Liechtenstein, December 2016

Ladies and Gentlemen,

Dear friends and companions,

Dear investors,

You may be in a rush to make it to one of your last appointments this year, or you may have already started your preparations for the festive season and are buying the last few presents as we speak. Perhaps snow is even falling, wrapping the world in a white blanket that soaks up any noise; the hustle and bustle of the pre-Christmas period is over; families are coming together, spending the last, most tranquil days of the ending year with each other. **The tranquillity of these days allows us to take a step back and look at the past year, which was definitely turbulent and instructive.** We also use the time around Christmas and New Year's for introspection, reflect critically on the past, and review our vision for the future.

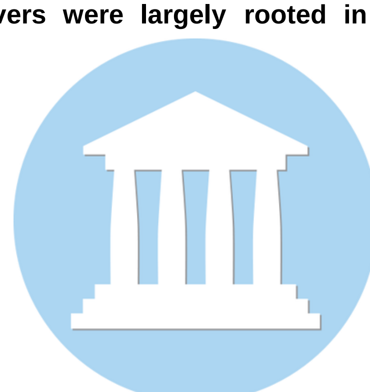
Like last year, we would like to present you our most important thoughts on our investment strategy as well as the exciting developments at Incrementum AG. We do hope that you will enjoy reading our annual letter to investors!

2016: All About Politics!

In our 2015 letter we wrote:

> *"Throughout history there have always been periods in which profound political, social and economic upheavals took place. In modern times, the intervals between such events have been becoming radically shorter – the escalation curve of revolutionary events is exponential: things that shape the world today, will already be anachronistic tomorrow. There are many indications that we are currently also right before major upheavals. Since it is particularly important in our industry to be prepared for such changes and to set the course for tomorrow's success, time diagnosis is a basic discipline to successfully participate in the dynamics that change the world."*

Whereas in 2015 the relevant surprises for most market observers were largely rooted in monetary policy, 2016 has been a year of drastic political change. Around the middle of the year, the Yes vote in favour of Brexit in the UK referendum came as a shock to the international markets – albeit only for a short while. The rise of nationalism has been a worrisome development across other regions in Europe as well, prompting questions about the future of the euro and the European Union itself.

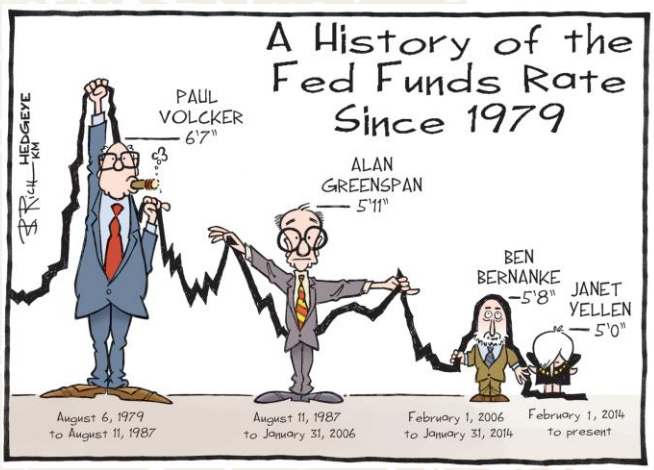


However, the most profound upheaval on the markets has been caused by real estate tycoon Donald Trump's victory in the US presidential election. **The 8th November 2016 requires a comprehensive re-assessment of the market scenario.** After a populist election campaign, the market participants now have to evaluate the extensive consequences to the best of their abilities. This is even more challenging given that **the President-elect promised a radical change of course across <u>all</u> political areas (foreign affairs, domestic and economic policies).** Unfortunately however, during his election campaign Trump would describe his plans in a rather vague fashion – presumably because at the time he himself was not clear about his specific modus operandi in the event of his victory either.

Regardless of the fateful election in the USA, whose medium-term ramifications we will talk about in due course, we expect the staccato of political upheaval to continue in 2017. In the wake of the recently failed constitutional referendum in Italy and the resulting snap elections, a comeback of the euro crisis is looming at the horizon. The outlook on the imminent presidential elections in France is also unpalatable, and we can see signs of major shifts in the political balance of power in Germany, where Bundestag elections will be held in 2017.

The reasons for these political developments are complex and multidimensional. We are nevertheless of the opinion that there is an essential, systemic core reason for the political changes, which have largely come as a surprise to most of the market observers. We think that the "baffling" election/referendum results in the Western world are not merely the product of populist demagogues, but are due to a drastically widening economic gap in society. To put it in simple terms, one part of society regards itself as relatively prosperous at the moment and is clinging to the status quo in spite of – or because of! – the rising doubt about the sustainability of our current economic system. Another part of society, where the feeling of uncertainty and unfairness or indeed the hopelessness has turned into despair or even anger, is open to so-called demagogues – both to the far left and to the far right of the political spectrum.

The core reason behind this societal polarisation is not the least our current, unsustainable monetary system. When our uncovered monetary system was close to buckling under the pressure of the excessive debt burden in 2008, the system was saved by the bell and carried into the next round by the central banks' all-in reflationary policy. **The monetary measures are generally seen as success even if zero or negative interest rates continue to prevail and tons of fresh central bank money are still being printed as we speak – which should tell common sense that the crisis has not been overcome and we remain in dire straits.** The fact that this questionable treatment of the damaged system would not be without its set of side effects was foreseeable. One of those side effects has given rise to the gradual formation of a line of economic demarcation within Western populations.



Source: Hedgeye

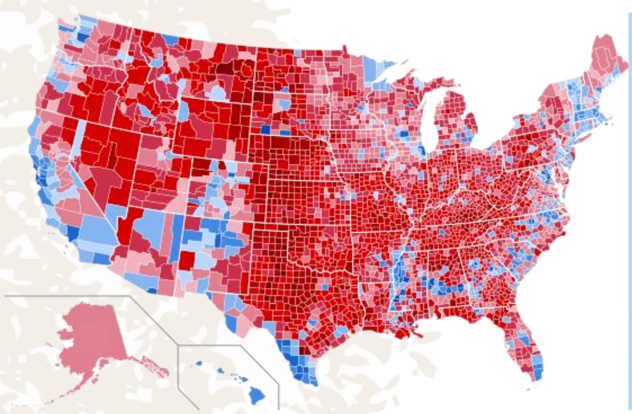
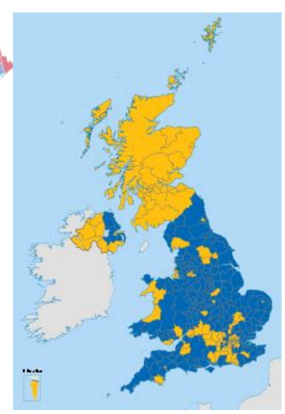
The legacy of Cantillon: Follow the honey

Advocates of the Austrian School of Economics will not tire easily pointing out the so-called Cantillon Effect. This is one of the highly negative effects caused by the creation of money ex nihilo. To anyone who has understood this mechanism, the resulting social consequences are easily comprehensible. But what exactly is the Cantillon effect? Here we would like to refer you to a passage from our book "Austrian School for Investors":

"Newly created money is neither uniformly nor simultaneously distributed among the population. This means that some users of money will benefit from rising prices, while others will be harmed. ***Money supply expansion is a transfer of wealth: market participants who receive the newly created purchasing power earlier benefit relative to those who receive newly created money only later or not at all.*** *The former are still able to buy consumer or capital goods at relatively low prices, the latter only after prices have already increased. If the money supply expands in a period of subdued economic activity, the money supply expansion can also fail to raise prices. However, even in this case there is redistribution, even though it is not immediately obvious: the larger money supply prevents a decline in prices to the level they would have attained had it not grown. […]* ***Inflation has the effect of a regressive tax, which due to the so-called Cantillon effect tends to hit the least affluent strata of the population the hardest.***

Friedrich August von Hayek compared the Cantillon effect to pouring honey onto a saucer. The honey only distributes itself slowly from the centre outward. Transposed to the effects of inflation, this means that governments and companies that are close to the source of money creation benefit from it. They receive the new money before prices in the economy have risen."[1]

The regional election/referendum results in the USA and the UK, respectively, make a clear case for where the honey has been flowing first: generally speaking, urban areas have benefited significantly from the reflation of the money supplies. Subsidised regions have also been among those that have been given access to the honey trough on the back of the fiscal deviation of funds. Rising interest rates could slow down fresh supply and put a sudden end to the trickle-down bubble philosophy of recent years, and they could do so with grave economic consequences.

Source: Wikipedia

Trump: From Zero to Hero?

This time last year, we were expecting the US dollar to depreciate drastically since we regarded the then held opinion of four interest rate hikes in 2016 as defying implementation. At first, this assessment turned out to be the right call. The US dollar experienced a trend reversal, with the gold price recording a fantastic first half of the year. However, the BREXIT put an end to this development, and Trump's victory turned the development by 180 degrees.

[1] Please refer to *Austrian School of Economics: Austrian Investing Between Inflation and Deflation*, pp. 153

US dollar index since 2014

Sources: Federal Reserve St. Louis, Incrementum AG

As early as June 2016 we dedicated a part of our tenth "In Gold We Trust" report to the phenomenon Donald Trump, and even at that time we regarded his election victory as possible contrary to the expectations portrayed by the media. This is also what we published as one of our ten propositions for the coming year at the International Precious Metals & Commodities Show in Munich in early November 2016, prior to the US election. In other words, we were less surprised by the result than many others; that being said, the reaction of the markets did indeed come as a surprise to us. **But why did Donald Trump, much-criticised by the markets in the run-up to the election, cause a veritable euphoria on the US equity and foreign exchange markets?**

We attribute this situation mainly to the clear majority the Republican Party now holds as a (surprising) result of the US election. The Republicans will shortly command a majority in both chambers, and they are in the White House. There is also the hope that after years of below-average growth an effective, business-friendly US government might be able to sort out the mess by granting tax cuts and that it could generate a self-supporting upswing. In this context, market participants have likened the Reagan era to the forthcoming Trump era. From our point of view, this comparison does not hold; neither in terms of personalities nor when it comes to the economy: the economic situation that Reagan started out on is practically contrary to what Trump will be finding upon taking office!

Reagan vs. Trump: the starting position could not be any more different!

	Beginning of era	End of era
Inflation (CPI):	14.8%	1.1%
Interest rate 10Y Treasury bonds:	10.7%	7%
S&P 500 P/E:	7.1x	22.4%
Government debt:	USD 800bn	USD 2,680bn
Government debt/GDP:	30.8%	49.8%

	Beginning of era	End of era
Inflation (CPI):	1.6%	?
Interest rate 10Y Treasury bonds:	2.1%	?
S&P 500 P/E:	20.4x	?
Government debt:	USD 19,800bn	?
Government debt/GDP:	105%	?

Sources: Wikimedia Commons, Grant Williams

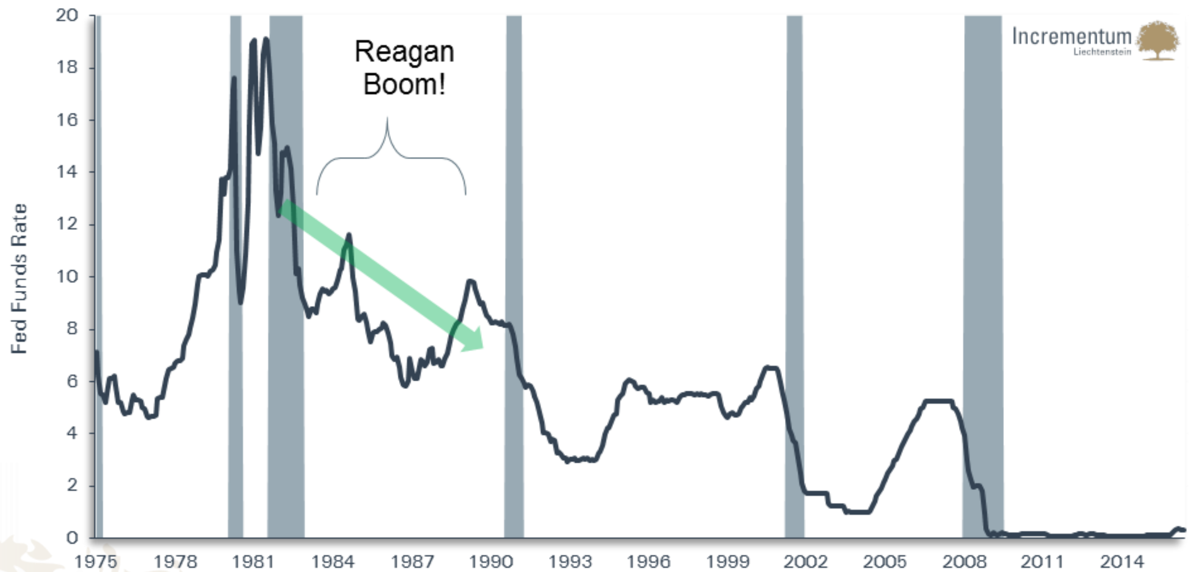
Throughout the election campaign, Trump had been playing the role of a saviour who would “Make America great again” – both the failing economy and the stricken country. **But the root causes of the current stagnation are more deep-seated, and an ailment cannot be cured by just changing doctors.** “Let me through, I am the President!” – seems to encapsulate the aura of the alleged saviour Trump. What is his recipe? **The old story of <u>debt-based</u>, fiscal stimulus. Keynesian Economics 101.**

The plan seems to currently allow for a tax relief of USD 500bn spread across the next ten years. By comparison, Reagan’s tax cuts at the beginning of the 1980s were significantly more profound in relation to economic output. Given that government debt at the time was substantially lower, the programme was also far more effective: as a result of the high level of government debt, the marginal utility of fiscal stimulus measures is nowadays much lower.

One should also ask the question how Trump’s economic programme will be financed once the budget deficit has reached a dimension of unforeseen proportions. **We believe that the idea of helicopter money – vigorously debated a few months ago – is very likely to worm its way into monetary and fiscal policy practice.** However, given that it was a centrally planned monetary policy that led the US economy (and others) to its current place of misery, we believe that a centrally planned fiscal policy that picks up from where its monetary counterpart has left off will at best produce a dead cat bounce. **From our point of view, a severe recession will inevitably occur in Trumps’ first term of office!**

The strong US dollar will constitute another entry hurdle for Trump; the US currency is currently trading at a 14-year high, while the Chinese yuan is at a 7-year low. A continuation of this dynamic would rather indicate a disinflationary, if not deflationary, development.

Fed funds rate since 1975: Reagan benefited from falling interest rates!



Sources: Federal Reserve St. Louis, Incrementum AG

To sum it up, the comparison of the imminent Trump era with the premises prevalent under President Reagan does not hold. The economic upswing under Reagan from 1982 to 1989 was the strongest boom in the history of the United States. However, it occurred in an environment of falling interest rates and inflation rates, which provided an enormous tail wind. At the outset of Reagan's term, two severe recessions occurred and had cleansed the system.

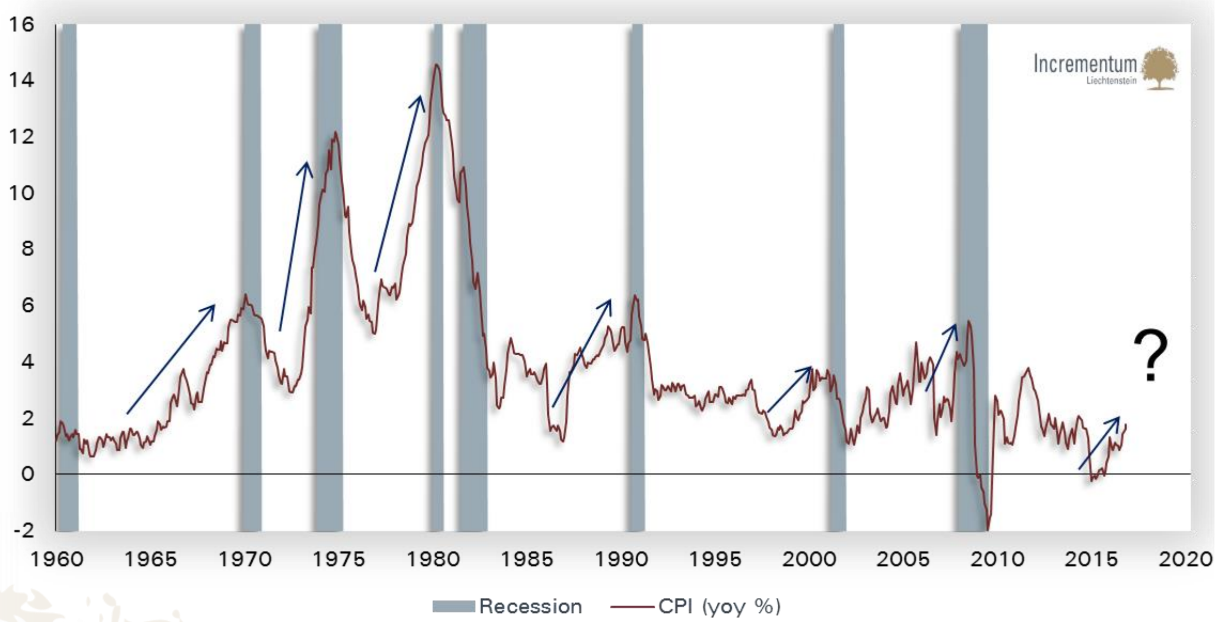
At the moment, interest rates and inflation are at respective lows, but at the long end of the curve we are witnessing an interest rate reversal: if this trend were to hold, it could badly affect companies in the emerging markets or in the Eurozone that depend on low interest rates or a cheap US dollar. **This in turn could directly translate into a setback on the financial markets and in the US economy. We are caught in a zero interest rate trap. Our optimism about Trump changing course sustainably without a cleansing recession happening before is very limited indeed.**

At the end of the zero interest rate trap: inflation

The US dollar, i.e. the leading global currency, has been locked into a falling inflation and interest rate trend for more than three decades. Within this super-cycle, we can single out the following two observations: intermittently rising interest rates, driven by higher inflation expectations, have almost always

1) either led to a recession in the USA, or
2) triggered crises in excessively leveraged regions, at times with supra-regional implications and feedback effects for the USA.

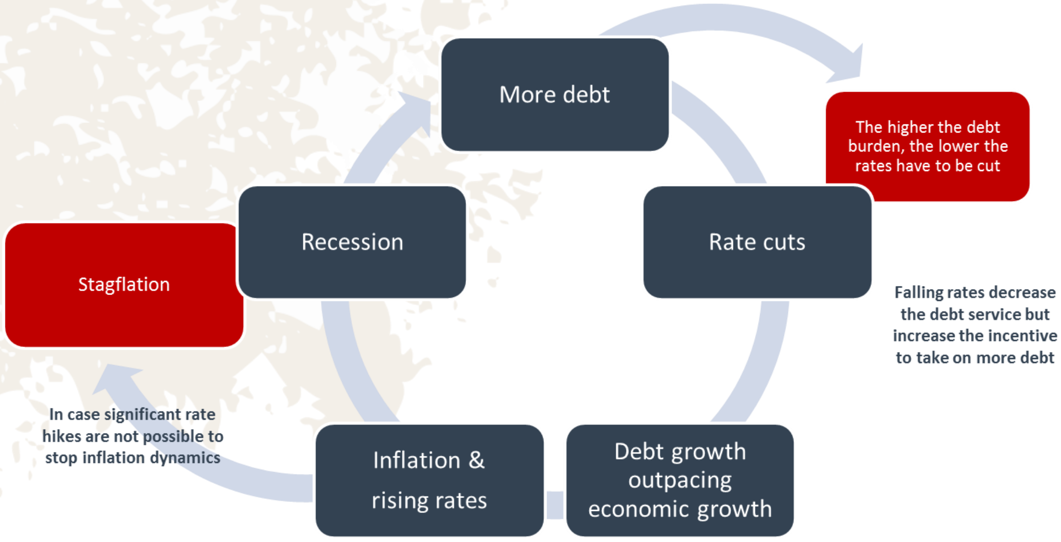
Inflation (CPI) and recessions in the USA



Sources: Federal Reserve St. Louis, Incrementum AG

We can also see that during this period the Fed set its Fed funds rate at lower levels after each cycle, and that overall debt (consisting of government, corporate, and private household debt) has increased exponentially. We do believe that this development is based on a crude, self-enhancing causality, which at its logical completion can only lead to a dead end with exactly one way out. **Once an economy is chronically burdened by excessive debt and interest rates have reached the zero lower bound, there is de facto no alternative to "printing until inflation kicks in."**[2]

During the falling interest rate trend and with constantly rising debt, the process of the cycle looks roughly as follows. The question this time around will be: **can the Fed orchestrate a significant hiking cycle without causing severe damage to the economy or the financial markets?**



[2] The faithful reader knows that it should be "to print until *consumer price inflation* kicks in".

From our point of view we will see in the coming year – after the current, highly subdued cycle of interest rate hikes – whether the economy will stall and trend toward stagflation amid its debt cycle, or whether another "ordinary", deflationary recession is looming at the horizon. We believe that the yield increase in the USA is likely the beginning of further frictions on capital markets, which ultimately may lead to the overdue recession in the USA.

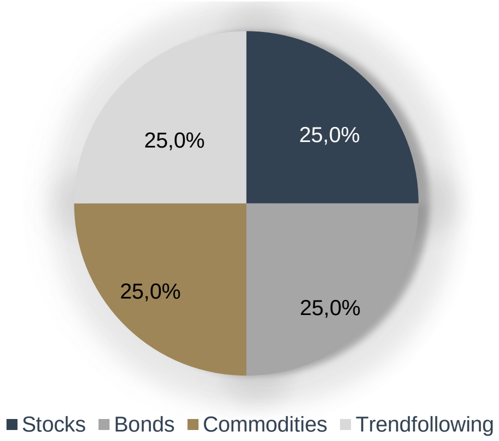
Could the boost in confidence by the Trump election extend the current economic expansion? Sure! But our optimism about Trump changing course sustainably without a cleansing recession happening before is very limited indeed. Perhaps our expectations regarding the timing turn out to be wrong and the current wave of confidence lasts longer than we expect. However, **there are enough "known unknowns" that do not go well with rising US interest rates or an appreciating US dollar.** First off, there are the latent problems with the well-known dollar debtors from the emerging markets, who are directly affected by any rise in the US currency and could find themselves in financial distress if interest rates were to increase. At the same time, higher US yields could also feed through to the yields of the Eurozone peripherals. The nominal interest rates for 10-year bonds in Italy currently do not differ significantly from those in the USA. The fact that many European banks have not done their homework and have been undercapitalised for many years could also come back to haunt the economy. An appreciating US dollar could also trigger an accelerated depreciation of the Chinese currency at dynamics that defy prediction.

If the long end of the interest rate curve in the USA continued to edge higher within the framework of rising degrees of uncertainty, the Fed would have to countersteer and take any expectations with respect to further interest rate hikes off the agenda. The crucial question in 2017 will probably be: **can the cycle of interest rate hikes continue without causing market turbulences? And, will the US dollar appreciate even more, or will it depreciate?** If market observers were to conclude amid the next bout of stress on the financial market that the rate hike cycle is off, we believe that this could pave the way towards stagflation. We would not at all rule out inflation rates of up to 4%.

Last year we had already pointed out that rising inflation rates would be the "pain trade" for most of the traditional portfolios, seeing that they would catch the majority of investors off-guard. Many signs suggest that we are heading towards a big shift in the financial and monetary system. Whoever addresses the issue in good times, has a significant chance of coming out stronger at the other end of the upheaval. The economist, entrepreneur, and publicist Roland Baader was making an excellent point to this effect when he said ***"The sensitive ones start feeling the autumn chills in the middle of the most boisterous summer party"***.

We can clearly identify ourselves with this quote. Of course, we may sometimes be a bit oversensitive, so we start feeling the chills too early. This may be due to the fact that we are standing outside the herd, where we can feel the chills coming on sooner than the market participants who are still being misled by the heat the herd itself is exuding. **But even though financial markets have superficially regained a certain degree of stability, we are convinced that a cycle of interest rate hikes that deserves that name is still utopian, and that the strength of the US dollar comes with an expiry date. Sooner or later the prevalent interest rate paradox will be recognised by most market participants.**

What does this mean for our investment strategy?



After years of a zero interest rate policy, investors have adjusted their mindset to the "Brave New World" of no interest income. Shares are now held more for the sake of cash flow or dividends, and they are regarded as being without alternative. Naturally illiquid real estate has become the fixed income surrogate, and it has turned into one of the most favoured vehicles of investment and speculation across continental Europe. Government bonds on the other hand are not held for their yield anymore but often due to a perceived upside potential in price, unless regulatory forces prompt investments in that segment.

From our point of view, investors should aim for broader diversification by including asset classes from alternative, systemically anti-fragile areas in the portfolio.[3] **As far as securities are concerned, we strongly wish to point out the generally underestimated risk factors of interest and inflation risk.** Many of the aforementioned adjustments made by investors as a result of the zero interest rate policy make portfolios more susceptible to the waves of inflation that we expect. Therefore, while a balanced portfolio should definitely come with a strategic allocation in equities and bonds, it should also provide a sufficient level of protection against unwelcome scenarios such as inflation or stock exchange slumps. These thoughts underpin the simple portfolio construction of the Permanent Portfolio Fund, which we launched at the beginning of 2016.

[3] Please refer to *"In Gold we Trust Report 2016"* pp. 117

Generally speaking, we currently regard many of the classic investments as expensive. For equities, the following table provides a few helpful pointers in this context; it represents a good compass to assess the current scenario. Ladies and Gentlemen, we are happy to leave the conclusion whether the market is currently rather in the right or in the left column up to you:

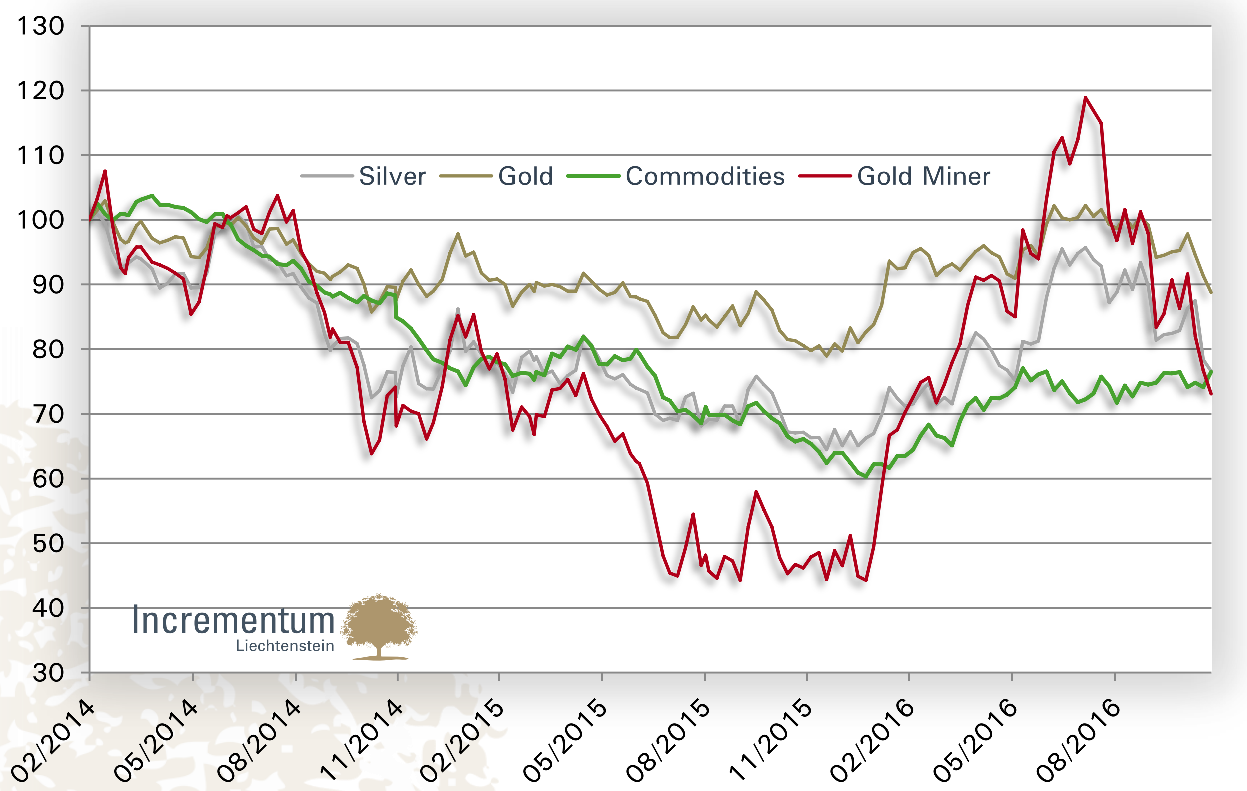
Market Bottom Signs	Market Top Signs
Corporate - Almost no M&A - Almost no IPOs - Almost no share buybacks - Dividends are cut and capex reduced - Corporate focus on deleveraging - Almost no new money for venture capital - Many bankruptcies and much distress - Companies restate financials and write down assets	**Corporate** - Wave of M&A and/or leveraged buyouts - Many low-quality IPOs - Large share buybacks - Dividends are less common and capex surges - High degree of corporate leverage - Venture capitalists are viewed as heroes - Cash flow insufficient for many companies, but obtaining loans - Accounting becomes more questionable
Valuation - Low price to sales and EV/EBITDA - PEs may be distorted by losses, but many very low - Many companies trading below book value	**Valuation** - High price to sales - CAPE Shiller PE high - Companies trade at many multiples of book value
Economic - Central banks have eased for at least six months - Building permits have declined for a year - Leading economic indicators are low but long leading rising - Recession declared officially, news is stale - ISM New Orders to Inventory turns up	**Economic** - Central banks tightening policy - Building permits are falling - Leading economic indicators turning down, outlook deteriorating - Most economists doubt recession - ISM purchasing managers index starts to fall - ISM New Orders to Inventory falling
Market - Credit spreads are wide - Credit is tight and only available to high quality borrowers - Margin debt reduced and sharply negative year-on-year - Frequent episodes of high volume selling - Yield curves have been steepening for months - Volatility is high for a sustained period - Market already down 20%	**Market** - Credit spreads are low but rising - Many bonds have low/junk ratings - High year-on-year increase in margin debt - Frequent days of climax buying - Yield curve is inverting or flattening - Volatility is low but rising
Sentiment - Investors are cautious and out of the market - No one is bullish - Front covers of newspapers and magazines are negative - Art and luxury shares are hurt - Consumer sentiment is negative	**Sentiment** - Investors are momentum-driven - Bears have given up - Front covers of newspapers and magazines are euphoric - Art market and luxury shares are booming - Consumer sentiment is falling from a high level - Financial press and TV becomes more popular

Source: Jonathan Tepper, Variant Perception

We do not want to keep this gold nugget of wisdom from you: the negative correlation between equities and gold seems particularly pronounced at the moment. To that extent, the low of the gold price might correspond to the high of the stock market. It would be unsound and impossible to predict when that will happen. If there is one thing to take into account when constructing one's portfolio, it could be this piece of wisdom from Pericles: *"Our job is not to predict the future, but to prepare for it."*

The performance of inflation-sensitive investments

Whereas experts were issuing warnings about the great deflation at the beginning of 2016, those concerns have meanwhile been replaced by the emergence of worries over inflation. After being locked into a downward trend for years, inflation-sensitive investments recorded a significant upswing in the first half of 2016. However, the performance over the year ended up a mixed bag.



Sources: Federal Reserve St. Louis, Incrementum AG

Gold and silver have been up 7.1% and 17.3% this year, respectively; gold shares have even gained 40.3%[4]. Cyclical metals such as zinc, nickel, copper, or energy commodities (above all coal and oil) have recorded increases as well. All of that happened in an environment in which the US dollar has climbed to a 14-year high. We consider this a remarkable development and a prime example of a bull market, whose beginnings most investors always fail to see unfold.

The way we read the market, two different sets of dynamics are currently prevalent. On the one hand, the inflationary forces are clandestinely getting the upper hand, which is reflected in the commodity area and in inflation-linked bonds. Price inflation is going to rise due to the base effect alone.

On the other hand, the yield increase and the renewed appreciation of the US dollar puts the brakes on the supply of “new honey”, to keep the earlier metaphor. Gold and silver prices have gone through a veritable “Trump slump”, which could also be seen as a warning signal in terms of the future path of inflation.

[4] Finance.yahoo.com, NYSE Arca Gold Bugs Index (HUI), as of December 19, 2016

There is still an abundance of deflationary risks: a rebooted euro crisis in combination with bank insolvencies, the bursting of the real estate bubble in China, or a recession in the USA on the back of the increased yields, to name but a few.

It remains to be seen where this journey is taking us. Either way, we will be keeping a close eye on the US dollar chart[5], which we regard as highly relevant in view of the current dollar-centric monetary system. Any profound break with the dollar strength would very likely lead us into inflation or stagflation!

Incrementum AG: internal developments

Allow us to give you some insights into the development of our company in the past year and an outlook on the milestones planned for 2017:

Dr. Christian Schärer, an accomplished expert on commodity equities and the structuring of special mandates, has joined our company as a new partner, which has been an important step in the development of Incrementum AG. The shareholdings are now split four ways, with the four partners Stefan Kremeth, Dr. Christian Schärer, Ronald Stöferle, and Mark Valek each holding 25% of the shares. Also, Dr. Christian Schärer has been appointed Chairman of the Supervisory Board.

In addition to the management of investment funds and to special mandates, Incrementum AG is now offering individual wealth management services. Our range includes a cash-flow-based version and fund-based asset management services in accordance with the Austrian School of Economics.

We have also expanded our staff and are honoured to now have the highly decorated Jean Eric Hiltbrunner on board as advisor; and our former intern, Marc Waldhausen, has joined our company as permanent member of the research team.

All this has led us to move into a new office with a wonderful view of the mountains, spacious conference rooms, and outstanding infrastructure ready for further expansion.

The publication of the 10th “In Gold We Trust” report was another milestone. It has been downloaded 1.7 million times to date. In this context, we have found new premium partners for our report and could professionalise our range of services even more. Along with numerous additional publications (chart books, Advisory Board transcripts, and op-eds, among others) we have given several presentations at home and abroad (e.g. at the *Precious Metal Summit* in Beaver Creek, at *Mines and Money* in London, and at the *Mint Directors Conference* in Bangkok) and managed to introduce our view on the financial markets and our investment philosophy to a wide audience. And in the third quarter, Ronald Stöferle was named “Most Accurate Gold Forecaster” by Bloomberg.

[5] E.g. the DXY index, or other currency baskets.

We are also very proud of having launched the first permanent portfolio fund in Europe. The fund is based on the original concept by Harry Browne, and we adjusted it according to our investment philosophy and the current market conditions, and implemented it in cooperation with our partners from Kahlenberg Capital AG. We are optimistic that this product will hit a nerve in Europe. **In Special Mandates, which is overseen by Dr. Christian Schärer, we will soon launch a credit fund, which will establish a link between SMEs and investors.**

Outlook 2017

The launch of our new web page will be a milestone in 2017. Our plan is to include a journal, i.e. a sort of investment diary, and to present an improved display of all performance, allocation, and risk ratios of our investment funds.

We are also going to rename the "Austrian Economics Golden Opportunities Fund" to "Incrementum Inflation Diversifier" Fund so as to make the investment strategy more obvious. We take pride in the fact that as of 1 January 2017, the renowned Liechtensteinische Landesbank will be the depositary bank of the fund. The switch from weekly to daily liquidity will be part and parcel of those changes in order to further enhance client value. We are pleased to say that by reducing our depositary fees yet again, we have already made major strides in that direction.

We are also going to publish a new book in the first half: *Die Nullzinsfalle – Nachhaltiger Vermögensaufbau in einem nicht nachhaltigen Geldsystem* (English: *Credibility Loss – Building Sustainable Wealth in an Unsustainable Monetary System*). The 11th gold report will be published slightly earlier in 2017, presumably on 1 June.

As you can see: 2016 has not only been a year of change in politics and on the financial markets, but also at Incrementum AG. We are ready for further changes coming our way and are looking optimistically into the future!

After all, we believe in an unwritten law in our industry that prevents us from making promises. The future is not predictable – this applies in particular to the markets, and also to our portfolio. **That being said, we can still promise you this: nobody will be working harder and with more dedication than us, and nobody will be trying more diligently to manage your wealth than us!**

We hope that you enjoyed reading this letter. We look forward to seeing you again and thank you for putting your trust in us! We would be happy to accompany you with a steady hand and clear sight through the coming phase!

Now we wish you, your family, and your colleagues happy Christmas and tranquil, cosy, and above all restful holidays and a healthy, joyful, and successful New Year!

Best wishes from all of us, and Merry Christmas!

Ronald-Peter Stöferle **Mark J. Valek**