Alps Precious Metals Group

Monthly Commentary and Update

February 2018

A) The Return of All Correlations to 1.0
B) The Classic Bank Contra-Indicator, Derivative Version
C) January 26 – February 14 Scorecard

The Return of All Correlations to 1.0

When compiling a list of the many convenient wonders of the modern age, microwave popcorn would certainly qualify – hot, buttery and ready to go in about 2 to 3 minutes; with virtually no mess. The key to having decent popcorn is listening for the first couple of initial "pops", then pulling the bag out after the crescendo of explosions from the majority of the kernels has diminished to just a handful. Hold this image.

From 2007-2009, the concept of "All Correlations are 1.0" was made manifest. The phrase simply means that the price movement of every asset was directly tied to every other. With the exception of U.S. Treasuries and the U.S. Dollar, every asset followed every other in price direction; obviously, for the most part, that direction was down. The phrase "there is nowhere to hide" was commonplace.

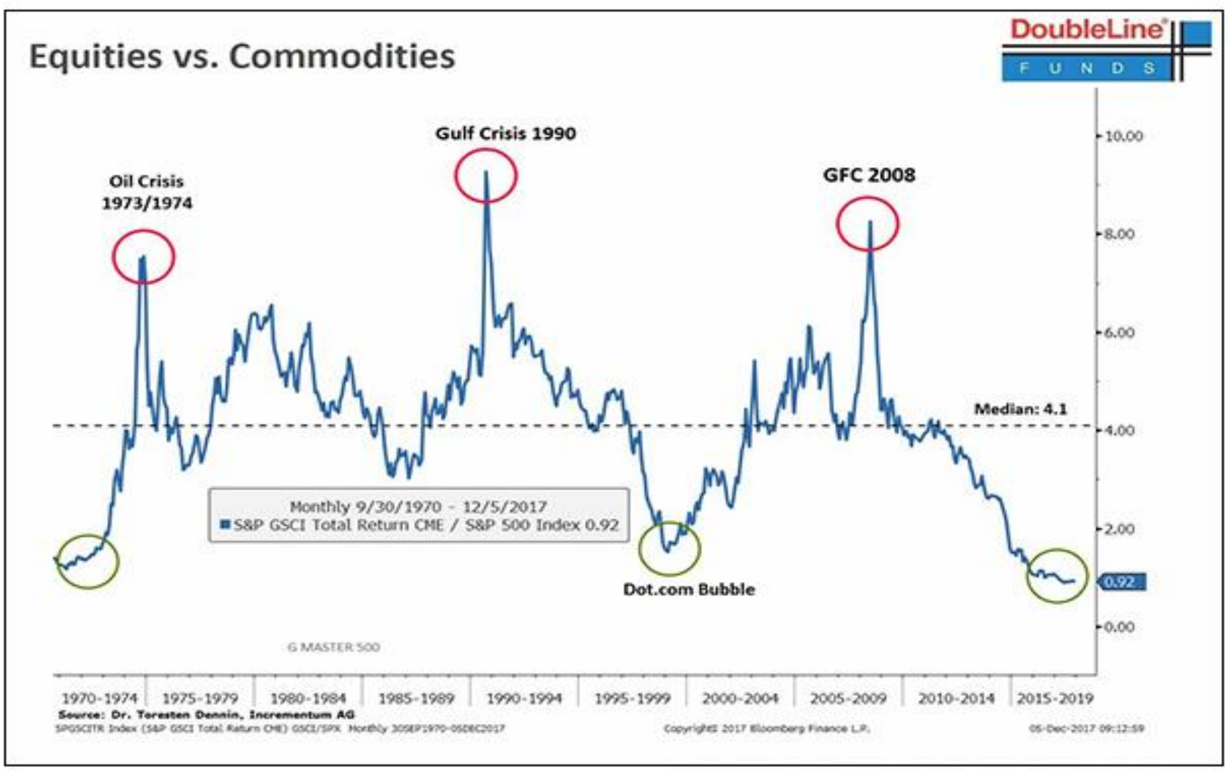
The move from utter complacency to total market meltdown began 11 years ago in late February 2007, when Chinese stock markets fell nearly 10% in one session – a seemingly "out-of-the-blue" event. Order was seemingly "restored" soon after the event; until the summer of '07 when two Bear Stearns hedge funds focused on mortgages disintegrated. July of 2007 was a major "Risk-Off" month, but again, all seemed to be "fine" as stock markets reached their all-time highs (at that point) in October of 2007. The first few kernels in the bag had popped.

From the "Risk-On" highs of October 2007, the trend was ever downward for the next 16 months; only 4 of those sixteen months saw a rally in the stock market (such as August 2008, the time of the Beijing Summer Olympic Games). Oil rallied to its all-time high in July of 2008 (probably also functionally related to the Games in China), before collapsing nearly 80% in the subsequent 3 months. Lehman Brothers imploded and went out of existence in September of 2008, 4 months after trading north of $40/share. Anything that had a bid was hit, all the way down until the lows of the first part of March 2009. The shrill and ubiquitous cacophony of the popping kernels was stunning.

The popcorn was done when the “fix” arrived in the form of the revision of the standard requiring reality in accounting for banks, along with unlimited credit created ex nihilo from the Fed (and other global Central Planners/Banks) - using that new credit to buy assets that were not allowed to be bought by the black letter of the law of the Fed charter. What has followed has been 9 years of “quiet” (with an interruption here and there), as equity markets have rallied a preposterous 300% while post-recession GDP growth has been the weakest in history and the deficits and debt of the United States and other OECD countries have gone beyond the description of “obscene”.

But given the current landscape, could one argue that a new bag of “popcorn” is in the microwave? Have we heard the first pops in the January 2018 bankruptcy of Carillion PLC, a British-based, global construction firm employing 50,000 people worldwide; alongside the possible demise of the global corporate titan General Electric? Both cases involve heavy indebtedness coupled with pension and health-care issues that are formidable. Also, the recent rise in average hourly earnings, concerns about consumer price inflation and the beginnings of “Quantitative Tightening” have catalyzed a rise in interest rates, a primary factor in the recent re-pricing down of the equity markets. These headlines detail events that are different from those that triggered the downdrafts of 10 years ago; however, the truism of history not repeating but rhyming is apropos.

A quick glance at the following chart demonstrates the elephant in the room – Inflation risk:



Source: Dr. Toresten Dennin, Incrementum AG

Of all of the hobgoblins that haunt risk markets, inflation is arguably the most disturbing; and as the chart above details, there is only one way to go for inflation. Despite having modern sophisticated tools at our disposal to measure and predict the phenomenon, no upper band exists for where inflation must stop. Given that unpredictable input, investment/risk pricing models must be fundamentally re-engineered to assume far more uncertainty (ie, "volatility"), resulting in a much more cautious approach to risk-taking. All this change in the midst of the Fed claiming that they actually will "Quantitatively Tighten" (perhaps to tame the inflation monster they were so driven to create) could likely result in a falling bond market alongside a falling stock market. To the extent that these fears of inflation/uncertainty/volatility/portfolio-losses become reality, on top of a global cauldron of ever increasing rise of geo-political/war risk, the word "chaos" becomes operative.

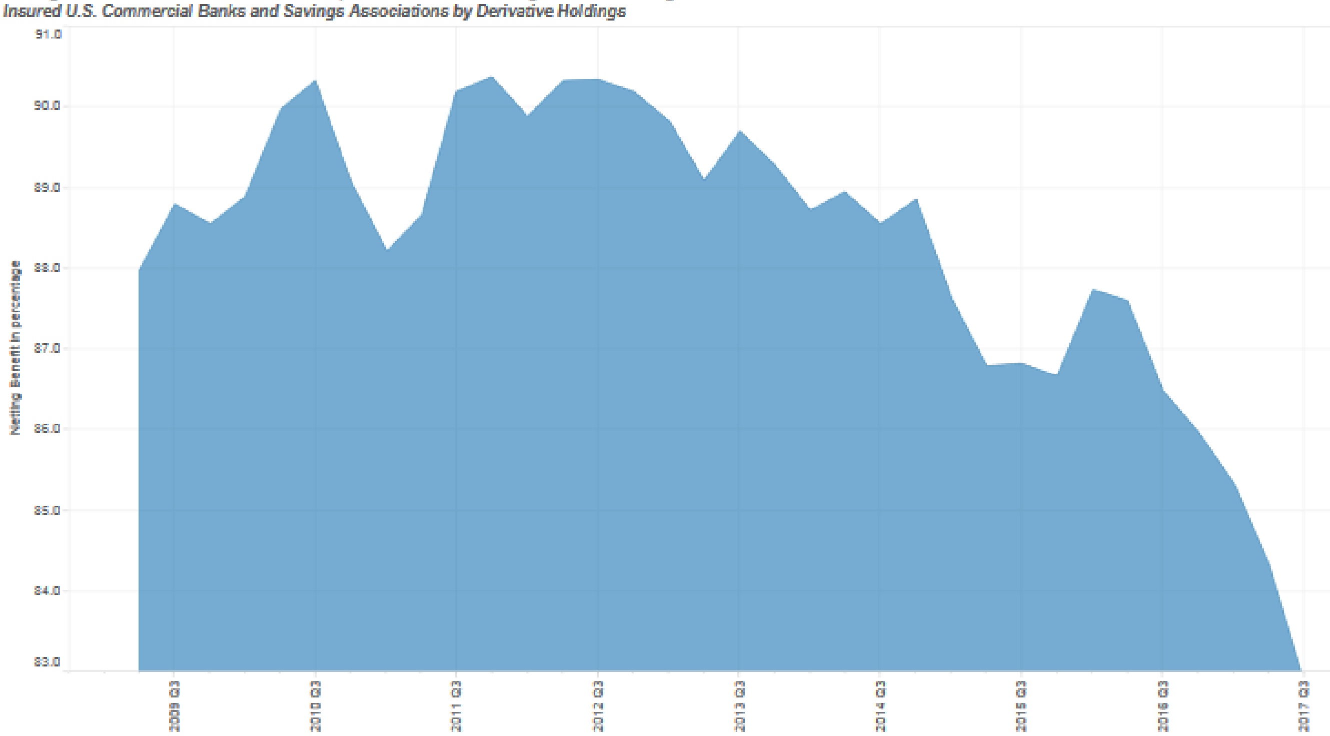
"Qui Bono?" to such a possible state of affairs? As you may have imagined, we would proffer that it is the owner of Physical Precious Metals. History would argue that whether the issue was a dramatically falling general price level or dramatically rising general price level, "chaos" was the result. And which asset was one of the very few to benefit from an inflation-created chaos? Precious Metals. The general price inflation of the 1970's, the asset price inflation of 2009-2011 and the chaotic atmosphere that accompanied both are cases in point. The argument is strong that we are entering another iteration of this theme. This is the type of period during which all correlations can indeed return to 1.0. Perhaps this time, however, given the price behavior of Gold and Silver over the last 5 years, the correlation of Physical Precious Metals to all other assets will be NEGATIVE 1.0. At the very least, some form of "insurance" allocation to the sector is compelling.

The Classic Bank Contra-Indicator, Derivative Version

When confidence is strong and finance stocks are hitting all-time highs, the competition for capital in the banking sector becomes intense. In order to boost earnings per share in such a setting, banks tend to lower loan loss reserves. Naturally, the timing often proves to be the absolute worst for such a revision; as the top of "the best of all possible worlds" for financial stocks is often seen in retrospect to be the time when ***additions*** to loan loss reserves were actually needed.

In today's markets, which include the relatively new sector of derivatives, risk of exposure to a firm's various and sundry counterparties can be reduced via "Netting" – essentially, if a firm is long a certain credit in a derivative transaction, that risk is "netted" to zero if it is simultaneously short the same credit in a separate derivative transaction. The United States' Office of the Comptroller of the Currency issues a quarterly report detailing a host of measurements of the risk contained within the derivative books of the members of the U.S. Financial System. As the next graph starkly details, U.S. banks and brokerages have been steadily INCREASING their exposure to risk in derivatives by lowering the percentage of credit exposure that has been eliminated via bilateral netting. "Right on schedule" for the lightning-quick demise of the "short volatility" trade!

Graph 6
Netting Benefit*: Amount of Gross Credit Exposure Eliminated Through Bilateral Netting
Insured U.S. Commercial Banks and Savings Associations by Derivative Holdings



Netting Benefit (in percentage)

2009			2010				2011				2012				2013			
Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
88.0	88.8	88.5	88.9	90.0	90.3	89.1	88.2	88.6	90.2	90.4	89.9	90.3	90.3	90.2	89.8	89.1	89.7	89.3

2014				2015				2016				2017		
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
88.7	88.9	88.6	88.8	87.6	86.8	86.8	86.7	87.7	87.6	86.5	86.0	85.3	84.3	82.9

*The netting benefit is defined as: $ amount of netting benefits/gross positive fair value.
Source: Call reports, beginning the first quarter of 2015 HC-R; otherwise HC-L

Conclusion? If the banks don't get "onside" quickly, a new Lehman moment may be upon us faster than the market can imagine, in an even more systemic manifestation than 2008. Of course, repairing this imbalance will create market turbulence (ie, "Risk Off"/stocks down). For the possible implications for Physical Precious Metals, please see the "chaos" discussion above.

Scorecard: Highs of January 26 to the Lows of February 9

Since we last wrote, the stock and bond markets have experienced the first material downdraft in quite some time. We thought it would be instructive to see how the various markets performed during this long overdue selloff. The following chart details the price return of the various listed assets from the heights of 1/26 to the low ticks of 2/9. Though these statistics are short-term, they are a result of a "change in course"; therefore, they may be displaying a fairly accurate picture of what is to come.

Index	Price on 1/26	Price on 2/9	Return
S&P 500	2872	2532	-11.8%
Nasdaq	7505	6630	-11.7%
VNQ (Reit ETF)	79.69	74.70	-9.6%
Bitcoin	11000	6000	-45.5%
Ethereum	1050	566	-46.1%
Gold	1357	1313	-3.24%
Silver	17.39	16.58	-7.2%

The conclusions drawn from the price action could be argued as follows:

1) Cryptocurrencies lose their bid in "Risk Off" trends; not likely to be a "safe haven" if the overall trend for equity markets is down.
2) Gold and Silver outperformed all of these risk classes, though they, too, were down. However, we believe inflation and bond market issues going forward will enable Precious Metals to not only outperform, but to also enjoy POSITIVE returns from current levels.
3) 10yr T-Notes, not shown above, had the best performance during this time; however, they were still DOWN (@ -1.6%) during a massive equity sell-off; an ominous sign for this asset class going forward.

Alps and Liechtenstein Precious Metals

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.

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