Hard Asset Research Report

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MARCH U.S. REPORT

Inflation Forecast: A new reason to buy hard assets?

Low oil prices have given American consumers persist low inflation over recent years. Now that some of President Trump's policies have begun to swing into effect, it's all about to change. But, is that any reason to worry? Perhaps not, if you invest in commodities and precious metals.

Trump's anti-migrant stance has already affected wage rises, but so have long overdue price rises of commodities and manufactured goods. Charles Schwab, the banking company, in its 2017 outlook put inflation at the top of its list of concerns for the bull market in stocks (domestic and international). Their concern is that rising wages will be a hit against corporate earnings.

Kiplinger forecasts an increase of overall annual inflation for 2017 to about 2.5%, from 2.1% at the close of last year.[1] Some analysts expect inflation to hit 2.5% for the first quarter of 2017, and possibly hit 3.5% by the end of the year.[2] The big generators for inflation will be rebounding in

[1] "Inflation Gets a Little Stronger," David Payne, Kiplinger Economic Forecast, February 21, 2017.

[2] "United States Inflation Rate," Trading Economics: Forecast 2016-2020.

energy prices from 2016's depressed levels and labor cost which have already risen by as much as 2.7% and may rise to 3% before the end of the year.[3]

Several factors could kick in that may produce even more wage increases for 2017. While Trump's immigration and border security policies could be a factor, there are many reports that U.S. businesses were already having problems hiring and retaining qualified workers, especially in technical fields in manufacturing, healthcare, and construction. These are more likely due to natural competition which probably will be a bigger factor in the short term, but not for the long term.

The fact is, few companies will relocate production to the U.S. and there are many reasons why government will not offer more incentives. For one think despite political and public debate, more manufacturing jobs will not help the U.S. economy. Policy-makers are aware that the U.S. economy is roughly 70% consumption based. Manufacturing only counts for about 15%. Why then would there be any impetus to hurt consumption to benefit a small sector of the economy, especially with midterm elections again on the horizon?

Service sector labor cost, where talent and specialized skills become more in demand, could also be another driver for inflation. It may be argued that the rise in rates could be fueled by the same labor factors as we mentioned earlier. Again, however, this is all part of natural competition that will be relatively easy to track.

The inflation rate could rise even more quickly from other effects from still-unknown variables likely to be generated by Trump's planned trade policies, especially if they turn protectionist. However, there is little appetite in Congress to endorse border tariffs and other types of punitive measures that are likely to harm regional constituencies.

Moreover, the U.S. Federal Bank has shown that it is willing to raise interest rates faster if inflation moves up too quickly. Fed kept rates low while inflation remained sluggish over a five-year period (2011-16). Now that we have seen 2%, we expect the U.S. central bank to be far more combative, thus quelling stimulus for core inflation. It is important to note that the Fed's preferred measure of inflation, the core personal consumption expenditures (PCE), showed inflation at just 1.6% in November of last year. A minority see inflation reaching 1.9 to 2% this year. Most are pushing a lower forecast. However, many economists have been predicting that inflation could finally break above the Fed's 2% target in 2017.

Conclusion

Fear is a rational investment strategy. Consider the fear of inflation. As it turns out, inflation will rise moderately on fiscal stimulus and tax cuts that are designed to boost GDP this year. Just like anything else, too much inflation is not good. But with years of lackluster economic performance, a

[3] "Salary Budgets Expected to Rise 3% in 2017," Stephen Miller, Society for Human Resource Management.

little bit of price traction is a good thing. All predictions of "Zimbabwe" style inflation in the U.S. has always been extremely theoretical. The reality is actually good news – at least in the short term. The economy may produce just enough inflation to give investors some incentive to speculate with precious metals and other commodities.

Let's agree that inflation results in the destruction of a currency's purchasing power. The historical defense among investors, central banks, and other institutions is to store a portion of wealth in hard assets (precious metals and rare coins). This practice fuels what can be called a "fear market."

Consider that when Donald Trump produced a surprise win for the U.S. presidency a month ago, the value of the Turkish lira plunged against the strengthening U.S. dollar. Turkish President Recep Erdogan then urged businesses, citizens, and institutions to convert all foreign exchange into either the lira or gold. The move supported the currency from falling further. It also helped nudge up world-wide gold prices.

Venezuela, meanwhile, has terrible inflationary problems of its own. Out-of-control socialism led to an extreme case of inflation (almost Zimbabwe, but not quite) due to high demand for commodities and food. The Bolivar is now devalued so low that shopkeepers don't count the currency, they weigh bricks of Bolivar notes on scales.[4] The country has since sold 25% of its reserves of gold to meet debt obligations, leaving official holdings at a historic low of $7.5 billion.[5]

The U.S. is not likely to experience "Zimbabwe" (or Venezuela) style hyperinflation anytime soon because the dollar continues to surge on bets that Trump's promise of lower taxes, streamlined regulations, and infrastructure spending will boost U.S. economic growth.

A case can be made for investors to weigh the potential gains from either investing into a "fear market" rise in gold or simply as a classic way to protect wealth. In our opinion, we believe this is ample reason to increase personal holdings in all hard assets, at least for now.

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[4] "Venezuelans Give Up on Counting Piles of Cash…," Fabiola Zerpa, Andrew Rosati, Bloomberg Markets, October 31, 2016
[5] "Venezuela's Gold Reserves Tumble," Noris Sato, Bloomberg Markets, August 18, 2016.