Minutes of the Advisory Board Meeting
Incrementum Inflation Diversifier Fund
January 10, 2017

A Volatile Year Ahead, Potential Chinese Currency Crisis & Further Dollar Strengthening

Highlights of the conversation:

Special Guest: Paul Mylchreest:

- **Major risk for 2017: a shortage of dollar liquidity outside the US**
- There is a structural shortage of Eurodollar liquidity
- On the US economy: positive soft indicators, but less positive in terms of hard numbers
- Impact of fiscal spending likely to happen in 2018 and beyond
- Confidence in markets will likely progressively fade in 2017
- PBOC is worried about a currency crisis, which could happen in 2017
- I expect further substantial strength in the Dollar
- China has burned through $1 trillion of FX reserves already and are struggling to contain the capital outflows
- We might see gold decouple and see it, and the Dollar, both strengthening

Heinz Blasnik:

- Despite popular opinion, the Fed has not started tightening
- Benefits of Trump policy: lower taxes and less regulation, which is always preferable
- But his ideas on trade are really wrongheaded. Raising tariffs will be bad for the economy
- Market participants concluded that the Republican clean sweep will be good for markets
- In post election years the market tends to be volatile, especially if the new president is from the opposing party
- Very much possible to see strong dollar and strong gold concurrently

Frank Shostak:

- Trump wants to decrease taxes, but you can't reduce effective taxes if you don't reduce government
- Trump basically wants to eliminate anything that undermines production in the United States, which in effect promotes inefficiency
- Money supply could get out of control sooner or later, but not immediately
- Don't expect a lot from the economy in 2017, and 2018 could be much weaker than 2017
- The effects of the past monetary policies are yet to come
- S&P could climb 14% this year, barring a collapse in money supply
- We expect 10-year yields to rise in H1 2017, then decline in H2
- The gold price could exceed $1,400 by July, but could drop again in H2
- Expect further strengthening in the US Dollar
- Unlike Paul, I do not see a liquidity crisis in China

Ronald Stöferle:

- Looking at the Renminbi versus the Dollar there is quite a lot of pressure and a lot going on when it comes to Bitcoin
- According to Zerohedge 98% of trading in Bitcoin at the moment is taking place in China
- Inflation surprise in Germany will lead to pressure on the ECB to become more hawkish
- Our inflation signal recently switched to disinflation. We reduced our mining stocks position and bought treasuries
- It seems like gold has made its lows

Biography of our special guest: Paul Mylchreest

Paul Mylchreest covers Equity & Cross Asset Strategy at ADM ISI in London. He began his career as a UK equity analyst a month before the crash in 1987. Since then he has covered a wide range of industry sectors, including Pan-European Chemicals, Oil & Gas and Metals and Mining at several well-known investment banks such as UBS (then SG Warburg), Citibank, JPMorgan Chase and the high quality boutique Redburn Partners. While covering the Metals & Mining sector, he developed a fascination with global macro issues and the interaction of equity markets with bond, commodity, precious metal and money markets.

Transcript of the conversation:

Ronald Stöferle:

Gentlemen, thanks for joining us! Happy New Year! We have plenty of topics to discuss. And we have a star guest – Paul Mylchreest.

For those of you who haven't heard of Paul; he is one of the writers that have had the most influence on me. Every time he publishes something it's a must read. And in fact Paul wrote a piece that basically was decisive for my career and the reason why I started caring and writing about gold. He wrote a brilliant piece in 2006, a report on gold, when he was working for Chevreux (click here for report). I recently flipped through the pages and it's still an excellent read. Paul, thank you very much for joining us today, it's a pleasure.

Paul Mylchreest:

It's my pleasure Ronni, and it's a privilege to have inspired you.

Ronald Stöferle:

Unfortunately, Jim, Rahim and Zac cannot join us today; they are very busy with travelling!

However, we've got some topics to discuss today. Of course we will talk about Paul's topic that he's written about quite often in the last few months, which he calls "the plumbing". It is crucial for financial markets and the outlook for inflation/deflation going forward. And besides that we will talk about a couple of other topics.

The first thing we'll talk about is what to expect from Donald Trump. Fiscal deficits and monetary tightening – is this combination really coherent? I think there are a lot of interesting things going on at the moment. Many deflationary and many inflationary forces are acting at the same time. So I'm really looking forward to this discussion. Mark should we get going?

Mark Valek:

Please, let's get started. We can start with the first topic Ronni mentioned, if the combination of fiscal deficits and monetary spending is coherent. Heinz, would you like to start?

Heinz Blasnik:

Thank you, first of all I just wanted to say something very general. There is the widely accepted opinion that government should interfere in the economy all the time. If the economy is overheating then government is supposed to tighten fiscal policy. On the other hand, if the economy is weak it should start deficit spending. I would say that none of these policies make sense. They can only make things worse. I quickly want to quote Ludwig von Mises on the matter and this quote should tell you everything you need to know.

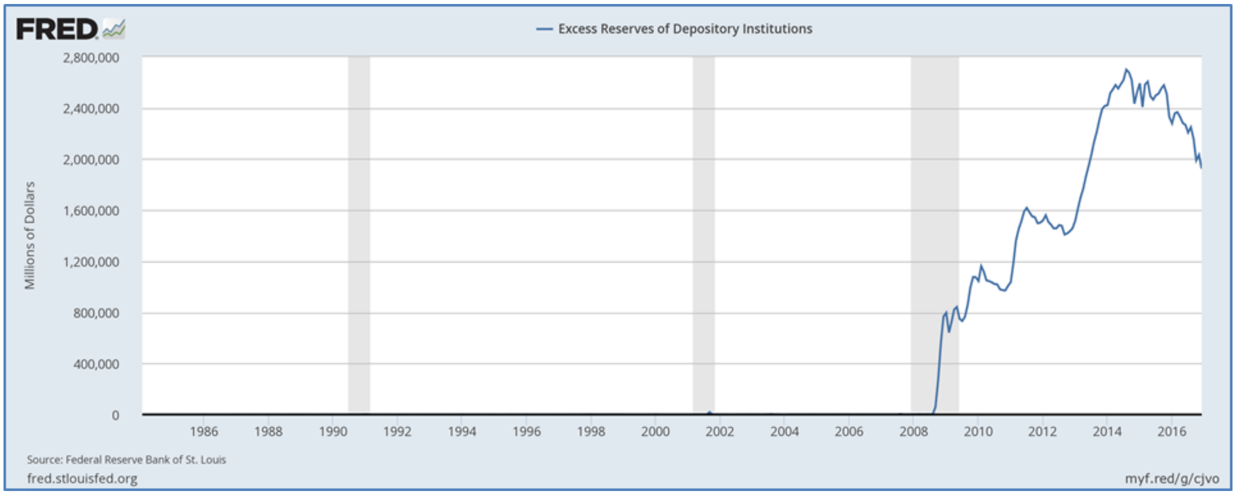
The quote is from Human Action, Chapter 6, "The Hampered Market Economy":

> *“At the bottom of the interventionist argument there is always the idea that the government or the state is an entity outside and above the social process of production, that it owns something which is not derived from taxing its subjects, and that it can spend this mythical something for definite purposes. This is the Santa Claus fable raised by Lord Keynes to the dignity of an economic doctrine and enthusiastically endorsed by all those who expect personal advantage from government spending. As against these popular fallacies there is need to emphasize the truism that a government can spend or invest only what it takes away from its citizens and that its additional spending and investment curtails the citizens' spending and investment to the full extent of its quantity.”*

That being said, what the Trump administration proposes, I think they want to spend a lot on infrastructure, which means that finite resources will be allocated based on the whims of government bureaucrats. These resources will no longer be available to the private sector. It’s either or. It’s now a question of who will allocate these resources. **You have to believe that government bureaucrats are better at allocating scarce resources than the private sector to make the case that this makes any sense whatsoever**.

Moreover, the Federal Reserve is said to have started tightening. However, I would argue they actually haven’t started to tighten. The Fed has started to hike the federal funds rate, but we have to keep in mind that the federal funds market is basically dead anyway. In it’s original form, as an interbank lending market, the Fed would influence the pace at which credit expansion occurs by setting a target rate and then adding or withdrawing reserves from that market. It’s not working in that sense anymore because banks are drowning in excess reserves. So there is not really a possibility to influence their lending decisions through this market.

Excess Reserves of Depository Institutions



Source: St. Louis Fed

So basically what is happening now is that interest paid on excess reserves is what sets the floor on the federal funds rate. But if we look at actual money supply growth we see that it was actually very high in the fourth quarter of last year. At one point, the year on year rate of money supply expansion (the narrow true money supply) expanded at a record rate since 2008. So we cannot say that the Fed is tightening yet, or that its actions have slowed credit and money supply expansion. It might genuinely tighten at some point, but it's not doing it as of today.

So if the Trump administration does loosen fiscal policy by increasing deficit spending then the economy is actually going to be subject to sort of a double whammy – loose monetary policy and loose fiscal policy. That combination does not yet exist, but it may at some point. If you ask if this is in any way coherent I would say for starters it cannot be. Basically when a government, through the central bank, manipulates interest rates we get *inter*-temporal distortions in the economy's production structure and if it influences the economy through deficit spending then we get *intra*-temporal distortions. Ultimately it always means that the production structure will be altered in such a way that it is no longer in line with the wishes of the consumers.

So what does the Trump administration favor? That is a very important question because we don't know yet. Trump has said many things and we don't know what's going to be his focus, what's going to be most important to him, and we don't know which of these measures he will be able to push through because he needs the co-operation of Congress, which he might not get on all these issues.

Now let me tell you what I think is good about Trump's policies. Contrary to Hillary Clinton who had a thoroughly socialist economic program that was really horrible from beginning to end, Trump does have a few points that we can probably agree with. One of them is **lowering taxes** and he wants to simplify the tax laws. That's a very good idea. It's always good when government lowers taxes. The other thing is that he **wants to reduce regulation**. To me that's the most important thing. He said something along the lines of: for every new regulation that is being put in place, two other regulations have to be struck off. That is a very good idea. His term would be the first since president Ronald Reagan's during which regulations actually decline.

Throughout the post WWII period, regulations have grown and grown and grown. But on the other hand his ideas on trade are really wrongheaded in my opinion. And I think if he were to focus on raising tariffs that would actually be quite bad for the economy. And it would probably give impetus to price inflation. Because if you for example raise tariffs on Chinese goods then prices of imports from there will rise. Importers are going to pass these price increases on to the consumer, or at least try to. So we have to see what Trump will actually focus on. It's difficult to say. The advisory board was good at predicting that Trump would win. However, we were wrong in how the market would react. But that's markets for you.

Ronald Stöferle:

Frank, what is your view on this topic?

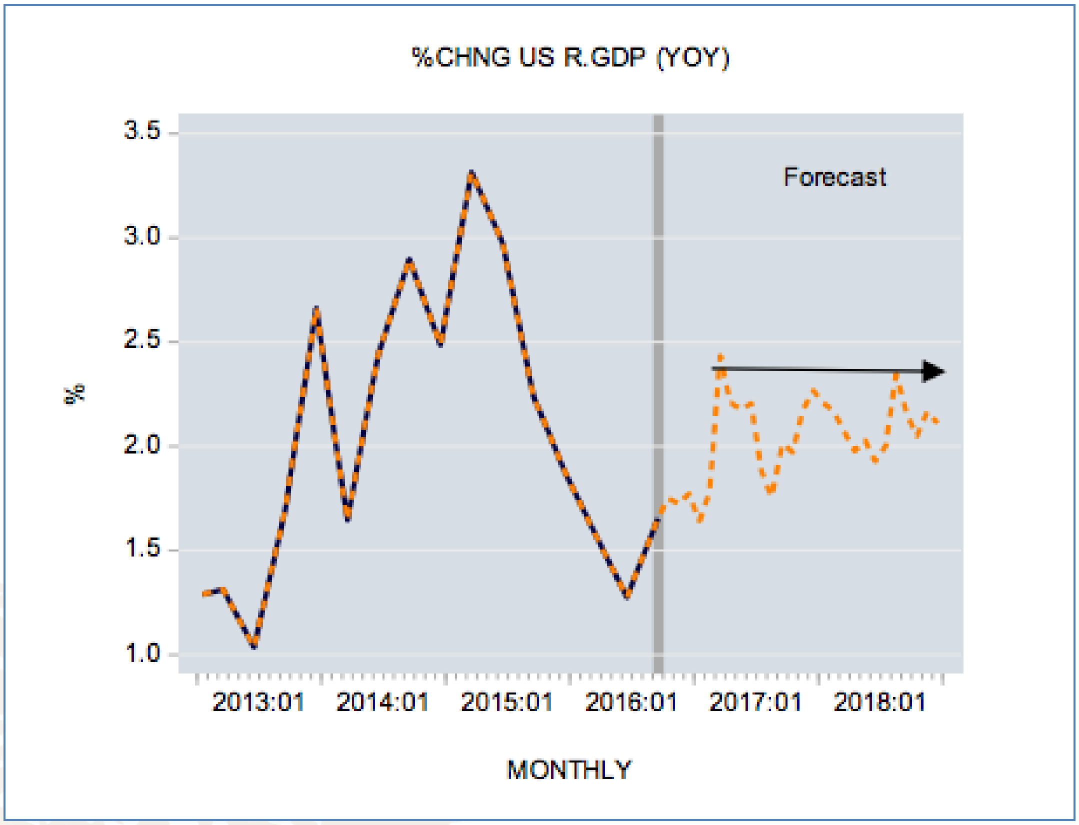
Frank Shostak:

First of all I think Heinz said a lot of things I completely agree with. I would just like to add a few things. Basically people like to talk about reducing taxes and how it is good. But the problem is that **you can't reduce effective taxes if you don't reduce government**. The larger the government, the more taxes we'll have to pay. It does not matter if it's through direct or indirect taxes. Unfortunately during the election campaign Trump said that he wants to lift employment and provide more jobs for Americans. He basically **wants to eliminate anything that undermines production in the United States**.

He is against international competition in effect. He is in effect promoting more inefficiency. Equally he may boost the fiscal spending a lot, which Krugman will probably love, and the way he is going to fund it is by borrowing from the Fed, which means printing. This is in effect a tax because it is diluting the value of the Dollar. So given all this, I would be inclined to believe that the **money supply could get out of control sooner or later, but not immediately.**

Also, for this year whatever Trump is going to do will have marginal effect because of the time lag. So the past policies of the Fed and Obama are soon going to have pronounced effects. So from this perspective our analysis suggests that **one should not expect a lot from the economy** (e.g. GDP and other indicators). But we still expect some upside in terms of GDP in the first half of this year and it would not surprise us if there is a deceleration in the rate of growth. And 2018 could be much weaker than 2017. And this is due to previous monetary policies.

US Real GDP Historical and Forecasted



Source: Frank Shostak - AAS Economics

We are also very concerned about the pool of wealth, or the net worth of the economy. We are not so sure if the net worth is growing, stagnating or, God forbid, declining. If this is the case, whatever Trump is doing will not be material. If the pool of wealth is stagnating or declining, and Trump introduces some crazy policies, we will run a risk that it could push the economy over the cliff and it could be a disaster. So again, on the question whether we are heading for inflation or deflation, Trump policy will probably be more inflationary than deflationary. However, if the economy falls over a cliff then we could have deflation because the credit will disappear and money could actually collapse. This is an extreme scenario that I'm talking about, but if we will not go out to the extreme and the pool of wealth will last for another couple of years then we might have some people saying that we are in a goldilocks economy.

Ronald Stöferle:

Thank you very much Frank. Paul, I would love to hear your thoughts on this topic, and as a segue what do you expect from Trump and what consequence will that have on the Dollar? And afterwards perhaps you could explain to us your concept of "the plumbing".

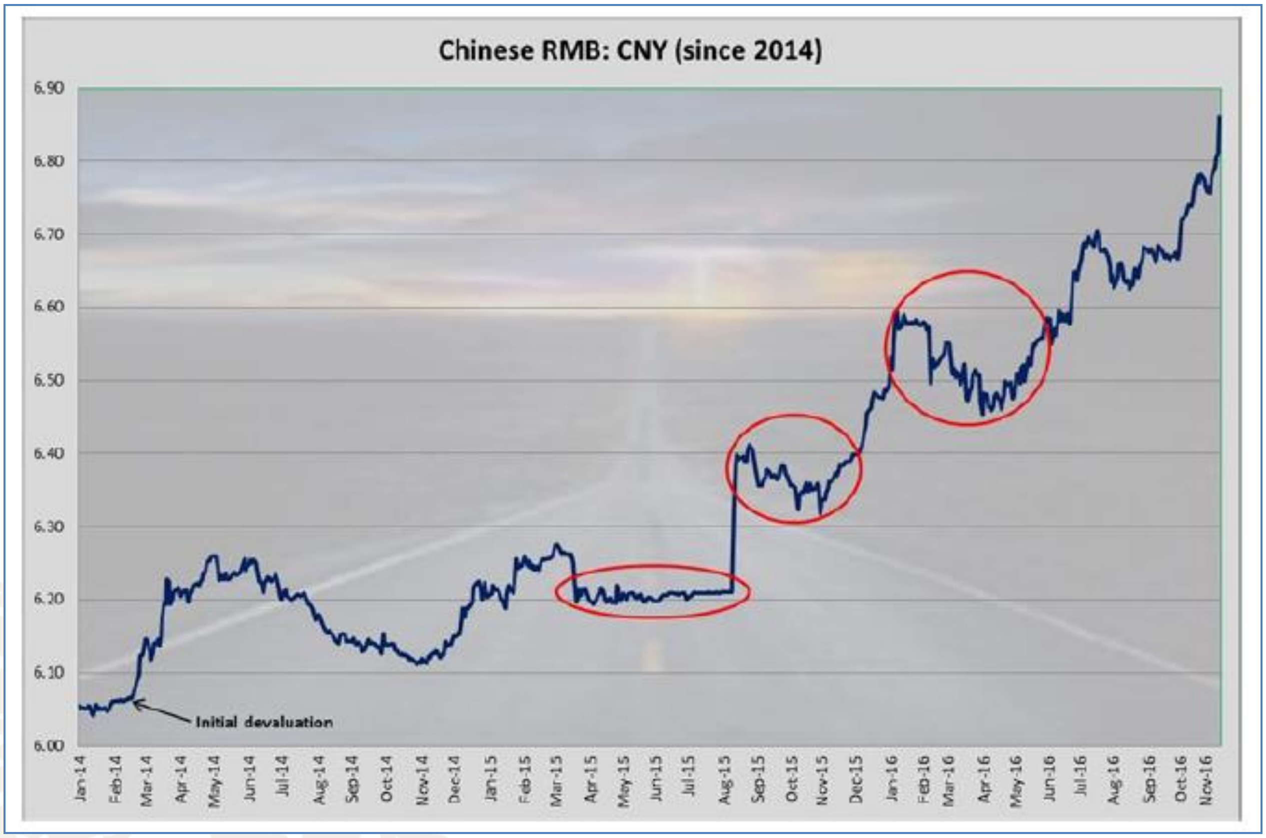
Paul Mylchreest:

Sure Ronni, thank you very much. Just briefly on Trump, I would say that as things stand what we've got are very positive indicators, but they are the softer economic indicators like the ISM and confidence. In terms of harder numbers of the US economy, you certainly see some improvements in inventory levels, but not much. And I think that will still be a problem as we go through 2017. I actually don't think there will be much impact from increased fiscal spending this year. I think it will happen in 2018 and beyond. But by that time we may well have much bigger problems to deal with. One other thing I would point out that's helping the US economy short term is that there has been a strong spike upwards in credit card debt in recent months. And that is something you typically see ahead of a recession. So my sense is that as we go through 2017 the confidence in the markets at the moment will progressively fade and the growth will slow, with the risk that there is some chance of a recession when we get into the second half of this year. But that would certainly be a higher possibility if the rest of the world were slowing down as well.

And just to follow on from what Ronni said; one of the major risks I see for 2017 relates to problems in the financial system's "plumbing" (click here for report). What I mean by that is a shortage of Dollar liquidity outside the US.

Just to give you my take on the Dollar and Dollar liquidity: my view is that the Dollar has taken on a role like a global Fed's funds rate. So when the Dollar strengthens it leads to tightening policy across the global economy. One reason for this is that we have had a massive post crisis build up in offshore Dollar debt, or Eurodollars, which are just Dollars outside the US. Since 2008 we have seen an increase in offshore Dollar debt to more than $10 trillion and it's mainly in the emerging world. If we do see further Dollar strength then this could pose a major problem. And a reason why we might see the Dollar strengthen from here is policy divergence with the Fed on a tightening cycle. But I would actually track this shortage in Dollar liquidity as going back to February 2014 when we first saw the surprise devaluation by China of the Renminbi. And if you want to track major Dollar liquidity events since then I would say that in the middle of 2014 we saw the oil price starting to decline, and then in January 2015 we saw the Swiss national bank break the Euro peg citing Dollar strength. In August 2015 we had the second Renminbi devaluation. And in 2016 we had a very strong Yen. This is counter intuitive, it's actually due to Dollar strength. I can go into this later if you want. Moreover, I think currently **the People's Bank of China is basically in a panic about the potential for a currency crisis in China, which I see as quite a strong possibility in 2017**.

Chinese RMB devaluation and PBOC intervention (red circles)

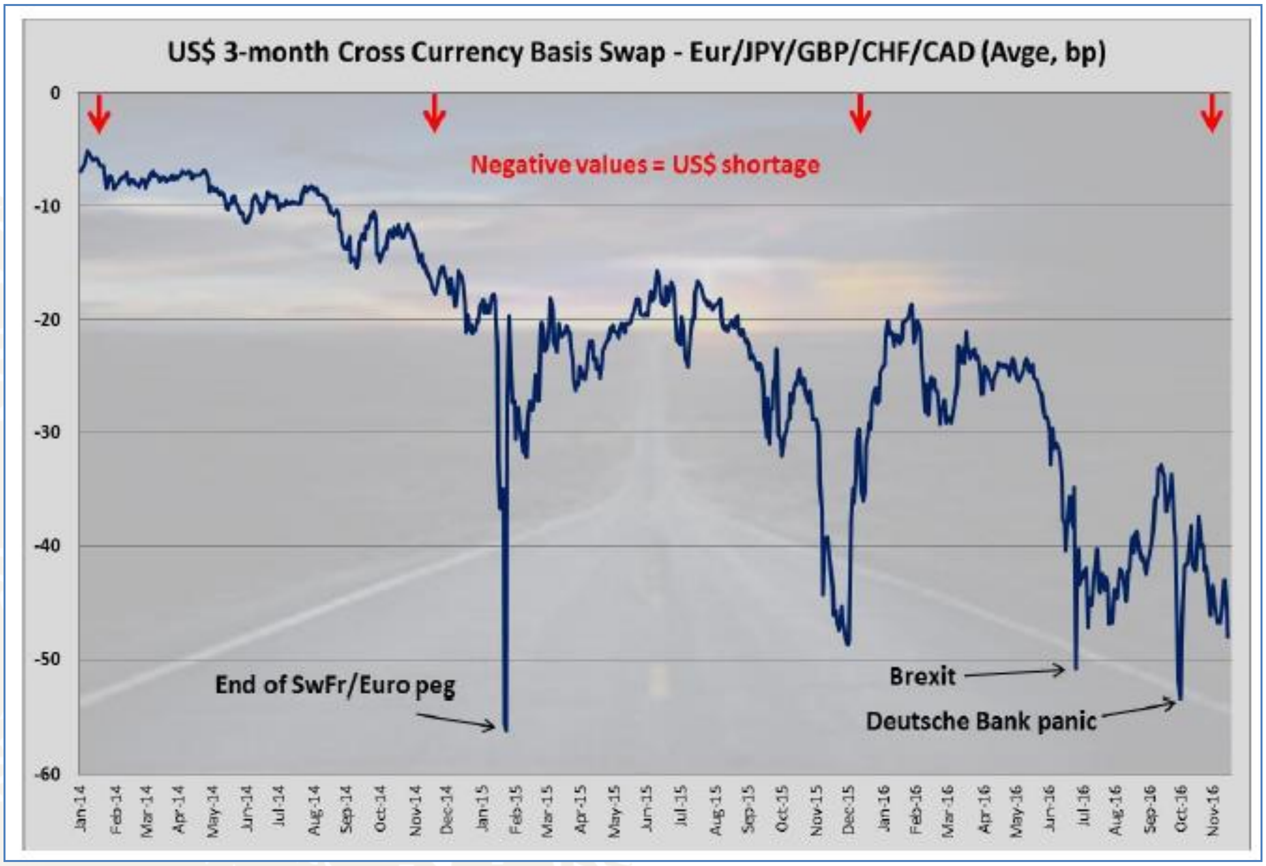


Source: Paul Mylchreest, ADM ISI, Bloomberg

But just let me briefly explain this shortage of Dollar liquidity outside the US. You have to think about who needs the Dollars and where the Dollars come from. A typical example would be a Chinese steel company that borrowed Dollars, let's say in 2012, because the RMB was a one-way bet and U.S. interest rates were lower than Chinese interest rates. If it borrowed in Dollars for ten years from a bank in Hong Kong you have potential problems rising because you have a currency mismatch between the steel company and the Hong Kong bank, and a maturity mismatch for the Hong Kong bank which has lent Dollars long, but has borrowed them in short-term global funding markets. So this regional Hong Kong bank would have to roll over its Dollar funding every three months, typically in Dollar funding markets. So then you would have to ask: "where does a regional Hong Kong bank get Dollar funding?" I would say it's going to be the big global Eurodollar banks like Citi, J.P. Morgan, BofA, Credit Suisse etc. Now the problem that is arising here is that these big global banks are much **less willing to offer Dollar balance sheets**.

One reason is because they are becoming ever **more risk averse**. Why would they want to keep extending credit through dubious Asian loans? Another factor is Basel III, which has been providing balance sheet strains progressively on these banks since it started being implemented in 2013, and still have quite a long way to go. So these large Dollar banks are not really extending credit outside the US to the extent that they were in the past. And you now have a situation where you have an unprecedented amount of Dollar debt that needs frequent rolling over. **So essentially we have this structural shortage of Eurodollar liquidity, which you can track in real time if you look on your Bloomberg screen to cross currency basis swaps.**

US Dollar 3-month Cross Currency Basis Swap (average)



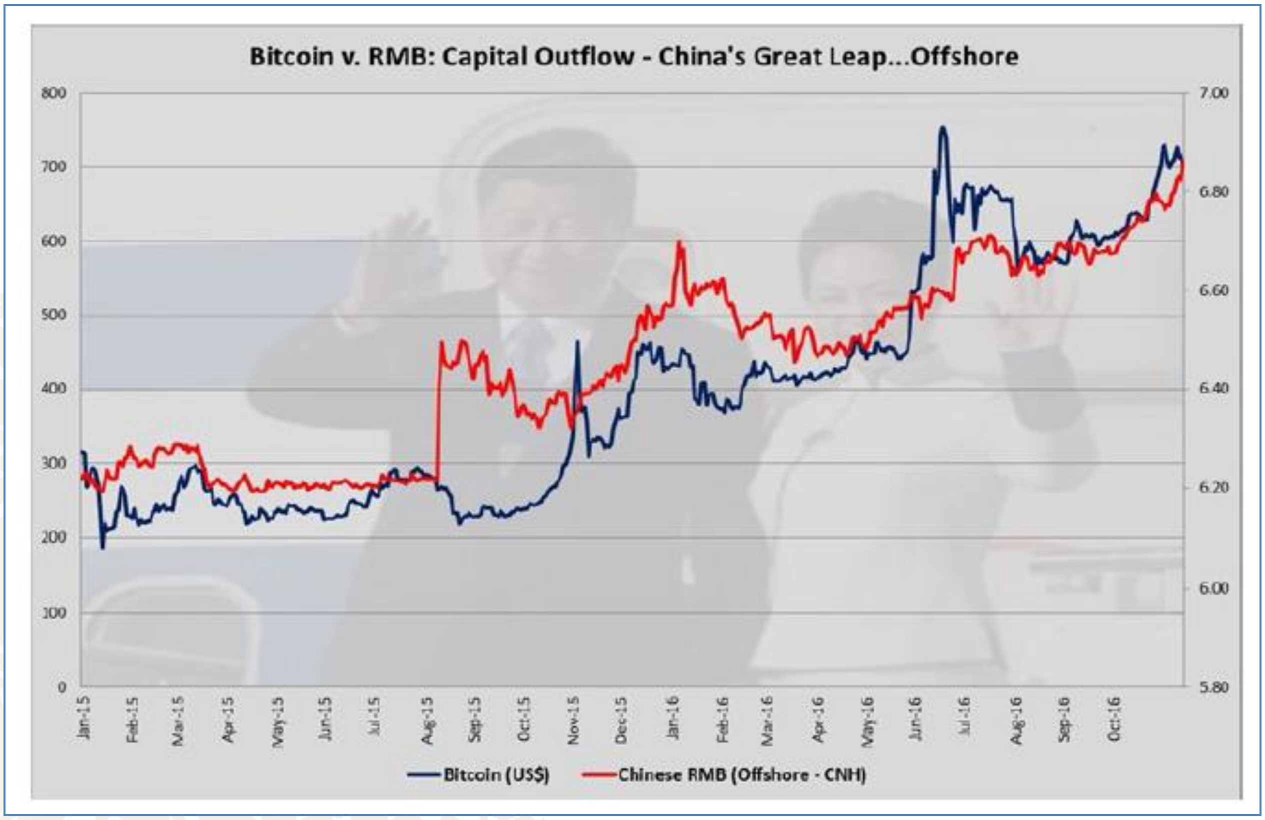
Source: Paul Mylchreest, ADM ISI, Bloomberg

I'll leave it there for now. If you want I can zero in a bit later and talk about China in particular because that to me is where the biggest Dollar liquidity and plumbing problem exist at this point.

Ronald Stöferle:

Many thanks Paul. If we look at the RMB versus the Dollar there is quite a lot of pressure and a lot going on when it comes to Bitcoin. **Zerohedge just wrote that 98% of trading in Bitcoin at the moment is taking place in China** (link to Zerohedge tweet). So there is huge financial stress in China. Mark, do you want to continue with the next topic?

Bitcoin Price and Renminbi Capital Outflow



Source: Paul Mylchreest, ADM ISI, Bloomberg

Mark Valek:

I love this first round because it was really broad. Now, back to Trump, we already heard from you guys that we don't really know exactly what to expect. But what does the Trump administration favor, and what economic policies can we expect that might have a significant influence on the market? If you have any ideas about what could in the short to medium term affect financial markets and asset allocations. Do you have any thoughts on this Heinz?

Heinz Blasnik:

Since the election the markets have been surprised and I think I can explain how this came about. I remember the election night quite well because I was watching the markets very closely and initially when it became clear that Trump would actually win the election, DJIA futures tanked by 900 points in Asian trade. A crash was basically starting, and then fairly quickly things began to turn around. And as the day went on I think what happened was that as it became clear that not only would Trump win, but the Republican party would make a clean sweep of both houses of Congress, market participants decided they wanted to cover their shorts.

Election Night Stock Market Reaction

Source: CNN Money, Factset

They also thought it was time to buy because the Republican Party won everything, and that means Trump's program will be implemented, which was seen as positive by the market. Trump is going to be good for Wall Street. He's going to repeal a lot of regulation. If you look at what sectors performed the best, on the one hand you had the infrastructure plays and on the other hand you had financial stocks. I believe Goldman Sachs went to a new all time high recently.

Goldman Sachs Share Price Post-Election

Source: Investing.com

So market participants concluded that this Republican clean sweep means that there will be a party on Wall Street. So now we have seen very strong advances in the stock market and that of course has been supported by the strong money supply growth I mentioned earlier. Frank is regularly updating these data and I am looking at them about once a month. We have seen money supply growth break out to the upside from a sideways channel. So we have a double whammy. There's the conviction that this will be good for Wall Street, plus we have a lot of money supply growth. We have all the preconditions for the markets to rise. But the question is what will happen next? It seems to me that at first everybody said that Trump would bring uncertainty. I don't know how many times I heard that. But suddenly uncertainty transformed to certainty overnight. Now the markets are certain, but I think this is misguided because I think it's actually quite uncertain what Trump will do.

And I think in the next phase market participants will reconsider some of the conclusions they came to after the election. Once Trump has been sworn in I believe uncertainty will increase again. From a statistical perspective, in post election years when the new president is from a different party there's a strong tendency for the market to behave quite differently than it does normally. So there's a good chance that the market will be very volatile this year and it's not going to produce gains similar to those we have seen thus far. My personal expectation is that we will see a correction at first, followed by a surge, and then a bigger correction. Actually it can be a year that ends with slightly negative returns.

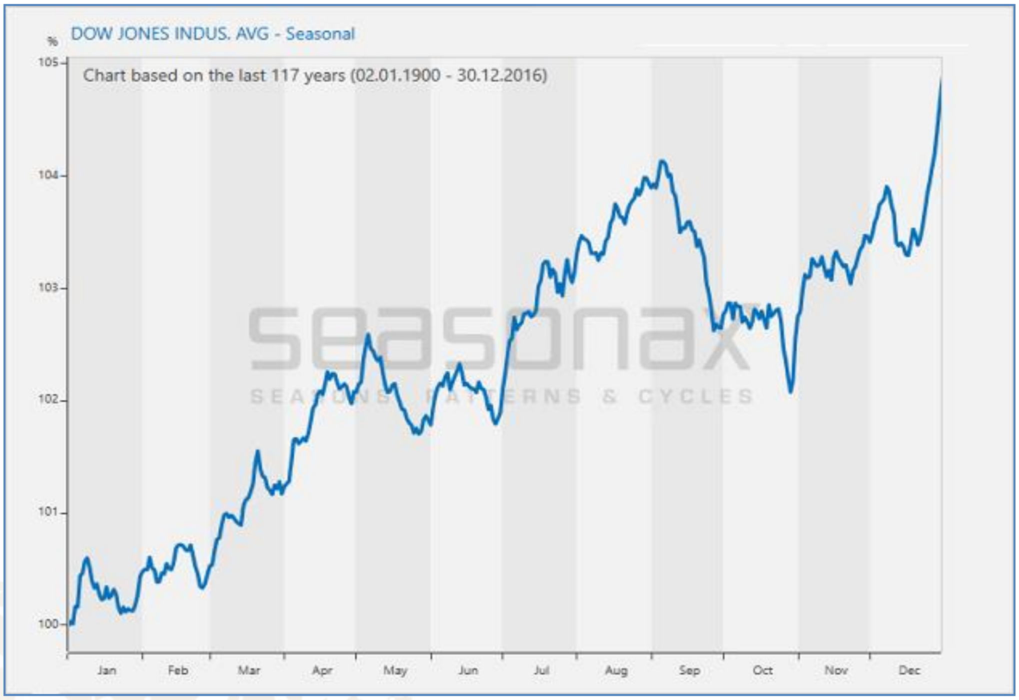
Mark Valek:

Just to clarify Heinz, what does your analysis about the markets in post election years tell you?

Heinz Blasnik:

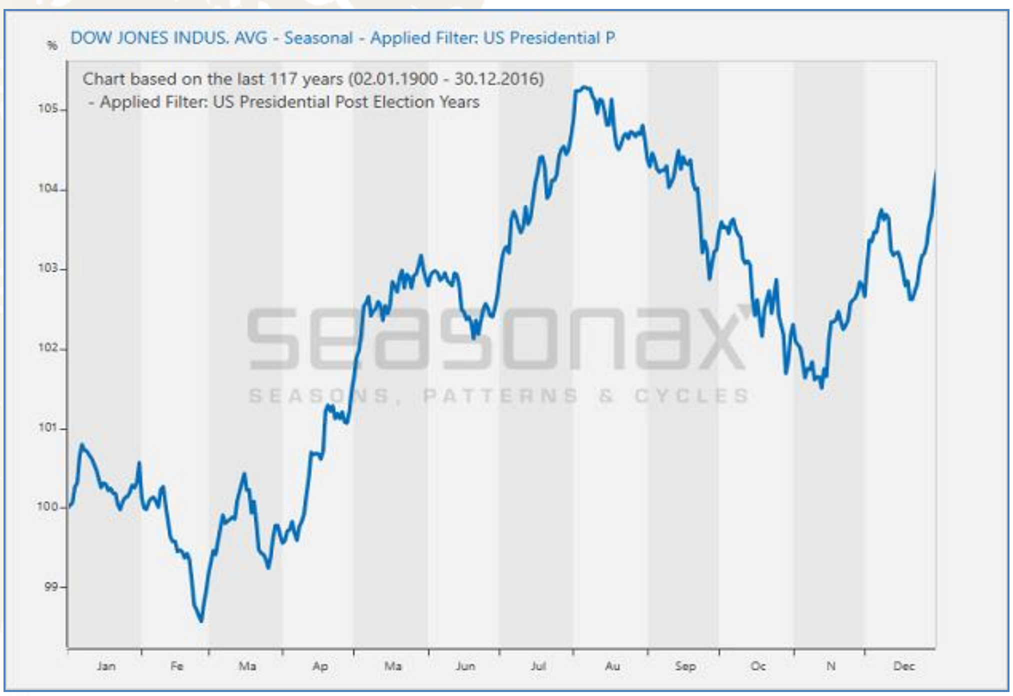
Historically the market rises into April on average then it makes no headway between May and October. Most of the gains are actually made at the end of the year, on average (first chart below). In the average post election year we see a midsize correction early in the year (January to the end of February) then the market rises into the summer months (July/August) and that is followed by a fairly big correction into late October. Any gains that the market makes in post election years are made in the last two months of the year, on average, since 1900 (second chart below). Lastly, when the new president is from the opposing party, all these moves are more pronounced. The correction early in the year is bigger. It's on average a 5% loss between early January to late February. And a 5% loss is actually quite big. And then you see a fairly sizeable gain into July/August and that's followed by a very big correction into October. And then the market recovers late in the year (third chart below). But one has to consider that this is an average.

DJIA seasonal patter since 1900



Source: Seasonax

DJIA seasonal average since 1900 – post election years



Source: Seasonax

DJIA seasonal average since 1900 – post election years when new president is from opposing party

Source: Seasonax

Then I would say that we should ask ourselves: "what has changed"? Everyone thought that Clinton would win the election and that it would be business as usual. So everybody based his or her expectations on this. But she didn't win so something must be different. Trump's policies will be different, but we have to remember that **what will happen in the markets is to a large extent predetermined by what has happened in the last few years**. Trump does not have a time machine. He can't go back in time and appoint a different Fed chairman who won't print as much money. He cannot alter the fact that the money supply has exploded since 2008. And as Paul mentioned, the rise in US Dollar debt overseas is becoming a problem as the Dollar rises. These things cannot be changed retroactively. They are already in place.

So regardless of what Trump does; some events are already preordained. But the timing might depend on new policies, for instance the effect on liquidity that Fed tightening might have will depend on the speed and extent of the tightening. **But ultimately the correction that is necessary to rectify all the distortions will have to happen.**

The main question is when it will happen. And are we going to see more of an inflationary or deflationary bent? But I actually think that in both cases gold should do relatively well. You questioned whether we could see a strong Dollar concurrently with a strong gold price and to this I would say that if something goes wrong then it's very much possible. If we see problems with the RMB or Euro I think the markets will be **looking towards the US Dollar *and* gold as safe havens**. And Japanese investors will repatriate and the Yen will strengthen as well.

Ronald Stöferle:

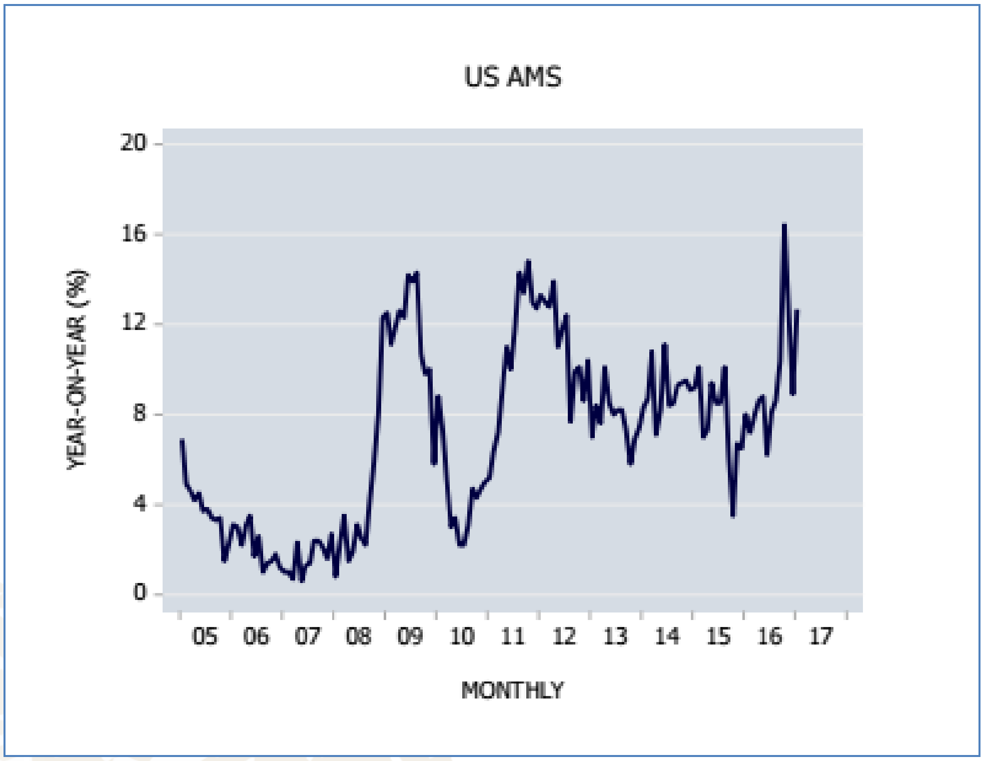
Frank, what would your concrete ideas regarding asset allocation be with the Trump presidency as a backdrop?

Frank Shostak:

All of us agree that things are predetermined to some respect. We don't believe in efficient markets and that everything is priced in. **We believe that the effects of the past monetary policies are yet to come**. And from this perspective I don't really make too much out of Trump and what he will do. We use two systems for asset allocation. One is a passive approach and the other is more discretionary from the large econometric model we have.

From the passive model, which is driven by lagged money supply, we believe that the US has entered stage four of the business cycle. For those who are not familiar we break the business cycle into four stages. Stage number 1 when things are falling at a rapid pace, stage number 2 when things are falling at a slower pace, stage number 3 when everything is rising at a rapid pace, and **stage number 4 when things are growing at a slower pace. We believe that the US is currently in stage 4**, based on lag money supply growth (chart below). And our recommendation, taking into account our view, is to be in consumer staples, healthcare, utilities and government bonds. And **for the Eurozone we believe they are in stage number 3**. We have identified consumer discretionary, financials, industrials, telecom services, materials and energy. For Japan we believe they are in stage number 3 and it's more or less like the Eurozone. Australia, we believe is in stage 4, and investors should behave according to what we laid out for US investors.

AMS – Adjusted Money Supply (changes affect economic activity with a lag)



Source: Frank Shostak - AAS Economics

If we were to just follow the econometric model we suggest that the S&P may still continue to do well. By the end of this year **it could climb another 14%.** And in 2018 we still expect around 6%, but that doesn't mean there won't be gyrations. But the trend is positive, provided we don't get a collapse in money supply. Obviously, if we were to forecast a disastrous scenario we would have to adjust our views, but we are not doing that at the moment.

The yield on the 10-year Treasury bond closed at 2.4% in December. **We expect yields to reach 2.9% by June and thereafter we see deceleration in yields and by December this year we expect 2.4% again**. And next year we expect 2.2% by December. For oil prices we see some increase until June this year, maybe to $58 per barrel, and thereafter we see deceleration, to perhaps $47, and by the end of next year we think it could reach $40.

The trend in the price of gold is up, although we expect volatility. By **July this year we forecast that the price could exceed $1,400**. And then it could drop again by December, and by July next year it could jump to $1,500. The underlying trend is up, but we expect volatility.

In terms of currencies we **expect further strengthening in the US Dollar**, not so much because of the interest rate differential, but because of the money growth differentials. The money printing in the US is slower than in the Eurozone, in other words everyone is printing but some central banks are printing much more than others. As a result we expect the Dollar to be strong against the Euro. It could actually reach 0.9 US Dollar per Euro by December this year. And around 0.85 by December 2018.

And we think the Yen will further depreciate. Abenomics resulted in a lot of money printing. They pumped massive amounts of money into the system. So the Yen is likely to weaken further and could reach even 130 by December this year and 136 sometime next year. The Swiss Franc on the other hand is likely to strengthen because Swiss money supply has been collapsing for a long time now.

So this provides a very interesting play, Yen versus Swiss Francs. Currently the Swiss Franc is around 1.01 per US Dollar, but this could go to 0.89 by December this year according to our model, and a slightly lower figure at 0.88 by December next year. This is all based on the money growth differential.

Ronald Stöferle:

Thank you very much Frank. It's interesting to see that you are highly bullish on the Dollar and bearish on the Euro. Here in the Eurozone there was quite an **inflation surprise in Germany when it spiked up to 1.7%. During the weekend there was large pressure on the ECB**, from both tabloid newspapers and more high quality newspaper, **to reverse and finally start hiking rates**. So I think the ECB will come under increased pressure going forward. Be careful what you wish for, it might come true, signore Draghi.

Let's finish the round with Paul – as you are focused on the plumbing you are very bullish on the Dollar and bearish on most of the other currencies, do you have any specific price targets? Do you think the Dollar index could spike up to $120 or $130? In my opinion that would be extremely deflationary, and would of course cause a collapse in the weakest links, which is currently emerging markets. If that were to happen, what would be the policy action based on your concept of "the plumbing"? Do you think some sort of Plaza according meeting would take place like it did in 1985 when the Dollar was too strong?

Paul Mylchreest:

Thanks Ronni, some years ago I gave up making specific forecasts because I always ended up getting them wrong. But in directional terms **I expect further substantial strength in the Dollar**. The last two major Dollar bull markets, the early 80s and the late 90s, both ended with financial crises. As you said we have to focus on the weakest link, **and the weakest link to me is China.** And it's a very big weak link. Just to make a couple of points: they **burned through $1 trillion of FX reserves already and they are struggling to contain the capital outflows**. And by selling down their FX reserves it's a bit like QE in reverse, but people seem to forget. So what you have seen is that people are trying to use their FX reserves in exchange with their banks to get Renminbi, and the Dollar liquidity problem is actually causing a domestic liquidity problem as well. And the numbers are quite significant. The PBOC now injected in excess of $5 trillion into the domestic banking system through various programs and I don't think most people have added up these numbers. But it's very substantial.

Now, by pushing all these Renminbi into the domestic banking system, what they are doing is keeping overnight money rates very low and if you look at overnight Shibor it's actually fallen sharply recently. At the same time the three-month Shibor is spiking very sharply. And I think that spread of three month versus overnight Shibor is something to keep a very close eye on because it really is a sign of acute monetary distress. We had a very big spike in early 2014 with the first devaluation. So to wrap that up I think there really is a strong possibility of a currency crisis for China, which may precipitate a push back from the BRICs nations to basically say: the Dollar doesn't work for us anymore.

Shibor Rate

Source: Paul Mylchreest, ADM ISI, Bloomberg

So whilst we are probably in agreement that there will be a monetary reset at some point, it's possible that there will be some kind of Plaza accord to try to manage the Dollar; e.g. moderate its rise or weaken it temporarily if we reach some kind of crisis later this year. If we were to have a Plaza accord it would be just another can kicking exercise. But just to briefly bring up another topic; there is one question that we haven't dealt with which is that if we see further strength in the Dollar, what does this mean for gold? This morning I updated my chart of the gold price versus the Yen and that inverse correlation is still very strongly in place. So if we are bulls on the Dollar, what we need is the gold price to decouple from the Yen and I think it really could be something like a currency crisis in China that precipitates it, and **we might see gold decouple and see it and the Dollar both strengthening**.

Yen vs. Gold (purple line), 3-Year Chart

Source: Investing.com

Ronald Stöferle:

Thank you very much Paul. Very, very interesting. Mark, what is next on the agenda?

Mark Valek:

I guess we more or less rounded it up already. We have touched on all the subjects that we wanted to discuss. Anything else you want to mention, Ronni?

Ronald Stöferle:

Just some info on what we recently did; **our inflation signal switched to falling inflation** a couple of weeks ago. **We bought treasuries and are very happy with the performance so far**. It seems that gold made its low because the price action looks pretty convincing. We have seen tremendous amount of reduction in speculation based on the commitment of traders report. Sentiment is pretty negative again. **So it seems that gold made its lows although we kind of hoped for some sort of a panic low in December, but we haven't seen that**. However, I think that the huge divergence in mining stocks looks really strong. So I think it's going to be a very interesting year for our field of expertise, meaning inflation sensitive assets. We therefore really look forward to this year.

Frank Shostak:

Just to jump in, I'm a little bit puzzled by what Paul was saying and I'd like to respectfully disagree. Paul said that the Chinese were aggressively selling American Dollars, which means they were taking money out of the system. But if I look at the **Chinese money supply statistics in November they were running year on year close to 20%**, which is a very high figure. In other words, from the liquidity perspective, even if they were defending the Yuan by selling Dollars, there were some other outlets that led to a strong money supply. Taking this into account **I do not see a liquidity crisis**, unless the real economy will collapse as a result of the previous declines in money growth, which is quite possible. We should bear in mind that the Chinese money supply (chart below) had quite a big deceleration from 2009 until 2015. But thereafter, from Q1 2015 it has accelerated in excess of 20%. So I'm a bit confused about why there should be a liquidity problem. But I do agree that China is a problematic case as a result of the measures taken by authorities. They created boom/bust cycles, but I cannot see a liquidity crunch at the moment.

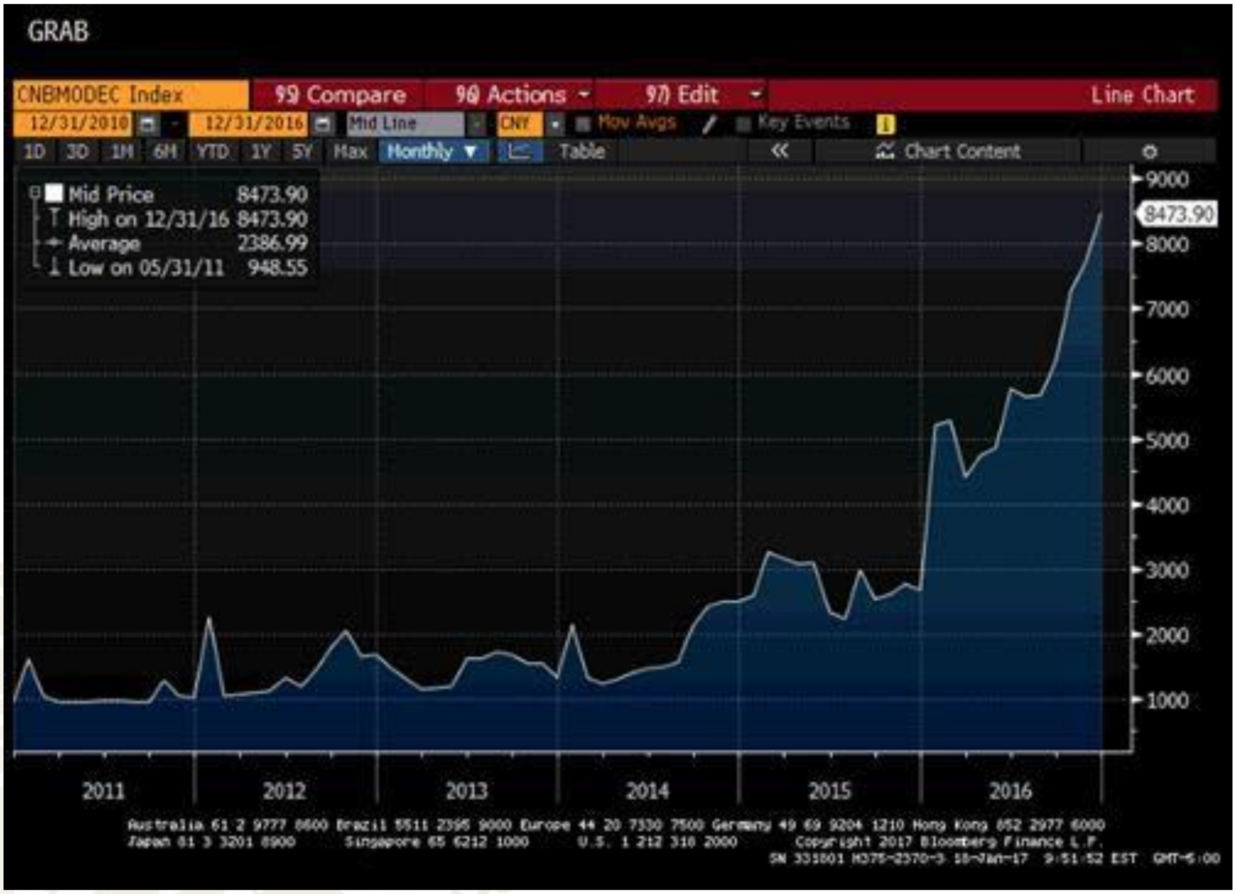
Chinese Money Supply % Change (YoY)

Source: Frank Shostak - AAS Economics

Paul Mylchreest:

Just a couple of points: one of the things I look at is the deposits of the banking system with the People's Bank of China, and what you see is that since 2014 it has flattened off after having essentially been on an unbroken growth trend. It's now flat lining. That's one way of looking at liquidity in the Chinese banking system. Another aspect is PBOC liquidity injection and I can send over a chart (chart below):

PBOC Claims On Other Depository Institutions



Source: Paul Mylchreest, ADM ISI, Bloomberg

Frank Shostak:

I'm not trying to challenge you, but I just wanted to say that the money supply is still very high and I don't think we're heading towards a liquidity crunch. At the moment we don't see many signs of that. In my opinion liquidity is always a factor of money supply. That's the ultimate liquidity – the supply of money versus the demand of money. This is at least how Austrian economics analyses liquidity. If the supply of money is rising, there's plenty of liquidity.

Paul Mylchreest:

I think there's a little bit of a difference between on hand liquidity in the banking system and the actual rate of money growth. In a credit system, which China has, loans create deposits. That's just double entry book keeping. What I think, though, is that in terms of available liquidity the Chinese banking system is in trouble. And the way you might think about that is that **there are an awful lot of nonperforming loans in that system where the cash flow to the banks is just not there to the extent that it was.** And as I said I think the banking system has been somewhat starved of reserves. But I take your point that on the surface loan growth, and therefore deposit creation, still looks healthy. But I think that if you talk about available liquidity in Chinese banks, it's not there.

Ronald Stöferle:

I think I tweeted a Chart showing that it's only the state owned banks that injected massive amounts of liquidity into the system while the other more private banks did not create too much credit growth.

Anyway, gentlemen I think it's time to wrap up. I thank you very much for this interesting discussion. Thank you Frank and thank you Heinz, and a special thanks to Paul for joining us.

Appendix A: Members of our Advisory Board:

Special guest: Paul Mylchreest

Paul Mylchreest covers Equity & Cross Asset Strategy at ADM ISI in London. He began his career as a UK equity analyst a month before the crash in 1987. Since then he has covered a wide range of industry sectors, including Pan-European Chemicals, Oil & Gas and Metals and Mining at several well-known investment banks such as UBS (then SG Warburg), Citibank, JPMorgan Chase and the high quality boutique Redburn Partners. While covering the Metals & Mining sector, he developed a fascination with global macro issues and the interaction of equity markets with bond, commodity, precious metal and money markets.

Zac Bharucha

Zac began his career in finance at the investment bank Kleinwort Benson and later became an equity portfolio manager at Philipps and Drew Fund Management. He then moved to AMP Asset Management where he was responsible for managing more than GBP 1bn of institutional assets. Afterwards, he moved to M&G in London. Since 1998, he has developed absolute return strategies and specialized in equities and commodities. After 25 years in asset management, he retired from professional life in 2011 and wrote his first book about market timing.

Heinz Blasnik

Heinz is an independent trader and market analyst for the consulting firm Hedgefund Consultants Ltd, as well as a regular publisher for the Independent Research House Asianomics in Hong Kong. Heinz primarily is responsible for his blog www.acting-man.com, on which he analyses developments in the financial markets from an Austrian point of view.

James G. Rickards

Jim is the author of the international bestsellers *Currency Wars* and *The Death of Money: The coming collapse of the international monetary system*. He is portfolio manager at the West Shore Fund. During his career, Jim has held senior positions at Citibank, Long Term Capital Management and Caxton Associates.

Dr. Frank Shostak

Frank is chief economist at AAS Economics. He has over 35 years of experience as a market economist and central bank analyst. He holds a PhD, MA and BA honours from South African universities. He was professor of economics at the Witwatersrand University in Johannesburg. He is one of the world leaders in applied Austrian School of Economics and an adjunct scholar at the Mises Institute in the US.

Rahim Taghizadegan

Rahim is the founder and director of the institute for value based economics, an independent research institute in economical and philosophical issues in Vienna. He is bestselling author and a popular speaker internationally. Rahim studied Physics, Economics and Sociology in Vienna and Lausanne. He has worked in the fields of economics, space research and journalism. He has also taught at the University of Liechtenstein, the Vienna University of Economics and Business Administration and the Universität Halle an der Saale.

Ronald-Peter Stoeferle, CMT

Ronald is a managing partner and investment manager of Incrementum AG. Together with Mark Valek, he manages a global macro fund which is based on the principles of the Austrian School of Economics. Previously he worked seven years for Vienna-based Erste Group Bank where he began writing extensive reports on gold and oil. His benchmark reports called 'In GOLD we TRUST' drew international coverage on CNBC, Bloomberg, the Wall Street Journal and the Financial Times.

During his studies in business administration, economics and finance at the Vienna University of Economics and the University of Illinois at Urbana-Champaign, he worked for Raiffeisen Zentralbank (RZB) in the field of Fixed Income/Credit Investments. After graduation, he participated in various courses in Austrian Economics and obtained a Chartered Market Technician (CMT) and a Certified Financial Technician (CFTe) designation. Next to his work at Incrementum he is a lecturing member of the Institute of Value based Economics and lecturer at the Academy of the Vienna Stock Exchange.

Mark J. Valek, CAIA

Mark is founding partner and investment manager of Incrementum AG. Together with Ronald Stoeferle he manages a global macro fund, which is based on the principles of the Austrian School of Economics. In 2014 he co-authored a book on Austrian Investing. Before founding Incrementum he worked at Raiffeisen Capital Management for more than ten years. There he was fund manager and responsible for inflation protection strategies and alternative investments. During his studies Mark worked in equity trading at Raiffeisen Zentralbank and at Merrill Lynch Private Banking in Vienna and Frankfurt.

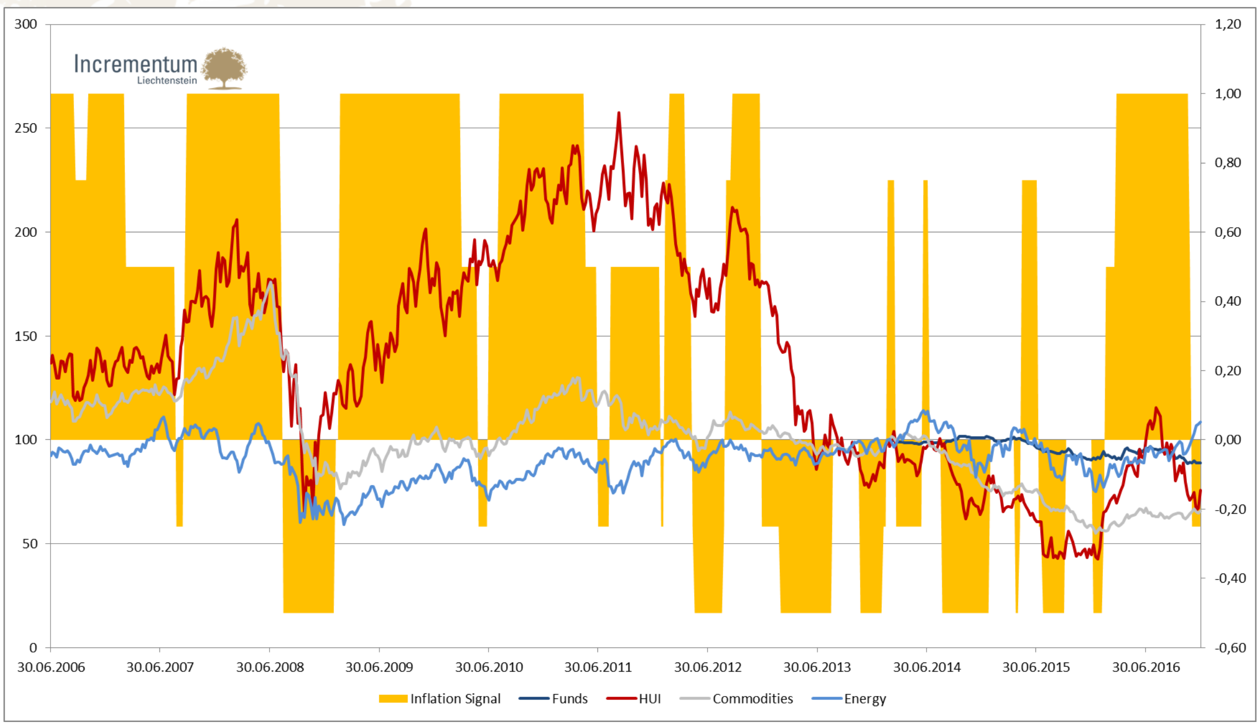
Mark's education includes a degree in business administration from the Vienna University of Economics and Business Administration. He is CAIA Charterholder and Certified Portfolio Manager. Next to his work at Incrementum he is a lecturing member of the Institute of Value based Economics and lecturer at the Academy of the Vienna Stock Exchange.

Incrementum Inflation Signal

At Incrementum, we are convinced that inflation is a monetary phenomenon. Because of the dynamics of "monetary tectonics", inflationary and deflationary phases can alternate. **To measure how much monetary inflation actually reaches the real economy, we utilize a number of market-based indicators** - a combination of various quantitative factors including the Gold-Silver Ratio - which result in a proprietary signal. This method of measurement can be compared to a "monetary seismograph", which we refer to as the **"Incrementum Inflation Signal"**.

In the fund we manage, our Incrementum Inflation Signal gauges the inflation trend and we position the fund accordingly. Historically, we observed periods of between 6 and 24 months during which disinflationary forces were dominant. These phases were particularly painful for the holders of inflation sensitive assets. Right now it looks as disinflation might continue for a while. **Our inflation seismograph triggered a "falling inflation signal" in August.**

Inflation-sensitive Assets and the Incrementum Inflation Signal



Source: Incrementum AG

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