

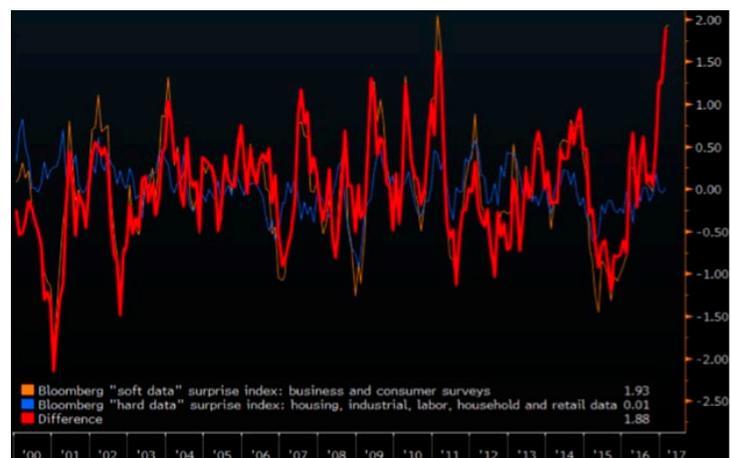
Precious metals resumed their upward climb during the first two months of 2017. During January and February, spot gold rose 8.34% (from \$1,152.27 to \$1,248.33) and spot silver increased 15.08% (from \$15.92 to \$18.32). During early March, however, precious metals suddenly reversed course, with spot gold declining 2.30% and spot silver declining 5.29% through respective March 15 closes of \$1,219.68 and \$17.35. Without question, the greatest variable affecting precious-metal performance during recent weeks has been market handicapping of the Fed's March 15 FOMC meeting. On 2/22/17, Bloomberg consensus expectations for a rate hike at the March meeting measured 34%. Ten trading days later (3/8/17), this percentage had swelled to 100%.

We attribute this swift shift largely to a short stretch of particularly impassioned Fed jawboning, book-ended by the FOMC's two crucial thought-leaders, Vice Chairman William Dudley and Chair Janet Yellen. On 2/28/17, Mr. Dudley commented, "I think the case for monetary policy tightening has become a lot more compelling," but then raised eyebrows with uncharacteristic frankness about U.S. asset prices: "There's no question that animal spirits have been unleashed a bit, post the election. **The stock market is up a lot.**" By 3/3/17, Chair Yellen sealed the deal for a 3/15 hike in a speech to the Executives' Club of Chicago, in which she remarked, "Indeed, at our meeting later this month...a further adjustment of the federal funds rate would likely be appropriate." As avid students of Fed communication, we find the Fed's tone change since 2/28/17 nothing less than abrupt. What factors account for this sudden shift to urgency following years of trademark caution? Might the Fed be reacting to strengthening economic data?

While "soft" economic data and sentiment measures have broadly improved since Trump's election, "hard" economic statistics (historically favored by the Fed) have remained stubbornly weak. During the recent period of hawkish Fed rhetoric (2/28/17-3/3/17), soft data continued to surprise to the upside: the Chicago PMI registered 57.4 versus estimates for 53.5 (2/28); Conference Board consumer confidence came

in at 114.8 versus estimates for 111.0 (2/28); and ISM indices for manufacturing (3/1) and services (3/3) totaled 57.7 and 57.6 respectively (versus estimates for 56.2 and 56.5). Hard data released during the same period, however, continued to disappoint: Q4 GDP (2/28) was adjusted downward to 1.9% versus estimates for 2.1%; wholesale inventories (2/28) fell 0.1% versus estimates for an increase of 0.4% (pressures Q1 GDP); the U.S. trade deficit (2/28) surged to the second worst reading since 2008 (expanding to \$69.2 billion versus estimates for \$66.0 billion); and construction spending (3/1) declined 1.0% versus estimates for a gain of 0.6%. On 3/15, the Atlanta Fed's GDPNow forecast for Q1 2017 collapsed all the way to 0.9%, after registering 2.5% as recently as 2/27 and 3.4% on 2/1. As shown in Figure 1, the spread between hard and soft economic data surprises has now expanded to a 17-year high (Bloomberg). Something has to give, and history overwhelmingly suggests soft data and sentiment measures are likely to recede dramatically in coming weeks. The Fed is well aware of these probabilities, yet still felt heightened urgency for a March hike.

**Figure 1: Spread between Bloomberg's Hard Data and Soft Data Surprise Indexes (2000-Present)**



Source: Bloomberg.

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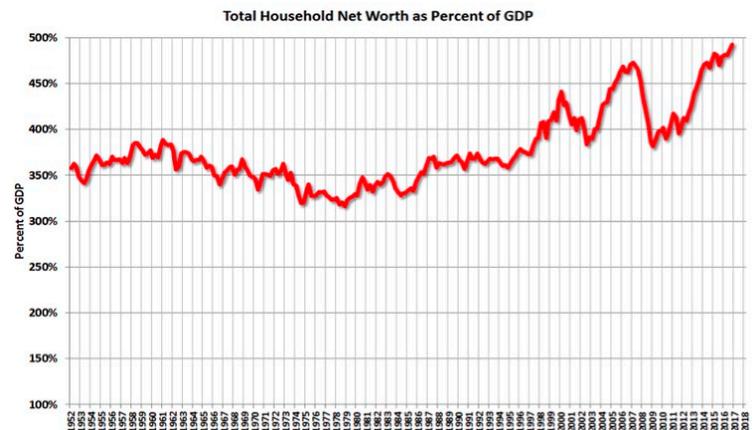
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**Our explanation for newfound Fed resolve is that we believe the Fed is finally becoming exorcised over the accelerating bubble in U.S. financial asset prices.** This past week (3/9/17), the Fed published its Q4 2016 Z.1 Report (Financial Accounts of the United States). According to the Fed, U.S. household net worth increased a staggering \$2.043 trillion during the final three months of the year. By way of context, during the same period, the U.S. Bureau of Economic Analysis informs us that U.S. nominal GDP expanded by some \$180.20 billion. During Q4 2016, therefore, U.S. household net worth increased at a rate **11.33 times** the rate of U.S. GDP growth. **This ratio is patently absurd and seems to have commanded the Fed's immediate attention.** Unfortunately, the Fed's apparent alarm over untethered U.S. financial asset prices is coming far too late to absolve FOMC participants of responsibility for yet another Fed induced boom-bust cycle. After all, the gaping detachment of U.S. household net worth from underlying U.S. productive output has been in full swing for almost eight years. Since Q1 2009, the Fed informs us that U.S. household net worth has increased (through 2016) an astonishing \$38.016 trillion (from \$54.790 trillion to \$92.805 trillion) during a period of time in which the BEA calculates a \$4.766 trillion increase in nominal GDP (from \$14.090 trillion to \$18.856 trillion). During the past seven-and-three-quarter years, therefore, U.S. household net worth has exploded at a rate exactly **eight times** the rate of underlying GDP growth.

As the S&P 500 Index sets new all-time highs on a weekly basis, investors may view discussion of HHNW/GDP ratios as little more than academic flagellation. We beg to differ. There are many relationships of which we are unsure, but we are quite certain no society can increase wealth eight times faster than output forever. Indeed, we attribute gold's ascent during the past 16 years to progressive recognition, at the margin, of precisely these imbalances. The Fed's Q4 2016 Z.1 Report suggests U.S. household net worth (\$92.805 trillion) has now reached an unprecedented 492% of GDP. To lend historical context, this ratio now rests **40% higher** than the 353% average during the **five decades** prior to the Greenspan/Bernanke/Yellen era (Figure 2). Because the Fed has relied on growth in HHNW as a potent transfer mechanism for "stimulative" QE and ZIRP policies, we would interpret current resolve to hike rates amid faltering economic growth as clear signal the Fed views

reigning financial asset prices as increasingly problematic. Because the Fed has a highly checkered history in evaluating negative impacts of pierced bubbles (generally of their own creation), we offer some perspective on how precarious current U.S. asset valuations may be, and how far they may need to fall to rebalance the U.S. financial system toward historical norms.

**Figure 2: U.S. Household Net Worth as a Percentage of GDP (1952-2016)**



Source: Federal Reserve Flow of Funds Report.

It stands to reason that in a normally functioning economy, household net worth should expand by some factor of GDP-growth-plus-savings. The greater the savings rate, the greater the rate of capital formation, leading to higher household net worth. Our examination of history and a dose of logic suggest to us that a reasonable approximation of this relationship might be  $(Real\ GDP\ Growth\ Rate + Net\ National\ Savings\ as\ \%\ of\ GDP) / Real\ GDP\ Growth\ Rate = Projected\ HHNW/GDP\ Ratio$ . In Figure 3, we apply our **representative** formula to **actual** GDP and savings growth-rates in decades since 1950 to calculate a reasonable **expected** rate of wealth formation. During the 1950's and 1960's, as real GDP averaged 4% growth and net savings grew by over 10% of GDP on an annual basis, the U.S. was experiencing what we would view as high-quality capital formation. Our formula suggests any society which can build wealth at such prodigious rates should enjoy a net-worth-to-GDP ratio approaching four, which was roughly the case in the U.S. throughout these decades, as reflected in the Fed's **reported** ratios in Figure 2. In subsequent decades, our formula continues to generate ballpark-type approximations of the Fed's reported HHNW-to-GDP ratios, all the way until the 1980's, when declining growth-rates for both GDP and

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savings cause our model to begin to project declining HHNW-to-GDP ratios (Figure 3). Of course, at exactly the juncture at which eroding productivity of U.S. economic activity should have begun to weigh on the HHNW-to-GDP ratio, the Fed's increasingly loose monetary policies generated three waves of inflation in various financial assets (stocks, then real estate, then everything) leading to the three upward spikes at the right of Figure 2.

**Figure 3: Real GDP Growth, Net Savings & Sprott Implied NW/GDP Ratio (1950-2016)**

	REAL GDP GROWTH RATE	NET SAVINGS/ GDP	PROJECTED NW/GDP RATIO
1950-59	3.63%	10.26%	3.83
1960-69	4.28%	10.53%	3.46
1970-79	3.18%	8.39%	3.64
1980-89	3.24%	5.33%	2.65
1990-99	3.40%	5.15%	2.51
2000-09	1.54%	1.94%	2.26
2006-16	1.35%	1.74%	2.29

Source: Sprott Asset Management

Since the turn of the millennium, as the intrinsic value of U.S. economic activity has been declining, the valuation of U.S. financial assets has been levitated by the easy-money policies of the Greenspan-Bernanke-Yellen Feds. As the U.S. economy has been generating less and less quality growth and savings, valuations of financial assets should have been declining, yet the Fed has interceded and intentionally fostered financial-asset inflation. Given the poor savings and growth rates of the past 16 years, our model suggests it would not be unreasonable for the ratio of HHNW-to-GDP to clear somewhere between 250% and 300%, implying a decline of between \$36 trillion and \$46 trillion in the aggregate value of the three major U.S. asset classes (stocks, bonds and real estate). To us, the only question is which asset class will bear the greatest readjustment burden in coming years.

As is always the case in assessing gold's investment merits, critical variables are significantly long-term in nature. For example, we maintain high confidence that the **eroding** quality of U.S. economic growth guarantees that U.S. financial asset prices will eventually reflect their true **eroding** intrinsic value, to gold's significant benefit. Along the way, such as during the S&P 500 Index declines of 2000-2002 (50%) and 2007-2009 (57%), gold has provided unparalleled portfolio protection as over-exuberant faith in U.S. financial assets has been punished. Should the Fed's recent shift in rate-hike urgency prove to be motivated by concern for stretched valuations of U.S. financial assets, as we suspect, it will be interesting to see just how far the Fed will go to press its message. We have long suggested the Fed's reticence to raise rates has reflected concern for the instability of excessive U.S. debt loads, and now the Fed may finally be forced to raise rates out of concern for the instability of excessive U.S. equity valuations. Our long-term expectation of a "rock and a hard place" may be the immediate reality in which the Fed now finds itself. ***If so, gold's role as productive portfolio diversifier is about to reassume center stage.***

Perhaps the single greatest misconception about gold, especially in contemporary trading circles, is the erroneous belief that rising U.S. short-term interest rates are inherently threatening to gold's prospects. We believe rising rates have far less to do with gold's performance than the reasons **why** rates are rising and whether the Fed is deemed to be "in control." After all, when gold exploded to all-time highs in January 1980, the Fed's discount rate was 12% and fed funds were targeted at 14%. Many will object that the January 1980 experience is not germane, because conditions in 1979 were substantially unique (inflation, oil shock, Iran hostages and Hunt brothers). Conceding all decades are different, we turn to the more recent past for evidence rising rates can coexist with surging gold prices.

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Figure 4: Spot Gold Versus Upper Band of Fed Funds Target Rate (7/4/03-3/1/07)



Source: Bloomberg.

In Figure 4, we plot the Fed's target fed funds rate versus spot gold from mid-2003 through early-2007. Between June 2004 and June 2006, the FOMC increased its target funds rate by 25 basis points at **17 consecutive meetings!** During the span, fed funds more than **quintupled**, from 1.0% to 5.25%, yet spot gold climbed as much as 86% along the way (from a \$392.55 close the day before 6/30/04 liftoff to an intra-day high of \$730.40 on 5/12/06). Obviously, Fed tightening has far less reflexive impact on the gold price than commonly perceived. Should the Fed have the temerity to push fed funds along the confines of their most recent dot plot (three hikes in 2017, followed by three more in 2018), we would expect immediate upticks in default rates across a wide spectrum of sketchy components of the U.S. \$66 trillion credit-market debt pile. In an environment of long-overdue debt rationalization, we would expect gold's traditional profile, as a portfolio asset immune to both default and debasement, to garner significantly renewed investor enthusiasm.

Sincerely,

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

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## Metal Prices

METAL	CLOSE	1 WEEK	YTD	1 YEAR
GOLD	\$1,229.29	2.0%	6.7%	-2.3%
SILVER	\$17.40	2.1%	9.3%	9.4%
PLATINUM	\$964.75	2.4%	6.8%	-2.0%
PALLADIUM	\$776.70	3.9%	14.1%	31.0%

Source: Bloomberg. Prices as at March 17, 2017.

## Sprott Physical Bullion Trusts

The goal of the Sprott Physical Gold Trust, Sprott Physical Silver Trust and Sprott Physical Platinum and Palladium Trust ("the Trusts") is to provide a secure, convenient and exchange-traded investment alternative for investors who want to hold physical bullion. The Trusts offer a number of compelling advantages over traditional exchange-traded bullion funds.

SECURE • CONVENIENT • COST EFFECTIVE • POTENTIAL TAX ADVANTAGE FOR U.S. INVESTORS

### SPROTT PHYSICAL GOLD TRUST

#### NYSE ARCA: PHYS

Price	\$10.13
NAV	\$10.10
Premium/ Discount to NAV	0.24%

#### TSX: PHYS

Price	\$10.13
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Total Ounces Held	1,757,354
Total NAV of Trust	\$2,161,081,694

### SPROTT PHYSICAL SILVER TRUST

#### NYSE ARCA: PSLV

Price	\$6.58
NAV	\$6.61
Premium/ Discount to NAV	-0.37%

#### TSX: PSLV

Price	\$6.56
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Total Ounces Held	55,659,095
Total NAV of Trust	\$970,138,138

### SPROTT PHYSICAL PLATINUM AND PALLADIUM TRUST

#### NYSE ARCA: SPPP

Price	\$7.67
NAV	\$7.80
Premium/ Discount to NAV	-1.54%

#### TSX: SPPP

Price	\$7.65
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Total Ounces Held	39,740 Pt 90,694 Pd
Total NAV of Trust	\$108,621,673

Figures as at March 17, 2017.

To learn more about the **Sprott Physical Trusts**, visit [www.sprottphysicalbullion.com](http://www.sprottphysicalbullion.com) or contact us at [bullion@sprott.com](mailto:bullion@sprott.com).

**Sprott** Physical Bullion Trusts

Find out why our Trusts are better »



**Sprott** Gold Miners ETF

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