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WEEKLY COMMODITY REVIEW

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Remembering the Forgotten Class

Like the Brexit result, it's remarkable that markets were so unprepared for the US election outcome, given the closeness of the polling right the way through the campaign, especially in the closing stages.

The US election also seems to have involved the same motivating factors with respect to voters – those who have lost jobs and feel they've been marginalized by globalisation and free trade agreements.

It's a worldwide phenomenon - the world is sick of politicians, particularly what are perceived as the elite and part of the problem not the solution - so voters are prepared to give someone else a go that's not part of the political 'establishment.' Oh, and voters don't like being referred to as 'deplorable.'

Like many I have had doubts about Trump, but a lot of American voters appear to have had even greater doubts about Clinton as a potential president - and I think that speaks volumes. I think a lot of Trump's more outrageous comments were cleverly crafted to generate as much media attention as possible (whether good or bad) during the campaign – after all he was massively outspent by the Clinton camp. So he needed as much 'free publicity' as he could muster.

In the wake of Brexit, markets fell and the world was going to end according to the experts. Well it didn't - the world kept turning, the sun rose again the next day. Markets too have pretty much recovered all of the ground they lost immediately post Brexit. I believe that Trump will now be a lot more moderate and 'presidential' in his language and will hopefully seize the moment and turn things around for the greater good within the US.

I saw a US election analyst commenting that "the mainstream media got the mainstream wrong." Seems to be the way in the modern age - perhaps too much attention is paid to social media discussion to try and gauge voter mood. Many who feel marginalised are too busy working 3 or 4 jobs to spend any time on social media!

The US election result has underlined the key point I've been making for some time - which is how fragile and narrow the US economic recovery actually is. The Fed has relentlessly 'talked tough' with respect to interest rates whilst at the same time pointing to US economic growth as clear evidence that its ‘easy money’ policies have been working.

The Dow Jones at record levels doesn’t necessarily reflect a robust underlying economy - it’s in many respects a reflection of an equity market that’s in many ways simply pumped full of Fed-administered hot air. Ordinary Americans haven’t enjoyed the fruits of a runaway sharemarket – in fact their situation has deteriorated.

Since the GFC it's been the average US battler that's done the hard yards - they didn't cause the financial mess, the Wall St crew did, but they're the ones who’ve suffered with jobs lost and savings wiped out with zero interest rates (if they've got any money left in the bank).

The Fed’s great monetary experiment involved quantitative easing (bond buying) and near-zero interest rates in order to lift financial assets, which in turn would lift the real economy. The reality is however that while stocks and speculative assets like junk bonds and commercial real estate have soared, the real economy hasn’t.

In fact it’s been described by some as the worst economic recovery since World War II. Financial markets of course have been completely comfortable with a continuation of the ‘easy-money’ scenario, as it helps maintain the value of already-inflated share and property investments. Which is why even the slightest hint of a rate rise sends the market into palpations and convulsions, until the Fed inevitable does nothing.

For years now there have been calls for Fed action on interest rates by those that can clearly see the danger signs. As far back as February 2012 (yes, almost five years ago), President and CEO of the Federal Reserve Bank of St. Louis, James Bullard, argued “the Federal Reserve should start raising interest rates next year.” At the time he disagreed with the Fed's decision during January 2012 to keep interest rates exceptionally low to bolster the US economy. He argued that many years of near-zero rates risks causing "disaster."

Keeping rates low for several quarters is a justifiable and useful monetary tool – however it is very different from keeping them there for years, as it inevitably punishes savers and forces investors to take greater risks in order to generate a return on their investment. The Fed's easy money policies have therefore distorted market prices and encouraged destabilizing financial speculation.

The biggest underlying concern lies in the fact that financial markets have become so heavily dependent on QE and artificially-suppressed interest rates. This means that it is now very difficult for the Fed to reverse these policies without causing major repercussions.

Why Gold Looks an Even Better Bet

All of this of course is good news for gold, which remains the ultimate 'insurance policy' for investors and which has stabilized and strengthened so far during 2016. It's done so whilst the Fed and mainstream media keep telling us that the US economy is healthy.

The facts however tell a different story. Trade and demand are weak, while manufacturing is hovering just above recession levels. Internationally, eight years after the financial crisis, virtually all central banks are still engaging in crisis-era policies, with little prospect of reviving economic growth.

How well Wall Street has done from easy money is illustrated by a report by Bank of America. Analysts added up the results of 606 global interest-rate cuts since the collapse of Lehman Brothers and the $12.4 trillion worth of central bank asset purchases following the rescue of Bear Stearns. The results represent a clear victory for Wall Street over Main Street.

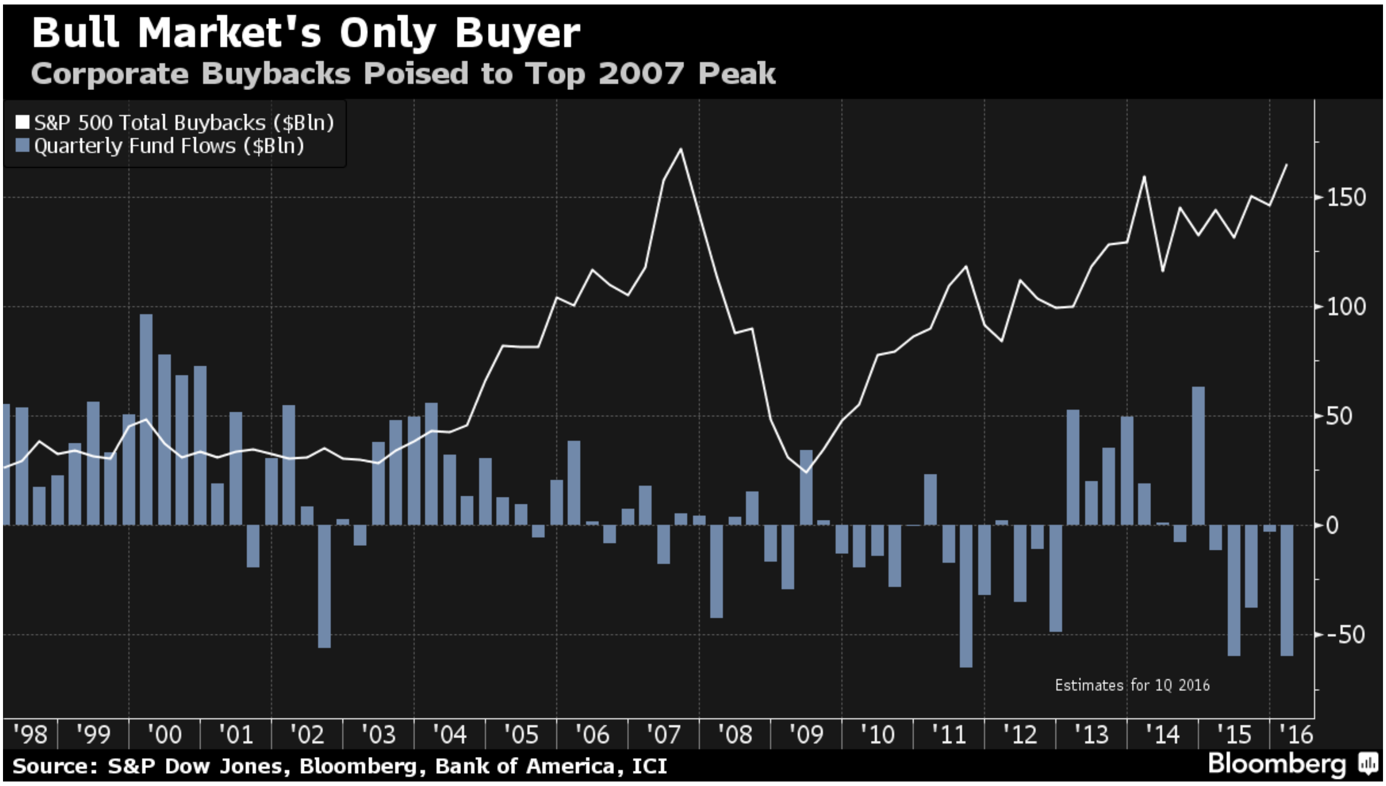
For example, the team found that for every job created in the US so far this decade, companies spent $296,000 buying back their stocks. At the same time, an investment of $100 in a portfolio of stocks and bonds since the Federal Reserve began quantitative easing would now be worth $205. Over the same time, a wage of $100 has risen to just $114.

For every $100 that US venture capital and private equity funds raised at the start of 2010, they are now raising $275, but for every $100 of US mortgage credit extended five years ago, just $61 was extended and accepted.

Then there is the issue of share buy-backs by corporations. US companies have gone on a borrowing binge, utilising the Fed's easy money – except they haven't been investing that borrowed money in the future. Instead, it's largely been spent on the financial engineering practice of stock buybacks.

Weak capital investment has strangely coincided with corporate leverage that's at its highest level in 12 years. The explanation is share buy-backs, with a Reuters study showing that since 2010 60% of the nearly 3,300 publicly traded non-financial companies have bought back shares.

Reuters found that of the 1,900 firms that have repurchased shares since 2010, buybacks and dividends amounted to 113% of capital spending, with buybacks and dividends higher than net income. This situation has never happened outside of a recession.



The one main direct effect of share buybacks is that they enhance earnings per share (EPS), since the number of outstanding shares is lower. Since 2012, overall US corporate per-share profits are up about 6.2% annually – however around 20% of these "gains" relate directly to share buybacks.

Corporate executives are the main beneficiaries, as a lot of executive remuneration is directly tied to short-term performance measures such as EPS. Which is a great scenario if you happen to be one of those executives – but for Middle America it's done little.

As US commentator David Rosenberg points out, the US labour market is anaemic - despite headline numbers suggesting otherwise. Mr. Rosenberg believes that the lack of strong wage growth is a sign that the US is far from full employment.

"There are officially eight million unemployed, but in reality, when all the underemployment is accounted for, that number is far closer to 20 million. The definition of the labour force renders the unemployment rate a meaningless statistic. There are a ton of folks not in the traditional labour force who would readily take a job if offered one", he says.

The employment-to-population ratio is a disappointing 77.7% for those aged 25-54 years old compared to 80% in early 2008 and 78.8% in September 2008 at the time Lehman Brothers collapsed.

So what does this mean for gold? Central bank policies of inducing negative real rates to 'incentivize' borrowing has expanded the money supply and devalued currencies across the world – in turn forcing investors to chase riskier assets in order to generate returns. Many mums-and-dads investors, along with the Chinese, Indians and Russians, have sought refuge in gold. Debt is inherently inflationary if you have the ability to print your own currency.

The implementation of a negative interest rate environment worldwide should in my view be viewed as a clear signal that Central Banks are well and truly out of ideas. Negative interest rates are an unprecedented phenomenon – and a clearly desperate measure to try and arrest declining economies that are burdened by enormous debt levels.

The gold price is however the antithesis of paper money. The last few years have seen gold reaching record levels measured in most emerging economies' currencies, but languishing against the US dollar.

However, growing economic uncertainty could well result in a strong rise in gold against all paper currencies – including the US dollar. Remember that central banks can print more money, but they can't print more gold.

Trump is likely to engage in the politics of economic expansion, which could well generate higher levels of inflation, higher rates and a stronger currency. Nevertheless, I believe that gold prices will remain robust given the enormous levels of worldwide debt. Accordingly, I maintain confidence in our base-case gold price target range for the yellow metal during 2016/17 of between $1200 and $1500/oz.