# Alps Precious Metals Group

## Monthly Commentary and Update

**February 2017**

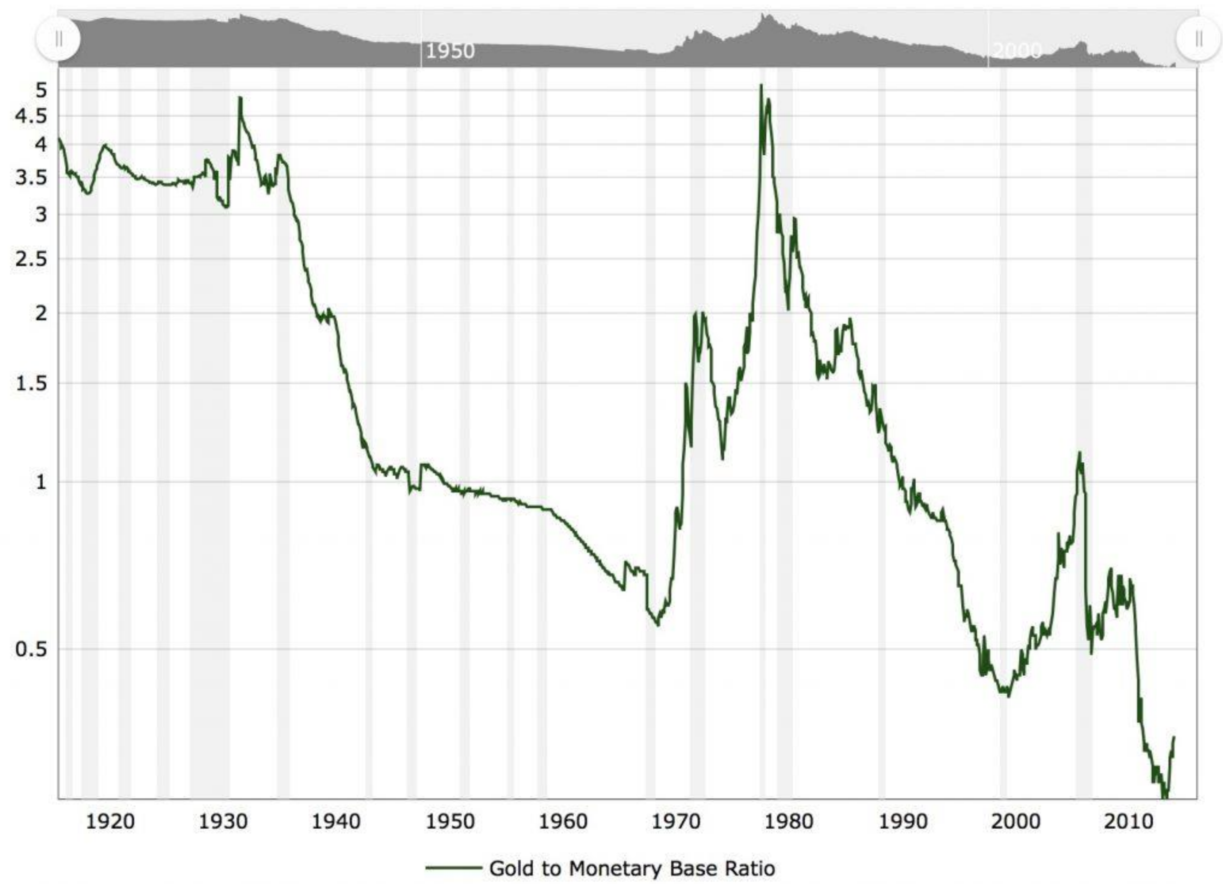
**A) A "'Flation" problem – But which one?**
**B) FDR battles – Version 2.0**
**C) U.S. Financial System Derivative Exposure**
**D) LPM – Updates on Vault capacity and trading Volume**

## Inflation, Deflation, Stagflation or Something Else?

From 1929 to 1932, equity markets in the United States fell 90%. Almost all other markets were similarly hammered. However, one market performed quite well – Gold. During the same time period that equity risk was in free-fall, Gold stocks such as Homestake Mining rallied 500% as the industry's costs plummeted while the price of the precious metal was fixed. Gold, though fixed in price, enjoyed a huge increase in its purchasing power during that deflationary time period. Therefore, in the most difficult DE-flationary event in U.S. history, Gold provided incredible outperformance.

50 years later, America was in the midst of a major IN-flation period. Double-digit inflation rates were the natural result of several years of pressures building from 1) a huge increase in the debt level of the U.S. in order to fund the Vietnam War and new social programs, 2) the U.S. government's decision to renege on its promise to convert dollars to Gold and, 3) a relatively easy-credit Federal Reserve when America's ability to export her inflation was not nearly as simple as it is today. The decade leading up to Gold's final spike saw the price of the metal rise to $800/oz from a starting point of $35/oz. For those long Gold, this period of inflation was also a material benefit for the value of their holdings.

So which is the best environment for Gold and are conditions ripe for another material spike in the price? The answer is that it can be either/or. Irrespective of the TYPE of "'flation" (h/t Bill Bonner) the U.S. endures, the key driver of Gold's price is the confidence the market has in the status quo condition of the governments, Central Banks and the state in general. Note the chart below:




*Source – Macrotrends.net - This interactive chart shows the ratio of the gold price to the St. Louis Adjusted Monetary Base back to 1918. The monetary base roughly matches the size of the Federal Reserve balance sheet. Data Sources: LBMA, Federal Reserve*

Each spike in the price represents the market's waning belief in the "system" and those that run it – the government and its Central Bank. From 1929-1932 and 1971-1980, Gold received a bid because the markets did not believe that the "Powers that Were" knew what they were doing. That lack of trust was manifested in crashing equity markets and soaring precious metals markets. The spike from 2000-2008 was similar, but not as dramatic as general trust and confidence remained. The recent downward spike was fueled by the extraordinary experiment of the Fed known as Quantitative Easing. Our belief is that as the ratio above has been artificially slammed lower, resulting in an inevitable reversion to the mean will be particularly unpleasant for those not exposed to Precious Metals. For those who are, the coming episode will simply be history repeating itself and material outperformance in Precious Metals will once again be enjoyed.

## **Trump and "10 'Old Men'"**

80 years ago, another New Yorker reveled in his election to the Presidency - Franklin Delano Roosevelt won in a landslide. However, he faced a problem. The United States Supreme Court was striking down much of his Depression-era legislation/programs and FDR was determined to prevent the Court from thwarting his plans. Given the "Nine Old Men" of the Court who stood in his way, the President proposed to make a mandatory retirement age of 70 for sitting justices. This caused a lengthy and impassioned debate across the country for half of 1937.

The President ended up "losing the battle but winning the war". The mandatory retirement age legislation never passed, but the Court began to change the way it voted. Why did it do so? Because any governmental body is by nature POLITICAL. Some of the Supreme Court judges of the time (esp. Judge Owen Roberts) caved into the fact that to continue to deny FDR what he (and, thereby, the majority of American voters) desired would have meant the enactment of mandatory retirement and the possible loss of their position.

Fast-forward the calendar to today and President Donald Trump may be faced with a very similar, though nuanced, situation with the 10 voting members of the Fed. Trump wishes to enact a number of programs to "Make America Great Again"; however, his POLITICAL opposition at the Fed – and, yes, the membership of that body is indeed highly political – likely wishes to see his Presidency (and the philosophy that won him the office) fail. Therefore, the Fed absolutely can and likely will do something they should have done long ago – tighten Credit, albeit for entirely the wrong reason. The Fed can appear to be "above the fray of politics" and simply state that they are fulfilling their mandate as inflation fighters and guardians of the sanctity of the nation's currency. The whole business will be as phony as their QE program, but it will likely be effective in causing markets to materially sell-off. Expect a tweet-storm from Trump about the incompetency of the Fed when markets begin to materially contract and the Fed shows no signs of relenting from their newly-discovered "hawkishness". If events prove this forecast to be incorrect and the Fed remains loose and easy with Credit, it is probably because they become too frightened of the outcome of crashing markets, or, like Justice Roberts, are concerned that their job/prestige is at risk by maintaining their view/votes. Remember that the political animal thinks of his own skin first!

What will be the impact on Precious Metals? Refer to the graph above as to what happens when trust is lost in the competency of the system and those who run it. The U.S. (and the world) are going to receive healthy doses of BOTH inflation and deflation, but it will be the uncertainty of the future AND present which will provide Gold and Silver with a healthy bid.

# Update on U.S. Banking System Derivative Exposure

One of the key risks in global markets today is the exposure of the financial system to derivative risk. A full discussion of the subject would be exhaustive, but the essence of the problem is banks in the U.S. (especially those in the "Systemically Important Financial Institutions" category) and those around the world are in the business of granting un-backed credit well in excess of the actual capital on their books. Here are the most up-to-date figures from the Office of the Comptroller of the Currency; note especially the column on the far right:

**TABLE 4**

**CREDIT EQUIVALENT EXPOSURES**
**TOP 25 COMMERCIAL BANKS, SAVINGS ASSOCIATIONS AND TRUST COMPANIES IN DERIVATIVES**
**JUNE 30, 2016, MILLIONS OF DOLLARS**

| RANK | BANK NAME | STATE | TOTAL ASSETS | TOTAL DERIVATIVES | TOTAL RISK-BASED CAPITAL | BILATERALLY NETTED CURRENT CREDIT EXPOSURE | POTENTIAL FUTURE EXPOSURE | TOTAL CREDIT EXPOSURE FROM ALL CONTRACTS | (%) TOTAL CREDIT EXPOSURE TO CAPITAL |
|---|---|---|---|---|---|---|---|---|---|
| 1 | JPMORGAN CHASE BANK NA | OH | $2,051,004 | $53,282,233 | $181,145 | $182,934 | $218,187 | $401,121 | 221 |
| 2 | CITIBANK NATIONAL ASSN | SD | 1,365,660 | 50,159,340 | 151,297 | 103,655 | 170,856 | 274,511 | 181 |
| 3 | GOLDMAN SACHS BANK USA | NY | 160,666 | 41,372,238 | 26,133 | 72,253 | 49,860 | 122,113 | 467 |
| 4 | BANK OF AMERICA NA | NC | 1,657,878 | 26,862,637 | 165,264 | 50,312 | 77,619 | 127,931 | 77 |
| 5 | Wells Fargo Bank NA | SD | 1,699,435 | 6,835,435 | 143,686 | 28,655 | 19,965 | 48,620 | 34 |
| 6 | HSBC NA | VA | 206,206 | 4,175,694 | 27,076 | 10,963 | 14,839 | 25,802 | 95 |
| 7 | MORGAN STANLEY BANK NA | UT | 135,608 | 2,122,485 | 16,321 | 3,333 | 4,484 | 7,817 | 48 |
| 8 | STATE STREET BANK&TRUST CO | MA | 251,261 | 1,389,582 | 17,091 | 10,150 | 8,632 | 18,782 | 110 |
| 9 | BANK OF NEW YORK MELLON | NY | 298,719 | 1,017,825 | 18,424 | 7,838 | 5,195 | 13,033 | 71 |
| 10 | PNC BANK NATIONAL ASSN | DE | 350,224 | 359,823 | 36,299 | 4,768 | 540 | 5,308 | 15 |
| 11 | SUNTRUST BANK | GA | 194,679 | 275,572 | 21,097 | 2,260 | 2,887 | 5,147 | 24 |
| 12 | NORTHERN TRUST CO | IL | 121,145 | 265,237 | 9,325 | 2,713 | 1,932 | 4,645 | 50 |
| 13 | U S BANK NATIONAL ASSN | OH | 433,463 | 261,106 | 43,456 | 1,855 | 4,633 | 6,488 | 15 |
| 14 | TD BANK NATIONAL ASSN | DE | 255,727 | 174,778 | 22,286 | 4,277 | 1,404 | 5,681 | 25 |
| 15 | MUFG UNION BANK NA | CA | 115,975 | 145,615 | 14,275 | 1,723 | 333 | 2,056 | 14 |
| 16 | REGIONS BANK | AL | 125,256 | 86,432 | 14,301 | 953 | 579 | 1,532 | 11 |
| 17 | CAPITAL ONE NATIONAL ASSN | VA | 278,661 | 79,038 | 23,769 | 1,841 | 921 | 2,762 | 12 |
| 18 | KEYBANK NATIONAL ASSN | OH | 99,138 | 71,872 | 11,161 | 1,201 | 287 | 1,488 | 13 |
| 19 | FIFTH THIRD BANK | OH | 141,112 | 66,227 | 16,376 | 1,315 | 844 | 2,159 | 13 |
| 20 | BRANCH BANKING&TRUST CO | NC | 217,159 | 62,750 | 22,905 | 1,405 | 819 | 2,225 | 10 |
| 21 | CITIZENS BANK NATIONAL ASSN | RI | 112,992 | 60,060 | 13,428 | 1,242 | 493 | 1,735 | 13 |
| 22 | BOKF NATIONAL ASSN | OK | 31,817 | 47,083 | 2,746 | 546 | 157 | 703 | 26 |
| 23 | COMPASS BANK | AL | 86,738 | 36,226 | 8,913 | 794 | 294 | 1,088 | 12 |
| 24 | HUNTINGTON NATIONAL BANK | OH | 73,864 | 31,397 | 7,552 | 448 | 274 | 721 | 10 |
| 25 | CAPITAL ONE BANK USA NA | VA | 103,537 | 31,218 | 13,424 | 595 | 157 | 752 | 6 |
| TOP 25 COMMERCIAL BANKS, SAs & TCs WITH DERIVATIVES | | | $10,567,923 | $189,271,906 | $1,027,750 | $498,029 | $586,192 | $1,084,220 | 105 |
| OTHER COMMERCIAL BANKS, SAs & TCs WITH DERIVATIVES | | | 4,461,491 | 560,605 | 480,021 | 7,701 | 4,308 | 12,009 | 3 |
| TOTAL AMOUNT FOR COMMERCIAL BANKS, SAs & TCs WITH DERIVATIVES | | | 15,029,414 | 189,832,511 | 1,507,771 | 505,730 | 590,500 | 1,096,229 | 73 |

Note: Total credit exposure is defined as the credit equivalent amount from derivative contracts (RC-R column B lines 20 and 21), which is the sum of netted current credit exposure and PFE.
Note: The total credit exposure to capital ratio is calculated using risk based capital (tier 1 plus tier 2 capital).
Note: Currently, the Call report does not differentiate credit derivatives by contract type. Credit derivatives have been included in the sum of total derivatives here.
Note: Numbers may not total due to rounding.
Source: Call reports, Schedule RC-R.

*Source: Office of the Comptroller of the Currency Quarterly Report on Bank Trading and Derivatives Activity – 2nd Quarter 2016 (published October 2016)*

Today's equity "markets" are not punishing this behavior due to the implicit "guarantee" these firms enjoy from Governments/Central Banks. The manifestation of this "guarantee" today is in the form of "Bail-In" law which was created after the crisis of 2008. If another crisis ensues and banks are in danger of failing, new capital will be sourced not from Governments and Central Banks, but from Bank DEPOSITORS. This is a material risk for any Institution or Individual with substantial cash (truly, assets of any kind) in the trust or safe-keeping of a financial company.

In a future time of acute and significant financial stress, equity holders will be wiped out with bond holders next on the slate. If liquidating a bank's fixed-income capital is not large enough to absorb the remainder of the liabilities, then the depositors of the bank will be next to receive drawdowns on their assets. Given the historical behavior of governments during a crisis, one would have to presume that precious metal holdings held in a banking institution might very well NOT be exempt from at least partial confiscation. Arguably, therefore, fiduciary wisdom would lead one to the consideration of alternatives for the storage and trading of hard money assets outside of the traditional banking system.

## Update on Alps and Liechtenstein Precious Metals

Alps Precious Metals Group enters the month of February with considerable tail winds for our business. The election of Donald Trump has elicited a great deal of uncertainty in the minds of many of our potential clients; uncertainty leading to heightened interest in physical precious metals. Additionally, the idea of holding at least some assets outside of the traditional banking/brokerage system is becoming more and more appealing to the market. Liechtenstein Precious Metals continues to experience growth in number of clients, amount of specie in the facility and trading volume. In just three short years, LPM has become a materially important private trading operation in Europe outside of the banking system. Due to growing demand, LPM is already planning for the future, inclusive of plans for the construction of new vault/trading facilities similar to the flagship vault in Liechtenstein to be located in property-rights friendly jurisdictions around the world.

Alps Precious Metals Group via our partnership with Liechtenstein Precious Metals Group is dedicated to providing the global standard for the finest and most secure storage and trading of Physical Precious Metals. Our Vault is constructed to the highest security standard in the world ("Class 10") and, via our relationship with Lloyd's of London, insures each client's specie at 100% of its market value. Our trading desk provides liquidity on each and every business day with as little as next day settlement. All of these benefits are enjoyed while simultaneously being freed from the status quo global financial system. Contact us (www.alpspmg.com) to discuss how APM/LPM can become a trusted partner in the creation, protection and utilization of the hard money portion of your portfolio.

James P. Hunter - Managing Partner
Alps Precious Metals Group