January 20, 2018

As we enter the New Year, I want to provide you with an update on both the portfolio as well as expectations going forward.

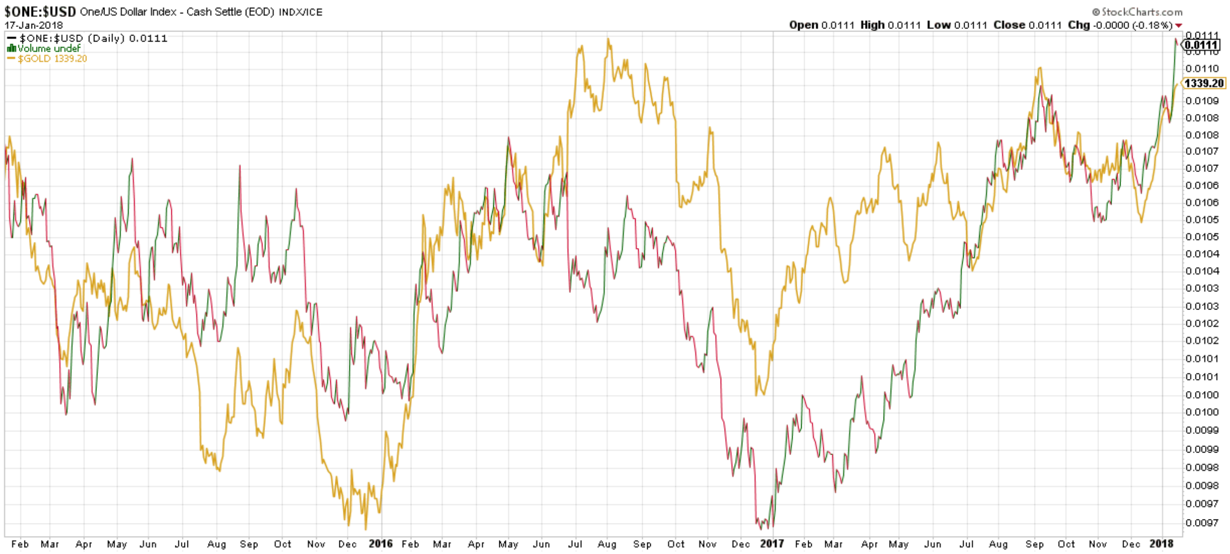
We recently reestablished positions in the precious metal and mining stocks at prices below our prior exit. I'm cautiously optimistic that we've seen the worst of the decline in the metals and are back on track with the bull market in gold. However, we need to see some very strong follow through in the price action during January to build upon this conviction. Much of the strength in December gold prices can be attributed to last minute capital flows in USD versus other currencies for year-end tax planning and other global account rebalancing by the banks. Consequently, we are keeping a very tight stop-loss trigger on the new precious metal positions in case what we've seen has been a false rally.

China's launch of a yuan-based futures market for oil is one major catalyst for gold that's not getting much press. Until now, essentially all global trading in oil has been based upon US dollar denominated transactions. However, the Shanghai International Energy Exchange is launching an oil futures contract denominated in China's currency, the yuan. While it's not a compelling alternative to the dollar for oil traders, this new futures contract is linked to an option to convert yuan into physical gold. That will allow international oil producers to efficiently sell oil for physical gold. It's likely that many oil producers, such as Russia, would much prefer to convert their oil exports directly into physical gold instead of dollars and US Treasuries. The consequences of success of this exchange can't be understated, and the negative consequences for the US dollar are profound. Conversely, this could be the catalyst that ignites a gold rally.

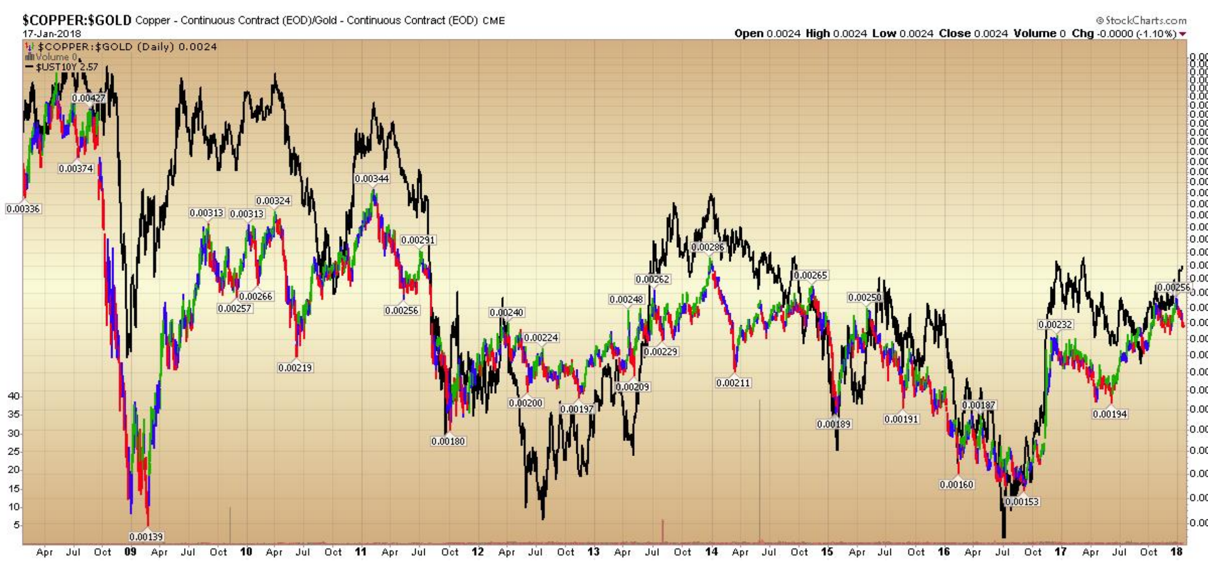
I'm monitoring several factors to assess how this is developing:

1) The change in USD exchange rate versus gold.
2) The yield of US treasuries versus inflation and exchange rate changes.
3) The divergence of oil prices between the domestic price, known as the West Texas Intermediate and the international price, known as BRENT crude.

Here are some charts illustrating these factors. The first shows the price of gold (colored in gold) over the past three years relative to changes in the US dollar index (on an inverted scale colored in red and green). Notice that gold is currently lagging behind the movement in the dollar, suggesting that more upside remains in gold if the weakness in the dollar continues.




This next chart depicts the relationship between the yield on the 10-year US Treasury bond (shown by the BLACK line) and the *ratio* between the spot price of copper and the spot price of gold (red/blue/green lines). Treasury bond prices rise and fall due to a variety of expectations related to interest rates, inflation, exchange rates, and a myriad of other factors. However, the simple ratio of copper to gold prices can explain about 60% of the price change in US Treasury bonds. One way to think about the magic of this ratio is that rising copper prices reflect both increasing economic activity and potential inflation—both of which lead to higher interest rate policies. Meanwhile, gold price changes cancel out the exchange rate fluctuations and commodity index bias, and provide a signal related to market stress. Based upon the current divergence in these metrics, the odds are that we will see some combination of bond and copper prices falling (higher interest rates), with gold prices rising.



It’s too early to tell if the China futures contracts on oil will catch on and have a major impact, but we’re watching that one closely too.

In order to take advantages of the last breath of the current stock market rally, we’ve added common stocks in the portfolio. The positions in IOO, VT, and SPY are an easy way to achieve this, except for the low level of liquidity in IOO and VT. These positions are held with tighter than normal stop loss exits because this market rally is happening in the midst of some of the highest valuations we’ve ever seen. Indeed, a buy and hold strategy right now will likely be very painful when the next bear market takes hold.

John Hussman provides an excellent analysis of just how overextended valuations are, and quantifies the long-term consequences in his recent post which can be found here: https://www.hussmanfunds.com/comment/observations/obs180115/

One thing driving stock prices higher is the international demand for US equities. Investors in Europe have little upside in holding US Bonds. In fact, after accounting for the cost of hedging, their yield is negative:


At the same time, if the equity market for these broad ETFs continues to be strong, then it will be even stronger for some individual stocks that we’ve added. Since the liquidity of IOO and VT is so poor, augmenting the common stock position with multiple positions that are more liquid should support the overall strategy. Some of these new names in the portfolio are Gamestop (GME), Comcast (CMCSA), and some airlines. Think of this group of stocks as similar to the positions in IOO or VT but with more upside potential. At the same time, expect them to be sold quickly if the market doesn't cooperate in the near term.

To give an example of how these stock were chosen, consider Gamestop (GME). I invested in Gamestop in 2006, after interviewing the CEO and most of the management team. I also toured their main facility in Texas, and performed extensive research on their competitive environment. It's rare to get an opportunity to buy stock in a company that's priced at book value, generates a return on equity of over 15%, and generates an 8.5% dividend yield. Such opportunities arise when there's a prevalent misunderstanding of the business. In Gamestop's case, that misunderstanding is the belief that digital downloads will do to the video game retail market what Amazon.com did to the bookstore business. While that sounds logical, the same argument was made over 10 years ago when I last bought Gamestop's stock at book value. Ten years later, they're still selling video games in retail stores. Why? Well, there are several reasons that cause this "simple short thesis" to fail. First, video games are often given as gifts, and Grandma is unlikely to put a digital download under the Christmas tree for her grandson (Grammar aside, that's a really good point). Instead, she buys a packaged game that can be wrapped with a bow on top. Second, the retail stores are oriented around merchandizing games that are not mainstream. They place thousands of games on display and have trained sales staff that can help gamers find a good fit. It's the same way that clothing retail has maintained a defensive position relative to online commerce. Third, Gamestop has a facility in Texas with patented technology that allows a cost effective process that refurbishes used games and allows them to be resold at a high margin. Herein lies a unique competitive advantage. Gamestop is more than just a retail outlet. It leverages a sophisticated back-end warehousing and physical processing capability that adds margin to their products. Finally, the company leverages digital incentives as part of their own strategy to adapt to the evolving market.

Aside from the qualitative analysis, the company's revenue is correlated to several metrics that can be inferred from online data sources. As an example, the revenue growth is highly correlated to growth in Twitter mentions. The following chart was generated by a system I use called Sentieo, which integrates data from Twitter, Google, and Alexa, as well as other online sources to predict changes in revenue for public companies. Here's an example for Gamestop. Notice how the current forecast is significantly above the average Wall Street revenue forecast in the following chart:


Overall, Gamestop is a solid business that's often misunderstood, and consequently mispriced. However, no amount of research exists that can guarantee a trade in the short term. This was exemplified by the sharp drop in the stock after the recent announcement of a non-cash impairment to goodwill related to a past acquisition. We used this opportunity to add to the position, but it also put us closer to our stop-loss limitation near our entry point.

Our investment in Comcast takes advantage of two major regulatory changes. While the change in Net Neutrality should be a positive catalyst for Comcast's business, the change in the tax law should be even more favorable for Comcast's cash flow. I know some clients who follow Martin Armstrong's proprietary Socrates trading system and won't be surprised to see if Comcast is a favorite of theirs too.

While positive sentiment, tax-deregulation, and economic growth are all positive factors driving the current market rally, I remain deeply concerned for the downside risks faced today. The valuations on overall equities are extremely extended. However, there is the potential for a global capital flow into the US in early 2018 that could drive valuations to even more irrational highs. If the tax cuts, combined with rising short term interest rates, stimulate appreciation in the US dollar without impairing short term economic growth, then it's likely that non-US investors will increase their allocation to US stocks. This will provide yet another source of demand for US equities and drive prices even higher. The more difficult questions will be to forecast the price of gold and related investments in the face of a rising US dollar. We will watch those closely.

Operationally, some of you have asked about fees in the New Year. Although our marketing expense paid to Chris Weber is offset by higher research costs, we're reducing fees for accounts where the assets are in excess of $1 million.

Several of you have expressed interest in investing in Bitcoin, or related crypto assets. While it's possible to invest in Bitcoin futures, our regulatory research has indicated that this creates a quagmire of problems for separately managed accounts. As a result, I have developed an alternative strategy for accredited investors that may be of interest. The recent pullback in the price of Bitcoin and other crypto assets is well overdue and creates a good environment for establishing long term positions.

Additionally, several clients have expressed interest in augmenting their portfolio with recommendations from Martin Armstrong's "Socrates" system. We've implemented this for a handful of clients, and the results have been positive. You can learn more about this strategy at: https://ask-socrates.com. If you're interested, let me know and we can discuss whether or not it is appropriate for your objectives.

I am excited for our prospects for this year. While this is one of the most difficult investment environments that we've seen in decades, there's still an opportunity to create significant value.

Best wishes for the New Year,

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