Sprott | **Gold Report**
December 20, 2018

Housing Crunch

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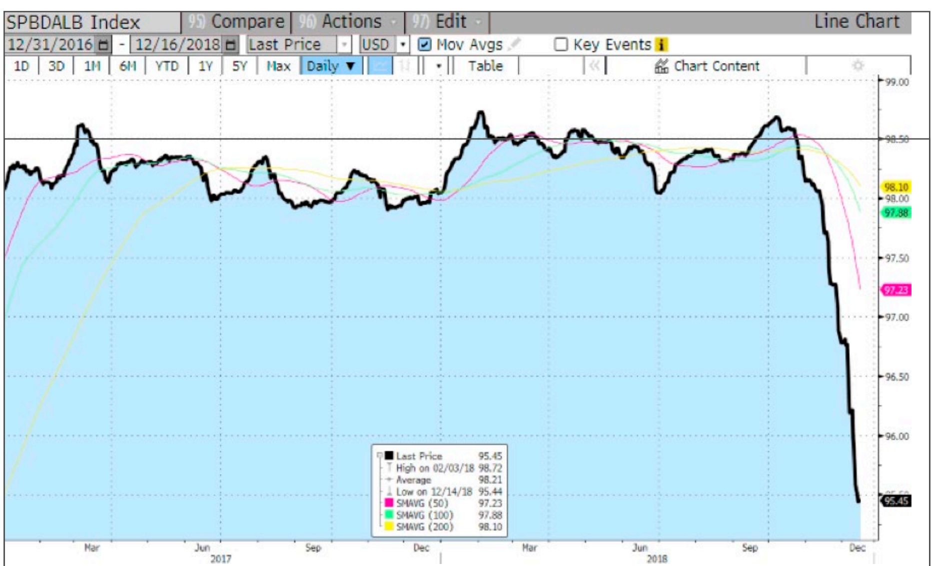
As we enter the holiday season, we close out our review of fundamentals suggesting Fed tightening is nearing completion. Our contention remains that the Federal Reserve's dual policy agenda of simultaneous rate hikes and balance sheet reduction is crimping global dollar liquidity to the significant peril of reigning financial asset valuations. In our November report, we examined the Fed's concern over deteriorating underwriting standards amid runaway corporate borrowing. In this letter, we provide a brief update on recent developments in leveraged lending, and then turn our attention to a critical economic sector being pressured by Fed rate hikes: ***U.S. residential housing***. We look forward to circulating in mid-January a comprehensive update on gold's prospects for 2019 and beyond.

Leveraged Mayhem

We have made the case that Fed tightening is already destabilizing the most vulnerable segments of the corporate borrowing spectrum. In a cruel irony of a central bank-dependent financial system, growing recognition that Fed rate hikes are winding down is pressuring the $1.3 trillion leveraged loan market. During recent years, the inferior pedigree of leveraged borrowers has offered intrepid investors the perceived protection of ***floating interest rates***. As the Fed has tightened, leveraged-loan yields have risen in concert—sweet! Now that probabilities for 2019 rate hikes are plummeting, logic would suggest prospects for the most challenged of corporate credits should actually be improving. Counterintuitively, however, yield-manic investors, sensing evaporating floating-rate protection, are abandoning the leveraged-loan ship at alarming rates.

Figure 1: S&P/LSTA Leveraged Loan Price Index
(12/31/16-12/16/18)

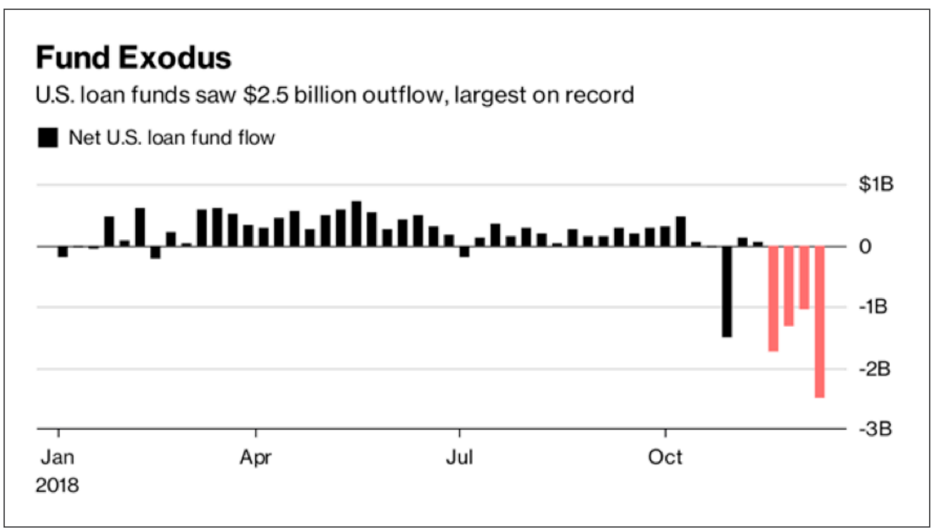


Source: Bloomberg.

As shown in Figure 1, the Standard & Poor's/Loan Syndications & Trading Association (LSTA) Leveraged Loan Price Index has collapsed in recent weeks. Anecdotal evidence suggests leveraged-loan markets have begun to seize in both the U.S. and Europe, with a growing list of scuttled financing (and refinancing) efforts in just the past few weeks: ConvergeOne ($1.3 billion), Vue International ($1.07 billion), Sorenson ($950 million), Perimeter Solutions ($542 million), Ulterra Drilling Technologies ($415 million), Jason Inc. ($383 million), Algoma Steel ($300 million), and Ta Chen International ($250 million). Citigroup Head of U.S. Credit Strategy Michael Anderson estimated in a 12/13/18 report that the number of U.S. leveraged loans trading at or above par—an indication of secondary market demand—had collapsed from over ***70%*** as recently as two months ago to just ***0.9%*** on 12/12/18 (see addenda graph).

There has never been an asset class less suited to mutual fund or ETF formats than leveraged lending. Leveraged-loan ETF's give investors the appearance of liquidity, despite the fact that transactions in the leveraged-loan sector average two weeks to settle. As shown in Figure 2, Lipper reports that after suffering $4 billion of outflows during the three weeks ended 12/5/18, U.S. leveraged-loan funds suffered a record $2.5 billion outflow during the single week ended 12/12/18. Of this total, $1.82 billion was withdrawn from sector mutual funds and $705 million from ETF's. It will be fascinating to observe how accelerating outflows from leveraged-loan funds jive with the extended settlement profile of underlying securities.

Figure 2: Weekly Inflows & Outflows from Leveraged-Loan Mutual Funds and ETF's
(1/3/18-12/12/18)



Source: Bloomberg; Lipper.

In final update to percolating corporate credit conditions, we highlight recent rating trends. Goldman Sachs reported on 12/14/18 that during Q4, $176 billion of A-rated bonds have been downgraded to the triple-B tranche, the highest amount since the oil fallout of Q4 2015. Complicating matters at the high end of the credit spectrum, Citigroup Head of Investment Grade Credit Strategy, Daniel Sorid reports that resolutions of rating differentials between S&P and Moody's are now running 80% in the bearish direction (15% of total corporate credits are currently rated at least two notches apart by the two agencies). Prior experiences of such bearish resolution (2003, 2009, 2013 and 2016) always ended with investment grade spreads gapping out. As Daniel observes,

> *"Times like now, when agencies are tending toward bearish over bullish consensus on disputed credits, have coincided with much wider spreads relative to even currently elevated figures…A narrative of vulnerability will pervade the U.S. corporate bond market in 2019 as an array of mighty U.S. nonfinancial companies take their turn in the barrel…While not quite a law of nature, the IG market is generally downgraded over time, and conditions are ripe for ratings of U.S. non-commodity industrials to undergo their biggest test of the post-crisis period as the rating agencies play catch up and global investors seek alternatives in Europe and at home."*

Adding grist to growing evidence of a general bond market freeze, the Financial Times reported on 12/16/18 that zero high-yield deals had been priced in December,

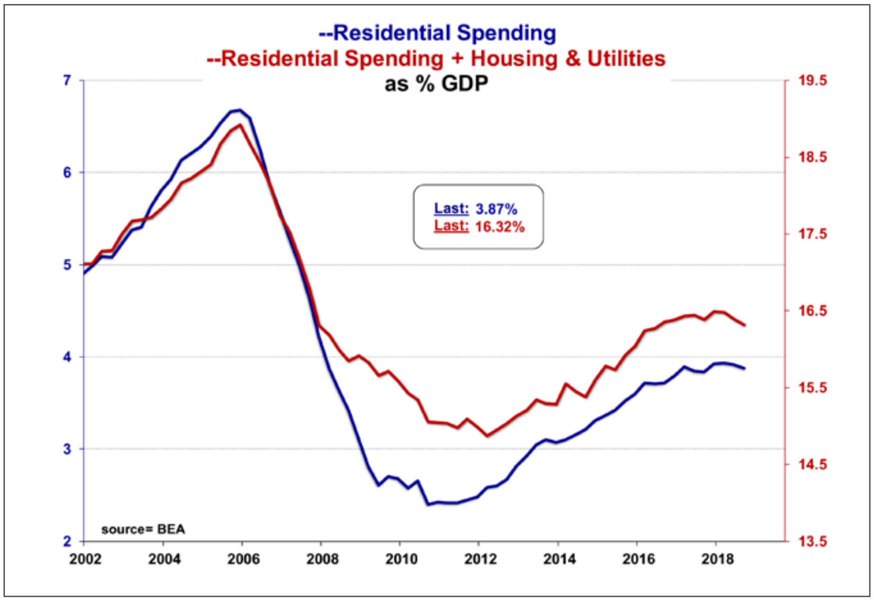
> *"U.S. credit markets are grinding to a halt with fund managers refusing to bankroll buyouts and investors shunning high-yield bond sales as rising interest rates and market volatility weigh on sentiment. Not a single company has borrowed money through the $1.2 trillion U.S. high-yield corporate bond market this month. If that drought persists, it would be the first month since November 2008 that not a single high-yield bond priced in the market, according to data providers Informa and Dealogic."*

With conditions this frosty across the credit spectrum of corporate lending, we expect the Fed to soften its tightening tune significantly at the 12/19/18 FOMC meeting. While a December hike is likely baked in the cake, ***we do not anticipate any additional rate hikes in 2019***.

Housing Crunch

In our experience, no economic sector is more reliably predictive of growth trends than housing. While the contribution of ***residential construction*** to GDP currently measures only ***3.8%***, the derivative impacts of housing on labor markets and related service industries are profound. For example, the U.S. Bureau of Economic Analysis (BEA) maintains a statistical series entitled Housing and Utilities which estimates the value of total ***residential spending*** (incorporating monetary rents paid by tenants and imputed rental value for owner-occupied dwellings). As shown in Figure 3, at Q3 2018, this BEA housing measure totaled ***16.32% of GDP!*** Further, this series does not attempt to quantify add-on effects such as building materials, real estate and mortgage brokers, and title and legal services.

Figure 3: U.S. Bureau of Economic Analysis Estimates for Residential Construction and Residential Spending as Percentage of GDP
(2002-Q3 2018)



Source: Meridian Macro.

While hardly a novel concept, we remind readers that ***Fed rate hikes translate directly into higher mortgage rates***. Further, the contemporary home buyer evaluates affordability far less with respect to the cost of an individual house than to the ***required payment*** to purchase that house. Chairman Powell can crow all he wants about the strength of the U.S. economy, but in early November (11/5/18), mortgage rates touched ***their highest level in 8 ½ years***. The Mortgage Bankers Association (MBA) reported (11/7/18) that total U.S. mortgage applications (purchase or refinance) fell to the lowest level since December 2014. Even more telling, the MBA's Refinancing Index retreated during the same week to its lowest level since ***December 2000***. The concept is just not that difficult to understand—***Fed rate hikes are crushing mortgage activity***.

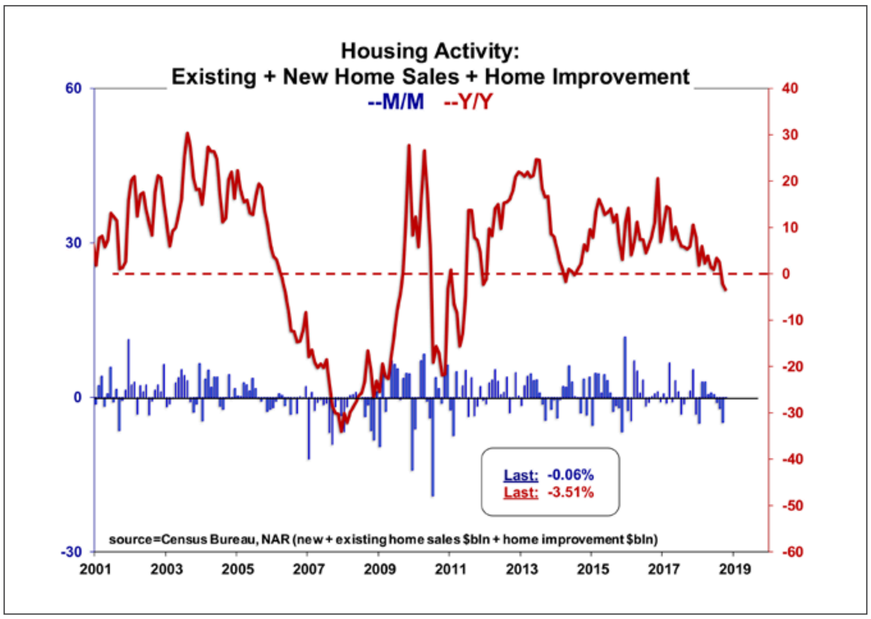
The National Association of Realtors (NAR) reported 11/21/18 that ***existing home sales*** had declined on an annual basis for eight straight months, the longest slump in more than four years. Yet the 5.1% October decline was the steepest year-over-year decline in any single month since 2014. NAR Chief Economist Lawrence Yun left little to the imagination in commenting,

> *"Rising interest rates and increasing home prices continue to suppress the rate of first-time homebuyers. Home sales could further decline before stabilizing. The Federal Reserve should, therefore, re-evaluate its monetary policy of tightening credit, especially in light of softening inflationary pressures, to help ease the financial burden on potential first-time buyers and assure a slump in the market causes no lasting damage to the economy."*

The U.S. Census Bureau reported on 11/28/18 that ***new home sales*** rolled off the predictive cliff in October, printing at 544,000, well below even the most pessimistic estimate of Bloomberg's survey participants, and down sharply from September's 597,000 annualized pace. This 8.9% month-over-month plunge stretched the 90-day decline in new home sales to a startling ***35% annualized rate***. The supply of new homes sitting vacant surged 4.4% in October to the highest level in over five years, bringing three-month growth in unsold supply to a mind-numbing 33% annualized rate. We are talking "brick wall" with these statistics.

Finally, the NRA reported on 11/29/18 that October ***pending home sales*** fell 2.6% month-over-month (versus estimates for a 0.5% gain) and 4.6% year-over-year, the lowest in more than four years, snuffing any expectations for a quick housing rebound.

Figure 4: Percentage Change in Monthly Sum of $Value of New & Existing Home Sales Plus $Value of Home Improvement Expenditures [Month/Month & Year/Year]
(2001-10/31/18)



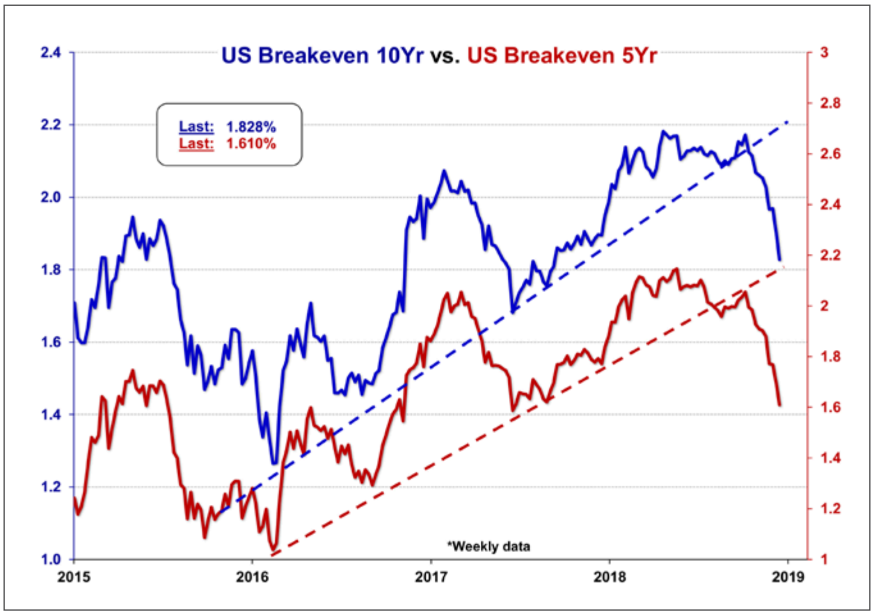
Source: Meridian Macro.

Eric Pomboy (Meridian Macro) combines new and existing home sales with home-improvement expenditures (from Census Bureau construction spending reports) to construct a proprietary index for housing activity. As shown in Figure 4, Eric's composite posted in October its lowest print since the Great Recession (excluding post-recession "noise" data). Given the fact that these depressed housing statistics are occurring against a backdrop of historically low unemployment, strong headline payroll growth and all-time records for household net worth, we are surprised they are not more troubling to consensus. ***Rate hikes anyone?***

End of the Line

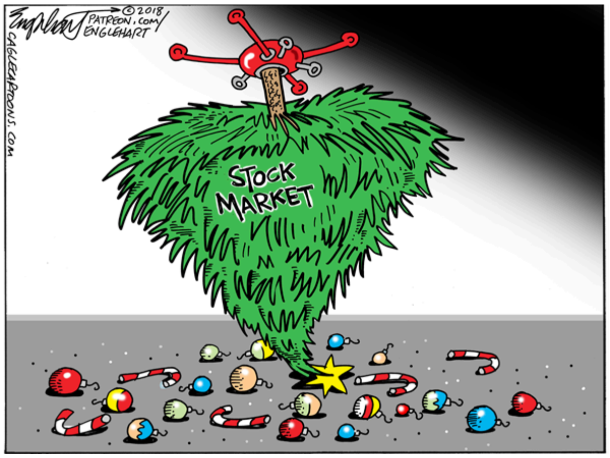
It is one thing for ***us*** to suggest Fed tightening is straining global liquidity and hampering economic growth. It is quite another for one of the highest-pedigree asset classes to flash the signal that the Fed is too tight. Ever since early October, premiums of Treasury Inflation-Protected Securities (TIPS) over Treasuries have been contracting, causing U.S. 10-year and 5-year breakeven rates to crash through trend lines in place since early 2016.

Figure 5: U.S. Treasury Breakeven 5-Year & 10-Year Inflation Rates
(2015-12/12/18)



Source: Meridian Macro.

While this trend reversal has progressed in lockstep with a one-third decline in the oil price (West Texas Intermediate Crude), we are confident that Fed rate hikes have had more to do with the declining global affordability of energy than is commonly appreciated. Side-stepping cause and effect, Figure 5, demonstrates that the 10-year and 5-year breakeven rates so closely watched by the Fed have virtually eliminated logic for additional rate hikes.



At the Federal Open Market Committee meeting on 12/19/18, we expect hikes of 25 basis points for fed funds and 20 basis points for the Fed's interest rate on excess reserves. We would be very surprised if these increases are not accompanied by some brand of white flag on further rate hikes in the FOMC statement. To those with gold exposure, this combination will likely provide a few Christmas portfolio trinkets, shaken off an otherwise challenging holiday season for financial markets.

Sincerely,

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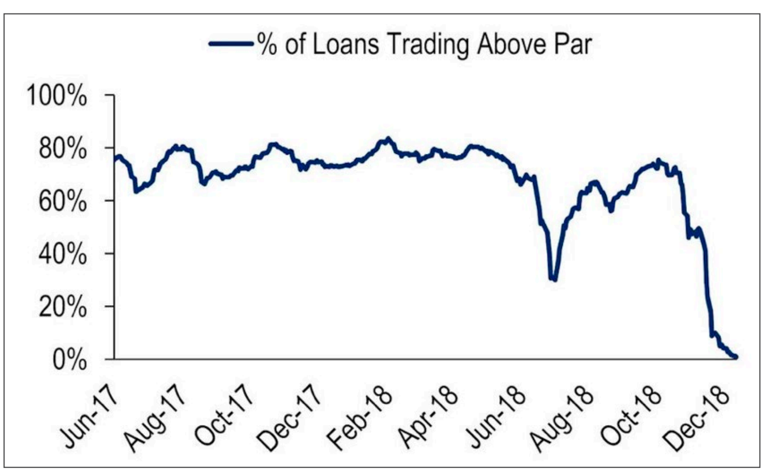
Addenda

Figure 6: Percentage of U.S. Leveraged Loans Tracked by Citigroup Trading At or Above Par
(1/1/17-12/12/18)



Source: Citigroup.

About Sprott

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