SEMI-MONTHLY FISCAL/MONETARY UPDATE - YOU DON'T WANT TO KNOW HOW THE SAUSAGE IS MADE !!

Date : July 10, 2018

SEMI-MONTHLY FISCAL/MONETARY UPDATE – You Don't Want to Know How the Sausage is Made !!

The general capital markets were fairly unchanged in June, gold bullion was down 3.4%. Interestingly, the gold mining stocks were down hardly at all. The gold mining ETFs, GDX and GDXJ, were almost exactly flat. The three major gold mining mutual funds were down an average of 0.8%. Every indication is that substantial quantities of physical gold continues to move from West to East but the "paper" market, including options and futures, dominates the day to day price. The mining stocks acted noticeably better, when normally they could be down (or up) at least twice the price of gold. There was documented accumulation of GDX and GDXJ which is often a precursor of an upward move in bullion and an even larger move in the miners.

THERE IS NO SHORTAGE OF MACRO DEVELOPMENTS WITH LONG TERM IMPLICATIONS !!

In just the last few days, the following articles support our long held conclusions that a great deal of turmoil in the worldwide financial/capital markets is ahead, which we believe will cause our Fed and other Central Banks to "cave" and move back to monetary accommodation, which will spark a new run in gold related securities:

(1) First Quarter GDP latest revision shows 2.0% real growth, down from the last estimate of 2.3% and the previous estimates in the high 2s. As for Q2'18, the latest NY Fed estimate is 2.7%, a lot lower than the highly touted 4% or more the Atlanta Fed and others have been talking about. Even if Q2 comes in north of 4%, real GDP growth over the last year or so has been no higher that the "high 2s", not much higher than the average of 2.3% average of the last 8-9 years and that modest increase from the "low 2s" is largely due to more government spending financed by more government debt and this is not healthy or sustainable over the longer term.

(2) *The global* yield curve, the spread between 1-3 year and 7-10 year government securities, has just gone "negative", per the JP Morgan GBI index. This yield curve "inversion" most of the time presages a recession within 6-12 months.

(3) With the Chinese stock market down 20% from its early '18 high, a Chinese government think tank (backed by the Chinese Academy of Social Science) has warned of a "financial panic" in the world's second largest economy, caused by leveraged purchase of shares (as in 2015), rising

US interest rates, trade tensions with the US, bond defaults and liquidity shortages in China. The Chinese government should “be willing to step in with full financial support, rather than taking piecemeal steps” the study said. Just yesterday, the Financial Times reported that the China Development Bank was tightening loan approvals for its “slum development” policy, a program which has provided (a cool) $1 trillion to homebuyers since (only) 2016. The implications of the monetary manipulations by the world’s second biggest economy are huuuge!. Our take: a much higher gold price will accompany future economic "adjustments" that will have been exacerbated by governmental interventions.

(4) Russia has cut its US Treasury holdings over 50%, from $102.2B to $48.7B in just four months from 12/17 to 4/18. While these numbers are small relative to the trillions that China and Japan hold, US Treasury securities held by all foreigners, as a percent of their reserves, has declined from 64.59% in 2014 to 62.7% in 2017, so they are steadily diversifying away from dollar related securities. Gold, as a share of foreign exchange reserves has held steady. Central Banks have continued buying hundreds of tons annually, as they have since 2009. They bought 116.5 tons in Q1’18, the most in any Q1 since 2014 and up 42% YTY.

(5) The Wall Street Journal, several days ago, headlined “UK Central Bank Warns on Debt Risk”. The article said “it sees pockets of risk to the stability of the financial system including US corporate borrowing, risky loans in Britain, foreign-currency lending and emerging markets….as central banks step back from the easy-money policies of the past decade and trade tensions escalate.” You can google the full article, but ***we don’t make this stuff up***.

(6) Just under the previous article, on June 28th, the headline read: “Fed’s Ability to Fine-Tune Interest Rates is Tested”. The Fed lost “control” of the markets in ’08, salvaged the situation with trillions of financial accommodation. In some ways, the problems are larger today and the Fed, with their hundreds of PHD economists, has had a poor forecasting record.

(7) While many observers underplay “systemic” risks in today’s financial markets, leverage in derivative securities is larger, non-financial corporate debt is at a new high (exceeding the last high in ’08), ETFs made up of cap-weighted securities will have little liquidity in a downdraft, which especially could apply to high yield fixed income ETFs. Rising default rates on student loans and subprime auto loans, sharply rising US deficits, underfunded social security and federal health care obligations are all problematic whether the market overlooks these trends for the moment or not. The momentum in capital markets can turn, literally, on a dime. If someone doesn’t think the Chinese monetary manipulation has provided at least the *possibility* of “systemic risk” to the worldwide economy, they are living on the wrong planet.

(8) The equity markets are highly valued by historical standards. Interest rates are still very low which means bond prices also have substantial downside risk, especially the high yield sector where investors around the world have been “reaching for yield” for a decade.

Conclusion:

Many of the above factors have been in play over the last four or five years, building over decades, and the timing of the unwinding of the worldwide credit bubble continues to be uncertain. It's been said that in every crisis, you can look like a fool either before the event or after. Another advisor, when asked how a crisis develops, said "very slowly and then very quickly". Just recently, we asked a highly regarded economist and market strategist, who agrees with us, when the turn will come. His response was as good as any: "On any given Sunday". When it happens, a great number of people will say "how could I have not seen that?"

Roger Lipton