Commentary for the third quarter of 2018

Winter is coming!
... and the market awareness is rising.

In earlier writings we stated that the central bank policies would change from being supportive for Wall Street to being supportive to Main Street, with the Fed leading the cha(r/n)ge. We said that the Fed put is dead and the market is finally beginning to accept this.

Indeed QT, balance sheet reduction, rate 'normalization', inflation and the next recession are now the new financial buzzwords.

The macro consequences are beginning to appear and are becoming more consistent at the start of Q4. **Goldilocks, widow maker** bond strategies and calm currency markets are now in a struggle to survive. We predict that they are already life-threatening wounded.

Goldilocks was the call for a worldwide beautiful deleveraging. Worldwide synchronous growth amid low volatile asset markets were to be expected. Inflation would rise but still behave well enough to stabilize around 2% for the longer term. Rates would forever stay lower, as the 'neutral rate of interest' in Fed jargon the R* was anchored much lower for … siempre.

But now at the beginning of the fourth quarter, markets seem to be uncomfortable about these expectations. Just looking at the incoming data makes one wonder.

<u>On Growth</u>

First the periphery began to wobble and now contagion is spreading to parts of the core.

Indeed multiple EM markets are growing more slowly or are flirting with recession. It can no longer be stated that Turkey and Argentina are self-inflicted cases and that contagion will not happen as we now see Brazil, India, Indonesia and South America being affected, to name just a few.

As the US economy got a shot in the arm from tax reductions and deregulation, growth divergence becomes unstable and worrisome. Capital flows affect not only EM economies but the core is also becoming under pressure. China, Japan and Europe are now also seeing currency weakening and their future growth is anticipated to be slower.

Of course, trade tariffs are not helping either.

Who will finance the growing US budget deficit once the capital plight is less and less fed by diminished non-US growth? **To answer you have to take into account also the contingency measures to attack the capital plight that will be newly implemented by suffering countries.**

Fed balance sheet reduction is another subtracting factor. Liquidity is not linear. Fear or greed have a habit to erupt with vehemence.

And if such financing were to be provided without interruption, at what rates will future long-term treasuries, in bigger and bigger quantities be placed? The US deficit was already 3.9% for budget year 2018 (it ends at the end of September).

How long will lower for ever R* fantasies survive? How high will EM and other countries have to up their rates in response, to stop **capital plight** into the dollar and defend their currencies? How effective will these measures be on their future growth?

Further, how high will this divergency push the dollar? We are already hearing people advocating for a new 'Plaza accord'.

<u>How realistic is this with Trump?</u>

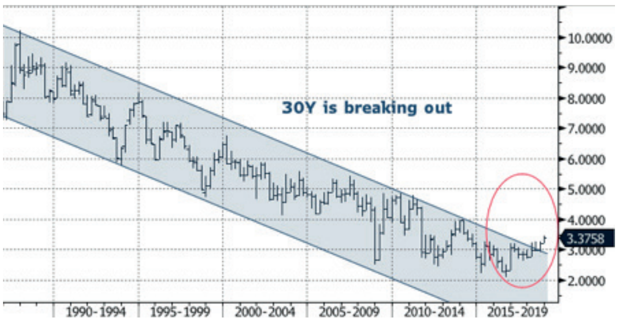
For the US specifically, economists are seeing diminishing returns from tax incentives as the positive boost culminates somewhere in the third or fourth quarter of this year. The Fed predicts under 2.5% US growth in the coming years. Our vision is that US inflation will accelerate even in a slowing growth environment.

With an unemployment rate at 3.7 at the end of September (a 48 year low), how plausible is it that wage inflation will stay well behaved? How plausible is it for the US that the current long during economic expansion will not suffer from labor constraints if growth continues at the current level?

Shorting Japanese public debt became famous as a **'widow making'** strategy, as rates stayed down for years and years, even in the face of the swelling public debt to GDP ratio. The same overcame treasury traders, anticipating higher rates with the end of QE. Taper tantrum, Yellen speak on normalization, nothing seemed to help. So the lower R* became the new credo. The effects reached even serial defaulters, with 100 y

Argentinian debt being so sought after that the emission was oversubscribed (another example of fear and greed).

Well, something did happen around the third quarter of 2018. US 10 and 30 y treasuries finally broke their decades long uptrend. Winter is coming for bonds! (chart 10y and 30y).



The effects spread even towards Bunds and JGBs. For Bunds it was also a strong signal that the rates went up even in the face of a renewed Italian public debt crisis. Italian 10y is now above 3.5% and their interest expenditures are already growing faster than their GDP in consequence.

WINTER IS COMING

Winter is coming means that higher rates are coming and this time on a worldwide scale. The IMF is already forecasting lower global growth. Rates seem to sniff out that inflation will progress on a durable basis now. Higher rates will strain the growth rate of future company profits and earnings multiples will begin to suffer from both sides of the equation. Trees won't rise to heaven, but there is still room for a new equity top. An ultimate blow up in the Dow remains our most probable scenario. Here under, some explanation constructing this vision.

Winter is coming means that the transition from bonds to equity can now happen, contrary to all the claims of an equity bubble explosion happening any day now. In the transition from bonds to equities, we see a lot of short-term fear. Some even foresee an economic recession rapidly. We do not agree. At least not or the US. Once the noise from Brexit cools down with an agreement one way or another and once China also accepts some trade deal (post US midterm elections), even European and Asian equity markets should be bid up again. We still maintain the vision, we've held for years now, that the Dow will be the leading market in this last equity run before the financial reset. Think of the Dow as a safe harbor for worldwide capital plight.

The US equity market is now showing on a near daily basis that a crash is not yet for tomorrow. We see too much resistance on bad news. We see the Dow flirting with all time highs, even in the face of the 10y treasuries above 3.24%, even with Powell announcing more rate hikes and claiming that yields will eventually be pushed above R* in 2020. Even faced with the heated trade skirmishes between Trump and China, the Dow did not really bow down. The Dow also resisted the loss of leadership in the tech sphere, where we see Tesla, Netflix, Facebook and other market darlings fall. We think that value will claim new leadership from (tech)growth in the equity markets. If it happens, banks will also be part of it. Hence our vision on Bank of America as our canary. With the market hesitation from the last months, we saw BAC correcting from $32-$33 to $28 and currently

consolidating. Preparing for a new rush up? If the Dow has to restart its run-up, BAC should go for new highs in our opinion. Our vision is that such a move will not be derailed solely by the Fed expected rate hikes.

Other forces have to come in play and maybe they are more related to politics than central bank policies! A Brexit resolution, good mid-term election for the republicans – Trump may retain full Congress control as the democrats seem to have overplayed their hand in the Kavanaugh nomination circus as indicated by the latest polls – and also possibly a US – China trade deal for the start of 2019 could give the perfect excuse for a restart of the equity bull.

For Europe the situation is more complex to predict. With Merkel increasingly losing control in Germany (the Bavarian October elections) and the deficit and bad bank debt in Italy, a political resolution risks to be still far-off. Same on the subject of immigration. Will Draghi really not save the Italian banks? Thus the question becomes: Will Europe be the first domino to fall, leading to the worldwide financial reset?

Winter is coming

Winter is coming also means that the role of the dollar is becoming more and more a point of discussion.

As a new form of the Triffin dilemma, Fed policy normalization – even when justified for the current status of the US economy – is causing collateral damage for the rest of the world.

Worthwhile to read on this is https://www.cnbc.com/2018/10/04/the-dollars-clout-in-global-finance-idiotically-outsized-jim-oneill.html . O Neil: 'Kingpin' role of the dollar in world finance is an issue. Other voices and think tanks have made comparable observations.

The Fed message is clear; Yellen gave the EM markets time to put things to order – when she put hikes on hold in December 2015 – now EM markets should be prepared as much as they can be. See Fed's Bullard comments on 8 October https://www.reuters.com/article/us-usa-fed-bullard-emerging-markets/emerging-markets-as-prepared-as-they-can-be-for-u-s-rate-moves-feds-bullard-idUSKCN1MI10Z .

Our opinion is that a dollar rising on optimism will not be the death knell for the status quo in world affairs. If fear and noise calm by political decision, trust in renewed US growth can also become a positive contagion for the rest of the world. EM markets and China are already **valuated low**. Bottom picking helped by a strong dollar should start once optimism spreads out.

At some moment, the dollar run will automatically reverse as market players see relative value opportunities in the non-US world during such a phase of optimism.

The real danger is coming from a dollar going up based on risk-off and a dollar liquidity trap exaggerated by a new US recession.

What happens when optimism boosts growth above capacity? Inflation accelerates! But due to the high public debt – for 2019 and 2020 the US fiscal deficit is expected to reach above the $1 trillion mark – the Fed risks to fall behind the curve.

As Trump is already lamenting about a crazy Fed, hiking to rapidly, economic shocks will happen. In fiscal 2018, the US government payed a record $523 billion in interest expenditures. **Imagine somewhere end 2019 start 2020 will US government interest payments reach 800-900 billion?**

Here the US gov would become restrictive for growth. Either taxes would have to rise exorbitant either government non- Interest outlays would have to be cut. Deficit and debt 'payback time'! Fed rates forced at 5% and higher end 2020? Forced to attract public debt financing and or growing inflation?

A recession would become assured and the leader of the world would become a global crisis inducer. Worldwide growth stalls and recession rages endemically like the flu, without good remedies. The US dollar becomes scarce. EM countries scramble for dollars just like enterprises as they have too much leverage, too much debt. Pessimism and fear start to conquer savers shy to finance credit and thus rates go up, even more so in the face of recession. Asset valuations would fall chaotically.

In the end, a crisis will force a financial reset with an exit for the dollar as a reserve system. We trust in precious metals to hedge this risk adequately.

Stay open to the US government trying to devaluate the dollar, by buying gold in the open market in such an environment. If they would intervene against foreign currencies, the pain in the world economy would only grow and trade conflicts and war would become global. Some long-term-thinking central bankers seem to see this coming, as they have already been increasing their gold reserves. Russia, India, China and even Polonia upped their gold reserves, others will follow, we predict(1). We called this the nuclear option of monetary policy. (The act of steering the economy by buying or selling gold by central bankers). With winter coming a 'nuclear' accident becomes more probable.

Winter is coming.

Winter will benefit precious metals.

If there is first a phase of relaunched hope, inflation will accelerate and precious assets will rise. And remember nothing better than inflation, to see mines leveraging the moves in bullion.

If this phase is booted off by policy errors – and you understand that we see more risks from political decisions (think trade, think deficits, extreme taxation, Brexit, Italy, rough regimes like Saudi Arabia, Russophobia, religious and or state terrorism etc.) than from central bank decisions – the fear trade demand could overwhelm supply in precious assets.

In the meantime uncertainties are growing. Risk premia have to go up when doubts gather the mind of the markets progressively. Precious assets become a needed diversification(2) in astute portfolio management. It hedges and betters returns.

Conclusion tailwinds for a renewed bull run in precious metals are blowing and they will strengthen "as winter comes"

For Q4 we still see a big possibility for precious mines to have a nice run up.

- Gold BGMI,Xau and Hui ratio at century lows end sept.
- Gold silver ratio at a level from where rallies started in the past.
- Indian love trade at good levels
- China jewelry sector growth expectations.
- Cot-report with speculative shorts at extreme level.
- Fusion between Barrick and Randgold, such operation always happens when a sector reach bottom.
- Inflation to pick up again.
- Diversification needs are growing(2)
- The dollar is still the biggest risk but the euro dollar should have less impact as dollar yuan is taking over this position

We hope that precious equity will end the year higher. For confirmation of this trend we will look at the dollar yuan rate and at the quotation of ABX. If ABX can hold the fusion bonus this would be a confirming sign. Further will every lowering of the gold silver ratio be good and under 81 a rally by the mines would gain a lot of credibility.

for iW Partners,

the fund manager

(1) (a) Gold reserves of EM markets rose 90% from 4596 tons in 2006 to 8755 tons in 2017. Source chartbook of the "In Gold we Trust" report 2018. We see this continue. (b) news from 16 Oct 2018 Bloomberg (already fulfilling our prediction of more central bank gold buying to come forward: Hungary boosts Gold Reserves 10-Fold (+29t)

https://www.bloomberg.com/.../hungary-increases-gold-reserves-ten-fold-citing-safety-

(2) Precious investment as a diversification will grow as studies like this only confirm. Since 1915 an annually rebalanced portfolio compromised of 30% BGMI and 70% SP 500 outperforms 100% SP 500 68% with reduced volatility.