Sprott | Gold Report
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Oopsie Daisy! Equity Markets Stumble in Early February

Authored by Trey Reik, Senior Portfolio Manager, Sprott Asset Management USA, Inc.

On the heels of historic 2017 complacency in broad equity averages, U.S. financial markets were jolted in the first week of February. The S&P 500 Index[1] ended its record-setting streak of 404 trading days unblemished by a 5% correction with a startling two-week pullback measuring 10.16%. Like a Rorschach inkblot, market observers have branded February's dislocation to fit their fancy. The bullish precis suggests the short-gamma of a tiny group of inverse-VIX ETFs mauled equity markets with bursts of compulsory selling, but these funds' quick demise has freed equity averages to resume their upward slopes. Echoes of Chairman Bernanke's March 2007 proclamation that subprime "seems contained" reverberate through recent FOMC characterizations of short-VIX equity declines as "small potatoes" with "virtually no consequence"(Dudley 2/8), "the most predicted selloff of all times" (Bullard 2/6), and ominously, "more volatility in markets can be a healthy thing" (Kaplan 2/7).

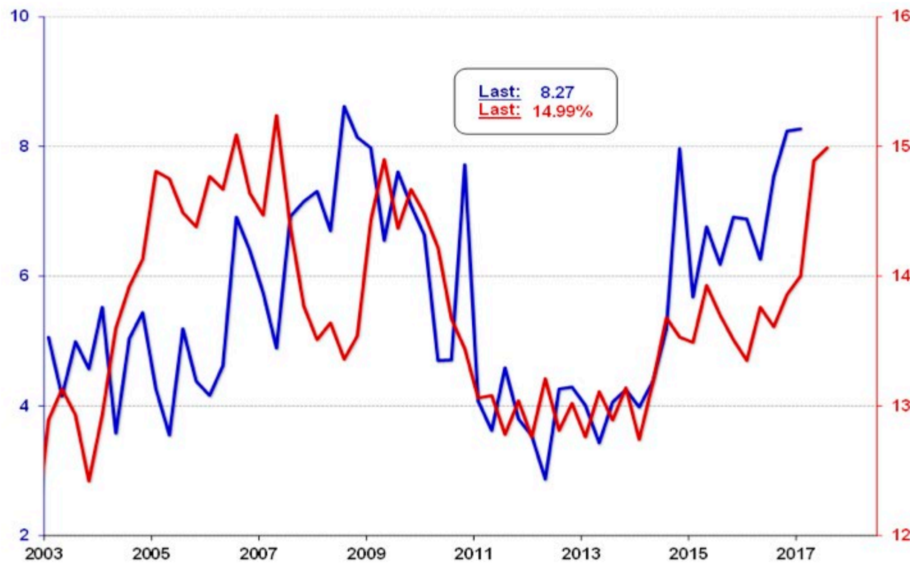
Fed Rate Hikes Inflict Damage on Financial Assets

As non-consensus as our gold thesis remains, early 2018 events have only served to validate our contention that in the context of excessive U.S. debt levels, **any increase in domestic rate structures (short or long) will inflict damage across the broad spectrum of financial assets**. Originally on the short end, the Fed's initial December 2015 rate hike almost unhinged the global financial system (China was forced to devalue and 2016 U.S. GDP growth slumped to 1.85%). It took **12 months** for the Fed to condition markets sufficiently to withstand a second baby step from the zero bound, a telling state of affairs for any legitimate tightening cycle. In our view, only the sentiment surges from President Trump's surprise election and December tax bill have provided sufficient cover for the Fed to eke out incremental fed fund hikes to their still historically insignificant 1.50%.

Rising Consumer Stress?

After initial corporate bankruptcies in over-levered industries such as retail (Q1 2017), it has taken a bit longer than we would have expected for Fed rate hikes to sour broad credit pools, but that fermentation is now brewing. The big four U.S. banks (JPM, WFC, BofA, Citi) experienced a 19% jump in credit card losses during 2017 (to $12.5 billion). As shown in Figure 1, the Fed's three rate hikes between December 2016 and June 2017 quickly translated into rising credit card interest rates and a **lockstep surge in seriously delinquent auto loans** (all credit scores). By late 2017, 9.7% of **sub-prime** auto loans originated by auto finance companies were more than 90-days delinquent, just below their crisis peak of 10.9%.

Figure 1: Seriously Delinquent Auto Loans (Blue) versus Average Credit Card Interest Rate (Red) (2003-Present)



Source: Federal Reserve; Meridian Macro.

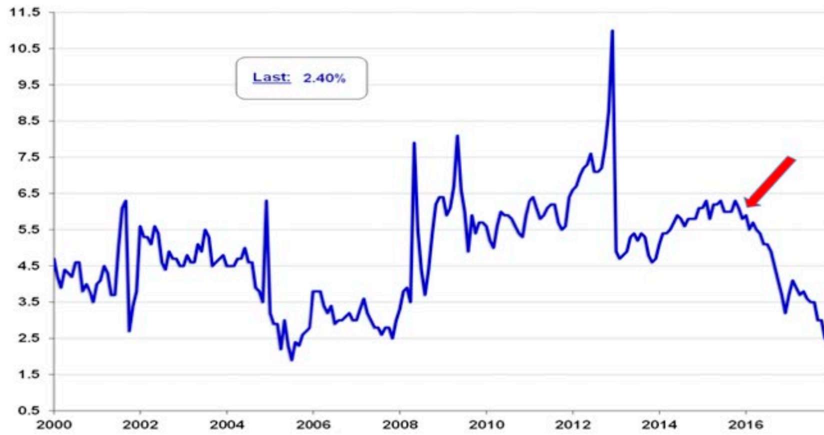
On 2/8/18, the Mortgage Bankers Association raised eyebrows with the news that Q4 mortgage delinquencies soared to 5.17% (from 4.24% in Q2). During the past 30 years, the MBA delinquency rate has risen above the critical 5% threshold on only three occasions: March 1991, June 2001 and June 2007, three especially perilous junctures for financial assets.

Our anecdotal observation has been that very few investors yet equate Fed tightening with rising consumer stress. A degree of comfort certainly accrues from the Fed's household debt-service ratio, which still registers a historically benign 10.29% of disposable income (Q3 2017). Prevailing logic asserts that while debt levels are high, rates are still low, so the debt-service burden remains manageable. We would caution against this conclusion because we believe debt-service ratios have become an ineffective barometer of the consumer stress they were designed to capture. Debt-service ratios measure U.S. **aggregate** debt obligations versus **aggregate** disposable income. **Unfortunately, the intersection of these two series no longer speaks to actual people**. The reality is that most debt obligations are carried by one subset of Americans while the lion's share of disposable income is enjoyed by a largely different subset.

Personal Savings Have Declined

To us, a far more telling measure of the impact on consumer comfort of recent Fed hikes has been the coincident collapse in the personal savings rate. As shown in Figure 2, the personal savings rate stood at 5.8% of disposable income when the Fed first hiked in December 2015 (red arrow). By December 2017, the savings rate had crashed to 2.4%.

Figure 2: Personal Savings as Percentage of Disposable Income (2000-2017)



Source: BEA; Meridian Macro.

To demonstrate just how quickly Fed rate hikes can impact monthly cash flows of American consumers, we plot in Figure 3, the monthly ratio of personal interest payments (excluding rent) to personal savings. The current Fed tightening cycle has already led to considerable cash flow stress for many consumers. **Indeed, for just the fourth time in history, monthly interest payments are set to exceed monthly savings**. With all due respect to the Fed's dot plot, we find it highly unlikely the FOMC will enact three or four rate hikes this year unless there is **significant** improvement in the variables displayed in Figure 3. We suspect FOMC participants are profoundly rooting that Trump tax cuts will deliver their advertised boost to take home pay (wages, hours worked) so consumers can ease their reliance on credit cards to fill monthly budget gaps.

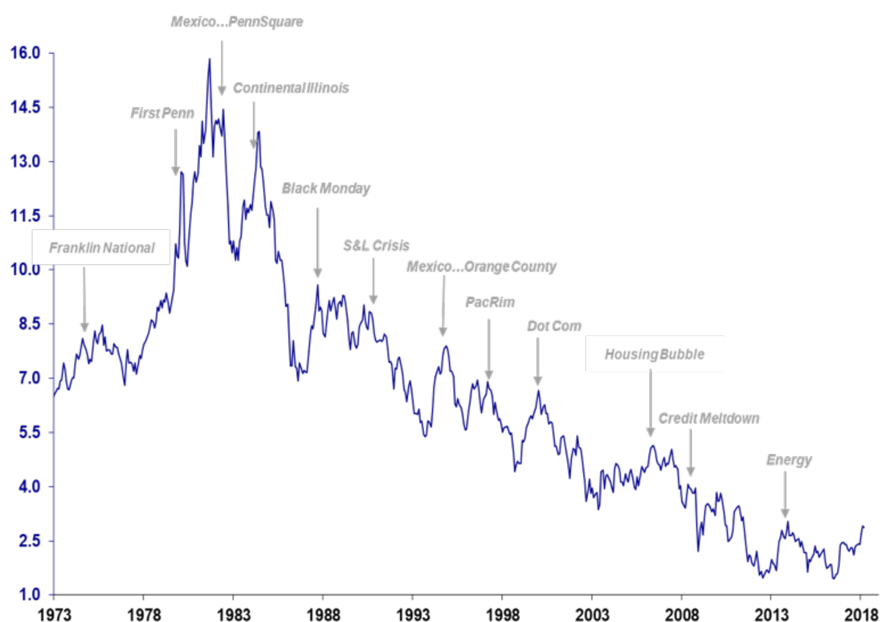
Figure 3: Fed Funds Rate (Red) versus Ratio of Personal Interest Payments to Personal Savings (Blue) (1961-2017)

Source: BEA; Meridian Macro.

Damage at the Long End of the Spectrum

On the long end of the spectrum, the collateral damage of rising interest rates materialized in far more spectacular fashion than from the Fed's first rate hikes. The mid-January breakout of 10-year Treasury yields from their 36-year downtrend (around 2.6%), quickly validated by strengthening wage data in the 2/2/18 employment report, promptly kneecapped the S&P 500 by 10.16% (1/26/18-2/8/18), while erasing $5.2 trillion from global equity market capitalization (S&P BMI Index[1]). **Sprott clients should not have been surprised**. We have often referenced the MacroMavens portrayal of 10-year Treasury yields reproduced in Figure 4, below. In every instance since 1982 in which yields have backed-up significantly, a financial crisis has quickly ensued. In a bit of contemporary structural debt irony, financial stress now inherent in bond market sell-offs tends to make their duration increasingly short-lived.

Figure 4: 10-Year U.S. Treasury Yields with Financial Crises Highlighted (1973-2/16/18)



Source: MacroMavens.

Paper Claims Update

In early February, as the Dow posted two 1,000-point declines in the space of four days, a common refrain was, "Market fundamentals have not changed in a week—this is not 2008!" We would agree that circumstances in 2018 are indeed different from those in 2008, in so far as most relevant measures of domestic and global debt are significantly worse today than at their financial crisis peaks. Contrary to popular perceptions of U.S. deleveraging, the Fed's Q3 2017 Z.1 Report discloses that every category of domestic nonfinancial credit (other than mortgages) has soared since Q1 2009.

Business debt has grown 26% (from $11.2 trillion to $14.1 trillion); state & local obligations have surged 35% (from $2.3T to $3.0T); consumer credit has ballooned 47% (from $2.6T to $3.8T); and federal debt has skyrocketed 145% (from $6.7T to $16.5T); all contributing to a 43% explosion in total U.S. nonfinancial credit (from $33.9T to $48.6T). On 1/4/18, the Institute of International Finance reported that total **global** debt had increased 56.4% during the past decade (from $149T at year-end 2007 to $233T at Q3 2017), reaching 318% of global GDP. For reference, at 318% of GDP, every 25 basis-point rise in prevailing interest rates costs the world economy 0.8% of global GDP. **Because debt levels were identified as a direct cause of the Great Financial Crisis, we recall in the early recovery years a sober and shared resolve to guard against repeating the mistakes of untethered credit creation. What happened to that resolve?**

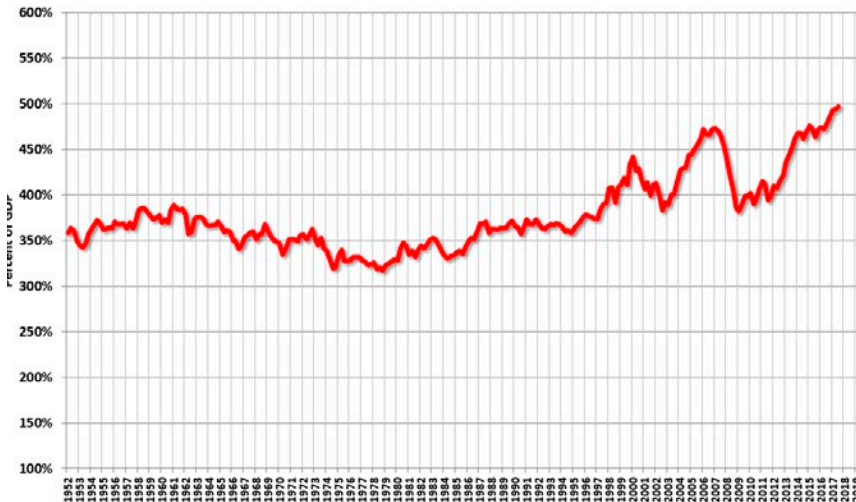
To any forensic accountant charged with analyzing the economic solvency of the United States, unprecedented (senior) debt obligations throughout the U.S. financial system would imply that ever-inflating (junior) equity claims rest on exceedingly tenuous grounds. As every traditional methodology for equity valuation has flirted with all-time highs in recent years, the near unanimous justification cited by equity market participants has been that **equity valuations are a rational manifestation of persistently low interest rates**. Given the famously selective reasoning of equity bulls, we suspect few are willing to concede that **rising** rates will inflict reciprocal damage on lofty valuations. It always seems to work this way.

To us, the greatest yardstick of asset price inflation fostered by eight years of QE and ZIRP has been the Fed's proprietary calculation of U.S. household net worth (HHNW). We find this measure useful in **quantifying** potential impact to financial asset prices from reversal of QE stimulus. In Q1 2009, with U.S. GDP measuring $14.1 trillion, household net worth stood at $54.8 trillion. At Q3 2017, with GDP measuring $19.5 trillion, household net worth had exploded to $96.9 trillion. Incredibly, these statistics imply that a $5.4 trillion increase in U.S. economic output somehow powered a $42.1 trillion increase in U.S. household net worth.

Narrowing in on the past twelve months, we believe the widening disconnect between output growth and financial asset prices became an important factor in the FOMC's decision to pick up the pace of rate hikes. The Fed's Q3 2017 Z.1 suggests year-over-year growth in U.S. household net worth registered a mind numbing $7.2 trillion, during a year in which nominal GDP averaged $19.2 trillion. **This means that U.S. household net worth appreciated in twelve months by an amount equal to 38% of total U.S. nominal output, all during a year in which GDP itself averaged only 2.3% growth, and net national savings expanded by roughly 2%**. Not since Jesus with the loaves and fishes has asset inflation been so spectacular.

Now that the levitating powers of QE and ZIRP are finally being dismantled, it is logical to assume the ratio of HHNW-to-GDP (currently 496%) will begin to settle back towards its historic 350% average prior to the Greenspan/Bernanke/Yellen era of Fed stewardship. Assuming stable GDP, this implies contraction in the aggregate value of U.S. household holdings of stocks, bonds and real estate on the order of $25 to $30 trillion. To us, the only mystery is which asset class will bear the greatest readjustment burden.

Figure 5: Ratio of Total Household Net Worth to Nominal GDP (1952-Q3 2017)



Source: Federal Reserve; Calculated Risk.

Canary

Given market projections for three or four FOMC rate hikes during 2018, combined with the current 2.17% **premium** of 10-year Treasury yields to German bund yields, the U.S. dollar should logically be strengthening. Instead, after declining 9.87% in 2017, the DXY Index[1] is off to a shaky start in 2018, declining an additional 3.28% through 2/16/18. **It is now becoming clear that while 2017 equity markets were celebrating Trumponomics and tax cuts, currency markets were already fretting over implicit deterioration in the U.S. fiscal position**. In recent weeks, as investors have contemplated the $1.5 trillion "cost" of Trump tax cuts, together with the surprising $300 billion spending hike approved by the Republican congressional majority (all against the backdrop of a suspended debt ceiling through March 2019), legitimate concern has emerged over Treasury funding requirements. OMB now estimates Treasury borrowing needs will almost double from $519 billion in fiscal 2017 (Sept.) to $955 billion in fiscal 2018, and then average $1.1 trillion in each of the next five years. Measured as 5.5% of GDP, Treasury borrowing in fiscal 2019 will exceed any year since 1945.

In a case of near priceless timing, the Fed still plans to peel assets from its balance sheet at an annual rate of $600 billion by yearend 2018. The irony of the $600 billion figure is palpable. In Senate Humphrey Hawkins testimony in March 2011, Fed Chairman Bernanke explained how the Fed had calculated the identical $600 billion figure as the optimal scale for QE2 asset purchases:

A rule of thumb is that $150 billion to $200 billion in purchases seems to be roughly equivalent to a 25-basis-point cut in the federal funds rate in terms of the stimulative power for the economy. So $600 billion is roughly a 75-basis-point cut in the policy rate in terms of its broad impact. Seventy-five basis points in normal times would be considered a very strong statement, a very powerful move….

While we have learned nothing is impossible, it seems a stretch that 2018 will witness three or four FOMC rate hikes, $450 billion worth of slated Fed balance sheet reductions and $1 trillion-worth of fresh Treasury issuance, all in the same year. Something has to give.

Mispriced Risk

The greatest upshot from the short-VIX market disturbance of early February has been recognition that eight years of QE and ZIRP have mispriced risk throughout the U.S. financial system. As avid students of market events, our heads now spin with technical distinctions between risk, volatility, VAR, and more Greek nomenclature than we can comfortably process. **No matter how you slice it, interest rate suppression has introduced a degree of unknowable risk to every asset class**. Any investor who claims to understand how eight years of "unconventional measures" will unwind is kidding themselves.

Global central banks purchased roughly $2.0 trillion of assets during 2017, and are currently scheduled to purchase only $500 billion in 2018. Factoring in $450 billion worth of quantitative tightening by the Fed, this means that global central bank liquidity provision will shrink by $2 trillion **in a single year**. We believe the comparatively modest first steps of tightening undertaken to date by the Fed (rate hikes and QT) and ECB (reduction in monthly QE) are already constricting global money-supply-growth viewed by central bankers as essential to stability of elevated debt levels. By way of example, the Fed reports that U.S. January M2 money supply grew only 4.2% (y/y), the slowest since December 2010, and down from 12 and 24-month averages of 5.4% and 6.2% respectively. Even more recently, 10 and 26-week annualized M2 growth had stalled to 1.83% and 3.53% respectively. For perspective, the Fed's current quarterly QT schedule equates to an annualized hit to total M2 money supply of 1.73% in Q1; 2.60% in Q2; 3.5% in Q3; and 4.3% in Q4. Given recent trends, the Fed's current QT schedule would flip U.S. M2 growth into outright contraction during 2018. We just don't think the Fed will let this happen.

1987 Redux?

By all accounts, new Fed Chairman Jerome Powell is an experienced and capable monetary steward. Given the Fed's somewhat bruised credibility in recent years, coupled with the market tradition of testing the resolve of incoming Fed Chairs, we expect Chairman Powell to stick to telegraphed Fed policy as long as possible. On the other hand, it is difficult to ignore developing parallels to the early tenure of Chairman Greenspan.

Mr. Greenspan received Senate confirmation as Fed Chairman on August 11, 1987. Some two weeks into his tenure on 8/25/87, the S&P 500 Index touched a year-to-date gain of 39.5%. Strength in U.S. equity averages had been all the more impressive because it had occurred into headwinds of rising 10-year Treasury yields, which by 9/2/87 had posted a year-to-date surge of 28%. During Chairman Greenspan's first month on the job, in what financial media branded "a tough stance on inflation," the FOMC hiked fed funds by 25 basis points on each of two consecutive days (9/3/87 and 9/4/87) to 7.25%, and then on 9/6/87 hiked the discount rate by 50 basis points to 6.0%. The discount rate hike was the first in three years, and the fed fund hikes brought the total for the unfolding cycle to 137 basis points. By all accounts, the new Fed Chairman had effectively demonstrated his mettle. The Fed was on the case…and, of course, the rest is history.

While we hope the remainder of Mr. Powell's first few months as Chairman proves less stressful than the Dow's 1,175 point swoon on his first day on the job, it is amazing sometimes how history repeats itself.

Trey Reik
Senior Portfolio Manager
Sprott Asset Management USA, Inc.
203.656.2400

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[1]The **S&P 500®** Index is an index of 505 stocks issued by 500 large companies with market capitalizations of at least $6.1 billion; it is seen as a leading indicator of U.S. equities and a reflection of the performance of the large-cap universe. The S&P Global BMI (Broad Market Index), which comprises the S&P Developed BMI and **S&P Emerging BMI**, is a comprehensive, rules-based index measuring global stock market performance. The **U.S. Dollar Index (DXY)** is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies.

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