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Chinese bust and commodities decline are a warning shot for risk assets!

Highlights of the conversation:

Heinz Blasnik:

- Relative to commodities gold has actually continued to rise. It is down in nominal terms, but it is actually going up relative to industrial commodities and esp. measured in oil.
- The threat of a Greek exit from the Euro area actually represents a deflationary threat, because if Greece had exited, it would have meant that there would have been a large depositor haircut in Greece. So, I think the reaction of gold is not all that unusual.
- In Europe monetary inflation is currently above 13% annualized, which is very high for the Euro-area historically. **In China, the money supply has collapsed to its lowest annualized growth rate in more than 15 years.** In the US, although the Federal Reserve – as we all know – has stopped with its quantitative easing program, the commercial banks have taken up the slack; and when we look at commercial and industrial loans, they are growing at more than 12% per year at the moment; and loans and leases of commercial banks overall are currently growing at well over 8% per year.
- **The underlying trend of the Chinese market is still very, very weak because if you need to basically outlaw selling in order to get it to bounce then something is very, very wrong.** And I personally think that they will actually fail in the end, because of the effect that money supply growth in China has collapsed from a very high level to the lowest level in a very long time and you need actually accelerating monetary inflation to keep a bubble going.
- That downturn in the Chinese stock market: I see it as a kind of warning shot for other markets, for other risk assets. In China's stock market there has been a lot of margin trading, so people have borrowed a lot of money to buy stocks. And we see similar high margin borrowing in other markets: **in the US market, margin debt is on an all-time high and it's right at the peak also relative to market capitalization,**

relative to GDP, also it's right in the insanity of the peaks we have seen in 2000, 2007, 1929 - all dates that were not exactly precious times to buy stocks.

- If anything is going to happen in Western in stock markets, then it's probably going to start in the credit markets. That is the weakest point – the lack of liquidity in credit markets combined with very tight spreads and extreme leverage.
- The reason why the Euro zone governments have always been so eager to keep Greece in is of course that they have very large contingent liabilities due to the EFSF financing of Greece which would be triggered if Greece exits the Euro. So, then the public-debt-to-GDP ratio of all the other Euro area members would actually rise quite significantly if they had to write off what they have already lent to Greece.
- **If Mrs. Yellen can somehow avoid it, she won't hike rates. But she may be forced by an improvement in labor market data to eventually do a baby step rate hike. One thing that could change that mind is if inflation expectations would actually rise sharply.**
- The one thing that I believe has kept the US stock market aloft is the fact that broad money supply growth in the US, TMS2, is still about 8 % per year. Apparently, it's not enough to push the stock markets significantly higher, it's just enough to keep it going sideways.
- **One should continue to accumulate gold at the current level. The risk-award-equation is very, very skewed.**

Jim Rickards:

- **In the early stage of a financial panic, the price of gold tends to go down. Gold is a funny market, it's thinly traded and liquid at the same time.** That's unusual, because usually markets that are thinly traded aren't liquid, markets that are heavily traded are liquid.
- **If you draw a comparison between gold and the CCI, you can see that gold held up very well compared to commodities.** My expectation is that Greece will not leave the Euro, that no other country will leave the Euro.
- **So, the Fed actually chases the economy, it doesn't lead the economy.** So, everybody has a it backwards: the idea that if she raises rates the economy gets stronger is complete nonsense!

Frank Shostak:

- **China is currently subjected to quite a deflationary pressure when we account for money supply.** Money supply rate of growth collapsed: using the Austrian Money Supply rate of growth: in January 2010 it was about 40% and currently it is about 3%. And this has a massive negative effect on commodity prices including the gold price.
- In America we still have an underlined down trend in the money rate of growth. This by itself I think exerts downward pressure on the economic activity at present.

- In Europe we have the exact opposite fact since October 2011 until now. We observe in terms of the growth momentum of money supply actually a strong uptrend, which can provide some explanations of why there are some so-called bubble activities rising again in Europe. But again it's consumption of capital in Europe.
- We don't see China recovering that soon. In fact, the Chinese market is I think right now overvalued probably by 40%.
- Charles Evans, the Chicago Fed president, he made various comments against the raising interest rates in America, at least until the mid of next year. **We don't expect a firework in America and therefore the Fed will be reluctant to raise interest rates.**

Ronald Stöferle:

- Chinese developments are putting a huge deflationary pressure on the markets. We are seeing copper, crude oil, but also nickel, zinc and so on collapsing basically. I think in this environment gold is actually doing what it should – because, as we know, disinflation and deflation are not the best environments for gold.
- Volkswagen is already selling more than 50% of its cars to China and we have already seen quite some effect on the stock price of Volkswagen. **Many market participants currently underestimate the global effects of a significant downturn in China.**
- If Greece would leave the Euro zone, I think they would really face a tough time for one or two years, but I think with a new devalued currency – like a new Drachme or whatever – I think they would do better in like 2 or 3 years. And then I would say that there would be a lot of political pressure from opposition parties coming up in Italy, in Spain, and in France: "You know, the Greece got their own currency again, they devalued and now they are doing better." One only has to have a closer look at the developments in Iceland.

Mark Valek:

- We have not seen according to our signal the break of the deflationary tendencies yet. Just recently our signal once more switched to deflation in beginning of July.
- According to our inflation signal we did allocate some of the resources of our fund in inflation-sensitive assets in May, which we had to cut pretty fast again, because – as I said – we have not seen this final breaking in this deflationary dynamics.

Transcript of the conversation:

Ronald Stöferle:

Gentlemen, thank you for joining our next discussion of our advisory board!

I think we all have been pretty busy these days with observing two important events on the markets: first, and foremost, the whole Greece discussion, which is already a bit annoying, and the decision (which is actually not a real decision) is not a big surprise for us. We will talk about this subject later on, of course.

But perhaps more importantly, we will discuss China. While markets and especially the media are concentrating on Greece, I think there is something much more important going on these days, which is the collapse of the Chinese stock market. We had a great call from Jim Rickards last time, he said: "*The third trade is concerning the biggest bubble in the world right now which is the Shanghai Stock Exchange.*" And he also said: "*When that bubble bursts, it is going to be one of the biggest collapses in the world.*" So Jim, congratulations on this great call!

Source: Investing.com

We will also talk about gold that doesn't really behave like many people would have expected in an environment where the Grexit is discussed. And we'll also discuss a possible rate hike in the US and when it will come, or if it will come at all.

Just some housekeeping at the beginning: Mark and I, we've been publishing our most important publication, the "In Gold we Trust" report. Our in-depth media survey for the last report found out that the report was downloaded more than 1 million times, so it is really read all over the world. We are really glad that this year's edition is also quite a big success. It's 140 pages full of our thoughts regarding gold, inflation, mining stocks and so on.

Moreover, we are glad that with the help of our dear friend Heinz Blasnik we are very close to publishing the English edition of our book on Austrian investing – we are currently finalizing everything and will publish the English version of our book "Austrian Investing" probably in the end of August / beginning of September.

So, that's it for the housekeeping.

Mark, can you briefly comment on our recent activities in our fund as well as our inflation signal, please?

Mark Valek:

Sure! We had a disinflationary environment according to our inflation signal for more than 10 months, starting in August 2014. Thereafter, we had a big collapse in oil and commodity prices, a big deflationary move generally. We were very happy with this signal and our market call, which helped us tremendously in our fund, as we avoided a downturn.

For the first time in 10 months, we had a brief inflation signal – two months ago, which just now has turned again. **So, we have not seen according to our signal** – and I think you can also see this on the fundamental level very clearly – we have not seen **the break of the deflationary tendencies yet.** So, that's at least how we read the markets and how the inflation signal, which we use for our asset allocation, reads the markets. Right now, we see deflationary signs most of the time for most segments of the markets and the signal has turned to disinflation at the beginning of July.

This is for us quite an interesting aspect. **According to our inflation signal we did allocate some of the resources of our fund in inflation-sensitive assets in May, which we had to cut pretty fast again, because – as I said – we have not seen this final breaking in this deflationary dynamics.**

One more thought on this special topic as well: we talked about a deflationary collapse two quarters ago, a short update on this topic would be something of quite big interest to us.

Back to you, Ronni.

Ronald Stöferle:

Thank you Mark! Yes, I think that basically sums up our most important thoughts very well. I think we should jump right into the discussion.

First topic: Why is gold behaving not as many market commentators would have expected? Let me give you my thoughts first: I think **we should not overrestimate the whole Greece discussion. But much more importantly, China is putting a huge deflationary pressure on the markets. And we are seeing copper, crude oil, most importantly, but also nickel, zinc and so on collapsing.** We are seeing that the gold-silver ratio, which is a very accurate indicator for inflation dynamics, is rising quite significantly. So, **I think in this environment gold is actually doing what it should – because, as we know, disinflation is the worst environment for gold.**

Gold/Silver-Ratio

Source: Goldprice.org

So, do you think that "deflation" is the name of the game and gold is actually doing what it should do? Or do you think that due to the high liquidity of gold there is some selling pressure and this is having some sort of impact on the price?

The floor is yours!

Heinz Blasnik:

I have actually given this some thought because initially I was also surprised that gold did not catch up a bit on this Grexit threat, which by now does not exist anymore (at least for now). Then I considered that, first of all, **relative to commodities gold has actually continued to rise. It is down in nominal terms, but it is actually going up relative to industrial commodities.** Then secondly, I actually believe you are right that gold serves as a source of liquidity, especially for people who have been trading commodity futures and so on. I think, you are right that gold served as a source of liquidity to CTA's and that like, people that have done margin calls and commodity futures because the collapse in China creates some pressure on commodities. That is one thing.

Source: Investing.com

Source: Investing.com

Source: Investing.com

And another thing is **the threat of a Greek exit from the Euro area actually represents a deflationary threat, because if Greece had exited, it would have meant that there would have been large depositor haircuts in Greece.** The remaining 160 billion in deposits probably would have been cut by 60% or more. So, Euro-area-wide the money supply would have declined by this amount. The ECB could be backing this up within a few months again – but initially it would have been a highly deflationary event.

So, I think the reaction of gold is not all that unusual, if you really think about it! And in fact, I could actually agree with what you said earlier: This might change, gold might actually go up in nominal terms if crisis conditions worsen further.

In China, the money supply has collapsed to its lowest annualized growth rate in more than 15 years. So, there is no monetary inflation in China right now, or let's say, there is very little monetary inflation in China compared to the historical data. So, **we actually have different areas of the world, we have very, very different rates of monetary inflation. In Europe monetary inflation is currently above 13% annualized, which is very high for the Euro-area historically.** At the end of 2011, growth in the Euro-area through money supply was about 0%; now it is something like 13.5-13.6%, which is a great deal more.

In the US, although the Federal Reserve – as we all know – has stopped with its quantitative easing program, the commercial banks have taken up the slack; and when we look at commercial and industrial loans, they are growing at more than 12% per year at the moment; and loans and leases of commercial banks overall are currently growing at well over 8% per year – and that is actually the highest growth rate since the 2008-crisis. **There is actually a good reason why inflation expectations in the Euro-area and in the US are rising somewhat and also a good reason why they are declining very sharply in China. And China of course is more important for commodity prices.** And as we all know, Chinese traders have used commodity inventories to back loans that they took out from banks, so, presumably a lot of margin calls are going out – that are happening outside of the system of standardized futures trading. So, I think this is a major source of pressure on commodities in general and gold as well.

Frank Shostak:

I am broadly in agreement with what Heinz said. I would just add two more things here. For instance, probably, **as far as gold is concerned, China is an important factor, a very important factor, in fact, <u>the</u> factor. And China is currently subjected to quite a deflationary pressure when we account for money supply. Money supply rate of growth collapsed from almost 40% using the Austrian Money Supply rate of growth: in January 2010 it was about 40% and currently it is about 3%.** So, it is a massive collapse in growth momentum. Obviously, **this has a massive negative effect on commodity prices including gold.**

And with respect to other countries: **in America we still have an underlined down trend in the money rate of growth.** It started in October 2011 and then there was a pronounced fall until October 2013, a slight bounce, and thereafter again softening. So, all in all I would say, the US money rate of growth is trending down. **This by itself I think exerts downward pressure on the economic activity at present** – I think we already see certain signs, not all is conclusive, but they are there, since also bad for commodities in this sense.

In Europe we have the exact opposite since October 2011 until now. We observe in terms of the growth momentum of AMS actually a strong uptrend, which can provide some explanations of why there are bubble activities rising again in Europe – a certain illusionary activity, but all this in terms of industrial production, GDP may show that encouraging figures. **But again it's consumption of capital in Europe. So, from a European aspect it should be positive for commodities a little bit, and the American is negative, and if you add the Chinese, obviously it's negative. So, all in all we have a negative effect on commodity prices.**

Jim Rickards:

I agree with what Frank and Heinz said that the action in gold is actually very similar to what we saw in 2008: In the early stage of a financial panic, the price of gold tends to go down. **Gold is a funny market, it's thinly traded and liquid at the same time.** That's unusual, because usually markets that are thinly traded aren't liquid, markets that are heavily traded are liquid. But we're in this upside-down world, where gold is thinly traded but liquid. And when we look at the Treasury markets, it's heavily traded and not liquid. Everyone there, Ben Bernanke, the IMF, the BIS and to all the members of the federal board of governors and my other contacts in the US Treasury markets are saying the same thing: they have never seen such illiquidity.

My experience in the government bonds markets in the 1980s and 1990s was very different in terms of liquidity. Let's say the customer calls and wants to buy $100 million in 10-years notes. That was a large order but we could probably get it done in minutes. Today you are scrambling around and the minutes are hours, the hours are days and trading anything but the most liquid instruments can take weeks. Corporate debt or Municipal debt, trades are hard to do at all. So liquidity is drying up in the bond market but it's still pretty good in the gold market. So when people are under stress – and there are people under stress in Greece or China and elsewhere – they might be selling gold to raise cash because they need cash to meet other margin calls or get their money out of the country etc.

But I also agree that, I never think of gold as a commodity, I think of gold as money. Now it's true that gold is traded on commodities exchanges and gold is treated as a commodity in most structures, in most research. But I actually don't think it's a commodity. But if you look at the CCI-index, it has 16 commodities in it and gold is one of them. **Now if you draw a comparison between gold and the CCI, you can see that gold held up very well compared to commodities.**

Mark Valek:

In response to that I would like to shift this discussion to – we touched it already – the China topic. What's your opinion, gentlemen, regarding potential overspills to the equity side perhaps?

Ronald Stöferle:

Just one number that I thought is astonishing: **Volkswagen is already selling more than 50% of its cars to China and we have already seen quite some effect on the stock price of Volkswagen.** So, I think, as I've said at the beginning, this is probably a kind of overshadowed by the whole Greece discussion, but what's going on behind the scenes in China is probably much, much more important to the markets than Greece.

Heinz Blasnik:

I want to just quickly say something about China's stock market. **As we have seen, the Chinese authorities basically made it illegal to sell anything. So, the market only started to bounce when they said: "Well, if you are a short seller, you gonna go to jail!". 80% of the companies listed on the stock exchange aren't trading at all, or they are simply suspended, and large Chinese institutions have been told they may no longer sell.**

That means that the underlying trend of the market is still very, very weak because if you need to basically outlaw selling in order to get it to bounce then something is very, very wrong. And I personally think that they will actually fail in the end because of – what Frank also said –, **because of the effect that money supply growth in China has basically collapsed from a very, very high level to the lowest level in a very long time and you need actually accelerating monetary inflation to keep a bubble going.** I was really surprised that they were able to get this bubble going in the first place. But anyway this bounce that we are now are seeing in this market is very weak because it's artificially induced.

And I see what has happened over the past month and a half, but **that downturn in the Chinese stock market: I see it as a kind of warning shot for other markets, for other risk assets. In Chinese stocks there has been a lot of margin trading, so people have borrowed a lot of money to buy stocks. And we see similar high margin borrowing in other markets: in the US market, margin debt is on an all-time high and it's right at the peak also relative to market capitalization, relative to GDP, also it's right in the insanity of the peaks we have seen in 2000, 2007, 1929 -all dates that were not exactly precious times to buy stocks.**

And also we hear – and that is something that people have been talking about for the past 2 years or so – we hear that **liquidity in the credit markets has really declined a lot!** Due to all these new regulations that force banks to reduce capital prop-trading and the financial repression type of laws that have forced banks to buy all sovereign debt supposed to for instance corporate debt. All this has sucked liquidity out of the credit markets! **This is probably the Achilles heel of the markets. If anything is going to happen in Western markets, in stock markets of Europe and**

the US, then it's probably going to start in the credit markets. That is the weakest point – the lack of liquidity in credit markets combined with very tight spreads and extreme leverage.

You have actually discussed it in the gold report: the lower yields go, the more inducement there is to take up leverage – because you want to have a decent return and if yields of government bonds are only half a percent and you can borrow 10 times your money to invest in that bond and you can boost your annual return to 5 percent. But you are taking a lot of risk – but at the same time the regulators are saying about these bonds are actually risk-free. So, **I think there is a time bomb in the market and China's market decline is a warning shot in that direction – it's telling us that things are actually on shakier grounds than it appears.**

Ronald Stöferle:

Frank, I think what would be tremendously interesting for our readers of the transcript would probably be a very short summary of the AMS that you are famously calculating – the "Adjusted Monetary Supply", also called "Austrian Monetary Supply". Could you tell us a little bit more about that for people who are not familiar with that topic?

Frank Shostak:

Sure. Basically the Austrian Money Supply deals with credit and with claim transaction and excludes all the credit transactions. In other words, for instance, if you buy certificate of deposits, the conventional definition will include this transaction in the money definition, like M2, M3. The Austrian approach is that this will be seen as double counting. Why? Because money is transferred from the person who bought the certificate of deposit and transferred from one account to another account, but overall money didn't change.

It also brings back the money which was paid to the government in form of taxes, because this type of money tends to be excluded from the official definitions and in the Austrian definition we bring it back. So, that's in a nutshell what the AMS stands for – that's Adjusted Money Supply in this sense and **provides a more true state of how much money is in the system. And it's quite important because if you believe that changes in money supply cause fluctuations in economic activity and also are an important cause of boom-bust-cycles, then it's relevant to have – at least theoretically – better defined what money supply is.** In terms of the mainstream approach: they define money in terms of how well it is correlated with something called GDP for instance without realizing that GDP is also money. So, they are correlating one money with another money to provide the justification of what the relevant definition of money should be. This is the way the monetarists are doing, the Milton Freeman followers.

The other guys don't pay attention at all to money supply as you know, **since the early 80s nobody looks at money supply, it has become a non-relevant issue, but unfortunately this is not so and the Austrians believe that money supply plays an**

important role in destroying the process of wealth formation and capital formation and loose monetary policies and fiscal policies are the main culprit behind it.

Ronald Stöferle:

And I think, Frank, what you are specializing, what you are working for probably for decades already is *the time lags* that are crucial for investors, right?

Frank Shostak:

That's right! The time lags between money supply and the fluctuations in economic activity are crucial. **We are looking at many various markets, but on average we are saying that the time lag between changes in money supply and a so-called cycle takes about 22 months to see an impact. In other words, money printed 22 months ago only now would start having an effect. And that's really important because if someone wants to build his asset allocation, we believe that one needs to know where you are on a so-called business cycle. Because business-cycles are there not because they should be there but because they are generated by the central banks through their reckless policies.** And it's important to know where we are, on what stage of the business cycle we are at any point of time. And that's crucial because by knowing where we are or where we are going at least, we can set up strategies for asset allocation.

We're using the so-called 4 stages approach to business cycle, which we determine by the means of lagged money supply. And then once we have established the stage that we are having, we provide an assessment and we are using our a priori statement or assessment where one should invest. If we observe that, if we say that the economy will start falling in a rapid pace – in other words: the cycle goes down and the slope of the decline is accelerating, then obviously we would say: we have 4 asset classes (stocks, cash, commodities and bonds) and in this phase we will try to minimize positions in stocks, probably we will only be in defensive stocks or non-cyclical stocks, we will be heavily-weighted in cash and we would probably consider also bonds and would exclude the commodities, right?

That's how the Austrian approach for asset allocation will be processed. **This runs differently of course from the Modern Portfolio Theory, which tries to correlate things. We don't do those kind of things, we don't believe that one should diversify just for the sake of diversification. Rather, one should invest in the right asset classes.** And this is also in line with what wise people like Warren Buffett are doing: they don't invest for the sake of diversification, but they are investing in the best assets.

Ronald Stöferle:

Thanks Frank! I couldn't agree more! I think we will keep it brief for the last two topics.

Well, I personally kind of promised myself to stop commenting on Greece as there is so much confusion around and it’s still a very big mess. However, I’d love to hear your thoughts. First of all, **a Grexit from my point of view will only happen if Greece will initiate it. I think that the politicians kind of stipulated conditions which are so tough that Greece is almost** obliged to not implement them. So, the whole deal that we are seeing is kind of a carbon copy of a memorandum of understanding from 2012, of which we all know that they failed to deliver. On the other hand, I think on the markets we don’t see such a big relief-rally these days although the Grexit is off the table. My view on the big picture: I think the whole discussion is not about Greece actually, it’s mostly about Spain, Italy, and of course France. **Based on our views, I think if Greece would leave the Euro zone, I think they would really face a tough time for one or two years, but I think with a new devalued currency – like a new Drachme or whatever – I think they would do better in like 2 or 3 years. And then I would say that there would be a lot of political pressure from opposition parties coming up in Italy, in Spain, and in France: “You know, the Greece got their own currency again, they devalued and now they are doing better.”** So, I think this is mostly about the other PIIGS nations, and I think of course from a political perspective, Tsipras capitulated fully, he got nothing, he got less than nothing, it’s a total disaster for him in Greece. But what is definitely going to be a big topic is that there’s a huge accountability gap in the EU history. I think no one really wants to deal with the result of five years of “pretend and extend” and therefore politicians – from my point of view – never have been further away from the European Union from the voters than today.

So, gentlemen, what’s your view on it?

Frank Shostak:

I agree with what you said about other countries. I think that as far as Greece is constant, what is happening there: all the noise is coming not from wealth creators, it’s coming from all the parasitic activities that are badly affected by the recent fall in money supply. So**, the overall policies that were implemented by the pre-Tsipras government were actually good. In fact they have provided some relief to wealth creators.** But even the fact that there were so many parasites there, so many bubbles, relative to the good guys, obviously you would hear the noise. You will hear a lot of noise, because there are so many people, so many civil servants and now they are dependent on the government. **The government activities cannot be supported any longer because of the private sector has gotten too weak. So, obviously these fiscal and monetary policies are the right recipe and they should be continued. What the European Union guys are forcing the Greeks to do: nothing wrong with that! The only tragic about that: they also want them to raise taxes.** All you have to do now is I just to continue cutting down government and allow the cleansing to go on, but don’t raise taxes!

So, all in all I would agree that Greece may be offering opportunities in some respect because the underlying wealth conditions might be improving then. Also there are some not bad signs in Spain because of the tighter fiscal policies there. And then again: all the positives that we are seeing in the Euro zone from the fiscal point of view might be destroyed by Mr. Mario Draghi with this monetary pumping. And that's really unfortunate! So, ultimately there will be a breakdown of the whole Euro zone as a result of all.

Heinz Blasnik:

Well, those of you who read acting-man.com out of there probably know that I couldn't agree more with Frank. By raising taxes they are trying to squeeze the last drop of blood from an already suffering private sector just to make sure that the government doesn't shrink.

This has happened everywhere, not only in Greece. In Italy it has happened as well: when Mario Monti took over, the EU technocrat, what did his reforms consist of?! It was just raising taxes, nothing else basically!

So, I'm in full agreement: **the prescription of the EU that have been made now in this new agreement with Tsipras are all positive with the exception of the tax hikes – they should have left that out!** They should give the private sector some breathing room to recover. Because that is the problem in Greece – precisely what Frank has said: **there are too many parasites that depend on government and not enough wealth creators that are given the room to actually do what they do best.**

Ok, there is not much more to be said to Greece. By the way, one more thing: **the reason why the Euro zone governments have always been so eager to keep Greece in is of course that they have very large contingent liabilities due to the EFSF financing of Greece which would be triggered if Greece exits the Euro. So, then the public-debt-to-GDP ratio of all the other Euro area members would actually rise quite significantly if they had to write off what they have already lent to Greece.** So, there are very, very strong financial and public relations incentives for them to keep Greece in. But of course they can no longer do it without setting very, very tight conditions – that is actually understandable.

Mark Valek:

Thanks Heinz!

Jim, any comments?

Jim Rickards:

My expectation is that Greece will not leave the Euro, that no other country will leave the Euro, that the Euro zone over the next several years will expand with new members. So, I do not look for any any other countries leaving the area. That does not mean that the solutions are sound. So, I would not opt for a Grexit, neither for any of the other countries to leave.

Mark Valek:

I think it's a good time for a final round. We would like you about your expectations for the main asset classes in the second half of the year.

Frank Shostak:

My forecast on the treasury bonds, the long-term yields: there is some possibility of a slight softening. But for the next year we'll see quite a significant decline.

With respect to the stock market**: I still think that there is simply a reasonable correction in most stock markets worldwide – the bubbles are still too high and the corrections still all to come. So far it did not happen, but I expect it will happen. Commodity prices are more also showing an underlined downtrend until the end of next year,** both for gold and base metals. Again China is important. **We don't see China recovering that soon. In fact, the Chinese market is overvalued probably by 40%.** There could be a correction at least to come on 40% in the Chinese market. And I agree with Jim that the Fed will not raise interest rates this year despite some comments by various governors**.** But the most important governor in this perspective, **Charles Evans, the Chicago Fed president, he made various comments against the raising interest rates in America, at least until the mid of next year.**

Heinz Blasnik:

Ok. What I was going to say is that Charles Evans is actually quite influential. And I think that he actually reflects Mrs. Yellen's thinking quite well. **If she can somehow avoid it, she won't hike rates. But she may be forced by an improvement in labor market data to eventually do a baby step rate hike.**

I'm not sure what that is going to achieve. In my opinion, it does not really matter, if the target corridor of the federal fund rate is 0 to 0.25 % or if it's 10 to 15 basis points higher. I don't see what difference it will may make. But anyway, if they can avoid it, I'm sure they will postpone it for as long as possible. I feel pretty certain about it.

One thing that could change that mind is if inflation expectations would actually rise sharply. And this is something we can never rule out; it doesn't look like it at the moment, but it could happen – we've had some surprises before in this respect. So, I expect the Fed to sit on its hands for as long as possible.

With respect to asset markets: **the one thing that I believe has kept the US stock market aloft is the fact that broad money supply growth in the US, TMS2, is still about 8 % per year.** And that is historically quite high. It's not as high as it was, but it's still quite high. **Apparently, it's not enough to push the stock markets significantly higher, it's just enough to keep it going sideways.**

Source: Investing.com

Ronald Stöferle:

Thank you very much, Heinz!

Last but not least, Jim, just one very short topic for which we haven't had time so far. I just read recently that you met up with Ben Bernanke at a conference in China. I would love to hear a quick comment on that as well as your final thoughts on the markets. Thank you!

Jim Rickards:

Yeah, let me try to do that. I wrote a very long article, the title was called "My conversation with Ben Bernanke".

My main take was, that Bernanke gave no reason to believe that the Fed will raise interest rates any time soon. He said a rate increase when it happens – of course he did not say the exact time when it happens – would be a good thing because this means the US economy is getting stronger. The point that I want to make is that the Fed does not lead the market, the Fed just follows the economy. So, the economy gets stronger, the Fed raises rates and it gets all stronger, then they raise rates in more offensive way. **So, the Fed actually chases the economy, it doesn't lead the economy.** So, everybody has a it backwards: the idea that if she raises rates the economy gets stronger is complete nonsense! In reverse, if the economy gets stronger, and then they raise rates. That is what Bernanke says and it makes sense – they look at the data: "Is there strength in the economy?" So, I am back to what I said, that they can't raise rates.

And we have some claims about the influence of Charles Evans. About 2 months ago he wrote the paper "**Risk Management for Monetary Policy Near the Zero Lower Bound**" (you can find this on the website of the Fed Chicago). He produced a really, really long, detailed model which analyses why they should not raise rates. It is fairly academic but I really recommend it if you want to understand Evans. And that's how Yellen understands the world, she's completely model-driven.

Heinz Blasnik:

One more comment! I want to agree with Jim that **one should continue to accumulate gold at the current level.** One doesn't have to buy everything at once. The trick is to slowly, but surely hoard it, basically. I think that would be a really good idea. We don't know when it's time will come, but it's coming and when it does... Let's put it that way: **the risk-award-equation is very, very skewed, very asymmetric.**

Ronald Stöferle:

But Heinz, hoarding is a very, very bad thing!

Laughter.

All right, thank you very much, gentlemen. We wish you a wonderful summer and I'm looking forward to our next advisory board discussion! Thank you very much!

Appendix: Members of our Advisory Board:

Zac Bharucha

Zac began his career in finance at the investment bank Kleinwort Benson and later became an equity portfolio manager at Philipps and Drew Fund Management. He then moved to AMP Asset Management where he was responsible for managing more than GBP 1bn of institutional assets. Afterwards, he moved to M&G in London. Since 1998, he has developed absolute return strategies and specialized in equities and commodities. After 25 years in asset management, he retired from professional life in 2011 and wrote his first book about market timing.

Heinz Blasnik

Heinz is an independent trader and market analyst for the consulting firm Hedgefund Consultants Ltd, as well as a regular publisher for the Independent Research House Asianomics in Hong Kong. Heinz primarily is responsible for his blog www.acting-man.com, on which he analyses developments in the financial markets from an Austrian point of view.

James G. Rickards

Jim is the author of the international bestsellers *Currency Wars* and *The Death of Money: The coming collapse of the international monetary system*. He is portfolio manager at the West Shore Fund. During his career, Jim has held senior positions at Citibank, Long Term Capital Management and Caxton Associates.

Dr. Frank Shostak

Frank is chief economist at AAS Economics. He has over 35 years of experience as a market economist and central bank analyst. He holds a PhD, MA and BA honours from South African universities. He was professor of economics at the Witwatersrand University in Johannesburg. He is one of the world leaders in applied Austrian School of Economics and an adjunct scholar at the Mises Institute in the US.

Rahim Taghizadegan

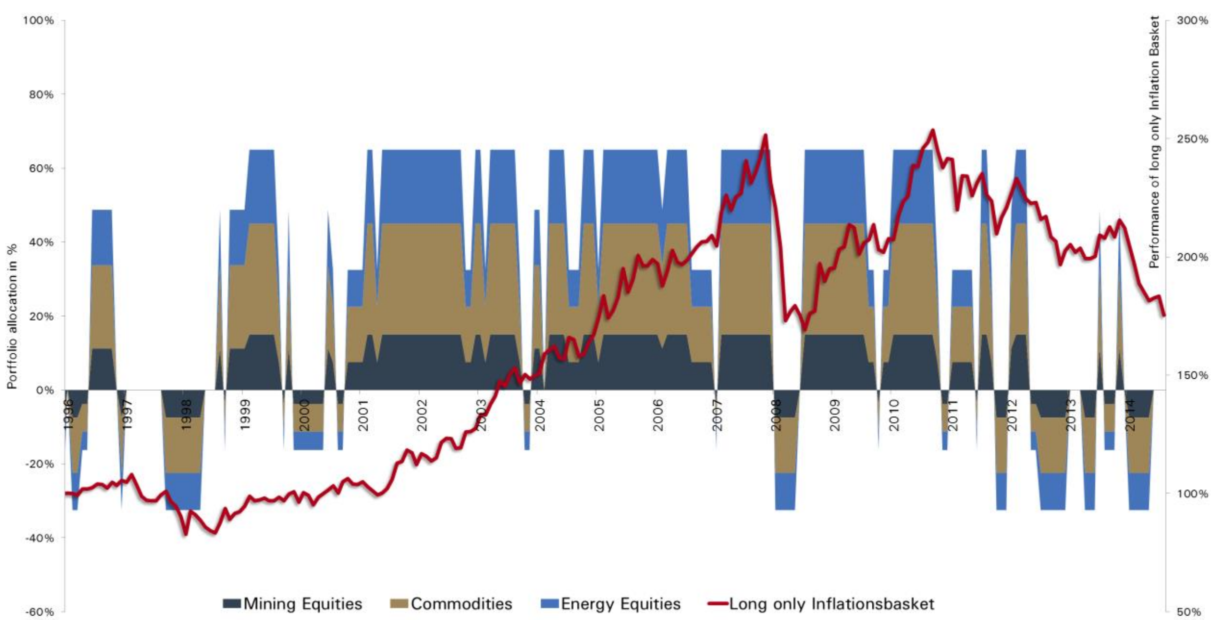
Rahim is the founder and director of the institute for value based economics, an independent research institute in economical and philosophical issues in Vienna. He is bestselling author and a popular speaker internationally. Rahim studied Physics, Economics and Sociology in Vienna and Lausanne. He has worked in the fields of economics, space research and journalism. He has also taught at the University of Liechtenstein, the Vienna University of Economics and Business Administration and the Universität Halle an der Saale.

Incrementum Inflation-Signal

At Incrementum, we are convinced that inflation is a monetary phenomenon. Because of the dynamics of "monetary tectonics", inflationary and deflationary phases can alternate. **To measure how much monetary inflation actually reaches the real economy, we utilize a number of market-based indicators** - a combination of various quantitative factors including the Gold-Silver Ratio - which result in a proprietary signal. This method of measurement can be compared to a "monetary seismograph", which we refer to as the **"Incrementum Inflation Signal".**

In the fund we manage, our Incrementum Inflation Signal gauges the inflation trend and we position the fund accordingly. Historically, we observed periods of between 6 and 24 months during which disinflationary forces were dominant. These phases were particularly painful for the holders of inflation sensitive assets. Right now it looks as disinflation might continue for a while. **Our inflation seismograph triggered a "falling inflation signal" in August.**

Implied commodity allocation based on Incrementum Inflation Signal



Source: Incrementum AG

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