SEABRIDGE GOLD

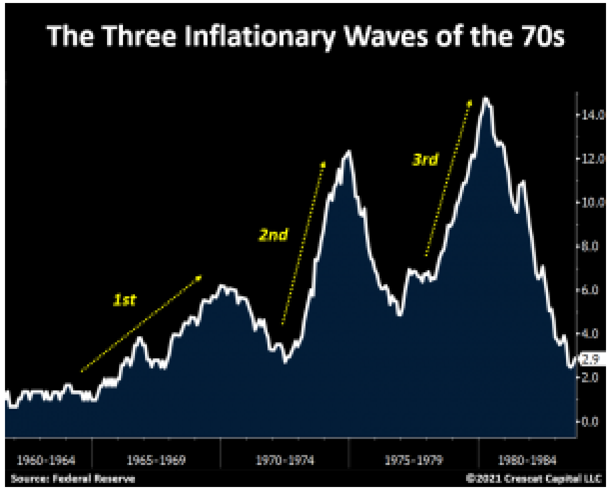
GOLD MARKET UPDATE

October 2, 2023

THE CASE FOR GOLD

The Economic Argument

- The gold price is all about confidence in the dollar. Confidence in the dollar depends upon confidence in the Fed…that they have inflation under control and raising rates will not cause a recession. The higher for longer narrative has been a real headwind for gold. We think both of these assumptions will prove wrong.
- Inflation has likely bottomed. Underinvestment in commodities is beginning to drive shortages. Energy prices are on the way up again. Food prices and shortages are on the rise worldwide with key producers now freezing exports. Wage settlements are soaring in the unionized sector where wage-price inflation usually starts.
- If you look at the inflationary periods of the past, the one right after WW2 and the one in the 1970s, they occurred in three waves. We have only seen wave one.



THE ECONOMIC ARGUMENT (CONTINUED)

- As for a recession, every historical predictor has been flashing red for months, from the yield curve at historical extremes to 16 straight months of falling leading market indicators. The recession has been delayed by the extreme money printing during the pandemic shutdown and the fact many businesses termed out their borrowings for 2-3 plus years in 2021 when interest rates were at 5,000-year lows. Every day, higher rates chew their way further into the economy where an estimated 37% of US businesses do not generate net free cash flow. Corporate and individual bankruptcies are already at 2009 (GFC) levels.

Figure 15.
Corporate Sector's External Financing Needs

- The key turning point for gold will come when the Fed abandons its monetary tightening policy. The so-called pivot. A recession will do that. But there are issues more pressing that are likely to happen sooner.

A SOVEREIGN DEBT CRISIS #1 FUNDING THE DEFICIT

The Fed's top priority is the stability of the credit market and especially Treasuries. There are two challenges that markets are not yet appreciating.

The first is the soaring size of the US deficit which is now running at 8% of GDP before we even get a recession. The last quarterly Treasury funding schedule released last month was a shocker as it showed the need to raise another $1.5T by calendar year end, up about a third form the previous quarterly estimate. Included was the projection that annualized Treasury interest expense will likely hit $1T by year end. Interest expense keeps rising as Fed rate hikes work their way through the $34T debt as it matures and rolls over.

A $2T deficit next year (assuming no recession) + $1-2T in net foreign UST selling if USD stays here or oil stays here, more if either rises + $1.2T in Fed QT + $5T in UST refinancings next year has to be absorbed.

Leave out the refinancings for the moment: private markets must absorb $2T + $1-2T + $1.2T = $4.2-5.2T in net effective new UST issuance markets or $350-$430B per MONTH… assuming no hedge fund UST sales…and with the US government needing to roll an additional $5T on top of that.

Can it be done without the Fed? We don't think so. Commercial banks are no longer buying, in fact they are selling too. Hedge funds have stepped in to replace them as market makers. You don't want the world's most important market depending on hedge funds reportedly using up to 500Xs leverage to play the so-called basis game. And that's the second issue that could trigger a sovereign debt issue.

SOVEREIGN DEBT CRISIS #2: LEVERAGE

Balanced on a knife edge? From http://ft.com as reported by @LukeGromen

Hedge funds have been playing an increasingly important role in the functioning of the Treasury market in recent years. Primary dealers, the 24 banks that transact directly with the Treasury department and facilitate trading for investors, have pulled back from their role since 2008, deterred by rules that have made it more expensive for them to hold bonds. As the Treasury market has grown — from about $5T at the start of 2008 to $25T today — hedge funds and high-speed traders, which are less transparent and less tightly regulated than banks, have picked up the slack… They now play an essential role, buying bonds and making prices for other investors, partly through the basis trade. {The Treasury basis trade is an arbitrage trade to take advantage of tiny price differentials between Treasury futures and Treasury cash bonds}

Because Treasuries are considered the highest quality collateral, the prime brokerage divisions of major Wall Street banks are happy to lend against them, often at their full-face value rather than a slight discount. In the repo market — short-term lending that facilitates a lot of Treasury trading — hedge funds need to post only small amounts of cash against their credit lines, sometimes levering up by more than 100 times...

There is borrowing on the other side of the trade too; futures are inherently leveraged products and again, hedge funds need to put up only a small amount of collateral to satisfy the margin requirements of futures exchanges. Ten-year Treasury futures offered by US exchange group CME allow trades of up to 54 times the cash margin posted, for instance...

By taking advantage of the ability to borrow on both sides of the trade, hedge funds can deploy huge leverage. The head of one fund that has engaged in this trade says traders have in the past been able to lever up to 500 times."

Can we see how a rapid unwind by a large unregulated hedge fund blowing up the global financial market? Or have we forgotten the Long-Term Capital Management fiasco?

A sovereign debt crisis will bring massive instant Fed liquidity injections as it did in September 2019 when liquidity issues in credit including a freeze up in interbank lending and the high yield markets led to a $1T tsunami of repo money (but not QE as we were reminded!).

We think a recent warning by economist Peter Boockvar will prove to be prescient:

"Things don't really break here in terms of the US government finances being treated by the marketplace like an emerging market…as it should…until the US dollar breaks. When you see US rates rising in addition to the US dollar falling, that's when we're in real trouble."