

in **gold** we trust
.report

June 1st, 2017 | Compact Version

Extended Version (170 pages) available at www.ingoldwetrust.report



incrementum

Ronald-Peter Stoeferle
Mark J. Valek

We would like to express our profound gratitude to our premium partners for supporting the „In Gold we Trust” 2017



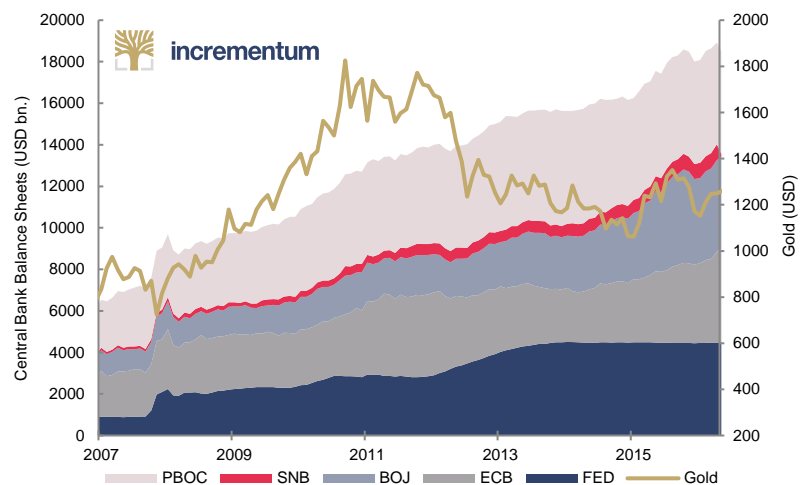
philoro
EDELMETALLE



Introduction

We live in an age of advanced monetary surrealism. In Q1 2017 alone, the largest central banks created the equivalent of almost USD 1,000 bn. worth of central bank money ex nihilo. Naturally the fresh currency was not used to fund philanthropic projects but to purchase financial securities¹. Although this ongoing liquidity supernova has temporarily created an uneasy calm in financial markets, we are strongly convinced that the real costs of this monetary madness will reveal themselves down the line.

Base Money inflation and the price of Gold in USD



Source: Bloomberg, Incrementum AG

„...whatever it takes!”

Mario Draghi

We believe that the monetary tsunami created in the past years, consisting of a flood of central bank money and new debt, has created a dangerous illusion: the illusion of a carefree present at the expense of a fragile future. The frivolity displayed by many investors is for example reflected by record-low volatility in equities, which have acquired the nimbus of being without alternative, and is also highlighted by the minimal spreads on corporate and government bonds. Almost a decade of zero and negative interest rates has atomised any form of risk aversion.

While the quantitative easing programmes are still going at full throttle in many places without the media paying much attention, the situation in the USA looks decidedly different: seven years after the Fed funds rate had been set to zero, the first interest rate hike by the Federal Reserve in December 2015 marked the end of the longest period of immobility in terms of interest rate policy in history. To many market participants, this overdue step towards normalising the monetary policy is the confirmation of the much-desired comeback of the US economy.

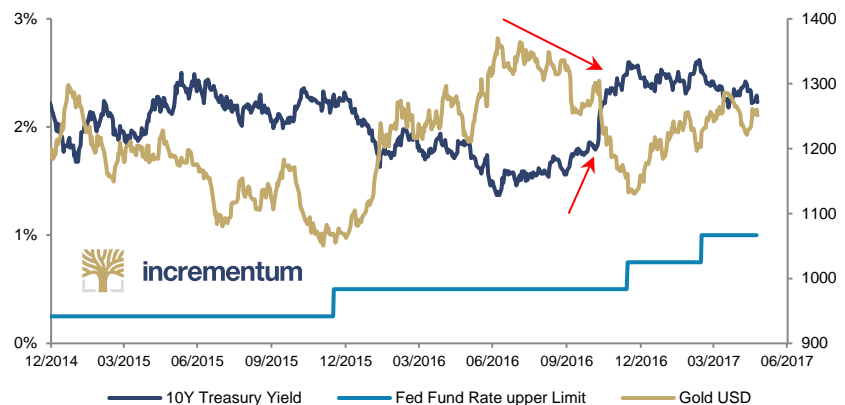
¹ With that amount of currency, one could purchase 20 Big Macs for every person in the world. Notably in the - according to the Big Mac Index - most expensive jurisdiction, Switzerland. Alternatively, one could theoretically buy one 1/10 oz. Gold coin for every person.

However, the interest rate reversal that had been announced for years got off to a sluggish start. Market participants became increasingly nervous in 2016 when it started turning out that central banks would not be remotely able to stick to the speed of four interest rate hikes as announced. After the FOMC meeting in March 2016, the first question that CNBC journalist Steve Liesman asked Janet Yellen was:

"Does the Fed have a credibility problem [...]?"²

We believe that the absence of the often-quoted sustainable economic recovery is one factor to blame for the passivity of the Fed. The depreciation of the Chinese currency and the still falling yields at the long end of the yield curve in 2016 are two others, as a result of which the Fed had to procrastinate until December 2016.

Mind the Donald: 10Y Yields, Fed Fund Rate (left scale) & Gold (right scale)



Source: Federal Reserve St. Louis, Incrementum AG

"The highly abnormal is becoming uncomfortably normal."

Claudio Borio, BIS

The gold price celebrated a remarkable comeback during this hesitant phase of the Fed. Last year we confidently opened the “In Gold We Trust” report with the line “Gold is back!”. We had anticipated the passivity of the Fed as well as the return of the bull market. The gold price seemed to have experienced a sustainable trend reversal in USD, and we felt our bullish stance had just been confirmed.

But our gold(en) optimism was stopped in its tracks again in autumn 2016. The gold price declined significantly, in particular in the last quarter of 2016, even though the maximum drawdown has never exceeded 20%. We can therefore still call the status quo a correction within the confines of a new bull market, but we want to openly admit that we had not foreseen the dent in the gold price performance. **Unfortunately, our target price of USD 2,300 for June 2018 may therefore prove overly optimistic.**

² https://youtu.be/aodavML_cb8?t=15m

But what was the trigger of the sudden reverse thrust of the gold price?



Source: https://de.wikipedia.org/wiki/Donald_Trump³

"There are two ways to be fooled. One is to believe what isn't true; the other is to refuse to believe what is true."

Søren Kierkegaard

"It's the economy, stupid."

Bill Clinton

"It's the economic, stupid."

Richard Lugner*

(*Austrian equivalent of Donald Trump)

"... Stocks, bonds and real estate have all become as overvalued as we have ever seen any one of them individually in this country. The end result of all of this money printing and interest rate manipulation is the worst economic expansion since the Great Depression and the greatest wealth inequality since that period."

Jesse Felder

Ironically, it was Donald J. Trump. The election of the presidential candidate originally unloved by Wall Street fuelled hopes of a renaissance of America on the basis of a nationalistic growth policy. President Trump brought about a change in sentiment, especially among a class of society that had lost its trust in the economic system and political institutions. Stocks received another boost, and the increase in the gold price was (temporarily) halted.

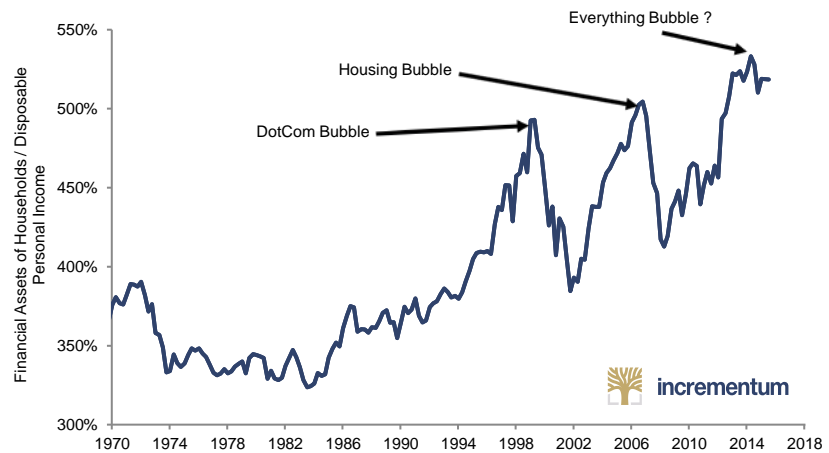
The Fed seems to be keen to use the new euphoria on the markets in order to push the normalisation of monetary policy. Even if the journalistic mainstream is abundantly convinced of the sustainability of the US interest rate reversal, a contradiction is embedded in the narrative of the economic upswing triggered by Trump: if the economic development, as claimed by the Fed in the past years, was actually rosy even *prior* to Trump's victory, the candidate promising in his central message to make America great AGAIN would presumably not have won. **The narrative of a recovering US economy is the basis of the bull market in equities.**

The valuation level of the US equity market is nowadays ambitious, to put it mildly - both in absolute numbers and in terms of the economic output. **This prompts the conclusion that the U.S. is caught up for the third time within two decades in an illusionary bubble economy created by money supply inflation and equipped with an expiry date.** In comparison with the earlier two bubbles, however, the excess is not limited to certain sectors (technology in 2000, credit in 2008), but it is omnipresent and includes various asset classes, especially also bonds and (again) property. **In view of the current situation, the renowned analyst Jesse Felder rightly talks about an "Everything Bubble".**⁴ From our point of view, the concept of the classic investment portfolio, which calls for shares to satisfy the risk appetite and bonds as safety net, must be critically questioned.

³ This is Donald Trump's official presidential photo. Seriously!

⁴ cf. "Welcome to the everything bubble", Jesse Felder, The Felder Report

The "Everything Bubble": Financial Assets relative to disposable personal income



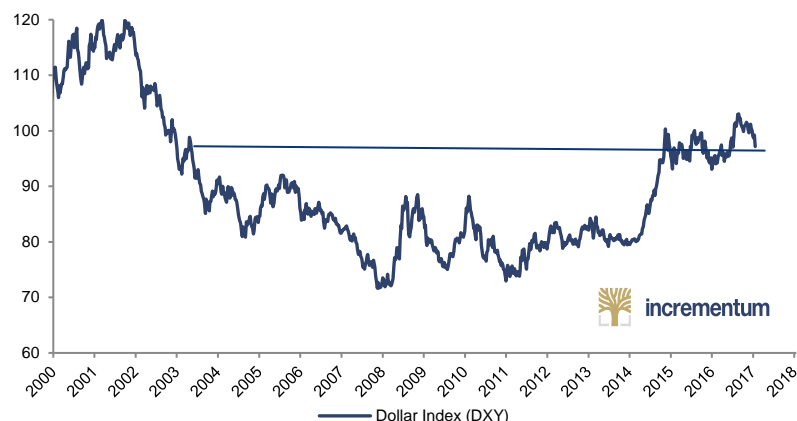
Source: Incrementum AG, Jesse Felder, Federal Reserve St. Louis

While markets are already celebrating the future successes of Trumponomics, the structural weakness of the US real economy is revealed yet again in the latest growth figures. According to the most recent estimate, the US economy expanded in Q1 2017 by a meagre 1.2 % y/y. In combination with an inflation rate of more than 2%, this means that the U.S. is at the edge of stagflation - a scenario we have warned about on several prior occasions. But markets are obviously taking a different view than we are. At least for now.

"Policy, profit and positioning trends all argue for rotation from deflation to inflation, from 'ZIRP winners' to 'ZIRP losers', from Wall Street to Main Street. As part of this rotation we expect real assets to outperform financial assets."
Michael Hartnett

In the past years, rate cuts and other monetary stimuli have affected mainly asset price inflation. Last year, we wrote: *"Sooner or later, the reflation measures will take hold, and asset price inflation will spill over into consumer prices. Given that consumer price inflation cannot be fine-tuned by the central banks at their discretion, a prolonged cycle of price inflation may now be looming ahead."* 2016 might have been the year when price inflation turned the corner. However, the hopes of an economic upswing due to Trumponomics and the strong US dollar have caused inflation pressure to decrease for the time being. **Upcoming recession fears resulting in a U-turn by the Fed, and the consequential depreciation of the US dollar would probably finalise the entry into a new age of inflation. This will be the moment in which gold will begin to shine again.**

Strong dollar supports disinflation: DXY at highest level since 2003



Source: Federal Reserve St. Louis, Incrementum AG

Low interest rates combined with the pressure to invest and FOMO, have nurtured a treacherous sense of carelessness within many market participants. Scenarios such as significantly higher inflation or a recession are currently treated like black swans, although history shows that these events do occur at regular intervals.

Where Things Stand

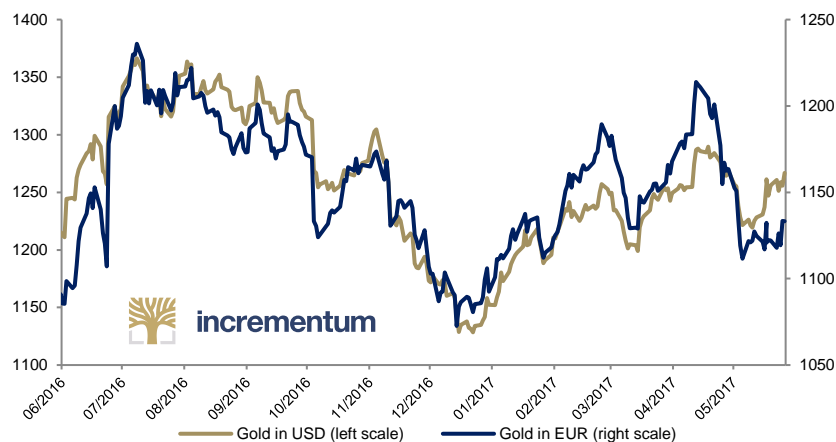
"It's all about relative supply curves – the supply curve for bullion is far more inelastic than is the case for paper money. It really is that simple."

David Rosenberg

At the outset, we would like to go through a number of performance data. The development since the publication of our previous report on 28 June 2016 has been slightly negative, both in terms of euro (-3.4%) and in terms of US dollar (-3%). The full year of 2016 was like day and night. A fantastic first half was followed by a disastrous second half, where the newly won confidence was brutally destroyed. Gold bulls were being tested again, with the market turning into a “pain maximiser”. The big caesura in the performance had to do with the election of Donald Trump.

Since the beginning of 2017, the picture has been clearly positive. After a rally from USD 1,150 to almost 1,300 within a few weeks, a correction set in around the middle of April, which now seems to be over.

Gold in US dollar and euro since the previous Gold Report



Source: Federal Reserve St. Louis, Incrementum AG

Gold is a classic appreciation currency

The performance in this secular bull market is still impressive. The average annual performance from 2001 to 2017 has been 10.15%. **Gold outperformed practically every other asset class and especially every other currency by a significant degree, despite intermittent (sometimes sharp) corrections.** Since the beginning of 2017, the development is quite robust, too. On average gold is up 5.88% ytd.

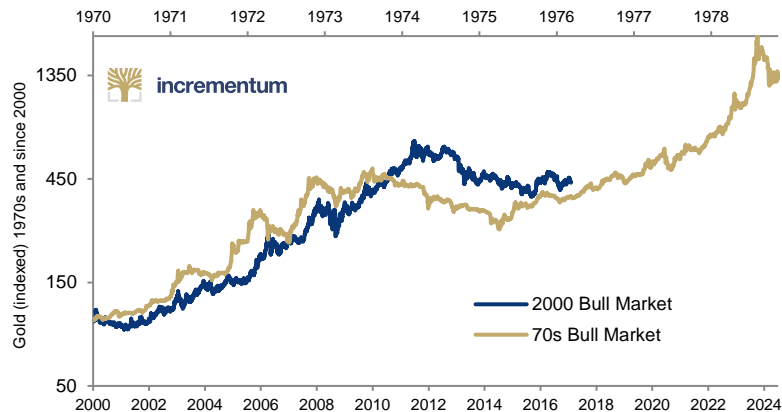
Gold performance since 2001 in various currencies (%)

	EUR	USD	GBP	AUD	CAD	CNY	JPY	CHF	INR	Mean
2001	8.10%	2.50%	5.40%	11.30%	8.80%	2.50%	17.40%	5.00%	5.80%	7.42%
2002	5.90%	24.70%	12.70%	13.50%	23.70%	24.80%	13.00%	3.90%	24.00%	16.24%
2003	-0.50%	19.60%	7.90%	-10.50%	-2.20%	19.50%	7.90%	7.00%	13.50%	6.91%
2004	-2.10%	5.20%	-2.00%	1.40%	-2.00%	5.20%	0.90%	-3.00%	0.90%	0.50%
2005	35.10%	18.20%	31.80%	25.60%	14.50%	15.20%	35.70%	36.20%	22.80%	26.12%
2006	10.20%	22.80%	7.80%	14.40%	22.80%	18.80%	24.00%	13.90%	20.58%	17.24%
2007	18.80%	31.40%	29.70%	18.10%	11.50%	22.90%	23.40%	22.10%	17.40%	21.70%
2008	11.00%	5.80%	43.70%	33.00%	31.10%	-1.00%	-14.00%	-0.30%	30.50%	15.53%
2009	20.50%	23.90%	12.10%	-3.60%	5.90%	24.00%	27.10%	20.30%	18.40%	16.51%
2010	39.20%	29.80%	36.30%	15.10%	24.30%	25.30%	13.90%	17.40%	25.30%	25.18%
2011	12.70%	10.20%	9.20%	8.80%	11.90%	3.30%	3.90%	10.20%	30.40%	11.18%
2012	6.80%	7.00%	2.20%	5.40%	4.30%	6.20%	20.70%	4.20%	10.30%	7.46%
2013	-31.20%	-23.20%	-28.80%	-18.50%	-23.30%	-30.30%	-12.80%	-30.20%	-19.00%	-24.14%
2014	12.10%	-1.50%	5.00%	7.70%	7.90%	1.20%	12.30%	9.90%	0.80%	6.16%
2015	-0.30%	-10.40%	-5.20%	0.40%	7.50%	-6.20%	-10.1%	-9.90%	-5.90%	-3.75%
2016	12.04%	8.50%	29.70%	10.10%	5.50%	16.50%	5.40%	10.40%	11.50%	12.27%
2017	3.02%	10.22%	5.63%	6.24%	10.35%	8.45%	4.24%	4.78%	4.32%	5.88%
Mean	10.50%	11.56%	12.50%	9.36%	10.37%	9.67%	10.21%	8.36%	13.87%	10.15%

Source: Federal Reserve St. Louis, Goldprice.org, Incrementum AG

The following chart shows the similarities between the 1970s and the status quo. The analysis reveals the fact that the bear market since 2011 has been following largely the same structure and depth as the mid-cycle correction from 1974 to 1976. However, we can see that the duration of both corrections diverges significantly.

Gold bull market 1970s vs. 2000 to date



Source: Federal Reserve Fred, Incrementum AG

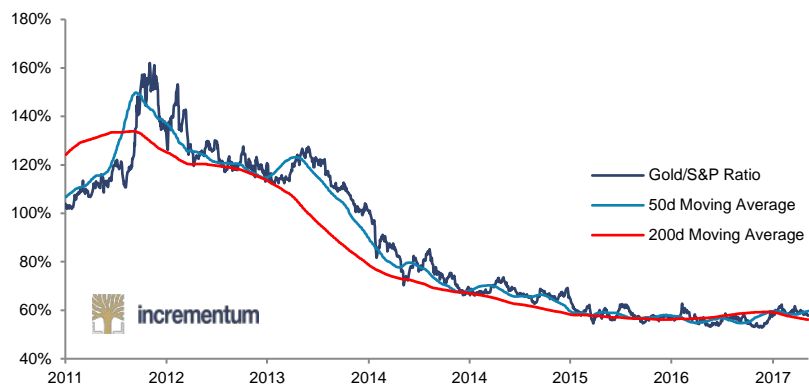
"If bond markets are smoking weed, then the stock market appears to be hooked on crack."
James Montier

Not only the absolute, but also the relative development is important for a comprehensive assessment of the status quo of the gold market. Along with gold, silver, and mining shares, industrial metals such as zinc, nickel, copper and energy commodities (especially coal and oil) marked stellar performances last year. All of this happened in an environment where the US dollar climbed to a 14-year high. **We regard this as a remarkable development and as a prime example of a bull market, whose starting gun has not been heard yet by the majority of investors.**

"Sell economic ignorance; buy gold."
Tim Price

We consider a bullish stock market currently as the most significant opportunity cost for gold. Therefore, a clear break-out of the gold price should only be occurring amid a stagnating or weaker equity market. If we now compare the gold price performance with the development of equity prices, we can see that the relative weakness of gold seems to be slowly coming to an end. Last year we had already noticed that the intensity of the upward trend had declined significantly. After almost five years of underperformance relative to the broad equity market, the tables might slowly be turning now in favour of gold.

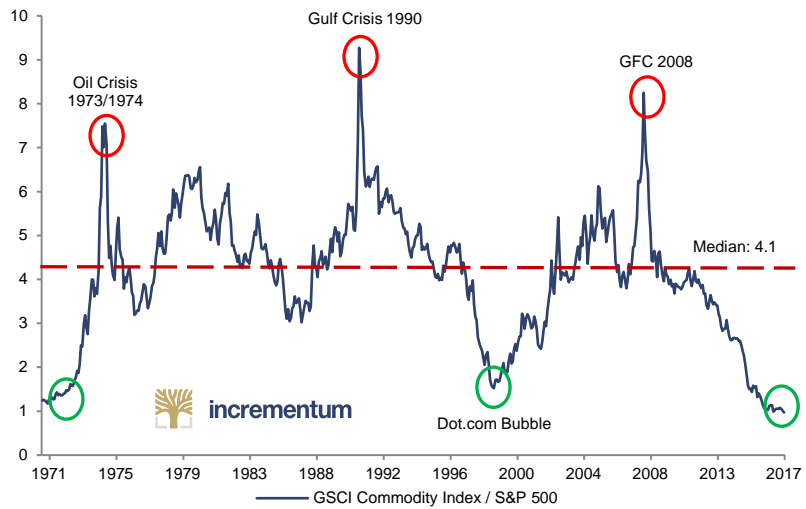
Gold/S&P500 ratio, 50-day and 200-day Moving Averages



Source: Federal Reserve St. Louis, Incrementum AG

In a historical context, the relative valuation of commodities to equities seems extremely low. In relation to the S&P500, the GSCI commodity index is currently trading at the lowest level in 50 years. Also, the ratio sits significantly below the long-term median of 4.1. Following the notion of mean reversion, we should be seeing attractive investment opportunities.

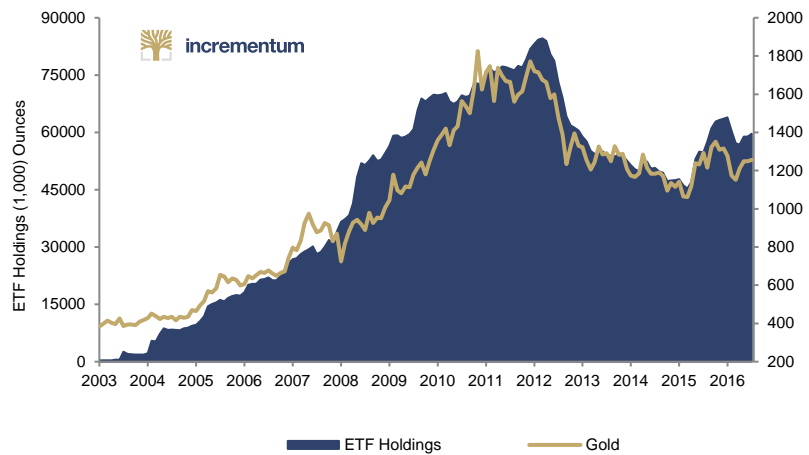
GSCI/S&P500 ratio: equities expensive, commodities cheap?



Source: Dr. Torsten Dennin, Incrementum AG

Inflows into gold ETFs have been picking up since the beginning of 2016. To us, this key ratio represents Western financial investors who choose ETFs as primary instrument to manage their gold exposure. In spite of the general trend reversal, the euphoria revolving around Donald Trump has left its marks in this area as well.

ETF holdings (in 1,000 ounces) vs. gold price (right scale)



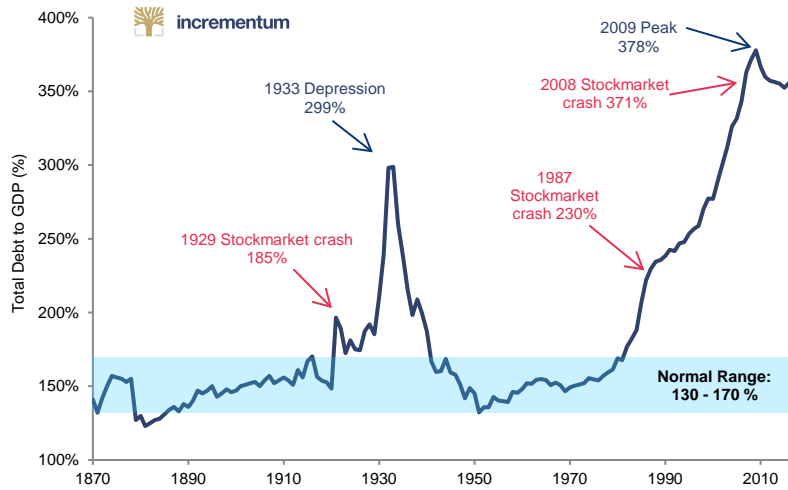
Source: Bloomberg, Incrementum AG

As always, we feel it is important to point out that the rise of already excessive debt levels progresses unnoticed. Let us look at the USA for

example. The ratio of total debt to the US GDP has been around 150% in the past 150 years. Historically, there have only been two significant exceptions: the 1920s (“the roaring twenties”), where a strong expansion of credit laid the foundation of the stock market crash and the Great Depression; and the current phase, which originated in the 1970s.

Unlike October 1929, even more debt was encouraged to build up in the economy after the 1987 stock market crash, driven by Alan Greenspan’s loose interest rate policy. In 2009, the ratio was at 378%, reaching an all-time-high. Since then, gentle efforts have been made to deleverage, but at 365% we are still in unhealthy regions. **No trace therefore of deleveraging and austerity.**

Total US credit market debt in % of GDP



Source: Dr. David Evans, www.sciencespeak.com, Incrementum AG

A Recession in the US: A White Swan

"Most financial traders are picking pennies in front a steamroller exposing themselves to the high-impact rare event yet sleeping like babies, unaware of it."

Nassim Taleb

"We are living in a fragile interim period between the Great Financial Crisis and another crisis that is likely to be no less (and may possible be even more) severe."

Thomas Mayer

"Our economic forecasting record is nearly perfect."

Janet Yellen

The future is always uncertain. It is nevertheless possible – and sensible – to gather and interpret information in order to draw up different future scenarios and consider reasons both for and against their potential occurrence. Based on the “black swan” concept, we want to discuss “**black, gray and white swans**”.

The surge in total indebtedness and money supply aggregates has made the uncovered monetary system even more fragile than it already is based on its fundamental nature. In the wake of the many non-conventional monetary policy measures implemented by central banks, it is important that the belatedly begun normalization of US monetary policy succeeds in order to maintain investor confidence. We will examine potential scenarios that are liable to cut the normalization effort short, which would ultimately lead to systemic upheaval. Naturally, such a development would have a significant effect on the gold price.

It is widely acknowledged that a US recession represents one of the greatest extant risk factors for international investors. In our opinion, financial market participants currently display a suspiciously pronounced degree of complacency.

In the following we want to examine five indications which despite the currently prevailing optimistic sentiment suggest that a recession is far more likely than is generally believed. These signs are:

1. Rising interest rates
2. Artificial asset price inflation
3. Consumer debt and slowing credit expansion
4. The duration of the current upswing
5. Stagnating tax revenues

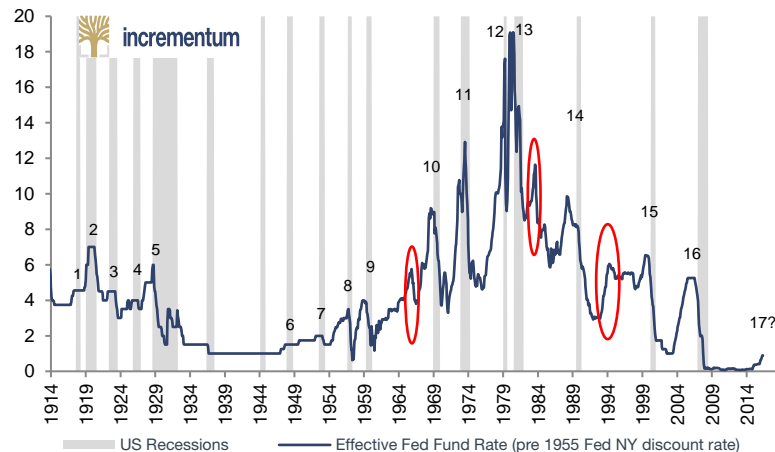
Indication #1: Rising interest rates

As a long-term chart of the federal funds rate reveals, the vast majority of rate hike cycles has led to a recession and every financial crisis was preceded by rate hikes as well. **The historical evidence is overwhelming – in the past 100 years, 16 out of 19 rate hike cycles were followed by recessions. Only three cases turned out to be exceptions to the rule.**⁵

⁵ These deliberations were inspired by van Hoisington - see Hoisington Quarterly Review and Outlook, Q1 2017



Rate hike cycles and following recessions in the US



Source: Federal Reserve St. Louis, Federal Reserve New York, Incrementum AG

*"It is hard to imagine a more
"The tightening of policy that
puts an end to the further
expansion of an asset bubble and
the subsequent reopening of the
liquidity spigots are **always**
asymmetric."*

www.acting-man.com

This illustrates the boom-bust cycle and its relationship with monetary policy quite well. In our opinion, the most cogent and helpful explanation of this phenomenon and the associated concatenations is provided by *Austrian business cycle theory* (ABCT).⁶

Future rate hikes should therefore be looked forward to with great interest as a matter of principle.

Indication #2: Artificial asset price inflation

A declared goal of the Fed's QE programs was the inflation of asset prices, which was supposed to stimulate consumer spending down the road:

"...we made a decision back in 2008, early 2009 we were going to have a wealth affect. That was achieved, it made wealthy people wealthier but the point is, it didn't trickle down..."⁷

Richard Fisher, former president of the Federal Reserve of Dallas

*"We have the worst revival of an
economy since the Great
Depression. And believe me:
We're in a bubble right now."*

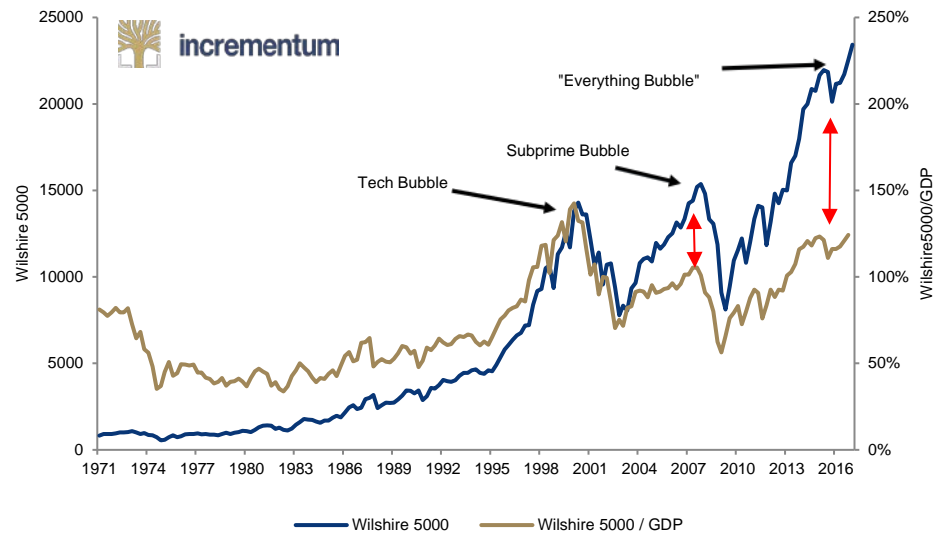
Donald Trump

We have often pointed out that such a monetary policy represents anything *but* a sustainable approach. Every artificial inflation of asset prices will sooner or later end in a painful denouement for asset prices. **In the current cycle, the surge in asset prices has once again generated suspiciously extended valuations.** Apart from the ratio of income to total household wealth shown earlier, the so-called "Buffett indicator", i.e., the ratio of total market capitalization to GDP, which is reportedly the favorite valuation indicator of legendary investor Warren Buffett, is sending a clear warning signal. For the third time in slightly less than two decades, it shows that the US stock market is significantly overvalued relative to total economic output.

⁶ A detailed explanation of ABCT and its implications can inter alia be found in our book *Austrian School for Investors*

⁷ http://www.realclearmarkets.com/video/2016/09/08/richard_fisher_wealth_effect_did_not_trickle_down.html

Wilshire 5000 Index and Wilshire 5000/US GDP ratio



Source: Federal Reserve St.Louis, InCREMENTUM AG, Kevin Duffy⁸

Numerous other valuation metrics also suggest that stocks are currently (significantly) overvalued, among them also the well-known Shiller P/E ratio (a.k.a. CAPE, or cyclically adjusted P/E ratio). The fact that rate hike cycles invariably have a negative effect on stock market valuations makes the current level of this ratio particularly worrisome - the recent reading of 29.1 is only slightly exceeded by the manic figure posted in 1929 and the sheer lunacy of early 2000.

Indication #3: Consumer debt levels and a slowdown in credit expansion

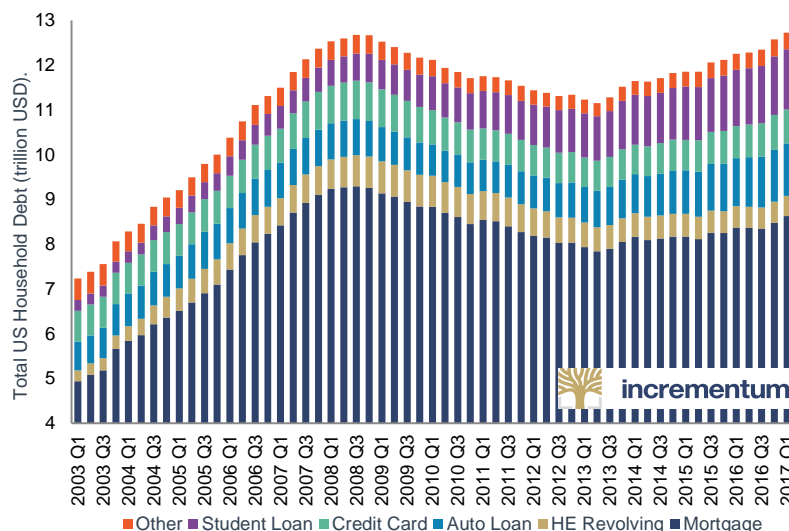
Interest rate signals deliberately manipulated by the central bank create unnatural behavior patterns. For one thing, relatively wealthy individuals think that they are becoming richer due to surging stock market and real estate prices; but these higher prices are ephemeral, they represent phantom wealth created by the “money illusion”, which can, and eventually will, disappear faster than it was accumulated. For another thing, artificially low interest rates undermine incentives to save and promote the taking up of additional debt. **In times of zero or near zero interest rates, society at large will tend to eschew long-term, future-oriented saving in favor of conspicuous consumption.**

In April this year cumulative US household debt exceeded its pre-crisis level again for the first time. While we regard the new record high in debt levels as a cause for concern, the press welcomed the news as a thoroughly positive development.⁹

⁸ See: "Mr. Market flunks the marshmallow test", Presentation from Kevin Duffy, Grant's Spring Konferenz 2017
⁹ See: "Household debt makes a comeback in the U.S"

"Credit is a system whereby a person who cannot pay gets another person who cannot pay to guarantee that he can pay."
Charles Dickens

Total US household debt outstanding (trillion USD)



Source: Federal Reserve Bank New York, Incrementum AG

Indication #4: Duration of the economic upswing

"One day everything will be well, that is our hope. Everything's fine today, that is our illusion."
Voltaire

There is usually very little consensus among economists on a great many issues: *"If you put two economists in a room, you get two opinions, unless one of them is Lord Keynes, in which case you get three opinions."*¹⁰. Nowadays "Lord Keynes" would probably have to be replaced with Paul Krugman, who is almost as prominent and well-known for frequently supporting completely different conclusions based on the same data points, depending on whatever pet agenda of his is in need of buttressing).¹¹

"There is always some chance of recession in any year, but the evidence suggests that expansions don't die of old age."
Janet Yellen

There were 49 economic expansions since the founding of the United States, which lasted 36 months on average. Looking exclusively at the 12 post-war expansion phases, the average duration of an upswing was 61 months. As of June 2017, the current expansion has lasted 96 months, making it the third-longest in history. **Should the current economic expansion continue for another 24 months, it would become the longest in US history. In light of the evidence discussed above, we believe it is unlikely that the old record will be broken.**

Indication #5: Federal tax revenues are stagnating

An interesting development can currently be observed in the trend of tax revenue growth rates, which typically correlate strongly with economic growth. Federal tax receipts have recently stopped growing, which is historically quite a negative sign for the economy's future performance. An outright decrease in tax receipts is as a rule only seen during economic contractions.

¹⁰ This quote is generally attributed to Winston Churchill – it shows that there is nothing new under the sun. Today one would have to replace John Maynard Keynes with Paul Krugman.

¹¹ Although this comment is a bit tongue in cheek, it is actually not merely a "partisan" assertion – it is backed by plenty of evidence, much of which can be found at a site run by Tom Woods, which is actually quite fair and meticulous in its analysis of Krugman's economic fallacies, despite being explicitly dedicated to drawing attention to them: <http://contrakrugman.com/>

The consequences of a recession

Should the current expansion fail to become the longest in history and US GDP growth indeed turn negative within the coming 24 months, we believe the consequences could be grave. The knee-jerk reaction by the government and the Fed would definitely comprise renewed stimulus measures in order to arrest the downturn, which implies a U-turn in monetary policy. Currently financial markets are almost exclusively focused on the planned normalization of monetary policy. Almost no-one seems to expect an impending recession or a return to loose monetary policy. Over the past 30 years, the Fed has implemented an increasingly asymmetric monetary policy. The extent of rate cuts routinely exceeded the extent of rate hikes.

It would be a big surprise, so to speak a black swan, if the response of the authorities to the next economic downturn were to deviate from the usual one.

"In a theater, it happened that a fire started offstage. The clown came out to tell the audience. They thought it was a joke and applauded. He told them again, and they became still more hilarious. This is the way, I suppose, that the world will be destroyed – amid the universal hilarity of wits and wags who think it is all a joke."

Søren Kierkegaard

Since the normalization of monetary policy hasn't progressed sufficiently yet, renewed stimulus measures would probably shake market confidence in the efficacy and sustainability of the monetary therapies applied to date. Historical experience indicates that the crumbling of such a deeply ingrained faith is often a wonder to behold; the best thing that can be said about it is that it will sell newspapers and raise the ratings of TV news programs. **Moreover, the dosage of said monetary therapies are subject to the law of declining marginal utility, in other words, the next round of QE would probably have to be significantly larger than QE3 was. If the markets were to sense that such a development was likely, the gold price would probably rally quite dramatically.**

Stagflation: A Gray Swan

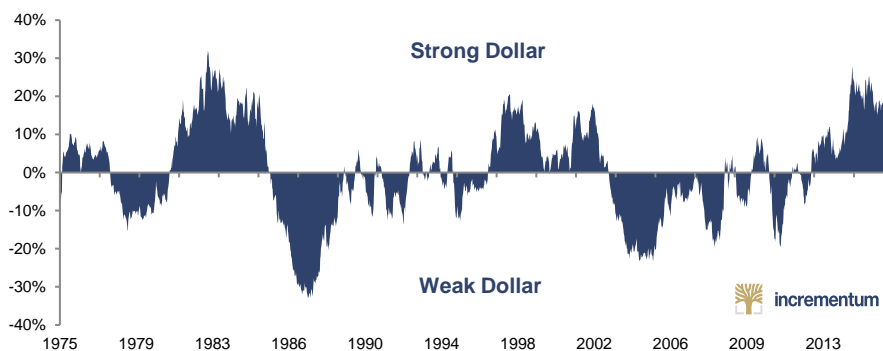
As discussed above, we currently believe that the probability of a US recession is significantly higher than is generally assumed. But how would a recession affect price inflation dynamics?

"There seems to be an unstated assumption that a central bank that has so far not even been able to push consumer price inflation rates up by doing everything to debase its currency, will somehow be able to keep price inflation in check if or when it finally does rear its head. It seems more likely to us that a chimpanzee will one day find the answers to all unresolved questions of theoretical physics."
www.acting-man.com

Contrary to the popular opinion that developed nations are characterized by very low inflation, enormous *monetary* inflation has already occurred. Thus, asset prices have increased to a rather conspicuous extent. It seems more than passing strange that rising food prices are as a rule regarded as great calamity, while rising home prices are considered a blessing. **Both simply reflect a decrease in purchasing power; whether it finds expression in home prices or food prices is not relevant to the fact that purchasing power has been lost.¹²**

A decisive factor likely to determine future price inflation dynamics will be the response of the US dollar to an economic contraction. In past recessions, the dollar tended to initially appreciate against most important foreign currencies. Then the Fed adopted an easy monetary policy and the dollar's external value decreased again. The extent and persistence of these moves depended also on the dollar's relative value at the outset of economic downturns, as well as on other contingent circumstances (such as dollar shortages in the euro-dollar market and similar market structural or psychological aspects). In that sense, the current situation differs markedly from that prevailing at the beginning of the last downturn, as the dollar has already appreciated considerably in recent years. Persistent further strength in the dollar would be the exception rather than the rule under these circumstances.

US dollar index: when will the tide turn?



USD Index (30 month change.)
 Source: FRED, Incrementum AG

Should a US recession strike concurrently with a devaluation in the US dollar, investors would be faced with a very difficult situation. **While in 2008, it was primarily concerns about liquidity and the fear that “not enough money would be printed” were dominant (a situation known as a “deflation scare”), the markets may arrive at a different assessment in the next downturn.** That would be particularly likely if confidence in the Fed's ability to revive the economy with another round of stimulus measures were to falter before they are even implemented. As soon as market participants consider rising price inflation to be a serious possibility, a fundamental shift in general market sentiment is likely to occur. The currently still prevailing expectation that

¹² See: "Why Keynesian Economists Don't Understand Inflation", Frank Hollenbeck, Mises.org

“if there are problems, central banks will implement further inflationary measures” would be increasingly questioned if inflation expectations were to rise.

Further Potential Gray Swans

Below we briefly list a number of additional gray swans, which we believe have strong potential to become relevant at some point.

- A credit crisis in China
- A political crisis in the US in the context of an impeachment of president Trump
- An escalation of geopolitical tensions in the Middle or Far East
- Hyper-deflation as a result of a global banking or government debt crisis
- An inflationary Boom in the US
- Reorganization of the global monetary order including a (partial) remonetization of gold

"The idea that China is now the driving economic power in the world, I think, is illusory or somewhat of a fallacy."

Kyle Bass

"The record of fiat currencies through history, 100%, is eventual failure. The record of gold for 5,000 years, 100%, is lack of failure."

Simon Mikhailovich

Gray Swans and their possible effect on the gold price

Gray Swan	Influence on USD	Expected Influence on Gold (in USD)	Expected Influence on inflation
Stagflation	Depreciation	positive	inflationary
Credit crisis in China	Appreciation	positive	uncertain
Political crisis in the US	Depreciation	positive	uncertain
Geopolitical escalation in the Middle/ Far east	Uncertain	positive	inflationary
Hyper deflation	Appreciation	negative	deflationary
Inflationary boom	Depreciation	strongly positive	inflationary
Reset of global monetary system	Depreciation	strongly positive	inflationary

Source: Incrementum AG

Mining Shares

"The great financial success stories are people who had cash to buy at the bottom."

Russell Napier

When our last gold report was published, the Gold Bugs Index (HUI) stood at 240 points. After a stunning rally of more than 180% in eight months, the sector suffered a 61.8% correction of the advance. Since the beginning of the year, the tide has turned again and the technical picture has clearly brightened. **In the following pages, we will discuss why we believe that the turnaround last year marked the end of the cyclical bear market and why the rally in the precious metals sector has probably only just begun.**

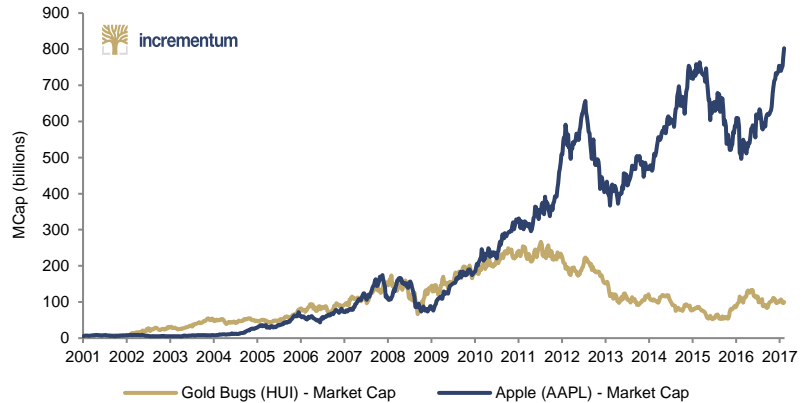
"Sometimes life hits you in the head with a brick. Don't lose faith."

Steve Jobs

A glance at the market capitalization of gold mining companies reveals a significant valuation discrepancy compared to other asset classes. At the moment the entire HUI, which includes the 16 largest unhedged gold producers, is valued at a mere USD 99 bn. This amount represents just 0.4% of the market capitalization of all S&P 500 Index members. The market capitalization of Apple alone exceeds that of the 16 companies in the index by 720%. **Another interesting numbers game: One could use the cash hoard of Apple (AAPL) to purchase the entire Gold Bugs Index 2.5 times over, or**

alternatively buy 6,500 tons of gold. If Apple did the latter, it would be the second largest gold holder in the world.

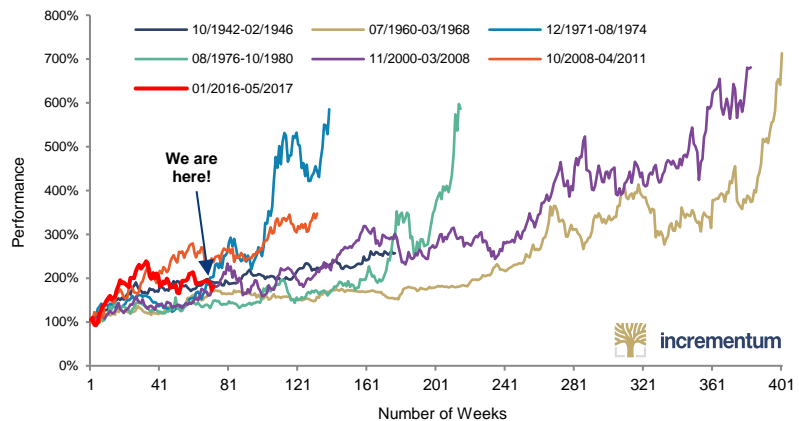
Market capitalization of the HUI vs. AAPL, in USD bn.



Source: Bloomberg, Incrementum AG

If one looks at all bull markets in the Barron's Gold Mining Index (BGMI)¹³, one notices that the current uptrend is still relatively modest in terms of duration and performance compared to its predecessors. Should we really be on the cusp of a pronounced uptrend in the sector – which we assume to be the case – quite a bit of upside potential would remain.

Bull markets compared: BGMI bull markets since 1942



Source: Nowandfutures, TheDailyGold.com, Barrons, Incrementum AG

"A speculator is a man who observes the future, and acts before it occurs."

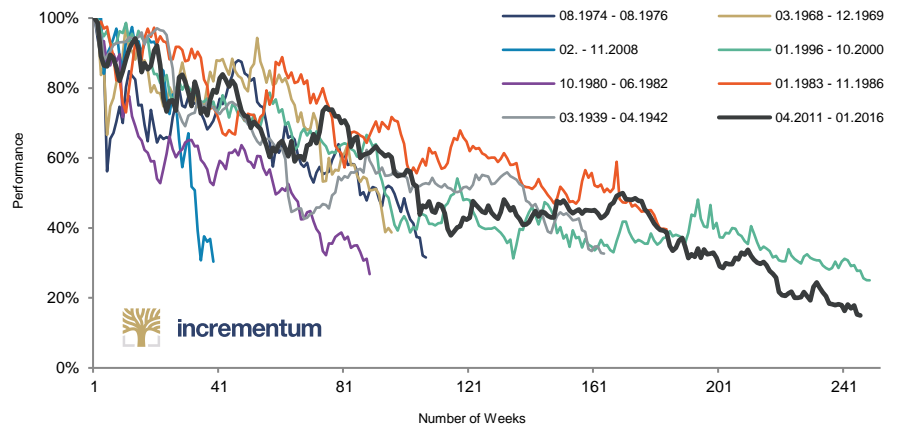
Bernard Baruch

Jordan Roy-Byrne, an analyst whom we greatly respect, describes the sector's status as "bearish bull". While the fundamentals of the mining sector stabilized in the 2014-2015-period, early 2016 was the time of the final capitulation. At the time, precious metals mining stocks exhibited the worst 5 and 10 year rolling performance in 90 years. During the final slump, they fell to an all-time low relative to the S&P 500 Index, and their price to book ratios stood at the

¹³ The oldest existing gold mining index. Index data can be obtained at www.bgmi.us

lowest level in 40 years (which is as far back as the data go). The chart below also makes clear that the preceding bear market was an historically unique event.¹⁴

Bear markets compared: BGMI bear markets since 1942



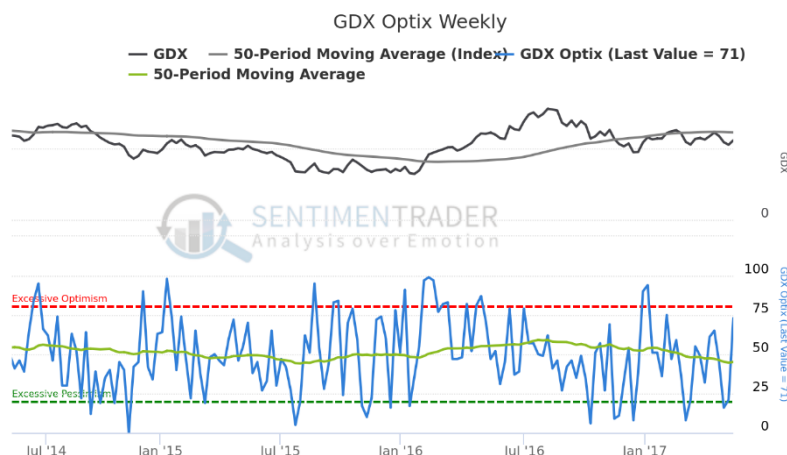
Source: Nowandfutures, TheDailyGold.com, Barrons, Incrementum AG

Despite the confidence that we have expressed with respect to gold miners, a number of factors have to be kept in mind:

- **Gold producers were able to lower their production costs in recent years by implementing comprehensive cost cutting measures.** The decline in energy prices, which traditionally represent a significant share of mining cash costs, was undoubtedly helpful in this context. Moreover, many producers have cut their annual exploration budgets drastically. As gold reserves are steadily depleted through mining, we expect a considerable acceleration in M&A activity in coming years. We primarily expect to see takeovers of exploration and development companies in politically stable regions such as Australia and North America. This assessment was most recently confirmed by the takeover of Integra Gold by Eldorado Gold.
- **In the short term, sentiment appears a tad over-optimistic to us.** As the Optix (optimism index, a mixture of a variety of sentiment and positioning data) shown below indicates, sentiment in the GDX ETF is approaching excessive optimism territory. In line with the seasonal pattern in mining shares, a correction in the summer months may well provide a favorable entry point.

¹⁴ See "The Bearish Bull", Jordan Roy-Byrne, TheDailyGold.com

GDx Optix



Source: Sentimentrader

"The great menace to the life of an industry is industrial self-complacency."

Joyce Carol Oates

"Put not your trust in money, but put your money in trust."

Oliver Wendell Homes Sr.

"The optimist thinks this is the best of all possible worlds. The pessimist fears it is true."

J. Robert Oppenheimer

The focus should be on conservatively managed companies which are not merely pursuing an agenda of growth at any price, but are instead prioritizing shareholder interests. From a valuation perspective, the growth rate of free cash flows, reserves per share, and earnings growth per share strike us as the most important financial metrics. Often these have to be assessed over somewhat broader time frames than the quarterly song and dance that seems so (needlessly) relevant to other sectors, as the mining business is subject to relatively wide fluctuations based on seasonal factors, mine sequencing, capex cycles, and so forth. One should try to avoid investing in companies with a habit of incessantly diluting their shareholders by flooding the market with new share issues, particularly if one aims to hedge oneself against the inflationary policies of central banks.

In our investment process, we are currently focused on developers and emerging producers. Based on the premise that the bull market in gold has resumed, we expect the gold-silver ratio to decline over the medium term from its current elevated level. **In such a scenario, particularly promising investment opportunities should emerge in the stocks of silver mining companies.**

Conclusion

After years of zero interest rate policy, investors have become used to the “brave new world” bereft of fixed rate income. Stocks are increasingly held for the cash flows they generate or the dividends they pay and are widely considered to be without alternative. As surrogates for safe bonds, investment portfolios fill up with ever more illiquid real estate, which only appears to be liquid due to the miracle of securitization. Government bonds by contrast are no longer purchased for their yields, but often to speculate on further price gains. **Gold is currently seen as “too low in calories” for yield-starved portfolios.**



Source: Hedgeye

Superficially, the current situation in financial markets appears promising. According to the narrative propagated by the Federal Reserve, the recovery of the economy is steadily progressing. New record highs in stock market indexes and the decline in unemployment rates to pre-crisis levels serve as evidence for the success of current economic policy. After an extended period of extreme monetary policy interventionism, the long-promised normalization is underway. Calm has returned to China, which was seen as the economic "problem child" in recent years and not too long ago caused quite a bit of concern. Even in crisis-ridden Europe the political and economic all-clear seem to be in the air at present. Based on this picture, the prospects for financial markets appear good and low risk aversion is held to be justified.

We believe this perception, which is reflected in market prices and valuations, is incomplete and highly inconsistent. Most market participants seem to be dismissive of the fact that asset prices have become egregiously overvalued for the third time in less than two decades.

"There's no harm in hoping for the best as long as you are prepared for the worst."
Stephen King

Moreover, many investors appear to disregard the negative effects of rate hikes on the business cycle and they ignore that the US consumer debt has once again reached new record highs. Positioning seems to be based on the implicit assumption that the current US economic expansion will become the longest in history. Most ironic is probably the fact that they are de facto celebrating the political fall-out produced by years of misguided economic policies: the election of probably the most unpredictable US president of all time - Donald J. Trump.



"Never underestimate the power of stupid people in large groups."
George Carlin

It may appear as though our evaluation of the economic situation is diametrically opposed to the prevailing consensus. One might well think that we are all alone with such a contrarian perspective. Up to a point that may be true, but in our experience, we are not quite as alone with our views as the current levels of asset prices may suggest. A growing number of our readers are institutional investors who share our concerns. Paradoxically, it is precisely the recent surge in asset prices that has goaded many of them into continuing to ride the financial market merry-go-round, even if their heads are spinning by now. A certain type of fear is currently rife: the fear of missing out. Many skeptics remain on the dance floor – even if they remain close to the exit. **This raises the question whether the exit will be big enough to accommodate all of them.**

"Societal scale increases. Instability grows exponentially. Complexity breeds complexity."
Jim Rickards

One of the reasons why we are convinced that turmoil in financial markets is highly likely to strike in the not-too-distant future, is the insight that the current monetary system is not sustainable. Its design inherently results in a continuous increase in overall debt levels, which have grown at a faster pace than economic output for decades. Over-indebtedness makes the creation of additional wealth increasingly hard, and the economy becomes ever more crisis-prone as a result.



Source: Hedgeye

"Our winnings will come...from the people who wake up one morning to find their savings have been devalued or bailed-in...It's going to come from the pension funds of teachers and firefighters. The irony is that when gold finally pays off, it will not be a cause for celebration."

Brent Johnson

The higher the levels of outstanding debt, the greater their interest rate sensitivity – we have been stuck in a zero interest rate trap for quite some time already. Although the symptoms are obvious to almost everyone, there was to date no broad public debate whatsoever regarding the need for fundamental reform of the monetary system or the international monetary order.

Whether one fully agrees with our critical assessment of the system is one thing; the question of whether one should hold an appropriate share of one's liquid wealth in the form of a “golden insurance reserve” is a different kettle of fish entirely. In order to make up one's mind regarding this point, it may be helpful to ask oneself a few simple questions, such as:

When will I not need any gold in my portfolio?

When...

- debt levels can be sustained or can be credibly reduced
- the threat of inflation is negligible
- real interest rates are high
- confidence in the monetary authority is (justifiably) strong
- the political environment is steady and predictable
- the geopolitical situation is stable
- governments deregulate markets, simplify tax regulations and respect civil liberties

In our opinion, the current environment speaks for itself: purchasing gold as a hedge should be the order of the day for prudent investors.

Where will the gold price go next?

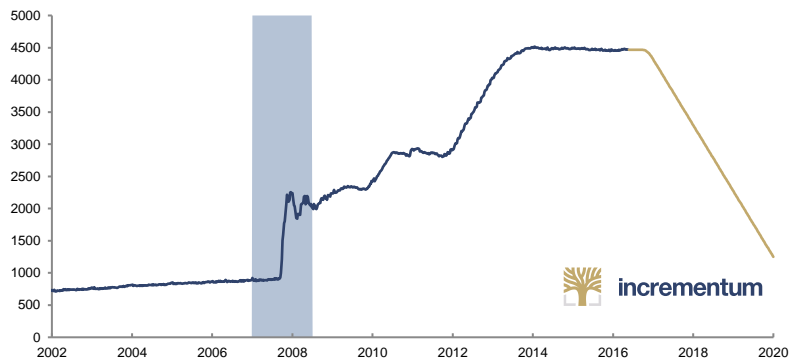
Two years ago, we made a quite audacious forecast, calling for gold to reach a price target of USD 2,300 by June 2018. At the current juncture that appears unlikely to happen. Nevertheless, the long term chart suggests that gold has pulled out of its rut. We continue to believe that the second phase of its secular bull market still lies ahead. There are numerous reasons for this:

1. The next US recession inevitably approaches - only the precise timing is open to question. It is not only certain that another recession will come, it is just as certain how central banks will respond to it: by switching back to (or intensifying) expansionary monetary policy, by implementing rate cuts, renewed rounds of quantitative easing, and quite possibly some form of “helicopter money” program. Should the next recession already begin before the process of policy normalization is finalized, confidence in the measures implemented to date could well crumble to disastrous effect. The following two criteria can be used to judge whether the Fed's monetary policy normalization effort can be considered a success:

- positive real interest rates in a range from 1 to 2 percent are established. Based on the Fed's consumer price inflation objective of 2%, this implies that **nominal interest rates should increase to around 3.5%**.

- **the Federal Reserve's balance sheet is reduced to pre-crisis levels.**

Reduction of the Federal Reserve's balance sheet – the litmus test for policy normalization



Source: St. Louis Fed, Incrementum AG

“I think gold should be part of everybody’s portfolio to some degree because it diversifies your portfolio. Its alternative money.”

Ray Dalio

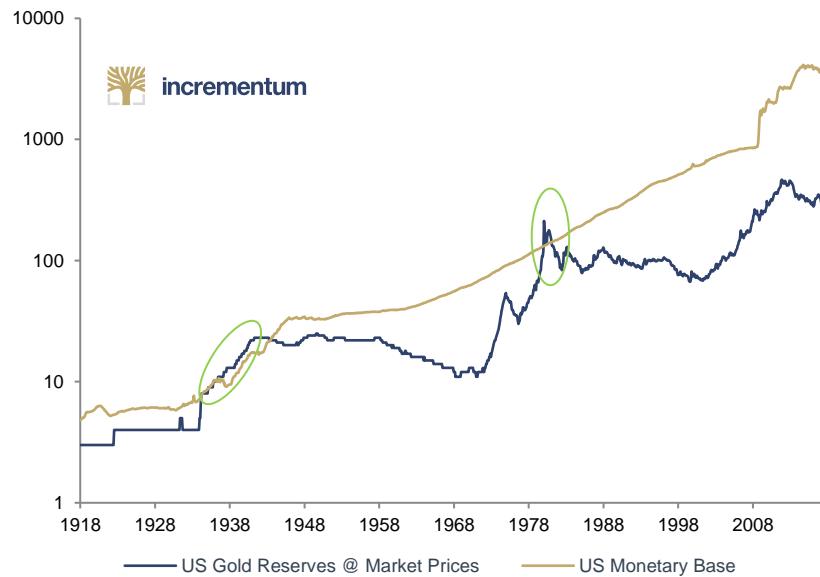
According to what has been conveyed regarding the current state of debate at the federal open market committee (FOMC), a cautious reduction of the balance sheet is to be set into motion fairly soon (initially by stopping or tapering the re-investment of proceeds from maturing bonds – no specific figures were so far released though).¹⁵ Even if the Fed were to reduce its holdings of securities at the same pace at which it acquired them during its last QE program, i.e., if it were to reduce them by USD 85 billion per month, it would take until sometime in 2021 to shrink the monetary base to its pre-crisis level. **From our perspective one can essentially rule out that this can be done without triggering a recession.**¹⁶

2. Excessive global over-indebtedness is by now glaringly obvious. That not only applies to developed countries, but to many emerging markets as well. Moreover, all sectors of the economy are afflicted by huge debt burdens. “Growing one’s way out” of this mountain of debt appears essentially impossible. The easiest way out of the situation would be a significant devaluation of the US dollar (and of all other fiat currencies) against commodities, primarily against gold. In this way, outstanding debt (in fiat money terms) could be made sustainable again. **The consequence would be high price inflation rates or a stagflationary environment.** A side effect would presumably be that gold’s current undervaluation as a monetary asset relative to the total monetary base would at least decrease.

¹⁵ See: <https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20170503.pdf> ; p.12

¹⁶ In the Fed's entire history there was only one occasion when it has deliberately allowed the money supply to shrink (by less than 2% year-on-year under Paul Volcker in 1981). The only noteworthy episode of monetary deflation under the Fed's watch occurred at the beginning of the Great Depression in 1930-1932 but that was entirely involuntary.

US monetary base vs. US gold reserves at market prices (log scale)



Source: Incrementum AG, St. Louis Fed

Since the end of the classical gold standard, parity between the US monetary base and US gold reserves was already restored on two occasions by an upward revaluation of gold (in the mid 1930s and in the late 1970s). Whether a potential dollar devaluation will happen in the framework of an international agreement or in an uncoordinated manner remains to be seen.

3. De-dollarization has begun. We regard this process as an uncoordinated form of dollar devaluation. Its main symptom is a gradual reduction of the US dollar's importance as a global reserve currency. If central banks want to hold a monetary asset that is liquid, stateless and above all requires no counterparty, it is not debt securities denominated in other fiat currencies, but gold that represents the only real alternative. That should become particularly obvious if or when the currently still preferred foreign exchange reserves are devalued as the associated securities held in central bank portfolios suffer price declines, and central banks come under political pressure.

4. Occurrence of a “black or gray swan” event. Numerous potential financial shocks can be envisaged in the current environment. Regardless of whether such a shock is triggered by geopolitical tensions boiling over, or by negative economic developments – an appropriate allocation to gold will mitigate the negative performance of assets that typically generate large losses in the wake of such events.

5. Based on our analysis of market structure, sentiment and price patterns, our assessment is that the medium to long term technical picture looks promising. Speculative positions in futures markets have corrected sufficiently to create a healthy basis for the advance to resume. The Coppock curve gave a long term buy signal in late 2015, while sentiment data indicate that skepticism in the market remains quite pronounced. We expect only little upside momentum in the short term though, primarily based on seasonality,

"There are three key biases in financial forecasting. Economists never forecast recessions, equity strategists are always bullish, and bond strategists are always bearish."

Albert Edwards

but also due to a number of signals from technical indicators that remain in bearish territory.

Of course, the future is always uncertain, hence we want to present several scenarios outlining potential future gold price developments. The US dollar's status as the senior global reserve currency remains (for now) a constant that is underlying all of them. That is also why we believe that economic developments in the US remain crucial for the price trend of gold. Since financial markets have fundamentally reassessed what the coming years are likely to bring in the wake of the US presidential election, we align the time-line of our scenarios with the Trump administration's term of office, which should last until early 2021. **From our perspective, the decisive factors for the gold price will be the momentum of GDP growth, as well as the further progress made in terms of the Fed's monetary policy normalization effort.**

Scenario A: "Relatively strong real economic growth"

The proposed economic policy initiatives are implemented and take hold, the US economy begins to grow strongly (>3% p.a.) and price inflation remains in an acceptable range (<3%). Monetary policy normalization succeeds. The central bank's "experiment" pays off.

The gold price should trade in a range from USD 700 to USD 1,000

Scenario B: "Muddling through continues"

Real US GDP growth and consumer price inflation remain in a range of 1-3% p.a. In this case we would not expect the gold price to enter into the second phase of the secular bull market we currently anticipate.

The gold price should remain in a range from USD 1,000 to USD 1,400 in this scenario.

Scenario C: "High inflationary growth"

Trump's economic policy initiatives are put into place, a large infrastructure spending program is launched, US economic growth accelerates significantly (>3% p.a.), but so does the consumer price inflation rate (>3%). Monetary policy normalization succeeds only partially, as real interest rates remain very low or even negative, due to the elevated consumer price inflation rate.

In this scenario, the gold price should trade in a range from around USD 1,400 to USD 2,300.

Scenario D: One of the four events listed in the table below occurs. Recession, stagflation and/or significant weakness in the US dollar push the gold price up noticeably. In the wake of another US recession and the cessation of the monetary policy normalization effort, significant changes to the global monetary order cannot be ruled out. A very large gold price rally has to be expected in such an environment.

Gold prices between USD 1,800 up to USD 5,000 appear possible in this scenario.

Term is characterized by	Growth	Monetary Normalisation	Gold price in USD
Scenario A: Genuine Boom	Real growth > 3% p.a.	Successful; Real Interest Rates >1.5%	700-1,000
Scenario B: Muddling Through	Growth & Inflation 1.5-3% p.a.	not completed	1,000-1,400
Scenario C: Inflationary Boom	Growth & Inflation > 3% p.a.	not completed	1,400-2,300
Scenario D: Adverse Scenario	Growth / Contraction <1.5%	Normalization paused or renewed easing	1,800-5,000

Source: Incrementum AG

"Gold is a currency. It always has been. It always will be."

Brent Johnson

"Let us not look back in anger, nor forward in fear, but around in awareness."

James Thurber

"Security... it's simply the recognition that changes will take place and the knowledge that you're willing to deal with whatever happens."

Harry Browne

"Whether it's the best of times or the worst of times, it's the only time we've got."

Art Buchwald

Given the analyses presented in this year's *In Gold We Trust* report, it shouldn't be too big a surprise that we assign the highest probability to the latter two scenarios. Similar to the 1930s and the 1970s, these scenarios would be difficult to navigate, but at the same time provide quite interesting investment opportunities. **The product range of Incrementum includes strategies that are specifically tailored to these scenarios.**

If the bull market in precious metals continues, the performance of mining stocks will be decidedly positive. Investors should continue to place their bets with conservatively managed companies in the sector, which rather than pursuing a "growth at any price" agenda are focused on delivering strong returns to shareholders. From a valuation perspective, growth in free cash flows, gold reserves/resources per share, and earnings growth per share strike us as the most important metrics.

This is a sector in which one must be particularly careful to avoid getting diluted by a flood of share issuance. **The sector's small size in terms of total market capitalization is both a blessing and a curse.** A blessing because outsized price gains can be achieved in boom times, and a curse because the flood of money flowing into the sector during bull markets invariably tempts managers of gold and silver mining companies to misallocate capital as they are constantly under pressure to "do something". This danger is usually particularly pronounced in the late stages of bull markets, once everyone's memories of the hardships of the bust period of the cycle have faded. **In our investment process, we are currently focused on developers and emerging producers.** Based on the premise that the bull market in gold has resumed, we expect the gold-silver ratio to decline over the medium term. **In this scenario, pure play silver mining stocks should offer particularly interesting investment opportunities.**

In summary, we expect to see significant upheaval in coming years, with noticeable effects on the gold price. We will monitor events very carefully and provide commentary on a regular basis.

www.ingoldwetrust.report

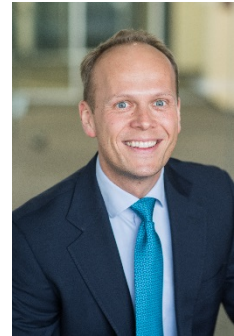
About Us

Ronald-Peter Stöferle, CMT

Ronni is partner of Incrementum AG and responsible for Research and Portfolio Management.

He studied Business Administration and Finance in the USA and at the Vienna University of Economics and Business Administration, and also gained work experience at the trading desk of a bank during his studies. Upon graduation he joined the Research department of Erste Group, where he published his first “In Gold We Trust” report in 2007. Over the years, the Gold Report has proceeded to become one of the benchmark publications on gold, money, and inflation.

Since 2013 he has held the position as reader at scholarium in Vienna, and he also speaks at Wiener Börse Akademie (i.e. the Vienna Stock Exchange Academy). In 2014, he co-authored the book “Austrian School for Investors” and in 2017 “Die Nullzinsfalle” (The Zero Interest Rate Trap). Moreover, he is an advisor for Tudor Gold Corp. (TUD), a significant explorer in British Columbia’s Golden Triangle.



Mark J. Valek, CAIA

Mark is partner of Incrementum AG and responsible for Portfolio Management and Research.

While working full time, Mark studied Business Administration at the Vienna University of Business Administration and has continuously worked in financial markets and asset management since 1999. Prior to the establishment of Incrementum AG, he was with Raiffeisen Capital Management for ten years, most recently as fund manager in the area of inflation protection and alternative investments. He gained entrepreneurial experience as co-founder of Philoro Edelmetalle GmbH.

Since 2013 he has held the position as reader at scholarium in Vienna, and he also speaks at Wiener Börse Akademie (i.e. the Vienna Stock Exchange Academy). In 2014, he co-authored the book “Austrian School for Investors” and in 2017 “Die Nullzinsfalle” (The Zero Interest Rate Trap).



Incrementum AG

Incrementum AG is an independent investment and asset management company based in Liechtenstein.

Independence and self-reliance are the cornerstones of our philosophy, which is why the four managing partners own 100% of the company. Prior to setting up Incrementum, we all worked in the investment and finance industry for years in places like Frankfurt, Madrid, Toronto, Geneva, Zurich, and Vienna. We are very concerned about the economic developments in recent years especially with respect to the global rise in debt and extreme monetary measures taken by central banks. We are reluctant to believe that the basis of today’s economy, i.e. the uncovered credit money system, is sustainable. This means that particularly when it comes to investments, acting parties should look beyond the horizon of the current monetary system. We want to re-think investment strategies and implement them in a way that is in line with today’s requirements.



We sincerely want to thank the following friends for their outstanding support:

Marc Waldhausen, Tobias Müller, Sebastian Müller, Nikolaus Jilch, Demelza Hays, Yannick Möhring, Lars Haugen, Bawerk.net, Philip Barton, Brent Johnson, Florian Grummes, Katja Stöferle, Markus Blaschok, Thomas Vesely, Carsten Ringler, Georg Bühler, Gregor Hochreiter, Nikolaus Jilch, Atle Willems, Hans Fredrik Hansen, Pascal Hügli, Luis Enrique, David Holzinger, Markus Rossmiller, Pater Tenebrarum, Veronika Svihalkova and Florian Hulan.

Contact:

Incrementum AG
Im Alten Riet 102
9494 – Schaan/Liechtenstein
www.incrementum.li
www.ingoldwetrust.li
Email: ingoldwetrust@incrementum.li

Disclaimer:

This publication is for information purposes only, and represents neither investment advice, nor an investment analysis or an invitation to buy or sell financial instruments. Specifically, the document does not serve as a substitute for individual investment or other advice. The statements contained in this publication are based on the knowledge as of the time of preparation and are subject to change at any time without further notice.

The authors have exercised the greatest possible care in the selection of the information sources employed, however, they do not accept any responsibility (and neither does Incrementum AG) for the correctness, completeness or timeliness of the information, respectively the information sources, made available, as well as any liabilities or damages, irrespective of their nature, that may result there from (including consequential or indirect damages, loss of prospective profits or the accuracy of prepared forecasts).

Copyright: 2017 Incrementum AG. All rights reserved.