Stock Market Dangers, Stress Test Your Portfolio; Axel Merk: Lot of Damage to Be Caused

Welcome to this week's Market Wrap Podcast, I'm Mike Gleason.

Later in today's program we'll hear from Axel Merk of Merk Investments. Axel gives a wonderful explanation of what's behind this week's wild market action, weighs in on gold's role as a safe haven in the midst of potential chaos and tells us why he believes volatility his here to stay. Don't miss a fantastic interview with Axel Merk, coming up after this week's market update.

Well, there were few places for investors to hide this week. Stocks, bonds, and to a lesser extent precious metals all got hit with selling.

On Monday, the stock market had one of its biggest volatility spikes and worst point drops in years. Gold prices held firm on Monday but succumbed to selling later in the week.

As of this Friday recording, the yellow metal comes in at $ 1,314 an ounce, down $ 19 or 1.4% for the week. Although down in terms dollars, gold prices are higher in terms of the Dow Jones Industrials. The Dow to gold ratio is lower by about 4% this week and now trades around 18 to 1.

It's too early to call a major trend change in the ratio, but it certainly has the potential to fall a lot further. The Dow/gold ratio bottomed at 6 to 1 in 2011 when gold prices peaked at $ 1,900 an ounce. And the ratio hit rock bottom at 1 to 1 way back in 1980. Gold prices had hit a secular high on stagflation fears as silver prices touched nearly $ 50 an

ounce.

Silver can now be had for an incredible bargain at just $ 16.28 per ounce spot price. The white metal is down 35 cents or 2.1% this week and is attracting more bargain hunters. Money Metals Exchange has seen an increase in gold and silver buying in recent days amidst the flight from equities as well as crypto-currencies.

In previous podcasts, we noted that margin debt was at all-time highs and stock valuations were at bubble levels. Yet markets kept moving modestly higher week after week, with the mainstream financial media and the White House celebrating each new milestone. Investors got complacent and became oblivious to the risks inherent in the stock market.

This week has certainly served as a reality check.

It's an interesting coincidence that Monday's selling occurred just as new Federal Reserve Chairman Jerome Powell officially took over from Janet Yellen. If Powell had hoped markets would greet him with a rally of approval, he certainly got a reality check of his own!

Now the question is whether Powell will continue with Yellen's gradual interest rate hikes. The next one had been due in March. Just a week ago, futures markets were pricing in a March rate hike at a near certainty. Now suddenly there is a 30% chance the Fed won't hike in March and a 50% chance they won't hike this summer, according to prognosticators.

But what precipitated the heavy selling in the stock market over the past few days was the steady rise in long-term interest rates. Rates reached a tipping point for some traders, and that's all it took to spark a bout of deleveraging.

Of course, the Fed doesn't directly control long-term rates, but it can certainly influence them with bond purchases or

sales.

Long-term interest rates have been rising in part due to concerns over inflation and also because of Uncle Sam's deteriorating fiscal outlook. The expected jump in economic growth this fiscal year from tax cuts is being financed by new debt creation. The U.S. Treasury Department announced it expects to borrow an additional $ 955 billion this fiscal year. That's a HUGE jump from the $ 519 billion deficit the government ran last year.

We're facing trillion dollar deficits even in the context of a rosy economic outlook. It's difficult to imagine what will happen when the next recession hits… or if the current correction in equity markets accelerates into a full blown financial crisis.

For now, it's just a correction. When the selling abates and the volatility dampens down, investors will have to re-assess where they want to deploy capital. Will they plough it right back into the stock market? Put it into bonds? Or diversify into precious metals?

Gold and silver tend to exhibit near zero correlation to conventional financial assets. That makes them ideal for portfolio diversification in turbulent times like these. You may even want to increase your position in case these market tremors mean we're headed for disaster.

> ***Except from the song: "Headed for Disaster" by Store Dore***
>
> *We're headed for disaster… faster and faster.*
> *Government is liable and out of control, for millions and billions and trillions and more.*
> *The rich get richer. The rest don't know. Their standard of livin's gonna fall through the floor.*
> *You better be ready, by making a plan, than trusting what you're told with your head in the sand.*
> *And grow your food, get ready, get some gold. Build up your*

bunker before ya get too old.
We're headed for disaster… faster and faster.
We're headed for disaster…. faster and faster.

Whether the chorus of the preceding song by Steve Dore rings true or if markets stabilize from here, investors should definitely stand up and take notice about the warning signs we've been seeing in the financial world this week. Having some financial insurance in the form of physical gold and silver just makes plain sense at all times, but especially now.

Well now, for more on the risks ahead and the likelihood of ongoing market volatility, let's get right to this week's exclusive interview.

Mike Gleason: It is my privilege now to welcome in Axel Merk, President and Chief Investment Officer of Merk Investments and author of the book *Sustainable Wealth*. Axel is a highly sought-after guest at financial conferences and on news outlets throughout the world, and it's great to have him back on with us.

Axel, it's a real pleasure to speak with you again, and thanks for joining us.

Axel Merk: Oh, it's good to be with you.

Mike Gleason: Axel, I'd like to jump right in here and get your thoughts on the health of the markets in general, because I think it's an appropriate place to start in light of the

whipsaw action we've seen of late. Now to us, the behavior is becoming more and more strange and artificial. We had an 1,100 point drop in the Dow on Monday, and it recovered nearly 600 points on Tuesday, almost right on cue. We know algorithmic trading is a big deal these days. We also know that price rigging and manipulation is real. There were six traders arrested a couple of weeks ago for cheating in a variety of markets including gold futures. Those were just the most recent examples of arrests and criminal charges.

So, on the one hand we have machines doing lots of trading and they don't respond to cues as humans might, and they are designed to front run anybody using traditional low speed connections. And on the other hand, we know at least sometimes the cues are phony – just order spoofing and other tricks employed by crooked traders. So, before we dive deeper into some of the specifics about what we're seeing, from an overall perspective what do you make of these markets here, Axel?

Axel Merk: Sure, let me first address maybe what you just said about conspiracies and manipulation. While I don't necessarily disagree with what you say, the one challenge with that viewpoint is that it assumes that if you just get rid of a few bad apples everything is going to be fine. My view is actually far more negative. I happen to believe that most people in the markets are actually trying to do the right thing, trying to be honest, it's just the dynamics of the system. Similarly, with policy makers, drives them in a certain direction. Let me just put that out there, and we can touch on that in different ways, but let me kind of address the broader point here.

Since early December, I've referred to this market a little bit like a washing machine. And what I mean with that is, that correlations have been breaking down. For years, everybody knew exactly what was supposed to be happening and one of the most noble thing, was during the financial crisis, stocks went down and the Fed went in to buy bonds. And the sort of thing that happened as a result is, one is, we had this immense

inverse relationship between stocks and bonds and the other one is, because of the Fed and so forth, volatility came down. And, so I don't think it's just a few bad apples, it's kind of the bigger policy of Federal Reserve stepping in, compressing volatility.

And so, fast forward to what happened just recently and volatility suddenly surged. And part of it is, when volatility has been so low, people have been trying to buy protection, it's costing an arm and a leg. They want to kind of have their cake and eat it, want to, buy the stock market and be protect on downside. If you want to bet on volatility rising, which is a form of buying protection, it would cost you over 10% a month.

Now there are some folks on the other side of the trade that were making over 10% a month, they were making over 100% a year, and guess what? That lunch was a little too good to be true and that blew up in their face and part of the trigger that blew it up was the other thing that didn't work anymore, this correlation of stocks and bonds.

On Friday the second of February, we had both stocks and bonds sell off; and that was just too much. Those folks who thought they're diversified and many of those folks that used the so-called risk parity trades, they said, 'Oh my God, we're losing on everything that we have, we've got to sell.' And you call it the machines, well, yeah, it's called rebalancing. I don't know whether it's the machines or the people. We just a little faster when the machines do it. But yes, they needed to get out of these trades, and on top of that, those folks who've been making 10% a month, or they lost over 90% in a day. And of you make, for those who don't know the math, if you make 100% in one day and lose 90% the next, net you're down 80%, so, those guys have lost big.

Mike Gleason: Fears over interest rates with the Feds potentially hiking rates several times this year and

continuing to shrink its balance sheet, was the explanation given for the most recent stock market losses. Is that really what's driving this long overdue stock market correction? And even if it is the reason, doesn't carnage in the stock market make it likely the Fed will pause its rate hikes here, Axel?

Axel Merk: Well, couple of things. One is, there are various ways of describing, and I just gave a technical explanation with kind of short volatility folks, but yes, volatility has been compressed. The reason volatility has been compressed, the primary driver, in my view, has been QE, has been low interest rates. And the Fed is stepping away from that rising risk premia. Top of that, on February 2nd with the Non-Farm Payroll report, inflation is a real thing now, wage pressure is moving higher. Another reason why volatility should move higher. We got these extreme speculators out of the way that were on the short-volatility trade, and by the way, I don't think that we've seen the last of that unwind yet. But that means, I think that volatility in the VIX below ten for an extended period is a thing of the past. And so, yes from that sort of view, turmoil is going to be here to stay.

To your other question, whether the Fed is going to pause, the Fed will tell you they will not react to a declining stock market, but they will react to deteriorating financial conditions. Now I tweeted the Bloomberg Financial Conditions Index and sure enough, it plunged on Monday. Now, the Bloomberg Financial Conditions Index is a little different from the other ones because it has a very heavy weighting on volatility itself, and so, yes that clearly reflects it.

I don't think the Fed is going to stop at this stage and there are several reasons for that. One is just reading it from the market. If you look at what is priced in as far as how people assess the Fed, that hasn't budged much. Importantly, inflation expectations haven't plunged. The inflation expectations are for real and that kind of makes the Fed to move slower. And then, most importantly, we got a new chief.

We got Mr. Powell and I think we've talked about Powell a little bit, but Powell, he is a bank regulator.

When he was asked a question about monetary policy, he was stuttering, he had to kind of look up what he had to say. He doesn't really have an interest in that. I'm not questioning his intellect, I'm not questioning his integrity, but I would think that, what he will do is, well he'll call his committee. He will take a while to make a decision. He is not going to be the one who's going to be there with a fire hose the moment that the markets go off the rails. He's going to be taking his time and saying, 'Oh we have some inflation and so let me look up in page 576 of the Bernanke manual what we have to do and so, oh yes, maybe we'll have to watch this and this indicator.' That means he's going to be very slow to react and I've argued for some time and continue to believe that there's going to be a lot of damage that's going to be caused to the market before the Fed is going to do a U-turn.

Mike Gleason: Yeah, the last time we had you on, we did talk about the potential Trump pick to replace Janet Yellen as Fed chair. We didn't get Warsh, we didn't get Taylor, we got Jerome Powell who appears to be a more-of-the-same type of pick. So now that we know what this new Fed is going to look like, comment if you would, and expand the point on how you're approaching your investing philosophy under this new regime now that it's mostly taken full effect under Trump here with the appointment of Powell as a key player when it comes to the near term monetary policy that we're going to get from our central planning overlords.

Axel Merk: So, with the caveat, of course, that I'm not allowed to give specific investment advice to a general audience, but let's just put the stakes out here where we are. We've had years of a bull market, everything has been going great if you invested in the stock market. I allege that a lot of investors have not rebalanced their portfolios, meaning taking chips off the table when times were good and then, put

them into something 'safe'. And even to the extent that they have put them into something safer, well two problems with that. One is, they have been chasing yield, which means they're not really in anything safe. They're still correlated with equities, and secondly, I indicated earlier, this washing machine effect.

Correlations are breaking down and that means you're not going to get the sort of diversification out of the things that you thought you would. And so, a lot of people, as volatility is going to be higher for longer, and I gave several arguments as to why that's going be the case, people are going to realize, 'Oh my God, I have too much in risk assets. Too much in equities, my alternative market isn't performing as it should be.' And so, people will take more chips off the table and will rebalance, will scramble what to do. And not just retail investors. Institutions that have their rigorous investment programs, those won't be working anymore, because the traditional 60/40 allocation putting 60% in stocks, 40% in bonds, or it could be more sophisticated. But whatever they might have done, those models are breaking down. And so, there's going to be a lot of uncertainty, scrambling as to what the right thing to do is.

Now, my take is, that investors should be stress testing their portfolios. They should look at what happened on February 5th in my portfolio, obviously that's not going to happen every day, but 'Is there anything that went up that day in my portfolio?' That's the sort of stuff you might want to look at whether you want to have more of, 'Is there anything else that I can do?' And it isn't easy to diversify in this environment.

I mean, one of the reasons why the short volatility trade was so profitable, is because anybody who was skeptical of these markets, had to pay an arm and a leg to do anything else. And so, one of the kind of the technical terms is that when your long carry, that means you're gathering money as you do something, in order to do that you got to have some sort of

risk investment, such as selling volatility. Whereas if you're short carry, meaning you pay up, that would be anything from buying a put option the market, but also even buying gold. If you buy gold you actually have to pay every year to hold the gold, so that's a negative carry idea. You're not getting rewarded other than potential price appreciation.

And so, all these conservative ideas tend to cost you money. And so there are many, buying gold is an easy one, not always the best one, but it's one of the easier ones. But anything beyond that really goes into the short and long kind of things. Your hedged equities… we do long/short currencies. Complex stuff that most people don't understand and frankly many don't want to touch. And so then, the alternative is cash, well, cash, especially if you are professional investors, you have clients are going to run away and, if you're an individual investor, it may be the right thing to do but it's tough to be holding cash. And so in that process, a lot of people, I think, in the period to come, it may even be years to come, might be losing significant amount of money in the markets.

Mike Gleason: Let's talk a little bit more about precious metals here. Gold and silver have been trading opposite the U.S. dollar in recent weeks. The recent turmoil in the equities markets has not translated to safe haven buying necessarily, at least not on the futures markets. We have seen some in the physical markets. So, what are you expecting to drive the metals markets over the near term, Axel? Do you think we will get more volatility in the equities? And if we do, will metals futures ultimately get a bid from investors looking for safety?

Axel Merk: Well, it's the washing machine again. Things haven't worked the way they should've, might've, would've, whatever it may be. That said, take gold, year to date it has gone quite nicely. Indeed, we had this period where the dollar was plunging and gold was doing reasonably well. And then,

sure enough, the day, on Friday the 2nd, gold went down. On the 5th, when we had this big plunge, well gold was up a few bucks.

Well I'll take up a few bucks for gold over down a thousand for the DOW any day. The way I look at it is that in the context of volatility what everybody seems to be talking about right now, when volatility goes up, future cash flows get discounted more. So, if you buy equities that have cash flow, those are worth less. Not worthless, but worth less. Meaning as volatility goes up, valuations go down, everything else equal.

Well, gold doesn't have cash flow and as such, as volatility goes up, gold tends to shine relative to other risk assets, other relative equities and that's why gold is up, even if it's only five bucks, compared to equities that is down substantially. So gold has done what it should do. Some people say, 'Oh my God, gold didn't go through the roof.'

In this sort of environment, gold has done reasonably well year to date, has outperformed equities year to date, and don't get greedy. I mean, this doesn't happen overnight. And obviously interest rates have been moving higher, and so higher interest rates are a big competitor to gold and the fact that gold has been doing so well in this environment, suggests that people are scrambling to find diversifiers and gold again is just the easiest one of them. I call it the easiest rather than necessarily the best because it obviously doesn't always go up when the markets go down. But it something where people can wrap their head around it. People aren't invested in gold and such investors, in my view, should consider it. And importantly they should consider how much they want to have in the context of everything else they have in the portfolio.

Mike Gleason: How 'bout the U.S. dollar? It's been rallying in recent days, which has hurt metals prices. Is this rally more

of a dead cat bounce or is the bottom in for the dollar, at least for now?

Axel Merk: Well, depends on who you talk to. And none of us have a crystal ball. There's one thing I can tell you, that anybody's investments, any view that you have, will be challenged in the coming months. And that's again this washing machine idea.

These markets do not walk in lockstep anymore. Sometimes the dollar goes up with gold, sometimes it goes down with gold of late. These things don't move in tandem anymore. So, no matter if you love equities you'll have days when you say, 'Oh my God, how can I love equities.' If you love gold, there will be days when gold is down significantly. And so, similarly, rates have been moving higher and usually, that's a good thing for the dollar. That said, we had four years when the dollar was moving higher and higher and higher and in the last year and a bit, that's been unwinding despite moving rates higher and that's very consistent with the history. The dollar historically goes up in anticipation of a rate hike, but then when the rate hikes actually start happening, it doesn't move anymore.

Now, if you look at Europe, we now have talk about the European Central Bank tapering and stopping QE. It's not going to happen for a while, but it's that talk that keeps that bid on the euro and as has been moving in high end as you may recall, we've had the euro in the kind of mid-one teens and it was going up to 1.25/1.26. So, yeah, it had this huge run up. Now everybody says, 'When the plunge happened, the dollar was surging.'

I had argued last year that in a risk-off environment, the euro can do quite well because the euro has become a funding currency meaning people sell it when times are good and then have to buy it when they go back. But again, the correlation broke down now a few weeks ago, and people say the dollar is

stronger but what the heck… the dollar, as we are talking, is at 1.2260. That's much higher than it was just recently, yet it's down in recent days. And so, I think being married to these short-term correlations, everybody is going to be called into question what it is.

My view is that in Europe, rates are way too low for the economic activity, for the level of activity so the Europeans, the European Central Bank, in particular, has to be tighter on monetary policy than what is currently priced in. At the Federal Reserve, I happen to think they'll probably go along the path that's currently priced in. Maybe a little bit less with more turmoil in the markets but that sort of change relative to what is expected, in my view, should be a bad thing for the dollar and a good thing for the euro. And I mention the euro because that's just the biggest driver here in the dollar index that's usually referred to.

Mike Gleason: Well, as begin to wrap up here, Axel, maybe talk about the environment you see ahead for safe haven assets like gold and other precious metals. And are you expecting more volatility in equities and bonds? Should investors brace for more rough riding and what are you watching most closely here in the near term.

Axel Merk: Well sure, I do believe volatility is going to move higher compared to what it was last year. I think we're not going to go back to those levels so anybody that said, 'Oh the Brexit selloff and the Trump election selloff was just brief and we going to recover.' And sure, we may reach new highs before we plunge much further potentially but, the reason why these volatilities are going to go higher is because of all the things I said including the short vol(atility) craziness where people were selling volatility and making 100% a year.

Those days are over. The derivatives were driving the spot market. During the introduction talked about manipulation, that is a form of manipulation of the markets. It's probably

not illegal, but it certainly impacted the market and it was absolutely insane and the problem is you couldn't bet against those folks because it cost you an arm and a leg to bet against them. And so, you just had to kind of wait it out on the sidelines and now we're dealing with it.

But yes, how the 'safe havens' will do that? They're not safe either right? I mean, they do move quite a bit. Anybody who's been in gold, silver for an extended period knows the volatility can be high. So we have to make sure that anybody who has these is comfortable with the risk profile.

These days, I happen to be more concerned with the equity portion and the fixed income portion of many portfolios. The equity portion because I happen to think that equities are too expensive and going to be more volatile; and the fixed income side is because they're not going to serve the role that many people think that they have served. And so from that point of view, yes they should look beyond.

Cash is not a bad option and then gold and precious metals again, I can't make a specific investment recommendation, but I think yes, investors should have that as a core position or I have to say they should consider having it at a core position of their portfolio. I certainly do. Beyond that, one has to get into more sophisticated instruments that are unfortunately, probably not suitable for many investors that don't understand them. And I'm not trying to belittle them but, for example, we do long-short currencies. I happen to think it's the best thing since sliced bread but I spend day and night looking at these sort of things. I try to use things like a currency strategy because that's where I can generate uncorrelated returns, but that's just one piece in a portfolio.

I just happen to think that the quote 'traditional' piece people have in a portfolio, the equity portion, is going to continue to be in for quite a rough ride.

Mike Gleason: Well, on that note, for folks that want to learn more about you and your firm before we let you go, tell them how they can do that. Tell them how they can follow you more so they can trust the professionals when it comes to their investments.

Axel Merk: Sure, well, don't have a crystal ball. We do have lots of opinions, but come to MerkInvestments.com, follow me on Twitter, follow me on Linkedin. We have a variety of ways. We even have a Patrium site now, I don't know whether you're familiar with that service, where we publish a research service. So, we have lots of ways to connect but MerkInvestments.com is probably a starting point. Where you can sign up for a newsletter and then you can also, of course, look at the sort of products we have. But follow me on Twitter, follow me on Linkedin, Facebook, anywhere there. We try to be expressing our views, and part of that is because we appreciate the feedback. Because that helps us to kind of brainstorm as well and to consider viewpoints that we might not consider. So, we very much appreciate the feedback that we're getting and you can do that through social media if you wish.

Mike Gleason: Well, we've been following you for a long time. A lot longer than we've had you on the podcast here these last 6 or 8 months, which we've certainly appreciated and it's a very studied view that you bring to the table and we love having you on. Appreciate your insights. Thanks very much, I hope that we can catch up with you again before long. Appreciate it, Axel.

Axel Merk: My pleasure.

Mike Gleason: Well that will do it for this week. Thanks again to Axel Merk, President and Chief Investment Officer of Merk Investments, manager of the Merk Funds. For more information, be sure to check out MerkInvestments.com.

And check back here next Friday for our next weekly Weekly Market Wrap Podcast. Until then, this has been Mike Gleason with Money Metals Exchange, thanks for listening and have a great weekend everybody.

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