap on central banks and monetary policy. When the world's central banks appear to be in control, and things are going swimmingly, the value of gold declines. There is no need for an insurance hedge when the skies are bright blue. At the same time, the gold price rises when central bankers start to make mistakes – or when the perception arises that big mistakes are coming. There is also a flow of retail gold demand, from countries like India, China and others. But the fluctuations in the actual price of gold moreso depend on the investing component, and what price levels investors are willing to pay to have gold as a form of policy accident insurance in their investment portfolios. But more than just an insurance contract, gold also functions as a speculative vehicle and a form of portfolio hedge. The speculative aspect comes into play when buyers rush in on anticipation that "the big one" is coming… the big move upon which gold finally surpasses, say, $6,000 per ounce. There are, in fact, so many devoted true believers waiting for the big breakout movement in gold, it is their too-early buying (and then follow-on forced selling!) that fuels big pops and drops.

We think that, one day, there will indeed be a time to buy gold with both hands. The odds of a return to destabilizing inflation, given a sufficiently long time window, seem almost 100%. And the catastrophe scenario (central bankers facing recession at the zero lower bound) is also non-trivial. We'll wait for one of these to unfold before again getting involved.

THEMATIC VIEW: Triumph of the Geeks

To find the opposite of gold, look to Google. And by that we do not mean looking to Google the search engine, but rather Google the stock price. Shares of Google exploded higher last week on news of earnings momentum and cost cutting. The company has a new CFO, Ruth Porat, who cut her teeth at Morgan Stanley. And revenue has been smartly rising (thanks to advertising sales and increased YouTube viewing) even as currency costs acted as a headwind and search revenues declined. The perception is that Google is one of the last few bastions of big picture growth – a tech juggernaut who can earn more profit by more efficiently monetizing a gigantic fixed cost audience. As Ben Thompson of Stratechery puts it:

…it is [important] to understand the fundamental difference between vertical companies like Apple and horizontal companies like Google: the latter have massive fixed costs that they seek to leverage over a massive number of users; because serving the latter requires minimal marginal costs (usually $0) the more users you serve the more leverage you get on your initial investment… Google is treating both its infrastructure spending and its sales and marketing teams as fixed costs that should be spread across all of Google's different businesses… Google is making the same pitch to advertisers that they are investors: don't look at our portfolio as a group of separate products that you invest in individually; instead, simply spend your money with "Google" and we will dynamically determine the best way to allocate…

Facebook shares have also gone vertical, now approaching $100 per share (as shown in the lower left column). As far as investors are concerned, both Google and Facebook are now making good on the implicit promise of the dot com bubble that burst roughly fifteen years ago – the ability to "monetize eyeballs" in a massively efficient way. Google and Facebook both have cutting edge, global-scale technology platforms for building, measuring and tracking corporate ad spend campaigns, leveraging the anonymized data pool of billions of users. In that vein Facebook now officially has more MAUs, or "monthly active users," than China has people. (Does that make Zuckerberg "Chairman MAU?" Sorry, couldn't resist.)

The tech world is also showing unique signs of excess and hubris, above and beyond the crazy $25-$50 billion private valuations of "sharing economy" plays like Airbnb and Uber. One example of this comes from a social media kingpin with alien fever dreams, as the *Wall Street Journal* explains:

Man's quest to discover life on other planets is getting a $100 million boost from a Silicon Valley magnate. Yuri Milner, the Russian billionaire who burst onto the U.S. venture-capital scene with early bets on Facebook Inc. and Twitter Inc., is personally funding the bold new effort to scan the skies for signs of intelligent alien life. Mr. Milner's check will go to support a team of researchers, based at the University of California, Berkeley, tasked with collecting more data from outer space in a single day than previous efforts collected over an entire year…

It is a far-fetched gamble even for the 53-year-old Mr. Milner, a venture capitalist known for investing large amounts of capital into relatively unproven tech startups. Mr. Milner's firm, DST Global, invested $200 million in Facebook in 2009, when the social network was valued at $10 billion. Now its market value tops $250 billion. DST has amassed large stakes in several of the most highly valued startups, including Chinese handset maker Xiaomi Corp., Indian e-commerce firm Flipkart Internet Pvt. and room-rental service Airbnb Inc.

Nothing says "victory lap" quite like committing a hundred million bucks to the search for alien life forms! Then again, given the wildly inflated values of Mr. Milner's holdings, it is probably rational to convert a portion of equity holdings into cash for most any venture at all. He could fund twenty such projects, each one wackier than the last, and the net cost, if paid for via share sales up front, will almost certainly be far, less than the amount of valuation contraction that hits when Silicon Valley comes back down to earth. There is also irony in the bubble connection between "scanning the skies" and a backyard tent in Palo Alto renting out at $900 per month.

Another sign of theory hubris comes from Google itself, the hot investor darling of the moment via eyeball-monetizing algorithms. The Chief Economist at Google, Hal Varian, argues that the US economy does not have a productivity problem. It has a "measuring problem," as the WSJ reports:

The 68-year-old Mr. Varian, dressed in a purple hoodie and khaki pants, says the U.S. doesn't have a productivity problem, it has a measurement problem, a sound bite shaping up as the gospel according to Silicon Valley… One measurement problem is that a lot of what originates [in Silicon Valley] is free or nearly free. Take, for example, a recent walk Mr. Varian arranged with friends. To find each other in the sprawling park nearby, he and his pals used an app that tracked their location, allowing them to meet up quickly. The same tool can track the movement of workers in a warehouse, office or shopping mall. "Obviously that's a productivity enhancement," Mr. Varian says. "But I doubt that gets measured anywhere…"

This is a fascinating debate (in our humble opinion). The tech world wants to argue the sharing and app economies have increased US productivity, even while eating up revenue sources and jobs (replacing large numbers of inefficient jobs with far fewer, far more efficient jobs; replacing services that used to cost money with advertising supported services that are free). Think of what Craigslist did to the newspaper classified ads business: It imploded a multi-billion-revenue-stream business… while delivering huge value to users at a massive scale… and then only took a small fractional portion of the original revenue stream for itself. This is a classic means of getting rich in the scale-based tech world: Vaporize the profit margins in a bloated industry… deliver tremendous value at low or no cost (e.g. if advertising supports you)… and keep a nice fat slice of the far smaller pie (enough to make you and your investors quite rich) as an industry disruption prize. This is a beneficial model for end users and consumers.

But the productivity angle is not clear… because revenue streams and jobs disappear in this process. This is why we (and many others) argue that technology is often "deflationary" in a positive sense of the term: It brings down prices and costs, in a way that allows people to have a higher quality of life for less money. Five years from now, a smartphone with ten times the capability of a second or third generation iPhone, which would've cost five hundred dollars just recently, will likely be somewhere between $50 and free (possibly thrown in with a phone contract). Or maybe it will be mailed to you as a thank you for renewing your Amazon Prime account. This is well and great – for end users – but it is also deflationary because, on an end-to-end basis, less money is spent by the consumer, in an economy that supports fewer jobs and greater automation on the whole.

If you extrapolate these tech trends to illustrative extremes, you have an economy where the average worker scrapes by on minimum wage (because high paying jobs are so scarce), yet has all the entertainment and medical care and lifestyle technology he needs because costs for tech (and even medical care) have asymptoted above zero by this point. In a world where everyone has access to Bruce-Wayne-style gadgets, most people are "poor" in relative terms, while enjoying access to the cool gadgets and ad-supported services that took their jobs. This is a natural extension of the digital feudalism paradigm… except 21st century serfs will have a lot more access to quick contentment. This, in turn, brings to mind a prescient Aldous Huxley quote that is more than six decades old. (What if Zuck really is Chairman MAU?)

"There is, of course, no reason why the new totalitarians should resemble the old. Government by clubs and firing squads, by artificial famine, mass imprisonment and mass deportation, is not only inhumane (nobody cares much about that nowadays), it is demonstrably inefficient and in an age of advanced technology, inefficiency is the sin against the Holy Ghost. A really efficient totalitarian state would be one in which the all-powerful executive of political bosses and their army of managers control a population of slaves who do not have to be coerced, because they love their servitude. To make them love it is the task assigned, in present-day totalitarian states, to ministries of propaganda, news-paper editors and schoolteachers… The most important Manhattan projects of the future will be vast government-sponsored enquiries into what the politicians and the participating scientists will call "the problem of happiness"—in other words, the problem of making people love their servitude."

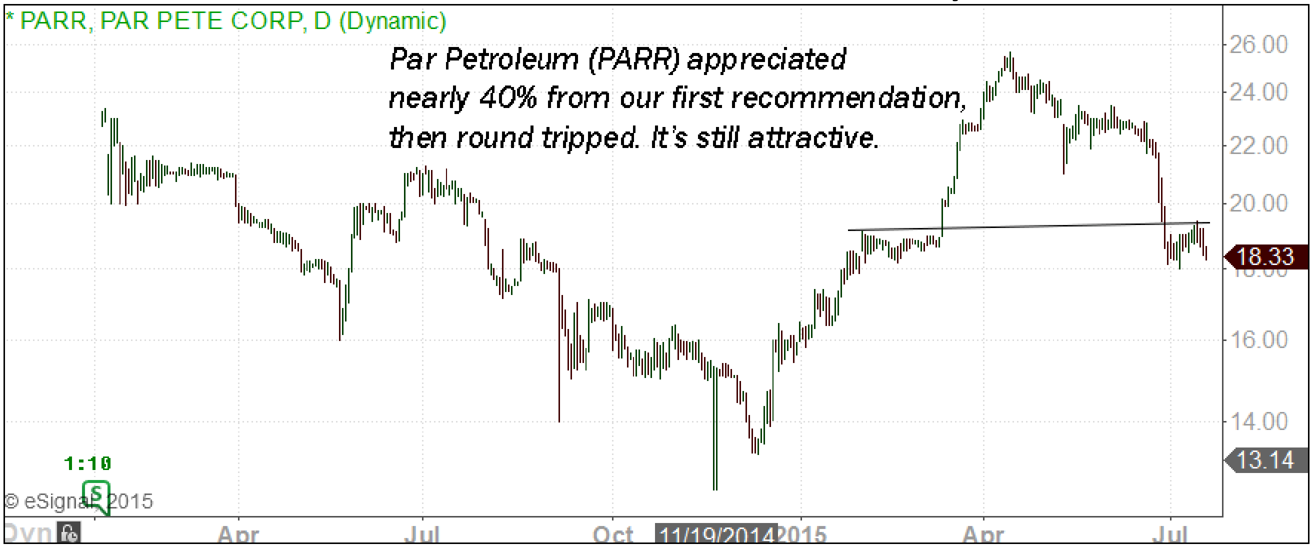
Our final observation of Silicon Valley bubbliciousness is the debut of a startup with one of the most suicidal business models we have ever heard of, barring the multi-colored spaghetti thrown against the wall in the first dotcom boom. As the WSJ once again reports (bold emphasis ours):

Online marketplace Jet.com Inc. has almost no revenue, years of likely losses in its future and a strategy that includes ***underpricing mighty Amazon.com Inc. on millions of items.*** *Jet also has perhaps* ***the highest valuation ever among e-commerce startups*** *before their official launch… More than just about any other current startup, Jet seems* ***reminiscent of the dot-com boom era,*** *when e-commerce companies assumed giant losses before breaking into the black.*

Amazon.com is Thanos and Conan combined when it comes to profitless expansion on seemingly endless scale, booking $408 billion in revenue and less than $2 billion in net income over a period of twenty years… and Silicon Valley is big-backing an attack on Dread Pirate Bezos. Well alrighty then!!

Strategic Intelligence Report

SPOTLIGHT: A Case of Mistaken Identity



We initially wrote up Par Petroleum (PARR) in January 2015 (SIR 67). From the time of the initial recco, PARR appreciated nearly 40%. Then it round-tripped. Within our trading desk service, which broadcasts actual fills in real time, we closed out our initial PARR position for a roughly 25% profit protected gain. The questions now are: Why has PARR round-tripped? And does it still look attractive? The quick and simple answer is yes. As we wrote in SIR 67:

When is an oil and gas stock not merely an oil and gas stock? When it turns out to be a tax-advantaged acquisition vehicle, with a roster of razor sharp investors behind it. The backers of Par Petroleum (PARR), an up-from-the-ashes refinery with a slew of tax credits, have a history of value creation with beaten down assets. Par Petroleum could be another score…

PARR still has a great profit shelter angle (via one-billion-plus in NOLS, aka Net Operating Loss tax credits). It is still an attractive takeover target. The "island economics" of PARR's Hawaii refinery remain attractive. There is still solid potential in the development of a downstream energy business. And the top notch investment minds who were behind PARR in the first place are still involved. PARR's two largest-scale owners, Zell Credit Master Opportunities Fund and Whitebox Advisors, own more than 50% of the shares. And PARR has since joined the Russell small cap indices, creating visibility.

Why then the slump? A clue resides in the full name of the company: Par Petroleum Corporation. Because PARR has the word "petroleum" in its name, the company may have been lumped in with generally hard-hit energy stocks. Oil has been hit too in recent weeks, with spot futures back below $50 per barrel as of this writing. And energy stocks in general have been schmeissed, with bellwether XLE in freefall mode.

But here is the thing. Not only is Par Petroleum Corporation NOT a traditional energy stock -- it actually benefits from oil price declines! The economics of the refinery business are such that falling oil prices are a good thing. PARR's Oahu-based refinery, its primary working asset acquired in 2013, sees higher profit margins on refined products when the cost of oil (its chief input) falls faster than prices at the pump. PARR has also demonstrated savvy management capability with the deals it has put together. For example, a supply and offtake (SAO) agreement, struck with a commodities trading arm of Goldman Sachs, allows PARR to attractively finance crude oil purchases through Goldman, with agreements for Goldman to purchase a portion of the Oahu refinery output. This allows PARR greater flexibility to run the refinery at close to maximum capacity, which increases profit margins.

David Marcus, portfolio manager of the multi-billion-dollar Evermore Global Value Fund, maintains a $33 price target for PARR (more than 80% above current levels). Marcus has a strong bullish outlook for PARR based on "better crude sourcing, new contract wins, synergistic acquisitions and help from falling crude prices," as well as still-accruing benefits of management's successful refinery turnaround. Consider the fact a billion bucks of upcoming profits are tax sheltered (via the NOLs), and PARR remains a compelling fundamental value. It is a further irony that, in the event crude oil falls deep into the $40s, energy stocks in general will get killed even worse, but PARR's profit margins will fatten! Sharp investors with deep pockets are likely watching this situation with interest… as are we. If PARR returns to constructive price action, we will repurchase for another potential 25% gain… or possibly 50-75% this time around.