SEMI-MONTHLY FISCAL/MONETARY UPDATE – MAJOR RISKS SURFACE

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SEMI-MONTHLY FISCAL/MONETARY UPDATE – RISK & REWARD IN NEWLY VOLATILE MARKETS

Both bond and stock markets have had to digest lots of news in recent weeks, and it hasn't always been pretty. Capital markets don't like uncertainty, which exist relative to trade tariffs, the clearly slowing economies worldwide (US, Europe, Japan, China), the uncertainty regarding our Fed's plan relative to interest rates, the exploding US deficits, Mario Draghi's announcement of an end to QE in Europe, the ongoing political turmoil in and out of the White House, the collapse of Bitcoin and the crypto-currency market. The result has been more volatility, especially in the stock market, than we have seen in years. Intra day moves of 3-4% have become common place, which in and of itself creates a level of discomfort among investors.

There are major macro developments, within the broad brush concerns mentioned above:

- The new US fiscal year started in October, and the stated (now called "on-budget" by some) deficit was $100.5B in October, versus $63.2B last year. November came in at $205B vs. $139B last year. For two months, the deficit is $305B. vs. $202B, up 51%. The actual debt is up $334B, reflecting "off-budget" items, the largest of which is Social Security obligations. We continue to suggest that the "on-budget" deficit will be closer to $1.5 trillion in the current fiscal year, and the total debt will be well over $1.5 trillion, due to government spending (up 18% so far YTY), higher interest costs, higher defense spending, higher VA support, health care support, THE WALL, etc. There seems to be rare bipartisan agreement right now regarding an unwillingness to talk about the explosion of the deficit and the debt. It is just too disturbing. All the deficit hawks have put their heads in the ground. THERE IS NO POLITICAL WILL in this area.
- There is an ongoing move away from the US Dollar, the world's reserve currency since 1944. China, Russia, and mideast countries are increasingly using the Yuan and gold for oil trades. There is also a consistent reduction within foreign exchange reserves, of US denominated securities. This has been accompanied by accumulation of physical gold, which can't be diluted by a computer keytap.
- There are many indications that China is accumulating far more gold than they have announced. Recall that three years ago China announced that their Peoples Bank of China (PBOC) had increased ownership to 1600 tons from 1000 tons over the previous five years. Considering that China is the largest miner of gold on the planet, 400 tons per year, and nothing leaves the country, an increase of 600 tons over five years is obviously an understatement. It may be Chinese government agencies other than the PBOC that is

holding it, but they are government “affiliates”. Various sources have reported that thousands of incremental tons have moved into the hands of various government agencies in recent years, and we would not be shocked if China announces at some point soon that they own 10,000 tons or more. This would be substantially more than the 8,400 tons owned by the US, currently assumed to be the largest holder. This would allow the Chinese to create a trading currency backed in some way by their gold ownership, joining, or even replacing the US Dollar as the primary trading currency worldwide. Surprisingly, based on reported gold holdings, Russia is in the best position to make their currency convertible into gold. Both China and Russia could have multiple political reasons to link the Ruble or Yuan to gold, provide more credibility to their currency than the US can provide.

- Jay Powell’s newfound uncertainty over the pace of further rate increase provides the possibility that Quantitative Tightening is slowing down, if not stopping altogether should our economy weaken further. It is now clear that fourth quarter GDP will be more like 2% or so than the 4.5% in Q3. Especially in light of slowing economies elsewhere in the world, which will slow further if interest rates are moved higher, Powell may find that the next important course of action is “QE4” or whatever they choose to call the new monetary accommodation.
- Since September, foreign purchases of US Treasury securities can no longer be made, financed by low interest (or negative interest) borrowing abroad, with currency hedging providing an overall positive carry. Borrowing costs abroad have gone up modestly, hedging costs as well, so the guaranteed positive return has gone away, removing some material portion of the $5-6 trillion of annual demand for US Treasury securities. Since $5-6T of US Treasury Securities have to be “rolled” over the next twelve months, the $1.5T of incremental government debt has to be financed, and the absence of perhaps $2-3T that was previously invested (and hedged) by foreigners, provide a total of something like an incremental TEN TRILLION of US securities that has to be bought in the next twelve months. People… ($10,000,000,000,000) this is a lot of money and could be a strain on the financial system.
- The market for “leveraged loans” and high yield loans has shown serious signs of strain in just the last sixty days. Wells Fargo and Barclays Bank failed to sell $415 million of debt on Ulterra Drilling Technologies, a manufacturer of drilling bits. Blackstone received their funds to help in their buyout of Ulterra, but WF and BB are hoping to market the debt in a better environment in ’19. There were a number of other deals actually pulled from the market in Europe over the last several weeks. The Financial Times said today that the “’junk bond’ market, whether in loans or bonds – has frozen up, and the US credit markets have ground to a halt….not a single company has borrowed money through the $1.2T US high-yield corporate bond market this month….if the freeze continues until yearend, it would be first month since November 2008 that not a single high-yield bond priced in the market..”

Our conclusion from all of the above is that our economy and, indeed, the worldwide economy will have very modest growth, at best. The debt load is too heavy, and the unintended consequences of ten years of monetary promiscuity have yet to play out. Equity investors right now assume that

Jay Powell will more or less stick to his plan of higher interest rates, even if at a slower pace. If he "cries wolf", however, the equity markets would rally, but we don't think for long. The last recession of '08-'09 required "monetary heroin" to the tune of $4T in the US alone, but each hit has to be bigger to keep the addict functioning. Once capital markets realize that, a more major downdraft is likely.

In the long run: we believe there will be a new monetary paradigm, and gold related securities will be an important part of a more disciplined fiscal/monetary approach. The ownership of gold has protected one's purchasing power for the last five thousand years, the last two hundred years, the last 105 years (since the Fed allowed the US Dollar to be diluted by 98%), the last 47 years (since 1971, when the gold window was closed), the last 18 years (since 2000, when deficit spending again took off).

It is of course true that since 2012 gold and gold related securities have been poor investments, but, in the sweep of history, that is a mere blip. With a new level of financial uncertainty compounded by geopolitical concerns and fiat currency dilution rampant around the world, it is only a matter of time before gold establishes itself again as "the real money". Gold is not the only hedge against inflation, but, among the possibilities, it is the most undervalued right now. As James Grant, the preeminent monetary historian has said: "A gold backed monetary system is not perfect, but it is the least imperfect system". We don't expect a new gold backed monetary system to be in place any time soon, but any small progress in that direction will allow for substantial appreciation in gold related assets.

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