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QUARTERLY INVESTMENT OUTLOOK

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SUMMARY

- In an article entitled "Paradigm Shifts," Ray Dalio, founder of Bridgewater Associates, anticipates the formation of a new monetary regime (featuring money printing) in the next decade. It will likely be driven by unorthodox fiscal policy aimed at bolstering consumer spending, featuring guaranteed incomes, wealth tax and "helicopter money."

- Federal deficits could rise by $12.2 trillion over the next decade, and that assumes no recession. Debt could approximate 140% of GDP according to Deutsche Bank Global Research. Higher deficits over the past two years is causing the government to ramp up borrowing, which is running at the annual rate of $1 trillion per annum.

- The combination of both loose monetary and fiscal policies will drive a new inflation cycle. Commodity prices should enter a new bull market. Gold prices, having broken out of a 6-year base, are the "canary in the coal mine."

- The Conference Board Leading Index, which measured as a 12-month moving average of a 12-month roc, is at +3.65%. This is signaling continuing economic expansion. The IHS Eurozone Markit PMI Manufacturing Index has leveled off (slightly below 50) over the past six months, while the euro at 110 has cheapened, potentially giving European auto makers a reprieve. China's Caixin Manufacturing PMI, taken from a sample of 500 firms, also ticked up in June. Business confidence was at a 3-month high.

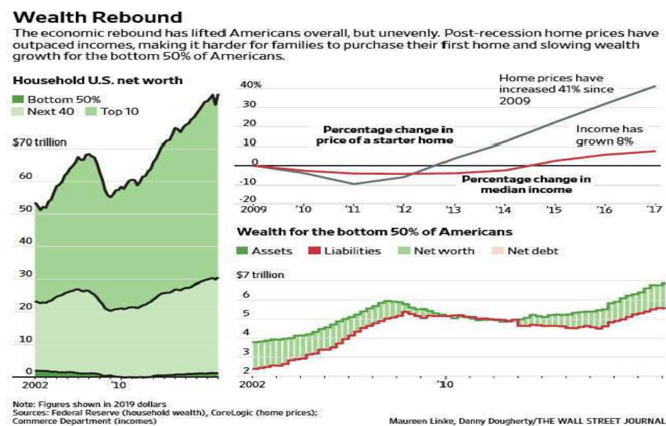
U.S. FINANCIAL MARKETS OUTLOOK

The Fed is expected to lower their policy rate by 25bp this month. This combined with a modest recovery in global ex-U.S. economies should exert downward pressure on the dollar, providing additional stimulus (liquidity) to the financial markets. Credit spreads have been stable and business loan demand is firm, while money supply growth is running at a 10% annual rate over the past three months. Commodity prices have been stable despite the slowing in global exports. However, the trade dispute with China continues to weigh on risk assets.

We expect stocks to outperform bonds over the next 6-12 months. This assumes a trade truce is reached, and the USMCA is enacted. Bond yields are at risk, but should rise gradually back to 2.5% over the next twelve months. Should inflation surprise to the upside, we expect the Fed to remain passive until after the next general election. The late Sir John Templeton said, "bull markets don't die of old age, they're murdered by the Fed." It is too premature to expect the Fed to "take away the punch bowl."

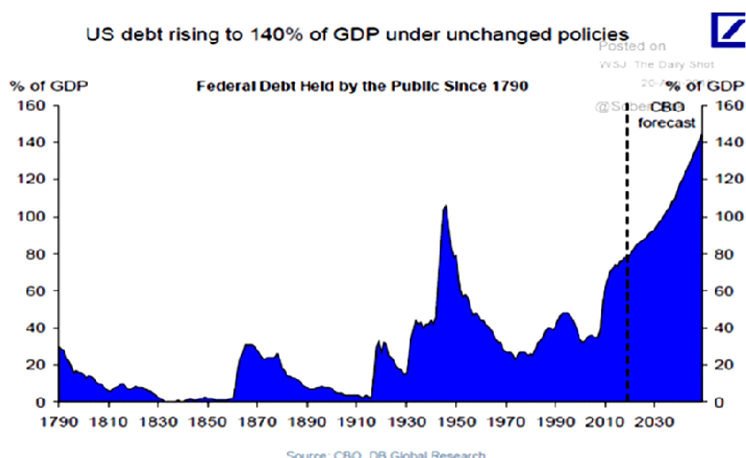
In a recent article titled Paradigm Shifts, Ray Dalio suggests that a monetary regime change will occur in the next decade, which will cause a significant alteration in the behavior of the financial markets. The impact on risk assets could be the polar opposite of that which occurred over the previous ten years since the GFC.

The Great Recession ended in 2009, leaving the major U.S. banks severely undercapitalized. In an effort to deal with this shortfall, the Fed undertook a series of three QE programs pumping over $3.5 trillion into the banking system, driving its policy rate to zero (now 2%). This added liquidity benefitted risk assets i.e. stocks and bonds. The impact on the economy was muted with real growth averaging 2.3%, while inflation generally remained under 2%. As a result, real wages have remained largely unchanged. The unintended consequences of this policy has fostered a rise in wealth inequality. According to a recent WSJ analysis the bottom 50% of U.S. households have only recently regained the wealth lost in 2007-09. Meanwhile the top 1% of households have more than 2x the wealth they had in 2003.



In addition to wealth/income inequality there has been a trend towards de-globalization, political polarization and rising protectionism. Global central banks have embarked on a massive move to lower interest rates, leaving $17 trillion of bonds in negative yields. The U.S. central bank only recently turned accommodative, lowering rates in July to 2% - 2.5%. As a result, the spread between the U.S. 2-year Treasury/German 2-year yield is 240bp in favor of the U.S. However, the cost of forex hedging has made that trade unprofitable. Still the dollar has firmed, to the detriment of U.S. manufacturers, which happen to be in states crucial to Trump's re-election.

It is unusual to see rates decline ten years into an economic recovery. The fact that we are facing years of trillion dollar deficits and sharply rising unfunded liabilities (mostly healthcare related), will exert enormous pressure on the Fed to keep rates low. Even with low rates, interest costs eventually will rise above the increase in our national income, thereby causing an increase in the debt stock. A recession in the next two years will only accelerate the day of reckoning.

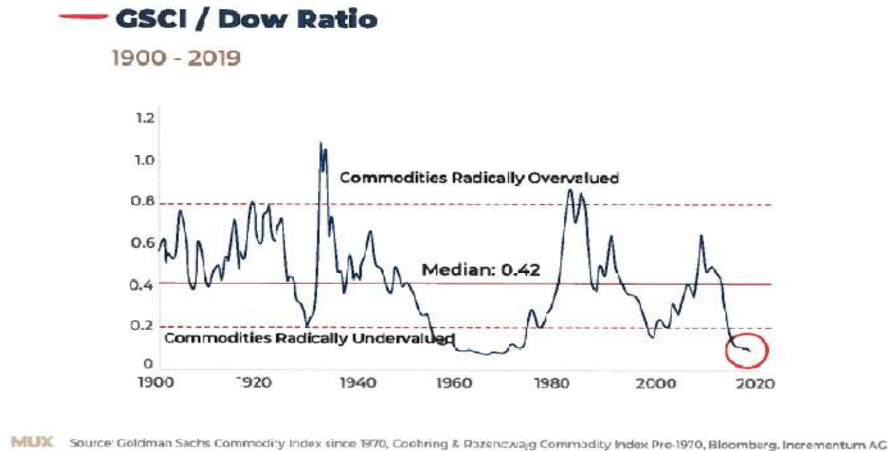


Dalio's prescription, which is gaining political support, is a combination of fiscal policy featuring a wealth tax, guaranteed income and possibly direct cash transfers (helicopter money) and ultra loose monetary policy, as the primary funding mechanism. We concur and conclude that should Dalio's remedies become the political norm, the next paradigm shift will feature a period of dollar devaluation and inflation!

COMMODITIES LEAD INFLATION CYCLES

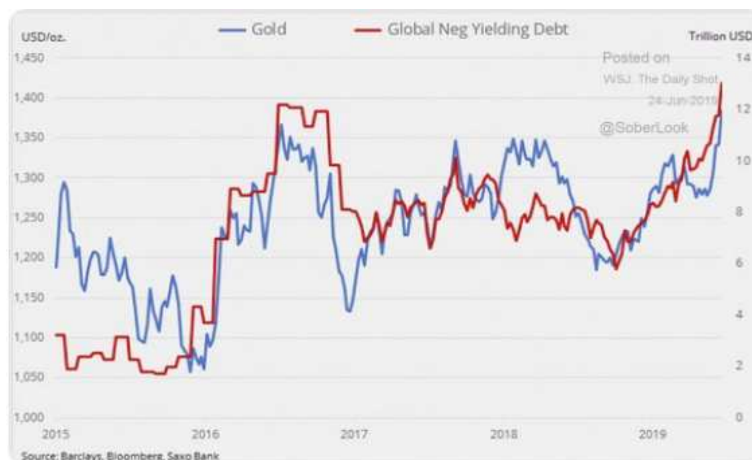
The chart to follow, courtesy of McEwen Mining, shows the Goldman Sachs Commodities Index relative to the Dow Jones Industrials from 1900 - 2019. The ratio is currently at a five decade low. Very rarely do investors get the opportunity to buy commodities at such low relative values. Commodities collectively are raw inputs that are essential to the production of both industrial and agricultural products. Their prices are very sensitive to changes in demand and supply. Small changes

in either often result in outsized price movement. Being first in the production chain they lead changes in wholesale prices, which in turn lead to changes in the general price level. In a monetary regime change we expect commodities to be among the single best performing risk asset.



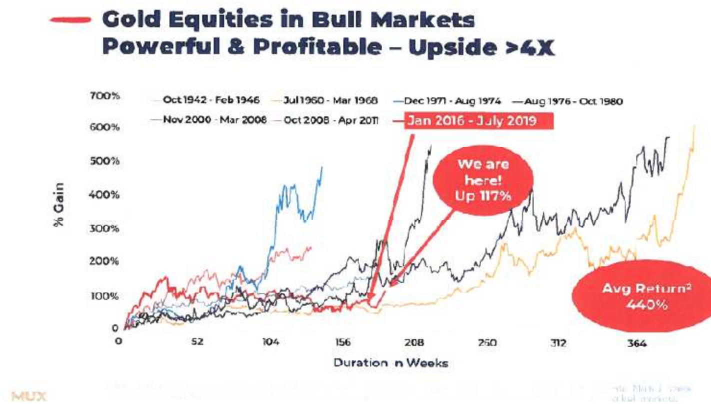
GOLD/GOLD MINERS HAVE ENTERED A MAJOR BULL MARKET

The chart below shows a positive correlation exists between the gold price and the amount of global bonds trading at negative yield. Negative yielding bonds are highly stimulative. It pays for borrowers to max out issuance, and use the proceeds to invest in risk assets, as the cost is negative. This eventually lowers the expected future return on those assets to zero. At that point investment would cease, and without investment, there would be no savings. This is a prescription for economic disaster! Hence, holding gold provides a natural hedge against this uncertainty.



The chart to follow, courtesy of McEwen Mining, shows the current bull market in gold equities (Jan 2016-July 2019) against 5 previous bull markets. The previous five bull cycles had an average

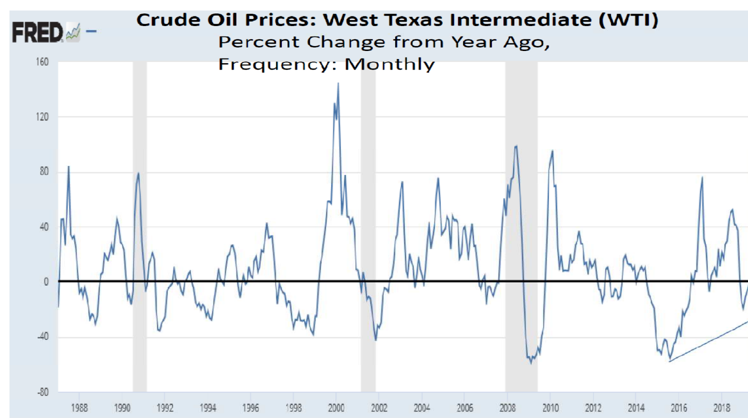
appreciation of 440%, versus the current cycle, which has gained 117%. Noteworthy is that two previous bull markets had a duration of over seven years.



OIL PRICES SET TO MOVE HIGHER

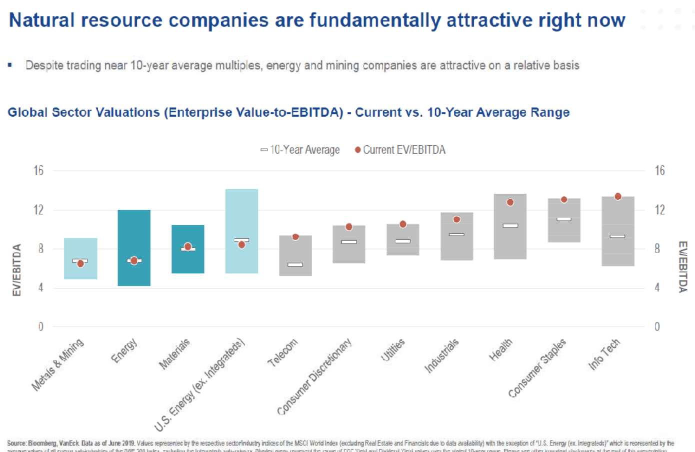
Since 1980 there is an 82% positive correlation between gold and oil prices. The fundamentals point to higher oil prices. The Saudis have set 2020 as the year to IPO Saudi Aramco, which is key to MBS's plan to reorient the economy away from energy. Meanwhile, global oil demand is firm while inventories contract, closing in on their 5-year moving average. U.S. production at 12.5 million bbl/day is strong, but a decline in the yoy rig count suggests production should flatten out, once DUC well inventories reach normal levels.

The chart below shows the yoy monthly change in the WTI price since 1988, plotted against major recessions. Historically, oil prices rose by roughly +80% yoy, peaking either ahead of or coincident with recessions. One year ago, WTI traded at $45/bbl. which implies prices should eventually peak above $80/bbl. in the current cycle.



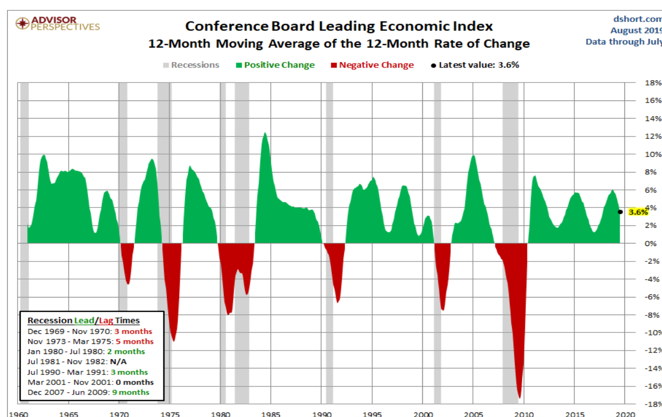
VALUATIONS SUPPORT INVESTING IN METALS, ENERGY AND MATERIALS

Shown below is a valuation of all non-financial MSCI Global Sectors, courtesy of Van Eck. The valuation metric is a measure of Enterprise Value - to - EBITDA. The width of the bars shown in the graph represent a ten year range for each sector. The white line shown in the bar is the 10-year average. The red dot is the current value. The three sectors shown at the left, Metals & Mining, Energy and Materials show up as being the most undervalued relative to their 10-year average.



LEADING INDICATORS POINT TO CONTINUING EXPANSION

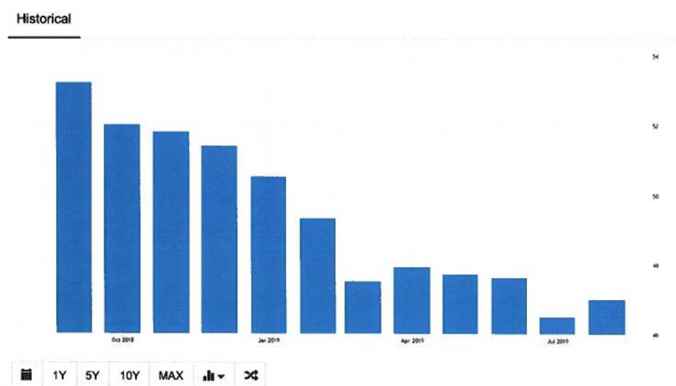
Below is a chart of the Conference Board Leading Economic Index, computed as a 12-month moving average of a 12-month rate of change.



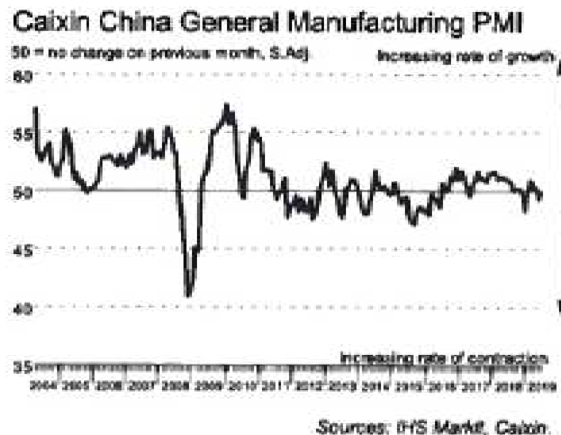
Based on suggestions from Neile Wolfe of Wells Fargo Advisors and Dwaine Van Vuuren of Recession Alert, we can tighten the recession lead times for this indicator by plotting a smoothed 12-month rate of change to further enhance our use of the Conference Board's LEI as a gauge of recession risk. As we can see, the LEI has historically dropped below its 12-month moving average anywhere between -9 to

+5 months of a recession. The latest reading of this smoothed rate-of-change suggests no near-term recession risk.

A second confirming indicator is the Citigroup U.S. Economic Surprise Index (not shown). It has risen from -60 to -9 over the past 6 weeks. In contrast, the G-10 Surprise Index at -10 is still weak. Shown below is a chart of the IHS Markit Eurozone Manufacturing PMI, which rose to 47 in August 2019 from 46.5 in the previous month. While still signaling a contraction in factory activity the level has been stabilizing over the past 6 months. Meanwhile the euro has cheapened to 110 and Draghi has promised additional stimulus this month.



The Caixin China General Manufacturing PMI (see chart below) showed manufacturing conditions were broadly stable at the beginning of the third quarter. Business confidence regarding output for the year ahead improved to a 3-month high in July. The index at 49.9 was marginally higher than the 49.4 reported for June. We expect continuing infrastructure spending on railway construction and a catch-up spend on the electric grid to bolster demand into yearend.



RISK FACTORS

- Failure to resolve the trade dispute
- The yield curve remains inverted
- China policy makers err
- Service Sector output contracts

John Cooper, CFA
Pete Daly
September 2019

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