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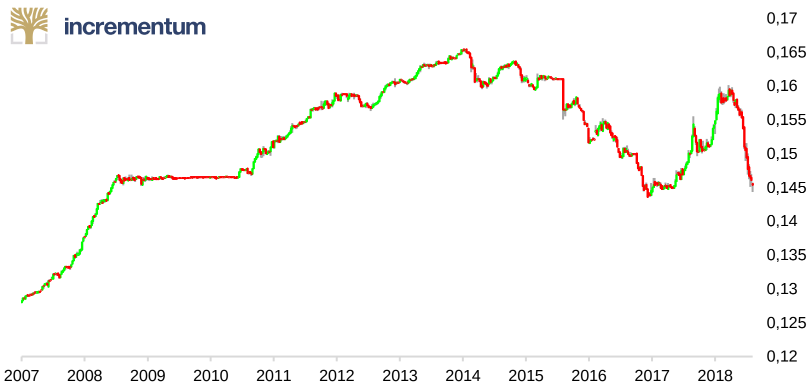
Incrementum Market Commentary

What has happened in markets?

Inflation-sensitive asset classes, including gold and especially silver, have suffered significant declines in the past three months. We want to take this opportunity to provide a comprehensive analysis of the current market situation.

It is well-known that the US dollar is a very important gold price driver. In fact, currently the correlation between the dollar and gold is at it's highest level in 30 years! In recent months the US dollar posted a remarkably strong advance, especially against a number of emerging market currencies. The backdrop to this was provided by the continuing rate hike campaign of the Federal Reserve, as well as the trade disputes instigated by President Trump. The recent move in the Chinese renminbi against the US dollar is particularly noteworthy in this context.

CNY-USD: 10% depreciation since June



Source: www.investing.com, Incrementum AG

The People's Bank of China has devalued the RMB by nearly 15% within just four months, with the pace of the depreciation accelerating quite noticeably in July and August. In recent history such a rapid devaluation by this otherwise cautious central bank is unprecedented. On the one hand this radical monetary policy measure reflects rapidly weakening economic growth, on the other hand it has to be brought into context with the escalating trade war. The devaluation of the yuan is a monetary policy measure intended to counter the impact of US import levies. This is exactly what Jim Rickards described in his book „Currency Wars“.

Why the Trump administration cannot win the trade war and the potential future consequences of the dispute

The desperate attempt to assert US interests under president Trump's “America First” policy could ultimately lead to a complete unraveling of the current global monetary architecture. In order to explain this statement we have to back up somewhat and discuss the bigger picture.

Up until now, the post-war global monetary order was characterized by US dollar dominance. The US held more than 90% of global gold reserves at the end of World War II, thus it was considered impossible to return to the classical gold standard of the pre-1914 era. At the Bretton-Woods conference in 1944 it was decided to introduce a gold exchange standard instead. Under the slogan "the dollar is as good as gold", the US dollar was adopted as an international reserve asset in addition to gold.

In 1959, when it was at least still possible for foreign central banks to convert their US dollar reserves to gold, US-Belgian **economist Robert Triffin highlighted a fundamental flaw in the design of this system**. According to Triffin, the liquidity required to support growing international trade could only be provided by a steady expansion in the global supply of US dollars. From the perspective of the US this was both a blessing and a curse. On the one hand the US could obtain funding from all over the world at very favorable conditions, but on the other hand it was condemned to run a perpetual balance of payments deficit. When US government debt began to steadily grow in the 1960s, other countries became increasingly suspicious and started to make use of their right to redeem dollars for gold. In order to halt further outflows of US gold reserves to foreign countries, president Nixon on 15 August 1971 "temporarily" suspended the US dollar's gold convertibility.

President Nixon suspends convertibility of the US dollar into gold

Source: Youtube

However, this decision did not render the "Triffin dilemma" moot. The necessity for the US to export liquidity via current account deficits in order to support global growth remained in place, and deficits began to grow at an explosive pace after the end of the gold exchange standard. In the almost 50 years in which the post-Bretton Woods system has been in place, the US has been largely deindustrialized and transformed into an extremely consumption-oriented economy. This compulsive consumerism goes hand in hand with a low savings rate and chronic trade deficits.

Reducing the US trade deficit is an explicit policy goal of president Trump. The president intends to reverse the process and lead the US back on the path to former greatness by reindustrializing the country. **For this plan to succeed without triggering a profound global economic crisis, the international monetary order will have to be changed fundamentally.**

The more trade barriers the US administration erects by imposing punitive tariffs, the more likely it becomes that the global supply of US dollars shrinks in the short term. At present, more and more export-dependent emerging market economies are falling prey to this phenomenon. This trend is exacerbated by rising interest rate differentials between the US and other important economies, as well as by the fact that servicing dollar-denominated debt becomes ever more difficult. Moreover, president Trump seems to enjoy using the US dollar as an instrument of power politics. In countries such as Venezuela, Iran and recently even Turkey, domestic economic problems are exacerbated further by US trade sanctions and currency policy pressures.

Alas, taking advantage of the privileged position of the US in this manner is a double-edged sword. To the same extent Trump flexes his currency policy muscles, awareness of the potential drawbacks of a US dollar-centric monetary order increases as well. A number of countries are trying to gain greater political leeway and boost their sovereignty in matters of currency policy by abandoning the US dollar as a trade and reserve currency. For example, Iran announced that it plans to increasingly use the euro in foreign trade. Libya is reportedly also frequently considering whether to denominate invoices for its oil sales in euro. China has already entered into several agreements with oil-exporting countries enabling it to pay in yuan. Moreover, trading in a yuan-denominated oil futures contract was launched in early 2018. Russia has for quite some time actively worked on reducing its dependence on the US dollar. US policies with respect to economic sanctions have inter alia resulted in Russian authorities classifying US dollar reserves as risky assets. Consequently Russia recently sold the bulk of its official holdings of US treasuries and redoubled its efforts to boost use of the ruble as a trade currency. Even German foreign minister Heiko Maas recently stated that Europe needed to reduce its dependence on the US with respect to international payments in view of the conflict over the US imposing renewed sanctions on Iran.[1]

At the same time a well-known traditional reserve asset is quietly celebrating a comeback on central bank balance sheets: gold. Over several decades the metal was discredited as a “barbaric relic” and inventories were gradually reduced. In the wake of the 2007/2008 financial crisis this trend reversed. Central bank gold reserves began to grow again, but this increase was exclusively confined to the gold reserves of emerging market countries. While the amount of gold reserves held by developed countries continued to fluctuate around the 25,000 tons mark, gold reserves of emerging market countries rose from a low of 4,596 tons in 2006 to 8,755 tons as of 2017 – a respectable 90% increase.

Particularly China, Russia and Turkey have significantly boosted their central bank gold reserves since 2007, namely by 307% (China), 408% (Russia) and 468% (Turkey).

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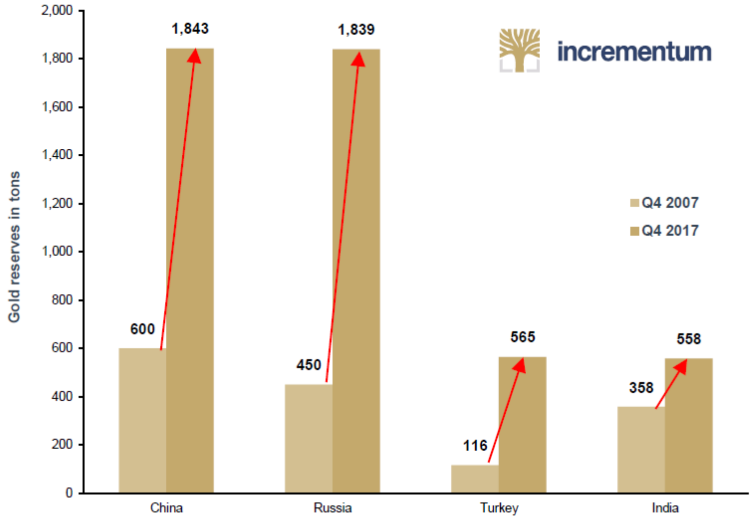
[1] For further discussion about the topic of „De-Dollarization“, please have a look at our In Gold we Trust Report 2018: https://ingoldwetrust.report/?lang=en

History of gold reserves held by the central banks of selected emerging market economies (in tons)



Sources: World Gold Council, Incrementum AG

In Q4 2007, China, Russia, Turkey and India together held 1,524 tons of gold, which at the time represented 5.1% of global central bank gold reserves. In Q4 2017, this total had increased to 4,804 tons or 14.3% of total official gold reserves. Upon closer inspection of the statistics a surprising datum is revealed. **Around 55% of Russia's monetary base M0 are currently backed by gold reserves.** The comparable figures for the euro area and the US are 9.5% and 8.8%.

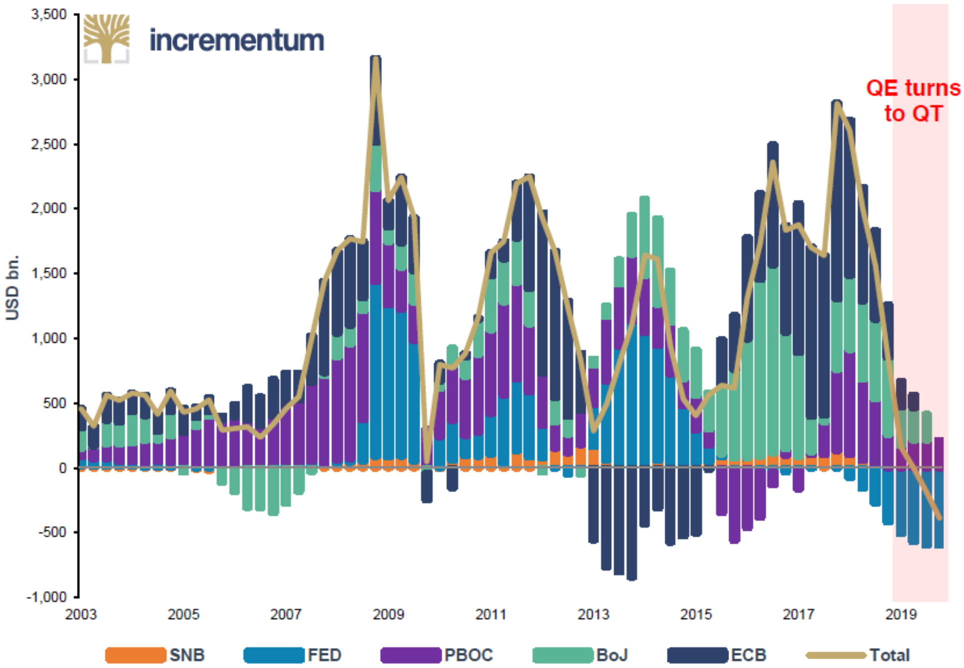
China, Russia and Turkey are among the countries questioning the US dollar-centric currency system and US hegemonic claims ever more aggressively in recent years, if not challenging them outright. The gradual build-up of gold reserves of this „axis of gold“ can probably be regarded as evidence for rising distrust in the reign of the US dollar and may well be a measure taken in preparation for an eventual new global monetary order. Contrary to the US dollar specifically and paper money in general, gold is free from the latent threat of a currency issuing nation one day refusing to accept its currency as a means of payment and thereby devaluing the reserves of other countries - possibly completely. Apart from gold's inherent political independence, it has the fundamental advantage that chronic balance of payments deficits cannot emerge under a gold standard.

In our opinion the Triffin dilemma ensures that Donald Trump cannot possibly reduce the US trade deficit without either triggering a global economic crisis or relinquishing the US dollar's dominant international position.

What could happen in the markets from here on out?

Expansionary monetary policy all over the world has primarily triggered asset price inflation in recent years. Along with rising stock, bond and real estate prices, outstanding corporate and government debts have continued to increase as well. **However, the monetary tides have turned.** This is to say, the most important central banks are planning to withdraw excess liquidity from the markets for the first time since the 2008 crisis.

Turning point in aggregate central bank QE will be crossed in 2018 (quarterly net flows into/out of securities in USD billion, annualized)



Sources: Bloomberg, Incrementum AG

The Federal Reserve has started this new trend. As noted above, the resulting bout of dollar strength is partly responsible for the recent market upheaval in debt-laden emerging market economies such as Venezuela, Argentina, Turkey, Iran, Brazil and South Africa. While economic growth in China remains actually quite strong on a relative basis, the devaluation of the currency coupled with slumping domestic stock markets provide clear evidence of a notable slowdown in the Middle Kingdom. Further turmoil has to be expected in a number of other countries as well.

What could trigger a reversal of recent trends?

US equities have so far remained essentially untouched by the upheaval elsewhere in the world. We believe though that it is precisely the US stock market that will ultimately be the pivotal factor. As soon as it suffers noticeable weakness, the Fed will sooner or later feel forced to abandon and reverse its restrictive monetary policy stance. There are already a few signs indicating that the current rate hike cycle is close to ending. For example, the Fed Fund Futures Curve now sees the Fed to cut rates in 2020 already.[2]

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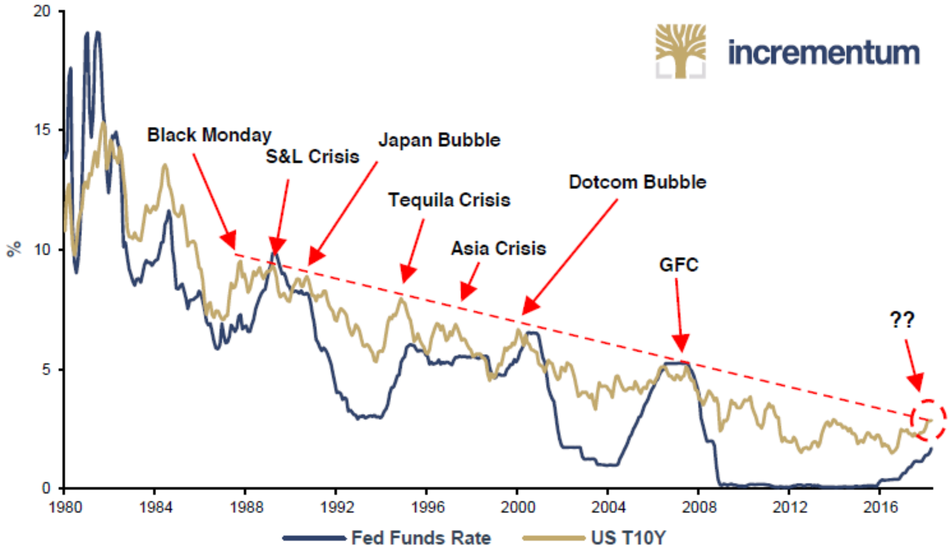
[2] https://twitter.com/RonStoeferle/status/1034100762677264384

Since June, the current economic expansion is in its tenth year, which makes it the second-longest in US history, while the bull market in US equities is already the longest on record. The rapid flattening of the yield curve meanwhile indicates that the Fed's leeway for imposing further rate hikes is by now rather limited. Moreover, historically US rate hike cycles were frequently the trigger for bear markets in stocks and international crises. **We believe that contagion due to the fragile international situation might soon spread to the US as well.**

US - federal funds rate & 10-year treasury note yield



Sources: Bloomberg, Incrementum AG

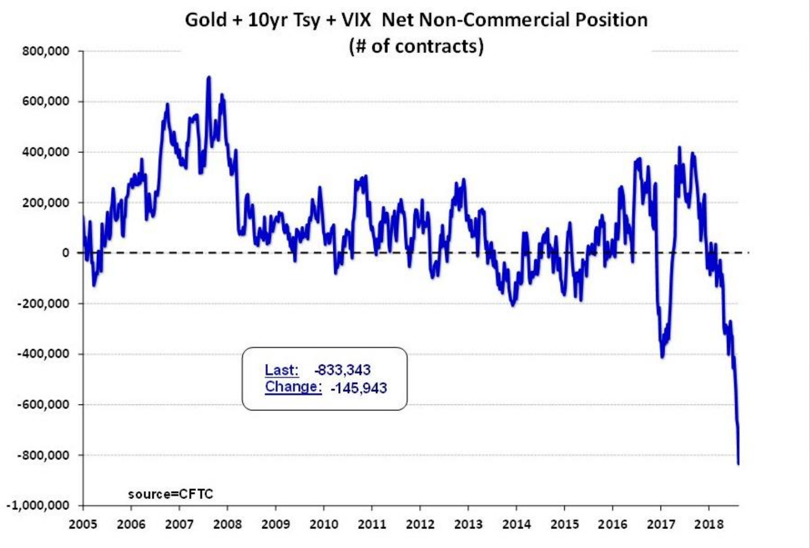
The current market paradigm, which has already prevailed for several years, is characterized by rising US stock prices combined with once again weakening commodity prices and a strong US dollar. In our opinion a long overdue downturn in US equities coupled with a reversal in US monetary policy could eventually bring about the transition to an environment of rising inflation and strengthening commodity prices.

Technical situation

In the context of the recent rally in the US dollar the gold price has suffered a noticeable slump. Since mid April the gold price has declined by roughly 12% from a high of USD 1,350 to around USD 1,200 per ounce with almost no interruption.

Financial markets are rarely trending in one direction without counter-trend moves. The longer such a uniform trend persists, the more likely an offsetting counter-trend move will emerge. Positioning in gold futures by speculators and the managed money category has recently become extremely one-sided, partly reaching historical records, as can be seen on the next chart.

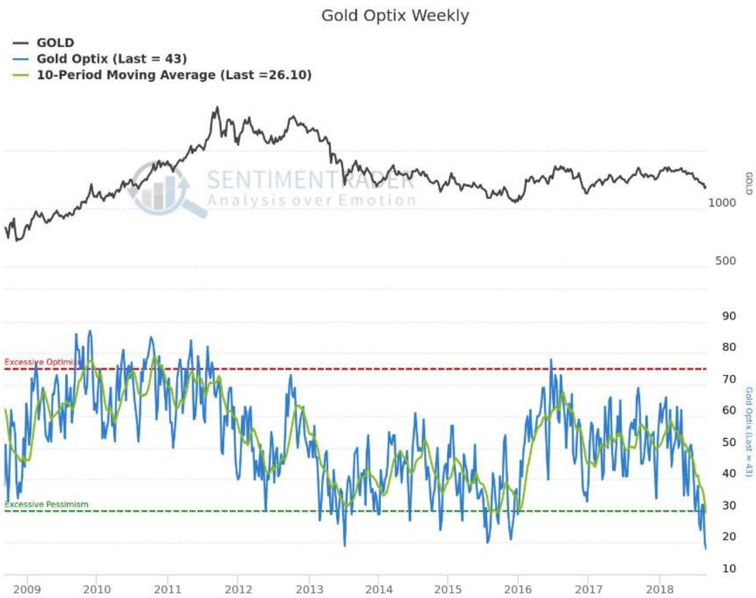
Combined positioning of speculators in gold, treasury and VIX futures



Source: Meridian Macro Research

Moreover, sentiment just hit extreme levels of pessimism as can be seen on the following chart. This suggests that a significant move to the upside is quite overdue. It may well become the beginning of a more substantial trend change. However, as long as the trade dispute remains a major market-driving issue and China keeps devaluing its currency, the market situation – including future gold price trends - will be challenging to gauge.

Gold Optix (weekly)



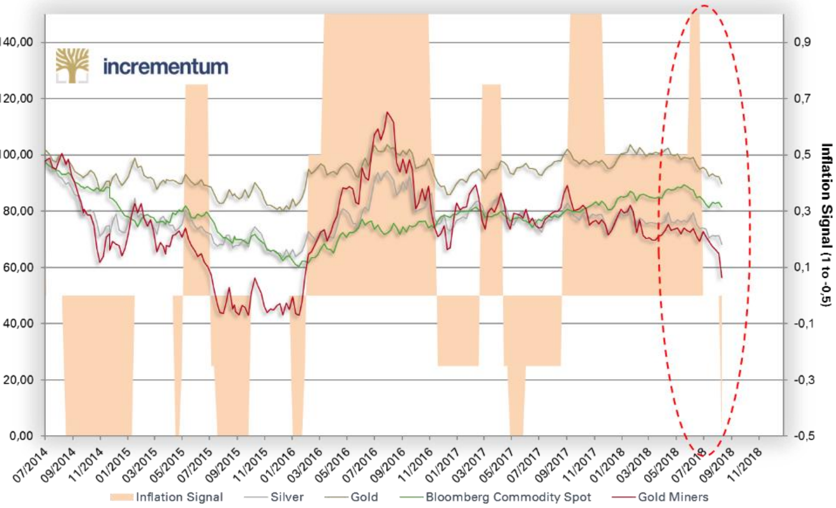
Source: Sentimentrader

Incrementum Inflation Signal Just Fell Into Negative Territory

In the course of the yuan devaluation and the associated weakness in gold and commodity prices our proprietary inflation signal initially declined into neutral territory and shortly thereafter fell further into negative territory.

In the Inflation Diversifier Fund we have partly reduced existing positions, while securing the remaining holdings by setting tight stop loss limits. In addition we have accumulated deflation-oriented positions by going long 30-year US treasury bonds.

Incrementum Inflation Signal



Source: Incrementum AG

Ladies and gentlemen, our central point remains: The global boom, fueled by ultra-low interest rates and the never-ending expansion of the money supply and credit, is on shaky ground. **The likelihood of the boom turning into a bust is high – much higher than the mainstream expects.**

We therefore anticipate a significant global economic dislocation with a substantial effect on the gold price in the coming years. As always, we will monitor these events, analyze them in detail, and comment on them regularly. Gold will definitely contribute to staking out a comfort zone in the turmoil of the tidal changes that we have discussed.

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