Incrementum Chartbook #4

WHO'S AFRAID OF RECESSION?

Why A Recession In The US Is Coming Closer & How To Be On The Right Side Of The Trade

Photo credit: Wikimedia Commons

Ronald-Peter Stoeferle & Mark J. Valek

www.incrementum.li

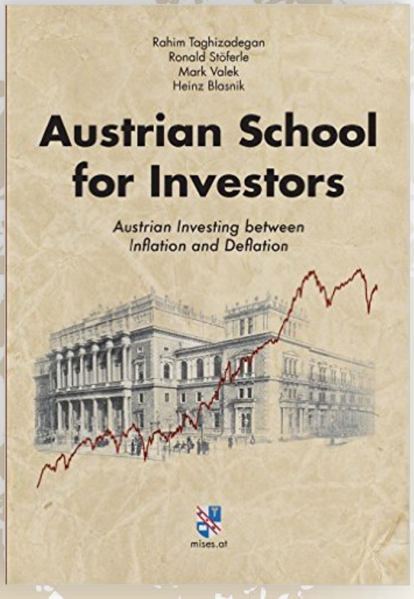
February 19, 2016

Our Conviction

Financial markets have become highly dependent on central bank policies. Grasping the consequences of the **interplay between monetary inflation and deflation** is crucial for prudent investors.

Due to structural over-indebtedness and the resulting addiction to low/negative real interest rates, **we are certain that the traditional way of thinking about financial markets and asset management has lost relevance for investors.**

Therefore, **at Incrementum we evaluate all our investments not only from the perspective of the global economy but also in the context of the current state of the global monetary regime.** This analysis produces what we consider a truly ***holistic view*** of the state of financial markets.



We sincerely believe that the Austrian School of Economics provides us with the appropriate intellectual foundation, especially in this demanding financial and economic environment.

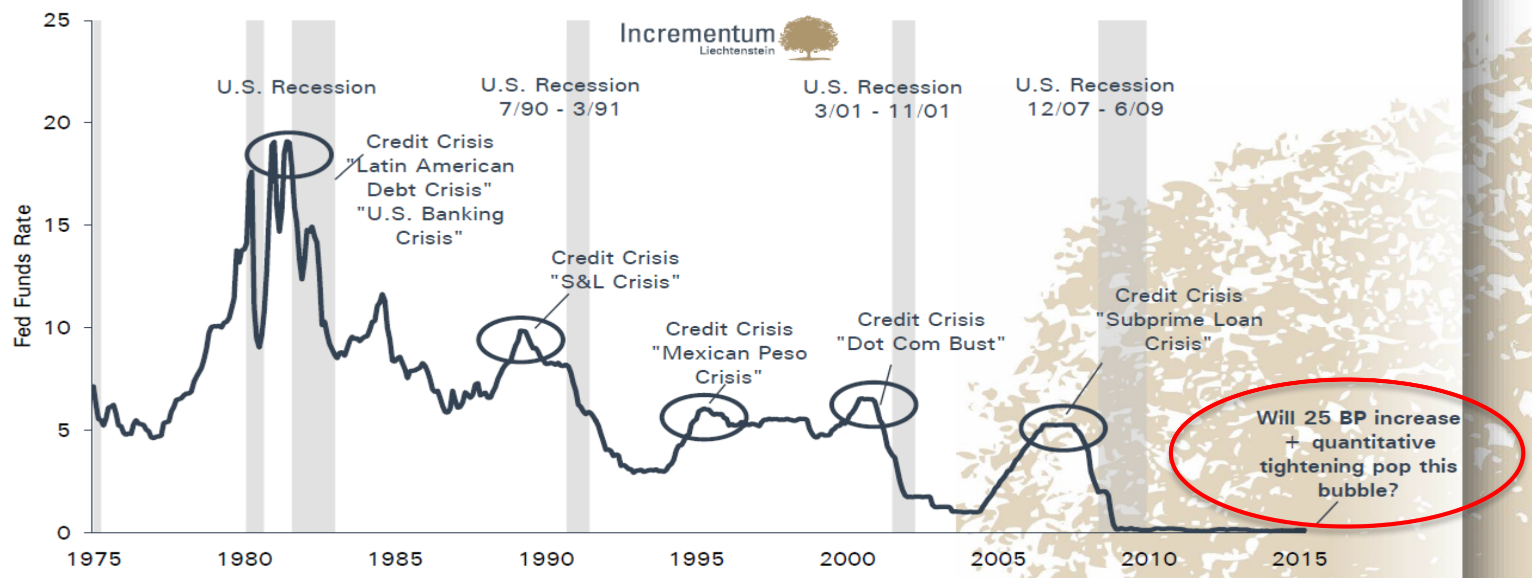
Ronald-Peter Stoeferle, Mark J. Valek

Recession Ahead? – An Overview

1. Introduction

In 2015 We Warned On Several Occasions…

High Debt Levels And Rising Rates… What Interest Rates Other Than Zero Could Governments Be Able To Pay?



This long-term chart of US policy rates reveals that rate hikes have always been followed by recessions and financial crises. Low interest rates are a trap, as people and governments engage in low marginal-return projects that cannot survive rate hikes. **This time around talks of a rate increase and "*quantitative tightening*" (which is happening via EM Central Banks which have to sell T-bonds) could trigger the next crisis.**

Source: Chartbook Gold & Market Update: September 2015 p.17, Incrementum AG

Markets Are Now Starting To Price In Our "Scenario I" That We Outlined In Our Last "In Gold We Trust Report" (June 2015)

We are strongly convinced that we are now close to a fork in the road. Over the coming three years, a paradigm change is likely to become evident in the markets, quite possibly including rising inflationary trends. We believe the following scenarios to have the highest probability:

Scenario I: The current economic cycle nears its end and the fairy tale of a self-sustaining recovery is increasingly questioned by market participants. **This leads to a significant devaluation of the US dollar relative to commodities, since the Fed – as it has stressed time and again – will once again employ quantitative easing or similar interventions if occasion demands it.** In this case gold would benefit significantly from wide-ranging repricing in financial markets. A stagflation-type environment would become a realistic alternative in this scenario, something that is currently on almost no-one's radar screen.

Source: *In Gold we Trust Report 2015, p.119, Incrementum AG*

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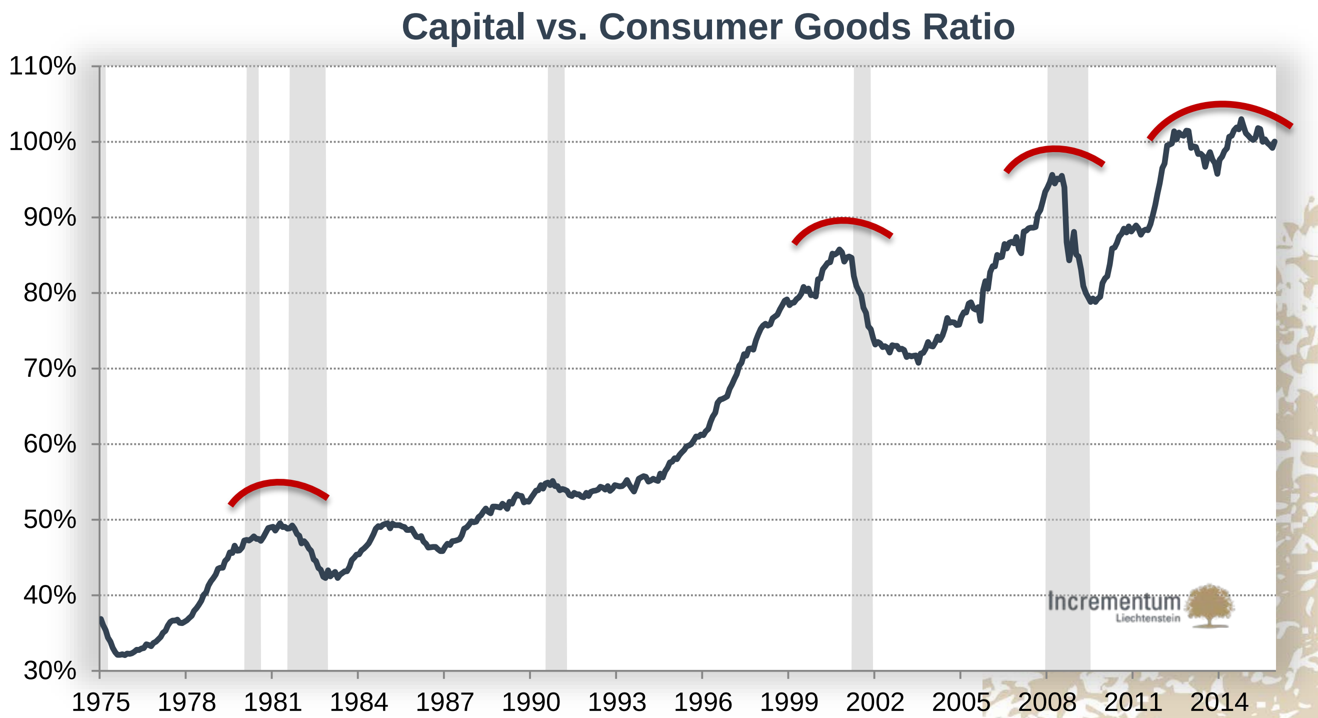
Why Were We Cautious Already Back Then? The Austrian Perspective Leads To A Different Understanding Of The Economy…

"To combat a depression by a forced credit expansion, is akin to the attempt to fight an evil by its own causes; because we suffer from a misdirection of production, we want even more misdirection – an approach that necessarily leads to an even more serious crisis once the credit expansion comes to an end."

Friedrich August von Hayek

…And Teaches Us That Artificial Credit Expansions Distort The Capital Structure, Which Eventually Has To Correct…



- If real interest rates are distorted, market participants receive misleading price signals and invest too much into capital goods (e.g. oil exploration) relative to consumer goods
- A reallocation of capital (i.e. bankruptcies, liquidation of debt) becomes inevitable, which usually coincides with a recession
- This phenomenon is primarily explainable by an unsustainable credit-induced boom

Sources: Federal Reserve St. Louis, Incrementum AG

…And That Bureaucrats Are Not Likely To "Save The World"

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Neither Have They Warned About Calamities In The Past…

*"…given the fundamental factors in place that should support the demand for housing, we believe the effect of the troubles in the subprime sector on the broader housing market will likely be limited, and **we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system**."*

May 17, 2007

"The Federal Reserve is not currently forecasting a recession."

Jan. 10, 2008

…Therefore We Would Take Warning Of A False Sense Of Security Now…

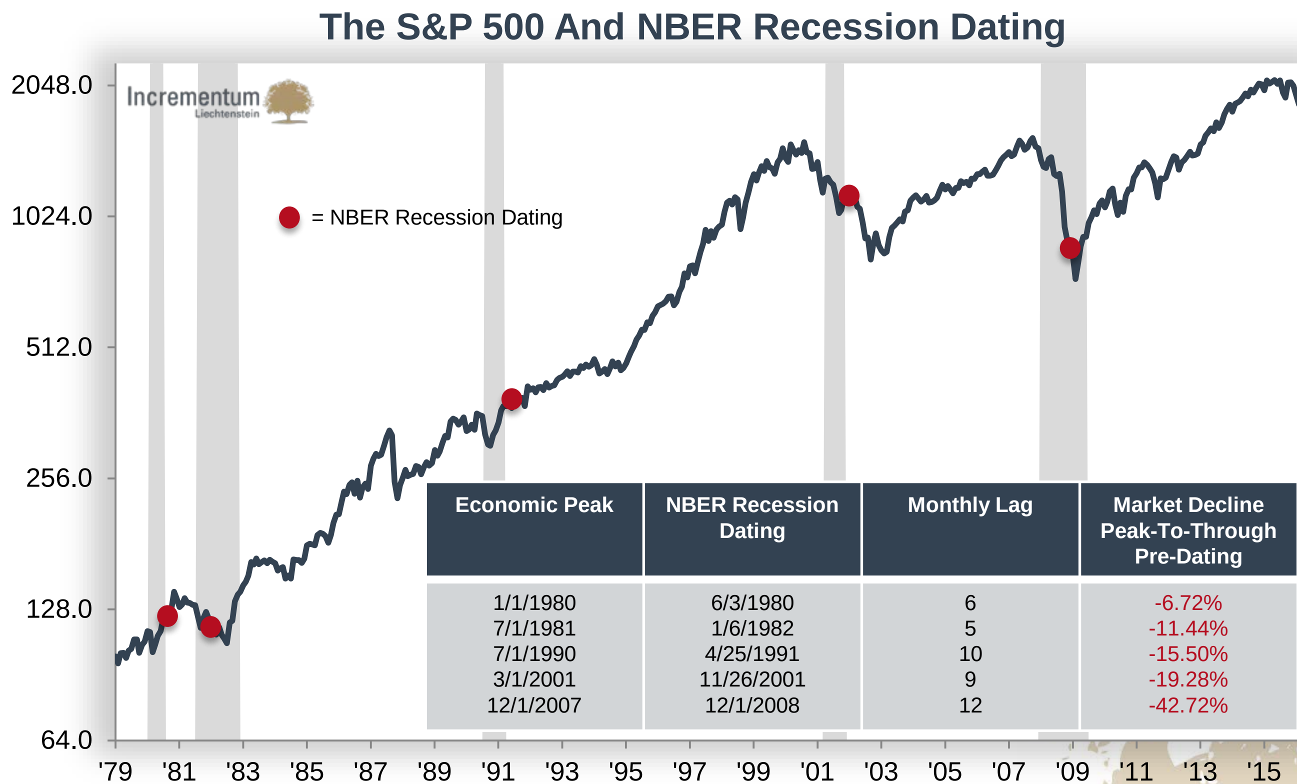
"So I think the first—the first thing that Americans should realize is that the Fed's decision today reflects our confidence in the U.S. economy […], ***we see an economy that is on a path of sustainable improvement.****"*

Janet Yellen, Dec. 2015

"I don't think it's going to be necessary to cut rates"

Janet Yellen, Feb. 2016

It's Not Only About Forecasting Recessions: Also Recognizing Them Once They Occur Is A Puzzler



Economic Peak	NBER Recession Dating	Monthly Lag	Market Decline Peak-To-Through Pre-Dating
1/1/1980	6/3/1980	6	-6.72%
7/1/1981	1/6/1982	5	-11.44%
7/1/1990	4/25/1991	10	-15.50%
3/1/2001	11/26/2001	9	-19.28%
12/1/2007	12/1/2008	12	-42.72%

- **It takes 6-12 months before the economic data is collected and evaluated in order to officially attest a recession (e.g. in 2007 it took 1 year until NBER made its official call)**

Sources: Realinvestmentadvice.com, Incrementum AG

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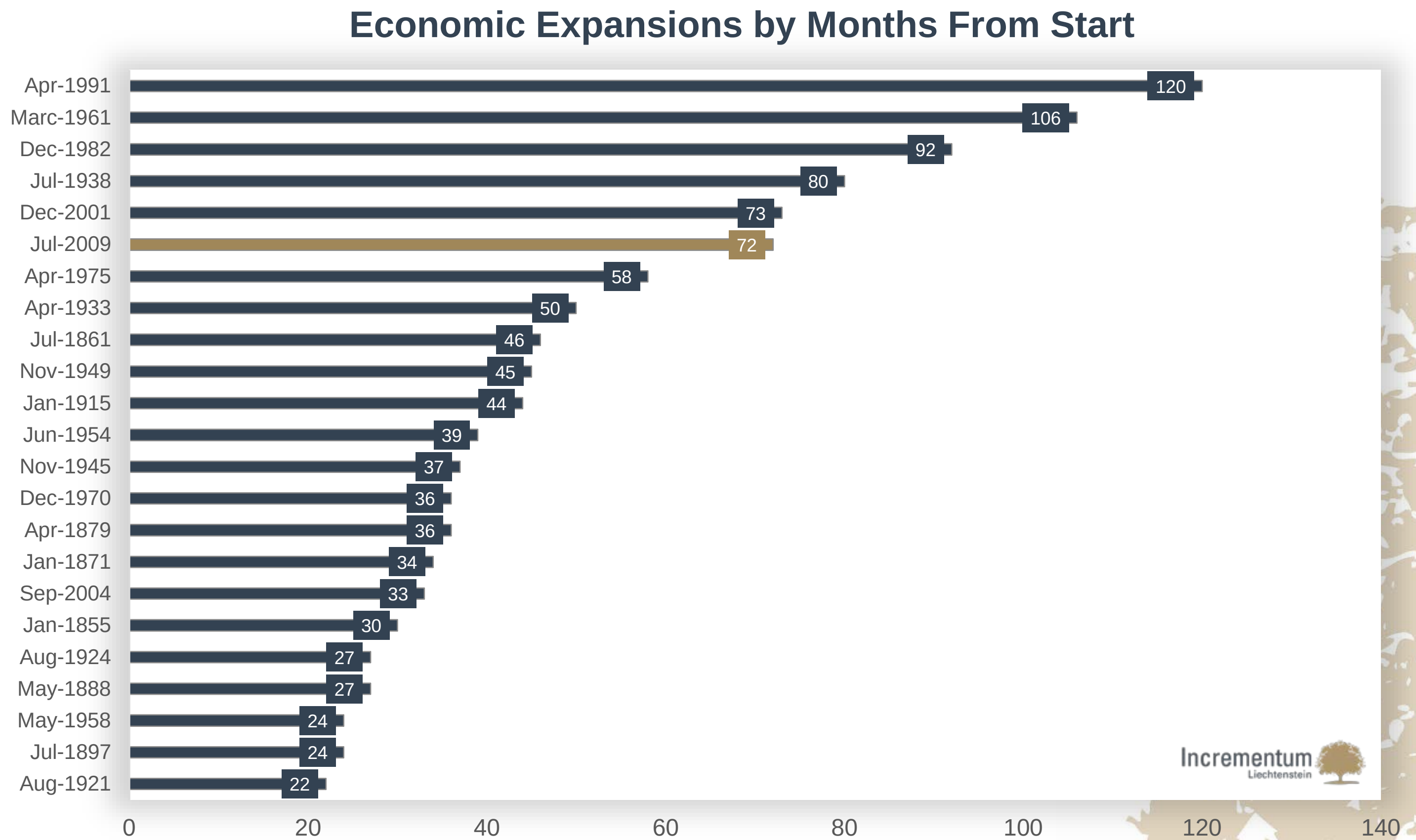
2. Did We Go Through A Whole Economic Cycle Without Growth Having Really Taken Off?

The Current Expansion Has Been Long…



- **Currently, the US economy is (officially) already in its eighth year of economic expansion. This suggests that in light of historical business cycle patterns the beginning of a recession appears to be increasingly likely.**

Sources: Bawerk.net, Incrementum AG

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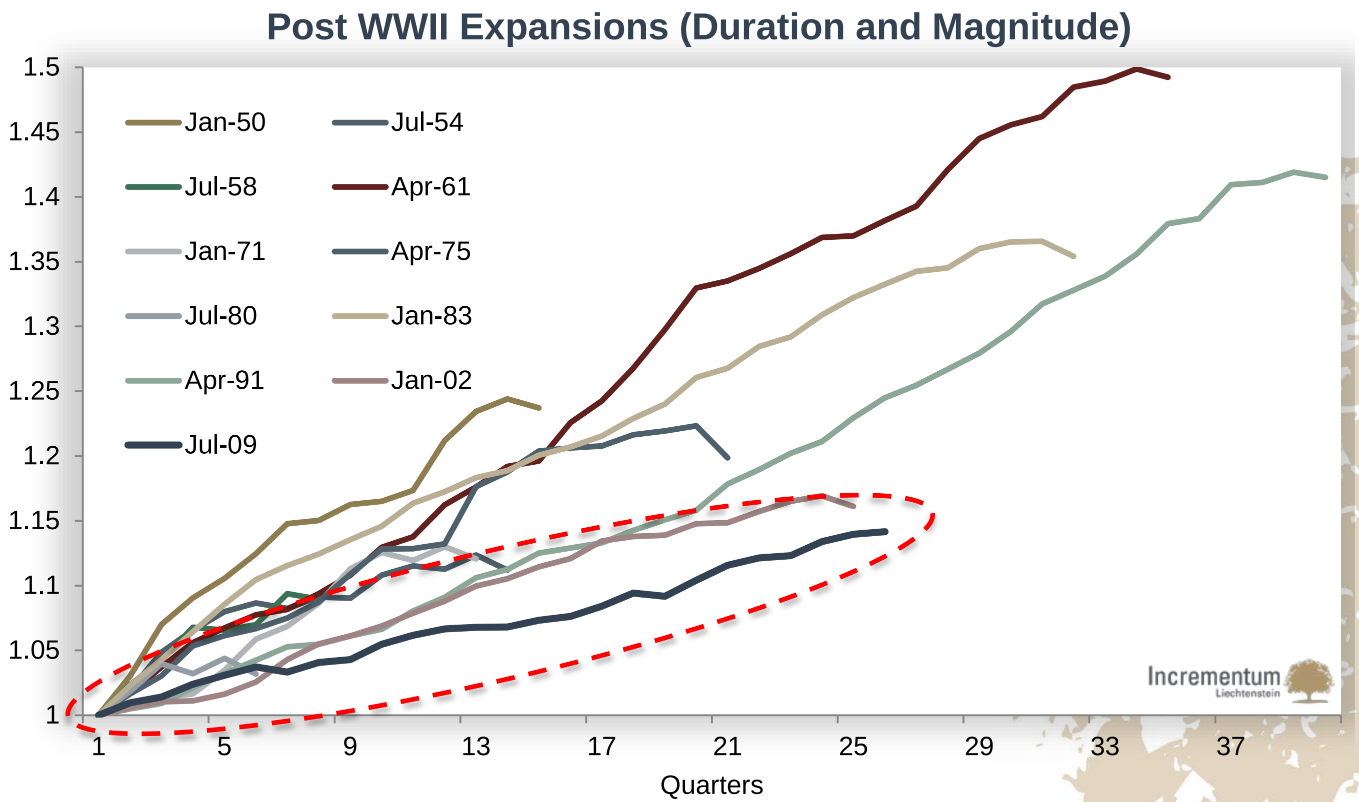
… But Also Weak



- **Since 1971, there have been six recessions in the US**. The duration of the average economic expansion between these contractions amounted to 5.4 years, whereby the longest period without a recession lasted 10 years.

Sources: Bawerk.net, Incrementum AG

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The New Normal Or The End Of A Weak Recovery?

Sources: Federal Reserve St. Louis, Incrementum AG

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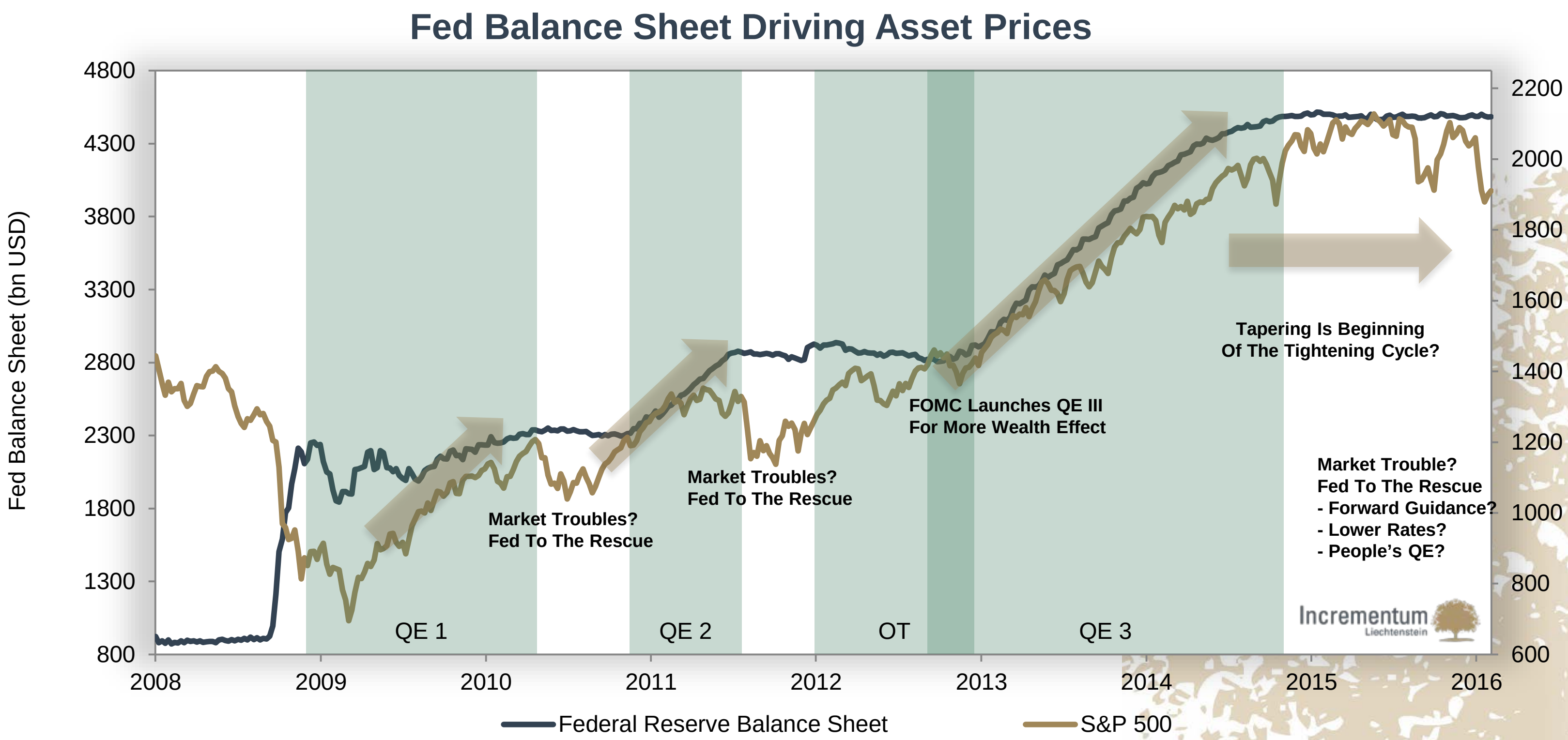
Tapering = Tightening?
…32 Months* Into The Tightening Cycle Already



- **Tapering and the end of QE3 were de facto a tightening**
- Printing money has created only artificial wealth by boosting asset prices
- **Current market corrections make further loosening likely (instead of further rate hikes)**

*** Ben Bernanke announced tapering in May 2013**

Sources: Realinvestmentadvice.com, Incrementum AG

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3. Signs Of An Upcoming Recession

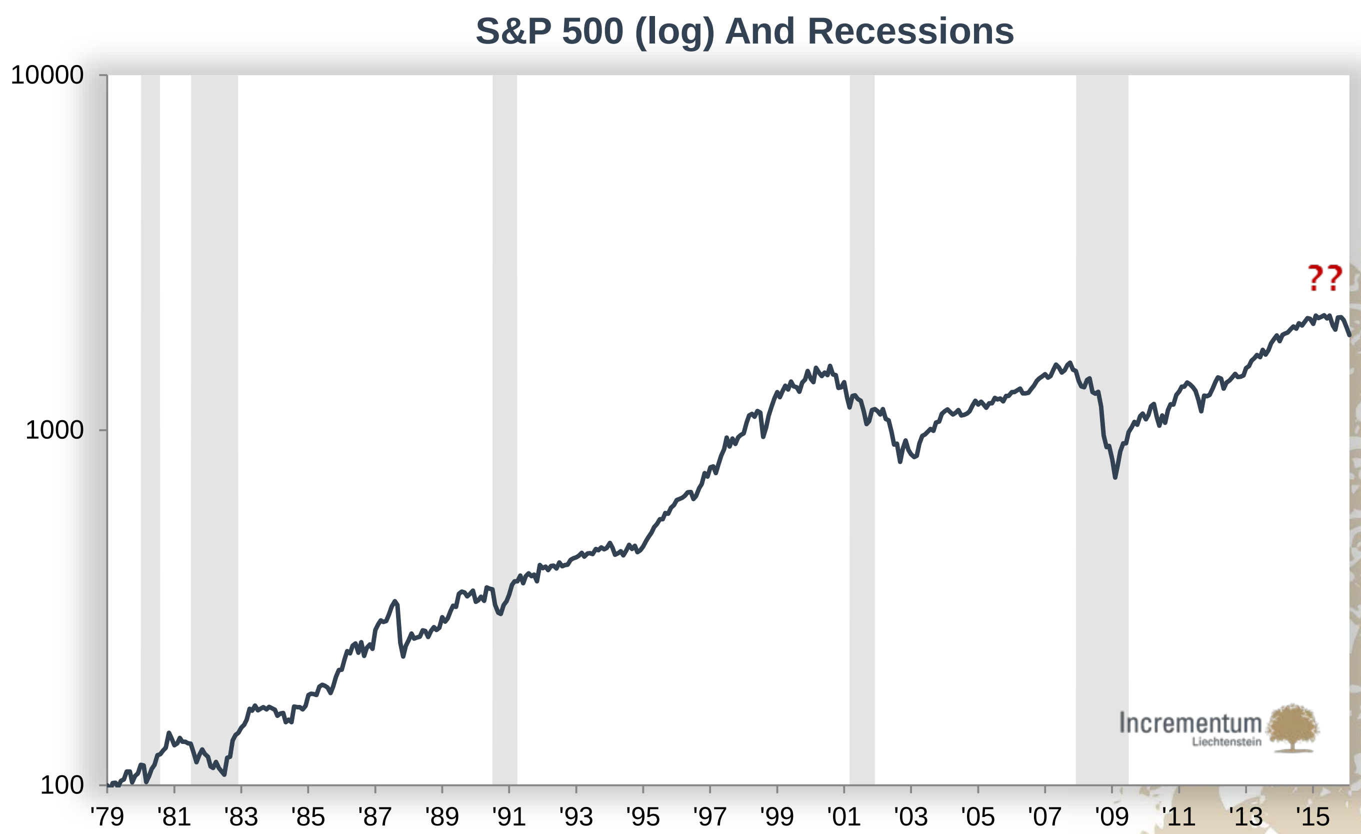
Due To The Highly Levered State Of Our Financial System, Recessions May Be Triggered By Decreasing Asset Prices

2000
Decline in Tech Stocks → **Early 2000s Recession**

2007/2008
Decline in Home Prices → **2008 Financial Crisis**

?? 2016 ??
Decline in financial conditions → Downgrades → Cost of capital increases → Corporate cash flows are pushed down → Liabilities cannot be paid → Deflation / credit crunch / reflation??

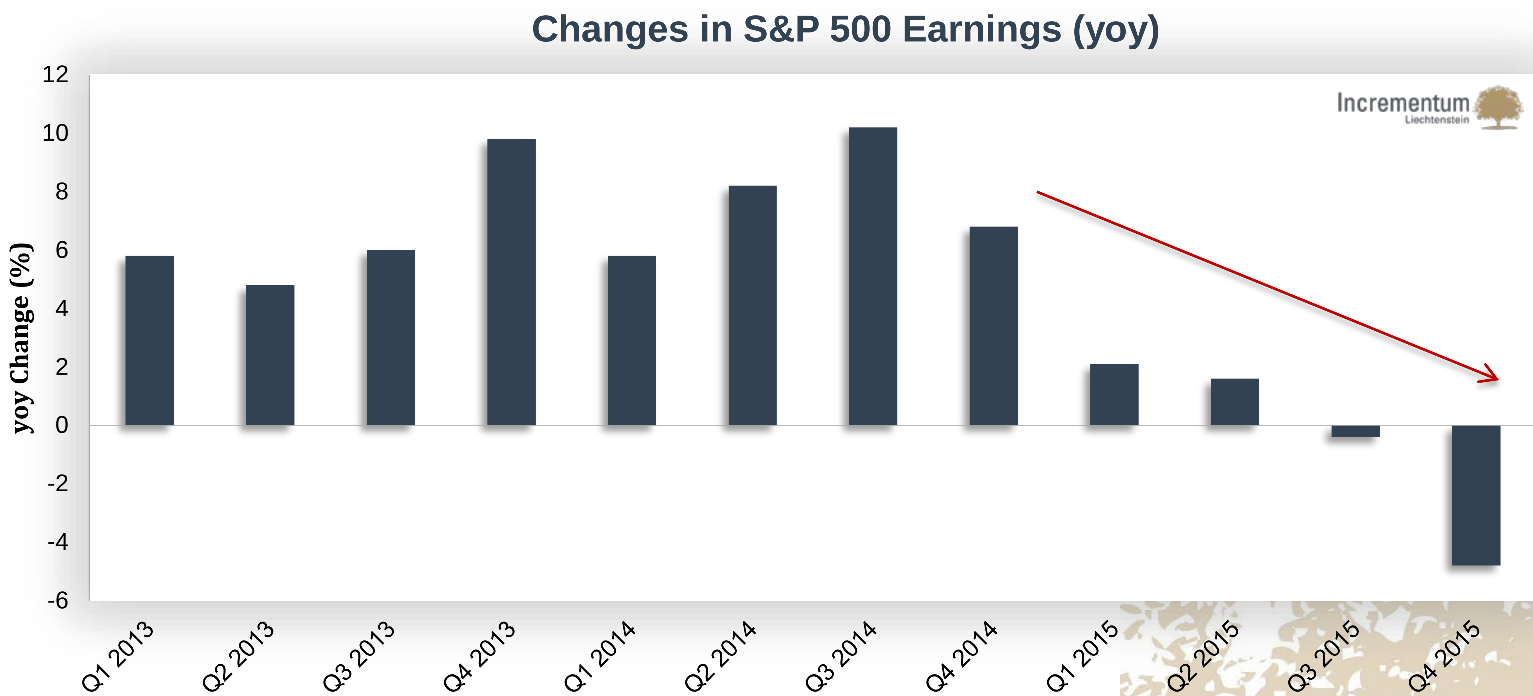
Recessions Coincide With More And More Radical Downturns In The S&P 500



- **Recessions do not cause asset prices to decrease, but decreases in asset prices can trigger recessions**

Sources: Federal Reserve St. Louis, Incrementum AG

Trouble Ahead?
Earnings Are Already In Recession…



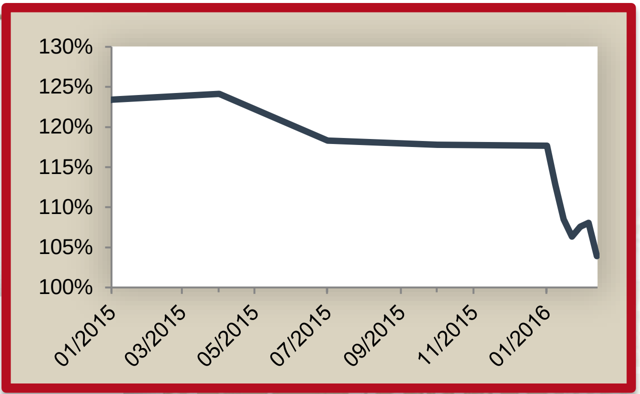
- **Earnings have been weak for almost a year now, in Q4 that trend has accelerated**
- **One reason is the strong US dollar: especially the big companies of the S&P 500 index derive about 40% of their revenues from overseas**
- **Weak earnings precursor to job cuts?**

Sources: Federal Reserve St. Louis, Incrementum AG

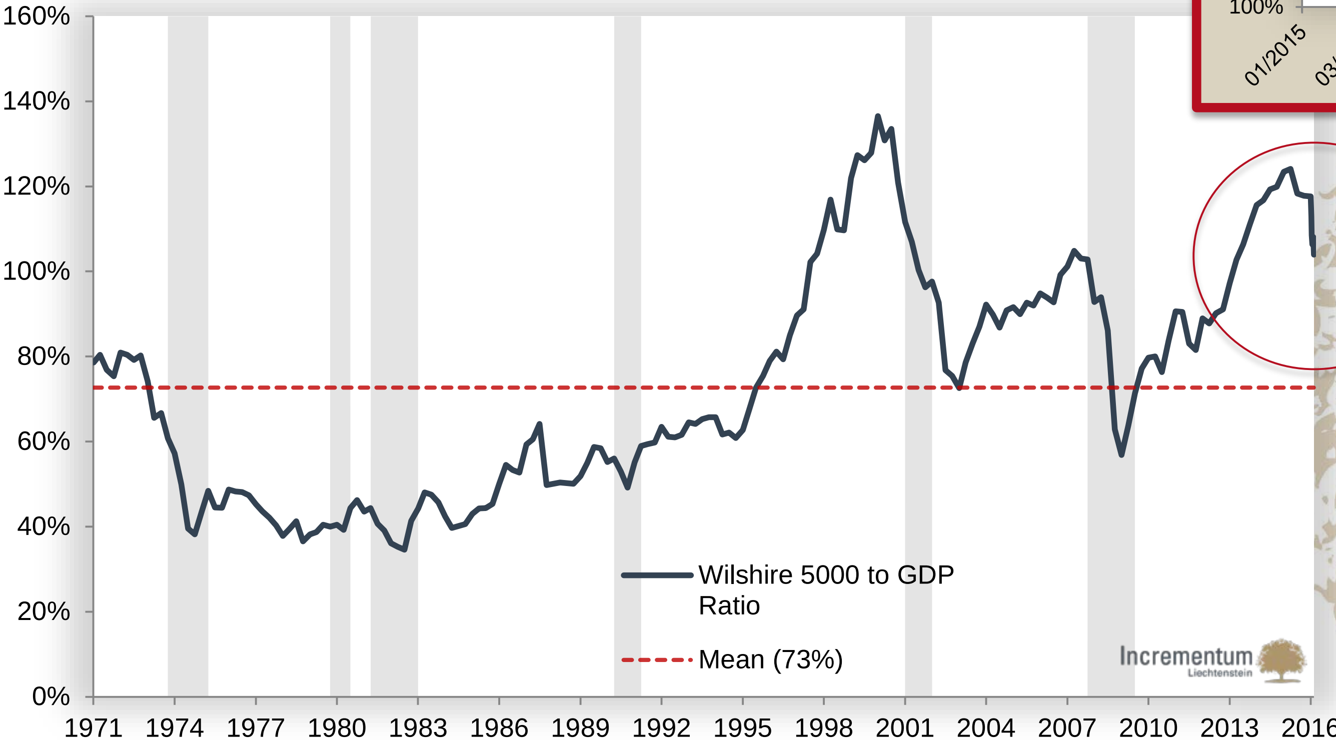
"Inverse Wealth Effect": Market Cap To GDP Is In Freefall

"It is probably the best single measure of where valuations stand at any given moment." [1]

Warren Buffett



Wilshire 5000 To GDP*

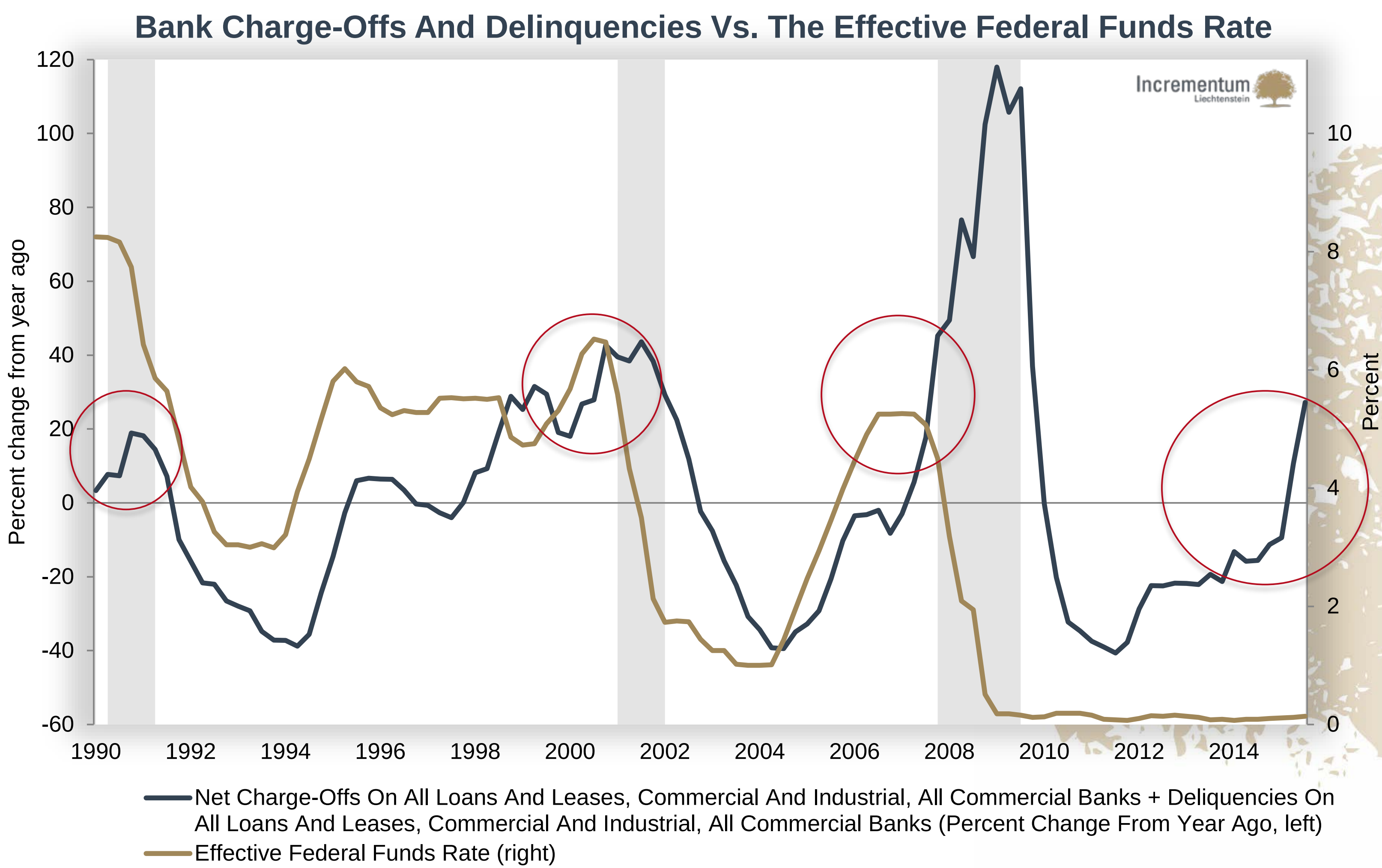


* Note: The Wilshire 5000 Full Cap Price Index© to GDP Ratio is a variant of the Buffett Indicator. The data from 1971/Q1 to 2015/Q4 is calculated quarterly, thereafter weekly. As an approximation, GDP is assumed to be constant after the latest official data release of 2015/Q4.

Sources: Federal Reserve St. Louis, Incrementum AG

[1] http://archive.fortune.com/magazines/fortune/fortune_archive/2001/12/10/314691/index.htm

Recession Warnings From Loan Charge-Offs And Delinquencies – Alert Now Even Before The Fed Began To Hike Rates



Sources: http://www.acting-man.com/?p=41924, Federal Reserve St. Louis, Incrementum AG

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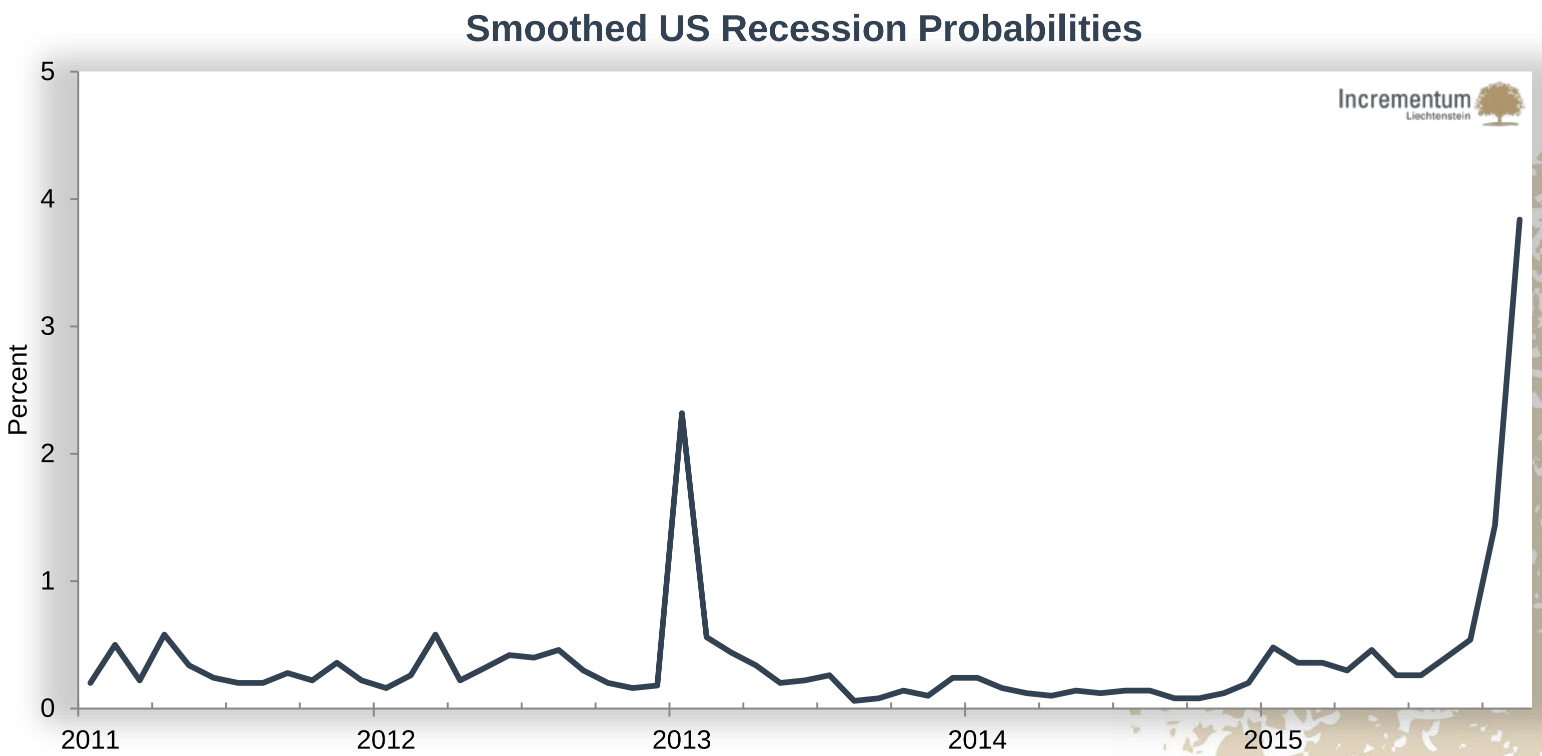
US Recession Probabilities Are Starting To Rise



"Smoothed recession probabilities for the US are obtained from a dynamic-factor markov-switching model applied to four monthly coincident variables: non-farm payroll employment, the index of industrial production, real personal income excluding transfer payments, and real manufacturing and trade sales. This model was originally developed in Chauvet, M., "An Economic Characterization of Business Cycle Dynamics with Factor Structure and Regime Switching," *International Economic Review*, 1998, 39, 969-996.

Sources: Federal Reserve St. Louis, Incrementum AG

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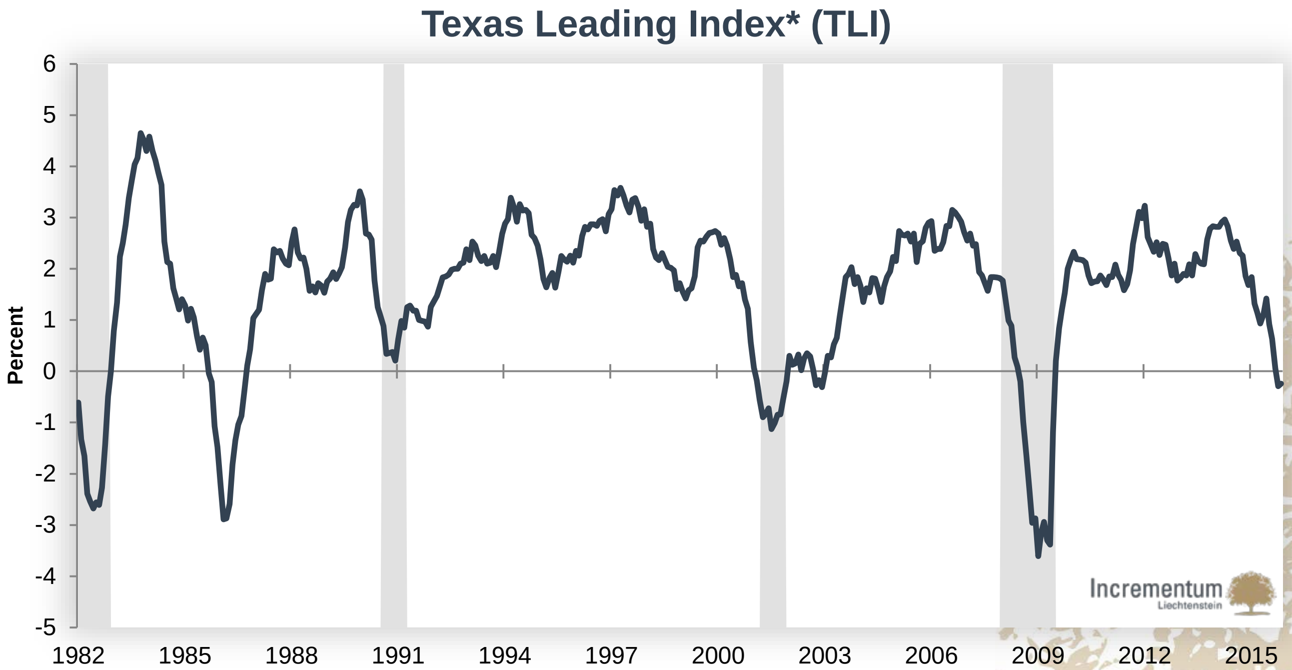
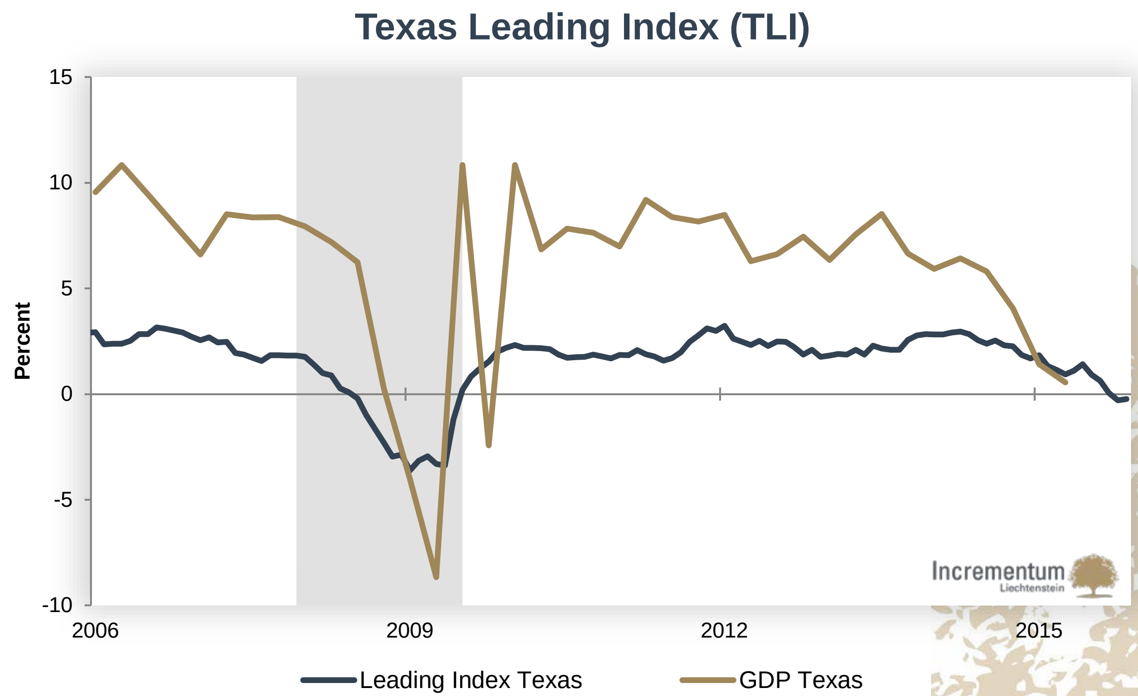
Will Distress In Oil And Gas Spill Into Other Sectors? Yes! (1/2)



- **Turmoil and rising default rates in the energy sector will spill over into other sectors, because the displacement in the boom sector has a multiplier effect on the overall credit cycle.**
- As energy companies leverage up to buy land and capital goods, and to hire labor, it stimulates spending and borrowing activity of the former owners of land and capital goods.

Sources: "Africa Strategy – Stormy seas ahead for SSA as easy-money's bubbles burst", Investec, Chris Becker, (2016-02), Federal Reserve Bank of Dallas, Bureau of Economic Analysis, Federal Reserve St. Louis, Incrementum AG

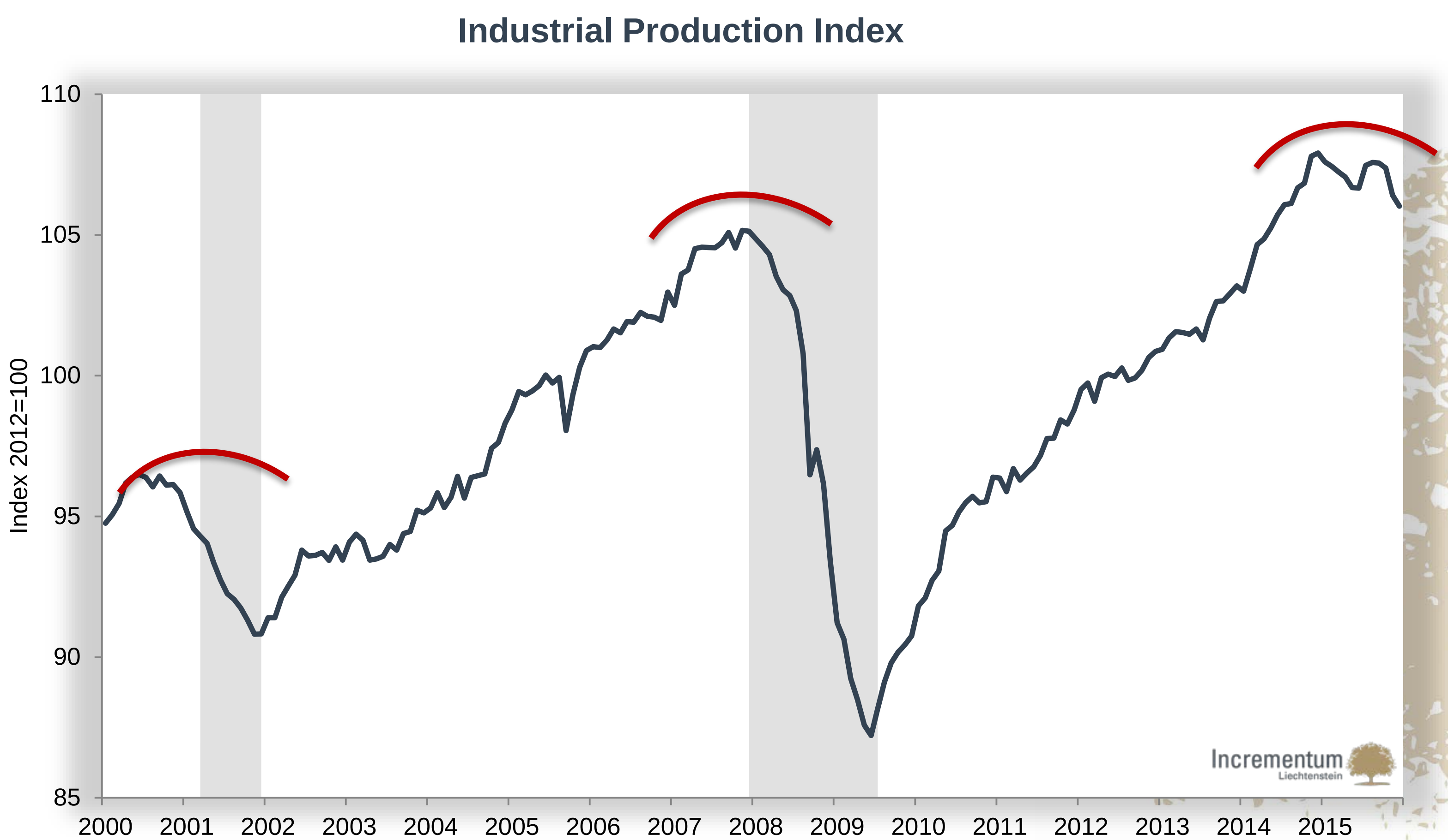
Will Distress In Oil And Gas Spill Into Other Sectors? Yes! (2/2)



- **The USD 1.6 trillion economy of Texas (the 12th largest in the world by GDP) – is already in sharp decline**
- Texas Leading Indicator (TLI) is a composite of 8 indicators that tend to anticipate the overall economic trend – **apart from 1986, sharp declines in the TLI usually coincided with US recessions**
- **The Dallas Fed Manufacturing Outlook Survey: contractionary territory for 13 consecutive months, and in January collapsed to -34.6 points, the lowest since early 2009**

Sources: "Africa Strategy – Stormy seas ahead for SSA as easy-money's bubbles burst", Investec, Chris Becker, (2016-02), Federal Reserve Bank of Dallas, Bureau of Economic Analysis, Federal Reserve St. Louis, Incrementum AG

The Industrial Production Index Has Come To A Halt



Sources: Federal Reserve St. Louis, Incrementum AG

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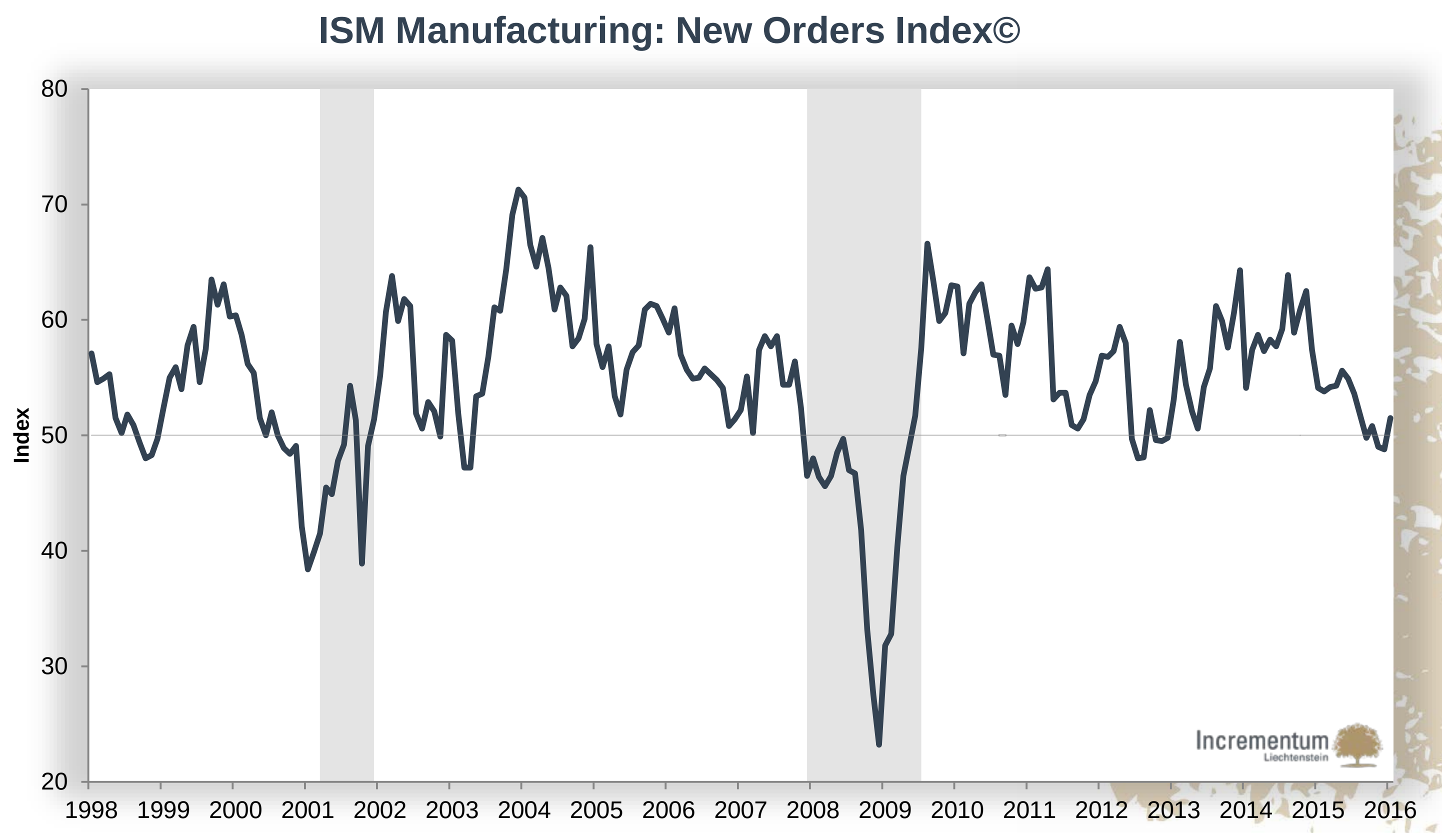
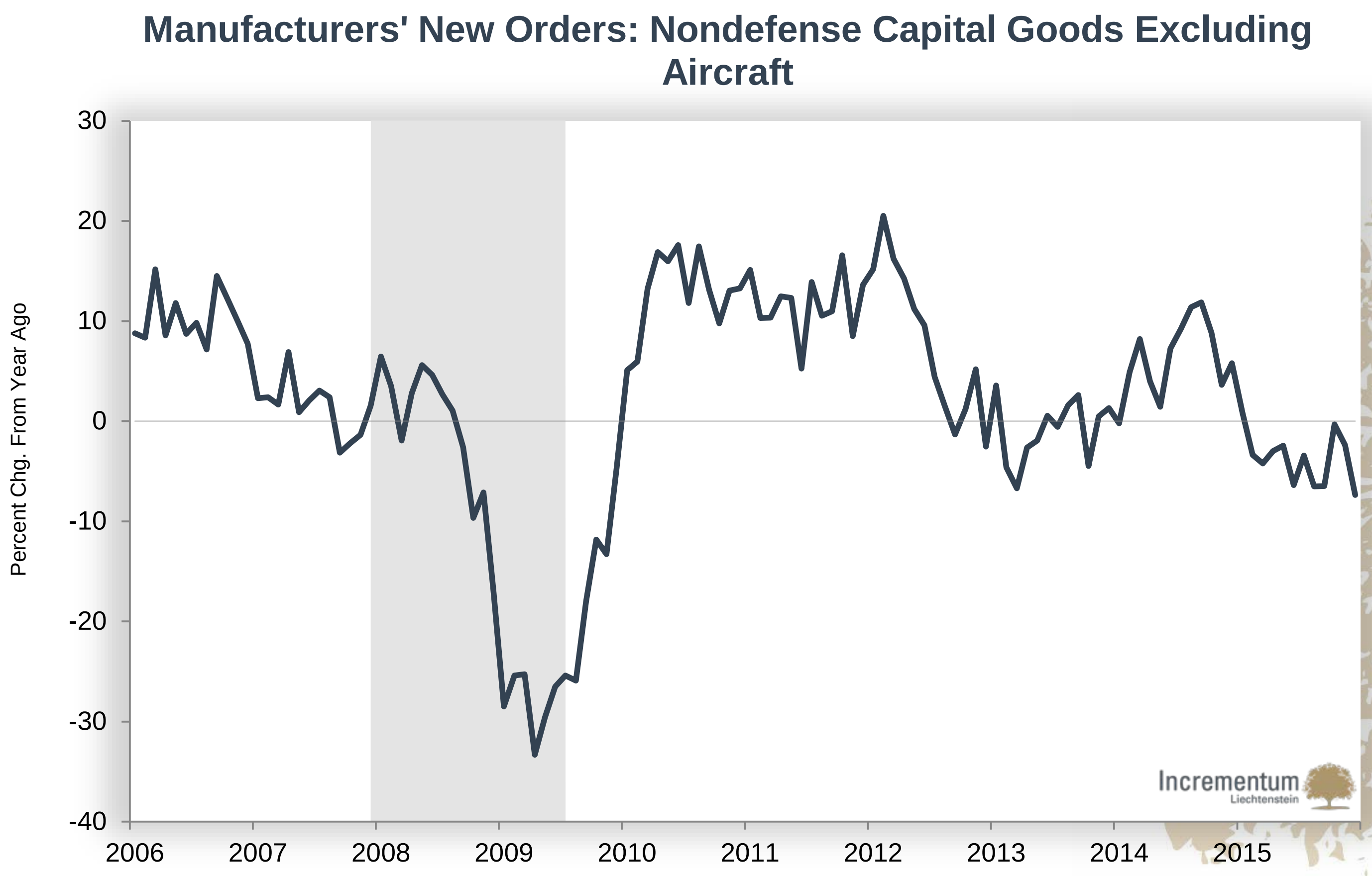
ISM Manufacturing: New Orders Are Entering Recession Territory



Sources: Federal Reserve St. Louis, Incrementum AG

Manufacturers' New Orders Have Been Declining for Almost One Year



Sources: Federal Reserve St. Louis, Incrementum AG

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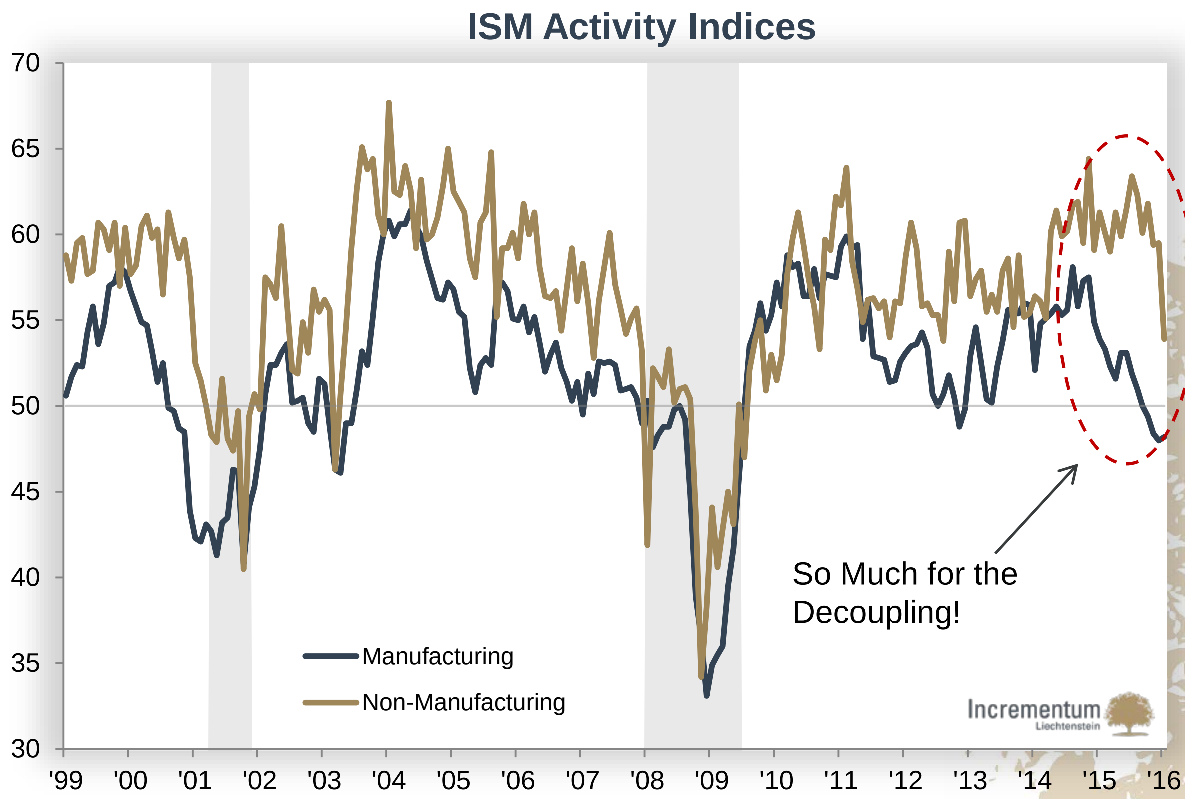
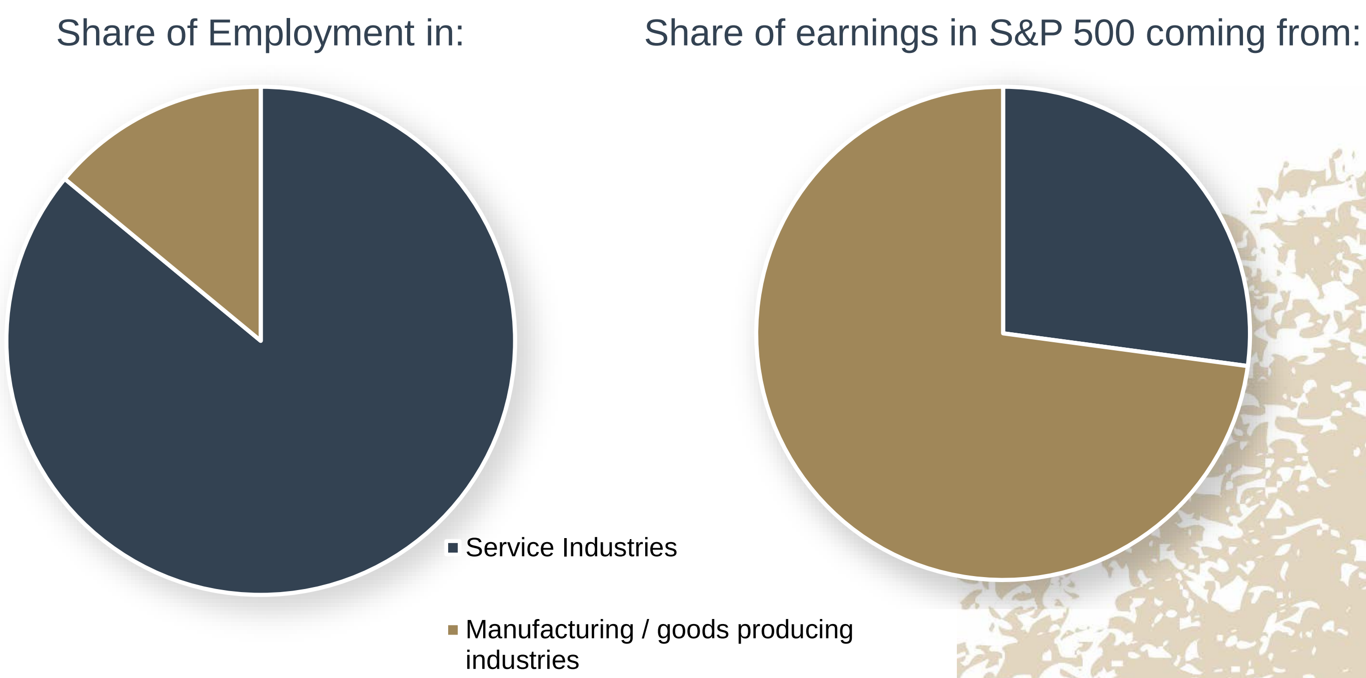
Weakness In Mining And Manufacturing Seems To Spill Over To The Rest Of The Economy



- **The current lag between Manufacturing and Non-Manufacturing resembles the situation ahead of the 2001 recession**
- The service sector can react very sensitively to declines in asset prices

Sources: Federal Reserve St. Louis, Incrementum AG

Manufacturing Still Matters – A Recession In Manufacturing Is Not Negligible

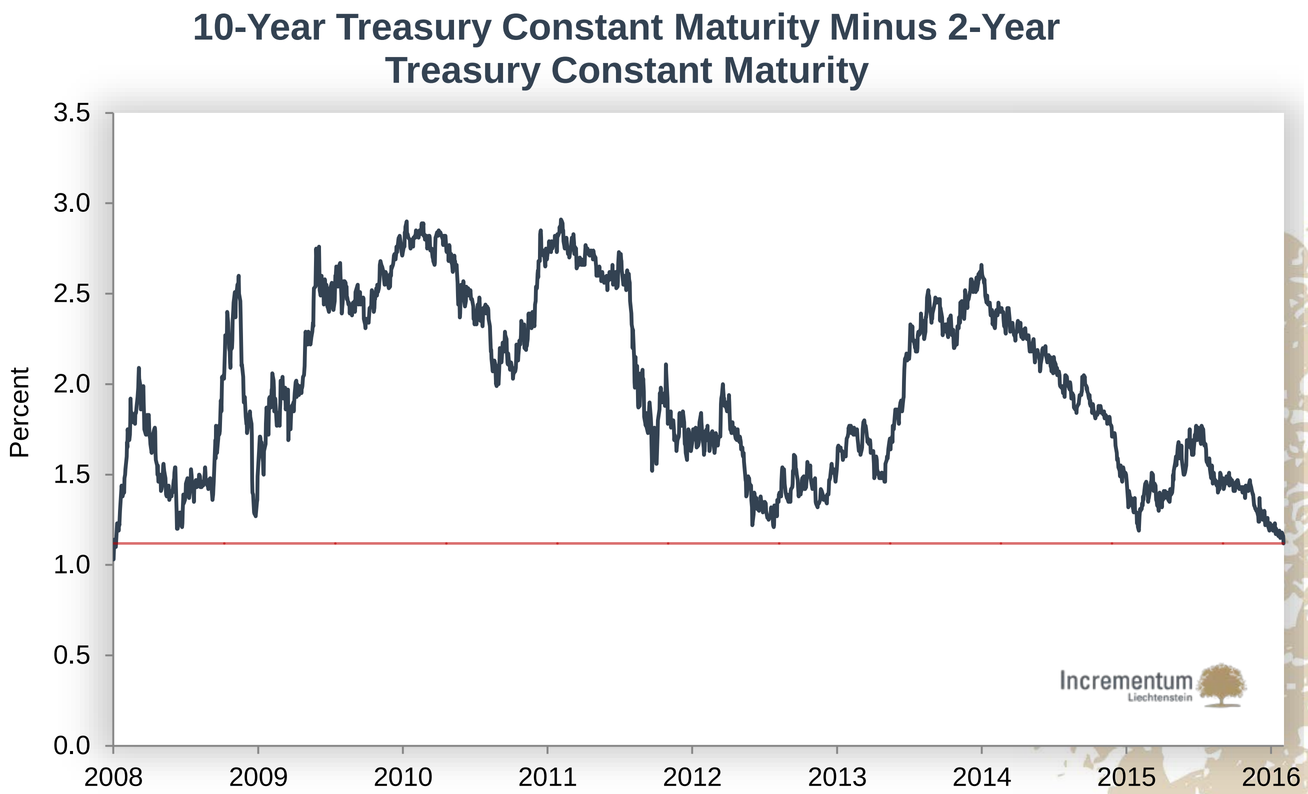


Note: Service industries are: Financials, Multiline Retail, Internet & Catalog Retail, Diversified Consumer Services, Hotels, Restaurants & Leisure, IT Services, and Health Care Providers & Services

- **Hence it's a myth that the US economy would be merely dependent on the service sector**

Sources: http://globaleconomicanalysis.blogspot.ca/2016/01/debunking-myth-consumer-spending-is-67.html, David Bianco, Ju Wang, Winnie Nip, Incrementum AG

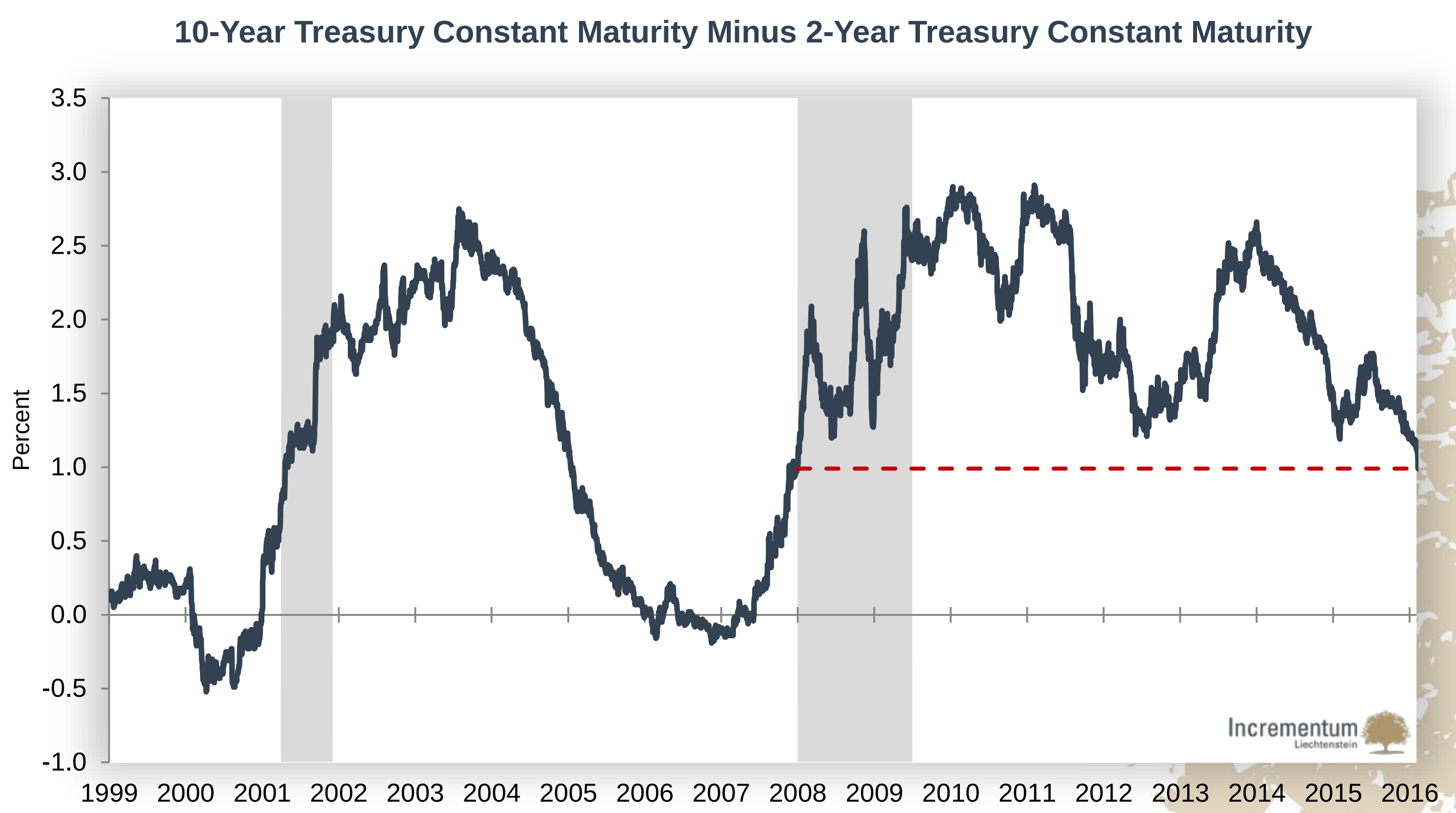
The Yield Curve Is Now The Flattest Since Early 2008



- **It is well known that the slope of the yield curve – i.e. the 10-2 year treasury yield spread – is a reliable predictor for future economic development**
- Appropriate for predicting recessions two to six quarters ahead

Sources: https://www.newyorkfed.org/medialibrary/media/research/current_issues/ci2-7.pdf, Federal Reserve St. Louis, Incrementum AG

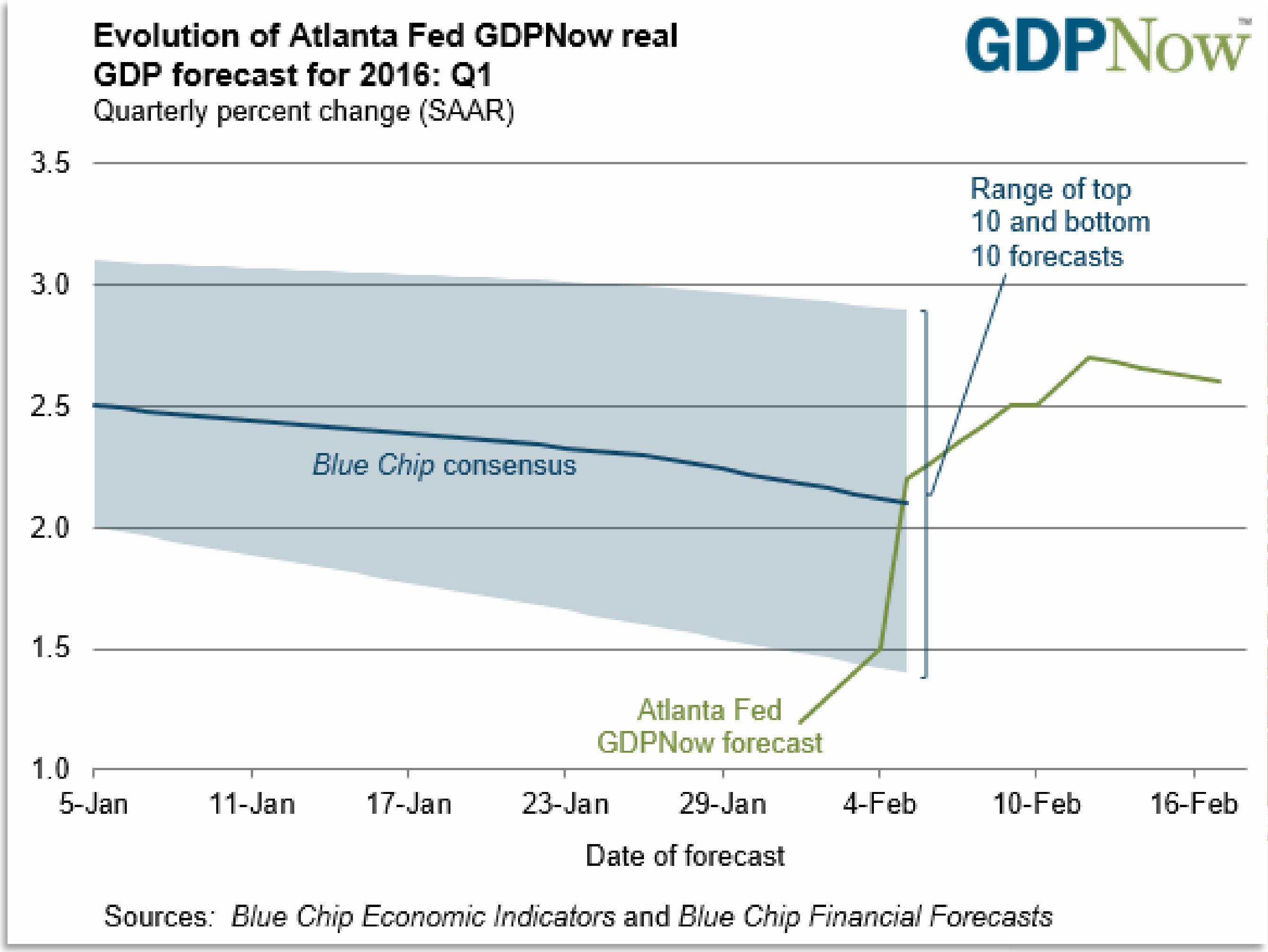
However, The Curve Is By Far Not As Flat As It Had Been Before The Last Two Recessions



- **While the yield curve is in significant decline, a recession does not appear to be just around the corner from this perspective**

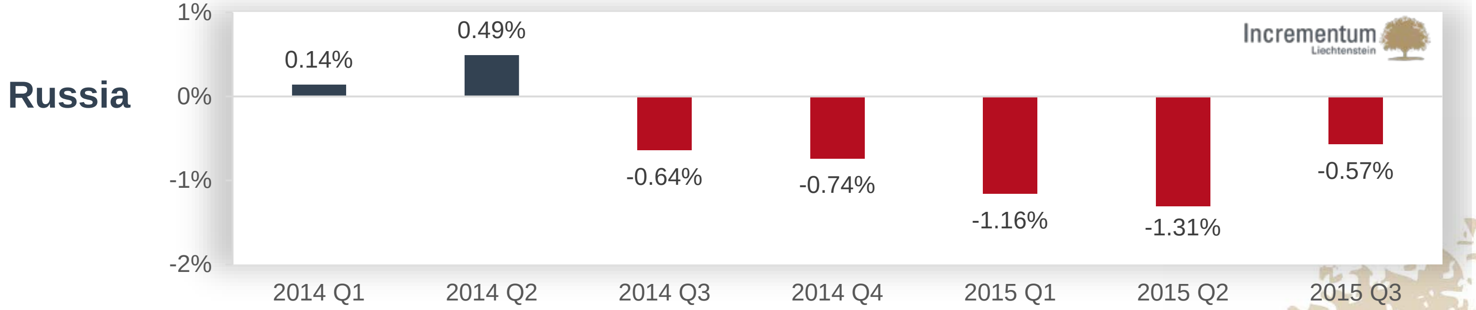
Sources: https://www.newyorkfed.org/medialibrary/media/research/current_issues/ci2-7.pdf, Federal Reserve St. Louis, Incrementum AG

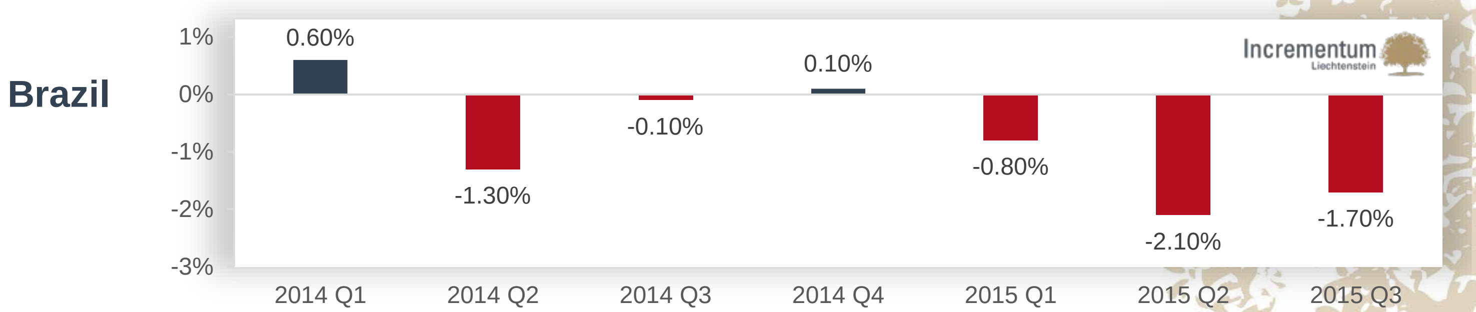
After A Weak Q4, Atlanta Fed's GDPNow Is Indicating Some Relieve…. For Now…

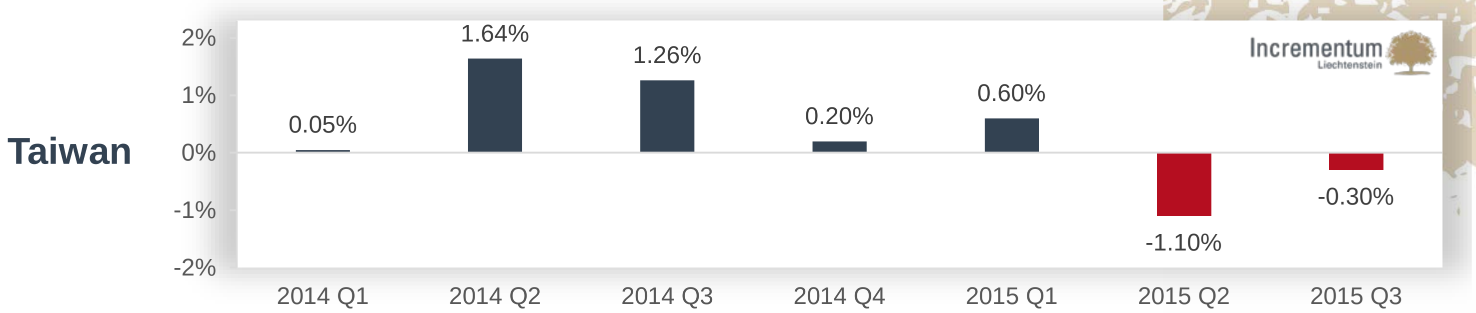


Sources: Federal Reserve Atlanta, Incrementum AG

However, Some Important Economies Are Already In Recession And Stagflation…



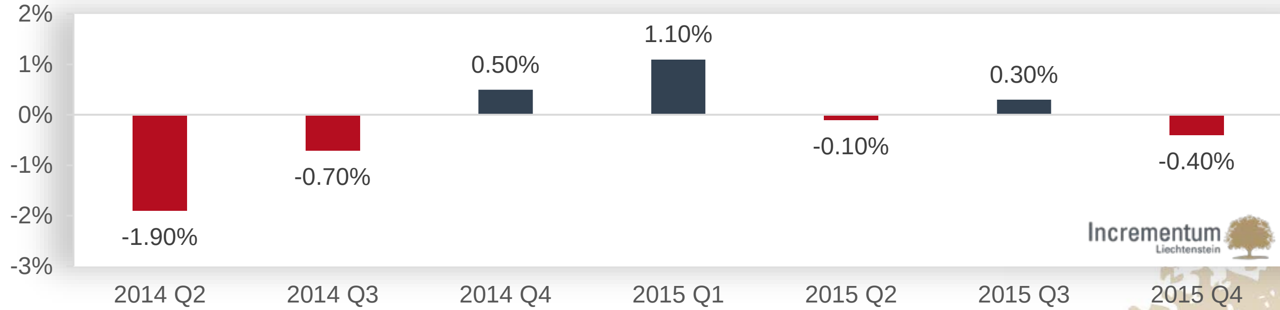




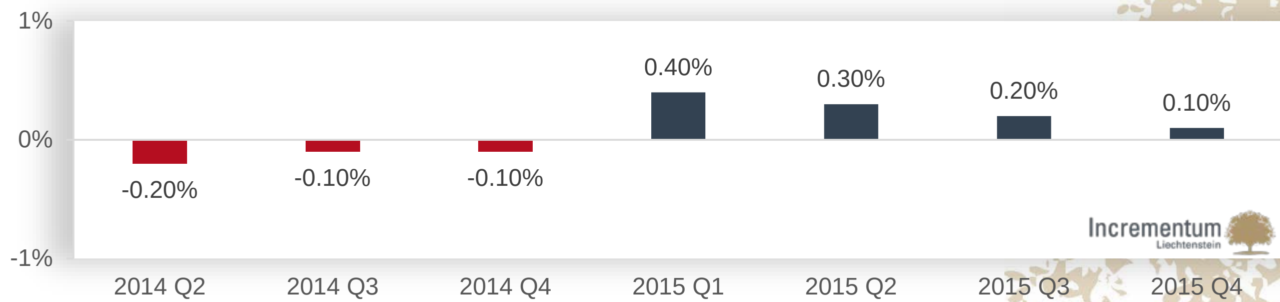
Sources: Tradingeconomics.com, Incrementum AG

… And Others Are Hanging On The Ropes

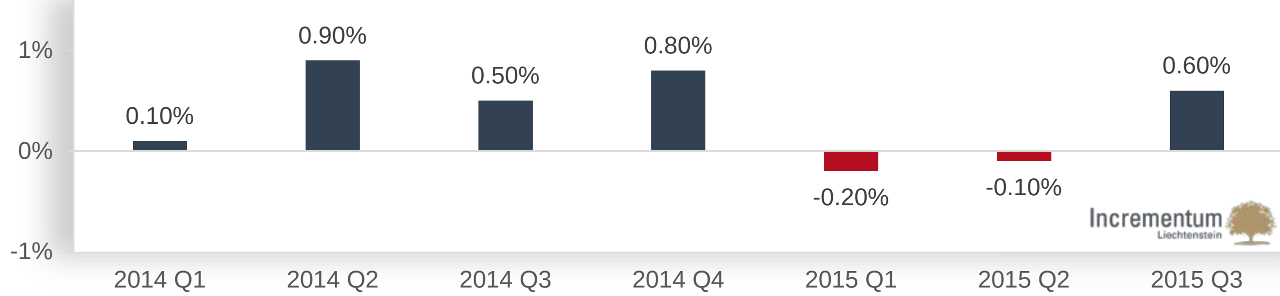
Japan



Italy



Canada



Sources: Tradingeconomics.com, Incrementum AG

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Recession Indicators At A Glance

- S&P 500
- Market Cap To GDP
- Loan Charge-Offs And Delinquencies
- Smoothed US Recession Probabilities
- Texas Leading Index
- Industrial Production Index
- ISM Manufacturing: New Orders Index
- ISM Activity Indexes
- 10-2 Year Treasury Yield Spread
- GDPNow
- Many countries already in or close to a recession

Recession alert | Recession tendency | No recession tendency

4. What's Going On In Central Bankers' Heads These Days?

Recession Forecasts Are Not Among The Strengths Of Central Bankers

"The U.S. economy has a strong labor force, excellent productivity and technology, and a deep and liquid financial market that is in the process of repairing itself.“

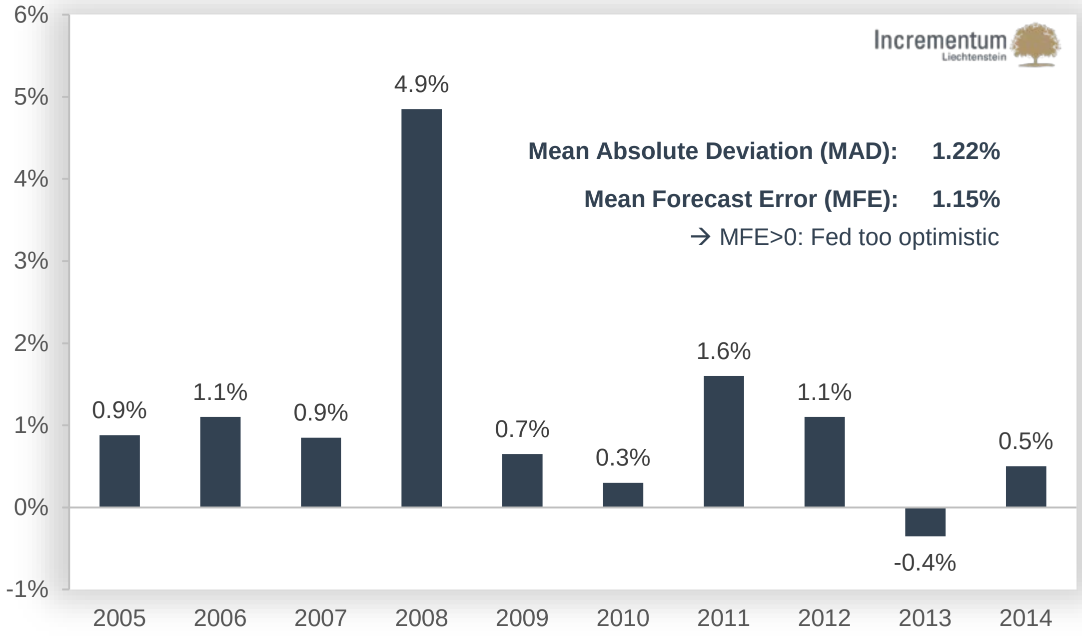
Ben Bernanke, Jan. 18, 2008

*“For my own part, I did not see and did not appreciate what the risks were with securitization, the credit ratings agencies, the shadow banking system, the S.I.V.’s — **I didn’t see any of that coming until it happened**.”*

Janet Yellen, Nov. 2010

The Central Banks’ Forecast Accuracy Is Rather Low (1/2)

Deviation Of Fed GDP Forecasts From Actual Growth Rates[1]



Growth Forecasts Of Other Central Banks

ECB
- MAD: 1.08%
- MFE: 0.33%

Bank of Canada
- MAD: 0.93%
- MFE: 0.69%

Bank of England
- MAD: 0.89%
- MFE: 0.53%

Bank of Japan
- MAD: 1.39%
- MFE: 0.70%

- In 9 out of 10 years Fed GDP forecasts have been too optimistic – “Is the Fed’s crystal ball rose-colored?”[2]
- The optimism bias holds true for all G7 central banks
- Reality appears to be much more volatile than central bank forecasts – recessions are underestimated

Sources: Bloomberg.com, Incrementum AG

[1] Data from http://www.bloomberg.com/news/articles/2015-07-07/here-are-central-banks-who-have-been-getting-it-right-and-wrong

[2] https://www.washingtonpost.com/news/wonk/wp/2013/03/19/is-the-feds-crystal-ball-rose-colored/

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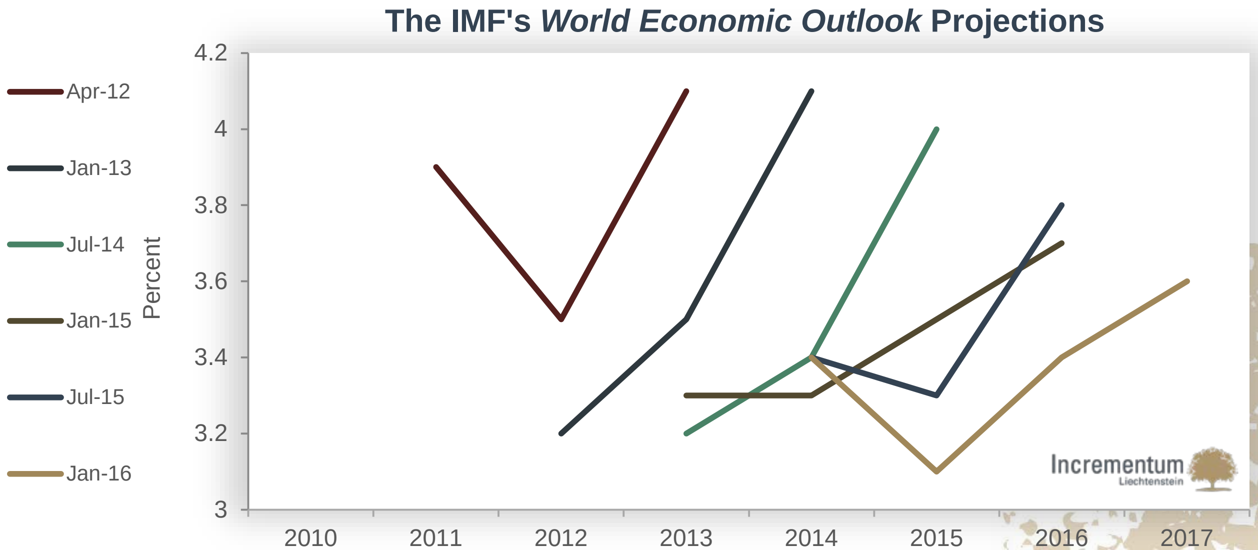
The Central Banks' Forecast Accuracy Is Rather Low (2/2)



- **The IMF's forecasts on global GDP have consistently been too optimistic** throughout the last 5 years
- However, the IMF's forecasts have proven to be **more accurate than the forecasts of the G7 central banks** between 2005 and 2014"[1]
- Falch and Nymoen (2011): "forecasts of Norges Bank, which is a leading forecast targeting central bank, could not outperform ex-ante real time forecasts from an outsider econometric model"[2]

"Central banks ought to be much better at what they do […] If they're trying to convince us all that they know where things are going by using forward guidance you'd think that they know something that we don't. But unless they're much better at analyzing the data, we shouldn't listen to them and they've got nothing to say." [1]

Rob Carnell, Chief International Economist at ING Groep, London

Sources: http://www.zerohedge.com/news/2015-07-09/five-years-glorious-imf-hockey-sticks, Incrementum AG

[1] http://www.bloomberg.com/news/articles/2015-07-07/here-are-central-banks-who-have-been-getting-it-right-and-wrong

[2] http://www.economics-ejournal.org/economics/journalarticles/2011-15

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What Makes Forecasting Difficult For Central Banks?

Methodological challenges

- Non-stationarity
- Parameter inconstancy (e.g. through structural breaks, macroeconomic shocks, regime shifts)
- Trade-off between a model's theoretical and empirical coherence
- Model specification (many central banks use ensemble forecasts / "model hedging")
- Real-time data
- Variable selection
- The true data generating process (DGP) is unknown
- Weighting formal model data and judgmental information
- Feedback effects (central banks' actions influence the DGP)

5. What’s Next?

What's Next?

- **An economic recession in the near future would represent a harsh loss of face for central bankers.** Their controversial monetary policy measures were justified as an appropriate means to nurse the economy back to health, to the eagerly awaited self-sustaining recovery.
- **It is remarkable that practically no relevant forecast by mainstream economists is taking the regular occurrence of recessions into account.** The forecasts that are based on stochastic equilibrium models always predict a medium-term convergence of future growth with so-called "potential growth". **An economic contraction is never part of any of the base case scenarios.** At most, it is mentioned on the side as a potential "tail risk".
- **But if central banks' forecasts are bad, can their policy measures be good?**
- **And what will they come up with next?**

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What Can They Come Up With Now?
Five Ways For The Fed To Further Ease*

QE4

- Each QE program so far has become less effective in terms of raising consumer prices (falling marginal utility)
- An enormous asset price inflation has been caused instead
- If markets are confronted with another bigger round of QE, it might trigger a loss of confidence in the USD and more inflation than is welcome…

Zero / Negative Interest Rates

- Flawed models have led the Fed to hike rates in December ("tightening into weakness")
- In the coming months the FOMC might finally have to admit that deflation is the name of the game
- Negative interest rates are increasingly being discussed

Currency Wars

- Cheapening the dollar could provide some superficial ease
- However, the others are trying the same (i.e. China, Japan, Eurozone)
- If everyone wants to devalue, the only things left to devalue against are gold and commodities!

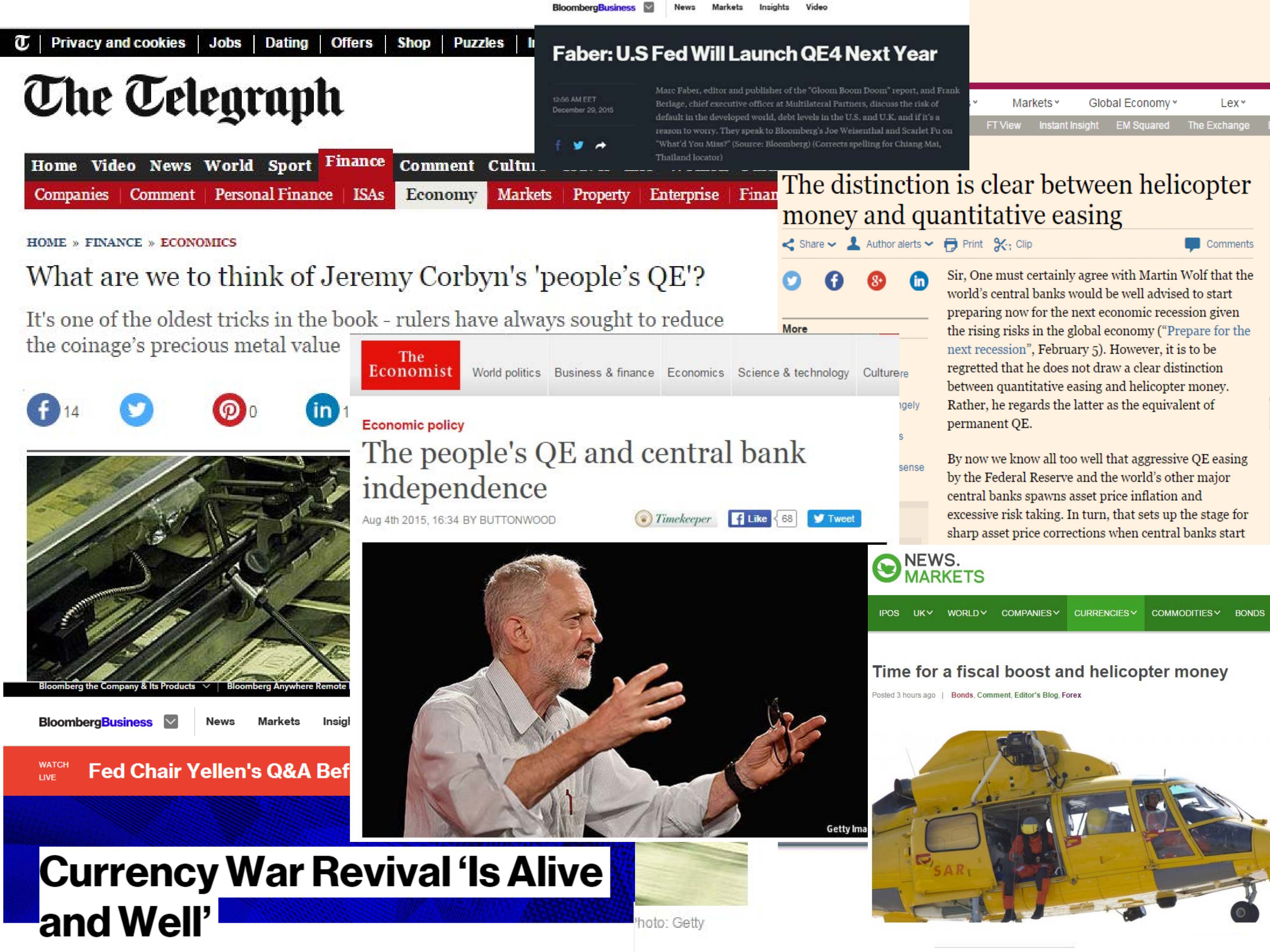
Forward Guidance

- Possibly the first policy tool: the Fed assures not to raise rates
- People will reenter carry trades: short the dollar, invest in emerging markets for the longer term
- This tends to weaken the dollar and import inflation

People's QE ("Helicopter Money")

- Running larger fiscal deficits and monetizing the debt through central bank action could "likely be the way forward"
- Contrary to "traditional" QE, People's QE incorporated with tax deductions would likely be more effective to raise inflation: money is definitely being spent

*Also refer to Jim Rickards' comments in our advisory board discussion
http://www.incrementum.li/wp-content/uploads/2016/02/AEGO-Advisory-Board-January-20161.pdf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What are we to think of Jeremy Corbyn's 'people's QE'?
It's one of the oldest tricks in the book - rulers have always sought to reduce the coinage's precious metal value
BloombergBusiness News Markets Insights Video
Faber: U.S Fed Will Launch QE4 Next Year
12:56 AM EET December 29, 2015
Marc Faber, editor and publisher of the "Gloom Boom Doom" report, and Frank Berlage, chief executive officer at Multilateral Partners, discuss the risk of default in the developed world, debt levels in the U.S. and U.K. and if it's a reason to worry. They speak to Bloomberg's Joe Weisenthal and Scarlet Fu on "What'd You Miss?" (Source: Bloomberg) (Corrects spelling for Chiang Mai, Thailand locator)
Markets Global Economy Lex
FT View Instant Insight EM Squared The Exchange
The distinction is clear between helicopter money and quantitative easing
Share Author alerts Print Clip Comments
Sir, One must certainly agree with Martin Wolf that the world's central banks would be well advised to start preparing now for the next economic recession given the rising risks in the global economy ("Prepare for the next recession", February 5). However, it is to be regretted that he does not draw a clear distinction between quantitative easing and helicopter money. Rather, he regards the latter as the equivalent of permanent QE.
By now we know all too well that aggressive QE easing by the Federal Reserve and the world's other major central banks spawns asset price inflation and excessive risk taking. In turn, that sets up the stage for sharp asset price corrections when central banks start
The Economist World politics Business & finance Economics Science & technology Culture
Economic policy
The people's QE and central bank independence
Aug 4th 2015, 16:34 BY BUTTONWOOD
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Currency War Revival 'Is Alive and Well'
Photo: Getty

Would Janet Yellen Shy Away From Very Radical Policy Measures?

"If it were possible to take interest rates into negative territory I would be voting for that."

Feb. 2010

"When the goals conflict and it comes to calling for tough trade-offs, to me, a wise and humane policy is occasionally ***to let inflation rise even when inflation is running above target."***

Feb. 1995

The Case For Negative Rates In The US

Press Release

FEDERAL RESERVE press release

Release Date: January 28, 2016

For release at 4:00 p.m. EDT

The Federal Reserve Board on Thursday released the supervisory scenarios for the 2016 Comprehensive Capital Analysis and Review (CCAR) and Dodd-Frank Act stress test exercises and also issued instructions to firms participating in CCAR. This year, CCAR will include 33 bank holding companies with $50 billion or more in total consolidated assets.

CCAR evaluates the capital planning processes and capital adequacy of the largest U.S.-based bank holding companies, including the firms' planned capital actions such as dividend payments and share buybacks and issuances. The Dodd-Frank Act stress tests are a forward-looking component to help assess whether firms have sufficient capital. Strong capital positions can absorb losses and help ensure that banking organizations have the ability to lend to households and businesses even in times of financial and economic stress.

Financial institutions are required to use the supervisory scenarios in both the stress tests conducted as part of CCAR and those required by the Dodd-Frank Act. The outcomes are measured under three scenarios: severely adverse, adverse, and baseline.

"In adjusting the scenarios for our yearly stress testing program, we strive to assess the resilience of the nation's largest banks in a variety of potential adverse environments," Governor Daniel K. Tarullo said. "It is important that the tests not to be too predictable from year to year."

For the 2016 cycle, the severely adverse scenario is characterized by a severe global recession in which the U.S. unemployment rate rises five percentage points to 10 percent, accompanied by a heightened period of corporate financial stress and negative yields for short-term U.S. Treasury securities. The adverse scenario features a moderate recession and mild deflation in the United States, as well as weakening economic activity across all countries included in the scenario. The adverse and severely adverse scenarios describe hypothetical sets of events designed to assess the strength of banking organizations and their resilience. They are not forecasts. The baseline scenario follows a similar profile to average projections from surveys of economic forecasters. It does not represent the forecast of the Federal Reserve.

THE FED GET EMAIL ALERTS

Fed officials seem ready to deploy negative rates in next crisis

Published: Oct 12, 2015 9:55 a.m. ET

1,373 165 718 Aa

By
GREG
ROBB
SENIOR ECONOMICS REPORTER

Bernanke says Fed likely to add negative interest rates to recession-fighting tool kit

Published: Jan 29, 2016 4:22 a.m. ET

153 Aa

Should not create a lot of anxiety for investors, former Federal Reserve chief says

By
GREG
ROBB
SENIOR ECONOMICS REPORTER

The Great Negative Rates Experiment

The Swedes, Danes, and Swiss venture to the subzero zone.

by Brendan Greeley
from **Bloomberg Businessweek**

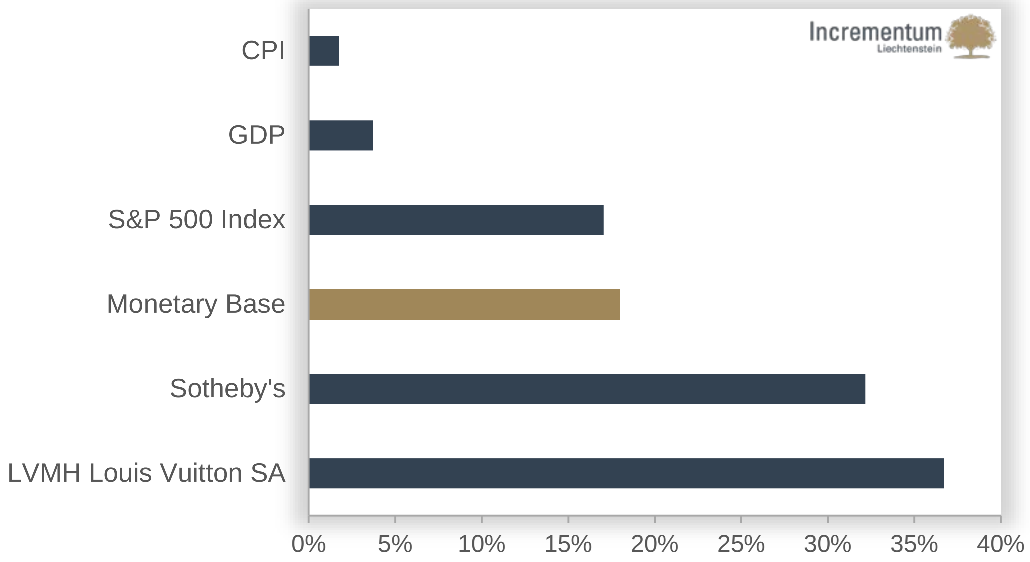
October 22, 2015 – 8:10 PM CEST

Central Banks Need to Think About Negative Rates: Rogoff

6. How Can Investors Prepare?

What Have Tailwinds Of Monetary Easing Turned The World Into?

2009-2015 Growth p.a.



Last 7 years in a nutshell

- Asset prices were raised in the hope to trigger an economic expansion
- However, inflating the monetary base by 18% p.a. has only coincided with little GDP growth
- Asset price inflation has on the other hand been immense
- Now we are in the 7th year of a bull market in stocks (third longest ever)

Where have we arrived?

- **Investors have become blindly addicted to QE – but now starting to question their anabolic drugs**
- **Part-time jobs created mostly in service sectors are misinterpreted as sound economic growth**
- **US consumers have been temporarily relieved through the strong USD and low commodity prices**
- **The economic structure is vulnerable as more low-paying jobs have been created and more resources are allocated towards sectors profiting from asset price inflation**
- **The nail in the coffin for the economy would be a loss of real income via a reversal of that trend**

Be Careful What You Wish For:
Rising Inflation Will Be The Nail In The Coffin For Growth

Is gold the canary in the coalmine for rising inflationary pressure???

Source: Incrementum AG

Incrementum
Liechtenstein

Turbulent Times Ahead – What To Expect (1/3)

Good investors differentiate themselves from bad ones in times of crises. From our point of view, 2016 will be dramatically different from previous years: risks taken on will become apparent.

US Dollar

- **We expect the US dollar strength to reverse into weakness!**
- Weaker DXY, also weakness against the EUR, CAD, AUD and some EM currencies expected, since many market participants will be surprised about further easing.

Gold

- **Gold has made a bottom. A new bull market is in the making.**
- Gold & silver miners will come into favor again.

Source: Wikimedia Commons

Incrementum Liechtenstein

Turbulent Times Ahead – What To Expect (2/3)

Oil & Commodities

- Oil will stabilize. Geopolitical events are a wild card, geopolitical premium will be priced in again sooner or later.
- Generally, commodities may bottom out soon and follow gold. 2008/2009 gold bottomed out a few months earlier than commodities, too.

Shares

- Shares will exhibit significantly higher volatility.
- The underperformance of emerging markets will end.
- We expect shares to tend lower unless the Fed eases again.

Source: Wikimedia Commons

Incrementum Liechtenstein

Turbulent Times Ahead – What To Expect (3/3)

Price Inflation

- Inflation rates will increase due to the base effect. Core PPI is already rising.
- In case of a major deflationary event (banking crisis?), a potentially internationally coordinated reaction of central banks could finally be the trigger for the **transition from deflation to stagflation.**
- **In case of further deflationary pressure, the Fed is NOT out of bullets:** QE, negative interest rates, "People's QE" (aka "Helicopter Money") are all on the table.
- Politicians will promote more fiscal spending and fiscal stimuli (infrastructure projects, a Marshall Plan for the US etc.).
- **Inflation is the favored way out of debt. As inflation dynamics cannot be controlled, this might end very badly.**

Source: Wikimedia Commons

Incrementum
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"Some things benefit from shocks; they thrive and grow when exposed to volatility, randomness, disorder, and stressors and love adventure, risk, and uncertainty. […] Let us call it antifragile."[1]

Nassim Nicholas Taleb

Source: Wikimedia Commons
1 Nassim Nicholas Taleb, Antifragile: Things That Gain From Disorder, p.17

APPENDIX

May Recessions Be Regarded As The Lesser Evil?

“Mises demonstrated that the recession, far from being a strange, unexplainable aberration to be combated, is really ***a necessary process by which the market economy liquidates the unsound investments of the boom, and returns to the right consumption/investment proportions*** *to satisfy consumers in the most efficient way.”*

Murray N. Rothbard

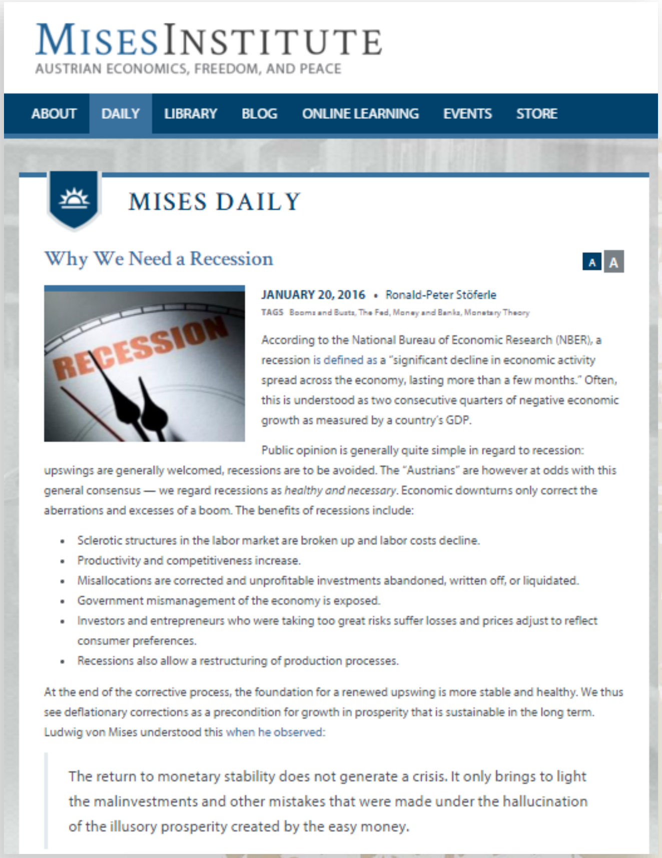
Why We Need A Recession

Public opinion is generally quite simple with regard to recessions: upswings are generally welcomed, recessions are to be avoided.

The “Austrians” are however at odds with this general consensus — we regard recessions as healthy and necessary. Economic downturns only correct the aberrations and excesses of a boom.

The benefits of recessions include:

- Sclerotic structures in the labor market are broken up and labor costs decline
- Productivity and competitiveness increase
- Misallocations are corrected and unprofitable investments abandoned, written off, or liquidated
- Government mismanagement of the economy is exposed
- Investors and entrepreneurs who were taking too great risks suffer losses and prices adjust to reflect consumer preferences
- Recessions also allow a restructuring of production processes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Why We Need a Recession

JANUARY 20, 2016 • Ronald-Peter Stöferle

TAGS Booms and Busts, The Fed, Money and Banks, Monetary Theory

According to the National Bureau of Economic Research (NBER), a recession is defined as a “significant decline in economic activity spread across the economy, lasting more than a few months.” Often, this is understood as two consecutive quarters of negative economic growth as measured by a country’s GDP.

Public opinion is generally quite simple in regard to recession: upswings are generally welcomed, recessions are to be avoided. The “Austrians” are however at odds with this general consensus — we regard recessions as *healthy and necessary*. Economic downturns only correct the aberrations and excesses of a boom. The benefits of recessions include:

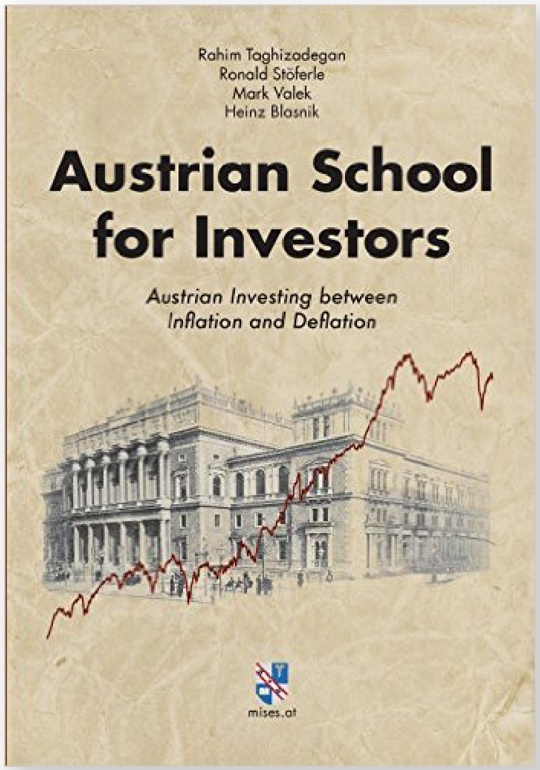
- Sclerotic structures in the labor market are broken up and labor costs decline.
- Productivity and competitiveness increase.
- Misallocations are corrected and unprofitable investments abandoned, written off, or liquidated.
- Government mismanagement of the economy is exposed.
- Investors and entrepreneurs who were taking too great risks suffer losses and prices adjust to reflect consumer preferences.
- Recessions also allow a restructuring of production processes.

At the end of the corrective process, the foundation for a renewed upswing is more stable and healthy. We thus see deflationary corrections as a precondition for growth in prosperity that is sustainable in the long term. Ludwig von Mises understood this when he observed:

> The return to monetary stability does not generate a crisis. It only brings to light the malinvestments and other mistakes that were made under the hallucination of the illusory prosperity created by the easy money.

Source: https://mises.org/library/why-we-need-recession

Our Book Explains Business Cycles: *Austrian School for Investors*



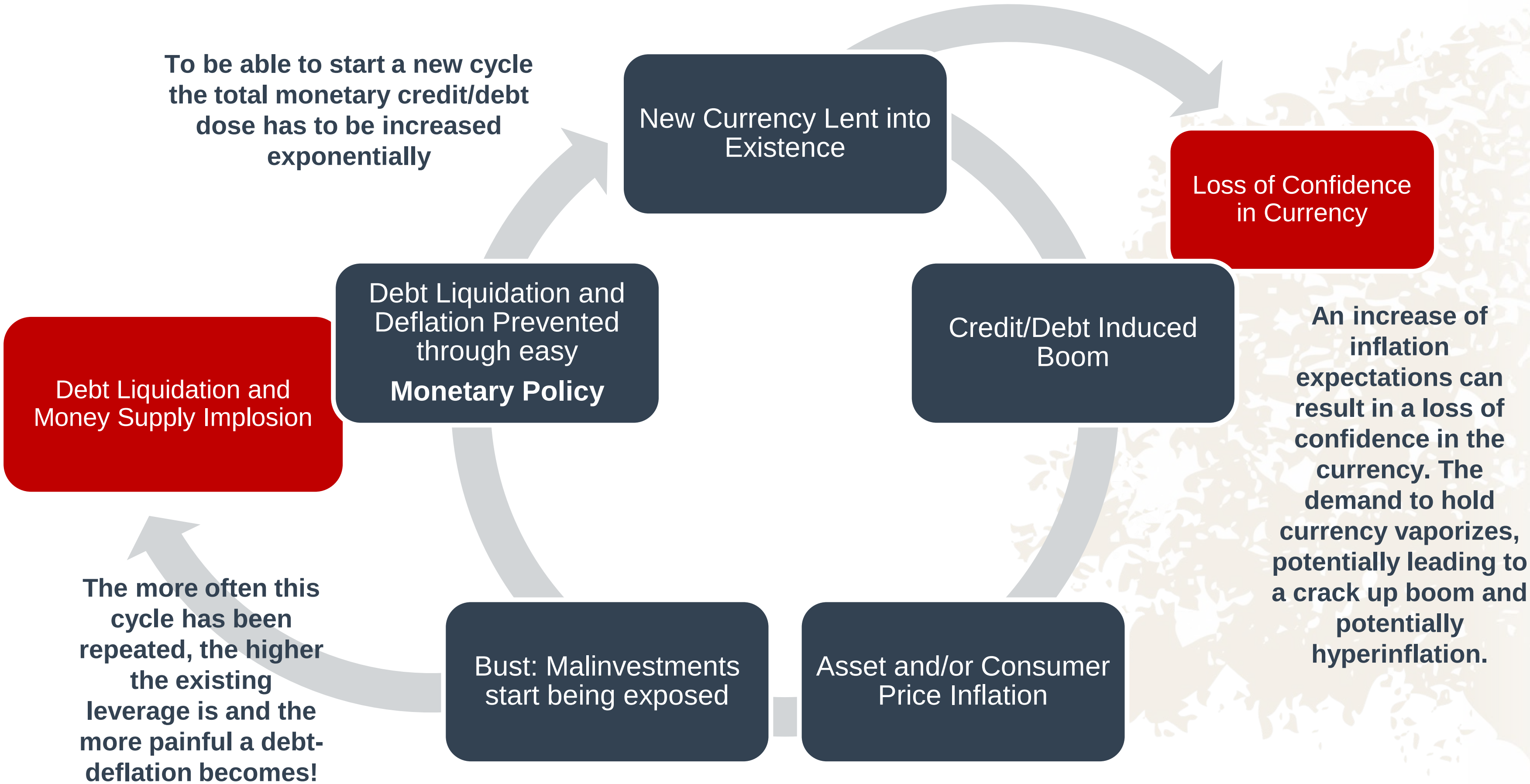
6. Business Cycles

Business cycles are periodically repeating, successive periods of booms and recessions, which is the term employed nowadays to describe economic collapse, respectively a bust. Since this represents a significant risk for investors, a profound understanding of the causes and the process of business cycles is of the utmost importance. One of the unique features of the Austrian School is precisely that it offers an explanation of business cycles. "Austrian" business cycle theory (ABCT), which can be traced back to Ludwig von Mises, who first elaborated it in his habilitation treatise "The Theory of Money and Credit", can explain why economies experience business cycles and periodic economic crises. They are by no means a feature inherent in the market economy, but a direct consequence of the interventionist monetary system. One

On the other hand, many companies and banks can be economically intertwined with insolvent companies and banks, which can lead to additional write-offs. This process is usually presented as the actual problem in public debate, which often conveys the impression that "Austrian" economists practically pine for a crisis. In reality, they simply regard the inevitable and necessary deflationary correction as an opportunity to lay the foundation for growing prosperity that is sustainable in the long term. Contrary to mainstream economists, they therefore do not regard the bust phase as a problem that needs to be prevented at any price, but simply as a necessary evil. The erroneous perspective

Source: Taghizadegan, Stöferle, Valek and Blasnik: Austrian School for Investors, mises.at (2015), pp.131 / 149

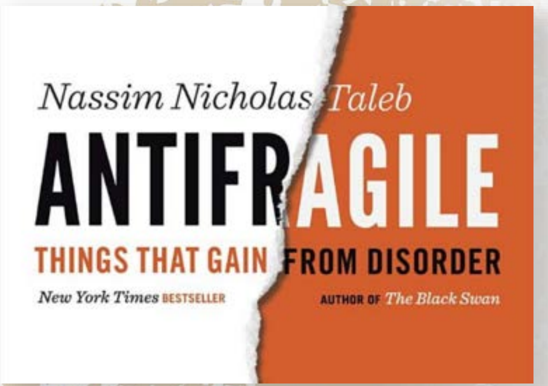
The Spiral Of Monetary Expansion Demonstrates That Countering Recessions Just Exacerbates The Final Deluge



Source: Incrementum AG

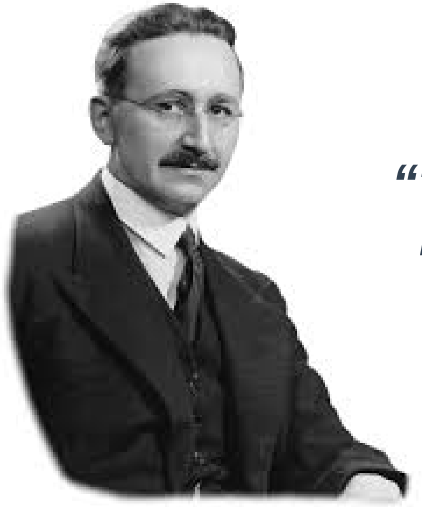
Investing In A Distorted World – Learning From Nassim Nicholas Taleb's Book *Antifragile – Things That Gain From Disorder*

- Things that are not only robust in times of disorder but gain are **antifragile**
- **Systems / institutions with a large size and a high degree of concentration are more vulnerable to small threats** (e.g. large banks, the euro, socialist countries)
  - → **A free market economy is an antifragile system, socialist systems are fragile**
- **Activist central banking, excessive debt and deficits have made Western economies more fragile**
- A banking system with a concentration of only some big banks is more fragile than a banking system with many small banks
- There is often a trade-off between efficiency and anti-fragility / robustness
- **Debt is fragile, equity is robust, venture capital is anti-fragile**; private debt can be robust, but only if it is turned into equity
- How to **get rid of downside risk**: e.g. penny stocks, distressed assets, and options



"The return to monetary stability does not generate a crisis. It only brings to light the malinvestments and other mistakes that were made under the hallucination of the illusory prosperity created by the easy money."

Ludwig von Mises



"The curious task of economics is to demonstrate to men how little they really know about what they can imagine they can design."

Friedrich August von Hayek,
The Fatal Conceit

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