Minutes of the Advisory Board Meeting
Austrian Economics Golden Opportunities Fund
January 18, 2015

Is the narrative of a healing economy finally collapsing?

Highlights of the conversation:

Question 1: During the last years we have heard, that the economy is healing and that we are just about to go return to "normal" monetary policy. As you are well aware, we have always questioned this narrative! Austrian Economics teaches us, that one cannot have a legitimate recovery built on monetary inflation. **Do you think that this narrative as well as confidence in central banking will burst in 2016?**

Mark Valek:

- As we wrote to our investors last December, we think that 2016 could really be the year when the confidence in central bankers starts to pop, as people lose their trust in them.

Heinz Blasnik:

- When such crises happen, there is a "forced deleveraging", the decline stops at some point – the market does this all by itself, it doesn't matter what the authorities do during this phase.
- However, after 2008 the perception was: Bernanke saved the world. That perception persists to this day. And also Mario Draghi is seen as some kind of a magician.
- If confidence in central banks crumbles, there isn't anything left.
- We can see already the first cracks in the edifice: e.g. the SNB that abandoned its peg, the Swedish central bank that hiked rates and then reversed course, the People's Bank of China that has been unable to do an open devaluation of the yuan and to stop the stock markets crumbling.

- Since the Fed hiked, the yield curve has been contracting again. So the opposite of what was expected is now actually happening.
- The rate hike is actually meaningless, because there's no Fed funds market anymore.
- Market expectations in the federal funds futures market have gone from expecting 3 rate hikes or 2 to now expecting just 1 and that is no longer expected in March, it's expected in July.
- So if the Fed wanted to preserve its credibility by hiking rates, it has achieved the exact opposite – its credibility looks worse than before.
- And they're having a problem: because they have this credibility issue, they cannot change course too quickly.

Jim Rickards:

- I think that the Fed will raise rates in March notwithstanding the weak data.
- In the short run at least deflation still has the upper hand, the US economy looks like it's heading into a recession.
- But we have to estimate the Fed policy on how Janet Yellen sees it – and she sees inflation just around the corner.
- So to me the policy question is: What will it take and how long will it take for reality to intrude on the Fed's thinking?
- There have been 8 major central banks that have tried to raise rates in the last 5 years and sooner than later had to turn around and cut them again. I think the Fed will be added to that list.

Zac Bharucha:

- I don't see that the credibility of the central banks is at an all-time high. I think the credibility of the technocrats (the people in power; the political leaders, central bankers, corporate leaders) is rather low in the eyes of most people.
- The technocracy that we have offers a myth of control – but not so much at the micro level as on the macro level.
- China's leaders don't control the economy – nobody controls the economy nor the stock market. Control is an illusion. We like to believe in these myths of control, but actually there is no magic controller for any of these things.
- Geopolitically, our imperial leaders are still overreaching and spending money we don't have, trying to manage chaotic regions elsewhere.

Question 2: What will trigger the change from deflation to inflation?

Mark Valek:

- In the beginning of the year, our inflation signal has switched to "falling deflation", after having displayed "neutral inflation" for a long period. Interestingly gold is performing quite well in absolute and relative terms That could tell us, that we are close to a bottom of the deflationary trend, as strong gold could signal us that more monetary and fiscal stimuli are around the corner. However, that is too soon to call for now.

Ronald Stöferle:

- Oil has gone down significantly again, so we won't see any significant base effect in inflation numbers for the next few months.
- We all know that, due to the debt situation and due to the structure of our monetary system, deflation is unacceptable for politicians as well as for central bankers.

Heinz Blasnik:

- If you look at different asset classes into which money might be deployed, then we have certain asset classes that are clearly overvalued at the moment, and others – at least relative to their recent history – look undervalued. Thus there might be some effect on relative prices simply because stock markets start declining. Some people might consider to buy commodities just because the money has to go somewhere.
- Surely, it will go to gold first. But usually, if gold starts to rise, at some point later industrial commodities rise as well.
- What could trigger the switch from deflation to inflation is when people generally lose confidence in the money issued by the state. And that is unforeseeable in timing and has nothing to do with the general performance of the economy. So even if everything points to deflation, this can flip around. If fiscal spending becomes a big issue, this could foster the loss in trust – but it might take a while.

Jim Rickards:

- I agree with the reasoning and the theory of the basic case, which is deflation first, followed by inflation. There is a long list of reasons why this has to be true. But I disagree with the timing. I think you see inflation coming fairly soon, even if deflation prevails today. I would say it's much more a late 2016, early 2017 event.
- But the Fed won't be able to ease very quickly, they cannot cut rates in August or September or October due to the presidential election. So the earliest they could cut would be in December.
- The most they could do in September is some kind of Forward Guidance, which I regard as a forward ease.

- Forward Guidance – in the form that the Fed assures not to raise rates – would induce carry trades: people would short the dollar and invest in emerging markets. This would weaken the dollar and hence import inflation.
- However, I don't see the catalyst through monetary policy. There might be different channels that are changing the psychology to declining velocity.
- Inflation will come through fiscal policy: it will be helicopter money / People's QE. First one runs much larger fiscal deficits, then one borrows to cover that deficits, and then one monetizes the debt through the central banks. Different from normal QE, there's money printing to monetize debt with the money that has already been spent.
- *"Debt pollution"* – that's a term that hitches the fiscal policy expending to the climate change debate and might prepare for helicopter money by pretending there would be a kind of "good debt".

Zac Bharucha:

- I'm not a bull on inflation. When it comes to seeing a generalized rise in prices: I don't envision that.
- I think we have this massive debt overhang and no real income growth – debt has just been shuffled from one account to another. So I don't see an engine of proper inflation based on for example a demographic effect, housebuilding, or production lagging behind consumption.
- I don't see such an engine at all! I see the opposite. I see mature economies that are massively debt-burdened, that can't create enough jobs where people could get real wage growth.
- And there is chronic overproduction now coming out of China, where already all this money has been created, giving false signals.
- So I cannot predict when the coin will flip from deflation to inflation.
- And the whole inherent weakness in the economic pitch, which has been exacerbated by ultralow interest rates, led to distortions in investment decisions.
- China is just going to export its deflation as much as possible through weakening the currency in order to keep domestic employment and output levels as high as possible.

Question 3: If you were forced to set up one speculative trade for this year and had to hold it until the end of the year, which one would you do?

Zac Bharucha:

- That's not how I think about markets! I am constantly in search of appropriate risk reward ideas.

- The trends that you should be trying to exploit during the calendar year should include a long gold bias and a short equity bias.

Heinz Blasnik:

- In South African Rand the gold price is at a record high. And South African gold mining stocks have begun to outperform the rest of the gold mining sector. This trend could have been exploited since November, but I cannot foresee for how long this will continue.
- I also think one should be long gold as long as no major support that has been established recently are broken, because then one has to step aside and wait a little bit for another sign of a turnaround.
- Everything points to a bear market in stocks – so I agree with the short equity bias.
- Long-term US Treasuries should actually perform reasonably well in this environment.
- I would avoid the European government bonds because of the ECB's influence there, and the perception of Europe's fiscal situation is that it's a bit risky.
- And there's not much upside left for the dollar compared to other major currencies.

Jim Rickards:

- I agree with Zac and Heinz. I would be long gold, long US Treasuries (5 yr to 10 yr).
- I would have some cash, because it's a good deflation hedge, provides optionality and reduces volatility in your portfolio.
- I would be very careful with equities! We could have weak equities during the summer, but if in September the Fed makes a surprise easing in form of Forward Guidance, then it could be a boomerang. That's why the time horizon until December is tricky.

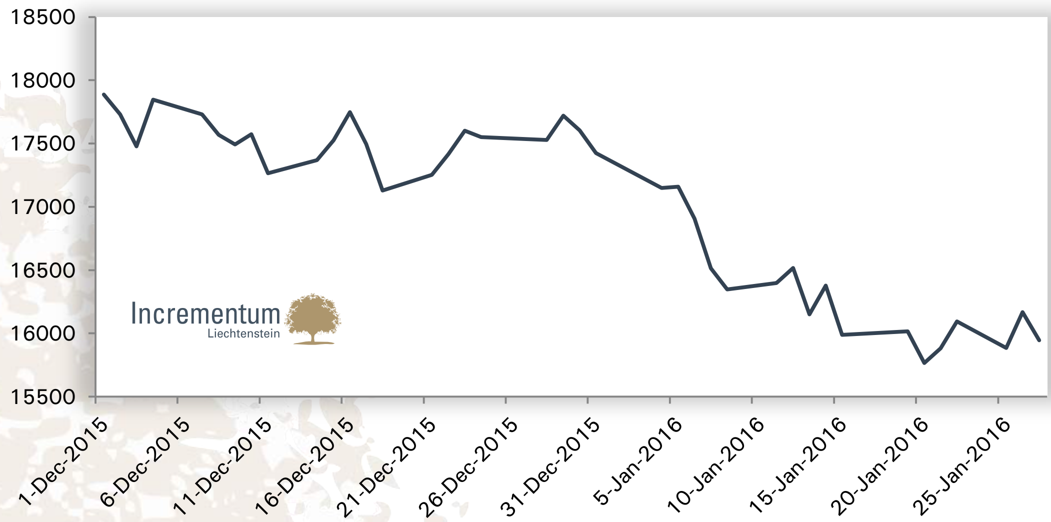
Transcript of the conversation:

Ronald Stöferle:

Welcome gentlemen!

I hope everybody had a good start into the new year! It's been quite a volatile new year – I think it has been the worst start since the beginning of the Dow Jones Industrials Index. And it seems that with our views that we discussed last year we've been pretty accurate. So we were right to warn the public about the things that are developing.

Dow Jones Industrial Average



Source: Federal Reserve St. Louis, Incrementum AG

First of all some housekeeping. **We just released the [English version of our book on Austrian Investing]**. It's the English translation of our book that four members of our Advisory Board wrote together: Rahim Taghizadegan, Heinz Blasnik, Mark Valek and me. It's quite a success so far with really good reviews.

We're also looking forward to Jim's new book: "The new case for gold", which is somehow an attribute to Ron Paul's "The case for gold" and released on April 3.

Jim Rickards:

In 1980, after his election, President Reagan started a gold commission to revisit going back to the Gold Standard. The commission on whole concluded that the US shouldn't do that. But there was a minority that felt strongly that they should. Ron

Paul, Lewis Lehrman and some others wrote a minority report arguing for the Gold Standard. This was a public document which was taken and published as "The case for Gold".

Mark Valek:

Let's go into the topic. **In the beginning of the year, our inflation signal has switched to "falling deflation", after having displayed "neutral inflation" for a long period.** That's quite interesting, because the deflationary forces could get to some systemically dangerous territory. There's an interesting disparity between the quite strong gold price and the falling silver price relative to gold. Definitely, "deflation" is the name of the game. This suggests that we'll see interesting things this year.

We would like to go through a few theses which we stated in our "Letter to Investors" and in other occasions in the end of last year. We'd first like to check up what's your opinion on that. And we'd be also glad if you supplemented our opinions with additional thoughts.

Let's start with one of the theses which we formulated in our letter. We think that 2016 could really be the year when banking and the model of central banking and central bankers start to pop, as people lose their trust into them. This is quite a broad and daring statement. What are your thoughts on this? **Do you think the central banking confidence bubble will burst in 2016?**

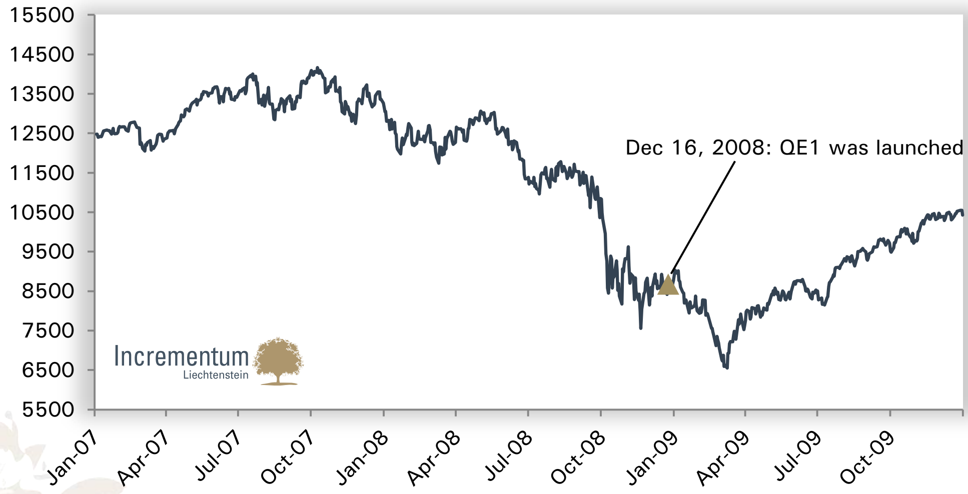
Heinz Blasnik:

If you think back to the crisis of 2008, at that time of the year nobody seemed to be able to arrest the decline. **When such crises happen, when there is a "forced deleveraging", the decline stops at some point. The market does this all by itself, it doesn't matter what the authorities do during this phase** – when the panic is on, it really doesn't matter; whatever they do, it's going to be wrong**. The general perception in 2008 was that nobody was able to arrest the decline; it was only arrested when finally the central banks went all out with inflating the money supply.**

Two things coincided: they started inflating the money supply in late 2008 and when by March the effects started to become visible, asset prices had already come down a lot. One mustn't forget that a change in the accounting rules – namely the suspension of market to market account – also helped greatly stabilizing bank stocks. But anyway, the general perception was, and maybe after a year or two it was very widespread: **Bernanke saved the world. That perception persists to this day. And also Mario Draghi is seen as some kind of a magician**, he only has to say something and already the markets stabilize. **So this confidence bubble is really a big thing! It's one of the major props holding things up. If confidence in central banks**

crumbles, there isn't anything left: there's nothing coming after the central banks (but maybe the IMF, of which it's uncertain what it can do in the case central banks crumble). So central banks appear to be the last bulwark that is keeping the flood in the bay.

Dow Jones Industrial Average during the financial crisis



Source: Federal Reserve St. Louis, Incrementum AG

So it's an important topic! And you mentioned in your forecast that **we could see already the first cracks in the edifice.** The Swiss National Bank had to abandon its peg. Some central banks had to reverse their courses, e.g. the Swedish central bank first hiked rates and then reversed course and lowered them again. The most recent example is the People's Bank of China that has been unable to organize an open devaluation of the yuan and the planners in China have been unable to stop the crumbling of their stock market, although they have thrown everything at it (they even threatened to jail people who sell short) in order to prevent closing the market down completely. And the Fed is actually the latest example of such cracks. Before the Fed hiked rates, the yield curve was actually widening, bank stocks became stronger, because the market expectation was that interest rate margins of US banks would increase now. **Since the Fed hiked, the yield curve has been contracting again. So the opposite of what was expected is now actually happening.**

I should add that **the rate hike is actually meaningless, because there's no federal funds market anymore**; I mean, who needs a market for federal funds when the banks are swimming in excess reserves? - Nobody. There are almost no transactions. And as they cannot shrink their balance sheet that would create outright monetary deflation, they're paying interests on excess reserves in order to keep banks from expanding credit too much. Otherwise the whole federal funds rate marketing would be doomed – and it seems to be doomed anyway. **Market**

expectations in the federal funds futures market have gone from expecting 3 rate hikes or 2 to now expecting just 1 and that is no longer expected in March, it's expected in July. So if the Fed wanted to preserve its credibility by hiking rates, it has achieved the exact opposite – its credibility looks worse than before. And they're having a problem: because they have this credibility issue, they cannot change course too quickly.

Ronald Stöferle:

That's probably the reason why they were confirming in the last few days that they're still seeing 4 rate hikes this year, even though the market is totally sure that there will only be 1 or 2. They have to pretend that they are strong.

Jim, what's your view on this first topic?

Jim Rickards:

I think that the Fed will raise rates in March notwithstanding the weak data. I agree with everything that has been said. We agree that there are inflationary and deflationary forces in play, they're pushing and pulling against each other. This creates an unstable dynamic, but at any given time one of these forces might have the upper hand. And I agree completely that at the moment the deflationary forces are more powerful – although it's just a matter of time before the inflationary forces come back. It's a big question when and how they will come back, and I am happy to give you my thoughts on that. But **in the short run at least deflation still has the upper hand, the US economy looks like it's heading into a recession**. The only people who see inflation are Fed monetarists, who are using obsolete models. I'm shocked to hear Janet Yellen mentioning the Philipps curve publically. I thought the Philipps curve was taken buried in 1981 – it seems like a zombie that comes back to life. **Yellen sees inflation right around the corner and getting back to her target**, while in fact every piece of data, every sensible analysis says the opposite.

But I think what's important is that we cannot estimate the Fed policy based on what we would do, or what we see. **We have to estimate the Fed policy on how Janet Yellen sees it. So you really have to put yourself into her shoes and look at the world with absolutely incorrect models in order to understand what they're going to do.**

So on the one hand deflation is dominant, the US economy is weakening and raising rates makes no sense at all. On the other hand, however, the Fed is working with models that makes them believe in tight labor markets; they believe that labor creates at least the progenitors of inflation; they keep saying the oil price decrease is transitory, but it keeps happening; it has been transitory at 60, transitory at 40, transitory at 30. But the point is: that has not played out yet, so the expected year-over-year flatness in energy prices hasn't happened, because we're still in decline.

The other thing that strikes me is a very serious contradiction in what the Fed is saying (which is probably not surprising, given how incorrect they are in everything else). Yellen keeps talking about energy prices being transitory, energy prices bottoming out, and that would set up fair year-over-year comparisons that would cause inflation to go up. And yet, energy is part of non-core. But they keep saying they don't look at non-core, they'd look only at core. So I don't understand why she's relying on the so-called transitory nature of energy prices to meet her inflation goals, when they say that they follow core inflation, which doesn't include energy. This is the very basic contradiction there.

But I think they're wrong on both points. If you look at core inflation, it's still going down; if you look at non-core inflation, it's still going down. That's the reality. But **the Fed doesn't operate on reality, they operate on models – and the models, at least for the time being, continue to tell them that inflation is coming. So to me the policy question is: What will it take and how long will it take for reality to intrude on the Fed's thinking? I think that probably won't happen before summer.** They probably have to see the first quarter first. Well, we don't even know the 4th quarter of 2015 yet, where GDP will come in well below 1 percent, maybe close to 0. That's going to put the full year 2015 GDP at somewhere perhaps as low as 1.7% or 1.8% (Q1 was 0.6%, Q2 was 3.9%, Q3 was 2.0%). That won't be enough to deter the Fed, because they'll say their models still predict stronger goals for the first quarter. So one may has to wait till the end of April, when they have the GDP data for the first quarter, at which point they will see that things look like a recession. And then another point one has to understand is that the Fed isn't doing anything quickly. They say they're data-dependent, which they really are; but even when they get data, they still think about them for a couple of meetings, they want to see two or three or four data points in a row to confirm a trend before they actually make their decision.

So I can see them still raising rates in March, which of course will just make everything we've just talked about worse (the predominance of deflation, the recession etc.). But I think the Fed will be bound to their December rate increase – the world hasn't ended since then. The stock market might be down 10%, but – as Bernanke told me – the Fed would be untroubled even if the stock market went down 15%. **The Fed won't take any notice until the S&P is well below 1,700**, because they'll say that they've done the business of propping up assets for 7 years and the research on the wealth effect has shown that it has a very weak effect, the research on QE has shown that it has almost no effect. The Fed clearly wants to "normalize" and not to continue propping up markets. So, as I said before: I still expect a rate increase in March, notwithstanding the weak data, but that will only make everything worse.

Now let me know you my thoughts on your "Letter to Investors"**. I agree with the reasoning and the theory of the basic case, which is deflation first, followed by inflation. There's a long list of reasons why this has to be true. But I disagree with the timing. I think you see inflation coming fairly soon, even if deflation prevails today. I would say it's much more a late 2016, early 2017 event.** The reason I say that is because the Fed is still on this kamikaze mission of tightening into weakness, mainly because they don't see the weakness. This might make history like in 1929 in terms of tightening at exactly the wrong time. I think that will persist at least till March, maybe even until June. It won't be until the summer when they realize the mistake, but by then the damage will be done. I see the problem then. If we're getting to July with at least one or two rate increases and deflation should really be persistent, the US economy is weak, the global economy is weak, markets are correcting etc. – then at that point, maybe in August, even the Fed will realize it's time to reverse the course.

There have been 8 major central banks that have tried to raise rates in the last 5 years and sooner than later had to turn around and cut them again. We saw it in Sweden, Norway and elsewhere. **I think the Fed will be added to that list** – they will tighten, and then have to reverse. They will be among those that cannot get away from 0. I think all interest rates in the world will basically go to 0.

But the Fed won't be able to ease very quickly, they cannot cut rates in August or September or October. That's why I don't agree with the timing that you suggest in your "Letter to Investors". **The reason is, we're having a presidential election. And it will be seen as unacceptably political for the Fed to cut interest rates 45 or 60 days before the election.** So I see this very unpleasant scenario: the Fed will plunder the economy based on bad modelling and then they will be politically incapacitated to cut, because it would be seen to favor the Democrats over the Republicans. The target federal funds rate will be at 75 basis points, the US economy is practically in a recession or remaining in a recession, and the Fed wants to ease but cannot due to politics. **So the earliest they could cut would be in December, after the election. The most they could do in September is some kind of Forward Guidance, which I regard as a forward ease** – but by then the damage will be done.

We will get to inflation, I agree with that. But I think there's still a lot more deflation to come first.

Mark Valek:

Thanks a lot, Jim!

Zac, do you have any thoughts on the popping of the confidence in central banking in 2016?

Zac Bharucha:

I'm not bullish on inflation. I think all the trends point in the opposite direction. I don't believe the credibility of the central banks is at an all-time high, I think we're still at the 'edge-of-chaos'. Furthermore, **I think the credibility of the technocrats** (namely the people that purport to control matters; politicians, central bankers, corporate leaders) **is rather low in the eyes of most people.**

I think the implications of implementing QE together with ultralow interest rates, created malinvestments. QE magic money that's not given to everybody but is just given out selectively, so it benefits ultimately only certain elements of the population – I think this gave some symptomatic relief in the sense that market prices rose, equities, corporate debt and house prices. By the way, I view it as negative that house prices have risen. Nobody can really extract value out of rising house prices except by equity withdrawal, it just creates more problems than anything else by pricing people out of the market. It is a non-productive asset. There have been further malinvestments in commercial property. And **I think with QE being rolled back by the Fed and this initial rate raise, you can see the endemic weakness in economies manifest itself. The US economic recovery has outperformed that of other countries, but by historic standards it has been a pathetic recovery.**

I think the backdrop remains that of worldwide gross overproduction. China's leaders don't control the economy – nobody controls the economy or the stock market for that matter. People like to believe in these myths of control, but actually there's no magic controller for these things. **China is going to export its deflation as much as possible through weakening the currency in order to keep up domestic employment and output.** The US is economy is clearly slowing down. European economies are absolutely stuck in the mud – there's little job creation or economic growth. I think we remain on the edge of chaos. **Geopolitically our imperial leaders are still overreaching and spending money we don't have, trying to control chaotic regions elsewhere.** As these forces coalesce, risk assets decline and gold and fixed income are likely to profit. So I think we will see some accumulation take place in the gold market. I think **the dollar is likely to go nowhere now against the other major currencies because the interest rate story is discounted.** Recently the Yen and also the Swiss franc have gained some strength. **Gold will continue to outperform paper money including the dollar.**

When looking back at last year and my last call at the Advisory Board in October: I thought there'd be another decline in stock prices into mid October. But that never happened, the market just ran straight up, some stock markets even revisited the highs. There was a clear divergence with corporate bonds. I think there was a lot of year-end painting the tape. I also said we'd have a year-end rally, and that the new year would start weak – and **that part of the call worked out; we have a bear market underway with a very powerful sell-off since New Year.** Suddenly the focus is going back to China, after a period when that was out of the news and the focus was on never ending free money.

So **this year's start is a warning flag for the whole year.** We don't have an accommodating Fed, we have worldwide overproduction, estimates for earnings for 2015 and 2016 are being revised down. And the Fed can't immediately run to a rescue. So the equity markets grind lower, punctuated by sharp rallies – but the correct action will be to sell those rallies. **At least for a year, there'll be a bear market in stocks.** In fixed income markets whilst there is little value prices will likely grind higher.

As to inflation I don't see any engine for it due to the chronic state of overproduction. Even in the oversupplied resources sector, pandering to the Chinese appetite itself stimulated by created credit, have we seen a big bankruptcy or massive scale-back? No. Glencore and the like continue to maximize output for cash flow.

So I'm pretty pessimistic on equities. The key takeaway is that **the technocracy provides an illusion of control. Their actions are crafted to benefit key interest groups, but I am not convinced they know very much about what they are doing. I think that confidence in this technocracy will erode further this year.** And **the whole inherent weakness in the economic pitch, which has been exacerbated by ultralow interest rates that created investment in a distorted fashion, stares us in the face.** The Fed is taking a first step in normalizing rates, just when it isn't needed. It is far too late to be tightening! It's remarkable to think that we haven't had a rate hike for 9 years! By its actions the Federal Reserve will reinforce the next cycle rather than counter it.

But I agree with Jim's point: we're here not to trade our opinions, we're here to trade reality. And what counts is not what we think the Fed should have done, but what they do. There might be another rate rise, maybe one more, maybe two, but by then that will be it due to that chronic overcapacity and the slowdown in activity. All the while China is going to export as much deflation as possible.

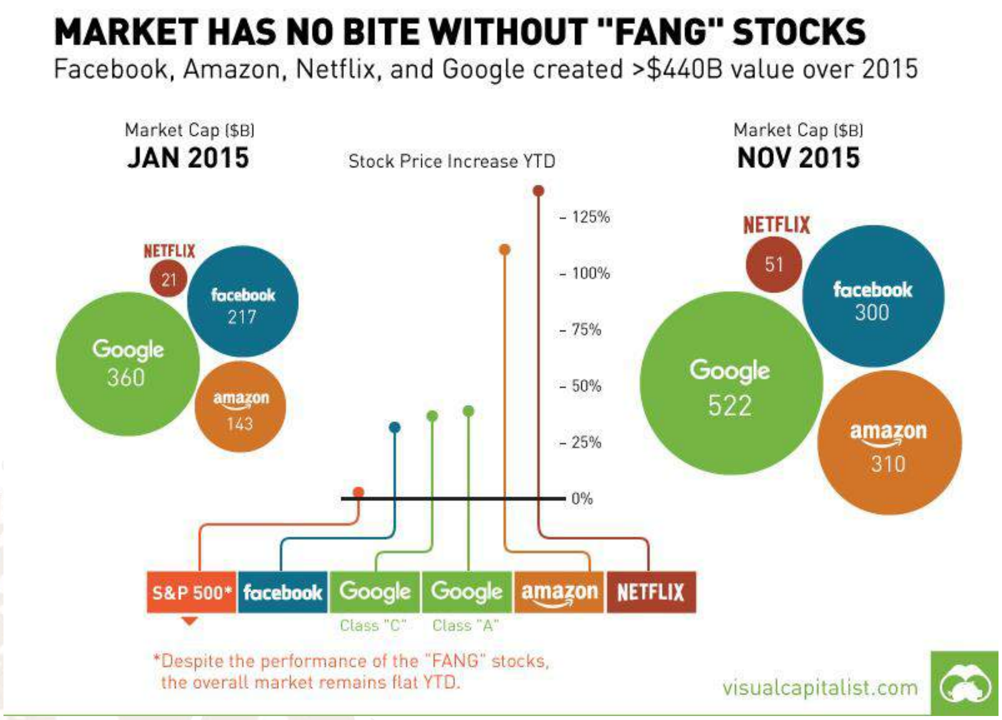
Ronald Stöferle:

Very good points! Thanks, Zac!

Just a few short comments on that. We already wrote about it in summer. Stanley Druckenmiller (who doesn't have the worst track record) said in early summer last year that we were already in a bear market. The chart of the Russell 2000 Index already confirms that. In the S&P 500, we've had for the last 4 quarters in a row declining earnings, and for the last 3 quarters we've had declining sales numbers. All this shows the weakness of the market.

I think, what held the markets last year were the "FANG" stocks (Facebook, Amazon, Netflix and Google) – and those broke down in the last few weeks.

The "FANG" stocks gain weight



Source: visualcapitalist.com

Percentage of stocks above 200-day average

Source: barchart.com

Heinz Blasnik:

That’s also deflation! We used to have the “Nifty Fifty” that have become the “Nifty Four”.

Ronald Stöferle:

And another crucial topic is the US dollar. In fact, the broad dollar index is still rising and making new highs. However, compared to the euro, the Japanese yen and gold, the dollar looks actually pretty weak.

Source: investing.com

Trade-weighted US dollar index (broad)

Sources: Federal Reserve St. Louis, Incrementum AG

We all agree that deflation and disinflation is the name of the game. In our “Letter to Investors” we wrote that we might see rising inflation soon, mainly driven by the base effect. However, meanwhile **oil has gone down significantly again, so we won’t see that base effect in the next few months. But we all know that due to the**

debt situation and due to the structure of our monetary system, deflation is unacceptable for politicians as well as for central bankers.

Now the question is: What will trigger the change from deflation to inflation? We expect much more fiscal interventions and at least the announcements of huge infrastructure programs and perhaps something like People's QE (former called helicopter money).

Heinz Blasnik:

The commodity market is at its highest stage of production and the furthest removed from the consumption stage. And in a typical fashion, this is the first sector in the economy that has come under pressure.

When we look at this sector and when we look at commodity prices, we not only have to consider the supply-and-demand situation of commodities themselves, but we also have to consider the money relation. How much money has been created in the past 10-15 years? The US True Money Supply has increased by 285%; China's money supply has risen by 300% just since 2008; European money supply is up since 2008 by 90%; even Japan's money supply has increased by 50% in that time. So we have to consider that while commodities are under pressure due to the economic situation (so the supply-demand-perspective), at the same time there's a lot of money in the system**. If you look at different asset classes into which money might be deployed, then we have certain asset classes that are clearly overvalued at the moment, and others – at least relative to their recent history – look undervalued. Thus there might be some effect on relative prices simply because stock markets start declining. Some people might consider to buy commodities just because the money has to go somewhere.** Surely, it will go to gold first. But usually, if gold starts to rise, at some point later industrial commodities rise as well (e.g. after 1999/2000). I agree with Jim that it will take a while still before we will see such a bottoming in commodities.

But there're also some technical reasons that suggest that things could turn around faster than expected. Remember the cover story in *The Economist* with the title "Drowning in oil" in 1999 when crude oil was trading at 10$ per barrel. The story was about the many tankers at sea that were full with oil, because there was no longer any storage space. They also talked about the fact that the OPEC lost control and that it wasn't able to cut production, because it needed the income, so cartel members were said to cheat when quotas were lowered – basically all the things that we're hearing also right now. But then the oil price turned up. Of course we don't know, if the current oil price discount is already sufficient – probably it's not. But **at some time fundamentals will still look awful, but the price will have discounted fully by them.** It will be very difficult to pinpoint this and it's going to happen in a matter that is not obvious. **Technical and sentiment conditions will be more informative on when we'll have the bottom.**

Another technical point about oil that hardly anyone is speaking about: when everybody in the oil market is producing all-out, then there is no additional capacity. And despite of everything, global oil demand is at a record high, it's still growing. The supply side is anything but calm, the new Saudi-Arabian government is taking a great many risks – some things can happen that are not predictable. Or, as Zac mentioned, we might see some big bankruptcies. I actually think that's going to happen. And then the market might be surprised by some big changes.

Let me also make some quick comments on **the stock markets. The fact that it declined in the first weeks of January is very significant statistically and historically.** Actually it's a seasonally strong time of the year. It's a strong signal – in this case a bearish one –, if markets do the exact opposite as what the long-term seasonal trend suggests. For example, 1962 started with very weak 10 trading days in January, and the overall decline by June was amounted to 25% since the beginning of the year; in 1973-1974 the market went down by more than 50%; or see Tokyo in 1990. There are similarities between today's stock market chart and that of 2007/2008. So there is a very strong historical pattern.

What Jim said about the election year and the dilemma of the Fed: the outlook on 2016 appears to support this pattern. There's a lot of uncertainty, we even have no idea who will most likely be the next president, but definitely the next president will be a different one. And **the last two times when we had a new president – namely in 2000 and in 2008 – we also had major bear markets.**

Mark Valek:

Thanks Heinz for contributing a lot of interesting points!

Let's revisit the initial question: What could really reverse these deflationary forces?

Jim, last time you named 5 options that the Fed would have: more QE, lower / negative interest rates, Currency Wars (= devaluing the dollar), Forward Guidance (= telling the market over some period of time what will be the next policy) and People's QE (former called helicopter money). People's QE has already been mentioned by Ronni. Do you think we'll see or we have to see some really big fiscal programs that aim at reversing that trend?

Jim Rickards:

I think monetary policy and money supply have reached the stage of irrelevance for the short run – even though it definitely matters a lot in the long run. The Fed has capacity to do harm by raising rates because of impact and expectations; but the ability to do good in the sense of creating inflation / fighting deflation through various forms of ease is almost gone.

Generally, I would distinguish between forecasting what the Fed might do and what I would do as I regard it as being effective.

What Forward Guidance does: if the Fed says they're not going to raise rates, people will do carry trades, they will basically short the dollar, borrow overnight and invest in emerging markets for a longer term. They'd risk something if the Fed raises rates, but if the Fed says it won't raise rates, one can put on the carry trade with confidence. And this tends to weaken the dollar, which imports inflation. **So there's a channel to get inflation through Forward Guidance.**

I think Forward Guidance is realistic and I expect it for September. I don't expect rate cuts before December, but then there is a very high probability for negative rates. However, I don't think that any of these tools will work, because they're offset when there is a declining velocity, which is a psychological phenomenon. My view is that psychology has suffered once in a century, e.g. during the Great Depression. What happened in 2008: it takes a great deal to change that psychology and it takes a great deal more to change it back again.

So **I don't see the catalyst through monetary policy; there might have been different channels that were changing the psychology to declining velocity.** Milton Friedman assumed that velocity was constant – but that's completely incorrect.

Now, getting back to the question: **What will cause inflation, what will be the catalyst? It will be fiscal policy, it will be helicopter money / People's QE.** The difference is that in normal QE central banks are printing money by buying bonds from the banks which could use the additional liquidity to give more credit to the economy. However, they tend not to do this but redeposit the money in form of excess reserves at the central bank, so the money is neither lent nor spent. So the impact on velocity is now really negative and it doesn't create inflation. But helicopter money / People's QE is different! **First one runs much larger fiscal deficits, then one borrows to cover that deficits, and then one monetizes the debt through the central banks. So there is still money printing, but it's money printing to monetize debt with the money that <u>has already been</u> spent.** That's the difference to traditional QE, where one is operating through channels with the money is not being spent. Then the progressives in the Labour Party in Great Britain and the Democrats in the USA will pick programs like health care etc., the Republicans will spend it on defense, weapons, IT etc. They will probably spend a lot.

Interestingly, the Paul Ryan compromise on the budget resolution in December happened on the same day that Yellen raised rates. It was like the perfect passing of the baton from monetary policy to fiscal policy.

If you want to understand this fully, there's a new book by Adair Turner: "Between Debt and the Devil". Turner is a former head of the FSA (basically the top financial regulator in the UK) and head of the *Institute for New Economic Thinking*, which is a think tank sponsored by George Soros. So Adair Turner is really a talking horse for the Soros agenda. In the book he lays out the case clearly, it's just an absolute playball for the global financial playbook to bring back inflation. And the way you can control debates is by controlling vocabulary. Vocabulary or certain terms can force people to think the way I want – it's a kind of thought control.

Turner introduces a new term, which we will hear a lot more: **"debt pollution". This a way to hitch the fiscal policy expending to climate change debate.** (That's interesting, because you hear remarks of the IMF on the climate change – why should the IMF care about climate change?) But obviously, the implication is that there's a "good debt" and a "bad debt": the good debt will be for progressive welfare programs and infrastructure spending.

So we can see helicopter money to come. We can see the fiscal Keynesian rhetoric coming. It will be old wine in new bottles – like using words like "debt pollution" to steer the spending into favored programs. **New spending programs will come extensively in 2016.** Turner's book is a good blueprint for the things that are going to happen.

So the answer to your question is: the catalyst will be helicopter money in the form of fiscal spending.

Let me just quickly let you know also my thoughts on the election. Truly, as Heinz said, new presidents in 2000 and 2008 came at times that were very bad for markets. Another aspect was told me by a very plugged-in US government bond market insider. When one gets into the final days of administration – which are starting now and prevail until the summer and into the fall, when the president is leaving but is still temporarily in office – a large number of middle-level officials do also leave (on the assistant secretary level). Many Treasury Department officials who manage the government debt, the auction process and the relations to the Primary Dealers are walking one by one out of the door and they're not being replaced by high-quality people. Thus **one other policy dysfunction might be that it**

might become difficult to coordinate policy because of talent departing from the administration.

Mark Valek:

Thanks for that! So you basically agree on our thesis that fiscal policies are going to come. However, you assume that these programs come a bit later, probably more than a year from now.

Zac Bharucha:

I don't have such a strong view on that point. Inflation, deflation, disinflation – these arguments have been discussed for many years and sometimes the discussions can remain on an abstract level without any practical usefulness. What counts is that if you're long in gold and gold is in a bull market, then you make money! The reasons for why gold is in a bull market are of secondary importance. I'm not sure that based on a theory of knowledge you can say why it is in a bull trend. That would be a supposition. I'm more interested in finding trends in the markets that I can exploit with real money. A narrative might give comfort but it is not a necessity for prosperity! Is the oil price oversold or is it a symptom of a general deflation? The reason might be unknowable.

When it comes to considering the liklihood of a generalized rise in prices: I don't see that outcome as likely. I think we have the circumstance of massive debt overhang and no real income growth – despite all the austerity chatter debt has just been shuffled from one account to another. So I don't see an engine of proper inflation based on for example a demographic effect, as the population is ageing or a housebuilding and chattel buying phase, or an inflation pull due to production lagging behind consumption. I don't see any such engine! I see the opposite. I see mature economies that are massively debt-burdened, that can't create enough jobs where workers receive real wage growth; and I see the chronic overproduction coming out of China, where all the post-crash money was created and gave false signals.

Mark Valek:

Thanks Zac!

We have one final, very short question. **If you were forced to set up one speculative trade for this year and have to hold it until the end of December, which one would you do?**

Zac Bharucha:

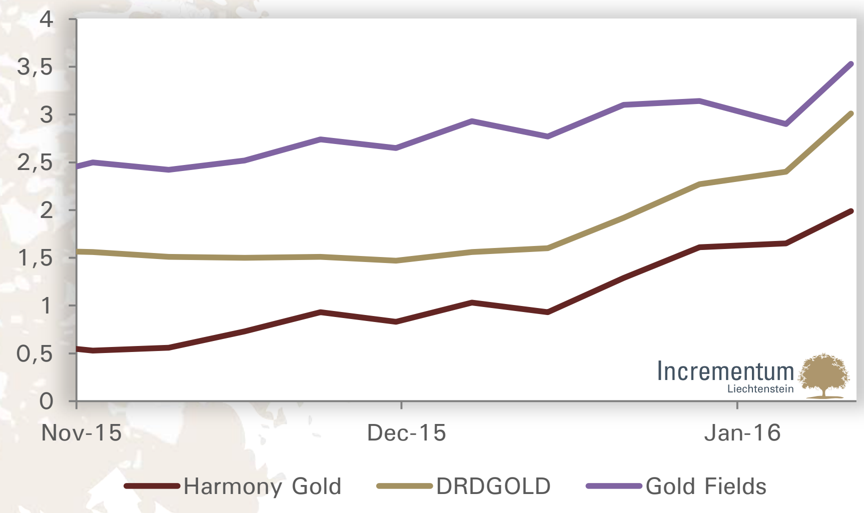
I can start with that. But I want to let you know that **that's not how I think about markets! I am constantly in search of appropriate risk reward ideas.** I'm interested in exploiting trends and trend reversals and the calendar cycle has no particular interest.

However, to get to the drift of your question, I see two trends likely to persist. I think **gold will work higher.** And I think **stocks will work lower.** In the light of the volatility we have experienced since last summer, I cannot give you a precise pattern for the coming calendar year. But I think **the trends that you should try to exploit during the calendar year include a long gold bias and a short equity bias.**

Heinz Blasnik:

I looked where the gold price is actually rising: **in South African rand the gold price is at a record high. And South African gold mining stocks have begun to outperform the rest of the gold mining sector.** So that's a trend that could have been exploited since November and I think it's going to continue for a while. But I wouldn't say this is going to last until year end, at least one cannot be certain. Maybe the South African gold stocks are going to outperform for a few months and then the baton is going to be handed over to the rest of the gold sector.

South African gold stocks



Sources: finance.yahoo.com, Incrementum AG

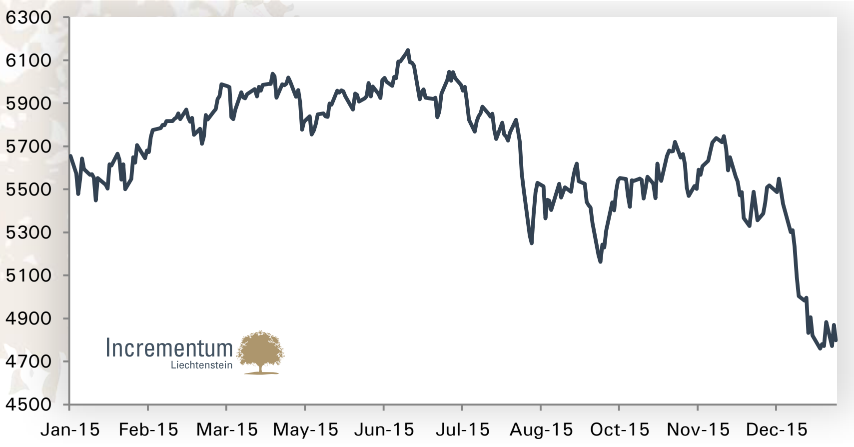
Gold (in ZAR)

Source: goldprice.org

I also think one should be long gold as long as no major support levels that have been established recently are broken. If that should happen, then one has to step aside.

In addition, the weak January, the Russell 2000, the Dow Jones Transportation Average, the leading indexes to the upside are now leading to the downside, market internals are weak – it's a typical bear market situation! Margin debt topped out in April. So **everything points to a bear market in stocks.** How far it will go, how long it will last – I cannot tell you.

Russell 2000 total market index



Source: Federal Reserve St. Louis, Incrementum AG

Long-term US Treasuries should actually perform reasonably well in this environment. I would avoid the European government bonds because of the ECB's influence there and the perception of Europe's fiscal situation is that it's a bit risky. But you have to consider that **there's not much upside left for the dollar compared to other major currencies.** Historically, once the Fed started to raise rates, the dollar soon tended to top out. (And that's also one of the reasons why one should expect gold to rally.)

One comment on inflation: **What could trigger the switch from deflation to inflation is when people generally lose confidence in the money issued by the state. And that is unforeseeable in timing and has nothing to do with the general performance of the economy. So even if everything points to deflation, this can flip around. If fiscal spending becomes a big issue, this could foster the loss in trust – but it might take a while.**

Mark Valek:

Thanks Heinz! And some final words from Jim?

Jim Rickards:

I agree with Zac and Heinz. I would be long gold, long US Treasuries (5 yr to 10 yr). I would have some cash, because it's a good deflation hedge and reduces volatility in the rest of the portfolio.

I would be very careful with equities! Surely, we're in a kind of bear market. But if you go like that the deflation expectations continue, that the rate increase expectations continue, which are one of the drivers of deflation and causing equities to go down, and then suddenly in September the Fed makes a surprise easing in form of Forward Guidance, then it could be a boomerang. That's why the time horizon until December is tricky. **We could have weak equities all the way through summer, and then suddenly if the Fed eases, equities could rally** as they did in the beginning of QE1, QE2 and QE3. So be careful with equities!

In addition, I want to add something to the point Heinz mentioned. Heinz said that after Fed rate hikes commodities have been best performers as compared to different asset classes. That's true if you observe the regressions. But there's a reason for that. The Fed always follows the market: the economy gets a bit stronger, labor markets get a bit tight, inflation goes up and the Fed says "Aha, we have to raise rates." If things continue, labor markets get still tighter, inflation goes higher, commodity prices get higher, then the Fed tightens again. Finally, the economy tops out and things reverse, inflation falls, commodity prices fall and at some point the Fed reacts and cuts; then they are following the market down. Then everything repeats itself. So the point is: **the Fed doesn't lead anything, they're following the market. And that's why historically commodity prices have gone up when the Fed hiked, because they were already going up.** So this historical correlation described by Heinz is completely correct, but it holds true except for now! **This is the first time (maybe since 1929) that the Fed is tightening into weakness.**

They're not following the market, they're trying to lead the market, almost psychologically, they're going to fool everybody in the sense: "Look at us! We're raising rates! This means the economy is getting stronger! So you better react as if the economy is getting stronger, maybe it'll be a self-fulfilling prophecy." That is complete idiocy! The Fed tries to lead, they're tightening into weakness and probably making the weakness more severe. **That might be the one time in 80 years when increases in commodity prices don't coincide with the tightening**, because the Fed is tightening at the wrong time and for the wrong reasons.

We've never had a Fed chairman in history who has been more out of touch with reality than Janet Yellen. People with very high IQs and PhDs from Stanford, MIT and so on that are amazing performers in abstract models and so on tend to lack some common sense (as I experienced during my 6 years at LTCM).

Ronald Stöferle:

All right gentlemen! It has been a great pleasure! Thank you very much for another great discussion!

Appendix A: Members of our Advisory Board:

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.

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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