GOLD & ENERGY INVESTOR

Newsletter #128 **July 2015**

What Happens If There is No Iranian Nuke Deal?

Source: www.aim.org

A framework to lift Iranian sanction was agreed upon in early April, but the details are being written and need to be agreed upon. At the time of this writing, there is a strong possibility that the deal could fall through as there is strong opposition to a deal being done by some in the U.S., Iran, Israel, and neighboring Sunnis.

Also, the Iranian's parliament approved a draft that would bar inspection of military sites and access to nuclear scientists and documents. The Ayatollah Khamenei is the final authority and he has also expressed his opposition to inspections and access to scientists. This is VERY likely to be a deal breaker.

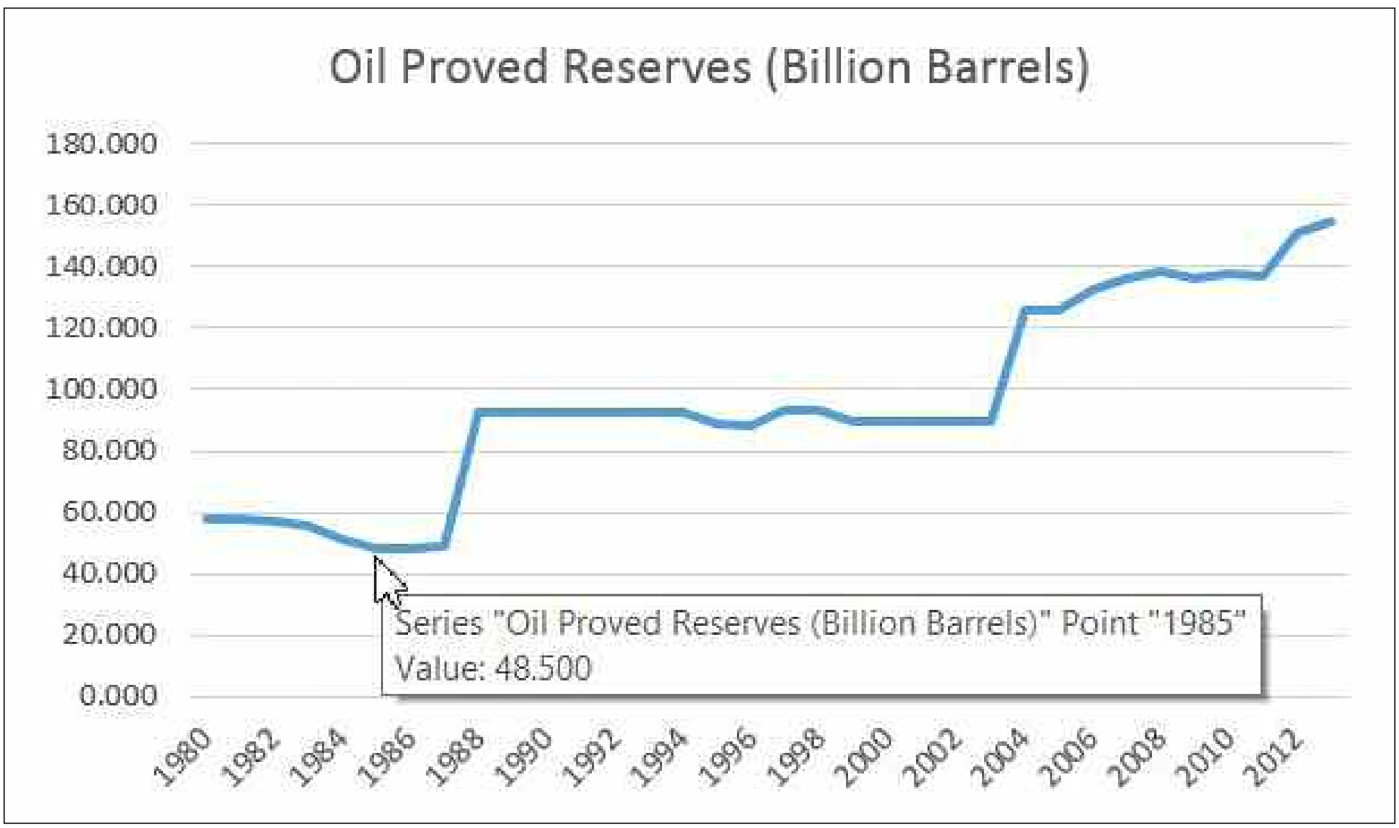
Since the oil market is tied to its production, and export is directly tied to whether Iran is once again allowed to export its oil production, we need to consider the consequences of not getting a NUKE treaty with Iran.

Here are the likely scenarios we see ahead at this point in time regarding the Iranian agreement and the increasing likelihood that deal will not come to pass, at least by the current deadline set by President Obama:

- **Most likely:** a deal agreement deadline will be extended. Impact on oil prices would be slightly bullish as new supplies from Iran would be uncertain.
- **Likely:** A deal is not approved by: the Ayatollah, the U.S. and other participants in the agreements (France, Germany, and U.K.). Russia and China are part of the negotiations but they will probably side with Iran. **Oil prices could rally as oil supplies would not change and the oil market may have priced in an agreement.**
- **Least likely:** A deal is agreed upon. Oil prices could fall, but the oil markets could be wrong. The next few sections explain why the concerns about increased oil supplies from Iran could be misplaced.

Iran's Proven Reserves

Below is a chart with Iran's proved reserves:



Source: U.S. Department of Energy EIA, Dan Hassey database

Below are the major take aways from the above chart:

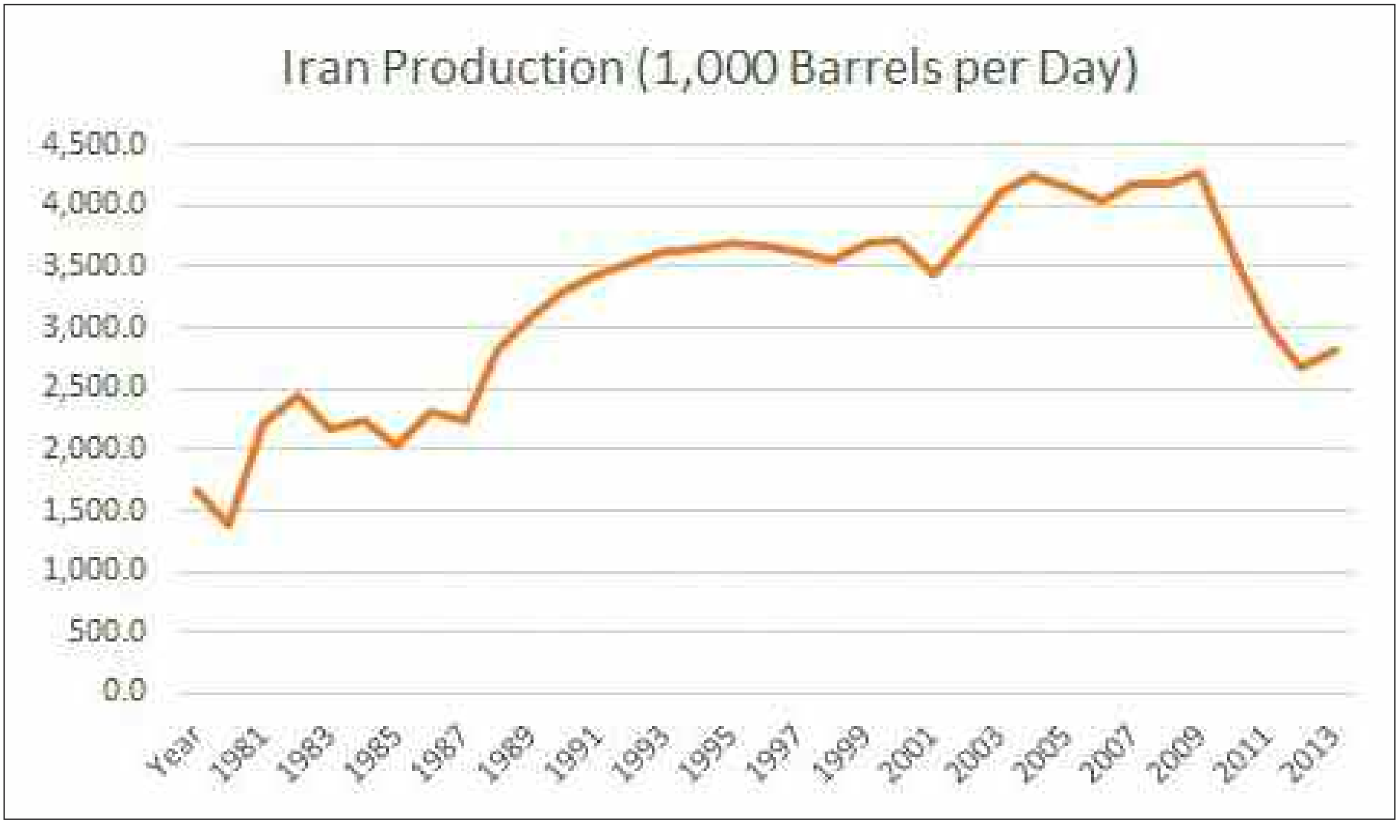
- In 1980 Iran had about 60 billion barrels of proved reserves. By 1985 Iran's reserves had fallen to about 48.5 billion barrels.
- In 1985 OPEC established a new rule that production quotas were based on proved reserves. Most OPEC members had dramatically increased the amount of reserves they reported in 1986.
- Iran, Iraq did not increase their reserves because they were busy fighting the Iran Iraq war. The war ended in 1988, and that is when Iran reported a doubling of the amount of reserves they had.

- Notice their reserves did not go down from 1988 to the early 2000s despite production increases. Most members' reserves numbers look like Iran's: a spike in the 1980s, and no drop in reserves despite increases in production. If a member reported lower reserves, their quotas would go lower, so there was an incentive to cheat.

When there are major discoveries, or when better technologies are used, normally it will be reported in the financial media or energy industry reports. This did not happen, for most OPEC reserve increased. Notice that their reserves have almost doubled again since the early 2000s. Some of the increase is probably legitimate, as oil prices rose some of their reserves became economical to produce, and those higher cost reserves can now be reported.

Iran's Oil Production Trend

Their production is reported by following the shipments of their oil exports. Below is a chart that looks at Iran's historical oil production.



Source: U.S. Department of Energy EIA, Dan Hassey database.
Iran's average production per year is about 3.2 million barrels per day.

Their production has come down due to sanctions.

I added up Iran's production since 1985, and they have produced about 61 billion barrels. So instead of having 160 billion barrels, they are probably closer to 100 billion or less. We shouldn't believe the reserves that OPEC states they have, as their production and reserve trends look the same as Iran: a dramatic jump in reserves after 1985, no decline in reserves despite increased production since 1985.

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Most analysts believe that Iran will not be able to ramp up production to their average production, about 3.2 million barrels a day until 2016. Energy analysts point out that Iran's biggest problem will probably be financing the increased production, especially at these low oil prices. They will need partners from China and from the major global oil companies. It will take some time to line up partners.

If they can get production up to 3.2 million barrels per day, about 500,000 more barrels in 2016, the extra supply could help as global oil demand is expected to increase at least one million barrels next year.

Eventually Iran can get their production to over 4 million barrels per day, the highest production in their history, but that will take more time, money and partners.

Iran is acting like the sanctions will be lifted as there are reports in the financial media that Iran is currently trying to line up partners and offering attractive partnerships and contracts. It's reported they will need about $130 billion to beef up their production from current levels and they need partners.

As I mentioned in the previous section, there are other short-term bullish catalysts for oil besides a failed Iranian sanctions agreement:

- Higher demand from summer vacations
- Hurricane season and potential supply disruptions from the Gulf of Mexico
- Instability related to wars and potential supply disruptions from the oil rich Middle East and especially Iraq
- Oil prices normally have a risk premium due to the instability of oil supplies (wars, terrorist attacks on oil supplies, weather, oil worker strikes, oil spills). Currently the risk premium for oil is not enough considering the risks to supplies
- Oil price discovery is done in the very leveraged oil futures market. Because of the leverage of the futures market, price movements tend to be exaggerated. We saw that happen with oil prices when they were over $100 last year and fell to about $43 at the bottom in March of this year.

Again, we think we could get a summer rally, so we recommended a leveraged oil ETF and an update on XOP. Here is the link for that recommendation:

http://www.goldandenergyadvisor.com/page/gez/updates/2015-06/2015-06-26-1720.html

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Is Deflation Gold's Achilles Heel?

By James DiGeorgia, with contributions from Dan Hassey and Lars Christian Haugen

Source: Princeton University Art Museum

Over the last few years, one of the main concerns plaguing investors, economists and Wall Street professionals has been the real danger of either an inflationary crisis or deflationary collapse. Gold investors have been especially sensitive to these dangers.

The gold bulls argue that the massive amount of money that's been created by the U.S. Federal Reserve, the European Central Bank (ECB) and China's massive infrastructure spending will eventually lead to a serious inflationary crisis, and consequently much higher gold prices.

The bears argue you can't eat gold. They insist the combination of the exploding government and consumer debt has helped create enormous speculative bubbles in key markets around the world including China's Real Estate and stock markets, and the U.S. stock market. The bears sincerely believe it's no longer a matter of if these speculative bubbles are going to pop, but a matter of when they will pop.

The "doom and gloom" crowd worries that when the speculative bubble bursts – a total economic collapse is guaranteed, and that will unleash an all out deflation spiral that even gold will not survive as a safe haven – and its price will drop dramatically along with paper assets.

Debating wisdom of owning gold in a deflationary environment is worthy of debate. Especially now. Because even though we are in the late stage of the current cyclical cycle that has nudged the recovery along here in the United States, the fact remains that we are STILL at greater risk of being confronted with deflation rather than overwhelmed by inflation.

Consider where our country is right now economically. Despite trillions of dollars of both new debt and the massive expansion of the Federal Reserve's ledger, i.e. monetary expansion in the last 15 years… Despite all that newly printed and created wealth, the inflation rate here in the United States is still holding under 2%. It's really remarkable.

Meanwhile in Europe, austerity has given way to a European Quantative Easing. China is showing continued signs of slowing and has triggered additional public sector projects and is approaching U.S. $3 trillion debt. Yet, China's inflation rate is just marginally higher than here in the United States.

Let's take another look at gold and consider the arguments against owning it in a deflationary period a bit closer, given the danger a deflationary crisis could create for investors.

While we're looking at gold and its relationship to deflation let's also examine why inflation remains so subdued, even as the Federal Reserve and global central banks have been so aggressively expanding the money supply.

Let's start with some background...

Different types of deflation

Deflation is often misunderstood. A deflationary crisis is a nightmarish economic condition that should be avoided at all costs. But not all deflation is bad. The truth is that there are different types of deflation. There's consumer price deflation and asset price deflation.

As a consumer, you should welcome price deflation when it is driven by technological advancement and efficiencies. New inventions and improvements in all areas of the manufacturing and services in the commercial goods sector can drive prices sharply lower.

Technological advancements, for example, over the last few decades, have resulted in widespread ownership of faster, more efficient smartphones, laptops, etc. An Apple iPhone 6 has exponentially more computing power than the iPhone 4 for roughly the same money. This type of deflation, driven by innovation is almost always a big positive.

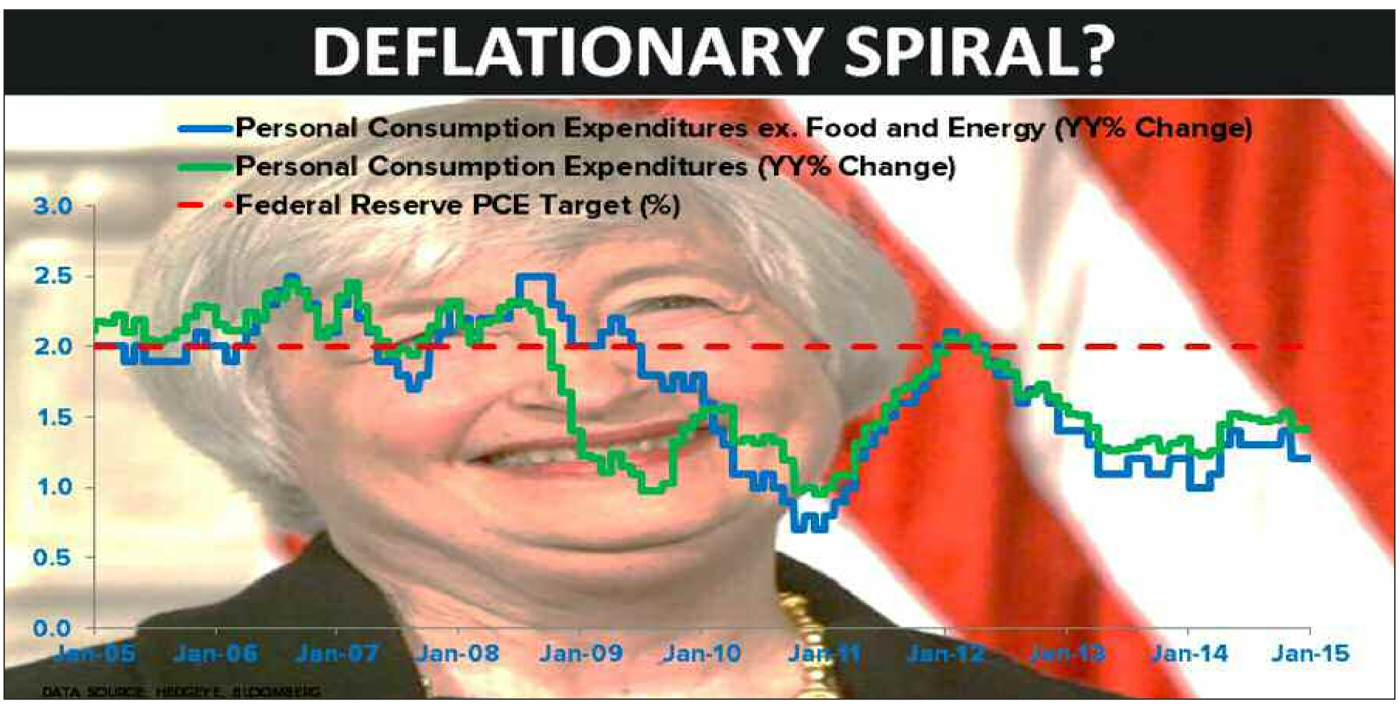
On the other hand, if you have asset price deflation, the experience is entirely destructive. The housing crash of ‘07-’08, which was further exacerbated by the Financial Crisis of 2008-2009 here in the United States sent a deflationary shock wave through the U.S. and worldwide economy. Mortgage defaults hit record highs and both commercial and residential real estate prices collapsed; worse, many properties were completely illiquid.

This deflationary wave in real estate and the nose dive in stock prices that accompanied the horrors of the 2008-2009 financial crisis immediately triggered millions of job losses in the first 6 months of the crisis. It was, to say the least, the definition of an economic meltdown.

Before the ’08-’09 financial crisis, all you have to do is look back to the crash in the stock market in 2000, that also set off a deflationary environment, albeit nowhere as severe as either the Great Depression or this last crisis. Yet, there was severe economic dislocation.

The jobless rate climbed sharply. Cities like New York and Chicago saw real estate prices fall as much as 20% in the months following the “Tech Crash” of 2000. The impact of the asset deflation (stock meltdown) was felt from London to Hong Kong, from Tokyo to Paris. The deflationary pain, as is so often the case, in this growing economically dependent and interconnected world.

The most dangerous part of asset price deflation is that it can lead to debt and credit deflation. Without getting into too much detail, our monetary system is based on credit and today credit is money. Just think of how you can use your credit card to pay for goods with money you have not earned yet.



If asset prices fall and people default on their debts, the amount of credit (or money) in the system decreases. This kind of deflationary event is extremely destructive. The most well known deflationary time was during our country’s 1930s Great Depression.

The stock market crash of 1929 is often pointed to as the beginning of the Great Depression. Yet, it really took more than a year for the crisis to take hold of the entire country. The ’29 market crash lit the fuse that set off nationwide job losses which triggered an overwhelming amount of consumer debt and mortgage defaults.

Each week, both unemployment and the number of banks that failed grew. In truth, The Great Depression unfolded across this country after the speculative bubble – which was incredibly exaggerated by cheap and easy credit – finally burst, the economic pain became so widespread, the Great Depression became unavoidable.

Policymakers here in the United States have been absolutely terrified of deflation since the 1930s. When the 2008-2009 financial crisis exploded on Wall Street, U.S. officials did everything to avoid the same deflationary death spiral that followed the 1929 stock market crash.

Instead of reducing and tightening money supply, like they did during the Great Depression, economic policy makers at the Federal Reserve confronted the crisis with a multi-trillion dollar expansion of credit. The Fed and politicians in Washington pumped literally trillions of dollars of credit into the banking system and economy to stave off a deflationary disaster – or at worst delayed it these past 6 years.

The Current Inflation/Deflation Tug of War

The low inflation rate here in the United States and rising value of the U.S. Dollar versus other currencies of the world has allowed the Federal Reserve to expand credit and provide the liquidity to fuel the current economic recovery – though sluggish.

The vast majority of history, to fall back on, clearly shows that monetary expansion like we have seen here in the United States should have resulted in inflation. It hasn’t occurred because the truth is global economic conditions, Middle-East wars and terrorism have driven investors to hold U.S. Dollars under the theory that our currency is the best of the worst.

The strength of the dollar has camouflaged the massive amount of newly created dollars. Even as the U.S. Federal Debt climbs towards $20 Trillion, the Dollar continues rise. The longer the Federal Reserve can maintain this accommodative monetary policy, the more investors will come to believe the day of reckoning will never come. Drunk on credit, people continue to see the U.S. economy improve without any consequences.

Still, it isn’t all about the best looking sister in a room full of spinsters – another likely reason why massive monetary creation in the United States has not led to higher inflation.

Deflation is a cruel contagion that hammers the velocity of money, slows commerce, credit origination down to a crawl. As you can see in the chart below the velocity of money slows, and can be extremely deflationary.

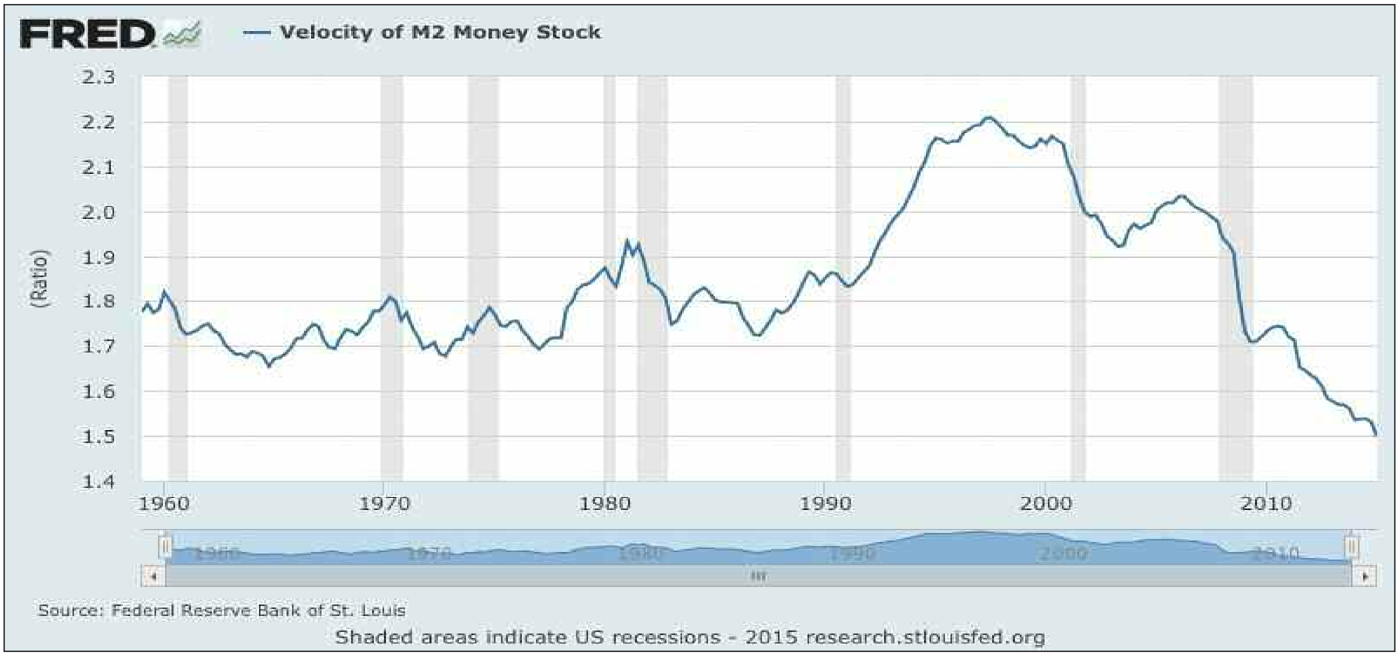
On the other hand, if more money and credit are being created but not being haphazardly deployed (spent) the deflationary pressure can be reduced. That’s the policy Janet Yellen and Ben Bernanke have pursued in the wake of the ’08-’09 financial crisis. As the deflationary wave that became so apparent in the wake of the crisis, the Fed provided as much liquidity as it could.

Liquidity increased money supply and credit; where it goes can be extremely important in the creation of both deflation and inflation. The debate centers around where the money goes.

If it goes to the expansion of goods created and services provided, the risk of inflation grows. If the liquidity is funneled into a major speculative bubble that leads to another severe recession, that could lead to a deflationary crisis.

Considering the record prices for diamonds and non-numismatic collectables have been bringing, this may be one of the places wealth is being stored and a reason inflation remains tame.

Below is a chart for the Velocity of Money



Source: Federal Reserve Bank of St. Louis

Normally, when the velocity of money increases, inflation is created (too many dollars chase too few goods). When velocity decreases, it normally means consumers aren't spending, and less spending could lead to deflation.

If we look at total credit outstanding in the U.S., it took a dip in '08-'09, but has been on a steep upward trajectory since then, which is inflationary (chart below).

Source: Federal Reserve Bank of St. Louis

Gold is an integral part of the inflation/deflation debate because the price of gold moves depending on the amount of dollars in existence. If we have inflation, there should be more dollars in circulation and a higher gold price. If we have deflation, there should be less dollars in circulation and we should have a lower gold price. Before we go into the analysis of whether we will have inflation or deflation, and how gold will react, it's important to understand gold.

Understanding gold

Gold, despite being universally recognized, remains one of the most misunderstood assets in the world. Today, the yellow metal is enjoyed by billions of people as jewelry, used in industry, and coveted as the only true form of money that has existed for over 5,000 years.

Throughout history, other things have been money as well, such as seashells, beads, grains, livestock, etc. However, gold has remained and survived as the premier store of wealth by pauper and king alike for few good reasons:

Reason #1: Gold is nearly indestructible, so it is a good store of value.

Reason#2: Gold is easily divisible, you can divide it up into smaller pieces that are easier to carry and exchange.

Reason#3: Gold is portable. It allows people to move great sums of money quickly and easily.

Reason #4: Gold is always liquid and recognized by most of the 7 billion people on this planet. There are always ready and willing merchants, farmers and service providers willing to accept gold as payment.

Reason #5: The amount of new gold production world-wide is declining. There haven't been any major new gold discoveries in more than 15 years. The few claimed have turned out to be scandalous frauds and scams.

Reason #6: There's an unlimited amount of paper that can be turned into fiat money while the world's supply of gold is very limited. Bottom line, we'll run out of gold long before the central Bankers of the world run out of ink!

Now that we understand gold we can explain why one of the most commonly held beliefs about gold is actually wrong.

Is gold really an inflation hedge?

Gold is generally considered an inflation hedge. But if that is the case, why did gold go from $250 during the beginning of last decade – which is not considered a high-inflation period – to a high of around $1,900 in 2011?

The truth is that gold is not primarily an inflation hedge, but a currency debasement hedge. As I mentioned in the section above, gold is measured in terms of currency (bank notes) so when more currency is put into circulation the purchasing power of each unit of currency decreases. The price of gold, in terms of the currency, will therefore increase.

In such a scenario, it's not only gold that will increase in price, but most other products as well, because a higher amount of currency is chasing the same amount of goods. Inflation is therefore just a symptom of a debased currency, but it is not the real reason why gold, or other goods, increase in price.

Although gold is primarily a hedge against currency debasement, it's also seen as a hedge against potential disasters. The metal is seen as a safe haven, so if people start to get nervous about world affairs, they might buy gold to protect themselves against a disaster. Hence the saying "buy guns and gold" if you think something bad is going to happen in the world. When a severe currency debasement takes place, it's so disruptive that it's usually coupled with a disaster (think Weimar Germany in the 1920s). Therefore currency debasement and financial disasters usually go hand in hand.

What will happen to gold if we have deflation?

If gold prices increase when the supply of currency also increases, the currency value should decrease. Conversely when the supply of currency decreases.

In a deflationary period such as the 1930s, the amount of currency decreased, and the price of gold should have decreased. But that did not happen. Several studies of asset valuations during the Great Depression, however, showed that gold was actually being hoarded by Americans and increased in value. This lead to President Roosevelt's Executive Order outlawing private gold ownership, and set in motion the Federal Government's gold confiscation in 1933.

After confiscating American citizenry's gold, the United States government raised the official price of gold from $20.67 per ounce to $35 dollars an ounce. Without the burden of having to exchange paper dollars for gold on demand, the Roosevelt Administration could fund thousands of work projects around the country in an effort to get the U.S. economy on the road to recovery.

Many will argue that the advent of World War II was what really pulled our country out of the depression. What no one can argue about is the fact that gold actually appreciated 75% i.e. $20.67 to $35 literally around the world, thanks to Roosevelt's gold recall and the declining Dollar valuation.

In the absence of a viable currency, when money becomes worthless, even suspect, humans from Hong Kong to Kiev, from Zurich to London and all around the world gravitate to gold.

Regardless of the crisis; everything from plagues to wars, from economic collapses to a hyperinflationary crisis, and economic panics, gold has always maintained its purchasing power, regardless of whether the threat was deflationary or inflationary.

The arguments against gold

I've presented some of the strongest arguments for gold ownership but there are risks also. A strong U.S. Dollar is always a negative for gold. Like Kryptonite to Superman, gold is always weakened by a rising U.S. Dollar because gold, like oil, is universally traded in the U.S. Dollar.

The Federal Reserve's impending interest rate hikes could further strengthen the Dollar and exacerbate the decline in the current low world market gold price. Moreover, some economists warn the world-wide expansion of money supply led by Europe and China will serve to further strengthen the Dollar, and weaken gold prices further. But the downside is very limited.

Below is a chart of the Dollar index (a basket of currencies of our major trading partners):

The Dollar is up about 30% since its low made in 2011.

Again, some investors and analysts believe the Dollar will move higher and gold has further to fall. This is the wrong conclusion: according to the chart above, the Dollar is already up about 30% and gold is down even more during the same period; the stronger U.S. economy and the expectation that rates will rise is probably priced into the Dollar and gold already.

Also, in the past, when the Dollar made a significant bullish move, it was based on much stronger economic growth and much higher interest rates. The Dollar is probably close to fair value. Any higher and the Dollar becomes overvalued.

The fact is that gold does have a floor price. The cost of production of an ounce of gold is about $1,000, so logically gold should not move far below $1,000 an ounce. At below the $1,000 level, gold production around the world would shut down.

Miners will close down their mines. That's what's happening in the copper and uranium sectors. The price of uranium has been below the cost of mining it for quite a few years in wake of the Fukushima Nuclear disaster and the resulting mass shutdown of nuclear power plants in Japan, the supply of new Uranium mined and prospected has declined dramatically.

We're also seeing it in the oil industry with the collapse in oil prices. Capital spending has been cut dramatically, the rig count has fallen about 50%, we are seeing production start to slow, and future production will probably start to fall. Equilibrium should be found with lower prices and slower growth in production.

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Conclusion for Gold, Inflation/Deflation

There are currently both inflationary and deflationary forces at play in the economy. Credit is expanding, which by definition is inflationary. Additionally, asset prices have been rising sharply the last few years. On the flip side, velocity of money is decreasing and many experts argue we are in a debt-deflation cycle (people and companies are deleveraging, which is deflationary).

However, eventually, there will be another market crash, and when that happens, it will be deflationary. In the crisis of ’08, the problem was too much debt and after the crisis, credit started contracting, which was deflationary. The Fed counteracted this by pumping more base money into the economy and today, total credit is much higher than it was seven years ago. When the new crisis hits, the outcome might therefore be worse than in 2008 and the ensuing deflationary credit contraction might be more severe.

It’s the policy makers’ reaction to the next crisis that will likely determine the future trajectory of gold. If they are committed to inflation, gold should do well in the years ahead, but if they are not able to fight the deflation, gold investors may be disappointed.

Furthermore, there are currently negative forces working against gold, such as a stronger Dollar and possible rate hikes. It is, therefore, impossible to predict what will actually happen in the years ahead. But I would assign a bigger probability to further currency debasement and consequently a higher gold price.

In my opinion, it is therefore prudent to hold and own large amounts of gold because its legitimately the only reliable form of money in a deflation or inflation crisis!

Short Term Outlook for Dollar, Oil and Energy Stocks

The GEA portfolio has fourteen energy stock positions, so let’s see what the short-term outlook is for energy stocks. Before we look at energy stocks, it’s important that we first look at the Dollar and oil.

U.S. Dollar

The Dollar’s rally peaked in March, and is about 6% below its peak. Below is a chart of the Dollar index:

The Dollar index is a portfolio of the currencies of our major trading partners.

Again, the Dollar peaked in March and is developing a bearish descending triangle, participants are selling the rallies.

It would be normal for prices to break support, 93, and establish a new lower support.

It’s also possible that prices remain in its current trading range, with resistance at about 100 and support at about 93.

At best, we can expect the Dollar to remain in its trading range for the foreseeable future.

Fundamentally, as I write about above, the Dollar has discounted the rise in rates and a U.S. economy that is growing faster than other developed economies in the world.

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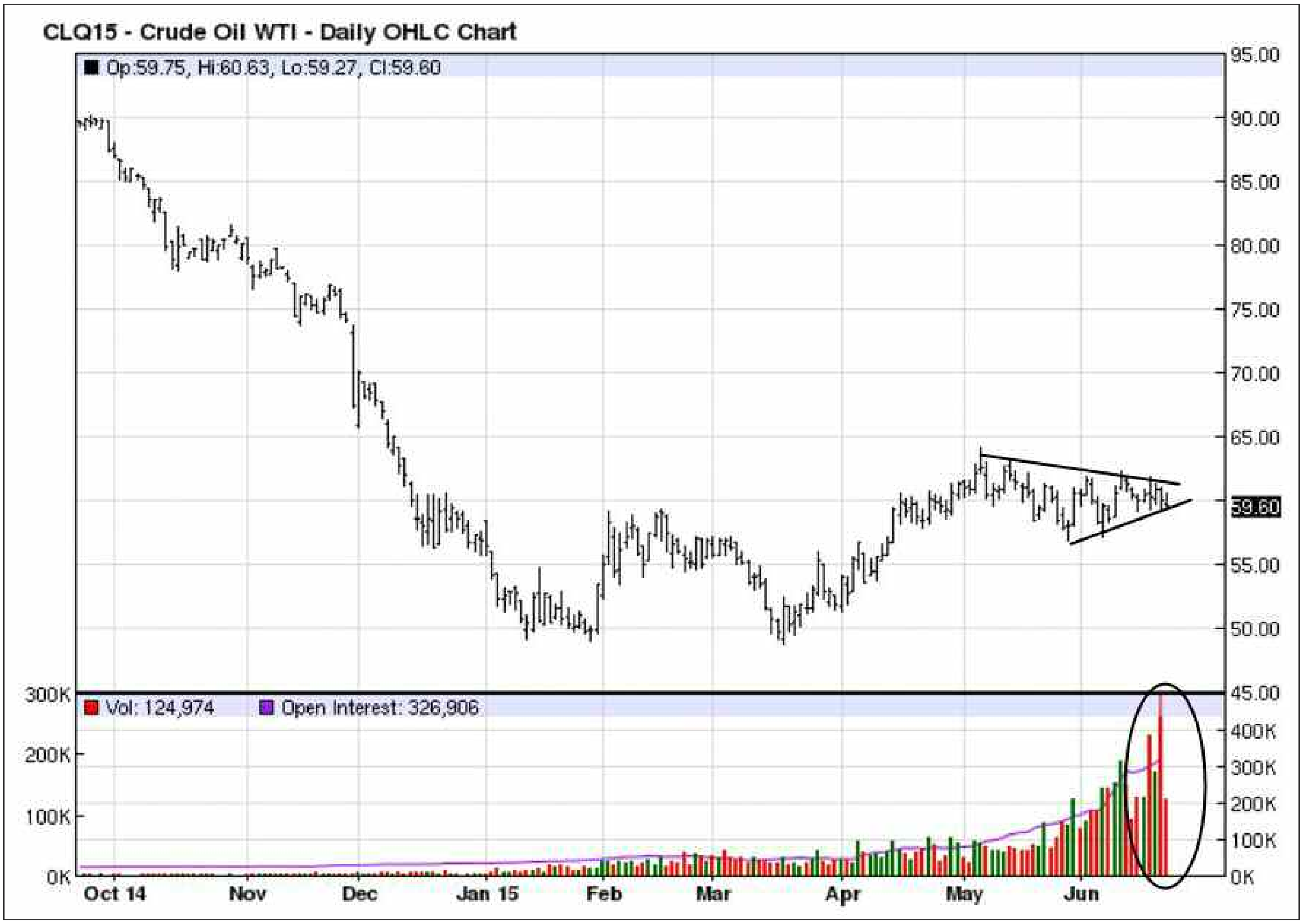
Oil

Oil companies have substantially cut capital spending, the rig count has dropped from around 1,858 last year to about 857 last week, and thousands of oil workers have been laid off.

We are starting to see production growth slow, and we may see actual production fall by the end of the year, especially if prices stay low.

Low prices, and the summer vacation season are expected to increase oil demand.

Below is a chart that shows the price action of oil:



Oil found a bottom in January and the bottom was tested in March.

Oil prices are up about 30% from their lows.

Prices have now formed a higher, narrow trading range. This pattern could be deemed bullish as participants aren't selling, getting out of oil. There was a lot of selling last week, but it did not result in prices moving down.

Normally, when we have a narrow trading range like this, prices are taking a pause and could resume its previous move. In this case the previous move was a rally.

The summer vacation and Gulf of Mexico hurricane season (about 25% of U.S. energy needs come from the Gulf of Mexico region), and participants not getting out of their oil positions mean oil prices could continue the rally that started in March.

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Energy Exploration and Production ETF, Symbol XOP

With the Dollar trading in a range, and oil looking like it is setting up for a summer rally, oil stocks could follow oil.

Here is a chart for the XOP:

Notice how profit taking occurred last month after the rally that started in January.

Oil does look stronger, as it does not have the profit taking that oil stocks have had.

It’s possible that if oil breaks out of its current range, it could take energy stocks with it.

We do want to sell most of our positions during the summer, before vacation and hurricane season ends.

If we don’t get a summer rally, we will have to be more active and buy and sell the current support and resistance price levels.

Another catalyst for energy stocks is bargain hunting. Most energy stocks are down substantially and represent some of the best value in a market that is fair to overvalued.

Good luck and best wishes,

James DiGeorgia

For the best buy and sell gold prices, call my rare coin company **Finest Known, LLC**, located in Boca Raton, Florida, at 1-866-697-4653 ext. 11038 or ext. 11406.

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