Commentary for the second quarter of 2017

At last some clarity

The markets have been distorted, usurped by unconventional central bank policies like QE and rate repression, even below the zero bound in many places. That at least, is the claim of a lot of (frustrated) market participants. Reach for yield has reduced macro-economic analysis to central bank watching and financial analysis has been supplanted by mere ETF following and passive index investing.

The hope for a rapid revival of the 'animal spirits' has become victim of a divided Congress this semester, even though the Fed policy clarity was real. Is the lack of clarity on future fiscal policy the sole culprit of today's market obfuscation, or is there something more sinister looming in the 'goldilocks' backyard?

Clarity was brought forward by central banks, at least in their comments and in the case of the Fed in real actions.

The Fed is done with the QE experiment. After hiking rates twice already in 2017, and with another hike planned before year end, rate normalization is now on track. The case for QT (quantitative tightening) will now be on the forefront of central bankers' discussions at the upcoming Jackson Hole convention. How much will the Fed reduce its balance sheet? Studies claim that a $1.5 trillion reduction is comparable to a 0.45% - 0.60% rate hike.

Why this new-found religion of the Fed? Two lines of thinking seem to lead.

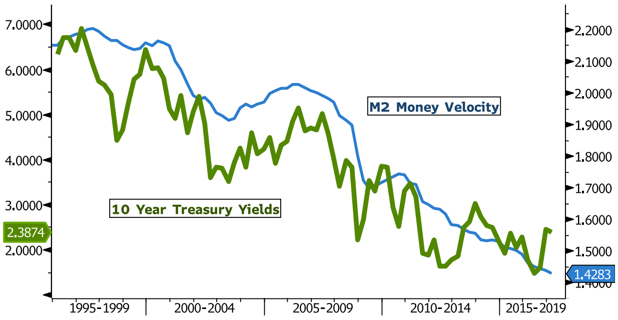
First the Fed wants to create a buffer, to be able to lower rates in the next recession. As the current up-cycle is already the third longest one since 1900, every month that passes, a new recession become more likely. Boom-times invariably die of old age at some point.

Second, we believe that the Fed was forced to recognize that the actual liquidity flows, created by worldwide central banks, did not fully reach the expected goals. However, they don't like to express this in the open, for fear of losing control and credibility. Yes, liquidity helped to repair bank balance sheets. Yes, they helped to give the government and the private sector time, to have a possible beautiful deleveraging. A lot of governments however, have misused this window of opportunity. For the private sector in the US, record high student debt and auto loans, indicate that part of the population did not understood the message from central bank policies all too well. And no, the expected effects on general consumption from asset inflation, did not trickle down from the rich to the poor. A growth of GDP under two percent just invalidates any such pretention. And no, the Fed – and its brothers in crime worldwide – cannot close their eyes indefinitely, on the effects of a growing reach for yield, forced by their own policies. This stretches from individuals engaging in releveraging in blunt asset speculation, to institutional money from – already underfunded – pension funds, committing ever less towards fixed income. They fear for finger pointing the day assets would undergo a brutal shock toward reality, because of inflation or a new recession. Risk premia and market forces could exert so much destabilization, that the whole financial system could relapse in a new 2008-like correction. The Fed is beginning to talk more and more about market valuations, and their third 'implicit' mandate of market stability. They know that next time, the populace will not accept the excuse that inhibiting too much speculation is not the role of the Fed, and that it has to be done primarily by regulation. This thought is furthered by the fact that, as a consequence of the Lehman fall-out, they are now the official entity responsible for bank stability. So there would be no future scapegoats for central banks on this matter.

The conclusion of the Fed was that 'normalization' is on, even if growth and inflation are still under 2%. In lay man terms, it means that Wall Street can no longer count on the famous 'fed put'. As so many market participants were mistrained in a Pavlovian reflex of 'buying the dip' any time in any market, it's no wonder that we are seeing new highs in the Dow, S&P and Nasdaq. Even bond markets continued to doubt the central banks' resolution to go against market excesses. We believe the majority of the market is wrong. The Fed will be more of a drag on future markets than a gratuitous reassurance for every bit of correction. Draghi will be forced to follow in the Fed's footsteps and begin to announce the end of euro QE, before yearend. We see the recapitalization of Spanish and Italian banks, ordered by the ECB, in preparation of the ECB's coming new policies. Expect also Japan to start talking about the end of QE in the coming months. Canada has completed a first rate hike last week and London is also starting to talk the same narrative.

So central banks will now start a reflation strategy. As the velocity of money went down for more than 2 decades with rates going lower and lower, if you want inflation, hike rates!

We know textbook economics explains the contrary. Indeed, markets have become accustomed to see rates lower for every



crisis, in hope of stimulating the economy. But is it so difficult to understand that once rates have been lowered to such an extreme, that even the zero-rate constraint was invalidated, that you create a paradigm shift. Isn't there an old proverb in French that states: "les extrêmes se touchent". Could it be that more interest income would actually help consumer demand and start to redirect money flows from buybacks and sterile asset uplifting – where money velocity dies – like in real estates, valuables and FANG stocks? Could it stop pension money from continuously climbing the risk ladder? Could it be that this would help to start to heal the business sector by killing of moribund competitors and giving back pricing power to sound financial corporates? Could it be that banks would reallocate money from central bank deposits into the real economy?

So yes, never in the last 30 or more years, have there been better chances to see central bank policies align more with the aims of Main Street instead of Wall Street. Even the 1 percenters having and earning it all – thanks to the collusion between politics and corporates, coupled with central bank help – know that the jig is up. Continuing the same would lead the restless, malcontent populace to become even more aggressive, and at some point, a personal-life and system threatening explosion would happen. A newborn revolution could open a chase on the rich, and bankers could be hanged in the streets.

So even the wealthy are now conscious that a rebalancing from Wall Street to Main Street has to happen. They are starting openly to demand a change of policy. The latest call of frustration from Jamie Dimon of JP Morgan speaks loud enough.

JP Morgan chief blasts US dysfunction: 'It's almost an embarrassment being American'

- Jamie Dimon rails at Washington and laments 'stupid shit' in US politics
- Dimon says bad policy is 'holding back and hurting the average American'

Will the normalization policy started by the Fed become virtuous? It remains an open question for now. We believe that real green shoots, indicating a regain in the vigor of the real economy, are perceivable. Even as inflation has not reached 2%, we see a labor market, where qualified workers are gaining salary negotiating power. US banks are lending more. Remember Greenspan talking about coming inflation, comparing money built up at the Fed, to a wooden tinderbox waiting for a match. Do not let your vision be obfuscated by the last fall in energy prices or a fall in some hot real estate segment or by the diminishing growth in job creation in the last months. Even lower auto sales may not be a correct indicator at this time. If the US economy doesn't fall off a cliff and continues to grow around 1.5 percent, it will be with a higher inflation. Every recovery after a recession, has always seen more inflation towards the end period of the recovery. No statistical exception is to be found. This inflation should progressively strengthen the Fed to implement its new policy.

Bank of America, due to its specific place in the US banking sector, is our canary to tell if the reflation is on track. We are content to have seen banking shares last month to begin to recover from a nasty correction.

Another sign will come from the Fed's money velocity chart, but here some patience is still warranted, as delays in the effects of the new normalization policy, make this a non-leading indicator.

Our main scenario is for the recovery to still continue, until the central banks are forced to overkill.

Rates above 3% would be needed to start a recession and the bar could still be raised higher if the reflation takes hold. We are nowhere near such interest rate levels currently. Equities still have time to perform the blow-off top we spoke of so many times, with a Dow above 32.000. Maybe we will see an autumn market correction before the blow-off top rally takes place. Delaying fiscal policy reforms and Congress not acting in time before the Debt Ceiling, could deliver the perfect excuse.

Have we no doubts now, now that so much has become clear? Yes, we still don't have 100% certainty. Indeed, we - just like the Fed - wish to formulate a scapegoat for our reflation scenario. The narrative to see a reflation scenario become successful in the coming quarters, needs the correct political actions.

QT has to be accompanied by fiscal policy: deficit spending, lower taxes and infrastructure programs, to create the correct environment for people to belief in economic healing. Or in lay-

man's terms a demand revival needs extra money directly in the hand of the average consumer. As the positive effects of higher rates have a delay of 6 to 9 months, we need government to make the common man act more optimistic and revive the 'animal spirits', to create a von Mises blow-off top.

Before year end we will know if government starts to deliver, instead of just promising goodies for the middle class.

We think that the conclusions on what to expect in coming quarters and what the triggers may be, are clear. Maybe it is still worthwhile to extrapolate on the consequences for precious metals investments.

For mines, we insist that we need reflation, to see the mines change course from underperforming against physical gold. Deflation and low inflation create a negative effect for precious mines on the actual valuation of their reserves. As margins diminish, the theoretical value of gold in the ground is lowered. For producing assets, less and less reserves become economically minable. With reflation, the contrary should happen… In such an environment mine stocks can rise together with equity markets!

For bullion, we have to concede that the downward slope on the technical picture since 2011 is still not breached. Gold needs to surpass \$1300-1320 to do so.

We think if reflation starts to perform, gold will break out positively. Indian gold imports in the first half of the year were at higher levels than expected and luckily the GST did not introduce a new negative for Indian gold buying. Further, a normal monsoon season this year, after some years of draughts, should also help to sustain good buying from rural India.

As long as China continues to grow at above 6.4%, buying from China will be another positive for the bullion market.

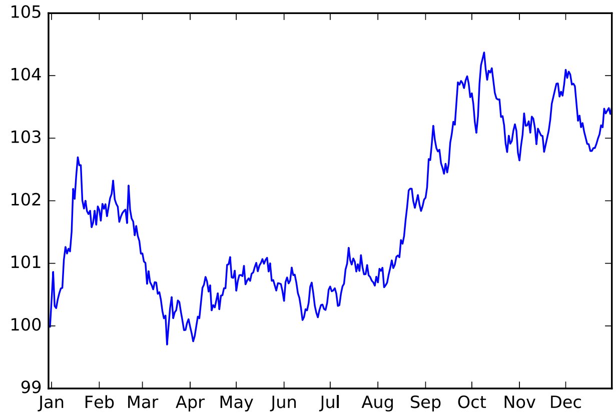
Blockchain gold, crypto gold and sharia gold are also positive factors although they are still in their infancy stage.

In the past months, we have seen the gold silver ratio go up from 68 to 76 as doubts on Trumponomics have made a lot of market observers to doubt the reflation trade. This is another indicator to observe: if the inflation engine accelerates, this ratio should go down.

The US dollar is in retreat and this should also help bullion rebound in the coming months.

Lastly here a chart on gold seasonality. From around 15 August, gold has a tendency to rise.

gold seasonality from 1980-2016



We hope you enjoy a nice vacation and a gold price revival starting in August to keep your post vacation moral high

for iW Partners,

the fund manager