Are you worried about an equity market correction?

Precious Metals Outlook: January 2018

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January 2018 will mark the 103rd month of the current bull market, the third longest in U.S. history, surpassed only by the booms of the 1960's and 1990's. Considering such bull market streaks have averaged five years since 1950, investors may naturally question when a correction is set to take place. While any number of indications are suggestive of continued market growth in the near-term, history suggests that there is a possibility of some type of corrective price action in the 2018-2019 period.

In a recent report, Goldman Sachs warned that the 'bull market in everything' of late has resulted in a valuation conundrum from the lack of inflation in the real economy. Seldom have equities, bonds and credit all been similarly expensive at the same time, with such scenarios experienced only in the Roaring 20's (which ended in the Great Depression) and the Golden 50's. Valuations across equities, bonds and credit in the U.S. are now reaching all-time high levels. What worries us, however, is that after reaching such simultaneous valuation peaks, the market has less of a buffer to absorb shocks. Surprise inflation or other exogenous events could cause either sharp contractions or prolonged valuation sluggishness. If companies cannot generate sustained earnings growth, stock prices may begin to fall, causing a market correction.

2017 was a year of historically low volatility, perhaps reflective of investor complacency, with the CBOE Volatility Index, or VIX, currently trading below 10, which is approximately half of the historical average of 19[1]. Adding further to the likelihood of increased volatility in 2018 is U.S. midterm elections, scheduled to take place in November. Historically, midterm election years have been associated with a higher degree of volatility, as in the past 14 instances since 1962, market corrections during these years have averaged 18%. Notably, these instances have not always signalled the end of a bull equity market, as equities have historically rebounded in the one-year period after the correction. In such volatile times, however, the diversification that gold provides has often been a useful addition to investor's portfolios.

Figure 1. Market corrections during years of midterm elections

1962	1966	1970	1974	1978	1982	1986	1990	1994	1998	2002	2006	2010	2014
-26%	-16%	-23%	-38%	-14%	-14%	-9%	-20%	-9%	-19%	-32%	-8%	-16%	-7%

Source: Strategas Research, November 2017

[1] Bloomberg, monthly closing price between January 1990 to December 2017

Will political tensions boil over in 2018?

Geopolitical risks have been ever-present, but entering 2018, there is a diverse range of potential flashpoints, from trade, to referendums, to political scandals, to all-out war and cyber terrorism. It has been puzzling to us how the commodity markets have shrugged major geopolitical events, such as the attempted bombing of the Saudi Royal Palace in December, which caused a retaliation bombing of sites in Yemen and the start of a war with Iran. This lack of market response suggests complacency or outright disbelief these events are likely to escalate. Investors appear to be more focused on U.S. tax reform and its positive impact towards U.S. GDP over the next few years. However, discussions around government debt and growing budget deficits are beginning to come to the forefront. And if the Republicans lose the midterm elections, more political gridlocks would very likely occur.

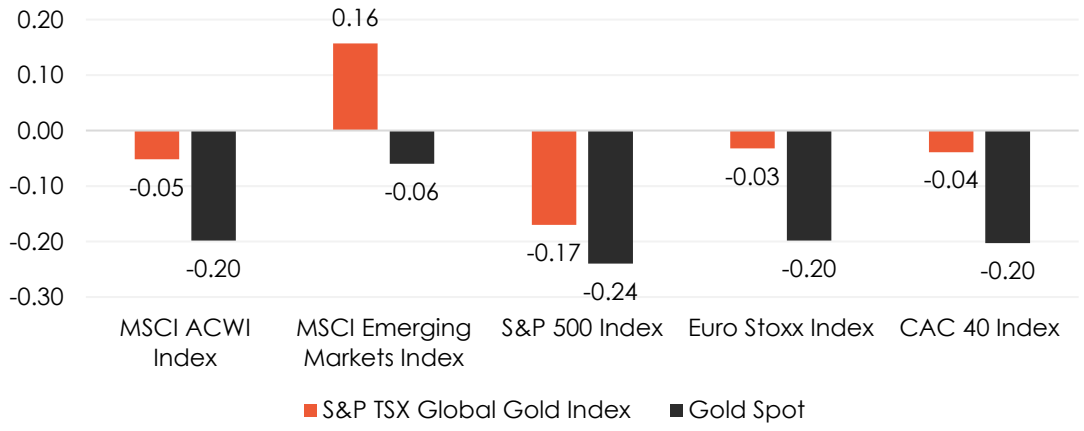
Under the watch of President Trump, the U.S. finds itself in a myriad of controversy. Temperamental relations between the U.S. and North Korea seem to be ignored by investors. While unlikely at this point, threat of an attack and subsequent war must be monitored closely due to the unpredictability of both leaders. Ongoing investigations into Russian connections of high-ranking officials at the White House are likely to continue. In trade relations, NAFTA negotiations have made very little progress to date, which increases fears Trump will terminate the deal entirely in 2018, not to mention the trade protectionist rhetoric Trump's Administration has used when talking about China, a far more significant trading partner.

Globally, there are more potential risks with Brexit proceedings still very much in question, destabilization of the European Union with actions against Poland, tensions in Spain over the Catalonia referendum not yet resolved, as well as Latin American political turmoil in Peru and Brazil. 2018 also brings elections in Italy and Mexico. Although difficult to quantify the impact from geopolitics on the currency markets, which have a significant impact on the gold price, safe-haven buying in gold is prudent, as it has historically served as an excellent store of value.

Diversification is key

In the world of investing, diversification has long been the most elementary of strategies in an effort to mitigate losses. Within the current economic backdrop, however, simply combining traditional asset classes of stocks and bonds may not be enough to protect investors from downside risk, as these assets are now expensive compared to their historic trends. Allocating across global markets has not proven to be highly effective either, with the U.S., European and emerging markets all relatively correlated amongst each other. Gold and gold equities have a low and even negative correlation to global equities, making for the optimal portfolio diversification tool.

Figure 2. Monthly Correlations, CAD (December 31, 2007 to December 31, 2017)



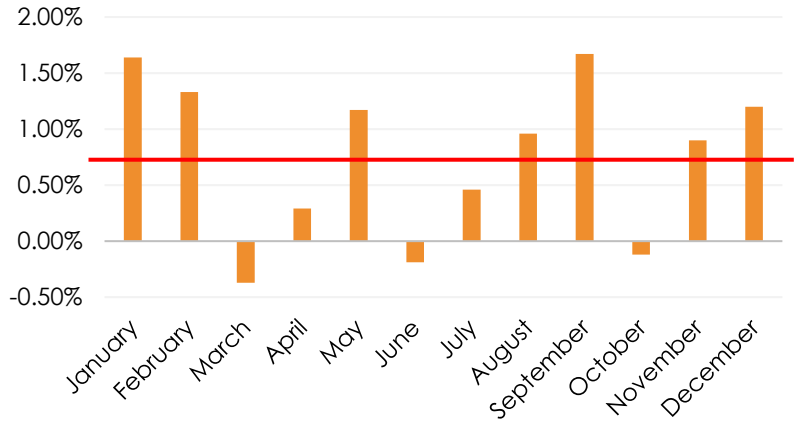
Source: Bloomberg, as of December 31, 2017

Unlike the heightened valuations of most major asset classes, gold on a relative basis is priced at decade-lows and importantly carries intrinsic value, a characteristic not held by some other speculative alternatives, such as crypto currencies – a topic we will elaborate on further in our next publication.

The calendar favours gold

Gold is in the middle of a seasonally strong period between December and February, with three of the four best performing months historically occurring during this stretch. This calendar effect is a function a physical stocking trends ahead of key gold-buying holidays and events, among other influences.

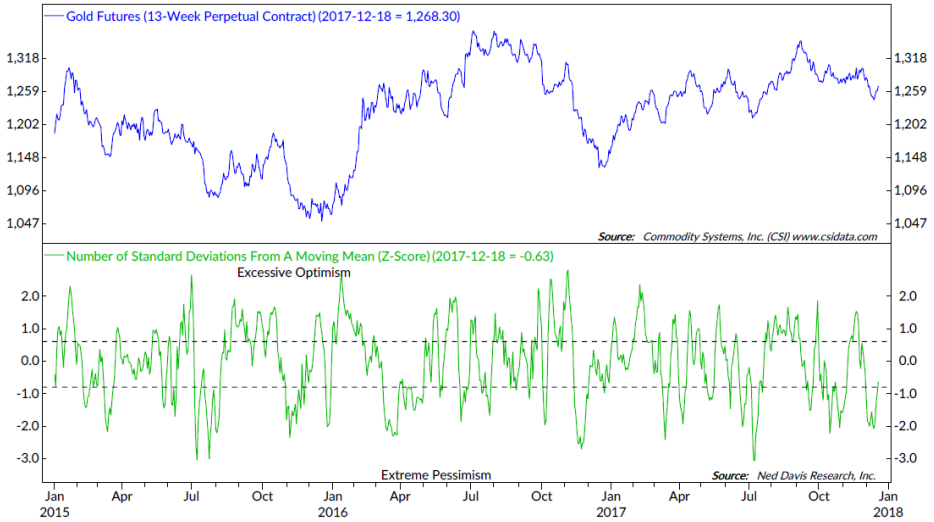
Figure 3. Seasonality of gold - historical % monthly gain



Source: Ned Davis Research, December 2017

The sentiment towards gold investments is also changing from extreme pessimism to more neutral, which historically has signaled pivot points for short-term trend reversals.

Figure 4. Gold futures (13-week perpetual contract) vs. gold calls / (calls + puts)



Gold Futures (13-Week Perpetual Contract) Performance **Full History:** 1989-03-20 to 2018-01-02		
Bottom Clip is	% Gain/ Annum	% of Time
Above 0.6	2.79	30.39
-0.8 - 0.6	1.20	45.85
Below -0.8	12.20	23.76
Buy/Hold = 4.20% Gain/Annum		

Gold Futures (13-Week Perpetual Contract) Performance **Chart View:** 2006-01-03 to 2018-01-02		
Bottom Clip is	% Gain/ Annum	% of Time
Above 0.6	1.68	29.96
-0.8 - 0.6	3.12	46.49
Below -0.8	26.65	23.55
Buy/Hold = 7.78% Gain/Annum		

Source: Ned Davis Research, December 2017

In Summary

High U.S. government debt levels and unfunded tax cuts have not scuttled the Federal Reserve's plans for continued interest rate hikes in 2018. The composition of the Fed, however, is likely to change dramatically, starting with the leadership by the new Chair, Jerome Powell. We will be closely monitoring the decision making trajectory for the U.S. monitory policy in the months to come.

The divergence in monitory policy actions taken around the world is likely to bring more volatility to currency markets. Unlike the U.S., several other central banks seem to be more on pause – Japan holding its short-term interest rate at -0.1% and ECB staying the course with the gradual reduction of their asset buying programs. Global synchronized economic growth is also expected to contribute to put more inflationary pressures, which we believe are likely to materialize in the second half of the year. Rising inflation expectations ahead of rate adjustments is generally positive for precious metals.

Portfolio diversification is important and finding the right type of diversification is key for wealth preservation. As long-term history shows, gold provides much needed protection against rising inflation and falling markets.

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