Ukrainian economic woes and Eurozone fears could lead to negotiated solution with Russia

The economy in Ukraine is collapsing and inflation has reached 17%. Its currency, the Hryvnia, has suffered the worst performance of the year, losing 48% against the US Dollar, in the world and, unless foreign aid arrives promptly, a default is expected. Ukraine's civil has had tragic effects on the economy and expectations of GDP having fallen 7.5% in 2014 are optimistic, while the central Bank expects even worse performance in 2015. In order to avoid a sovereign default, the European Union estimates that Kiev would need a USD$ 15 billion injection and Prime Minister Arseniy Yatsenyuk has already found it very difficult to obtain even a fraction of that as he considers the holding of a donors' conference. In this scenario, the International Monetary Fund has already allocated a USD$ 17 billion rescue package. What is especially troubling is that, despite the desperate financial condition, the government has forecast an increase in military spending of 5.2% and a cut in social spending to ease the burden on the state budget, while the imports "non-essential" duties will be doubled to 10%. Ukraine's dire economic situation plays into a complex geopolitical scenario that contains the seeds of a thaw in relations between itself and Russia and Russia with the West.

In recent weeks it has also learned that Ukraine has almost completely dried up its gold reserves from March to today, demonstrating the seriousness of the financial and currency crisis. Gold reserves in Ukraine are at the lowest levels since August of 2005, a decrease of 45% in 8 months. In contrast, while Ukraine has almost wiped out its gold reserves, Russia has continued to buy back, coming to 1,187.5 tons in November. Since 2005, Moscow has tripled its gold reserves, bringing them to the highest levels since 1993, suggesting that central banks, beyond Western Europe and North America, still have appetite for the shiny metal. Therefore, as hard as the situation may be for Russia, facing international sanctions and de-facto isolation from the West, Ukraine's financial situation is far worse. Indeed, the new government, which replaced the one led by former President Yanukovich a year ago in a US and European Union supported coup, Ukraine has proven unable to control and stabilize the internal political and economic situation, while becoming a virtual tool of foreign geopolitical interests and machinations. The good news is that, given its precarious financial condition, Ukraine will be forced to reach some kind of negotiated settlement with Russia in 2015 rather than risking default and the spreading of the conflict. Russia shares this interest because, the pursuit of a more intense military option is out of the question – apart from the cost, it would risk inviting additional encroachment from NATO powers. Surely, Russia will be in recession, but it should be able to avoid a default despite a predicted 4% drop in GDP for 2015.

President Putin said that Russia's economy will adjust gradually to the new level of oil prices. Therefore, while Russians can continue to expect bad economic conditions in 2015, a recovery should start in 2016; neither Ukraine or Russia stand to gain militarily or politically from a perpetuation of the war while the European Union will be overly preoccupied with 'Euro' exits to continue sustaining Ukraine. European investors – and voters – are weary of the volatility and increased risk resulting from a very possible Greek exit from the Eurozone: a 'Grexit' as some have called it. Doubtless, Greece represents a very small part of the Eurozone economy but even the departure of a small economy from the Euro would generate several problems from the ‘mathematical’ standpoint in the short term. The prospect of a Greek exit is a kind of ‘black hole’ of risk, because no one has ever come out from the Euro, and no one has ever suggested the release of the Eurozone economy. This uncertainty creates market volatility, a self-feeding mechanism that will inevitably force the European Central Bank to intervene to calm the markets. This possibility will reduce the appetite for foreign adventurism in the EU, leaving Ukraine more isolated. Russia, in turn, will fare better later in 2015 because the low oil prices that have so fiercely targeted its resource economy are unsustainable in the long term, despite recent Saudi rhetoric.

The price of oil is too low for OPEC, which will surely cut production in order to cause prices to rebound to at least USD$ 70-80 per barrel – it seems to be a fairly realistic number in the medium term. Therefore, Russia will be in a stronger position than Ukraine, which will be left with the ultimate responsibility to find a solution, even if it means leaving a part of itself to Russia. The conditions point to such a solution to emerge before the end of 2015 but, in geopolitics, there are many uncertainties and it could take longer. The more optimistic timeline for a solution is backed by the fact that France has already stated that it would stop sanctions against Russia in view of a continued diplomatic effort aimed at easing dialogue between Kiev and Moscow. Last December 6, France’s President Hollande held a surprise meeting with Putin in Moscow upon returning to Paris from a trip to Kazakhstan. Many other EU powers are eager to lift sanctions as well and it will not be difficult to convince the EU as a whole to suspend or ease sanctions in order not to cripple Russia in return for the intensification of negotiations with Kiev. On January 15, there will be a big test in this direction as the French, Russian and Ukrainian will shake hands to create a compromise to restore peace. That solution, which should be satisfactory to the White House (if not a Republican interventionist Congress), will likely see a deal whereby Russia will stop supporting pro-Russian Ukrainian separatists in exchange for full recognition of Russia's ownership of the Crimean peninsula plus any eventual reparations (in the form of gas supplies?). And then the ice between Russia and the West will break.

Sanctions against Russia ignore the real politik of the markets

The crisis in Ukraine, which started around last November, has intensified and exacerbated tensions between Russia and NATO to a degree unknown since the pre-Gorbachev Soviet Union.On September 30, The European Union decided to renew and add new sanctions against Russia, claiming that the peace plan in Ukraine has not yet been respected. Brussels had hinted that it would consider revoking the sanctions had there been progress by September 30 toward a ceasefire. The EU will continue to "closely monitor developments on the ground," but failed to issue another deadline. Should the EU consider the 'situation on the ground' to have stabilized, it will consider amending or revoking the sanctions, in whole or in part. The EU, in effect, is looking for any possible excuse to scrap the sanctions as even the most critical EU member states were reluctant to enforce sanctions while others continue to demand a softer approach toward Moscow.

Russia, meanwhile, has taken the first steps to comply with the EU demands, agreeing to a ceasefire with Ukraine, even as it has enforced its own, ongoing, retaliatory embargo against a number of European agriculture-food sector products. The ceasefire is holding tenuously but there is great uncertainty and fear because Ukraine aspires to join NATO and the European Union within the next six years. There is very little chance Russia would allow this to happen without its own retaliation, especially about the issue of NATO membership. The Russian Foreign Ministry has been controversially referring to Ukraine's 'restive east' as Novorossiya, the territory that once consisted of what in today's terms would be Odessa, Mykolaiv, Kirovograd, Dnepropetrovsk, Kherson, Zaporizhya, Donetsk, and Luhansk.

The EU's sanctions Russia concern companies operating in the energy, finance and defense sectors, including the oil giant Rosneft and the weapons manufacturer Kalashnikov. The EU has also imposed assets freeze and a ban on granting visas to travel to a number of officials and business personalities considered to have close ties to President Vladimir Putin and pro-Russian rebels in eastern Ukraine and in Crimea, annexed to Russia. NATO military command said that while the first phase of the ceasefire saw a significant withdrawal of Russian forces in Ukraine, there are still hundreds of troops, including special forces, in Ukraine. The conflict between pro-Russia rebels and Kiev's own troops has now claimed more than 3,000 lives.

The crisis worsened last July 18, when (still unconfirmed) pro-Russia rebels accidentally shot down a Malaysian Airlines Boeing 777 airliner, (Flight MH-17) sparking a slew of allegations against Russia and its reckless arming of the rebels. Evidence suggesting that the rebels had Russian 'Buk' surface to air missiles, which were deployed against Ukrainian fighter jets and helicopters, amounted to a "massive escalation" of the crisis said Jonathan Eyal, director of the UK's Royal United Services Institute. It should be noted that while Flight MH-17 served as the premise to bolster Western resolve against Putin, the Ukrainian government holds the actual technical fault because it failed to shut down its airspace at a time of aerial warfare. In fact, the families of that flight’s German victims plan to sue the government of Ukraine, rather than Russia’s, in accordance with that failure.

The international response was to boost sanctions against Russia that had been rather tepid until that point. However, the US State Department, and the neo-conservatives that still have influence there, primarily one Ms. Victoria Nuland, the US Assistant Secretary of State in charge of Europe and Eurasian Affairs, played a rather important role in fomenting the crisis. Nuland was secretly filmed as she addressed Ukrainian business and political leaders at a Washington meeting that the United States had spent “USD$ 5 billion to develop Ukrainian Democratic Institutions”. Nuland was evidently rather involved, then also in the successful coup (and it was a coup, regardless of one’s feelings about the previous Ukrainian leadership) against the democratically elected, but pro-Russian President Viktor Yanukovych. Indeed, the situation in Ukraine is not at all as clear as the Western media and diplomacy hawks have presented it; that is, one where Russia is bullying a ‘democratic’ neighbor, trying to improve its fortune by looking toward alliances with the ‘West’ rather than staying ‘East’. Many commentators have ignored the huge role played by the United States and its allies in prompting the Ukrainian crisis in the first place, ignoring, in the process, the very real risk of it escalating into a more wide reaching war.

The crisis has actually been rather less about Russian aggression in Ukraine than a Western attempt to lure Ukraine into NATO and the European Union, while weakening the political future of Russia’s President Putin. Victoria Nuland’s previously mentioned meeting proves that Washington invested many US tax payers’ dollars to finance Kiev’s Maidan public protests and the coup against President Yanukovych, who had been democratically elected. Russia sees NATO’s creeping into Eastern Europe as a challenge to Russia, which had been assured of its continued influence – free of NATO troops – in a formal agreement signed by Presidents Mikhail Gorbachev and the George H. Bush at the time of German reunification in 1990. NATO, meanwhile, has announced it will build five new bases in Eastern Europe last August. This cannot but deepen tensions between the Kremlin and the West. Meanwhile, Ukraine has gained nothing since its new 'democracy' started. Kiev needed, says the IMF, some USD$ 35 billion in aid last May; the IMF has revised that amount to USD$ 55 billion, while economist Desmond Lachman says it now needs "closer to USD$ 100 billion". Moscow has not done so, but it could shut off supplies of its gas to Ukraine as winter approaches. The fact is that the most democratic solution would be to allow a referendum in the pro-Russian Ukrainian provinces to vote whether to stay in Ukraine or join Russia.

Many of the opinions heard so far, enforced by sanctions and materialized through the deceptive use of campaigns costing billions of dollars, have come from people living far beyond the borders of Russia or Ukraine. Meanwhile the sanctions continue; are they effective? The last package of sanctions Treasury USA and the EU takes aim at Russian banks, the energy industry and the military. Sberbank, the largest bank in Russia, will not have to Western long-term capital (that is any loan lasting over 30 days). The USA and the EU want to cease the development of exploration projects in Siberia and the Russian Arctic, preventing the West's oil majors from selling equipment and technology for deepwater shale gas projects. Exxon and Shell, therefore, can no longer do business – building pipelines for instance – with such energy sector giants as Gazprom, Gazprom Neft, Lukoil, Rosneft and Surgutneftegaz.

The United States Secretary of the Treasury, David Cohen, has insisted that the sanctions package "isolate" Russia further from the global financial system. Interestingly, nationalist

Russian shareholders have seen to it that the shares of the companies on the list of sanctions go up rather than down while the shares of the oil majors in the United States have gone down! Oh, and because Russia has been isolated from Western capital, Russia will simply not be importing goods and services both from the USA and the EU – finding alternatives through its BRICS (Brazil Russia, India, China, South Africa) partners and beyond. Moscow is simply dealing in local currencies with its other business partners and this could hurt the West and its currencies in the long term, because other developing countries might start to do the same.

Russia may sell its energy resource in any currency except USD and EUR while importing clothes, technology, hi-tech electronics, computers, agricultural goods and raw materials it needs from Asia and South America. There are serious doubts, moreover, as to how long the EU member states, in absence of a shared energy policy, will last without Russian gas even if they manage to secure alternative supplies from other countries (Azerbaijan, Qatar, Libya?). The West is still banned by another set of, rather counterproductive, sanctions against Iran, which means that it cannot import oil or gas from there to meet the Russian shortfall. The markets are less 'irrational' than they are motivated by profit and profit is based in reality. The current intentional politics practiced by the West against Russia express very little 'reality 'and much ideology. Russia has a huge surplus of foreign capital – and can protect itself from the economic storm. The EU is still in austerity mode and failing to recover; even Germany, the Union's strongest economy, is hurting with recent growth rates noted at -0.2%. Markets respond to realpolitik and the economic wars launched by Washington and Brussels against Moscow will hurt the markets of the former rather than the latter.

Gold price catalyst for 'mysterious stock performance'

Carlisle Goldfields Limited ('Carlisle', TSX: CGJ | OTCQX: CGJCF) says that it has no material explanation to account for the recent drop in its share price. On September 9, Carlisle stock reached a yearly low of CAD$ 0.03/share only to rebound to CAD$ 0.04/share on Wednesday and holding on to that level today, September 11.

Carlisle completed a preliminary economic assessment (PEA) for the Farley Lake Project on April 15, showing intersections of 20.3g/t gold at over 6.0m of depth, which is higher than expected. The PEA covers two of the five deposits being explored by Carlisle and it suggests the project will be characterized by very favorable economics including a 34% internal rate of return and a very significant asset value of about CAD$ 250 million. Moreover, the mine itself has the potential to produce 145,000 ounces per year at an average grade of 2.2 grams, which makes it one of the highest grade open pit deposits in North America. Carlisle has even a conservative economic model for the PEA, assuming a gold price of USD$ 1,100/ounce rather than the current USD$ 1,300/ounce level. Surprisingly, even at that discounted price of USD$ 1,100/oz, Carlisle would still get a 34% internal rate of return. These are excellent economics, which add to the mysterious stock performance of the past few days. The mystery appears less daunting when Carlisle's performance is set against the competing forces that have been affecting the price of gold over the past few weeks.

Gold prices have dropped to yearly lows, hovering around the USD$ 1,280/oz. mark. The market appears to be acting counter-intuitively; the summer of 2014 has been characterized by at least three major geopolitical crises: Ukraine, Islamic State (ISIS) and the war in Gaza. Indeed, the crises and the Russian switch away from US bonds to gold ingots (some USD$ 400 million of them in August alone) to retaliate against western sanctions should, and have, supported gold prices. Gold has proven its characteristic as a safe haven, in a context of geopolitical crises; however, gold has also been confronted with pressure from improving economic conditions in the United States, the all-time record highs of the S & P 500. Meanwhile, the good news from the US has come just as geopolitical tensions have started to ease, thanks to the recent truce between Russia and Ukraine, on the one hand, and between Israel and Hamas on the other. The markets have reacted generally favorably to President Obama’s speech on September 10 outlining his government’s strategy to confront the threat from ISIS. This has had the effect – temporary as it may be – of diminishing that threat and the markets need few excuses these days, it seems, to rally. In addition, this optimism has also focused investors’ attention to the increasing strength of the dollar.

All eyes are on the outlook for monetary policy of the United States, since October marks the end of quantitative easing (QE) and is expected to prompt the Federal Reserve to raise interest rates in the first half of 2015. These factors have definitely halted the rise of gold prices – for the time being. The economic improvements from the US have gained momentum such that even the European Central Bank’s decision to inject more liquidity into the financial system, cutting interest rates by 10 basis points, while launching its program to purchase Asset-backed securities (ABS) could not boost the gold price. This is because the ECB’s actions have actually pushed the dollar to the highest level of the past 15 months, making gold – denominated in dollars – more expensive for investors who operate in currencies other than the dollar. Accordingly, this has made gold more expensive for Russia and China, which have been among the biggest gold buyers for geopolitical reasons – of the past summer. Therefore, traders see no compelling reasons to keep gold in their portfolios in the short term and prices appear to have found a base at USD 1,250 USD/oz or so. Nevertheless, the market highs are temporary. Geopolitical tensions are bound to increase again.

There is nothing resolved between Russia and Ukraine and new sanctions came into effect today against Russia, which has not shown any signs of relinquishing its authority over Crimea or what it sees as the pursuit of vital national interests in eastern Ukraine. The US strategy against ISIS and the related international efforts will be pointless without direct ground intervention and it is unclear how the markets will evaluate a 'return to Iraq', given all the risks this implies. There is also little permanent about the ceasefire in Gaza. The conditions leading to the war have not changed and a conflict could re-ignite at any time. Therefore, the chances for a gold rebound remain very high. Meanwhile, the World Gold Council (WGC) predicts that physical demand for gold (jewelry, coins and ingots, industrial uses) in China is expected to reach at least 1350 tons at the end of 2017 or some 20% higher than the record level of consumption in 2013. The WGC used fairly conservative economic assumptions (average growth rate of 6% over the 2014-2017 period), which means that Chinese gold demand could increase in larger proportions.

Western agricultural and

potash sectors suffers more from anti-Russia sanctions than Russia itself

Russia has delivered a textbook response to the growing list of sanctions that the West and NATO countries have adopted, with more or less conviction, over its inevitable interventions in the Ukrainian civil war. Russia has banned food imports from several Western countries including Italy, Germany and Canada. It has also banned Western investment projects in the Russian agro-food sector just as Russian food tastes and consumption habits have been expanding to include a wide variety of products. From the Western perspective that Russia should modernize politically, the sanctions will have adverse effects, delaying that very process of modernization, forcing a resumption of cultural and political insularity. Russia will put planned projects on hold or cancel them outright, hurting Western companies in the process.

Western companies – especially German and Italian – have been providing the modern technologies and know-how to modernize the Russian agriculture and processing industry. Germany alone has invested over a billion Euros in Russian agribusiness, which have enabled Russia to vastly improve □□plant production, resuming its role as a primary exporter of wheat along with the USA, the EU and Argentina. The increase in the production of wheat and other crops has also allowed for improvements in poultry and pig production, which has raised demand for such minerals as potash and phosphate. Meanwhile, as late as 2013, several European small and medium enterprises in the agricultural sector had asked their EU representatives to significantly expand their corresponding commitments in Russia, facilitating ties further. The crisis and the Western (especially from the EU) promise to include Ukraine in NATO or even the EU have contributed greatly to the crisis. Not surprisingly, trade relations and problem-resolution mechanisms must be in place to build trust in trading partnerships and now both are in short supply. It will be difficult, but the EU must pursue a more diplomatic line with Russia in order to avoid completely cutting political level discussions and opportunities to continue working in favor of Russia’s agricultural and food industry modernization, which benefit western companies directly.

The Russian government has chosen to ban imports of several food products from the EU and the USA not only as a means of political pressure, but also to highlight their positive impact on the development of Russian agriculture and food industry. It is therefore in the mutual interest of all powers concerned that the Ukraine conflict does not escalate further.

The effects of the embargo imposed by Russia have already been felt. Entire containers of EU food products have been blocked and sent ‘back to sender’, while Russian importers are advised have been terminated several contracts for the shipment of fruit and vegetables. The list of banned products covers the entire range of diets and tastes including beef, pork, chicken, fish, seafood, milk and dairy products, fruits and vegetables from the EU, USA, Norway, Australia and Canada, with the exception of alcohol and children’s products. It is a sharp brake on the increasing demand for EU products on the dinner tables of all countries that made up the former Soviet empire that had begun to appreciate such gastronomic delights as Parmigiano Reggiano and prosciutto, not to mention all manner of oranges, grapes and legumes. In the first quarter of 2014, Russian imports of EU food products had actually risen in the first quarter of 2014. Countries such as Italy, which are relying on exports to lead the path out of the economic crisis, consider agriculture as a very important economic sector. It is estimated that Italy alone will lose over 200 million Euros in lost agri-business with Russia alone. Now we are facing a worrying escalation of the conflict with a trade war, which confirms the strategic importance of food especially during periods of economic recession. Russian leaders are master chess players and they have not chosen to target food imports casually; they are very aware that agriculture is a primary pillar of growth for the European Union at a time of economic stagnation. Indeed, worldwide agricultural exports from Italy alone grew by 5 percent in 2013, reaching a record high value of 34 billion Euros, even as other sectors suffered.

As for Canada, while Prime Minister Harper engages in smug tirades against Russia, the sanctions and growing trade ‘Cold War’ may have consequences for the potash sector. Russia is part of the block of BRICS (Brazil, Russia, India, China and South Africa) countries, all of which have high potash and phosphate demand driven by their respective agriculture and food sectors. As western borders close in response to decisions in Bruxelles, Ottawa or Washington doors open to Russia’s East and South. In potash terms, the world’s largest potash producer Uralkali expects to be able to implement price increases by as much as 10% in the 2015 supply contracts with China. Uralkali is considered the clock for the fertilizer industry, which also includes Canada’s Potash Corp of course.

The People’s Republic of China is the world’s largest consumer of potash and now pays Uralkali USD$ 305/ton. Technically, this should be good news for Potash Corp and its CANPOTEX partners (Mosaic, Agrium), but China may well decide to increase its share of supply from Russia in solidarity over Western sanctions. In turn, Russia will replace Western imports with meat and dairy products from Brazil, Argentina, Ecuador, Chile and Uruguay, which are more than willing to step up to the opportunity. China has also indicated that it can increase the supply of fruits and vegetables to Russia. Uralkali also has close ties to India and if it should see it advantageous, it could slash potash prices below contract rates, revamping the ‘quantity’ model by increasing production and undercutting CANPOTEX. Moreover, Russia may decide to trade in local currency when dealing with other BRICS members, further damaging the potash market.