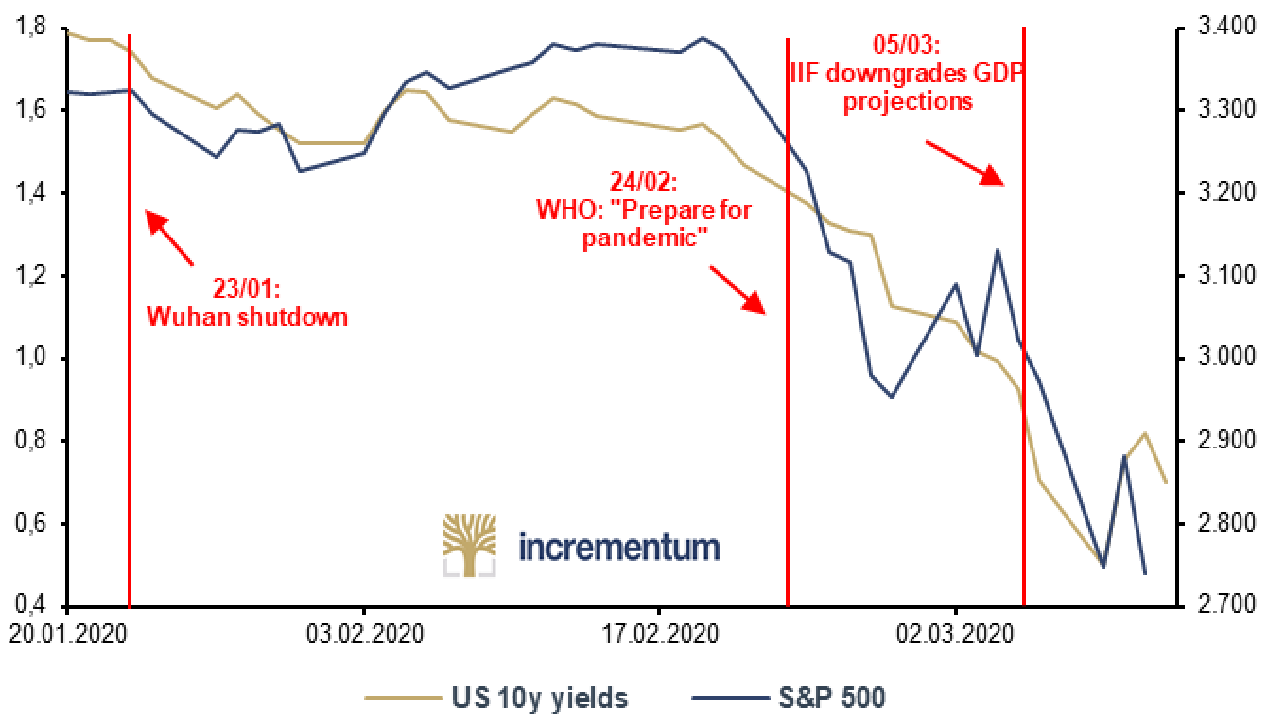
Incrementum Inflation Signal Turns to Falling Inflation Momentum – All Eyes on the "Mother Of All Stimulus Programs"

Dear investors, advisory board members, and friends,

We hereby want to inform you that as of last week **our proprietary inflation indicator has switched to a "FALLING INFLATION" signal from a "50% RISING INFLATION" signal.**

During the past weeks markets have been – and still are – hugely affected by the coronavirus and Covid-19 disease it causes. As governments around the world stepped up measures to prevent an even more rapid spread of the virus, **stock exchanges started to crash, as they significantly discounted lower growth and started to price in all kind of uncertainties**. The kneejerk reaction was a **highly deflationary move**, which has prompted market participants to flee into safe haven assets like US bonds. Once more, yields have fallen to record lows, and the four-decade-old bond bull market is celebrating its final blowoff.

US 10Y bond yields (lhs), and S&P 500 (rhs), 20.01.2020-12.03.2020



Source: Reuters Eikon, Incrementum AG

To put the recent move in equity markets into a historical perspective: **This is the fastest switch from bull to bear market on record.** It took only 19 sessions for this switch to happen, whereas the previous record, following the September 1929 peak, stood at 42 days. On average, it takes 136 days to go from a bull market peak to the onset of a bear market.[1]

Historically, market crashes have occurred in three stages:

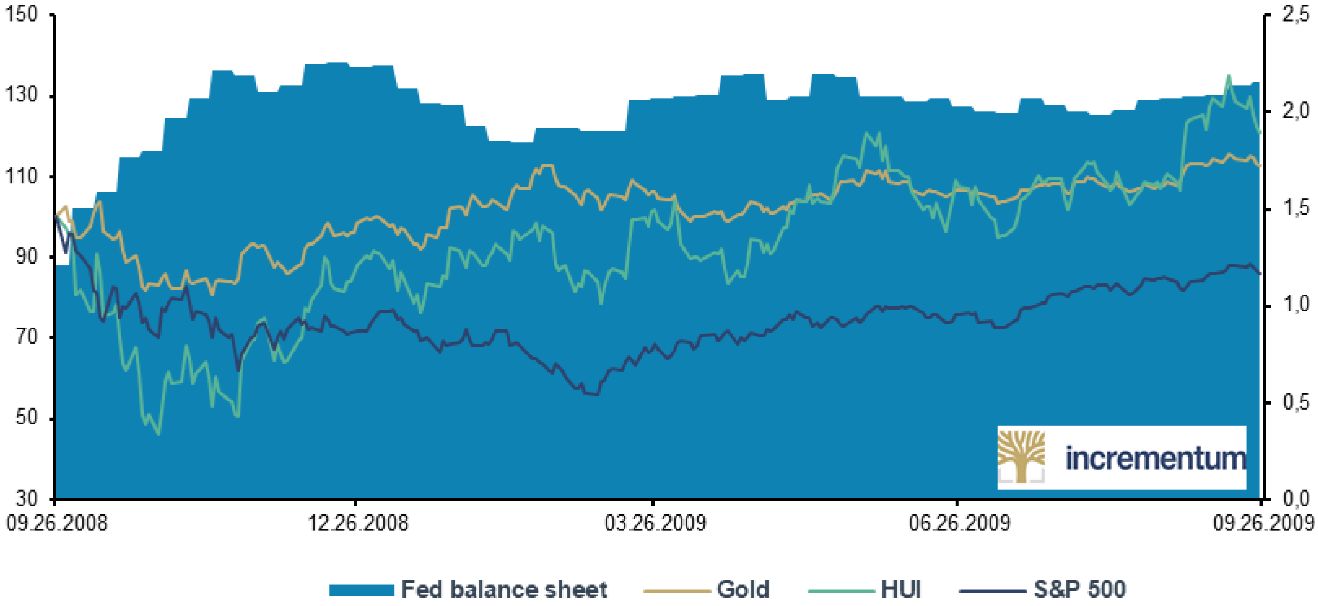
1. **Panic selling** (what we experience right now)
2. **Relief rally** off the lows ("dead cat bounce")
3. **Demoralizing re-test of the panic low** on supporting evidence such as terrible earnings or defaults. Please bear in mind that the bottom will occur *prior* to any good news!

Highly deflationary reaction

The highly deflationary move is a rational reaction of the markets to the coronavirus outbreak. Governments have now clearly moved into "panic mode". As they aggressively increase their measures and the media constantly reports on the fallout from the virus, consumers will be reluctant to keep spending at the same pace, except for everyday products. This will **reduce monetary velocity** (i.e., it will increase the demand to hold currency), which is highly deflationary.

On top of the virus scare, a huge price war among the "OPEC+" states, especially between Saudi Arabia and Russia, broke out last week, causing oil prices to plummet even further. While oil and most commodities plunged, gold was able to rally initially, but sold off later this week.

Gold, HUI & S&P 500 Performance, indexed 09.26.2008 = 100 (lhs), and Fed balance sheet, in USD tn, 09/2008-09/2009



Source: Reuters Eikon, Incrementum AG

[1] Source: Breakfast with Dave, Rosenberg Research, March 12th, 2020

The risk exists that the oil crisis turns into a credit crisis, and the sharp widening in high-yield spreads is highlighting these rising concerns. CDS spreads have already jumped at a pace last seen nine years ago. Therefore a credit crunch remains one of the most obvious risks, especially as European companies in the high-yield market face a debt refinancing calendar that tops USD 100 billion in the next few months.[2] In the US, the high yield market is now a massive USD 1.5 trillion space and 40% of this market rolls over in the next 5 years. We have warned about the inherent risks in US corporate credit already in our ***2019 In Gold We Trust report*** *"The downgrading of BBB debt by one notch to "junk" level would trigger a domino effect, as refinancing costs would rise significantly. More importantly, it would lead to automatic panic sales by institutional investors, especially ETFs and other passive investment vehicles that are allowed to invest only in investment-grade bonds. In this environment, ETFs and fund managers would become forced sellers at a time when there would probably be few buyers of junk."*

What is happenening to the gold price?

The current crisis is displaying some characteristics similarly to 2008. Back then, we also experienced a run on liquid assets and gold was sold off during the heights of the banking crisis.

Today once more, the huge demand for liquidity seems to be keeping a lid on the price of gold, at least for now. Similarly to 2008, central banks of the world have started to react with emergency measures, most prominently the Federal Reserve with a 50bp rate cut during an emergency meeting on March 2. Further rate cuts are already baked into the cake. The USD 1.5trn injection on March 12 did not calm markets at all. The market perked up for 20 minutes and then dove to new morning lows.

MOAS, the "Mother of All Stimulus" ahead!

These first measures will be only the beginning of a globally coordinated flooding of markets. Our highly leveraged credit system is not able to withstand severe deflation, and therefore central bankers will step in once more and do "whatever it takes" to reverse the deflationary momentum. It is often argued that **central banks do not have a lot of ammunition left to counter this move**, as they never were able to normalize monetary policy in the aftermath of the GFC. In our view there is no limit to the ammunition, since there is no limit to the currency they can create. Most probably a new round of QE will involve a massive corporate bond purchasing program, as spreads have increased rapidly and a series of bancruptcies could lead to a widespread debt deflation hitting banking systems around the world. We also expect that sooner or later equities, REITS, and all sorts of other assets might be considered to be on the menu of the central bank printathon.

But monetary policy will not be sufficient to calm financial markets. **More importantly, the fiscal side of the stimulus will be colossal and at the end of the day will be responsible for disseminating the newly created money via Keynesian infrastructure programs. Please also consider that 2020 is an election year, so we should expect very aggressive measures such as payroll tax cuts, mortgage leniency, and business credits to come!**

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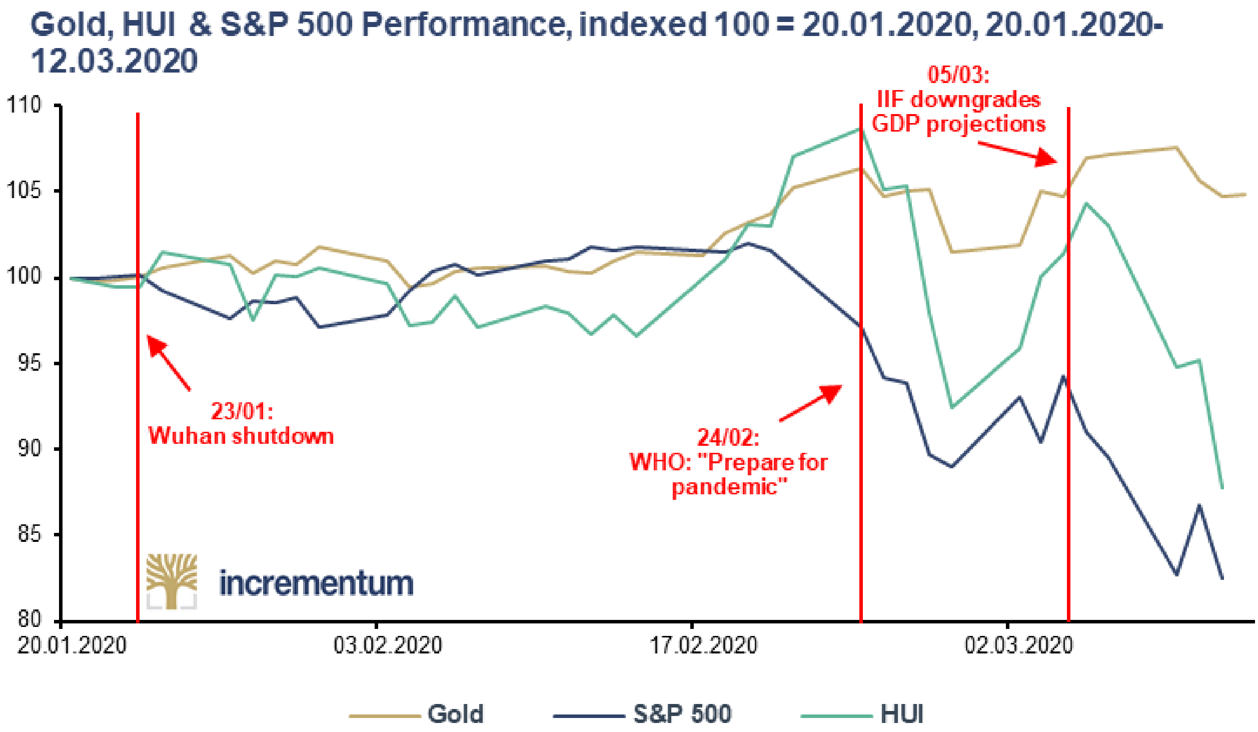
[2] Source: Breakfast with Dave, Rosenberg Research, March 1th, 2020

Will MOAS lead to price inflation?

We have been arguing for the past several years that monetary inflation has fuelled asset price inflation and will turn into consumer price inflation at some point. We have developed our proprietory inflation indicator to gauge this interplay between inflation and deflation and to take advantage of what we believe will be a huge asset rotation that will come as a byproduct of a change in the inflation dynamic. **For now, the deflationary shock is evident, but due to the gigantic scare and the systemic imperative for massive stimuli, we expect governments to panic and at some point go overboard. This could be the straw that breaks the deflationary camel's back.**

Big opportunities in gold mining shares?



Source: Reuters Eikon, Incrementum AG

We have pointed out some simliarities to the year 2008. Back then, during the liquidity shock, mining equities sold off harshly, even though they were one of the very few sectors whose fundamentals actually improved dramatically, due to a significant fall of their cost basis and a still relatively high sales price. The same thing is happening today. Mining equities have been dropping sharply during a time where the gold price has been relativly stable, but energy prices – gold mining companies' biggest single cost factor – were basically cut in half. This is a enormous boost for the margins of gold producers and makes them extremly attractive. The trigger for a price rise could be the stimulus packages that seem to be around the corner. Moreover, contrary to 2008, gold stocks are now coming out of a bear market, while in 2008 valuation levels and sentiment were already sky-high.

But there are also other contrasts. As our friend Dan Oliver just wrote:

"In 2008, the Federal Reserve learned of teetering financing institutions from the Wall Street Journal, at the same time as investors, and was completely reactive. Now, the Fed keeps moles inside the big banks to stay ahead of the information curve, making a deflationary debt collapse less likely. After all, the Fed's core mandate since the 1930s has been to avoid falling prices that would lead to a depression, and the Fed no longer has gold standard shackles to constrain its ability to print money."[3]

Ladies and gentlemen, Covid-19 is a temporary and not a structural problem. Covid-19 reveals many weaknesses in the global system, and we are convinced that governments and government-related organizations, local authorities, companies, and market participants will learn from this pandemic and that we will emerge from the crisis stronger. In some regions of China everyday life is already returning back to normal.

However, Covid-19 and its recessionary consequences should not be underestimated and should be treated with respect. We believe that the measures central banks and governments will be forced to undertake, will lay the perfect foundation for a switch from a deflationary to an inflationary dynamic. An indication that this may already be starting to happen is that during **the past two trading days treasury yields did not fall any more,** even though major equity indices collapsed nearly 10% on an intraday basis.

We believe that the current volatility in inflation-sensitive assets and especially in gold mining companies may prove to be a tremendous buying opportunity, which we want to utilize at some point. Looking at the commodity sector in general, we remain cautious for the time being, as long as we have no buy signal from our inflation indicator.

We are here for you and will be happy to take the time to talk to you about your investments. Do not hesitate to call or write us if you have any questions or suggestions.

Best regards, and above all, good health to you and your loved ones!

Sincerely yours,

Ronald-Peter Stoeferle and Mark J. Valek

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3 Myrmikan Research, „Pop goes the Bubble", Dan Oliver, March 12, 2020

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