Incrementum Inflation Signal turns to maximum bullish signal for inflation sensitive assets

Dear investors, advisory board members and friends,

We hereby want to inform you that as of last week friday, **our proprietary inflation indicator has switched from a "50% RISING INFLATION" to a full blown "RISING INFLATION" signal.**

First of all, please note that this signal change has occurred already **before the recent attacks** on the Saudi oil facilities. Therefore, we want to point out, that according to our signal, inflationary forces were already getting stronger beforehand, but might now have reached a tipping point.

The recent drone attack could have fundamental effects on the global economy beyond just the impact on capital spending from heightened uncertainty. As Dave Rosenberg recently said, "*It goes to show that it doesn't take more than couple of drones to cause such a massive supply disruption these days. The impact of these strikes caused a bigger oil supply collapse than the Iraq invasion in Kuwait in 1990 as well as the loss of Iranian production in 1979. And remember – both oil shocks back then presaged a recession...".*[1]

We are not sure if Saudis can really get oil production back online soon, but what is really key here is that what had long believed to be a stable source of global oil supply and of ample spare capacity, the Kingdom's infrastructure has now become prone to drone attacks and has added another fresh source of uncertainty.

Secondly, the Sept 18th Fed meeting was interpreted by the market a little more hawkish than expected and markets took a hit as they wanted more "candy". The Fed cut rates as expected by 25 basis points but offered very little guidance as the FOMC board seems more and more divided. Two dissents voted for no move, while Jim Bullard opted for a 50 basis points easing. Interestingly, the Fed downgraded its assessment of both business investments and exports. This is the first time that the Fed has mentioned the export industry as being a source of downside economic pressure. The dot-plots took the market by surprise, as 5 FOMC members want to raise rates between now and the end of the year. Another 5 want to stay on hold and 7 of the 17 FOMC officials want to ease again. As Dave Rosenberg rightly said: *"The dot-plots typically reflect what the Fed wants, not what it gets. This rates cylce ends at the zero-bound…and beyond."*[2] During the press conference chairman Powell once more emphasized the FOMC's data dependence. It is probably safe to say, that with the occurance of weaker data and/or a weaker stock market, the Fed will react decisively.

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[1] Breakfast with Dave, September 16th
[2] Snack with Dave, September 18th

Besides these two most recent events, a vast amount of macro data came out recently that clearly confirmed our recession call:

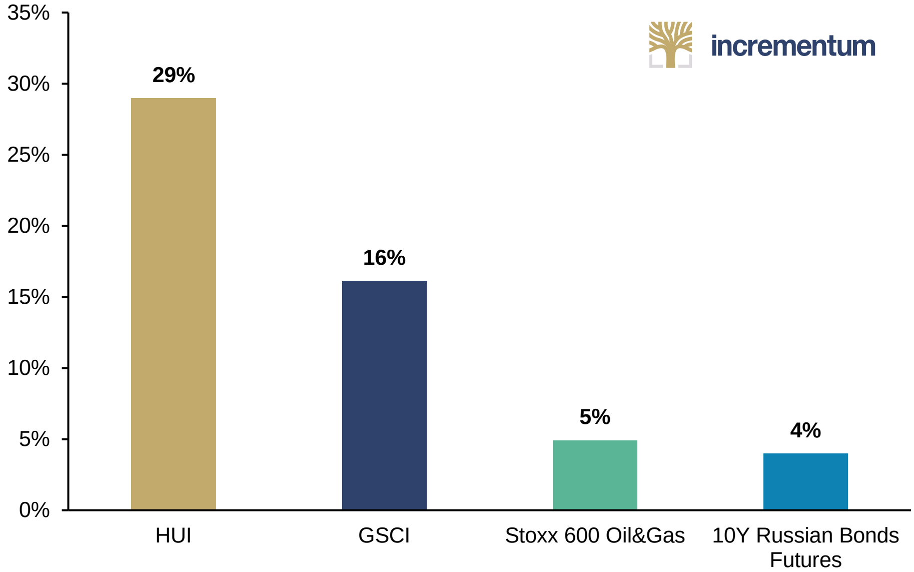
- The NY Fed's recession indicator hit a level that has foreshadowed a recession within 12 months 100% of the time in the past 30 years.
- The OECD leading indicator has declined for 19 months, which is the longest streak since the GFC.
- US Industrial production is in a recession, contracting at a 1.9% rate in Q1, followed up with a 2.2% decline in Q2. Q3 seems to have not seen any turnaround.
- Job creation and employment in the retail sector as well as in machinery manufacturing shrunk.
- 64% of world has PMI's that are negative. This includes Eurozone, China, Japan, South Korea, Malaysia, Taiwan, Mexico and Canada.
- 11 countries have posted at least one negative quarterly contraction and now 20 central banks have cut rates already.

Therefore, our rather cautious economic outlook seems to play out well. **But how does that fit into our view on inflation?**

At a point in time where disinflation and deflation scare once more seem to be the name of the game in financial markets, we are receiving an opposing indication from our inflation signal. We therefore want to take some time to discuss this signal change and explain our investors how this will impact our investment strategy.

As reported last January, our proprietary inflation signal gave a bullish signal in December 2018. We implemented this signal via **the largest long position in gold miners** since we started our conservative investment strategy (the Incrementum Inflation Diversifier Fund) over 5 years ago. However, we remained cautious on the rest of the commodity complex (ex-precious metals), especially once the signal lost some momentum during the previous months. Fundamentally there were obvious reasons like the trade war and the increasing weakness of the global economy which seemed to limit the upside of commodities. We therefore remained **underweighted in commodity related securities** and commodity FX pairs (AUD, CAD). Instead we took the decision to **make a substantial allocation into Ruble denominated Russian bonds**, which yielded over 7% at that time. So far, we are quite content with these decisions and also with the year-to-date performance of our strategy.

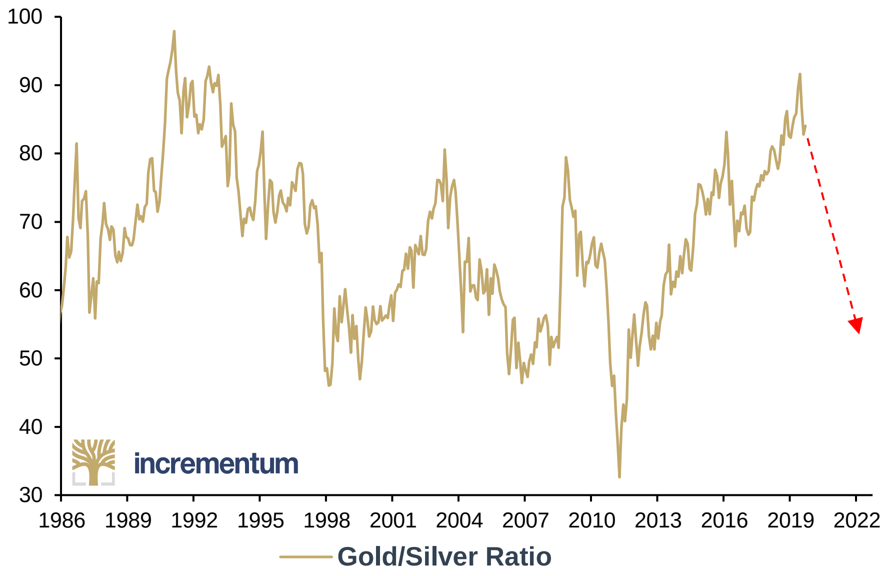
YTD Performance Mining Equities, Commodities, Energy Index and 10Y Russian Bonds



***Source**: Investing.com, Eikon Reuters, Incrementum AG*

The change in the Incrementum inflation signal is currently mainly driven by sub-indicators from the precious metals sector. Once more, the falling Gold/Silver Ratio was mainly responsible for the strengthening of the signal. And once more it has not been confirmed by the broad commodity sector (yet).

Gold/Silver Ratio



***Source**: Investing.com, Incrementum AG*

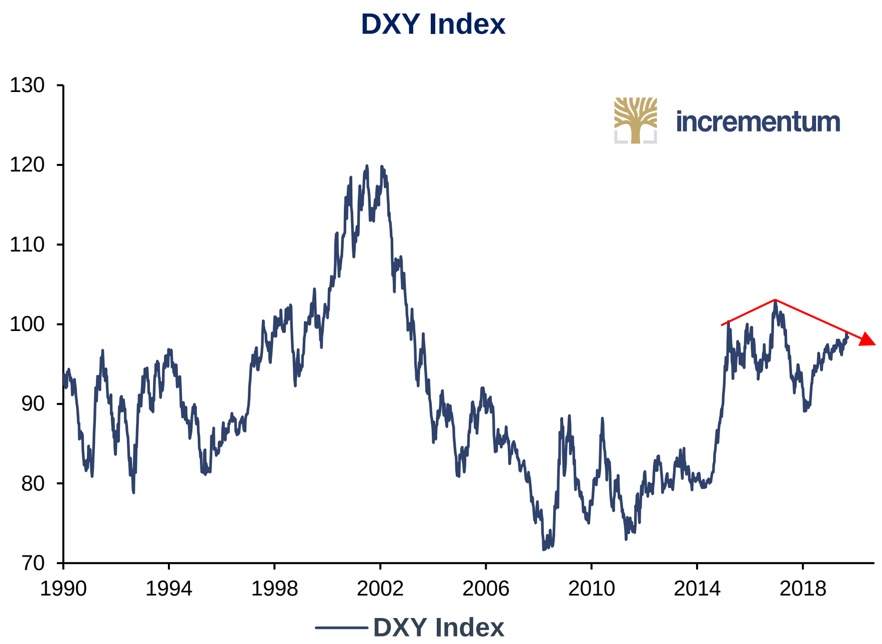
What is our interpretation of the signal change considering the current market environment?

The most remarkable move in financial markets this year has been the collapse of global bond yields. Global economic growth is obviously weakening significantly. Central banks, however, are slow to respond, as especially the FED has been desperate to normalize monetary policy.

Central bankers seem to be reluctant to give up on the narrative of a self-sustaining recovery. On a relative basis, the USD still seems to be one of the strongest fiat currencies.

In fact, the USD has been the linchpin of the deflationary mindset. This means an environment of capped commodity prices, constrained growth in EM's and capital flows to the US. This might now be changing. A weaker USD may be the final missing link for:

1. a stronger commodity performance, and
2. an increasingly stagflationary environment.



Source: *Investing.com, Incrementum AG*

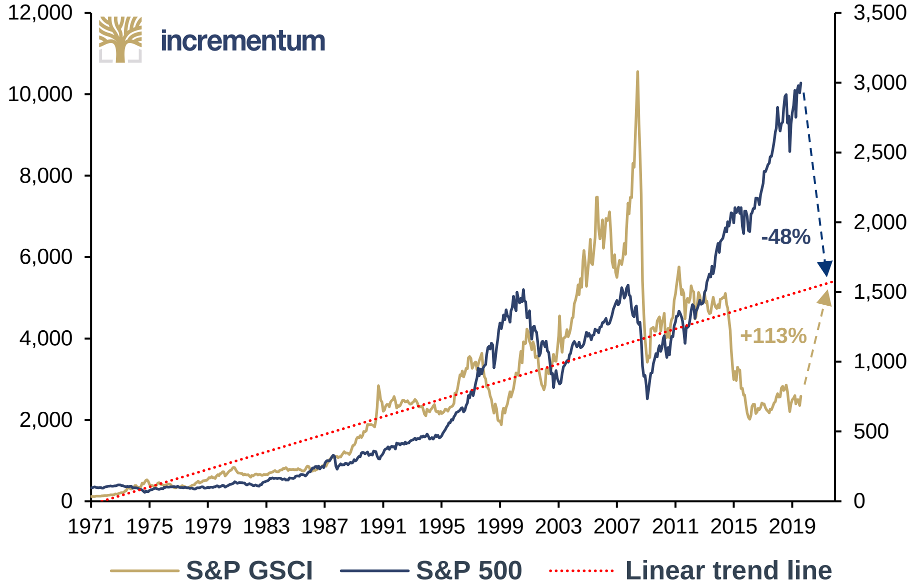
In our view, investors should definitely consider sufficient insurance in their portfolio if this materializes, as conventional asset classes tend to perform pretty poorly in this environment! **From our perspective the strong performance of the precious metals sector - including the convincing reversal in the Gold/Silver Ratio – is already discounting an increasing probability of new monetary and/or fiscal stimulus! This has been confirmed by the recent ECB move as well as some preposterous comments:**

*"The outgoing ECB president also announced that when his successor Christine Lagarde takes office, she will oversee a strategic review. This would have the **scope to examine even more radical ideas, including the possibility of changing its inflation target and even the idea of the central bank paying money directly into individual's bank accounts.**"*[3]

However, for the time being relatively robust US equity markets are preventing significant easing measures from the FED. As we have pointed out in various publications during the past years, there is a huge long-term divergence between commodities and equities.

[3] Source: Financial Times, September 13th

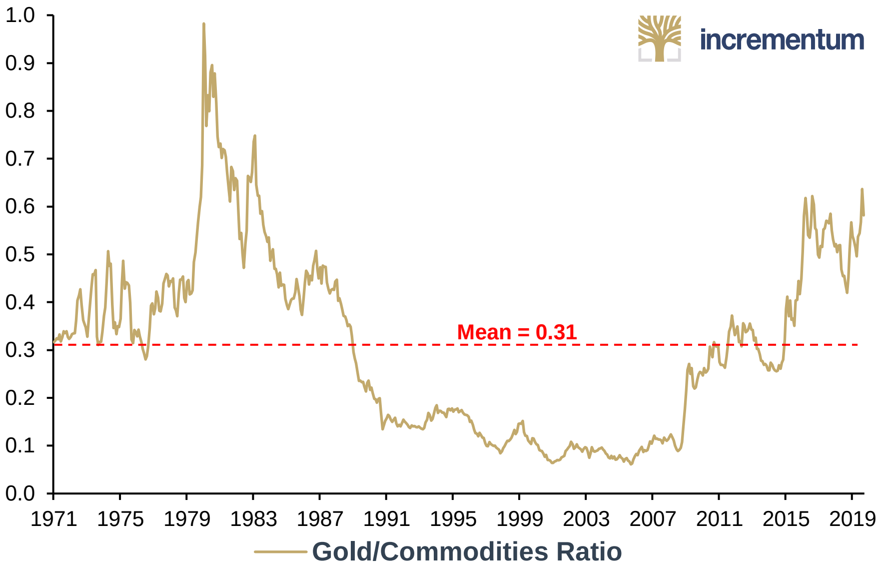
Bloomberg Commodity Index (left scale) & S&P 500 (right scale)



Source: *Bloomberg, Investing.com, Incrementum AG*

This divergence could finally reverse, once equities stumble and global central banks (including the FED) will aggressively start the next round of stimulus. In our view the probability of the next easing measures triggering outperformance of commodity markets and a falling USD has increased significantly. At this point this represents a huge contrarian position, as commodities (ex-precious metals) are extremely out of fashion currently. Also, from a relative value point of view commodities seem exceedingly cheap today.

Gold/Commodities-Ratio



Source: *Bloomberg, Fed St. Louis, Incrementum AG*

Investment Impact:

During the next weeks we are going to gradually increase our allocation towards commodity related securities (ex-precious metals) and are slightly reducing our precious metal exposure. Within the precious metals mining spectrum, we will use current pullbacks to rotate more towards the silver mining space. Altogether, our exposure towards inflation-sensitive assets will further increase.

Ladies and gentlemen, we believe that current valuations in inflation sensitive assets are a tremendous buying opportunity which we want to utilize.

If you should have any questions, please do not hesitate to contact us!

Sincerely yours,

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