GOLD'S OUTLOOK AND TRUMPONOMICS

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During 2016, gold markets shook off three consecutive years of price weakness. However, the gold complex suffered meaningful correction during the fourth quarter.

As is frequently the case in the gold sector, short-term sentiment is generally more reflective of recent price action than underlying fundamentals. Despite the recent pullback, we believe the investment opportunities for gold remain compelling.

Our investment thesis for gold does not involve financial Armageddon, Weimar Republic inflation or a collapse of the U.S. dollar. Rather, inevitable resolution of epic monetary and financial imbalances is likely to accelerate the rate of capital migration from global financial assets towards gold and other precious assets in the relatively near future. Given the comparatively tiny stock of investable gold, we expect gold's price to stabilize at significantly higher prices.

The motivating fundamental which powers our gold investment thesis has been the progressive decoupling in recent years of financial assets (claims on future output) from underlying output itself Gross Domestic Product (GDP). In essence, the United States economy suffers from a debilitating structural debt problem.

Gold's Prospects in 2017 and Beyond

Over the short run, trading in gold markets can be affected by consensus views for key market variables such as Federal Reserve (Fed) Policy policy, the level of 10-year Treasury yields and expectations for U.S. dollar strength.

Trumponomics

Over the long run, we believe the gold investment thesis rests squarely on monetary, economic and financial imbalances which continue to be resolved to the measurable benefit of those choosing to denominate a portion of their wealth in assets which can neither default nor be debased. Over the short run (one-to-two years), gold's performance can be impacted by consensus views on a wide array of market variables. We would highlight five such variables as motivating the lion's share of trading patterns in gold markets:

- Fed policy
- The U.S. dollar
- 10-year Treasury yields
- U.S. economic performance
- U.S. equity risk premiums

It is unusual for any single event to impart significant impact on all five of these variables simultaneously. The Trump election has certainly proven to be such an event! Trump's victory has unleashed one of the strongest expressions of business and financial optimism in history, starkly affecting variables central to gold's short-term trading patterns.

Populism

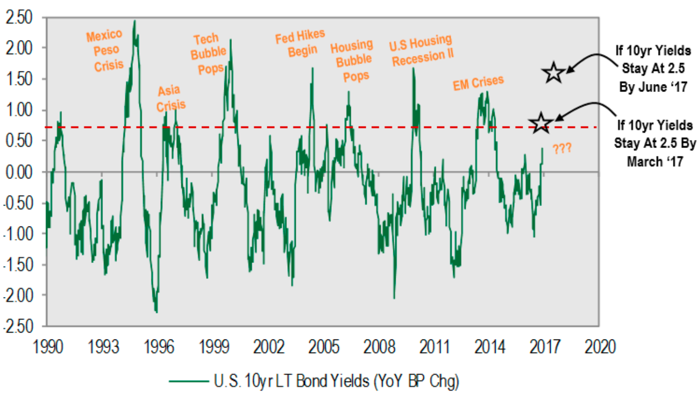
No discussion of the Trump phenomenon would be complete without addressing the ascension of populist political movements. While populist leaders such as Greece's Alexis Tsipras (Syriza) and France's Marine Le Pen (National Front) have garnered attention in recent years, the subtle implication in western media has been that European populists are like spoiled teenagers who don't really understand how the world works – they are to be tolerated but not taken seriously. Then, in the space of five months, the United Kingdom and the United States were rattled to their respective cores by completely unforeseen national populist victories.

Can Long-Rates Rise?

We believe the greatest miscalculation in contemporary financial markets is the consensus view that interest rates can rise and the U.S. dollar can strengthen without causing serious damage to the global financial system. We would argue that reigning global debt levels now preclude even moderate rate-increases without catalyzing immediate upticks in relevant measures of financial stress. With total U.S. non-financial credit now standing at $47 trillion, every 1% increase in market rates causes total interest charges in the U.S. to soar $470 billion, or over 2.5% of GDP. Further, eight years of Zero Interest Rate Policy (ZIRP) have fostered duration dynamics in institutional bond portfolios which leave them especially vulnerable to even modest upticks in rate structures.

Ten-year Treasury yields have marked ever-lower cyclical highs for the past 35 years. There is certainly more than one way to assert cause and correlation between the declining rate peaks in this graph and the ten highlighted crises coincident with these peaks. Our synopsis would be that aggregate debt levels have become so burdensome that even modest upticks in rates catalyze default episodes, in one economic sector or another, which in turn require even lower rates to ameliorate. Importantly, each outbreak of credit stress exposes prior malinvestment. In our view, the financial system has hit the point at which interest rates simply cannot rise until nonproductive debt is cleansed from the financial system.

Figure 1: How Close Are Rates To "Problem Territory"?



Source: Cornerstone Macro, January 2017.

Can the U.S. dollar strengthen?

In our experience, no opinion clears out a room quicker than questioning the pedigree of the U.S. dollar. We find Western investors remarkably closed-minded about the dollar's reserve currency status. The dollar bug doctrine cites that no country can rival the depth and liquidity of U.S. capital markets; that the dollar is the world's least dirty shirt, and that no arrangement could possibly replicate the dollar's dominance of global affairs. While we are not suggesting the dollar's role in global monetary affairs is about to disappear anytime soon, we are quite certain that many of the world's worst economic ills emanate directly from the dollar-standard system. We are sympathetic to the view that the U.S. dollar is facing late-stage, destabilizing, Triffin-dilemma quandaries.

The Triffin dilemma was first enunciated by Belgian-American economist Robert Triffin in the early 1960's. In impassioned testimony to Congress, Mr. Triffin warned against the failure of Bretton Woods by arguing no single country can perpetually issue the reserve currency for the world. Mr. Triffin's elegantly simple logic was that fiat control of a global reserve currency by any one nation will always lead to the currency's over-issuance, overvaluation and eventual demise. In essence, external demand for the currency necessitates that the host country run an ever expanding current account deficit to satisfy external commerce demands for the reserve currency. An inevitable consequence of chronic capital-account deficits will be overvaluation of the currency, leading in turn to eroding competitiveness of the issuer's domestic economy.

While Mr. Triffin's analysis correctly foreshadowed the demise of Bretton Woods in 1971, his work is even more relevant to the fate of the contemporary (floating exchange rate) dollar-standard system. While our views are decidedly non-consensus, our confidence increases with each passing day that the Fed's eight years of Quantitative Easing (QE) and ZIRP have only hastened the dollar's demise as hegemonic reserve currency. Global pressures linked to the issuance of $10 trillion in offshore dollar-denominated debt are now so acute, the Fed will remain trapped in a near-zero rate environment until such time as this uneconomic obelisk of debt is allowed to rationalize (default).

To those who might suggest that the U.S. economy is sufficiently strong, and the Fed's mandate sufficiently narrow, for the Fed to ignore overseas implications of Federal Open Market Committee (FOMC) rate hikes, we would cite in counterpoint the percolating monetary pressures now roiling the Chinese economy. So much is written about China, we hesitate to labor a long narrative in this context. However, we wish to highlight a critical change in focus by Chinese apparatchiks in recent months: it has become all about capital flows!

Recognizing that no country can simultaneously control domestic monetary policy, currency exchange rates and capital flows, Chinese stewards are notably shifting their focus to the capital-controls side of the equation. It is just our speculation, but this clear shift suggests to us that a change in policy may be on the horizon for one of the other two points on the monetary triangle. Assuming the People's Bank of China (PBOC) will always view control of domestic monetary policy as sacrosanct, it is logical to assume probabilities for an exchange-rate recalibration are rising.

2017 Outlook

Given the unprecedented scale of global monetary stimulus during the past decade, now clashing with the unpredictable nature of populist sentiment, it is fair to say that the range of potential investment outcomes has never been wider. Because so many market variables are registering such elevated readings, and because market plumbing is now measured in milliseconds, it seems inevitable that volatility will be a prominent market feature during the coming year.

During the past three months, market sentiment has shifted on fundamentals motivating short-term trading in gold markets. While consensus views have gravitated towards further Fed tightening, rising Treasury yields and a strengthening U.S. dollar, we believe each of these assumptions are likely to prove short-sighted. In our view, cumulative and immutable imbalances (debt levels, valuations, dollar liquidity) will soon test recent sentiment shifts, we expect decidedly in gold's favor. To benefit from this potential upside and gain access to an an asset class that has helped diversity traditional 60/40 stock and bond portfolios, a modest portfolio allocation to gold has never been more prudent.

During the past hundred years, even a modest portfolio commitment to gold has been proven to push total portfolio returns further to the right along return frontiers for any reasonable asset mix, generating equal returns with less risk and standard deviation, or superior returns with equivalent risk and standard deviation, versus identical portfolios without a gold investment component. During the past 16 years, gold's non-correlated and market-leading returns have provided invaluable portfolio alpha in an increasingly challenging investment environment. During the next several years, mounting monetary, economic and financial imbalances, which appear to be approaching important tipping points, suggest gold is a portfolio-diversifying asset worthy of serious consideration.

We view corrections in gold markets during the fourth quarter of 2016 as fairly standard retests of early 2016 breakouts from established downtrends. To us, underlying fundamentals suggest significantly higher gold prices during the next several years.

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