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SPROTT PRECIOUS METALS WATCH

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IT'S THE DEBT STUPID!

The investment climate of 2017 has been characterized by thematic cross currents. Communication from global central bankers has at times appeared more hawkish, yet global rates of QE have only accelerated. Optimism for the Trump agenda initially levitated sentiment measures, but hard economic statistics failed to follow. Despite almost continuous upheaval in global geopolitics, volatility measures and credit spreads have remained unfazed near historic lows. Since economic fundamentals can never compete with the intoxication of fresh weekly highs for the S&P 500, investor consensus now routinely ignores troubling imbalances in the global financial system. Indeed, investors and asset allocators with the temerity to have employed risk-mitigation and hedging strategies have only succeeded in impairing portfolio performance and career prospects. In an investment world now dominated by monthly inflows into ETF's and index funds, unconstrained by rational analysis of portfolio components, it has become somewhat passé to fret over underlying fundamentals.

Amid such fervor for U.S. financial assets, gold's solid year-to-date gains have been somewhat counter-intuitive. After trading in a tight $100-range for seven months, spot gold broke upwards through resistance at $1,300 in late-August and touched an intra-day high of $1,357.64 on 9/8/17 (up 17.8% year-to-date). Most investors are unaware that gold's performance during this span exceeded the total-return of the S&P 500 (+11.51%) by some 55%! Conventional wisdom attributes gold's recent strength to North Korean provocation and Mother Nature's wrath, but this narrative ignores the fact that gold broke through $1,300 (on its third attempt in five months) before Chairman Kim's 8/28 Hokkaido missile launch. We believe gold's unheralded price-performance in 2017 carries an important signal for investors. Much to the Fed's chagrin, economic and financial imbalances are bubbling to the surface (once again), placing consensus expectations for further FOMC tightening in jeopardy.

As precious-metal investors, we frequently encounter the refrain that global economic conditions, while somewhat lackluster, are a far cry from the negative extremes of the financial crisis. The funny thing about this nearly ubiquitous view is how precisely misinformed it actually is – virtually every measure of domestic and global debt is significantly worse today than at its financial-crisis peak. ***In this note, we seek to disabuse the popular notion of economic and balance sheet repair, through dispassionate review of relevant statistics.*** We recognize rehashing structural debt issues is a tiresome exercise for equity bulls, but we believe gold's recent breakout may be foreshadowing an imminent uptick in financial stress. If we are correct in our analysis, reigning positioning in prominent asset classes is likely to be recalibrated to gold's tangible benefit.

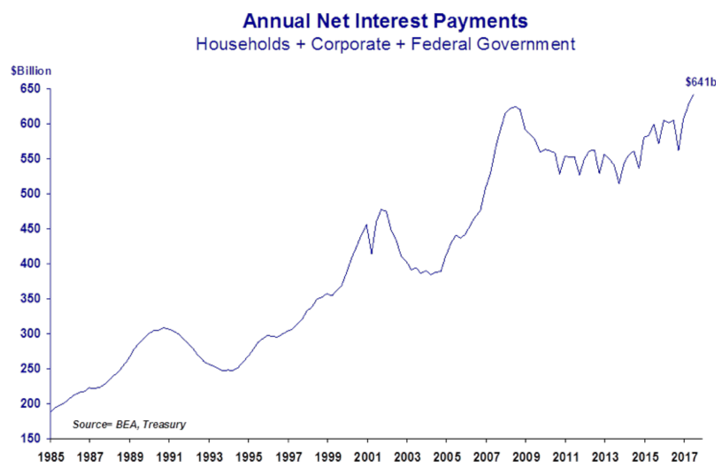
Perhaps the greatest misconception among contemporary investors is the belief that the U.S. economy has been deleveraging since the financial crisis. Nothing could be further from the truth. The Fed's quarterly Z.1 report discloses that domestic nonfinancial credit (including households, business, federal, state and local) has actually increased over 40% since Q1 2009, rising from $33.9 trillion to $47.5 trillion by Q1 2017. Of course, this aggregate measure does not capture growth in the Fed's own balance sheet, which has expanded from $930 billion in August 2008 to its current level around $4.5 trillion. Because we have always viewed the Fed's QE programs as tacit admission that the Fed feels compelled to provide a liquidity bridge whenever U.S. nonfinancial credit growth is insufficient to stabilize the U.S. debt pyramid (now $66.5 trillion including financial debt), we find it highly implausible that the Fed can now reduce the size of its balance sheet meaningfully without straining liquidity conditions in the U.S. commercial banking system.

Our gold investment thesis rests on the gross over-issuance of paper claims (debt) against comparatively modest levels of productive output (GDP). Total U.S. credit market debt of $66.5 trillion cannot be functionally serviced by a $19 trillion economy without annual creation of copious amounts of fresh

nonfinancial credit to help amortize existing debt obligations. Gold serves as a productive portfolio asset amid such "forced" credit growth for two important reasons. ***First, the only options for rebalancing unsustainable debt-levels back towards underlying productive output are default or debasement, and gold is an asset immune to both. Second, gold is an effective protector of portfolio purchasing power during inevitable episodes of official policy response.***

In Figure 1, below, we plot a simplistic illustration of how burdensome U.S. debt levels have become. During the past four quarters, net economy-wide interest payments approximated $641 billion, or over 90% of coincident GDP growth of $708 billion. This certainly does not leave much economic fuel to power capital formation!

Figure 1: U.S. Annual Aggregate Net Interest Payments (1985-2017)



Source: MacroMavens; BEA; U.S. Treasury

Drilling down in the ***consumer*** segment of total U.S. debt, historically high debt levels are frequently discounted by the observation that debt-service ratios remain manageable in the context of today's near-ZIRP environment. We view debt-service ratios as a classic tool of cognitive dissonance. While these ratios calibrate *aggregate* disposable income to *aggregate* debt service, they ignore the reality that the disposable income and the debt obligations are largely concentrated in different sub-sectors of the U.S. population, so netting them out is a pyrrhic exercise. Further, in the current environment of soaring healthcare and housing costs, traditional disposable income statistics have become far less instructive in gauging consumer financial-health than ***discretionary*** income measures (after basic needs are paid for). Reflecting growing consumer stress, delinquencies are beginning to spike (from low levels) on a wide range of revolving and installment credits, from JP Morgan's credit card portfolio to subprime auto loans, to everything in between. Rapidly declining fundamentals in important industries such as retail, automobiles and restaurants only serve to reinforce the message of tapped and retrenching consumers.

Corporate balance sheets have been deteriorating for many years. ZIRP fostered an epic decline in capex in favor of borrowing to finance share repurchase. In essence, corporate income statements have been consuming corporate balance sheets at an alarming clip. ***State and local*** governments are struggling with a $4 trillion funding shortfall in public pensions, due largely to the corrosive effects of seven years of ZIRP on the complexities of pension accounting.

The recently negotiated three-month suspension of the ***federal*** debt ceiling paved the way for a ***single-day***, $318 billion boost in our national debt, to $20.162 trillion on 9/8/17. Since the U.S. has not run a budget surplus in over two decades, it is no surprise that first breach of the $20-trillion-level generated scant coverage in financial press. Quickly recognizing he now faced the awkward timing of a year-end debt-ceiling standoff, President Trump once again demonstrated his trademark flexibility with respect to longstanding convention by floating the concept of abandoning the ceiling altogether (9/7/17):

For many years, people have been talking about getting rid of debt ceiling altogether, and there are a lot of good reasons to do that….It complicates things, it's really not necessary.

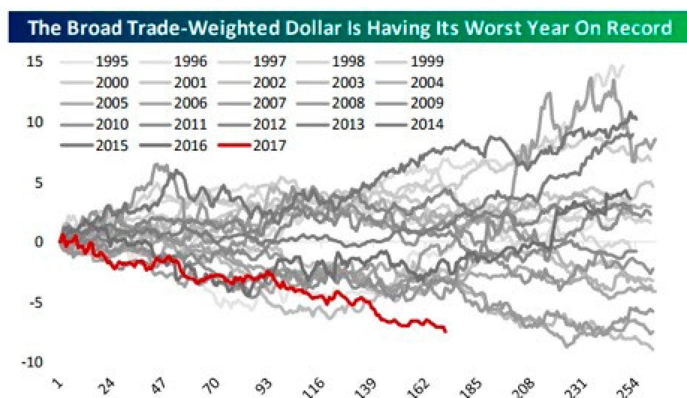
Rounding out the surreal quality of contemporary U.S. governance, Treasury Secretary Mnuchin on 9/13/17 issued veiled threats towards China which we found disturbing. Addressing an Andrew Sorkin question as to why the U.S. has been unable to "move the needle" in convincing China to pressure North Korea to change its behavior, Secretary Mnuchin responded:

I think we have absolutely moved the needle on China. I think what they agreed to yesterday was historic. I'd also say I put sanctions on a major Chinese bank. That's the first time that's ever been done. And if China doesn't follow these sanctions, we will put additional sanctions on them and ***prevent them from accessing the U.S. and international dollar system. And that's quite meaningful.*** *[our emphasis]*

As John McEnroe might protest, "You can't be serious!" The United States is the world's largest debtor nation, running the world's largest trade deficit, requiring more external capital than any other global nation. Yet Treasury Secretary Mnuchin saw fit to threaten to deny China, both our largest creditor and our largest trading partner, access to the SWIFT interbank clearing network, which underpins the dollar-standard system and, therefore, the vast majority of global commerce. Beyond almost inconceivable disrespect to China, Mnuchin's comments demonstrate either ignorance of, or reckless disregard for, the critical role played by ***savings*** (domestic or foreign) in the capital formation process. In the United States, we don't even pretend that savings matter anymore. It's all about the printing press!

Amid cavalier U.S. attitudes regarding the dollar-standard system, the global trend towards de-dollarization continues apace. In response to U.S. sanctions, Venezuela announced 9/14/17 that it will no longer accept U.S. dollars as payment for its crude oil exports. Even more intriguing was disclosure in the Nikkei Asian Review on 9/3/17 that China is launching a crude oil futures-contract denominated in yuan and ***fully convertible into gold*** on the Shanghai and Hong Kong exchanges (already beta-tested this past June and July). Long-held global resentments over the petrodollar payment-system are finally coalescing into tangible policies and products to reduce dollar hegemony. These currency-diversification efforts only compound the dollar's 2017 woes. As shown in Figure 2, below, 2017-year-to-date performance of the Fed's Broad Trade-Weighted Dollar Index has been the worst since inception of the index in 1995.

Figure 2: Annual Performances of Fed's Broad Trade-Weighted Dollar Index by Trading Days (1995-2017)



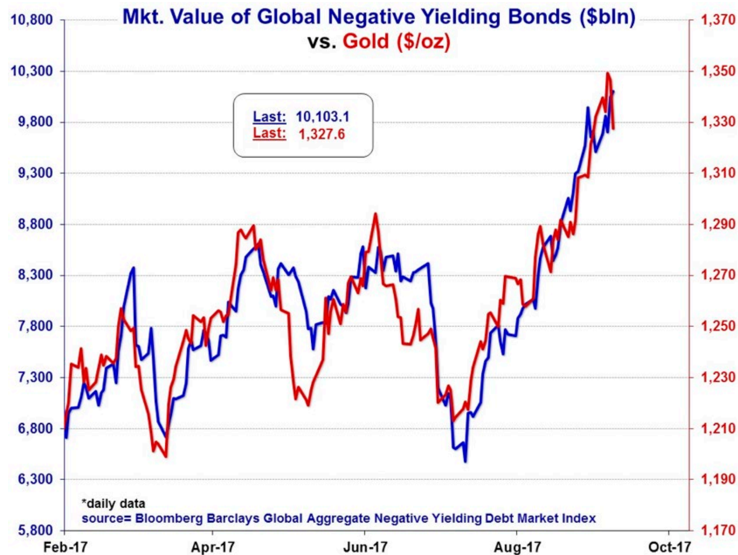
Source: Bespoke Investment Group; Zero Hedge

Pulling this all together, we attribute recent dollar weakness to growing speculation that the Fed is finished with its current tightening cycle. As we have communicated in the past, we believe outstanding U.S. debt levels absolutely preclude normalization of interest rate structures (on both the short and the long end). While it is still too early to cite definitive proof, we suspect the Fed's three most recent rate hikes have already begun to weigh on U.S. economic performance in manners the Fed will not countenance (such as declining growth rates in commercial-bank lending). On 9/5/17, Minneapolis Fed President (and 2017 FOMC voter) Neel Kashkari freely acknowledged his own apprehensions over recent Fed tightening:

Maybe our rate hikes are actually doing real harm to the economy. It's very possible that our rate hikes over the past 18 months are leading to slower job growth, leaving more people on the side-lines, leading to lower wage growth, and leading to lower inflation and inflation expectations.

Despite the Fed's recent rate increases and occasional outbreaks of hawkish jawboning from global central bankers during 2017, the U.S. dollar's extended decline, together with gold's recent breakout, signal growing market skepticism that the era of central bank stimulus is truly coming to a close.

Figure 3: Spot Gold vs. Aggregate Market Value of Global Negative-Yielding Sovereign Bonds
(February 2017-September 2017)



Source: Meridian Macro

Nowhere is this inflection in market expectations for central bank policy more evident than in the dramatic summer resurgence of sovereign bonds sporting negative yields. Figure 3, above, demonstrates that the global stock of negative-yielding sovereigns exploded by ***50%*** during the past ***three months***, and now stands just $2.1 trillion shy of its June 2016 record-total. Tight correlations in Figure 3 suggest gold has certainly taken notice.

Sincerely,

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