Classical Insights

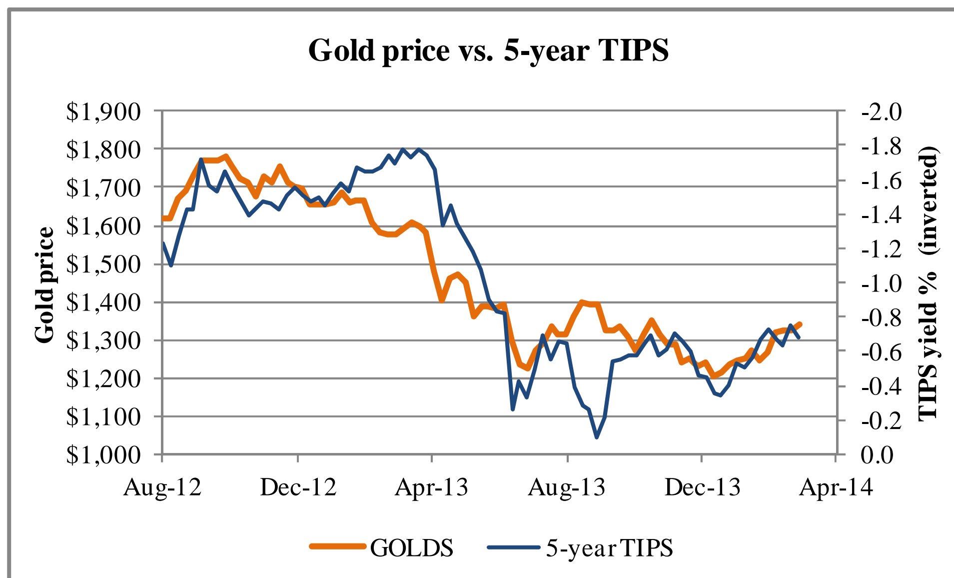
Global Investment Analysis Based on the Classical Economic Model

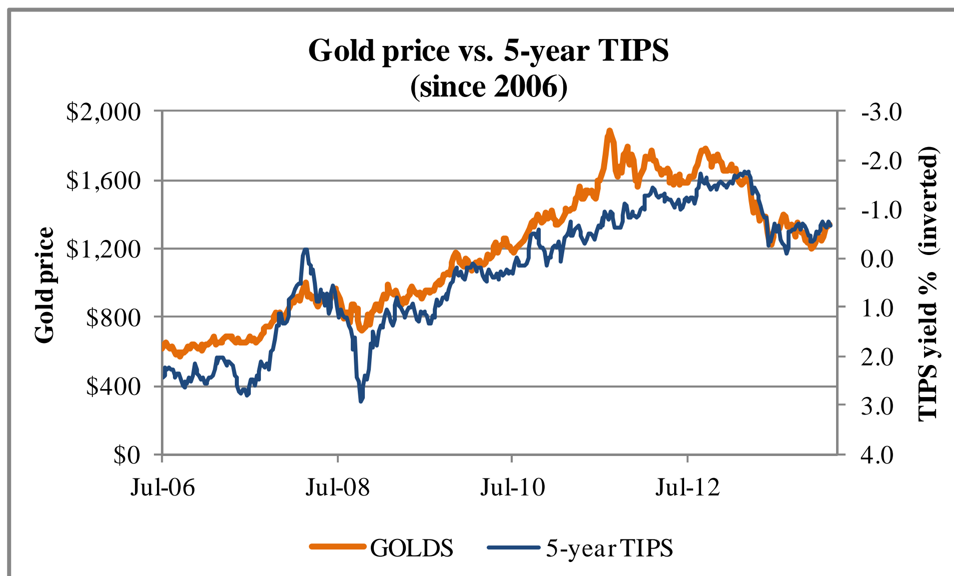
Classical Insights Bullet Points March 11, 2014

There is a lot going on out there. In this piece I touch on several topics including:

- The gold rally;
- Industrial commodities;
- Russia & Ukraine.

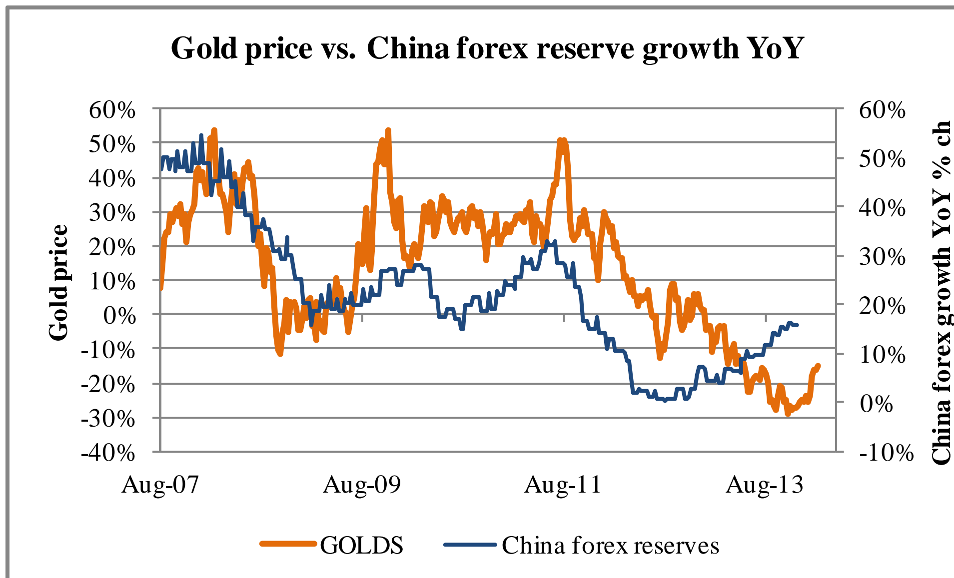
1) The gold price correlates well with both TIPS and China's rate of forex accumulation. Both series have been showing some signs of a turn (though neither is decisive). Here are two views of the gold/TIPS relationship. The first chart goes back 18 months, the second goes back to 2006. The long-term chart is an airtight relationship. The short-term chart contains the suggestion that TIPS may be making a head-and-shoulders bottom:



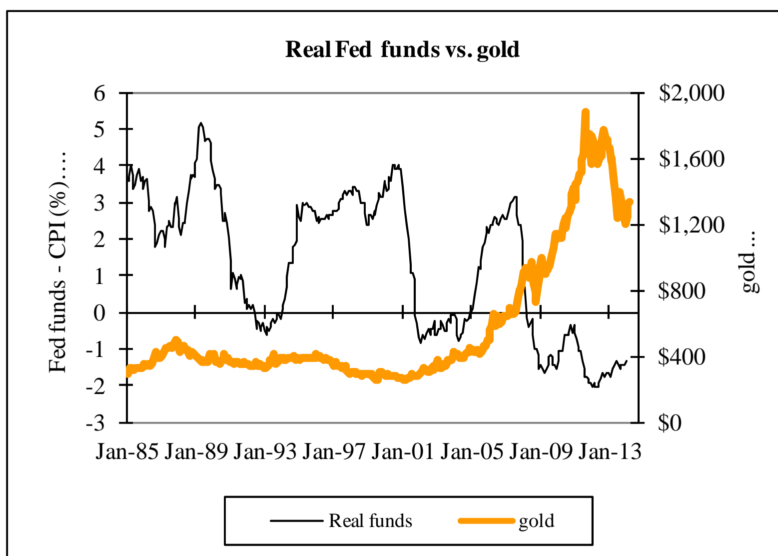


Are TIPS wanting to trend upward due to stronger growth expectations? Maybe. The behavior of the US 10-year Treasury bond yield is interesting here: The onset of last year's huge spike in the 10-year yield led the bottom in the gold price by six weeks. Gold later re-tested its low (in December), but held it and since has rallied. Perhaps gold lagged the 10-year yield due to an overhang of sellers who needed to be flushed out of gold. The larger interpretation would be that bonds may in fact be signaling stronger growth – as are TIPS. By extension, one could say US monetary policy has gotten looser just by absence of any big change in the Fed's QE policy.

2) Here is gold versus China forex reserves (YoY change). Great correlation. The China reserve data end at 12/31/2013 but clearly show an upward tack as of that date. Is China still piling up reserves? That's a key question. In theory, if the global economy continues to strengthen Chinese exports should rebound, allowing reserve accumulation to continue. A weaker yuan would help that effort.



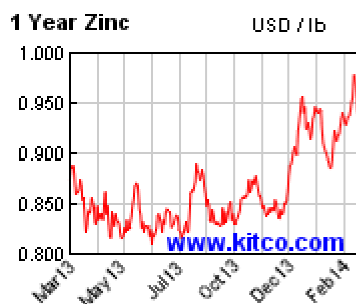
3) The relationship between gold and the real fed funds rate broke down completely over the past two years, but *might* be starting to re-align now. The problem here is that once you get into QE territory, the fed funds rate ceases to be a meaningful measure of liquidity tightness or ease. As such, the period from 2011 to 2013 saw the first instance in 30+ years of falling gold prices combined with negative real interest rates.

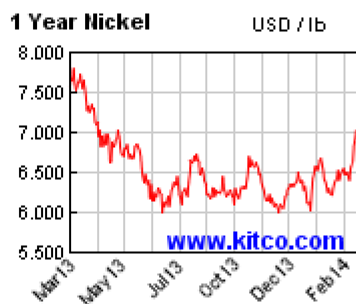


But, as noted above, the Fed may be getting *de facto* looser. Inflation expectations are rising a bit (see TIPS) because the economy is getting stronger but the Fed may not be tapering fast *enough* to offset that. Thus real interest rates could be viewed as effectively falling.

4) Silver has been underperforming gold but not horribly so. It's up about 9% from its late-January low, but hasn't broken its long-term downtrend.

5) Industrial commodities have been mixed – but interesting. While copper and iron prices have gotten the headlines with their big declines, long-suffering zinc and nickel prices actually have been rising nicely over the past three months. These price movements make sense: The drop in iron and copper likely are the result of a hangover from excess capacity brought on during the prior boom. Zinc, by contrast, has been in the dumps for eight years, which is long enough for any new capacity from the last (short-lived) boom to have been absorbed. The zinc chart is actually quite impressive and nickel looks pretty good too. Could they be signaling a China *rebound*? Strange concept, I know, but worth a thought.





6) Turning to Russia: On paper, at this is probably a buying opportunity. The problem is that it's hard to get comfortable with Russian stocks because most companies are run by thieves. My solution is to maintain extremely rigid selection criteria. I want to see two things:

- Strong, consistent free cash flow;
- High and steady dividend yields.

You'd be surprised how few Russian companies can offer this combination. The standard scam is to report strong earnings but then blow all the cash on "capex" of dubious merit. Many Russian stocks trade at 3x earnings yet have very low free cash flow and 0.8% dividend yields. Where is all the EBITDA going? Into their pals' pockets.

7) If you want to buy this dip in Russia, one logical name would be Sberbank, which now trades at 0.93x book and yields 3.4%. The trailing P/E is 4.8x. Some analysts have begun cutting estimates but even those guys are still calling for EPS of around 15 rubles/share this year, putting the stock on a P/E of 5x. Other analysts are expecting 17.5 to 20 rubles/share, putting the stock closer to 4x. Another bank option would be the big trade bank VTB (VTBR RM), whose valuation is similar to Sberbank on most measures, but with a price/book ratio of just 0.49x.

The argument for buying Russia's dominant banks rather than the smaller ones is that the big ones are far more likely to *get paid back* when they lend out money. If you borrow money from Sberbank, you are borrowing from Putin and his ilk, who likely have special ways to incentivize repayment. The same cannot be said for the smaller banks, Bank St. Pete (BSPB RM) and Vozrozhdenie (VZRZ RM), both of which have been disasters over the past four years. (That said, it's noteworthy that VZRZ shares have remained steady during the current Russian bear market, suggesting investors may sense a turn in that bank's fortunes.)

8) One Russian industrial name that meets my investment criteria is Nizhnekamskneftekhim (NKNC RM), which produces petrochemicals and synthetic rubber. The stock has paid 10%+ dividends each of the past two years and trades at 3.2x trailing earnings.

9) In Ukraine, the Classical Insights Frontier portfolio's positions actually continue to *rise* despite all the commotion there. This makes sense: The status quo was abominable: Slow motion suffocation combined with never-ending economic stagnation. Now there is movement on all kinds of fronts. The currency is floating (good), and the oligarchic stranglehold on grass-roots activity is, at the least, up for renegotiation. If the Crimea stand-off gets resolved peacefully (likely) and Ukraine gets a big loan from the multilaterals (also likely), the country will probably end up with a more west-facing technocratic government for a while. IMF functionaries will start to weigh in on some of the nuts-and-bolts details of economic policy, hopefully wrenching open Ukraine's Burma-like oligarchic fiefdom of an economy.

10) Regarding Crimea: It seems to me the circumstances of the Maidan revolt were sketchy enough (semi-coup), Russia's historical claims on Crimea strong enough, and the west's direct interests low enough that a semi-amicable resolution should be possible. Don Luskin offers an interesting scenario in which Crimea becomes a sort of unofficial protectorate of Russia – not formally acknowledged by anyone but Russia, but *de facto* acknowledged by everyone. "And then everyone moves on." Luskin's precedent for this is Cyprus, which Turkey invaded in 1974. Nobody acknowledged the legitimacy of that invasion but nobody did anything about it either, and the situation sat like that for four decades without too much fuss.

The Classical Insights portfolio holds Sberbank and VTB.

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