Commentary
By Steve Henningsen
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Emergence

"Whatever you do, you need courage. Whatever course you decide upon, there is always someone to tell you that you are wrong. There are always difficulties arising that tempt you to believe your critics are right. To map out a course of action and follow it to an end requires some of the same courage that a soldier needs. Peace has its victories, but it takes brave men and women to win them."
–Ralph Waldo Emerson

"The road to above average performance runs through unconventional, uncomfortable investing."
– Howard Marks, Chairman Oaktree Capital Management, 2014

Throughout antiquity, people looked towards the sunrise as a sign of hope, rebirth or simply an indication that the gods were appeased and that you were granted another day. For this commentary I will use it in the light of Hope, Rebirth and Cyclicality. Hope that our past two quarter's relatively-good performance signifies we are back on track, Rebirth in that I perceive our global monetary system is in the process of transformation, and Cyclicality in the geopolitical landscape. The majority of this report builds on last quarter's commentary where I briefly touched upon what I believe is a new global financial system and why I think it is already in gestation. But first I would like to briefly touch upon our portfolios' progress this year.

"We haven't yet reached the kind of loathing that was displayed towards us in 1999 where we were just told we were complete idiots and several clients banned us from their buildings. I think there is a broader acceptance of the power of valuation, but the longer the rally goes on, the shorter people's memory gets. Galbraith used to talk about the extreme brevity of financial memory and I fear that's kind of what we're experiencing now. People are looking at last year and say look, it can go up 30%, why on earth are you saying future returns are going to be dismal."
–James Montier, GMO Asset Management, 2014

I certainly sympathize with Mr. Montier's description of how one can feel when results deviate from expectations. Unlike my first decade at TWC, the past few years have been difficult for clients, especially new clients who never experienced our "good years." It's also challenging to keep people grounded in the understanding that there are still major risks imbedded in the markets even though we have experienced ever rising stock markets over the past several years.

"There is currently a debate being waged on Wall Street. On one side of the argument are individuals who believe that we have entered into the next "secular bull market" *and that the markets have only just begun what is an expected multi-year advance from current levels. This would certainly be welcome news for anyone with money invested in the financial markets. However, the other side of the argument points to the ongoing effect of artificial stimulus and a suppressed interest rate environment that have only temporarily "masked" the underlying fundamental issues."*

–Lance Roberts, STA Wealth Management, 2014 Daily X-change

You already know which side of the argument I'm on, so I need not waste additional ink in explanation. What I would like to point out is that your patience is *finally* paying off. While I have no crystal ball and can't guarantee our progress shall continue, what I can state is that I am encouraged by the performance of many of our portfolio holdings and will discuss this more in the Portfolio Pondering section. Before delving into my thoughts regarding some of the financial/geopolitical transitions that appear to be accelerating, I wish to comment on the Bank for International Settlements (BIS) annual report released this July, as it was a doozy.

They Said What?

"No problem can be solved from the same level of consciousness that created it."

– Albert Einstein

For those of you who do not know, the BIS in Basil, Switzerland is basically the central bank for central banks. Think of it as the mother-bank. Well, this mom just gave her kids a severe tongue lashing, outlining many of the same risks and concerns that I, and others, have been bringing up over the past several years. Here are some highlights – emphasis mine:

> *... it is hard to avoid the sense of a puzzling disconnect between the markets' buoyancy and underlying economic developments globally.... Despite the euphoria in financial markets, investment remains weak. Instead of adding to productive capacity, large firms prefer to buy back shares or engage in mergers and acquisitions.*
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> *As history reminds us, there is little appetite for taking the long-term view. Few are ready to curb financial booms that make everyone feel illusively richer. Or to hold back on quick fixes for output slowdowns, even if such measures threaten to add fuel to unsustainable financial booms. Or to address balance sheet problems head-on during a bust when seemingly easier policies are on offer. The temptation to go for shortcuts is simply too strong, even if these shortcuts lead nowhere in the end.*
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> *Financial markets have been exuberant over the past year, [...] dancing mainly to the tune of central bank decisions. Volatility in equity, fixed income and foreign exchange markets has sagged to historical lows. Obviously, market participants are pricing in hardly any risks…*
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> *Growth has picked up, but long-term prospects are not that bright. Financial markets are euphoric, but progress in strengthening banks' balance sheets has been uneven and private debt keeps growing. Macroeconomic policy has little room for manoeuvre to deal with any untoward surprises that might be sprung, including a normal recession.*
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> *There is a common element in all this. In no small measure, the causes of the post-crisis malaise are those of the crisis itself – they lie in a collective failure to get to grips with the financial cycle. Addressing this failure calls for adjustments to policy frameworks – fiscal, monetary and prudential – to ensure a more symmetrical response across booms and busts. And it calls for moving away from debt as the main engine of growth. Otherwise, the risk is that instability will entrench itself in the global economy and room for policy manoeuvre will run out.*
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> *Good policy is less a question of seeking to pump up growth at all costs than of removing the obstacles that hold it back. When policy responses fail to take a long-term perspective, they run the risk of addressing the immediate problem at the cost of creating a bigger one down the road. Debt accumulation over successive business and financial cycles becomes the decisive factor.*

...<u>The temptation to postpone adjustment can prove irresistible, especially when times are good and financial booms sprinkle the fairy dust of illusory riches. The consequence is a growth model that relies too much on debt, both private and public, and which over time sows the seeds of its own demise</u>.

Keep in mind that this is the same group that warned the Fed about the increasing risks in the U.S. real-estate market prior to 2007. That being said, The Fed's Ms. Yellan and the ECB's Mr. Draghi were quick to brush off the warning, while markets didn't seem concerned about the BIS's warnings. The fact that interest rates on several of Europe's sovereign bonds are trading at the lowest point <u>in centuries</u> (many below U.S Treasury Rates) demonstrates how distorted risk premiums have gotten and how complacent investors have become. However, not all see in the same way:

"The ECB's expansive "whatever it takes" guarantee may indeed be enough to help finance greater short-term stimulus than is currently being allowed; but the ECB's guarantee will not solve long-run sustainability problems."
-Kenneth Rogoff, *Europe's Debt Wish*, 2014 Project Syndicate

"The fundamental problems are not solved and everybody knows it. The euro crisis is not over..."
– Allianz SE's chief investment officer, 2014 Bloomberg

Rumblings from the Middle East

"Because things are the way they are, things will not stay the way they are."
–Bertolt Brecht, German Poet

Mention the Middle East to most Americans and thoughts of oil, terrorists, and sand dunes come to mind. But ancient Arabia and Persia, whose internal struggles are beyond the grasp of most Western minds, have deep sectarian roots that go back over a millennium. This area has long been comprised of three sectarian provinces; Sunnis, Shiites and the Kurds. Unfortunately, the hubris shown by Western powers in disregarding these factions when they carved up the Ottoman Empire at the beginning of the 20th century is starting to cause rifts. Lines on a map won't keep people together if they have fundamental religious differences.

Most of the region's skirmishes of the past few decades have been between the Sunnis and Shiites, with the most recent coming from *The Islamic State of Iraq and al-Sham* (ISIS) looking to take back the Sunni provinces, which mostly overlap parts of Syria and Iraq. As you can see on this map from the folks at Stratfor, the three sectarian groups are spread-out throughout this region, but also overlap into Saudi Arabia, Egypt and Turkey. The epicenter is between Persian-Shiite Iran, Arab-Sunni Saudi Arabia and Turkic-Sunni Muslim Turkey. While there is a real possibility of the map lines being redrawn in this area, the situation is made more unstable via political ties to various countries. Specifically, Russia supports Iran and the current Maliki Iraq government; Saudi Arabia (a mostly Sunni nation) supports ISIS; the U.S is attempting to get Maliki to be more accommodative to the Sunnis, while trying not to upset its Petrodollar partner Saudi Arabia, and China seems to support everyone, as they just want to trade and not get involved with local politics. So far this has not affected oil prices, but things could quickly change should conflict spill over to Saudi Arabia.

Historia magistra vitae est – history is life's teacher.

So what does all of this have to do with the potential realignment of the global financial system I've been concerned about lately? One needs to focus on the weakening of the Petrodollar system, and the potential effects it would have. For those not familiar with the Petrodollar, let's go to Wikipedia:

> In 1971 Richard Nixon was forced to close the gold window taking the U.S. off the gold standard and setting into motion a massive devaluation of the U.S. dollar. In an effort to prop up the value of the dollar Nixon negotiated a deal with Saudi Arabia that in exchange for arms and protection they would denominate all future oil sales in U.S. dollars. Subsequently, the other OPEC countries agreed to similar deals thus ensuring a global demand for U.S. dollars and allowing the U.S. to export some of its inflation.

This agreement was crucial in helping the U.S. gain economic power and increase its standard of living through cheap energy and low-interest rates. All countries had to buy oil using U.S. dollars, thus flooding the world with our currency and helping it maintain its place as the reserve currency. Even better, we got Saudi Arabia, and others, to take their excess dollars and invest them in U.S. Treasuries; a.k.a. petrodollar recycling. When the U.S. needed oil, we just printed up our own currency for nothing and swapped it for oil. The petrodollar is the lynchpin to America's power, and in my opinion, the U.S. military intervened in Iraq, Libya and Syria over the years in order to protect it.

Lately, our relationship with Saudi Arabia has soured. The U.S. has chosen not to help Saudi Arabia with some of its local problems; most recently in Syria. Adding to the power shift from West to East (Russia, China, India, Iran) is the fact that Saudi Arabia now exports more oil to its Eastern consumers than it does to the U.S. Simultaneously, the U.S. has greatly increased its own oil production capability, which profoundly alters the two countries symbiotic relationship. Should Saudi Arabia announce that it intends to sell its oil in other currencies, besides the dollar, shockwaves might be felt globally, as the dollar would likely decline and interest rates rise. American economic and political hegemony is tied to the dollar, and I expect it would erode with it.

This isn't just an "oil" thing. Over the last few years, an increasing number of countries (China, Russia, Iran, Australia, Brazil, United Arab Emirates, Turkey, etc.) have decided to ditch the dollar by putting in place bilateral trade agreements using their own currencies. The $400 billion natural-gas deal between Russia and China is a recent example. This is the first major deal done without the use of the dollar. Though the majority of global trading is still done in dollars, a trend is in place that will decrease its volume in global trade.

"We [Europeans] are selling to ourselves in dollars, for instance when we sell planes. Is that necessary? I don't think so. I think a rebalancing is possible and necessary, not just regarding the euro but also for the big currencies of the emerging countries, which account for more and more of global trade."
–Michel Sapin, French finance minister, July 2104

It is not just the BRICS (Brazil, Russia, India, China, South Africa) nations that are calling for an end to this unipolar system, but other countries that are tired of a financial system that benefits the world's largest debtor nation while undermining creditor countries. French-government officials lashed out recently at the U.S. after one of their banks was fined billions of dollars while U.S. banks were pretty much let off-the-hook after the 2008 financial crisis. Also, news that the U.S. is spying on everyone is adding to the discontent, as much of the world – especially Germany – grows tired of America's hypocrisy and intimidation. There are increasing signs that the world's financial institutions are beginning to discuss structural changes to reduce U.S. power and allow others greater say in our global financial system. In fact, if one were simply to follow the breadcrumbs back over the decades, one would see that these thoughts are not new.

A Monetary Sunrise Coming?

"People only accept change when they are faced with necessity,
and only recognize necessity when a crisis is upon them."
–Jean Monnet, French political economist and diplomat, July 2014

The current management of our global financial system mainly consists of a handful of government/private institutions – BIS, IMF, World Bank, and maybe the G20 – with the U.S. being in the driver's seat. (Most of these institutions were developed after WWII, when the U.S. held the most poker chips at the table – over 20 tonnes of gold – during negotiations to develop an international monetary system a.k.a. Bretton Woods.) In the late '60s the IMF created an international-reserve currency known as Special Drawing Rights (SDRs), which is simply a derivative/basket of the U.S. dollar, Japanese Yen, Euro and Pound Sterling. These SDRs weren't used much until recently, but I'm getting ahead of myself.

Ever since these institutions were created, talks/rumors of one-world governments and currencies have persisted. In 1988, The Economist magazine ran this cover with the title, *Get Ready for a World Currency*. The article inside, *Get Ready for the Phoenix* began, *"THIRTY years from now, Americans, Japanese, Europeans, and people in many other rich countries, and some relatively poor ones will probably be paying for their shopping with the same currency. Prices will be quoted not in dollars, yen or D-marks but in, let's say, the phoenix. The phoenix will be favored by companies and shoppers because it will be more convenient than today's national currencies, which by then will seem a quaint cause of much disruption to economic life in the last twentieth century."*

After several currency crises throughout the '70s and '80s, people were looking for increased stability. However, the Economist was quick to point out that "*Governments are far from ready to subordinate their domestic objectives to the goal of international stability. Several more big exchange-rate upsets, a few more stock market crashes and probably a slump or two will be needed before politicians are willing to face squarely up to that choice."* Eerily, the article ended with this prediction: *"Pencil in the phoenix for around 2018, and welcome it when it comes."* Hmm…

Thanks to the introduction of the Euro, regional currencies were being discussed throughout the 2000s such as the Union of South American Nations (UNASUR), the Gulf Cooperation Council (GCC), the Association of Southeast Asian Nations (ASEAN), and the Economic Community of Western African States (ECOWAS). In addition, prominent economists such as Robert Mundell and James Tobin were proponents of a global currency, as was former Governor of the Federal Reserve Board, Paul Volcker. Even revered *Financial Times* scribe Martin Wolf, wrote an article in 2004 titled, *We Need a global Currency*. Over the years several more articles have been written about this possibility, including papers from the IMF. (I don't want to waste space here listing articles but for those interested I obtained most of this information from Andrew Gavin Marshall's paper, *The Financial New World Order: Towards a Global Currency and World Government* where you can find many more articles and thoughts.)

"The world is closing in
Did you ever think
That we could be so close, like brothers
The future's in the air
I can feel it everywhere
Blowing with the wind of change"
–Scorpions, Wind of Change

The financial crisis of 2008 was a catalyst for further global currency considerations, as the U.K.'s Prime Minister, Gordon Brown, called for a "new Bretton Woods," followed by officials from China, India, and

Russia. When the IMF used the SDRs in 2009 to increase liquidity throughout the world, *The Telegraph's* Ambrose Evans-Pritchard covered this move in his article titled; *The G20 moves the world a step closer to a global currency*.

"Explain to me how increase in paper pieces can possibly make a society richer? If that were the case, explain to me why there is still poverty in the world? Isn't every central bank in the world capable of printing as much paper as they want? And do you then think society as a whole would be richer?"
–Hans Herman-Hoppe, political philosopher, sociologist and economist

Fast forward to today where there are cumulative signs of change: the BRICS opening their own "IMF type bank", increasing direct currency-swap agreements, increasing frustration with the Fed's QE program and its effect on emerging markets, the development of new credit-rating agencies, and continued transfer of gold bullion from West to East. There are also scary things being discussed by these financial institutions such as wealth taxes and bank bail-ins – a.k.a. stealing your savings account.

All this leads me to believe that the current monetary system is in flux as the current credit/debt based system is not functioning and needs change. For the first time in history, all the major economic powers of the world are overly indebted. It seems the only way out is through some type of deleveraging/depreciation event. There are many details that lack clarity. Will it involve the SDRs or will another country simply come in and back their currency with gold? Will global governances hold hands together or will fractions develop with the East going one way and the West another? Keep in mind that global-reserve-currency holders rarely give up their power without a fight. Can this be done under what is perceived to be a stable financial environment or do politician's need another financial crisis to birth this new monetary system?

Latin root of the English word "credit"– Credere = to believe, to trust
"If you weaken the currency, you weaken society, you weaken trust."
– Dylan Grice, Aeris Capital, 2014 Strategic Investment Conference

With the majority of the world's developed economies battling to see who can depreciate their currency faster, I think investor's faith will also abate as Mr. Grice states. The process may be slow at first, but is likely to accelerate as people take notice of what's going. What history has shown is that when people lose trust in the financial system, they tend to transition their wealth towards hard assets. The current trend in the high-end real estate, collectables and art markets is an indication of this shift. Another one of these "hard-assets" is gold and silver which, after 12 positive years, had a rough going in 2013, but has perked up so far this year.

"It is the thing you won't see coming that will take the system down. Things happen much more quickly than what investors expect. What will happen in gold is that it will chug along and then all of a sudden–boom. It will be up $100 an ounce, and then the next day it will be up another $200 an ounce. Then everyone will be on TV saying it's a bubble—boom. It's up $300 an ounce, and before you know it, it will be up $1,000 per ounce. Then people will say gee, I better get some gold, and they'll find out they can't get it because the big guy will get it. You know, like central banks and sovereign wealth funds will be able to get the gold. The typical investor will run down to the coin shop and they will be sold out, and the U.S. Mint will say sorry, we're not shipping. You're going to find out you can't get it because the whole thing is set up for massive shortages in supply."
– James Rickards, author, economist and attorney, June 2014

Portfolio Ponderings

"In skating over thin ice our safety is in our speed."
- Ralph Waldo Emerson

I am encouraged by these past two quarters' performance, but by no means do I think it will be clear sailing ahead. Setbacks can occur in this environment at any time given the underlying risks in the markets – the main risk being complacency! I believe that the risks that most investors seem to have thought gone or fixed will return over the next 18 months. Europe's banks are again wobbling, and the Fed's QE liquidity is being removed from the markets just as the U.S. economy appears to be slowing again.

In my 4th quarter commentary from 2013, I discussed our "Absolute Return" managers, and I would like to continue this process of educating clients on our holdings. This time I will discuss a few of our holdings that seem to confuse clients the most, specifically Royal Gold, Silver Wheaton, Sandstorm Gold, and the Dow Jones-UBS Livestock Subindex Total Return.

The first three all share similar characteristics in that they are royalty and/or streaming companies, which are like banks that deal exclusively with mining companies. A royalty or streaming company will agree to pay a mining company a certain amount of cash, or sometimes stock, in exchange for the right to future metal production at a fixed cost, regardless of the metals current market price. Specifically, a royalty agreement is one in which the royalty company doesn't have to pay for each ounce of metal it receives. Rather than owning gold mines or exploring for gold itself, royalty companies help finance mining companies and earn a "royalty" on its production. A streaming agreement entitles the company to buy the metal at a fixed price usually well-below the prevailing market price.

For the royalty companies, the model eliminates many of the risks of traditional mining, because they don't have to waste time and money exploring barren territory. Instead, they can hand-select the most promising prospects and spread their risk across numerous projects. When the mine is fully developed, and the mining company begins repaying the investment, the income allows the royalty companies to add more and more prospects to their portfolios.

For example, Silver Wheaton's business is simple. It buys, or "streams," silver and gold production from miners at a fixed cost, regardless of the market price. They make money by paying them the market price for the metal. Silver Wheaton has purchase agreements with 16 mining companies. The agreements cover production from 19 operating mines located worldwide and while they have revenues over $700MM, their firm is very efficient and employees a mere 30 people.

Another reason I like these stocks is that they will provide inflation protection, and best of all, they pay dividends! Their price is obviously correlated with the price of gold and silver bullion, so they have all dipped the past few years. However, they have begun to recover this year and I remain excited about the potential for all three positions.

As outlined on their website, The Dow Jones-UBS Livestock Subindex Total Return (the "Index") reflects the returns that are potentially available through an unleveraged investment in the futures contracts on livestock commodities. The Index is currently composed of two livestock commodities contracts – lean hogs and live cattle. This is our "food inflation" hedge, and although it struggled initially, we remain committed to it as the price of beef and pork has shot up this year. (I'm sure you have noticed this barbeque season!) Regarding food inflation, agriculture and food related stocks are one area I plan to increase our weightings because I expect this trend to continue as the world's population grows.

I thank you for your continued patience.

It's another tequila sunrise
This old world still looks the same
Another frame
–Tequila Sunrise, The Eagles

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