Commentary
by Steve Henningsen
October 2017

Monetary/Societal Pendulum Shift?

"We are living an unprecedented historical period. If interest rates are meant to protect against the "future's uncertainty", negative rates would imply that the future is more "certain" than the present, which is philosophically stupid. We live in times where illogicality reigns supreme... thus it is logically impossible to predict what's going to happen and who is in danger."
–Charles Gave, Economist and financial analyst [9-28-17]

"We cannot therefore avoid the question that Hyman Minsky posed —whether a monetary economy with debt contracts and capitalist financial institutions will ever be stable, and in particular whether stability is possible as long as there are fractional reserve banks."
--Adair Turner, *Between Debt and the Devil: Money, Credit, and Fixing Global Finance, 2016*

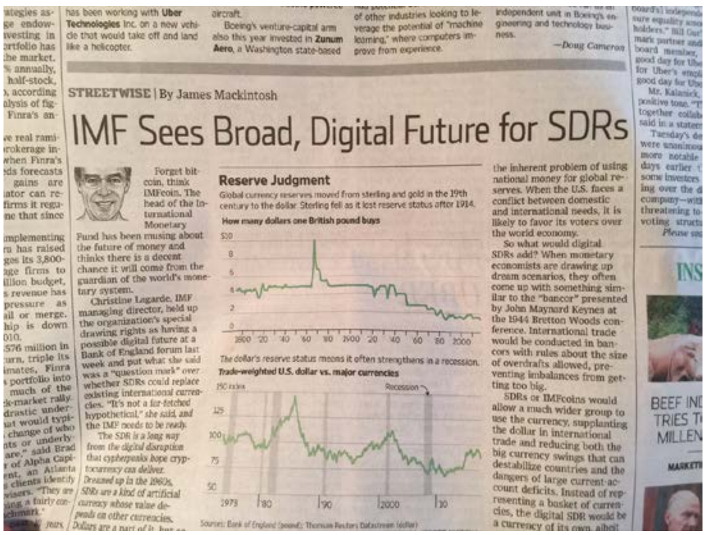
"The structural integrity of our long-established global economic framework, built upon a financial foundation, is showing clear signs of fatigue. The ability of credit to drive output growth, trade and capital formation has been meaningfully compromised. Econometric models are struggling for accuracy. Central banks are having great difficulty exiting unconventional policies that have supported output growth and boosted asset prices. Credit-funded fiscal initiatives, if enacted, could help output, but only marginally as matching debt and the attendant weakness of trade partners would offset temporary benefits."
–Paul Brodsky, Macro Allocation Inc., *Structural Shift, 9-7-2017*

As we all know, pendulums swing until their period is complete and then reverse direction. I have the feeling we are approaching the end of the period for our current monetary system. This isn't "news" for most clients, as I have been writing about this for many years (Monetary Crescendo, July 2011; Stumbling Towards Monetary Change, Jan 2012; Emergence, July 2014). I am reminded of the saying, *just because something is inevitable, doesn't mean it's imminent*. It's not just the current credit-based financial system that's approaching a turning point. Polarization has seeped into politics, religion, education, and even nationalism, causing many of us to feel "out of sorts" today. In my opinion, much of it can be attributed to the current monetary system, which has led to a world of wealth inequality, indebtedness, and malinvestment due to suppressed interest rates. The United States is a country where the top 1% now control 38% of the wealth, and the disparity is just as great (or greater) in other countries.

Central bankers have spent the past eight years proclaiming that economic growth is right around the corner, yet most developed countries can barely obtain 3% GDP growth. That's no surprise in a world where global debt continues to weigh upon economic growth. However, there are hints that a change in the global monetary system is slowly underway, and I'm not the only one who senses it. Central banks have long been hinting at creating a new monetary order going back to the 2008 financial crisis.

"The outbreak of the crisis and its spillover to the entire world reflect the inherent vulnerabilities and systemic risks in the existing international monetary system.... The desirable goal of reforming the international monetary system, therefore, is to create an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run..."
–Zhou Xiaochuan, Governor of the PBOC, 2009

Just last year, Claudio Borio, the chief economist of the Bank for International Settlements, called for a new monetary order. Even some financial journalists are starting to catch on; In his April 17, 2017 article, The shadow hanging over central bank control, Wolfgang Münchau wrote that, "Every few decades or so, the world of central banking turns upside down. Over the last 100 years we had systems in which central banks targeted a fixed conversion rate to gold, the supply of money in circulation or, more recently, a rate of expected future inflation. A combination of deep changes in the money markets and financial crises is now conspiring towards another big change."


STREETWISE | By James Mackintosh

IMF Sees Broad, Digital Future for SDRs

Forget bitcoin, think IMFcoin. The head of the International Monetary Fund has been musing about the future of money and thinks there is a decent chance it will come from the guardian of the world's monetary system.

Christine Lagarde, IMF managing director, held up the organization's special drawing rights as having a possible digital future at a Bank of England forum last week and put what she said was a "question mark" over whether SDRs could replace existing international currencies. "It's not a far-fetched hypothetical," she said, and the IMF needs to be ready.

The SDR is a long way from the digital disruption that cypherpunks hope cryptocurrency can deliver. Dreamed up in the 1960s, SDRs are a kind of artificial currency whose value depends on other currencies.

Reserve Judgment

Global currency reserves moved from sterling and gold in the 19th century to the dollar. Sterling fell as it lost reserve status after 1914.

How many dollars one British pound buys

The dollar's reserve status means it often strengthens in a recession.

Trade-weighted U.S. dollar vs. major currencies

Sources: Bank of England (pound); Thomson Reuters Datastream (dollar)

the inherent problem of using national money for global reserves. When the U.S. faces a conflict between domestic and international needs, it is likely to favor its voters over the world economy.

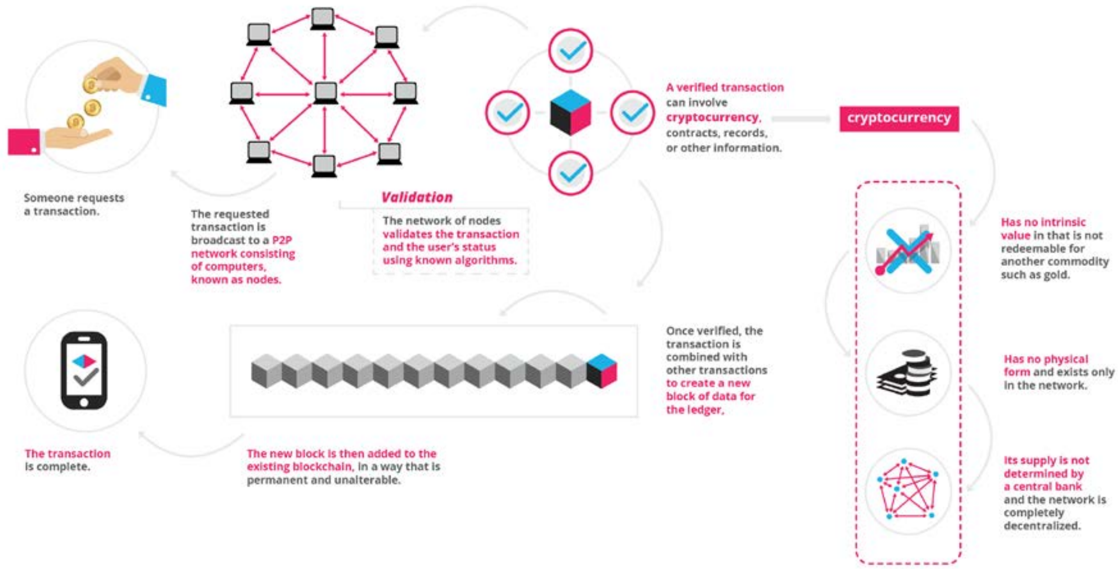
So what would digital SDRs add? When monetary economists are drawing up dream scenarios, they often come up with something similar to the "bancor" presented by John Maynard Keynes at the 1944 Bretton Woods conference. International trade would be conducted in bancors with rules about the size of overdrafts allowed, preventing imbalances from getting too big.

SDRs or IMFcoins would allow a much wider group to use the currency, supplanting the dollar in international trade and reducing both the big currency swings that can destabilize countries and the dangers of large current-account deficits. Instead of representing a basket of currencies, the digital SDR would be a currency of its own, albeit

Another sign that there is movement among the monetary elite is the recent announcement that the International Monetary Fund (IMF) is considering digital currency technology in its special drawing rights (SDR) currency. It was even covered in the Wall Street Journal. I have discussed the SDR several times in the past, but this is the first time I have seen it mentioned alongside cryptocurrencies. I haven't discussed cryptocurrencies before, as they are a relatively new phenomenon and a rather difficult concept to grasp. Nonetheless, I wish to take some time now to give you a basic understanding.

Blockchain vs.Bitcoin

The first thing one needs to do is differentiate between blockchain and cryptocurrencies; Bitcoin being the most well-known. Blockchain is defined by Wikipedia as a decentralized and distributed digital ledger that is used to record transactions across many computers so that the record cannot be altered retroactively without the alteration of all subsequent blocks and the collusion of the network. By using open-source software (available for free on the web for anyone who wishes to study, distribute, or use it), blockchain creates a method of payment that is verified by a decentralized and shared public ledger (a list of transactions). However, not one public ledger, but thousands of copies of the exact same ledger which are stored and maintained on computers all around the world. The system is not controlled by any central authority, but instead run and maintained by its users. Now, take five minutes and watch this short video explaining the technology.



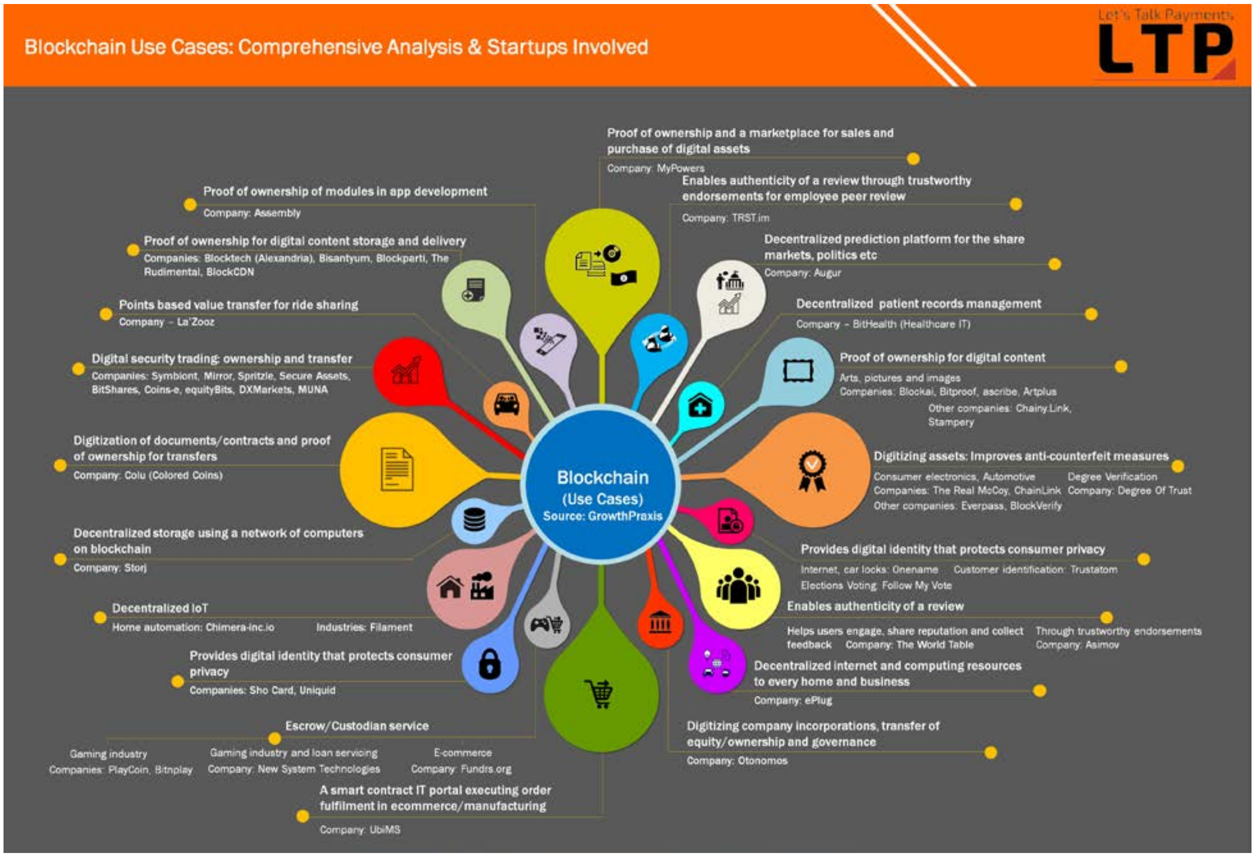
source: blockgeeks.com

Bitcoin is a form of peer-to-peer money/cryptocurrency built using blockchain technology. Bitcoin is one of the first decentralized digital currencies, as the system works without a central repository or single administrator, and the software protocol is written in a way that limits the number of Bitcoins that can be brought into existence. Now take a moment again to watch this 2-minute video on Bitcoin.

While Bitcoin is the first and biggest kid on the block (no pun intended), there are now over 900 competing cryptocurrencies from which to choose. Initial coin offerings (ICOs), an unregulated means by which funds are raised for a new cryptocurrency venture, seem to pop up everyday now. As this technology is still in its "Wild West" phase, fraud and investor abuse are prevalent. See here and here. With little regulation and a whole lot of hype, I expect to be reading about investors getting hurt speculating in these ICOs down the line, especially given that many of them have no idea what they are buying.

I see the development of blockchain and Bitcoin (cryptocurrencies) similar to the development of the internet in the '90s where many of the companies that built themselves upon the internet's technology foundation came and went (Netscape, Infospace, Pets.com, Napster, etc.), but the internet itself survived and thrived. I would guess that most of these cryptocurrencies will not be around in a few years, especially given that I doubt the government will stand back much longer before instituting regulation over the industry. My speculation would be that they come out with their own cryptocurrency (see digital SDR above) and ban existing ones; Governments don't like competition in the currency world. While I wouldn't necessarily talk anyone out of investing in cryptocurrencies, I believe it's safer to stand back and wait for the eventual cryptocurrency shakeout before jumping in.

However, I am much, much more excited about the hundreds of commercial applications that can use the blockchain technology for banking and capital markets, music distribution, data storage, proof of ownership, digital identity, voting systems, etc. The potential disruption to traditional industries is enormous as shown in this graph:



Source: letstalkpayments.com

Be prepared to read much more about how blockchain is a revolutionary force of change throughout many industries in the years ahead. Investing in companies that develop and enable this technology is still in its infancy, but I expect it to become easier soon.

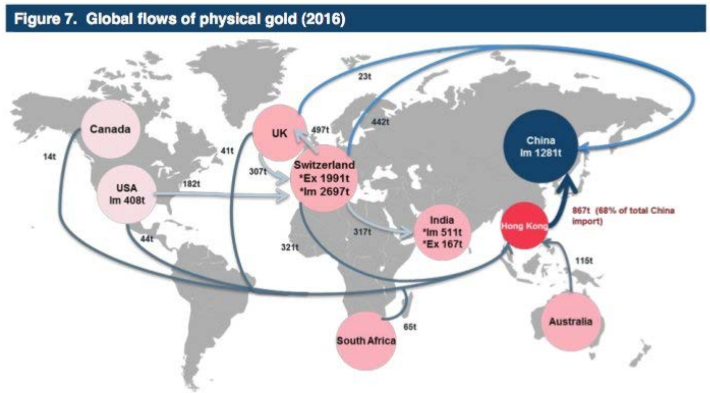
Rise of Asia Expediting Change?

"We think that the post Bretton Woods (1971-) global financial system remains vulnerable to financial crises… We think the final break with precious metal currency systems from the early 1970s (after centuries of adhering to such regimes) and to a fiat currency world has encouraged budget deficits, rising debts, huge credit creation, ultra loose monetary policy, global build-up of imbalances, financial deregulation and more unstable markets."

–Jim Reid, Deutsche Bank's credit strategist, Next Financial Crisis

What the future monetary system will look like is unknown. Will it involve cryptocurrencies, such as suggested in the WSJ's previous article related to SDRs? Or will a totally new system develop out of the next crisis? I remain confident that gold will play a part in whatever system comes about, and the recent news regarding China's possible use of crude-oil-futures contracts priced in yuan and convertible to gold has some intrigued. As shown in this picture, it is clear where most of the world's gold bullion has been flowing, not just last year, but over the past several.

Figure 7. Global flows of physical gold (2016)



Note: Unit in tonnes (t).
Source: HKEX, analysis based on Metals Focus data.

The way I see it, the period of the U.S. dollar being the reserve currency for the world is coming to an end. The only question is the speed of change. Since U.S. dollars are the Jenga blocks supporting the world's fragile financial system, most can agree it's best that they be removed slowly. That being said, sometimes change happens overnight. A few years back, I showed this cover from The Economist from 1988 entitled, Get Ready for a World Currency. The article ended by guessing the global currency might appear in 2018, so we don't have long to wait to see if The Economist's prophecy comes true.

Another sign is that Asia and Russia are getting restless under the current U.S. dollar system. China's economic clout seems to be growing inasmuch many investors who once doubted China's One Belt, One Road project have recently changed their minds as China continues its expansion of trade routes throughout Eurasia. Russia has also been busy building its own banking network to offset the U.S.'s Swift system. Additionally on the geopolitical front, some are questioning China's growing relationship with Saudi Arabia and the possibility of the U.S.'s Petrodollar system coming to an end. Recently Saudi Arabia announced a military deal with Russia - which would have been unthinkable a few years ago.

Pensions

"When a state has mortgaged all its future liabilities, the state, by necessity, lapses into tranquility, languor and impotence."
–David Hume, Of Public Credit, 1752

"It's unequivocal now: We are taking money from the new employees and using it to pay off this liability for the old employees," said Turner, a Gov. John Hickenlooper appointee. "And some might call that a Ponzi scheme."
– Denver Post, 6/27/17

I have written extensively regarding the pending pensions problems we face globally, but financial writer John Mauldin has done an excellent job over the past month writing about the broken promises headed our way. I thought I would highlight his articles below for those interested in reading them.

Build Your Economic Storm Shelter Now
Global Retirement Reality
Uncle Sam's Unfunded Promises

Neither John, nor I are doom-and-gloomers. We both just face the realties shown to us and wish to prepare those who will listen to the probable disruptions ahead.

Portfolio Ponderings

"When things are going right, we all need a 26-year-old. There's nothing better than a 26-year-old in a great bull market especially in a bubble. They're fearless. They don't know. It will never end. They will tell you why it will never end. They know that it cannot end and will never end. So in the bull market, you've got to have a 26-year-old. But when they end you don't want the 26-year-old around… they make a lot of money. They don't know why they made money. So they don't know why they lose money. They don't know what happened."
–Jim Rogers, investor on Realvision 9-2017

Well, I'm certainly not 26 years old and have lived through two previous bear markets (2000 and 2008) in the past 17 years. Therefore, I can recognize when we are in an environment of overvalued stocks and bonds, such as now, but am not prophetic enough to know when the downturn begins or how much higher prices could climb. I would have guessed a few years ago, but I've been wrong, as central bank liquidity has lifted asset prices higher than most of us thought possible. You know things are nutty when some of the most prominent investors are saying they don’t understand the markets any longer, as Bill Gross [proclaimed]() the other day, “We have fake markets because of the Fed.” A day later you have famous economist Richard Thaler accepting his Nobel prize in economics for his work in behavior finance claim, “[We seem to be living in the riskiest moment of our lives](), and yet the stock market seems to be napping. I admit to not understanding it.” So good luck to the rest of us, right?

The way I see it, we are in a period of complacency unlike anything I’ve experienced. Neither Trump Tweets, North Korea missiles, Mexican earthquakes, terror attacks in Barcelona and London, riots in Charlottesville, nor a couple of hurricanes plowing through Texas, Puerto Rico and Florida are enough to spook investors. It may be hard to sense in the liquidity-driven asset bubble propagated by the central banks, but there is much risk underneath the euphoria that surrounds the almost daily reminder of new stock market highs. Keep in mind though, stock markets are almost always at new highs before they drop. While investment managers who are defensive or hedge their portfolios are currently viewed like pariahs, I have a feeling their popularity will rise after the next fall.

Speaking of outcasts, I realize the financial press is all about stocks these days, but gold has been doing just fine so far this year and has made nice gains against all currencies as shown in this chart.

Gold Price Performance: % Annual Change Tuesday, September 26, 2017

	USD	AUD	CAD	CHF	CNY	EUR	GBP	INR	JPY
2002	24.6%	13.4%	22.7%	4.4%	24.6%	5.9%	13.0%	23.8%	12.0%
2003	19.7%	-9.5%	-0.4%	7.7%	19.7%	0.5%	8.6%	13.6%	7.7%
2004	5.3%	1.8%	-1.9%	-3.4%	5.3%	-2.7%	-2.3%	0.6%	0.7%
2005	20.0%	28.9%	15.4%	37.8%	17.0%	36.8%	33.0%	24.2%	37.6%
2006	23.0%	13.7%	23.0%	14.1%	19.1%	10.6%	8.1%	20.9%	24.3%
2007	30.9%	18.3%	12.1%	21.7%	22.3%	18.4%	29.2%	16.5%	22.9%
2008	5.6%	31.3%	30.1%	-0.1%	-2.4%	10.5%	43.2%	28.8%	-14.4%
2009	23.4%	-3.0%	5.9%	20.1%	23.6%	20.7%	12.7%	19.3%	26.8%
2010	29.5%	13.5%	22.3%	16.7%	24.9%	38.8%	34.3%	23.7%	13.0%
2011	10.1%	10.2%	13.5%	11.2%	5.9%	14.2%	10.5%	31.1%	4.5%
2012	7.0%	5.4%	4.3%	4.2%	6.2%	4.9%	2.2%	10.3%	20.7%
2013	-28.3%	-16.2%	-23.0%	-30.1%	-30.2%	-31.2%	-29.4%	-18.7%	-12.8%
2014	-1.5%	7.7%	7.9%	9.9%	1.2%	12.1%	5.0%	0.8%	12.3%
2015	-10.4%	0.4%	7.5%	-9.9%	-6.2%	-0.3%	-5.2%	-5.9%	-10.1%
2016	9.1%	10.5%	5.9%	10.8%	16.8%	12.4%	30.2%	11.9%	5.8%
2017	12.8%	2.7%	3.9%	6.8%	7.8%	0.1%	3.1%	8.2%	7.8%
Average	11.3%	8.1%	9.3%	7.6%	9.7%	9.5%	12.3%	13.1%	9.9%

I’ll end here with another paragraph from Paul Brodsky’s paper entitled, Structural Shift:

“Monetary authorities will have to formally address the declining market share of fiat currencies used as savings in the global economy, and we think they will ultimately be forced to include gold in a new monetary platform that seeks to combat what will be a growing black market for goods and services. Gold is presently the only asset held on central bank balance sheets against which fiat currencies may be devalued, which we believe is precisely why it remains there.”

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