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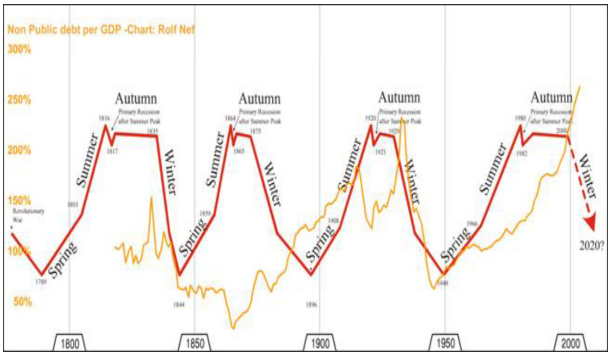
Review and Outlook Q1 2013

The first report of the year is an opportune moment to reflect on what we already know and what lies ahead.

We know, for example, that announcements about further monetary easing from both the European Central Bank (ECB) and the Federal Reserve (Fed) were made in October. This open-ended approach to additional money creation allowed precious metals to perform especially strongly in the third quarter of 2012. This was no surprise as this is exactly how hard assets should perform in the face of an increasing money supply. We felt that the Fed's unending quantitative easing statement would allow the hard asset sectors to continue to perform strongly from this point in time. However, the last quarter of 2012 saw weakness in these sectors and market commentators gave all sorts of reasons why this was the case, from the uncertainty of the US election to the Mayan prediction of the end of civilisation. The fiscal cliff impasse was America's own way of trying to meet Mayan expectations (!) but in the event this is simply another unresolved monetary problem (too much debt and spending versus too little income). Expect more wobbles as talks on the fiscal cliff come back into focus.

The fall in price of gold and silver in the 4th quarter was especially surprising given the scale of physical buying of both metals by central banks and individuals towards the year end. This physical buying has carried on into the New Year which shows that buyers are investors and not speculators, as they are taking advantage of price weakness in an asset class that they remain committed to. Central bank buying is of course of greater significance, as banks across the world look to increase their gold reserves after years of divestment. They are insiders to the workings of the monetary system and benefit from the paper money system, so the fact that they are buying is a classic canary in a coal mine warning!

It is worth us going back to basic fundamentals given the confusing picture that asset markets seem to present to investors and the market conundrum comes back to just three simple words: debt, deflation and inflation. The excesses of the past have led to the biggest debt bubble in history and the normal resolution for this would be deflation, which would allow the excesses to dissipate. Kondratieff would say that the world is now in the winter part of his long wave cycle model.



Kondratieff cycle

(Kondratieff was a Soviet economist who studied long waves in economies and divided the cycle of activity into the four seasons i.e. Spring, Summer, Autumn and Winter. In his theory the long wave economic cycle could extend to 60 years and would start with an improving economy, follow on to a boom, then a bust and a period of readjustment before starting all over again. His theories were not popular with the Soviets who had asked him for his study and he was subsequently sent to the gulag and executed in 1938. Indeed, his approach is still not liked by the mainstream, but as the world's debt crisis is unresolved, his name is used more often than it was during the boom time.)

The Fed and the world's central banks understand where we are in the economic cycle but there is a collective unwillingness to accept the nasty medicine that would allow the economy to reposition itself and grow organically once more. This has been the case for many years and most especially ever since Alan Greenspan decided to come to the rescue by cutting interest rates in order to support the markets – remember the term the Greenspan put? This was the market acknowledging that if things went wrong, then the central bank (Alan Greenspan as head of the Fed) would ride to the rescue.

Therefore, we find ourselves in a situation where the biggest debt bubble in history keeps casting its deflationary shadow and each time that deflation appears to be gaining strength, inflation is unleashed with massive monetary stimulus. The Greenspan put has been passed on to the current head of the Fed, Ben Bernanke.

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Unfortunately, each subsequent round of money printing has to be bigger than the last in order to prevent the deflationary collapse as the debt pile remains unresolved.

The current head of the Fed, Ben Bernanke, is well aware of the forces of deflation and he prides himself on his studies and analysis of the 1929 crash. He has stated on many occasions that it his express goal to avoid the policy mistakes of the 1930s and he has spoken of the ability of the central bank to distribute money to prevent deflation (his speech was made in 2002. *"Deflation: Making sure it doesn't happen here."* It is well worth reading as it outlines much of current anti-deflation policy).

http://www.bis.org/review/r021126d.pdf

In the speech he said the following:

"Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation."

It is obvious from this and the trend in stimulus, that there is an attempt to counteract the strong forces of deflation by encouraging inflation as the antidote. It is also a means of ensuring debts are repaid in nominal terms – it is a form of default but on different terms. Central banks across the world are catching on to the QE game. The newly elected Liberal Democratic Party in Japan led by Shinzo Abe has been brought to power on a specific mandate to stoke up inflation. He is targeting 2% inflation backed by *"unlimited"* monetary stimulus!

There is a new economic council which has set a growth target for nominal GDP of 3%. It is important to bear in mind that there has been a singular lack of growth in Japan for 15 years so the goal is extraordinary. The intention is to weaken the yen in order to boost Japan's export economy and they intend to buy foreign assets (bonds etc) as a way of achieving a lower value for the yen in much the same way that Switzerland has kept the Swiss Franc in line with the Euro. There are huge risks to this approach and the Bank of Japan look set to put up a fight to prevent this. The flight out of yen would impact the stability of the bond market and undermine the country's pension funds for example.

Given the size of Japan and the public nature of their stated aims they have made it clear that they see the world's paper currencies in a race to the bottom in terms of relative value with one another and Japan wants to be at the head of the field to gain whatever marginal advantage it can in the world's export markets. It seems to us that their policies will speed up the devaluation of other currencies as they try to keep their own exchange rate competitive.

It is amazing to see the path that central banks have chosen especially as Japan has been printing money for years and this has not stimulated the economy back to growth. They have even resorted on several occasions to handing money directly to consumers – this too failed to deliver a boost to the economy. Einstein himself said that insanity is doing the same thing over and over again and expecting different results and yet they continue on the same path as before.

The analyst Michael Pento recently said:

"When a government tries to create demand by disseminating money that is printed by a central bank; all you get is a falling currency, faltering GDP, soaring debt levels and inflation—and eventually rising interest rates as well. Japan illustrates this point perfectly. Indeed, Japanese Government Bond yields have increased sharply in the last month.

As stated before, one consequence of destroying your currency is to make those things priced in Yen rise in price. That also applies to equities. The Nikkei Dow closed up 23% on the year and has continued its increase so far in 2013. That's great for those fortunate to own hard assets, but pernicious for those in the middle class that must spend a greater portion of their income on food and energy. The result is a faltering middle class and an economy that is plagued by intractable debt and an unstable currency.

The failure of Japan to allow bankrupt institutions to fail, to let asset prices fall, to balance their budget and to embrace a strengthening yen, has helped turn their lost decade into the lost quarter century. And it is now etched in stone that the entire nation, as well as Europe and the United States, are all facing a currency and bond market crisis that is not too far in the future."

What happens in Japan is of key importance as a sovereign debt crisis there will have a knock-on effect on other countries.

A loss of faith in the debt of one developed country will lead to a loss of confidence in other parts of the world. That is when you will see paper money panic into hard assets.

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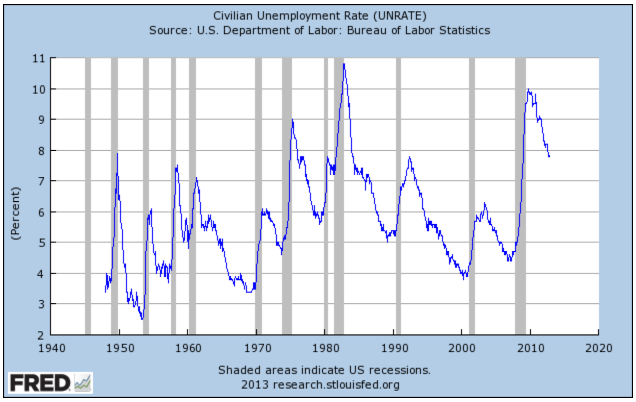
However, the Japanese are not alone in raising the subject of inflation and growth targets recently with the Fed now undertaking to keep monetary policy loose until the economy reaches 6.5% unemployment (currently 7.8%).



US unemployment rate: last 7.8%. Source: St Louis Federal Reserve

We also have the incoming head of the Bank of England taking central bank policy into a whole new direction by actually abandoning inflation-targeting and instead adopting a cocktail of different policies:

"To achieve a better path for the economy over time, a central bank may need to commit credibly to maintaining highly accommodative policy even after the economy and, potentially, inflation picks up.

"To 'tie its hands', a central bank could publicly announce precise numerical thresholds for inflation and unemployment that must be met before reducing stimulus.

If yet further stimulus were required, the policy framework itself would likely have to be changed. For example, adopting a nominal GDP level target could in many respects be more powerful than employing thresholds under flexible inflation targeting."

Is it a case of desperate times call for desperate measures? It is clear that deflation is being resisted at all costs even though creating cost-push inflation (as opposed to demand-led inflation) is a disaster. This is because costs are pushed higher on items where there is no suitable alternative (food, energy etc) and this removes discretionary spending money out of the real economy leading to a general decline in living standards.

Another unfashionable school of economic thinking is the Austrian School (Keynes is still in favour) and one of the tenets of the Austrian thinking is that booms are founded on excessive credit advanced by banks that make poor lending decisions. Essentially the boom is artificially induced and ultimately leads to a bust that is needed to let the economy regain a stable footing – in line with Kondratieff's thinking. One of the best-known Austrian economists is Ludwig von Mises and he said the following:

"This first stage of the inflationary process may last for many years. While it lasts, the prices of many goods and services are not yet adjusted to the altered money relation. There are still people in the country who have not yet become aware of the fact that they are confronted with a price revolution which will finally result in a considerable rise of all prices, although the extent of this rise will not be the same in the various commodities and services. These people still believe that prices one day will drop. Waiting for this day, they restrict their purchases and concomitantly increase their cash holdings. As long as such ideas are still held by public opinion, it is not yet too late for the government to abandon its inflationary policy.

But then, finally, the masses wake up. They become suddenly aware of the fact that inflation is a deliberate policy and will go on endlessly. A breakdown occurs. The crack-up boom appears. Everybody is anxious to swap his money against 'real' goods, no matter whether he needs them or not, no matter how much money he has to pay for them. Within a very short time, within a few weeks or even days, the things which were used as money are no longer used as media of exchange. They become scrap paper. Nobody wants to give away anything against them.

It was this that happened with the Continental currency in America in 1781, with the French mandats territoriaux in 1796, and with the German mark in 1923. It will happen again whenever the same conditions appear. If a thing has to be used as a medium of exchange, public opinion must not believe that the quantity of this thing will increase beyond all bounds. Inflation is a policy that cannot last."

The so-called *"crack-up boom"* when it occurs will bring about currency crisis and an eventual transition to a different currency system, which will be necessary to restore confidence.

In the meantime investors will have to accept that the authorities will do all in their power to try to sustain the current fiat money system and this is why we see continual attacks on alternatives to paper money such as gold and silver.

The minutes of the Fed that were released in the first week of January hinted that the Fed wishes to see an end to their bond buying programme this year. Metals took an immediate knee-jerk dive lower, as the minutes implied an end to quantitative easing (QE).

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In fact these sell-offs continue to provide investors, who understand the wider macro picture, with opportunities to buy gold and silver at lower prices as there is no possible end to QE without collapsing the current banking and welfare system, indeed government itself. The respected market commentator Jim Sinclair said:

"*If QE ceases, the US bond market collapses and the Fed must debt monetize all required debt, which means if QE stops, it starts up again immediately and in a crisis mode.*"

He also referred to a recent official IMF report which looked into the state of the derivative market and they conclude that the sheer scale and complexity of outstanding positions makes it a ticking time bomb.

"Systemic Risk from Global Financial Derivatives: A Network Analysis of Contagion and Its Mitigation with Super-Spreader Tax

Link: http://www.imf.org/external/pubs/ft/wp/2012/wp12282.pdf

The establishment is clearly cognisant of the risks that have built up in the system and QE allows the problems to be held at bay for the time being. We are still of the opinion that hard assets are one of the main places to invest in and we think it is a sector that will ultimately cushion investors from the inflation still to come.

Although 2012 was again a tough year for the fund there are signs that the QE trends are accelerating and we think it is important to stay the course. The following quote is taken from Silas Marner by George Eliot and is a good summation of the current situation:

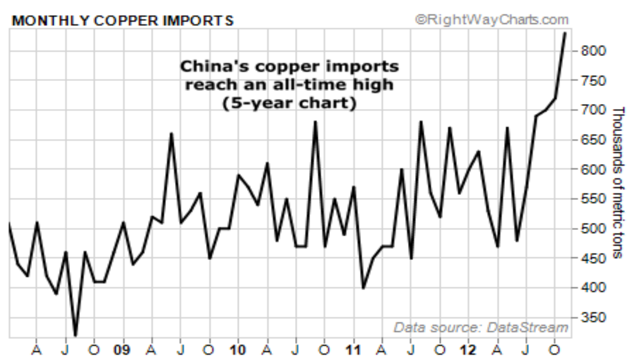
"The lapse of time during which a given event has not happened is…alleged as a reason why the event should never happen, even when the lapse of time is precisely the added condition which makes the event imminent."
~ George Eliot in Silas Marner

The Economy

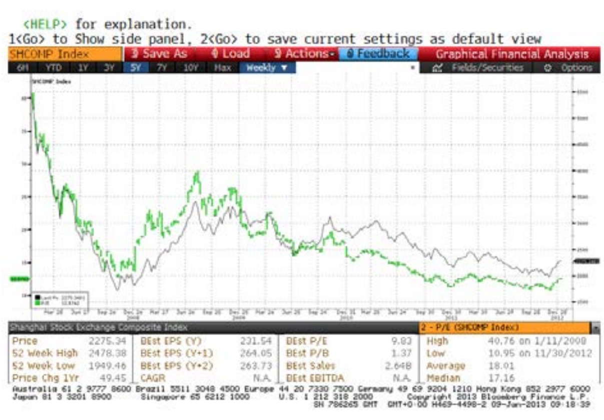
All of this central bank intervention is having at least some impact on economic growth around the world and there are glimmers of hope in the key markets of the US and China. The Chinese manufacturing sector has risen to just over 50, which is mildly expansionary and although not the sort of growth that China has been used to, it is welcome nonetheless. This should herald a period of restocking of inventory.

Chinese real GDP growth (annual YOY %). Source: Bloomberg

There has been a clear pick-up in the purchases of key materials such as copper as can be seen from the following chart which tracks copper imports:



Source: The Growth Stock Wire – Stansberry Research and Datastream



Shanghai Composite Index (black line) with PE ratio (green line). Source: Bloomberg

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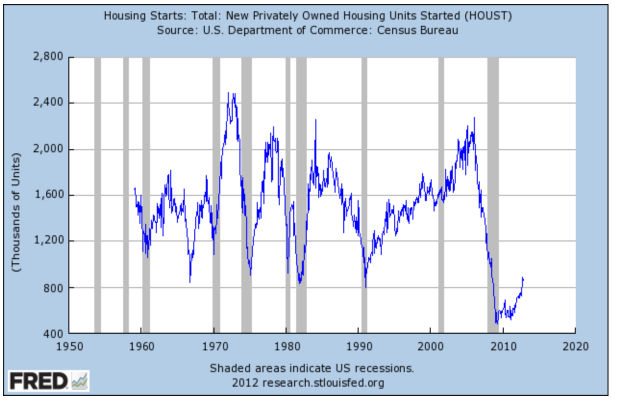
If we look at the commodity industry bellwether stock BHP Billiton then it is apparent that after months of consolidation it is becoming more dynamic again as investors realise that the commodity super cycle is still far from over. The recovery is also apparent in many of its peers but also in the performance of iron ore and aluminium companies in particular.

BHP Billiton 5 year chart. Source: Bloomberg

In the US we can try to look beyond the National Debt of US$16.4 trillion and over US$225 trillion of Federal entitlement liabilities. With 125 million people on benefits there are very clear arguments for continuing QE as well. However, there are signs of improvement in pockets of the economy such as:

US Credit card delinquency rates (90+ days). Source: Bloomberg

Michigan consumer sentiment numbers – improving with an end of year wobble Source: Bloomberg



US Housing starting to improve from a low base.
Source St Louis Federal Reserve

EUROPE

Indicators in Europe are less hopeful given the problems faced by the European periphery – Spain, Greece and so on. France, which is at Europe's core, is also experiencing a serious drop in growth and Germany is starting to feel the pain given the general downturn in business.

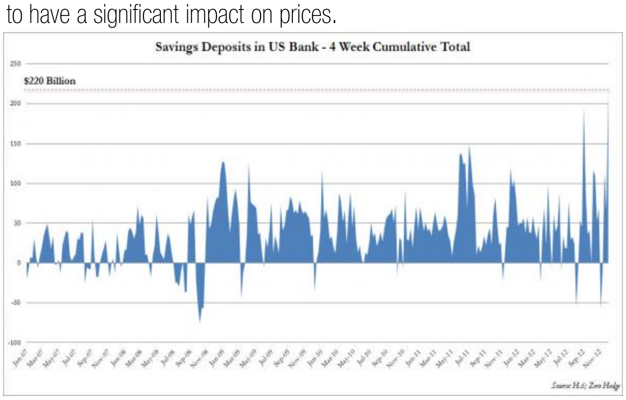
However, the Euro itself shows every sign of surviving in spite of all these difficulties, which may come as a surprise to many. The fact that the Euro has been able to remain strong compared to other currencies is perhaps a good indicator of just how bad conditions around the world really are!

Manuel Barroso said on 7th January with satisfaction that the "*existential threat to the euro has essentially been overcome*".

Whilst he may be correct in terms of the European debt crisis, at least for now, he is completely wrong when it comes to the imbalances that exist within the union and the divided between the north and the south.

The manifestation of the ongoing crisis for Europe is European unemployment. Spain's unemployment rate is 26.6% but youth unemployment is at the horrifying level of 56.5% and it is similar in countries like Portugal, Slovakia, Ireland and, of course, Greece. As these countries do not have the luxury of letting their currency weaken as they are tied to the euro, then there is little that is there to stimulate recovery. This is a serious concern for Europe but, as we have said, it is a concern everywhere.

There are good reasons to think that 2013 will be a good year for the fund given the current taste for zero interest rate policies in many countries and investors will continue to look for solid and sensible alternatives.We note that China bought a further 91 tons of gold in November which will mean that they bought double the amount of gold compared to 2011. Buying of physical metals has continued in the early days of 2013 and this bodes well for the precious metals investments we hold. Furthermore, a record US$220 billion was put into savings accounts in December in the US. It is the biggest 4-week total amount injected into US savings accounts ever. Even if individual investors are shy of the market this built up deposit money is going to be used by the deposit banks to invest and that is going to have a significant impact on prices.



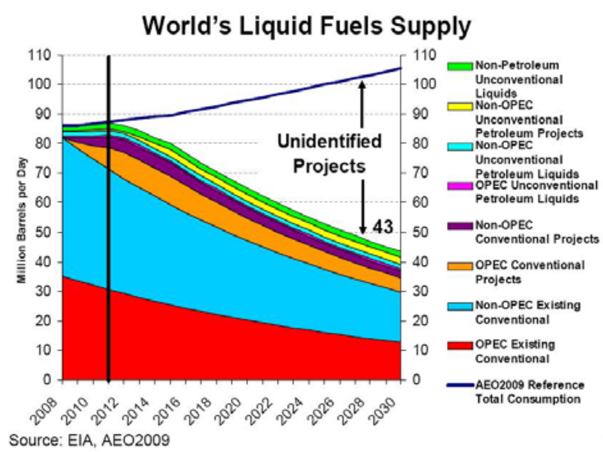
Source: Zerohedge

Oil and future supply and demand – official expectations

Oil has remained fairly resilient in price terms especially given the concerns about world economic growth. We thought it was time to have another look at the oil market and what the experts anticipate in terms of future supply and demand.

We will refer to an official presentation made by an official of the US Energy Information Administration, which is an official arm of the Department of Energy.

The presentation looks out to 2030 when demand is expected to be approximately 105 million barrels per day (bpd). They then look at current producing oil fields and project that their production will have fallen to 43 million bpd giving a quite staggering shortfall of 62 million bpd. This is consistent with a current decline rate of global oil production of 4% p.a. The shortfall is forecast (expected!) to be met by unidentified fields and new production. Perhaps this will prove to be the case as the human race has been adept at improving technology in order to extract oil in ever more inhospitable places. In addition, there has been a great deal of excitement surrounding oil and gas fracking, which is predicted to make an enormous amount of energy accessible for use now and in the future.



However, let us consider just how much 62 million bpds actually is. If we take Saudi Arabia today, daily production was 9.2 million bpd in December 2012 so the overall shortfall in production in 2030 requires the world to discover more than 6 producing sources the size of Saudi Arabia. With *"easy"* oil having already been discovered and exploited it is a very tall order to expect this rate of discovery of new oil. It should also be borne in mind that production is the key word, as oil needs to actually flow in order to meet real energy needs – it is not a theoretical exercise.

It is all very well discovering a large oil field but extraction is fraught with any number of risks and profitability is a major consideration. If the oil is expensive to get to then it will only come out when the price rewards the risks that the operator has to take. That implies higher prices and is something we spoke about when we looked at gas and fracking in our last report. Interestingly, the EIA has noted that global production of crude oil is in decline and has been since 2006.

It is worth mentioning that the EIA has predicted oil shale production by 2030 of 140,000 bpd and although a welcome source of production it hardly makes an impact on the missing 62 million bpd. Of course, the estimates they are using may be wrong but they would have to be wrong by a very large factor in order to fill the gap meaningfully.

Adam Sieminski, the head of the EIA, said in a recent interview in Riyadh that US production will peak in 2014 at 8 million bpd, which is the highest production level since 1988. He noted that:

"It will be very difficult for US crude oil production to reach the level that Saudi Arabia is capable of."

Oil shale and fracking do not look like being the magic discovery that will fill the substantial production shortfall. Indeed, the concern we should all have is that oil prices have remained high and are perceived as being too high given the current economic outlook and yet this has done nothing to bring on new supply to the market, which would normally be the case. On this basis energy prices in general look set to remain firm in our opinion.

With kind regards from the SUNARES team,

Colin Moor