

## A Message from the CEO

December 24, 2019



Peter Grosskopf  
Chief Executive Officer,  
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### This Tide Will Turn

#### Peter Grosskopf

Chief Executive Officer, Sprott Inc.; Managing Director, Sprott Resource Lending

The big story of 2019 for financial markets turned out to be the melt-up in U.S. equities. This big wave has not only floated broad equity averages to fresh all-time highs but has also extended the length of this bull market to the longest on record. Market surfers cite favorable conditions such as decent economic strength, supportive interest rates and a central bank pivot back towards easing as powering excellent runs by equity all-stars (from FAANG stocks<sup>1</sup> to financials). Traditional riptides, such as widening credit spreads and surging default rates, are nowhere to be found. (Pardon the surfing analogies, but I am heading to find waves in Costa Rica with my family for the holidays.)

Without question, favorable central bank trade winds (as opposed to Trump trade headwinds) fostered awesome conditions in traditional asset markets this year. Not only did global central bankers orchestrate a 180-degree directional flip during the spring, but the Federal Reserve has now abandoned balance sheet runoff in favor of its fastest balance sheet expansion of the QE (quantitative easing) era. The requisite attendant money supply growth is shown in Figure 1.

We caution our clients that 2019's uniquely favorable conditions are unlikely to be sustainable, especially at the margin. Shifting fundamentals are creeping into the forecast and are likely to create more ominous wave sets. Speaking from the perspective of Sprott's precious metals franchise, gold performed extremely well in the face of this year's market jubilee, which transpired amid supportive conditions including a stable U.S. dollar and benign inflation. (As of this writing, gold bullion was up nearly 16% through last Friday's close.)

"This environment is nirvana for gold....For twilight surfers, we believe gold's lifeguard role has never been more important."

For twilight surfers, however, we believe gold's lifeguard role has never been more important.

### Monetary Policy Update

In capturing the stunning about-face of Federal Reserve policy in recent quarters, I reference the narrative of former Sprott colleague Trey Reik (now of Bristol Gold Group).

- "In perhaps the most widely telegraphed policy action in its history, the Fed just spent 23 months...running its balance sheet down some \$750 billion..."
- After declaring in December 2018 that its balance sheet runoff was "on autopilot, working well, and not subject to review," Chair Powell abruptly reversed direction and shuttered the program completely in August 2019.

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- Now, in the 10 weeks since 8/28, the Fed has expanded its balance sheet by a mind-numbing \$283 billion, or an annual rate of \$1.5 trillion.
- Further, the Fed's proposed schedule of Treasury bill POMO's<sup>2</sup> will tack another \$510 billion on the Fed's balance sheet by June 2020, returning its size to its prior all-time high of \$4.5 trillion!"

As shown in Figure 1, the Fed's two years of vastly over-promoted balance sheet runoff unwound a paltry 20% of aggregate QE asset purchases before not only being halted, but then being reversed into incremental asset purchases at an even steeper slope.

In our view, gold has clearly called the central printer's bluff.

**Figure 1. U.S. Fed Balance Sheet (\$Billion) vs. Spot Gold Price (Top) / Weekly Change (\$Billion) in Fed Balance Sheet (Bottom)**

2003-12/11/19



Source: Sharelynx.

Our contribution to the debate as to whether recent Fed balance sheet growth, and underpinning of the repo market, qualify as "QE" would be a heartfelt, "Who cares what you call it!" The relevant point is that the Fed's balance sheet can now never decline without causing widespread stress. Regardless of what Chairman Powell seeks to label it, 2019 markets have been hugely pumped by the Fed and global central bank money-printing binge. And still, Trump wants more "of that money"! Yessir, the Fed Put makes for good big wave surfing! This environment is nirvana for gold.

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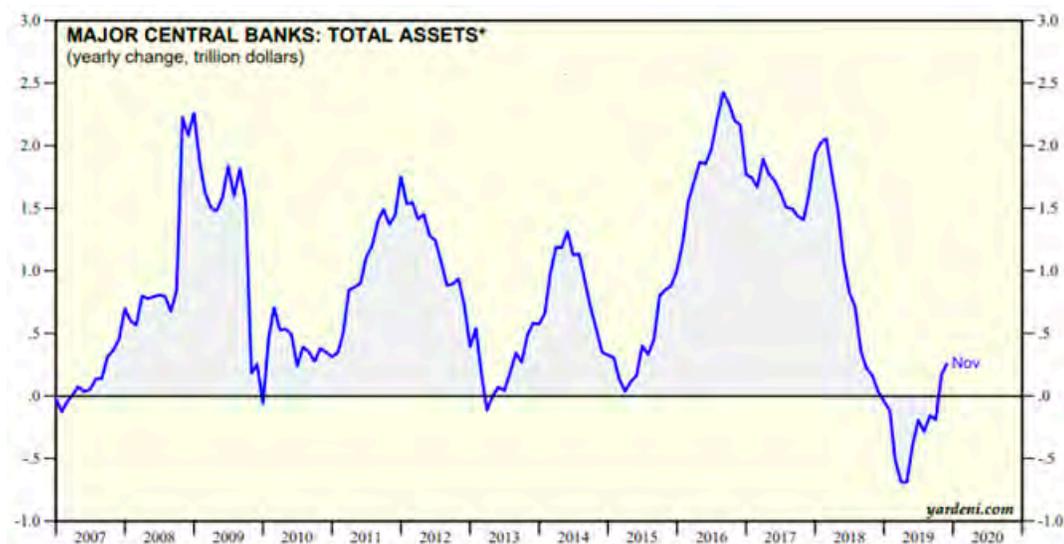
## Debt and Deficit Levels are Out of Control

Our investment thesis for gold rests on our belief that global debt levels have reached the “point of no return.” Whether one uses the broad lenses of global, emerging or developed economies or a narrower focus on G7 countries, the message is identical. Debt levels have become so onerous that they can only be serviced in the context of always accelerating rates of fresh credit creation — i.e., more debt to service existing debt.

Nothing summarizes the debt conundrum of developed economies more than the 2019 pivot of global central banks back towards easing posture. As shown in Figure 2, the U.S. Fed, the European Central Bank (ECB) and the Bank of Japan (BOJ) have engaged in a giant tag-team of global debt monetization for the past 13 years. The precipitous Q4 2018 swoon in the S&P 500 Index<sup>3</sup> reminded global central bankers in stark terms that global liquidity can never be withdrawn without immediate damage to the reigning prices of global financial assets.

**Figure 2. Total Assets of Major Central Bank Balance Sheets**

(2007-11/2019)



\*Total of Fed, ECB and BOJ. Source: Haver Analytics.

In short, with this much debt in the system, global central banks are painfully aware that, from a balance sheet perspective, the only two possibilities to recalibrate debt levels back towards productive underlying output are default or debasement — and central bankers will always do everything in their power to avoid debt deflation. Gold’s unique portfolio utility is that it is possibly the only investment asset that can provide protection in both scenarios.

From an income statement perspective, it is equally concerning that global sovereigns display little capacity to service and eventually pay down their debts. Current tax rates, which are close enough to being maxed-out are not going to procure cash flow increases at the margin.

Studies have shown that tax increases from contemporary levels generally diminish government receipts, and tax-targeting the ultra-rich becomes ineffective due to the global mobility of extreme wealth.

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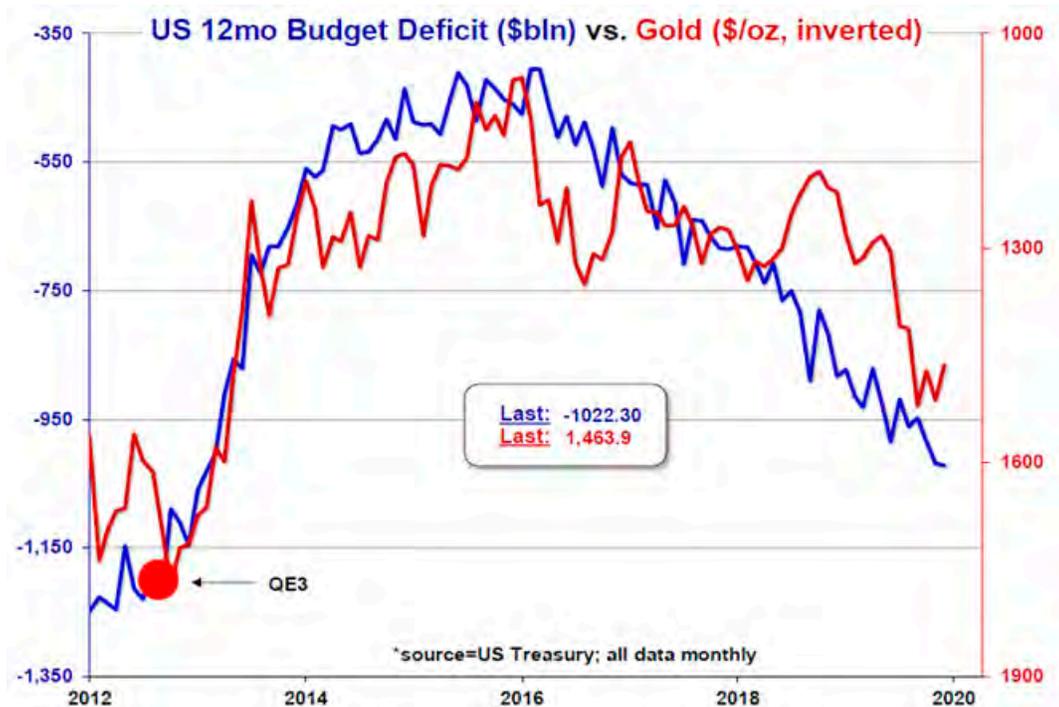
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Unfavorable demographics further complicate global debt loads, generating severe stress on entitlements and increasingly unfunded future obligations. Economies, in general, are not growing fast enough to outpace debt growth and are falling far behind in their ability to do so.

As shown in Figure 3, we believe gold is increasingly sensitive to the unraveling fiscal situation in the United States.

## Figure 3. Spot Gold Price (Inverted) vs. Trailing 12-Month Federal Budget Deficit

(2012-11/2019)



Source: Meridian Macro.

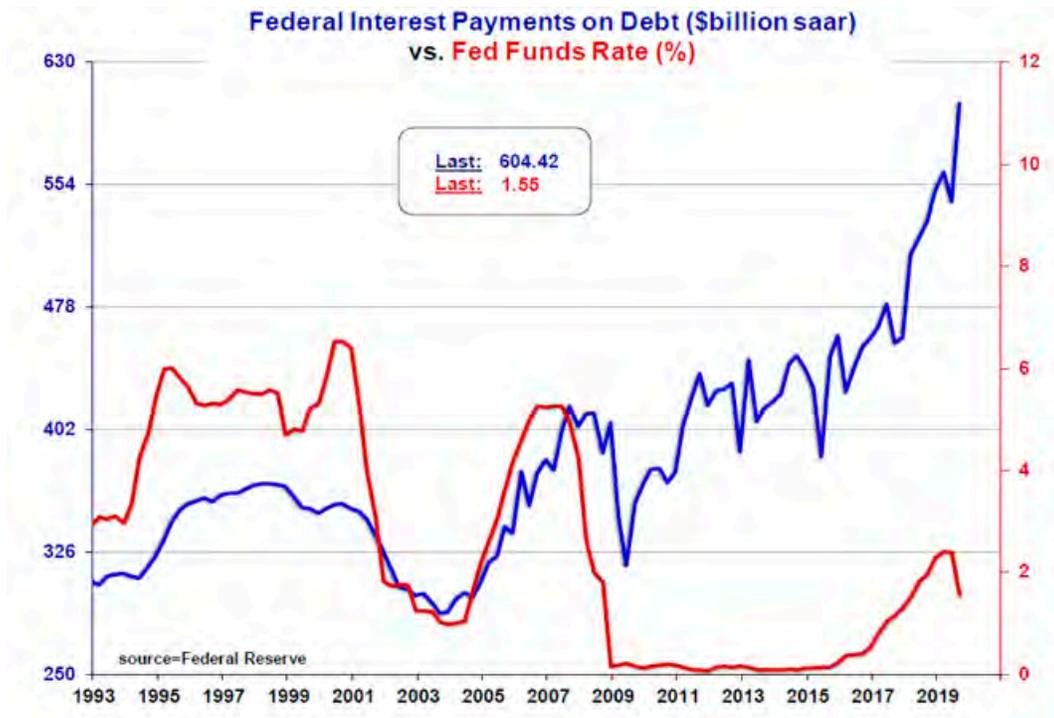
Logic and mathematics suggest that government deficits in developed countries can only increase in future periods. Debt service consumes a growing percentage of government cash flows in developed countries and there is likely to be increasing pressure from the funding of the populist promises now winning elections worldwide. The combination of these funding requirements cannot naturally be absorbed by government bond markets without central bank support, leading to a vicious cycle involving yet more money printing.

We are always amazed that investor consensus ever concludes that interest rates can rise. As shown in Figure 4, the Fed's 2018 rate hikes were vaulting federal interest payments much higher even with a historically low basis.

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**Figure 4. Federal Interest Payments on Outstanding Debt (\$Billion SAAR; Seasonally Adjusted Annual Rate) vs. Federal Funds Rate (1993-11/2019)**



Source: Meridian Macro.

Shame on today's and yesterday's political parties and their supporters for leaving this mess to be solved by our future generations. Should we worry? Perhaps not until the bubble bursts, but we can get prepared.

## Preparing for the Next Decade

We are of the view that the greatest consensus realization of the next decade will be the recognition that global sovereign debt can never be paid off or, for that matter, even reduced. The gorilla in the room henceforth will always be debt service. Future debt service depends a great deal on the re-emergence of inflation, which in turn will drive debasement and the financial repression of savers.

Since central planners and political parties will do everything in their power to foster and mislabel required inflation, it will be critical for investors to remain on high alert in order to independently measure inflation's impact on their investment portfolios. Those looking for consumer price index (CPI)-type inflation are looking in the wrong place. Asset-price inflation is alive and well, and is already crushing portfolio purchasing power around the globe.

Also, front and center on government agendas will be concepts related to printing money without legitimate accounting, such as helicopter money, basic minimum income and MMT (Modern Monetary Theory). These economic blasphemies may seem to bolster real economies into fake economies, by helping create inflation and sustain debt levels, temporarily, until it becomes obvious that this is the equivalent of a financial drug binge — it feels good at first, but may eventually kill you. In a nutshell, these ideas fly in the face of rational economic theory and will invariably lead to runaway inflation. They are, however, coming to a theater near you.

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In this environment, the “don’t fight the Fed” strategy may continue to deliver results. Maintaining a reasonable weighting to solid, cash flow producing equities seems to us like it has a decent chance of keeping pace with inflation. Treasury bonds, on the other hand, are a tougher call. While they would work in a recession, they also have tremendous downside in the event of a “blow-off” of the current debt bubble. We at Sprott handicap the chance of an economic slowdown as high in the next few years but would advise our clients to tread cautiously with fixed income and avoid duration. Real estate and other alternative real assets may, due to their high degree of leverage, be more sensitive to cap rates than revenues and are therefore likewise susceptible to correction.

## Threats on the Horizon

Of course, the bigger this bubble gets, the worse the inevitable blow-off becomes. Our list of threatening potentialities only continues to swell:

- Normalization of rates, after extensive free money experiments have inflated financial assets, threatens valuation levels across-the-board;
- Relentlessly rising deficits and debt levels (especially at deceptively low interest rates);
- Record entitlement and health care funding gaps;
- Increasingly insolvent state and local governments and pension funds in the U.S. will ultimately require bailouts;
- A massive Chinese debt bubble which is keeping the lid on the renminbi — setting up a boomerang effect countering any positive trade gains;
- Emerging market economies hamstrung by U.S. dollar-denominated debt;
- Wealth gaps are their widest in the last century and are causing populist political results.

## No Portfolio is Complete without Gold

In short, we believe that latent systemic risks have never been more troublesome. Call us paranoid, but we are in Ray Dalio’s boat in believing that we are nearing a paradigm shift where that easing of monetary policy by central banks “can’t continue.”

At Sprott, our recommendation remains that no portfolio is complete without a prudent allocation to gold. We agree with Jim Grant’s timeless observation that the gold price, most simply, is the reciprocal of global confidence in central banking.

Once a few rogue waves wash into the equation, and the asset-surfing public recognizes our government lifeguards are drinking their own spiked Kool-Aid, “Surf’s Up” may not sound so compelling. Or, should confidence in the waves be shattered by one or more significant accidents, the rush into the gold market will become a tsunami. Either way now is no time to surf without some gold.

***Happy and healthy holidays to all. Pura Vida!***



Peter Grosskopf, CEO

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<sup>1</sup> Facebook, Amazon, Apple, Netflix and Google stocks.

<sup>2</sup> Permanent Open Market Operations are the purchase or sales of securities for the Fed's system open market account, and are used by the Fed to implement monetary policy.

<sup>3</sup> The S&P 500 Index is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States.

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