Cavelti

Cavelti & Associates Ltd.
188 Eglinton Avenue East, Suite 706
Toronto, Ontario, Canada M4P 2X7
Phone 416 - 486 1900

Year-end 2016

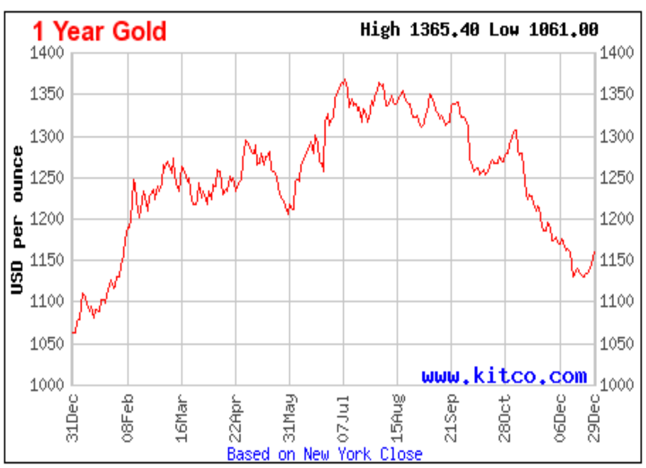
To: Our Clients
From: Peter Cavelti

Now What?

Dear Client :

During the days before the presidential election, the financial media uniformly declared that if Trump won, the stock market would collapse and gold go through the roof. The opposite happened: U.S. stocks embarked on a massive honeymoon rally, while gold prices collapsed.

Knowing that the media almost always gets it wrong, we never bought into its narrative, but what actually unfolded vastly surpassed our expectations. We did not think the stock market would rally to such an extent, nor did we believe gold would retreat so fast. As we end the year, the bullion price is only marginally up from last year's closing level, and considerably down from its 2016 highs.



Where to from here? To determine that, I want to look at current sentiment indicators and, in turn, examine gold through various relevant lenses. At the moment, public sentiment heavily favors the U.S. dollar and U.S. stocks. Donald Trump is Wall Street's new god. The people who were thought to be Hillary Clinton's allies are proving remarkably open to change: Donald Trump's stated views, regardless of how difficult to implement, are viewed as an elixir that will help corporate profits to new highs.

My guess is that, within a few days or weeks, some really hard questions will be asked, with the result that confidence in Trump and the Trump rally will be tested. When that happens, some important people will take profits on their stock gains, which will cause the dollar rally to pause and interest in gold to revive.

Looking a bit further out, I can't take guesses. President Trump's initiatives may go further and bring more positive change than people think, but they may also get bogged down and end up significantly watered down. If Donald Trump manages to do all the things he wants to do, we'll have a stock market reaching for the moon and gold will linger. If things get a bit more complicated, stocks and the dollar are likely to retreat and gold will regain its shine.

Three Tests for Gold

Now, because the recent fall in gold prices begs for a comprehensive reassessment, let me subject the yellow metal to three tests. How does gold look as a currency alternative, how does it stack up in terms of commodity fundamentals, and how does it look when viewed through the lense of technical analysis?

The last test is the easiest to answer—gold has fallen to a level that is critical. If it declines further, the technicians say, the bull market that characterized 2016 will be ended. As I write, the yellow metal is making feeble attempts to disprove such negative thinking, which goes to show that the nears still have the upper hand. A strong base needs to be built at present price levels to reassure investors.

In stark contrast, the profile for gold as a currency alternative looks excellent. Central banks around the world have vastly inflated their balanced sheets in the past few years, creating money to buy up all kinds of dubious assets, in order to contain first the financial crisis, then a stagnating economy. Because most of our clients view gold in terms of U.S. dollars, we should look at money creation in the U.S. as the most relevant statistic. The U.S. Federal Reserve's balance sheet has increased from $887 billion in 2008 to $4,470 billion in late 2016. If the financial media were as diligent in covering this issue as they are on largely imagined topics like Russian hacking, confidence in our currencies would quickly melt away.

Gold also looks good as a commodity. At current prices, numerous miners are losing money and that, in itself, is a virtual guarantee that supplies will shrink. The era of finding low-cost, world-class gold discoveries is now more than a decade behind us. Meanwhile, demand for bullion is robust, particularly from central banks. Russia, China and several emerging economies are steady buyers of gold, as they try to lessen their economic dependence on the U.S. dollar.
In short, at current gold prices, most mining companies are struggling, which makes gold stocks a risky investment. The price of gold bullion, on the other hand, is largely influenced by supply-demand equations, which are quite solid.

The bottom line: we continue to believe that a physically segregated holding of gold should continue to be a cornerstone of a prudently managed portfolio. In our opinion, an appropriate percentage for a bullion holding is around 15% of total assets. The current lull in gold prices makes this an ideal time to rebalance your holdings.

With best wishes for 2017—may the new year bring you health, happiness and success!

Best regards,