SA BULLION

The SA Bullion Gold Report

First Quarter 2017

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Table 1: Gold Performance to 31 Mar 2017 (% per annum)[1]

	Quarter[2]	1 Yr	2 Yr	3 Yr	5 Yr	10 Yr	Since 31/12/99
Gold in US Dollar	8.2	0.6	2.4	-1.2	-5.6	6.5	8.8
Gold in Rand	1.2	-12.3	6.4	5.4	4.7	12.9	13.6
Gold in Euro	5.0	7.4	2.6	7.5	-1.3	8.9	n/a

[1] Based on LBMA PM Fixes.
[2] Not annualized for periods of less than one year

Table 2: Quarter-End Gold Prices and Exchange Rates[1]

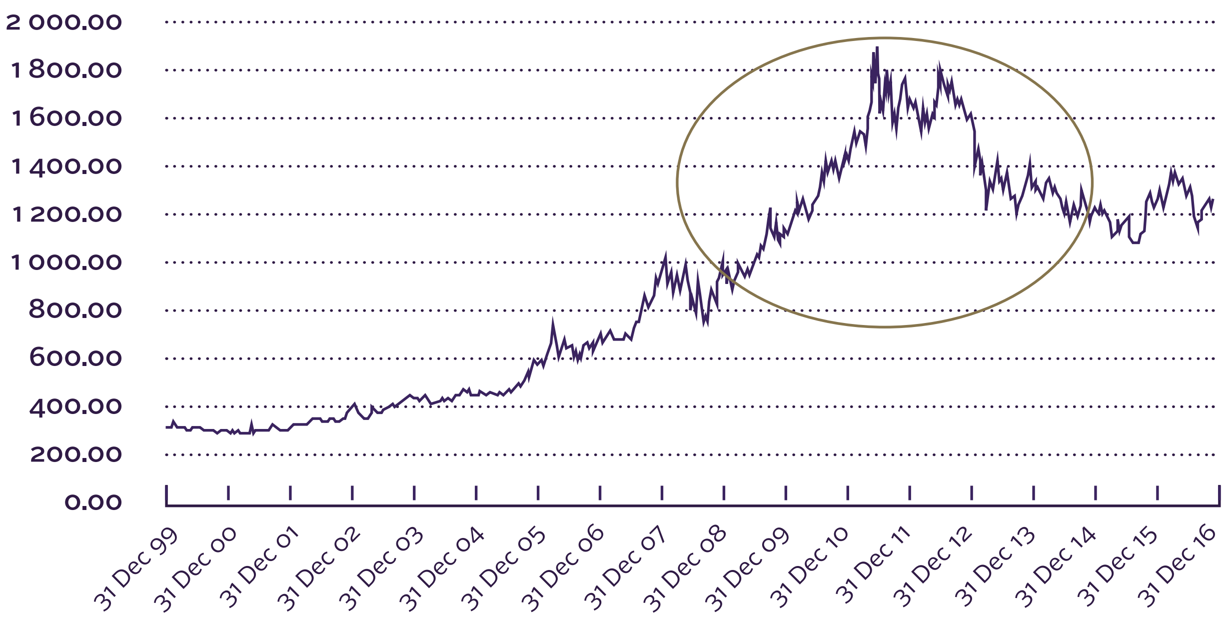
	Gold in US$/oz	R/$ rate	Gold in R/oz[2]	$/€ rate	Gold in €/oz
31 Mar 2007	661.75	7.25	4,799.34	1.33	496.70
31 Mar 2008	933.50	8.13	7,586.09	1.58	589.59
31 Mar 2009	916.50	9.86	9,032.22	1.33	688.99
31 Mar 2010	1,115.50	7.31	8,154.49	1.35	825.07
31 Mar 2011	1,439.00	6.75	9,717.63	1.42	1,014.52
31 Mar 2012	1,662.50	7.68	12,776.01	1.33	1,246.63
31 Mar 2013	1,598.25	9.32	14,902.44	1.28	1,245.90
31 Mar 2014	1,291.75	10.57	13,737.29	1.38	936.59
31 Mar 2015	1,187.00	11.96	14,194.58	1.07	1,106.22
31 Mar 2016	1,237.00	14.83	18,345.95	1.14	1,084.85
31 Mar 2017	1,244.85	12.92	16,080.80	1.07	1,164.93

Note 1: Gold prices in US$ and € are LBMA PM Fixes.
Note 2: Gold price in Rand from Rand Refinery
Note 3: Gold prices at time of writing - $1,252.90 and R17,336.75

Table 3: Calendar Year Performance of Gold

	% US Dollar	% ZA Rand	% Euro
2007	31.9	27.9	18.9
2008	4.3	41.1	9.7
2009	25.0	-0.4	21.1
2010	29.2	16.1	38.2
2011	8.9	33.0	12.6
2012	8.3	13.6	6.2
2013	-27.3	-11.8	-30.3
2014	0.1	10.4	13.4
2015	-11.4	19.1	-1.1
2016	7.7	-2.5	13.3
2017 year-to-date	8.2	1.2	5.0

Figure 1: Chart of Gold Price in US Dollar from 31 December 1999 (LBMA PM Fix)



Circle: Washout of 2008 Global Financial Crisis

Figure 2: Chart of Gold Price in South African Rand from 31 December 1999

Circle: Washout of Nenegate

Gold Price Action

Gold produced a strong performance in the first quarter of 2017. Gold bullion began the quarter at $1,151.00 and ended the quarter at $1,244.85 to return 8.2% in US Dollar. A strengthening Euro lessened the return in that currency but still produced a gain of 5.0%. A massively strengthening Rand caused a return of 1.2% in the South African currency.

Over the last ten years, from 31 March 2007 to 31 March 2017, holders of gold have been well-rewarded. In US Dollar the annualized rate of return has been 6.5% and in South African Rand it has been 12.9%. This century, i.e. from 31 December 1999 to 31 March 2017, gold has delivered an annualized return of 8.8% to Americans and 13.6% to South Africans, the difference being loss in Rand value equating to 4.8% per annum.

In the Era of Unbacked Currencies, i.e. from September 1971 to the present (31 March 2017), gold returned 8.9% per annum in US Dollar and 14.3% per annum in South African Rand, with the difference representing a loss by the Rand relative to the Dollar of 5.4% per annum.

It should be noted that in the 12 days since quarter-end, gold has risen by 0.6% in Dollar and, due to Rand weakness related to President Zuma issues, gold has risen by 7.8% in Rand (equating to a gain of R1,256.00 per ounce).

Optionality

Most people have a need to hold some of their savings in cash (in the bank). It may be that the cash, along with the home, represents the final refuge if all else goes wrong. It may be that the cash represents liquidity, so that in times when other assets cannot be easily traded, the cash-pile means that the other assets do not have to get sold at knock-down prices. It may be that all other investment opportunities at the time appear unattractive – or that cash in the bank is unduly over-rewarded. There are many possible reasons.

We understand the need to hold some cash, and in a sense SA Bullion is a bank of gold.

Cash in the bank is a complicated subject. Some know this because they found they could not draw their savings in times of stress – ask the Argentines. Some know this because their bank went insolvent – ask the Saambou Bank and Washington Mutual depositors. Some know this because their currency went to zero – ask the Zimbabweans. Some know this because the rate of interest compared to the inflation rate meant that they were getting poorer with their cash in the bank – ask the Americans and the Swiss.

Gold has a strong investment case as an alternative hard currency. In fact, gold is the only hard currency, where the holder does not have to rely on governments to do the right thing. In the case of all other currencies today, the holder submits to faith in the government of the country that issues the currency – this is the nature of fiat currencies, and this has been the status since 1971.

Whilst there is a very strong investment case for gold as an alternative to cash in the bank, there is another extremely compelling reason to hold gold, especially now – optionality.

Optionality: The value of additional optional investment opportunities only after having made an initial investment. (Definition: https://en.wikitionary.org)

Gold offers upside linked to catastrophes – be they political, military, natural or other. (It should be noted that the reverse is also true). We are by nature wary of venturing too far into this speculative realm, but the nature of these times compels us to bring matters to your attention.

For three reasons we are reasonably confident in focusing on the value of optionality in gold right now:

1. Over the last few years gold has retreated to a low price and has formed a huge base of support in the range of $1,100 to $1,300;
2. The US and the US Dollar are facing significantly increased risks; and
3. South Africa and the Rand are facing significantly increasing risks.

Our gold charts in this report cover the extent of the present century i.e. 16 years and 3 months. There are so many interesting stories in these charts but we will draw your attention to two stories:

1. In the US Dollar chart of gold, the circle indicates the gold price rise due to the onset of the 2008 Global Financial Crisis and its subsequent washout;
2. In the SA Rand chart of gold, the circle indicates the gold price rise due to the ouster, in December 2015, of the then Finance Minister Nhlanhla Nene and its subsequent washout.

It is visually evident from these two charts that the gold price is at normalized long term levels in both Dollar and Rand. This means two things: it is an excellent time to be entering into gold due to its fair pricing, and secondly, that at current prices you get tremendous optionality.

We do not wish ill on any people or countries, but when we study the US we see massive potential for disorder. We see a President and administration that is incompetent and promotes lack of experience and expertise as virtues. We see a President and cabinet with extraordinary ties to the country's main adversary – Russia. We see the growing list of government and campaign officials who have in one way or another been knocked down due to their foreign connections – National Security Advisor General Mike Flynn, Attorney-General Jeff Sessions, House Intelligence Committee Chairman Devin Nunes, Trump Campaign Chairman Paul Manafort, Trump Campaign Foreign Policy Advisor Carter Page and so on. Logic leads us to expect that the current Congressional and FBI investigations will lead to unprecedented revelations and troubles for the President of the United States and his administration.

As if the issues listed above were not enough, we envision geo-political and military missteps by this undisciplined, intemperate and tempestuous President. Taken together, the domestic political issues and the foreign politico-military issues represent very significant risks to the US and its currency.

South Africa has a similarly compromised and problematic President and administration. We go into South African issues in some detail below.

The upshot of the above is that gold currently offers incredible optionality at the current time. Were things to unravel politically for President Trump and his administration, or militarily for the US in its adventures abroad, for example with North Korea, the Dollar could suffer and gold could start realizing considerable optionality value. Much the same can be said in South Africa for President Zuma and the Rand as it relates to gold. Punishment for rating downgrades and a nuclear-build deal could spell big trouble for the Rand and much optionality value being realized for gold. We think that it's an opportunity in gold not to be missed. Seize the moment!

South Africa

Our longer term clients know that we have been opining about the Zuma government and South Africa's credit ratings for a long time.

In our Second Quarter 2016 report (go to www.sabullion.co.za) we focused on ratings and advised that: "The three major rating agencies, namely S&P, Moody's and Fitch, all have South Africa teetering on a rating of BBB-". We also said: "we see an economy that is suffering under troubled global growth and awful political management. Compounding those woes is the likelihood of a ratings downgrade that would set the cat amongst the pigeons... We see cash in the bank in South Africa as a certain bet for losing money...The full faith and credit of the US government, and more so, that of the South African government, is, for us, eroding before our eyes. For years we have been advocating 'gold rather than cash in the bank'."

Junked

On Friday 31 March we awoke to the news that President Zuma had fired Finance Minister Pravin Gordhan. It was this Minister who stood between the President and his patently nefarious intentions, most notably his secretive and likely highly-corrupt, nuclear-build deal with Russia.

On the following Monday S&P Global Ratings cut South Africa's foreign debt to BBB-, or 'junk status'. On the following Friday Fitch Ratings downgraded all South African government debt to junk. As the second junk rating, South Africa's junk status became official and this automatically triggered the downgrading of all of South Africa's banks to junk (banks cannot be rated higher than their national governments). So far, in the early days of this developing tragedy, the Rand (and therefore the country) has lost approximately 12% of its value.

What is the background?
The government of South Africa lives way beyond its means. In the last financial year government expenditure amounted to R1,445.2 billion, while revenue fell far short at R1,297.3 billion. This enormous shortfall of R147.9 billion represents a staggering budget deficit of 11.4%. (source: www.treasury.gov.za). This shortfall has to be financed by borrowings from the private sector i.e. banks, insurance companies, pension funds and such like. Consider that over and above all taxes raised, this means that the South African government has had to borrow R740 million every business day of the year in order to keep the wheels turning.

As a credit addict, it is important for the government to be able to:

1. access credit;
2. access credit at the lowest possible interest rates; and
3. not fall into a debt trap (where it becomes impossible to even service interest).

In the huge and highly organized capital markets, where government and other forms of institutional debt are traded, buyers and sellers of debt rely on professional assessment of the risks associated with the various debt instruments on offer. This means that the creditworthiness and trustworthiness of the debtors are scrutinized and assessed. This is the work of rating agencies.

Ratings agencies are companies that are employed by the debtors so as to come up with assessments of their debt. The South African government pays S&P, Fitch and Moodys very large sums of money to come up with their risk reports – or ratings. These ratings (available on the agency websites) are then used by institutions in deciding their capacity for South African government debt instruments, and furthermore in determining the rate of interest that will satisfy them for taking on the associated financial risks.

Why and how this unholy mess?
The economy of South Africa has been appallingly mismanaged by the Zuma government from the outset. Government has been openly hostile to business and has consistently eroded business confidence. Meanwhile, government has become increasingly a racket, plagued by nepotism, corruption and maladministration. Zuma has constructed an idiocracy built on patronage and in this way been able to remain in power while he dismantles Chapter 9 institutions and deflects blame.

Finance Minister Gordhan, his deputy Mcebisi Jonas, Director General Lungisa Fuzile and the senior team were seen as the last bulwark between the Gupta-controlled president and the Treasury. It was this team that would not sign off on an irrational nuclear-build program and various other dubious projects. With this entire team now out of the way, the great worry for the nation is that it will become committed to unaffordable programs that will make the scale and corruption of the infamous Arms Deal seem minor.

What now?

Most international pension funds, insurance companies and other institutional investors have rules that prohibit investment in junk bonds. Typically their policies require them to disinvest from newly junk-rated bonds in less than a year.

The new junk status will ensure that government access to the capital markets will shrink dramatically. This means that government will have to do business with more speculative, and therefore more expensive, lenders of capital. The cost of new borrowings will therefore go up significantly, and compounding the problem is the lack of institutional skills and capacity at Treasury in convincing lenders to take on new South African debt.

President Zuma and his acolytes continue to show their disrespect of rating agencies and western capital. This is very unwise. In a contest of who-needs-who-more, the answers are simple. Zuma has made a big mistake. He may learn the error of his ways soon when the pool of credit shrinks away from South Africa's shores and civil servants, social grants and SOEs run into funding problems.

Then what?

Government enterprises will suffer from funding cuts and will be forced to shrink the workforce and programs.

Firms that do business with the state will find less opportunity for contract work as funds dry up. These firms will come under pressure and lay off workers. The jobs market will get tougher and household income will shrink. Many firms will get wound up.

Interest rates linked to bond yields will go up. All private sector borrowings, such as homeloans, will become more expensive to service.

The bank downgrades will ensure that cost of capital for banks will go up. This will make borrowing from the bank more expensive and more difficult to obtain as less credit becomes available.

Businesses will become less viable. Marginal businesses will go insolvent and close. Unemployment will rise.

The Rand will weaken and oil and all imported goods will become significantly more expensive. The petrol price will rise a lot, soon.

Inflation will rise well above the Reserve Bank's target range and this will put pressure on the central bank to increase interest rates.

How does South Africa self-rectify?

Junk status is very bad for South Africa and for Zuma. The President's mistake is enormous and cannot be fixed by him. Unfortunately, his political party, the once illustrious ANC, is in crisis and unable to fix (or even recognize!) this self-engineered set of problems due to Zuma's polarizing of its ranks. The replacement people at Treasury will not be able to fix the problems, even if they are not Zuma stooges who will commit the country to a ruinous deal with Russia.

The likelihood is long term economic recession with increasing clamor by the poor for populist (and self-defeating) policies. In a good scenario the nation and its people will suffer economic hardship while inflation and currency depreciation accelerate. And then under good leadership the country will rise slowly until in 20 years' time it is again able to acquire an investment-grade rating and a new era of vitality will begin. In a bad scenario South Africa will have new leaders who will protect Zuma and his nuclear-build legacy, the Rand will decline considerably, SOE's and social programs will shrink and perhaps collapse, and the country will rapidly get to resemble most other African states.

SA Bullion news

SA Bullion conducted a Johannesburg roadshow in March. Presentations were made to various financial advisory firms and culminated in an excellent evening seminar with Luthuli Capital – of whom we have only the highest opinion.

Less exciting news is that the firm was attacked (legally-speaking) by the South African subsidiary of a Bahraini banking group for trademark infringement concerning our muslim-tailored, halaal product BarakaGold Facilty. These matters are complicated and exasperating even with reasonable prospects of success. With a complete picture the company made the decision to draw a line under the matter and change the product name. Under the stewardship of SA Bullion director Imran O'Brien, and with the assistance of our agency Unisoul (and in particular Zach Sonday) and the guidance of our special advisor Prof Yasin Dutton we are delighted to have settled on HasanaGold Facility. We love the name and our trademark attorneys assure us we are in the clear!

Hasana - your good deeds and virtuous actions

Hilton Davies
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