

## Brinkmanship

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Over our two decades following global monetary affairs, we have often marveled at default confidence awarded the Federal Reserve. Don't misinterpret us—the Fed's power borders on surreal. Seven governors and twelve regional bank presidents set the price of money not only for the world's largest economy, but through auspices of the dollar standard system, for the entire globe. No matter how practical "don't fight the Fed" logic has proven over time, it does not diminish the folly that 19 capable and well-supported individuals might possibly price the world's reserve currency more efficiently than free markets.

Record valuations for U.S. financial assets have inured investors to the daunting risks of unwinding eight years of QE and ZIRP. Because such radical monetary policy has never before been deployed, our 19 monetary mandarins, by definition, command no special insight into broad implications of Fed policy normalization. Into this unprecedented monetary vortex steps new Fed Chairman Jerome Powell, a seemingly low-key and forthright communicator bent on rational steps to normalize Fed policy. In this report, we share our perspective that the Fed's dual policy agenda of simultaneous rate hikes and balance sheet reduction, rather than constituting some sort of scientifically-formulated policy elixir, amounts to little more than glorified brinkmanship—the Fed's signature policy tool. Events of the past few weeks only serve to support our contention that Fed tightening is pinching global liquidity to a degree which threatens reigning valuations of traditional financial assets.

## Emerging Markets

In our June report, we highlighted a 5/8/18 speech delivered by Fed Chairman Powell at an IMF-sponsored conference at the Swiss National Bank in Zurich. At the time, we observed that Chairman Powell made specious claims in suggesting "the role of U.S. monetary policy is often exaggerated," especially with respect to its impact on emerging market [EM] economies. Among his most curious assertions, Chair Powell alleged,

*"Monetary stimulus by the Fed and other advanced-economy central banks played a relatively limited role in the surge of capital flows to EME's in recent years. There is good reason to think that the normalization of monetary policies in advanced economies should continue to prove manageable for EME's. Fed policy normalization has proceeded without disruption to financial markets..."*

It was in reading these patently disingenuous assessments that we first recognized our seemingly mild-mannered Fed Chair is actually on a determined crusade to roll back (what he perceives as) over-zealous accommodation of his predecessors, hell or high water. Chair Powell even noted in his Zurich speech that Fed policy normalization is likely to break a few things along the way.

*"All that said, I do not dismiss the prospective risks emanating from global policy normalization. Some investors and institutions may not be well-positioned for a rise in interest rates, even one that the markets broadly anticipate."*

As recently as 10/8/18, St. Louis Fed President James Bullard weighed in to ratify the Powell doctrine that EM disruptions in the wake of Fed tightening will be exceptions to the rule of better preparedness.

*"We do want to take into account international developments. However, I think that what has happened, let's say in 2018, has been limited to countries that have special circumstances attached to them."*

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Well, through 10/12/18, EM currency declines (versus USD) now measure 49.24% for the Argentine Peso, 35.33% for the Turkish Lira, 14.71% for the South African Rand, 13.19% for the Indian Rupee, 12.86% for the Russian Ruble and 12.50% for the Brazilian Real. While the Fed may attribute these FX performances to “special circumstances,” we would counter that these six countries total roughly 10% of global GDP and 25% of the world’s population. For a quarter of the world’s population, we suspect the “special circumstances” most top-of-mind are significant hits to collective purchasing power and quality of life now being inflicted by the Fed’s latest policy reversal.

## Neutral Rate

In mid-September, Fed stewards began to float the possibility that the FOMC’s short-term neutral rate might exceed its long-term neutral rate (3% in current dot plot). In a 9/12/18 speech, entitled “*What Do We Mean by Neutral?*” Fed Governor Lael Brainard opined,

*“It appears reasonable to expect the shorter-run neutral rate to rise somewhat higher than the longer-run neutral rate. These developments raise the prospect that, at some point, the Committee’s setting of the federal funds rate will exceed current estimates of the longer-run federal funds rate.”*

Governor Brainard cited fiscal stimulus (tax cuts) and heightened risk appetite (rich financial asset valuations) as economic conditions potentially supportive of a higher short-term neutral rate. Following Governor Brainard’s lead, Chair Powell espoused the temporarily-higher thesis in his 9/26/18 FOMC press-conference remarks, “Maybe we’ll be raising our estimate of the neutral rate and we’ll just go to that, or maybe we’ll keep our neutral rate here [making a precise gesture with both of his hands] and then go one-or-two rate increases beyond that.”

Why would Fed Governors suddenly propose temporarily hiking rates above long-term targets so painstakingly established in prior dot plots? We contemplate two opposing explanations. Perhaps the Fed fears fiscal stimulus and tight labor conditions are combining to spur steeper-than-desired inflation. Alternately, the Fed may be recognizing that its dual policy agenda is pinching global dollar liquidity to an unacceptable degree, and, in preparation for imminent policy downshift, is jawboning markets to accomplish desired long-end tightening the Fed has so far failed to engender. **While only time will tell, we view probabilities of these opposing interpretations far differently than current consensus!**

## New Sheriff

Displaying escalating self-confidence typical of Fed Chairs, Mr. Powell raised a few eyebrows in a 10/2/18 speech to the National Association for Business Economics in Boston. In his prepared remarks, Chair Powell credited “better conduct of **monetary policy** over the past few decades” for having greatly reduced the impacts of tight labor markets on inflation. [Huh?] In the same speech, Mr. Powell asserted that the Fed’s balance sheet runoff is “working very well.” The following day, in an interview with PBS’s Judy Woodruff, Chair Powell stumbled into a classic central-banker trap in proclaiming, “There’s no reason to think this cycle can’t continue for some time, effectively **indefinitely.**”

Then, in response to a question about the FOMC’s removal of the phrase “accommodative” from its September assessment of monetary conditions, Chair Powell may have finally jumped the shark in proclaiming,

*“Interest rates are still accommodative, but we’re gradually moving to a place where they will be neutral. We may go past neutral, but **we’re a long way from neutral at this point, probably.**”*

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Whoa! With this much global debt outstanding, “a long way from neutral,” equates to, “a bridge too far,” for financial asset prices. Immediately following Chair Powell’s 10/3/18 comments, 10-year Treasury yields popped to seven-year highs (3.234% on 10/5/18) and the S&P 500 Index slumped 6.7% in six trading sessions (to a 10/11/18 close of 2,728.37).

## What Just Happened?

On Wednesday, October 10 and Thursday, October 11, the Dow Jones Industrial Average shed 1,377 points. What the heck? Did anyone see this coming? Well, just as February’s equity-market dislocation was dismissed as ill-fated gamma at a handful of inverse-VIX ETF’s, October’s air pocket is now being pinned on “computer-driven option gamma hedging.” The good news is that by Friday (10/12/18), JP Morgan Chase global derivatives analyst Marko Kolanovic saw clear to proclaim “the majority (70%) of the systematic selling is behind us.” Unfortunately, Barclays Capital’s Maneesh Deshpande quickly countered that “volatility-control and risk-parity funds may need to sell \$130 billion of equities over the next couple of days,” on top of a likely \$40 billion in sales by exchange-traded-fund investors. At the risk of self-impeachment, we wonder, “Exactly which tea leaves are these guys reading?”

Conceding our limited grasp of Greek variables in contemporary markets, we proffer two pedestrian explanations for this past week’s equity-market swoon. First, following a well-established pattern, October weakness occurred directly in the middle of the Q3 blackout for share buybacks (generally two weeks prior to quarter-end through two days after earnings release). **It is getting tough to ignore the fact that equity markets are increasingly vulnerable to dislocation when the undiscerning spigot of share-buybacks is turned off.**

Second, Fed policy may simply be too tight to maintain current financial-asset valuations. As we have suggested, with this much debt in the global financial system, reigning asset prices cannot withstand rising interest rates (of either the long or short variety). Perhaps President Trump summed things best (10/10/18),

*“The Fed is making a mistake. I think the Fed has gone crazy. The Fed is going loco and there’s no reason for them to do it.”*

In our estimation, a cogent analytical framework for evaluating the impact of Fed tightening on global dollar liquidity is maintained by Sprott colleague Andy Lees (Macro Strategy). On a daily basis, Andy calculates the **U.S. dollar value** of global money supply. In the context of the dollar-standard system, especially with \$11.5 trillion in offshore dollar-denominated debt, it is the **dollar value** of global money supply which truly matters in evaluating global liquidity conditions. As Andy logically explains,

*“In a 2-country world, say Europe and the States, if Europe doubled its money supply, then all other things being equal, as the euro would halve, there would be no change in the dollar value of world money supply. On the other hand, if Europe doubled its real GDP, again all other things being equal, then as its dollar purchasing power would rise, the dollar value of world money supply would rise by 50%.”*

In the wake of this past week’s market volatility, the dollar value of world money supply has now declined \$3.691 trillion or 4.29% from its 4/2/18 high. Perhaps more relevant, a 60/40 portfolio of the MSCI World Net Index and JP Morgan Global Aggregate Total Return Bond Index has now declined an annualized 1.89% over the past six months and an annualized 5.36% over the past three months. The 60/40 allocation peaked slightly later than the dollar value of global money supply, but is clearly following the same path. In Andy’s words,

*“The fall [in the 60/40 global portfolio] highlights what is happening at the real economy level, inferring that U.S. rates are too strong for the world, and that the world’s ability to service its dollar debt or buy oil and*

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*other dollar goods is falling. It would appear therefore that President Trump is correct to say that the Fed has over tightened, at least in the context of global growth...*

We may be talking our own book, but it is interesting to note that analysts of Andy's pedigree are beginning to focus on the April 2018 period as a potential tipping point for the impact of Fed tightening on global liquidity. We wholeheartedly agree!

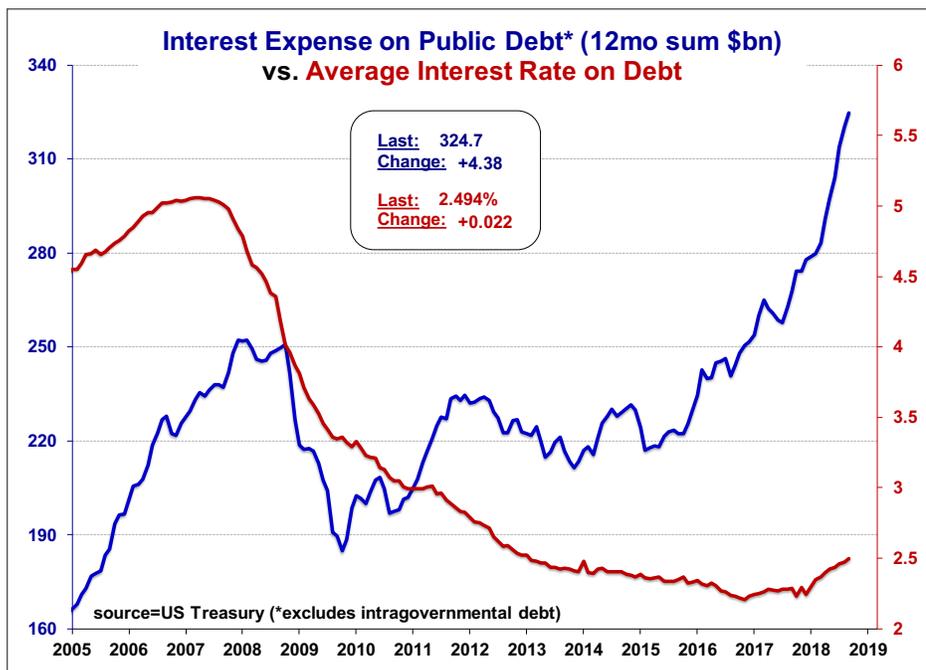
## U.S. as Basket Case?

A topic of current financial-market debate is fundamental assessment of the recent back-up in 10-year Treasury yields (from an 8/24/18 low of 2.81% to a 10/5/18 high of 3.23%). At the risk of oversimplifying, we would suggest Treasury prices are under pressure because there are not enough buyers to absorb exploding Treasury supply. At some point (perhaps already), Chair Powell's bravado about levitating neutral rates will run smack into global disenchantment with the rapidly deteriorating U.S. fiscal position. It is one thing for our foreign creditors to pitch-in to bridge our gnawing federal budget deficit, but quite another to do so while the Fed is actively promoting a rising U.S. rate structure.

U.S. gross national debt rose by \$1.27 trillion during the 2018 fiscal year to \$21.52 trillion (105.4% of GDP). This increase was 33% higher than \$954 billion average-annual-growth between 2011 and 2017. Including fixed-rate, intra-governmental obligations, total 2018 interest on the U.S. federal debt measured \$523 billion, or roughly \$1.5 billion every calendar day. As shown in Figure 1, the floating interest burden on the public portion is beginning to surge geometrically on the heels of relatively modest interest rate increases.

**Figure 1: Average Interest Rate on U.S. Public Debt vs. Trailing Twelve Month Sum of Total Interest on U.S. Public Debt**

(1/31/84-9/30/18)



Source: Meridian Macro.

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Despite recent upticks in GDP, the U.S. Treasury reported on 10/15/18 that the 2018 federal budget deficit surged 17% during fiscal 2018 to \$779 billion. Even more troubling, current Treasury estimates peg the 2019 deficit at **\$1.085 trillion!** In a mid-September report, Bank of America Merrill Lynch ranked 45 global economies by the quality of their domestic finances, measuring twin deficits (current account deficit plus federal budget deficit) as a percentage of forecast 2019 GDP. Among the 45 ranked countries, the U.S. ranked fifth from worst, with domestic finances in better shape than only Argentina, Turkey, Brazil and Pakistan. **Treasuries anyone?**

With all due respect to the gallantry of our crusading Fed Chair, global capital flows are signaling Fed policy is already too tight, and by extension, the U.S. dollar's tepid 3.4% YTD 2018 performance is actually **too strong** to facilitate overseas U.S. funding needs. Morgan Stanley currency strategist Hans Redeker nails these points in a 9/23/18 Bloomberg interview,

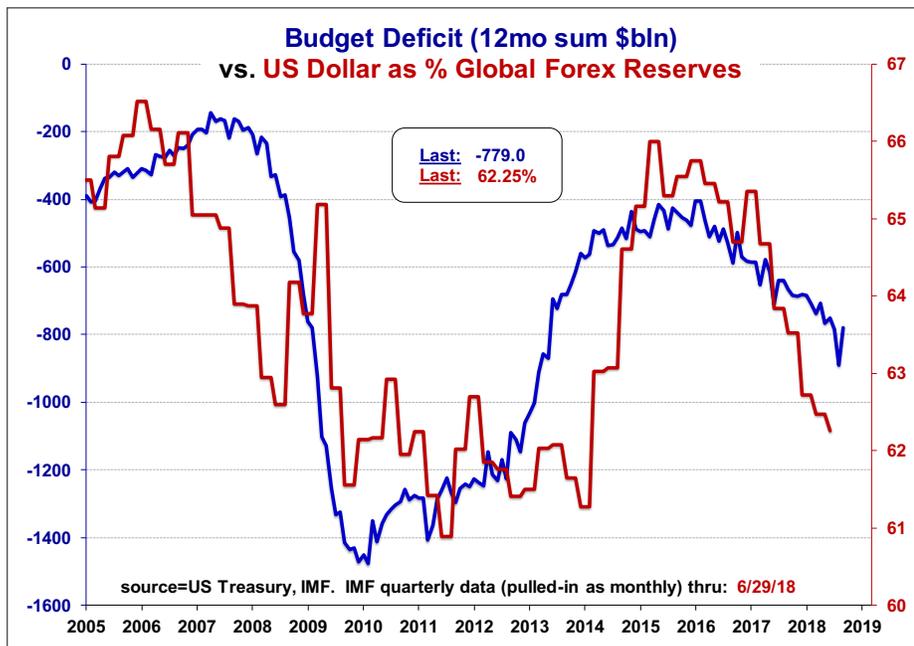
*"Widening dollar-supportive yield differentials should be seen in the context of rising capital import needs. We believe the current yield compensation offered by the U.S. is no longer adequate to attract sufficient foreign funds to cover U.S. capital import needs. The dollar has to decline to attract international funds to the U.S."*

Bingo!

In our addenda, we update a chart we have shared in the past, outlining the tight historical correlation between the U.S. dollar and the federal budget deficit. Tying into Mr. Redeker's comments above, we reproduce in Figure 2, the even tighter correlation between the exploding federal budget deficit and the sinking percentage of U.S. dollar-denominated global FX reserves. **Foreigners are generally proved prescient when first jumping ship.**

**Figure 2: U.S. Federal Budget Deficit versus U.S. Dollar Percentage of Global FX Reserves**

(1/1/05-10/15/18)



Source: Meridian Macro.

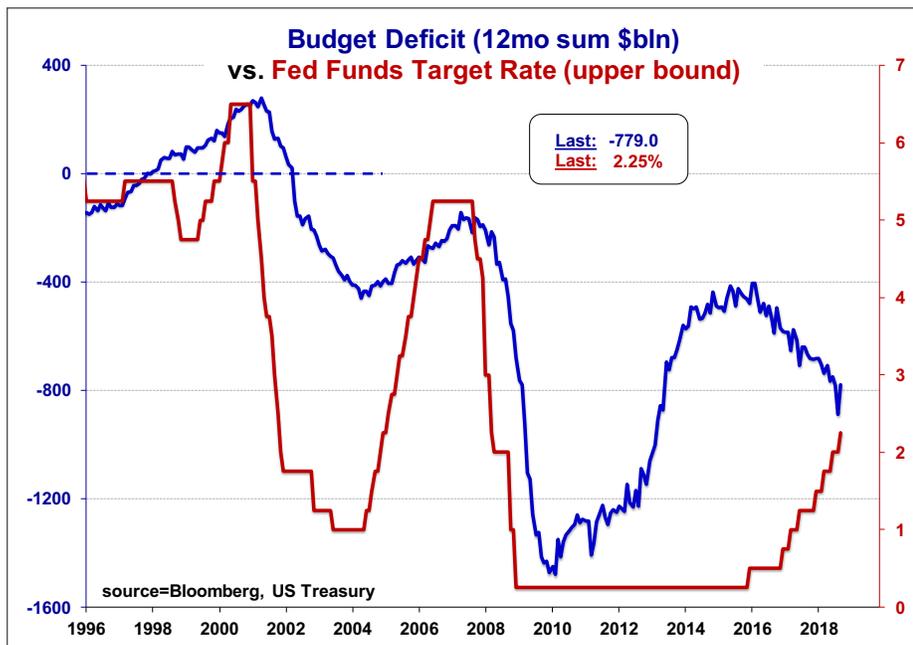
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We offer a final visual we feel best captures the Sisyphean task Chair Powell faces in his quest to roll back eight years of FOMC largesse. Ironically, the petrol of Trump tax cuts is now fueling GDP growth which the Fed is interpreting (we believe mistakenly) as sufficient cover to normalize policy. Figure 3 dramatizes the resulting anomaly that **the Fed is tightening directly into the teeth of an exploding federal deficit**. It is literally only a matter of time before one of the two forces depicted in Figure 3 reverses course with a vengeance. We would suggest wagering on sudden reversal of the surging federal deficit is the losing proposition.

**Figure 3: U.S. Federal Budget Deficit versus Federal Funds Target Rate**

(1/1/96-10/15/18)



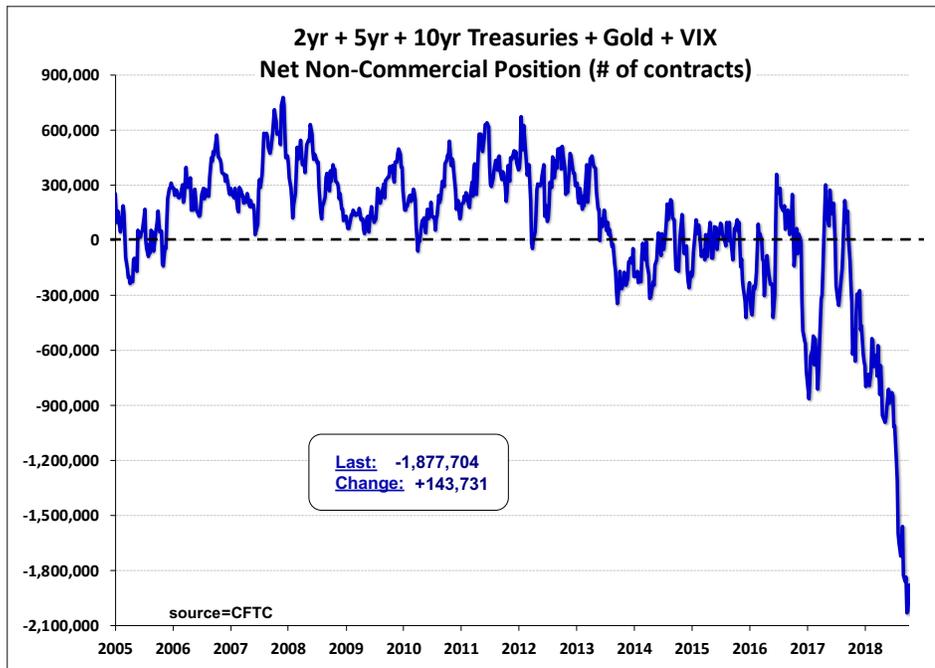
Source: Meridian Macro.

## What About Gold?

During the next few months, we expect asset markets to come to terms with grossly misplaced investor faith in the sustainability of the Fed's dual policy agenda of simultaneous rate hikes and balance sheet reduction. Should our suspicions prove correct, it is interesting to note that not only is consensus positioning **diametrically opposed** to our views, this positioning is also off the charts in terms of its **unanimity**. As shown in Figure 4, aggregate spec short positions in spot gold, VIX, and 2-, 5- and 10-YR Treasuries are completely unprecedented. What could possibly go wrong here?

**Figure 4: Aggregate Net-Short Speculator Positioning on COMEX for Gold, VIX Index, 2-, 5- and 10-YR Treasuries**

(1/1/05-10/12/18)



Source: Meridian Macro.

A common institutional apprehension over gold's portfolio merits is fear that gold and gold equities will prove vulnerable to any sharp downdraft in U.S. asset markets, so why bother with gold in the first place? This logic no doubt stems from "what happened last" reasoning tied to the 2008 market experience. In the fall of 2008, gold succumbed to broad financial asset deflation. We would suggest market conditions for gold in 2018 bear little resemblance to those in play back in 2008. Commodities were perhaps the hottest hedge fund theme on the planet during 2008, exceeded only by ubiquitous shorts in U.S. financials. Complicating matters, the hedge fund community was wildly leveraged on London-based (non Reg-T) "total return swap" platforms, routinely extending 4-to-1 credit for standard portfolios. Most forget that on 9/19/08, the SEC stunned the world in enacting a "temporary emergency action to prohibit short selling in [U.S.] financial companies to protect the integrity and quality of the securities market and strengthen investor confidence." Translation being, hedge funds which were correctly and massively short U.S. financials were forced to cover these shorts and, by way of risk management, liquidate offsetting long positions across the commodity spectrum.

Given the brutal and sustained collapse of broad commodities since 2014, we would suggest commodity positioning in 2018 is virtually opposite that of 2008. Further, when proverbial "detritus" next hits the monetary "fan," the U.S. dollar is unlikely to enjoy anywhere near the safe harbor bid it commanded in 2008, when the Fed's balance sheet measured a svelte \$928 billion, or just **22% of its currently bloated profile**.

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Interestingly, during the 1,377-point, **5.2% decline** of the Dow Jones Industrial Average on October 10 and 11, spot gold **rose 2.9%**. Even more impressively, the venerable Philadelphia Stock Exchange Gold & Silver Index (XAU) **soared 7.84%** over the two-day span. Suffice it to say, these divergent performances herald far different market conditions for precious metals in 2018 than those existing in 2008.

## Got gold?

Sincerely,

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Senior Portfolio Manager  
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203.656.2400

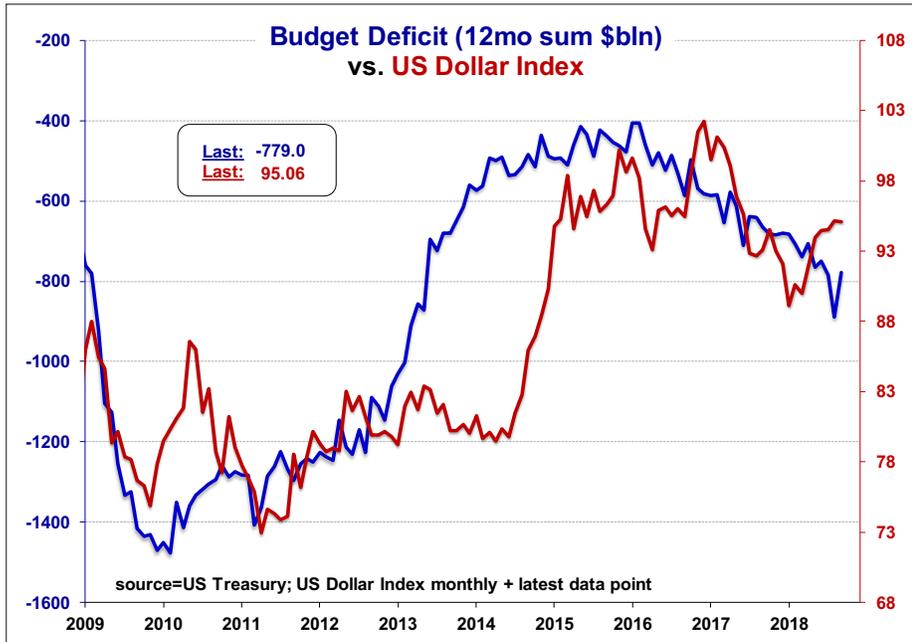
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## Addenda

Figure 5: DXY Dollar Index vs. 12-Mos. Federal Budget Deficit

(1/1/09-10/15/18)



Source: Meridian Macro.

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