Vol.03 Issue 23 | 11 December 2016

Things that make you go hmmm

Get It. Got It? Good.

Hawkins: It could be the key to the whole plan. Get it?
Ravenhurst: Got it.
Hawkins: Good.

– Dialogue, *The Court Jester*

Hawkins: I'd like to get in, get on with it, get it over with, and get out. Get it?
Ravenhurst: Got it.
Hawkins: Good.

– Dialogue, *The Court Jester*

"Our task, your task... is to try to connect the dots before something happens. People say, 'Well, where's the smoking gun?'..."

– Donald Rumsfeld

"You can't connect the dots looking forward; you can only connect them looking backwards. So you have to trust that the dots will somehow connect in your future. You have to trust in something - your gut, destiny, life, karma, whatever"

– Steve Jobs

Hawkins: I've got it! I've got it! The pellet with the poison's in the vessel with the pestle; the chalice from the palace has the brew that is true! Right?
Griselda: Right. But there's been a change: they broke the chalice from the palace!
Hawkins: They *broke* the chalice from the palace?
Griselda: And replaced it with a flagon.
Hawkins: A flagon...?
Griselda: With the figure of a dragon.
Hawkins: Flagon with a dragon.
Griselda: Right.
Hawkins: But did you put the pellet with the poison in the vessel with the pestle?
Griselda: No! The pellet with the poison's in the flagon with the dragon! The vessel with the pestle has the brew that is true!
Hawkins: The pellet with the poison's in the flagon with the dragon; the vessel with the pestle has the brew that is true.
Griselda: Just remember that.

– Dialogue, *The Court Jester*

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THINGS THAT MAKE YOU GO HMMM...

GET IT. GOT IT? GOOD.

This week's *Things That Make You Go Hmmm...* is a little different in that it is based around the speech I gave recently at the Mines & Money conference in London. I had so many requests for a copy of the speech after I had delivered it that I thought I'd share it with you in full this week.

I will work on a video version of it which I will post at a later date so you can see the progression through the slides as I had intended (and hear the carefully-chosen music, of course!!) but the reaction I received to the speech suggests that it might be something you will enjoy. I hope so.

The length of this week's *Things That Make You Go Hmmm...* might seem a little daunting but its extremely chart-heavy so it'll fly by. I promise!

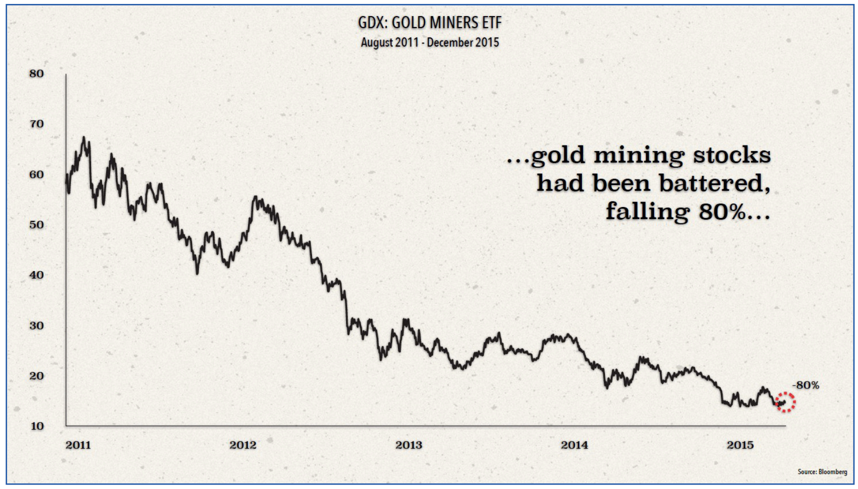
The story—inspired by the magical Danny Kaye comedy ***The Court Jester***—begins with gold, moves on to President-elect Donald J. Trump, sprinkles in a dash of Japan and finishes by connecting a fascinating series of dots which have been rattling round my brain for the last couple of years but which I finally began to piece together a short time ago—with the help of a man from Cleveland, OH.

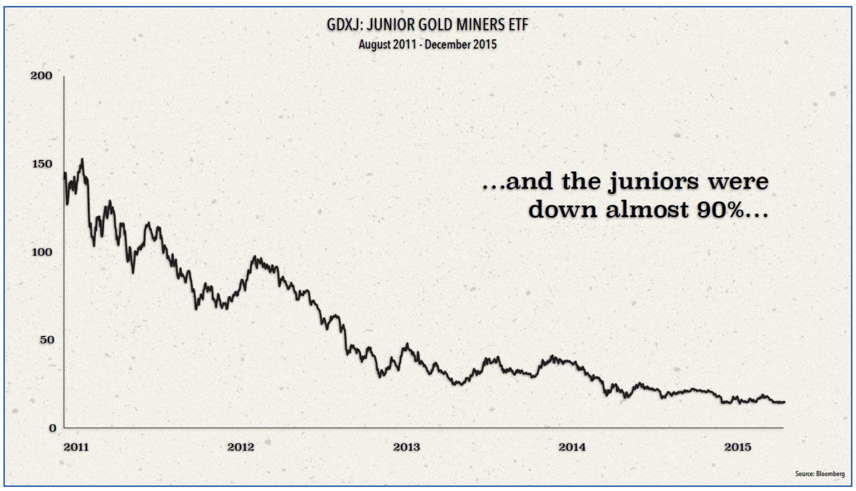
Exactly a year ago, almost to the day, I gave a presentation at Mines & Money in London which was entitled 'Nobody Cares'. Virtually on the very day I gave that presentation— purely by coincidence I would be the first to stress—precious metals prices turned around and embarked upon an 8 month bull run which had gold & silver investors emerging from their cellars after four damp, dark, lonely years. In those eight months, the world of precious metals changed significantly.

As a reminder, here's how things stood in December of 2015 when I first unveiled 'Nobody Cares':

The gold price had been cut virtually in half...

...mining stocks had plunged 80%...





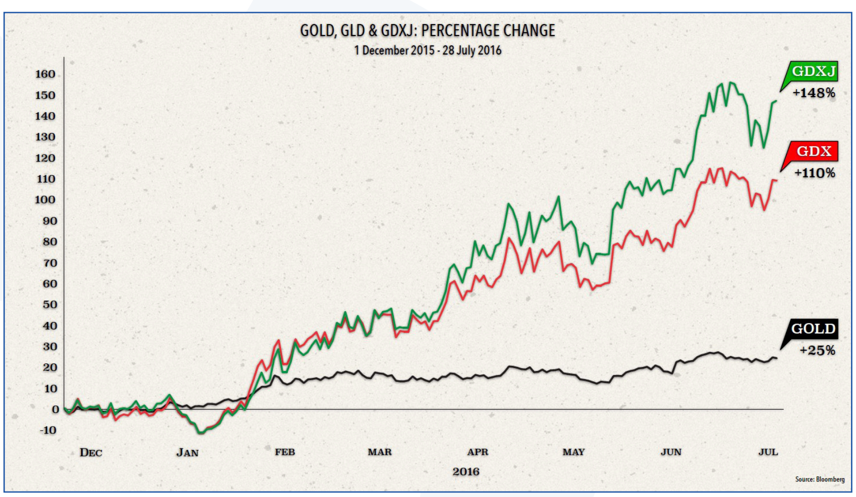
...while the juniors had been smashed, losing about 90% of their value.

The media was filled with negative stories under headlines such as:

> **"Gold Is the Worst Investment in History"**
> -Brian Lund, Daily Finance, Feb 2015

...and:

> **"Let's Be Honest About Gold: It's a Pet Rock"**
> -Jason Zweig, WSJ, July 17, 2015



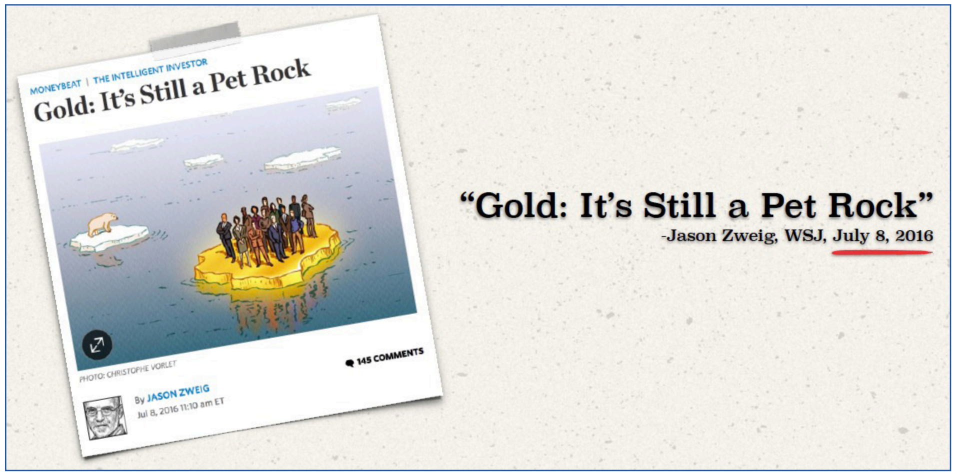
In the next eight months though, things turned around sharply with the gold price climbing 25%, the miners doubling (and then some) and the juniors soaring an astounding 148%.

This is exactly what precious metals and, particularly, the companies who pull them out of the earth do at the right point in the cycle.

Sentiment turned around abruptly and suddenly, everywhere you looked there were bullish articles on gold.

Everything had changed.

Well...al*most*:



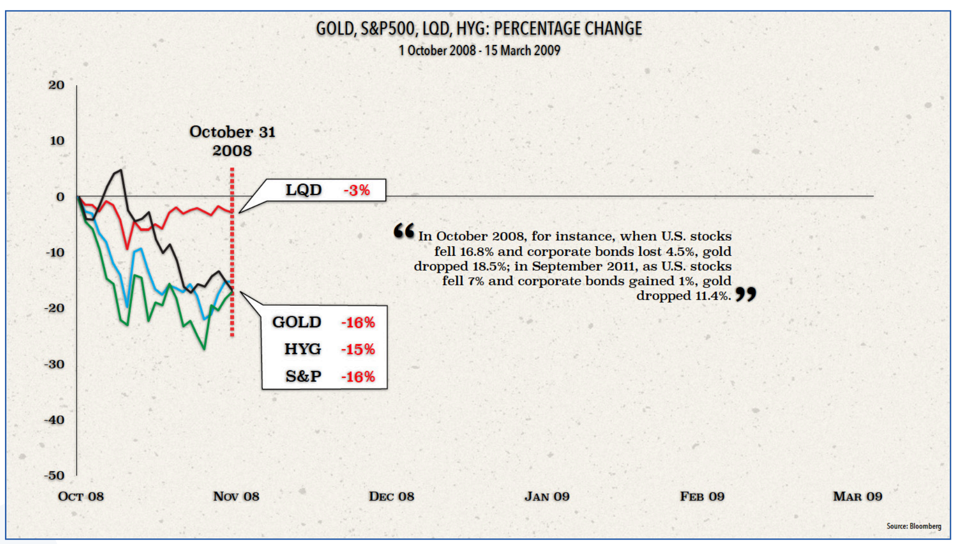
During those 8 months, gold bulls were euphoric and the haters like Mr. Zweig were silent until, eventually, I guess he could take it no more and was compelled to explain all over again to 'intelligent' investors just why this ridiculous asset—a ridiculous asset which, at that time, had risen a little over 30% in 8 months—was STILL nothing more than a pet rock.

These fiat bugs are a dogged bunch.

Mr. Zweig explained that gold is only *really* valuable if you lock it away for a couple of thousand years and that, in the short term, it is a disaster.

He then went on to highlight how poorly gold fared in 2008 - selecting October of that awful year as his benchmark:

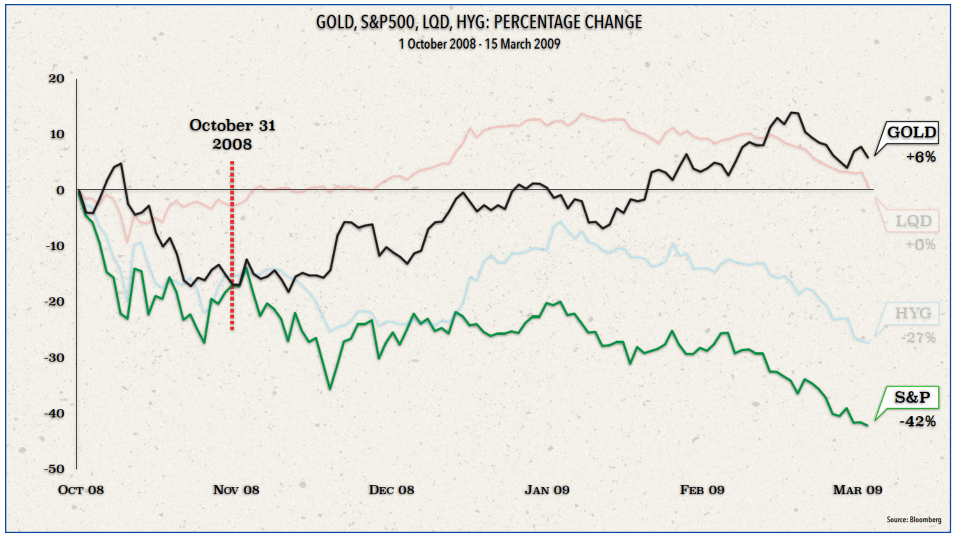
> ***(Jason Zweig, Gold is Still a Pet Rock, WSJ, July 8, 2016): "In October 2008, for instance, when U.S. stocks fell 16.8% and corporate bonds lost 4.5%, gold dropped 18.5%; in September 2011, as U.S. stocks fell 7% and corporate bonds gained 1%, gold dropped 11.4%."***



And, in fairness to Mr. Zweig, though his numbers were a little off by my reckoning, gold did, in fact, fall just as hard as the S&P 500—some 16%—in October of 2008

However…

There *MAY* have been an element of cherry-picking on Mr. Zweig's part as, pretty much from the day he chose to show that gold was just as bad an investment as equities, gold began to recover while the S&P500… well, not so much.

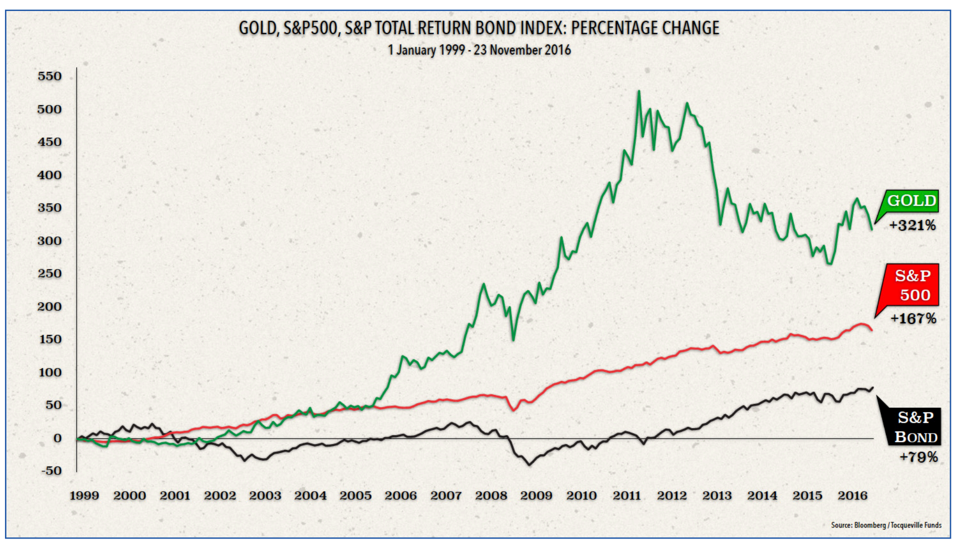


Anyway, by March of 2009, gold had actually risen 6% while the S&P had fallen 42%.

Gold did EXACTLY what it was supposed to do.

Anyone who possessed the foresight to sell their gold and invest it into stocks at the March '09 lows has done very well—all thanks to the purchasing power that their bullion preserved.

In his article, however, Mr Zweig was quite clear that the short-term was not gold's sweet spot and I'd hate to be accused of being disingenuous so I thought I'd split the difference between my 6 months and his two thousand years and look at the performance of gold, stocks and bonds since the turn of the century which I think represents a decent enough investment horizon.



When I did, guess what I found?

Well, as you can see, not too shabby. Gold—despite virtually halving from its highs—has still doubled the performance of the equity market and has returned four times that of the S&P total return bond index.

Pet rock my arse.

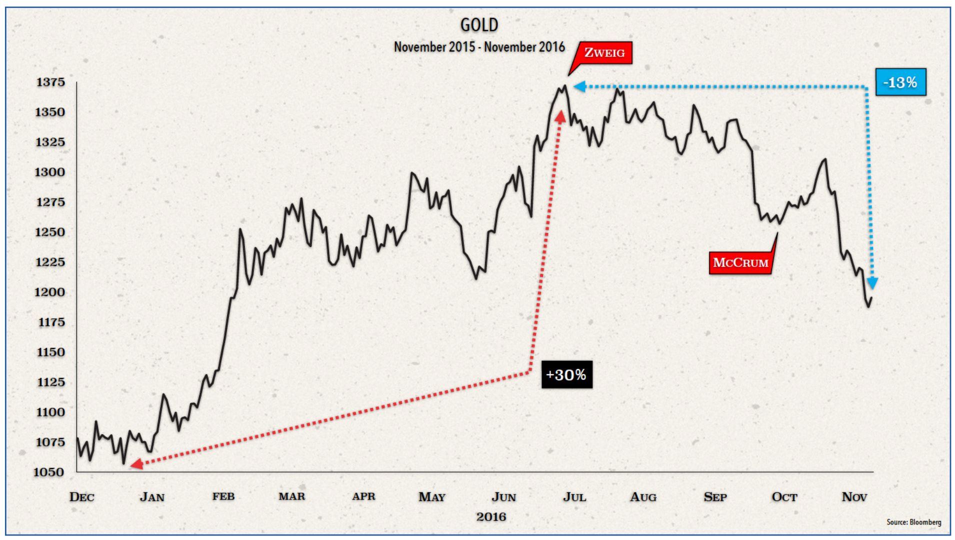
However, after the auspicious start to the year, things started to wobble a little as summer gave way to autumn and, by October, with gold having corrected after its stupendous run, a gentleman by the name of Dan McCrum took his turn at a little gold bashing—this time offering us his 'insight' in the FT—that bastion of clear-eyed, unbiased financial reporting.

The gold price—according to Mr. McCrum—is and will only ever be ‘fashion’ and those of us that own it, are forever condemned to be merely ‘poseurs’.

Apparently.

Now, in their defence, Zweiggy and McCrum—doesn’t that sound like the worst cop show ever created?—got their timing just about right.

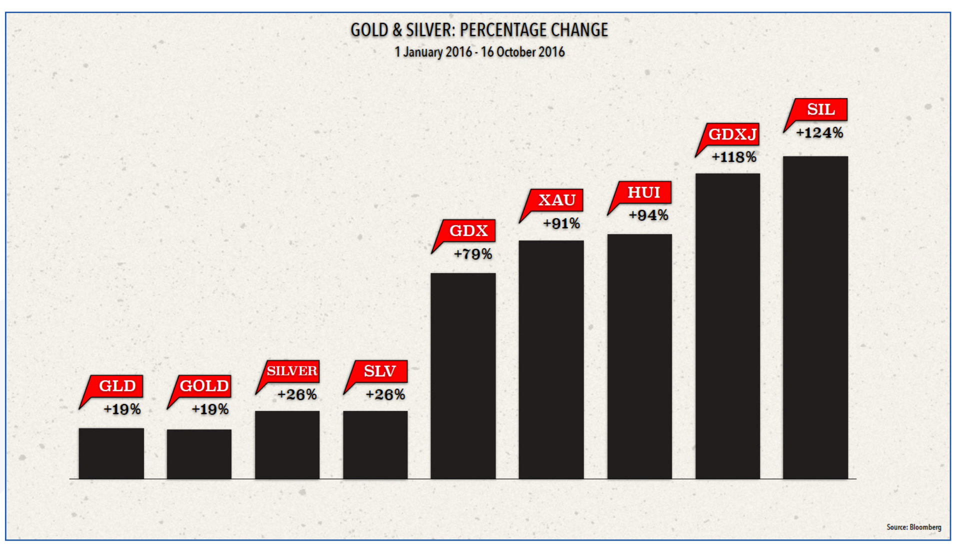
Jason picked the very top of the year to write his piece (bravo) while Dan McCrum’s “insight” came immediately before a $50 rally but, fortunately for him, that turned around pretty fast.



Gold has fallen 13% from the peak back in July and the grave dancers are no doubt high-fiving each other as I speak.

Naturally, there has been no mention of the 30% rally which preceded the fall, but then what did we expect?

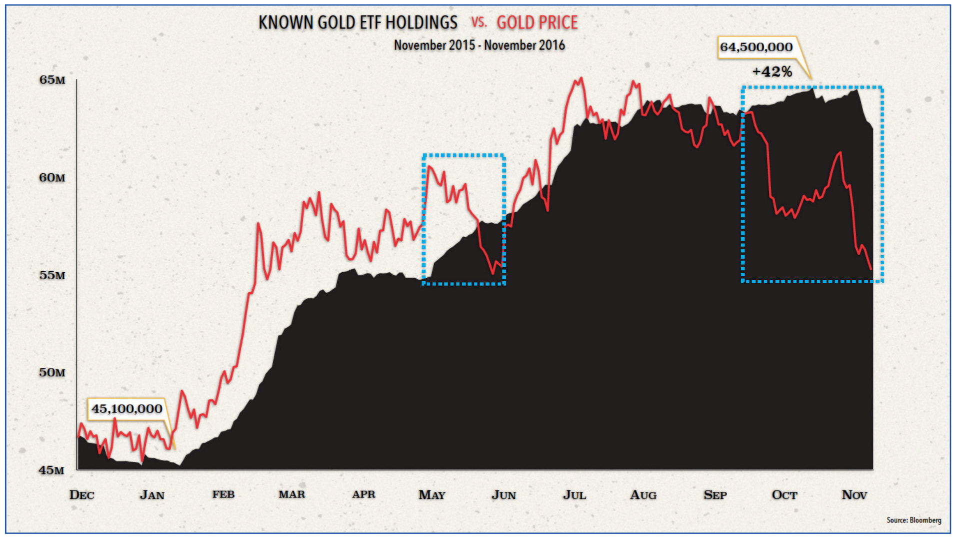
On the day McCrum went to press explaining how gold was nothing but fashion, here is how the scorecard looked year-to-date.



Not bad. Not bad at all.

Anyone so inclined could have read McCrum’s article and, realizing they were a mere poseur, quickly sold out of their precious metals positions—however they had chosen to hold them—and, even after the pounding gold had taken, been nicely ahead on the year.

In fact, throughout 2016, gold has continued to consistently pour into the ETF vaults at an astounding rate—increasing total ETF holdings by some 42% between the January low and the October high.



Interestingly, despite sharp sell-offs in May and again in September and October, ETF vaults kept seeing inflows.

It wasn't until November that we started to see some of the gold start to be pulled from those vaults and *THAT* was down to one thing...

Yeah...***THAT***... the U.S. election.

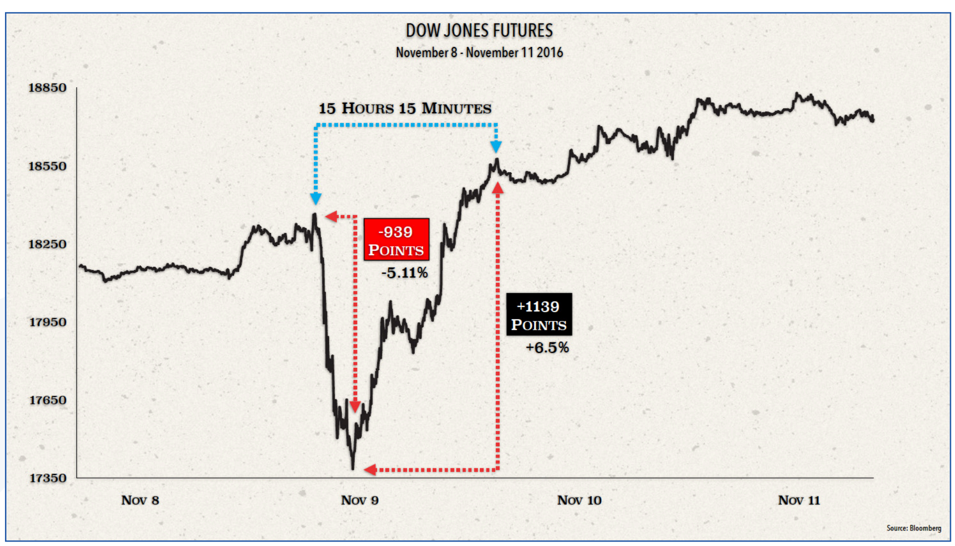
For those of you still intending to watch the U.S. Election when the DVD box set is released please consider this a massive spoiler alert—Donald Trump will be inaugurated as the 45th President of the United States on January 20th, 2017.

In the weeks following Trump's election, among the many things he's been trying to escape has been a large shadow looming over every discussion of his upcoming presidency...

...that of The Gipper himself, Ronald Reagan.

But before we attempt to compare the two, we should take a quick look at how the markets reacted to the surprising elevation of Trump from a man *believing* himself to be the most powerful in the world, to it actually being *true*.

On election night, as the results trickled in and it became less of an impossibility that Trump would win, Dow Jones futures crashed.



Hard.

They fell almost a thousand points before being halted limit-down.

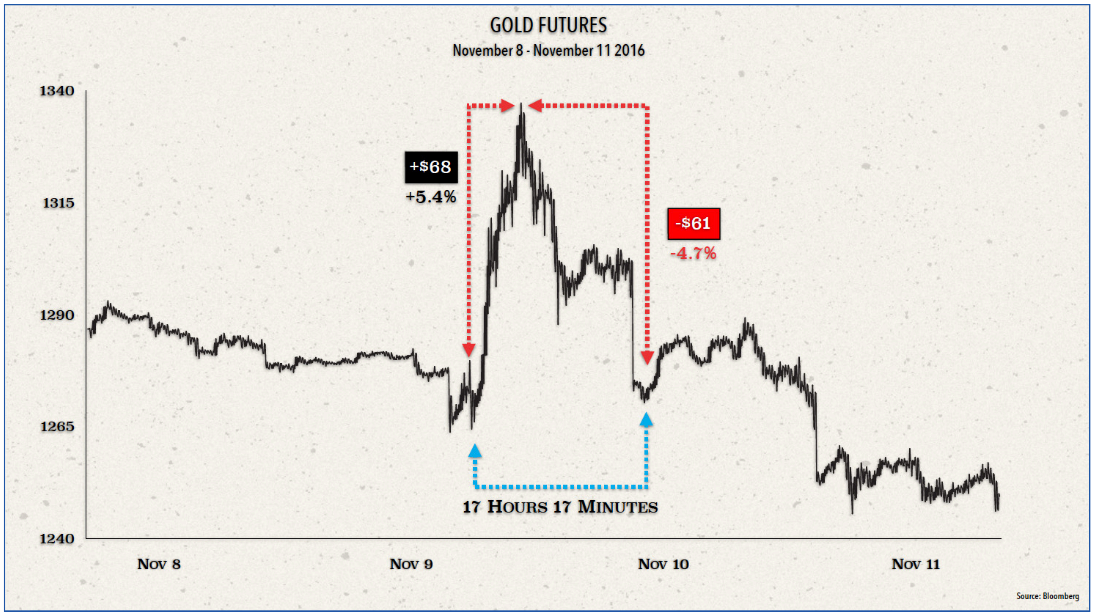
The next morning, they rallied eleven hundred points...

...and the entire round trip took just 15 hours and fifteen minutes.

When the smoke had cleared, the Dow had fallen 5% and rallied 6.5%...

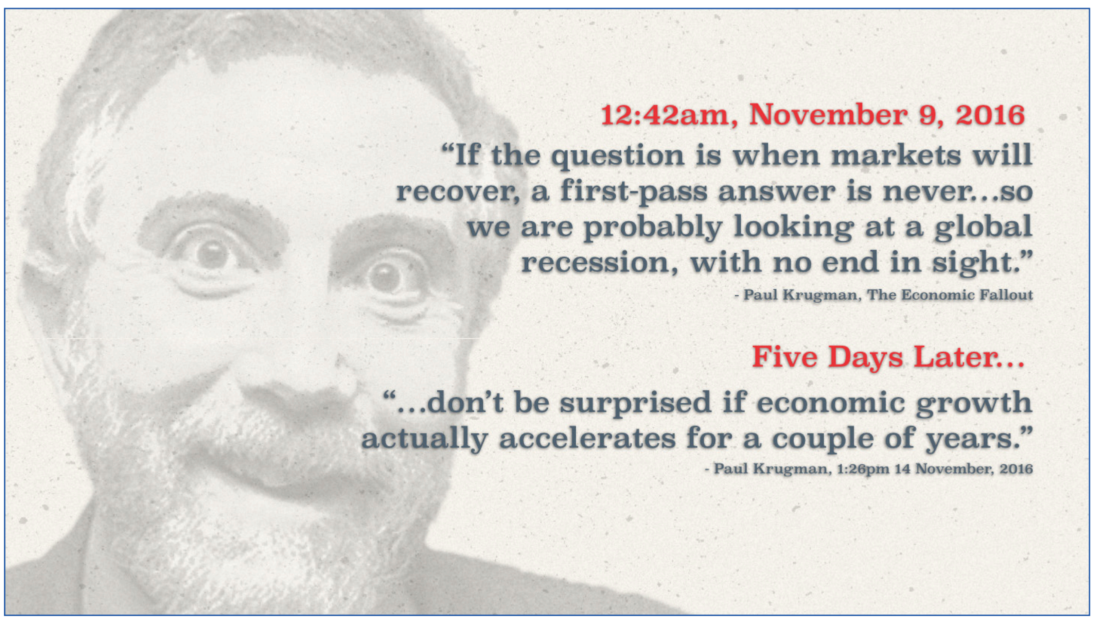
ON THE SAME NEWS.

Perhaps unsurprisingly, gold had a similar time of it—rising 5.4% before falling 4.7% in a little over 17 hours but, again, both moves were ***ON THE SAME NEWS.***



Folks—any market which can behave in this way is inherently unstable and should be treated as such.

However, it's comforting, in such confusing times as these, that ordinary folks like us can rely on the considered wisdom of a Nobel Prize winner or two to explain things for us...



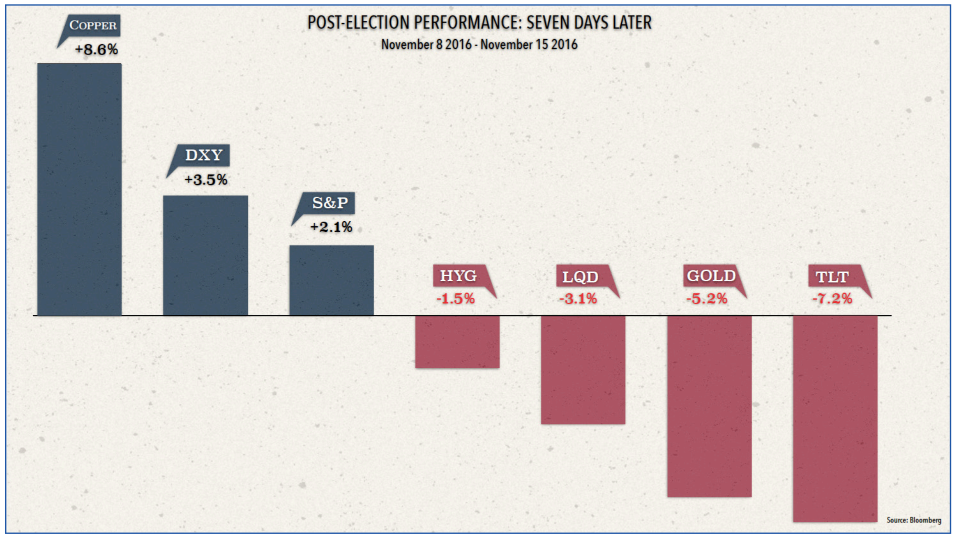
Yes, the great Paul Krugman was quick to ~~try and get into the news cycle~~ share his wisdom with the little people and subsequently, as you can see here, he helpfully clarified exactly what he meant by *'a global recession with no end in sight'* for us a few days later.

What *WOULD* we do without him, I wonder?

Seven days after the election, however, things were at least a TINY bit clearer and one could at least start to assemble a narrative of sorts.

Copper was strong on Trump's proposed infrastructure spending, the dollar was strong because rates were going higher, the S&P was up because... well, you know, growth 'n' stuff.

Bonds were down because rates were going up and there would be a ton more of them floating around to pay for Trumponomics and gold was down because of inflation...no, wait, because of the strong dollar....



Ahhhh.... gold was down because of COURSE it was down.

But before people like Zweig & McCrum write yet another gold obituary, let's take a look at a few of the suppositions baked into the post-Trump euphoria to see how the current frenzied rally stacks up... after that, we can move onto something a little more fun.

As I mentioned, the pro-Trump narrative has him as the second coming of Ronald Reagan but if he ISN'T.... then let's just say markets have gotten a little ahead of themselves.

The comparisons being drawn with Reaganomics are understandable, I guess (see box, below), except perhaps with the possible exception of the underlined part, given Trump's loathing of NAFTA, TPIP, TPP, LGBTQ ... and, as far as I can tell, every acronym except MAGA (#MakeAmericaGreatAgain).

But if we look at the pillars of Reaganomics, we see a few familiar ideas—ideas like reducing government spending (which Trump is all for),or cutting taxes.

Rea·gan·om·ics: noun:

The economic policies of the former US president Ronald Reagan, associated especially with the reduction of taxes ***and the promotion of unrestricted free-market activity.***

THE FOUR PILLARS OF REAGAN'S ECONOMIC POLICY WERE:

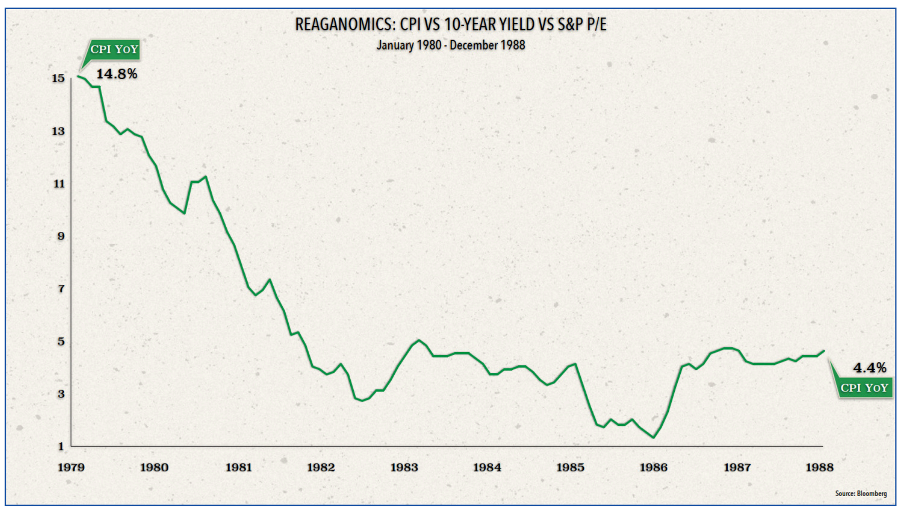
- REDUCE THE GROWTH OF GOVERNMENT SPENDING
- REDUCE THE FEDERAL INCOME TAX AND CAPITAL GAINS TAX
- REDUCE GOVERNMENT REGULATION
- TIGHTEN THE MONEY SUPPLY IN ORDER TO REDUCE INFLATION

And who *DOESN'T* love Trump's pledge to cut two existing government regulations for each new one enacted?

...and of course, his plan to tighten the money supply in order to combat.... ohhhhh....OK... so we may have our first little problem.

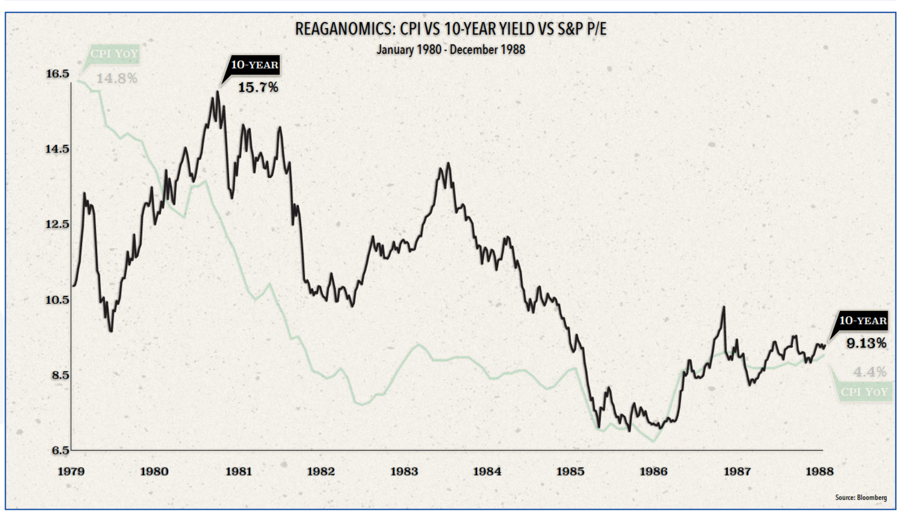
So let's take a look at the economy Reagan inherited and compare it to that with which the President-elect will soon be wrestling.

As you can see from the first chart, Reagan inherited a CPI which probability suggested was only going in one direction after the wild, oil-led inflation of the 1970s. Meanwhile, 10-year bond yields were in double-digits and would peak at 15% before starting the journey to where we find them 36 years later—that's some tailwind...



...as was the S&P price/earnings ratio of 7 which allowed plenty of scope for multiple expansion (chart, next page).

The fall after the 22.4x peak was largely due to the '87 Crash which, in case any of you has forgotten a time when markets were actually allowed to fall, wiped a quarter of its value off the stock market in a single day.



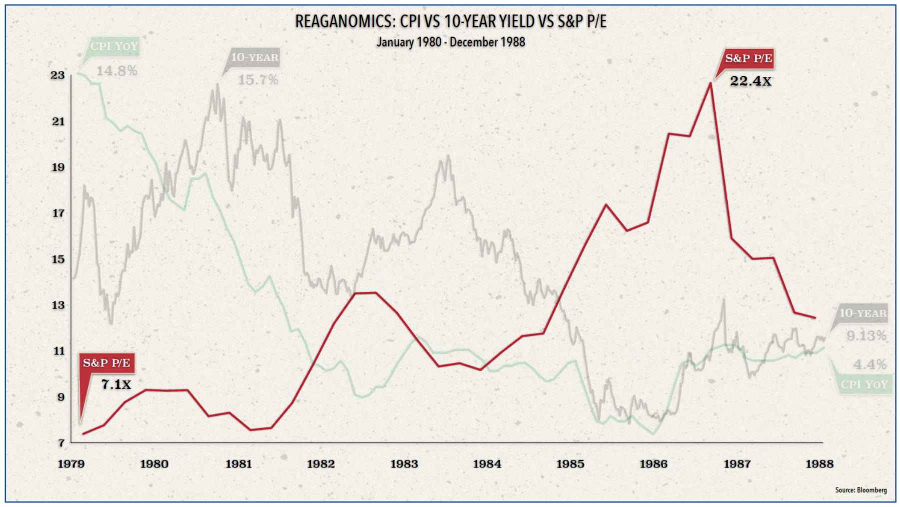
Reagan also inherited a national debt molehill of just $863 billion - something he would start to turn into today's mountain by increasing it to $2.68 trillion during his two terms in office.

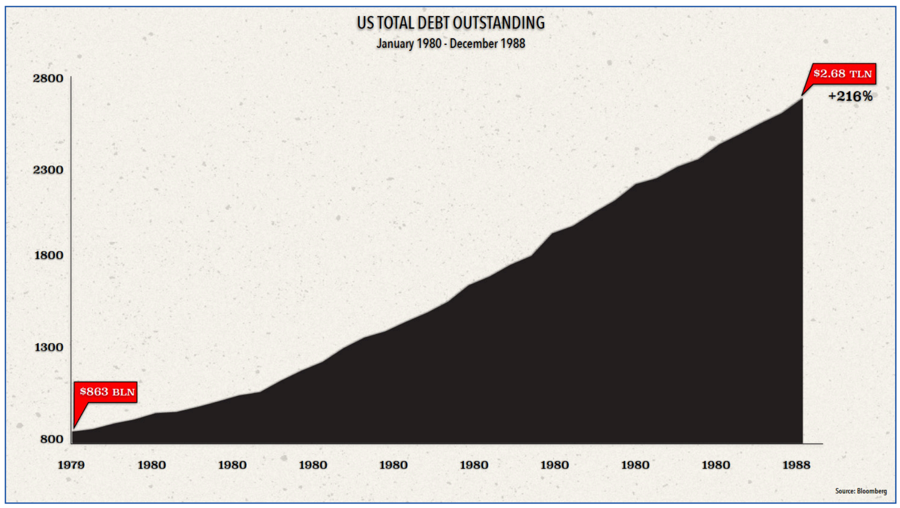
Again, more tailwinds.

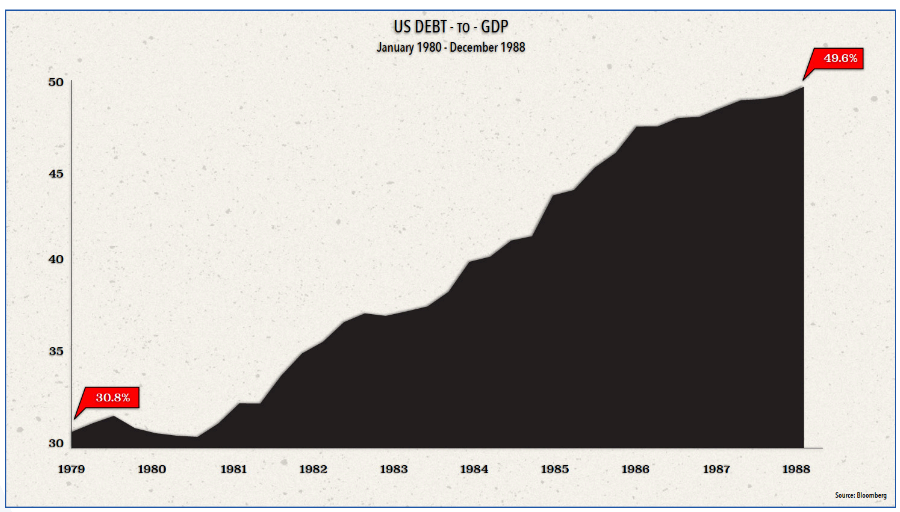
And then there was America's debt-to-GDP ratio which back in 1980 sat at a very respectable 30%...before climbing to 50% under Ronnie's stewardship.

But even *WITH* a set-up like that and having the room to stimulate and expand the nation's borrowing and spending, and with equities as cheap as they had been since the Great Depression, the S&P still fell by a quarter in Reagan's first two years in office (chart, next page) before turning and beginning what has been an epic 35 year bull market interrupted only fleetingly by the '87 crash, the bursting of the tech bubble and all that 2008-stuff.

A look at where he started and where he finished shows that Ronnie got his timing juuuuust about perfect.







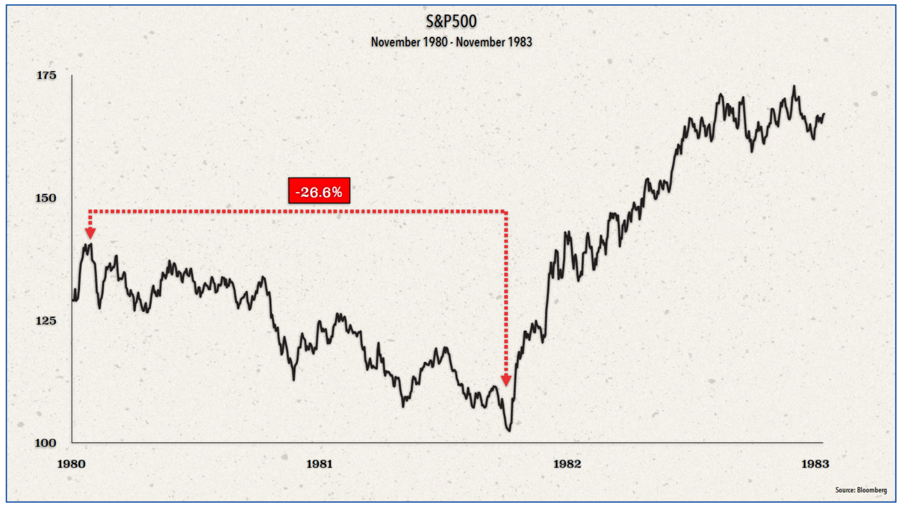
Now *DONNIE*, on the other hand.... well that is likely a different story. Where does he go from here? Well it remains to be seen but the euphoria currently on display is a little....premature methinks.

We'll see.

Now, according to *The Committee For A Responsible Federal Budget*, Trump's economic plan—you know, the thing that has people buying equities hand over fist—will ***de***crease government revenues by $5.8 trillion over ten years and ***in***crease the deficit by a further $5.3 trillion over the same period.

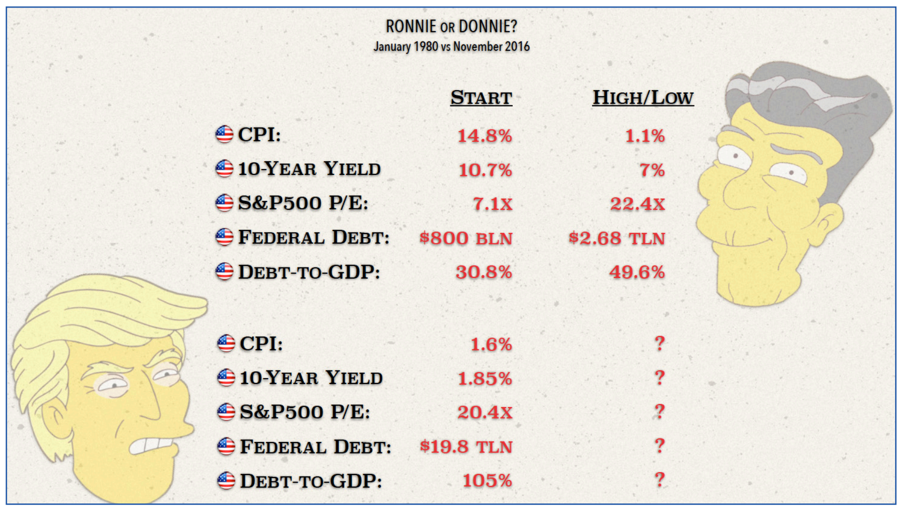
On the plus side, it will cut spending by $1.2 trillion during that decade. Which is nice.

However, Trump's plans set the U.S. debt-to-GDP (chart, bottom right) on a wholly different trajectory—a trajectory which one would *THINK* would perhaps lead to higher rates and crimp the equity markets.



That kind of thinking, though, is passé these days. Everything is going up forever regardless of silly things like interest rates... or economic principles.

So, at the risk of channeling my inner 'therapist'...what exactly IS America's problem, if indeed it does have one?



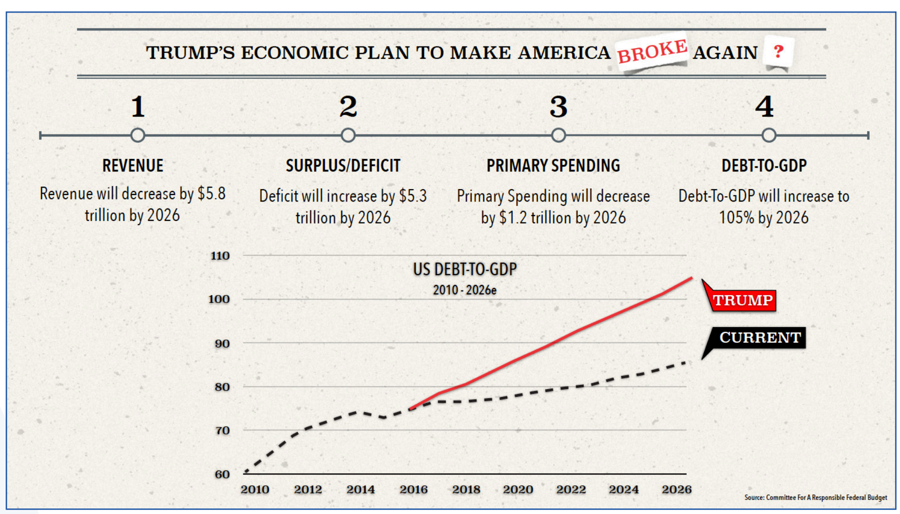
Is it lack of innovation?

One look at Silicon Valley would tell you the answer to *that* one is a resounding "no."

Is it a lack of either natural resources or competitive advantage?

Surely not

Trade deals? Well The Donald will answer that for us in time.



Is it a lack of any real economic growth? Possibly. A strong dollar? That also remains to be seen

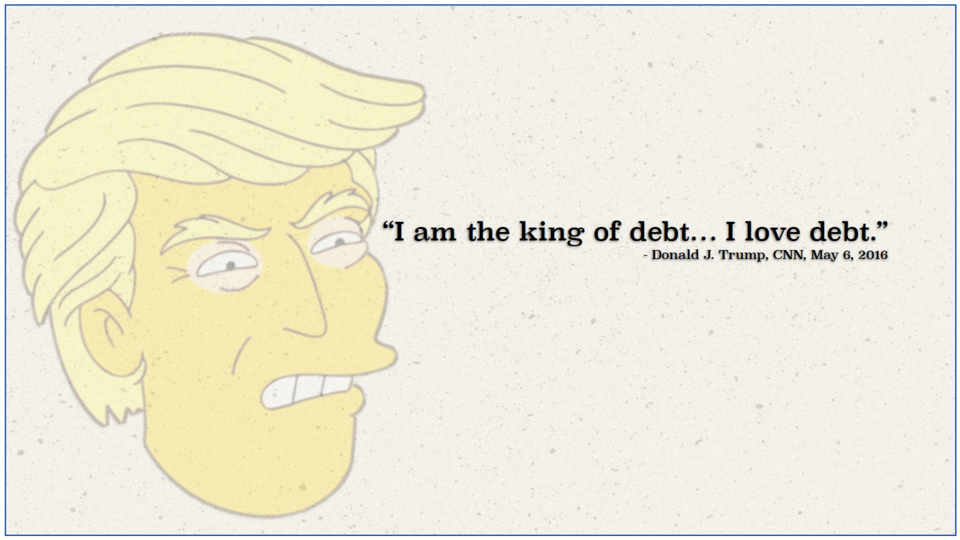
But there is one yuuuuge problem that America—just like every other G7 country—has to deal with.

DEBT.

Of course.

Now, fortunately, it seems as though America has elected the right man for the job:

...as was made more than evident in an interview Trump gave to CNN's Wolf Blitzer back in May.



Yes, the self-proclaimed 'King of Debt' *LOVES* debt (and if he loves debt, just think how happy he's going to be now that he is responsible for $20 trillion of it overnight—to say nothing of the $100 trillion in entitlements still to come).

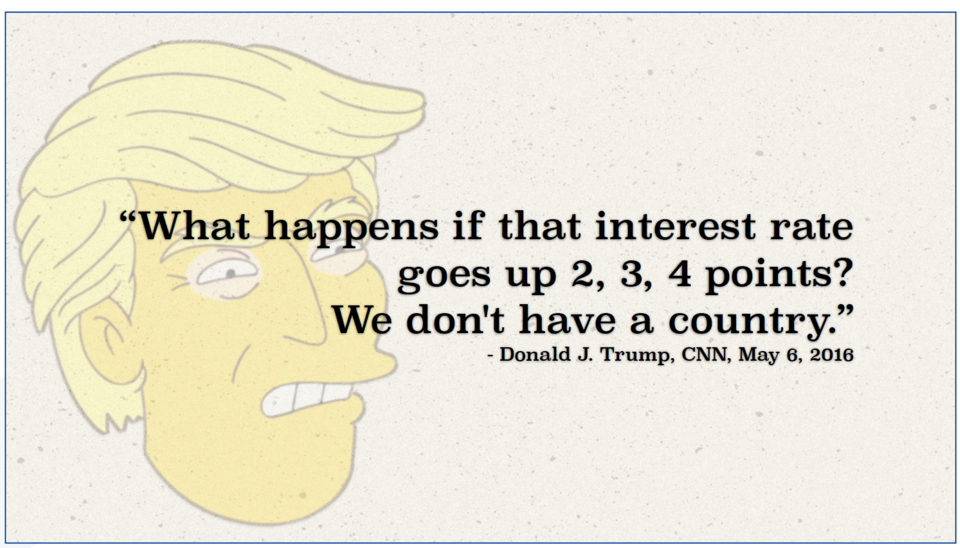
Happy days!

In that same interview, having declared his love of leverage, Trump addressed the problem of rising rates in America, explaining how a 1% increase would be, quote, "devastating".

In typical Trump fashion, though, Donald dared to dream a little bigger, imagining an America which saw rates rise "2, 3, or even 4 percent".

His stark assessment:

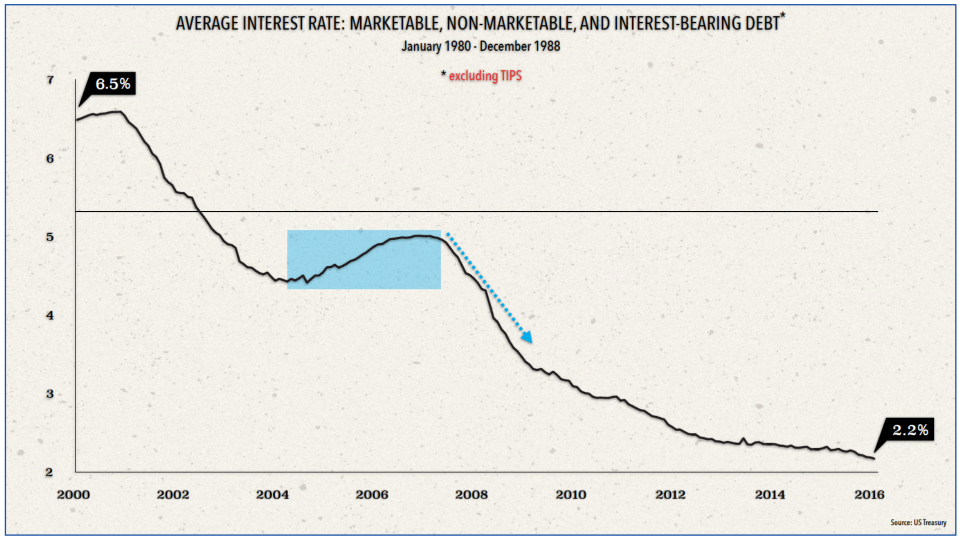
"We don't have a country"



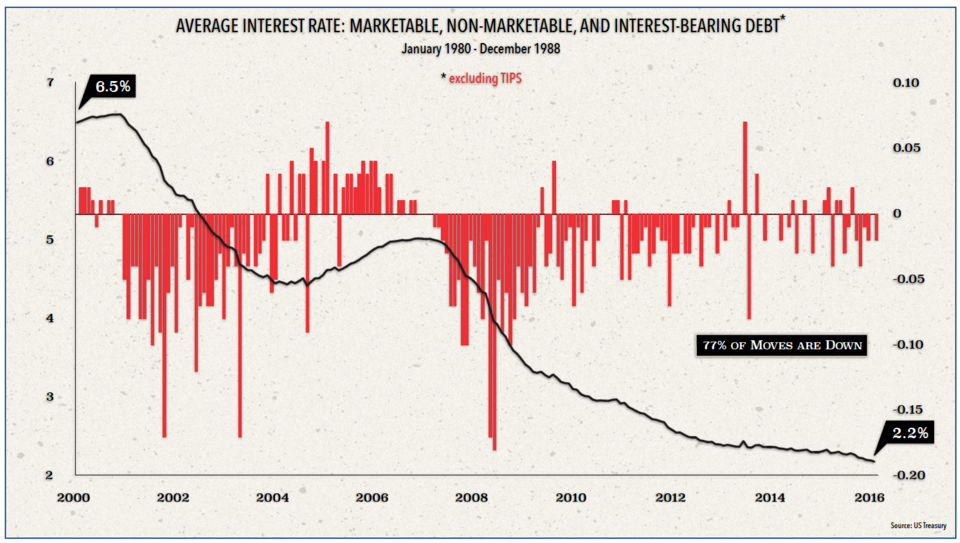
But let's take the road less traveled (particularly in what has aptly become known as the 'post-truth world') and try to look at a few *facts* about those various scenarios Trump opted to entertain and we'll start with this chart, which takes a look at the average interest rate paid on US debt between 2000 (when that average rate was 6.5%) and today (when it isn't).

As you can see, between 2000 and 2016, it has fallen from 6.5% to 2.2%

Interestingly, the only time that average interest rate increased during those 16 years (and we are talking 50 basis points here, certainly *NOT* 2, 3 or 4%) 2008 happened…



In fact, if we look at the monthly changes in the average debt cost of the United States, we find that, in an astounding 77% of the months between 2000 and 2016, they fell.



And thank God for *THAT* because, due to the Credit Crisis and the measures enacted to stifle it, the national debt grew from $9.229 trillion at the end of 2007 to $20 trillion on Halloween of this year—a 114% increase in just 9 years as Barack Obama added the same amount to the U.S. debt in eight years that America's 43 previous Presidents has managed to accumulate between them in the previous 232 years.

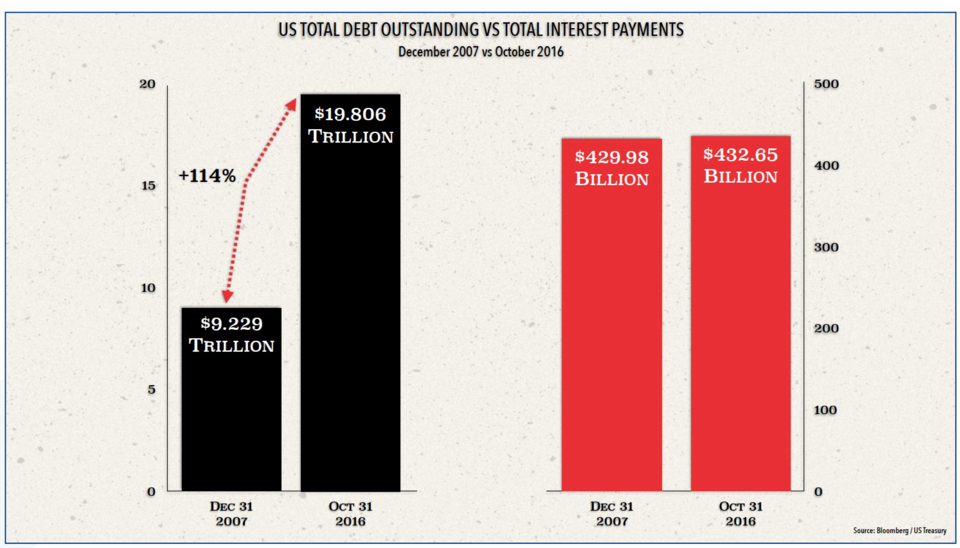
HOWEVER...

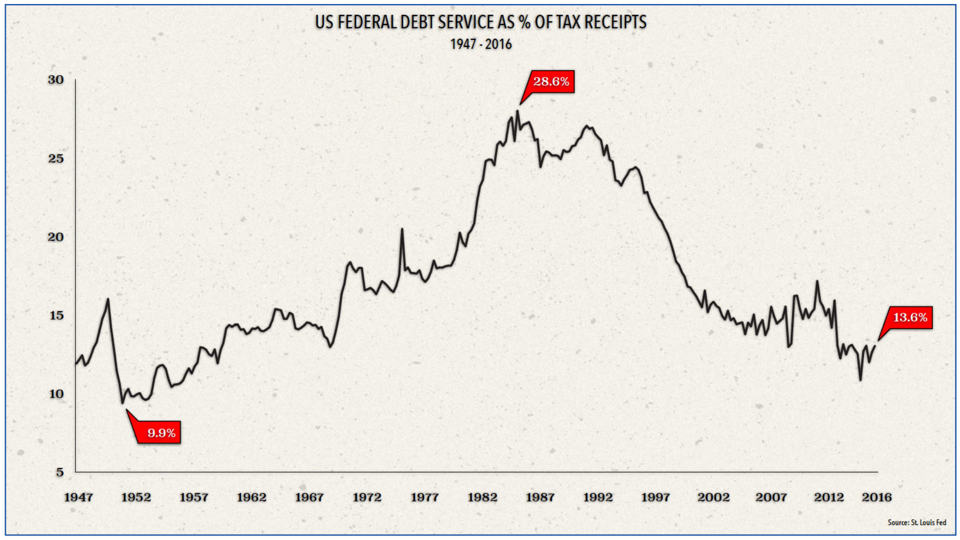
...thanks to those persistently falling rates, the cost of servicing twice the amount of debt ~~doubled~~ increased from $430 billion to...

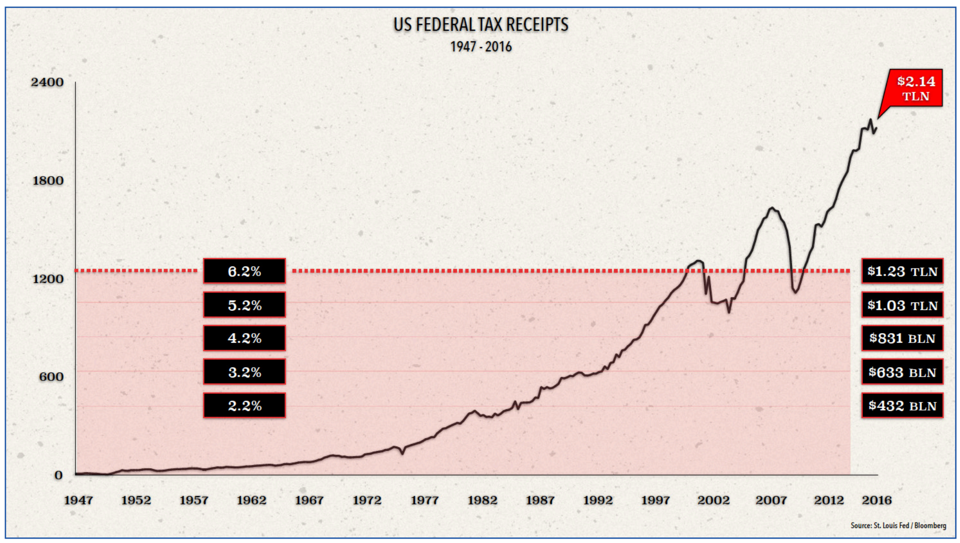
...$432 billion.

Ta-dahhhhhhh.

Behold. Magic!







The US is currently setting aside just 13% of its tax receipts to pay down its debt-servicing costs which, given that the debt has grown 60-fold since the last time the percentage was that low, is astounding.

Currently, the U.S. is tracking at a little over $2 trillion of tax receipts and this chart shows where that puts them at the average rate of 2.2%.

But what if rates DID rise by 1, 2, 3 or even 4 percent?

Would there, as the King of Debt suggested, be no country?

Well, as you can see, a 1% rise would hardly be 'devastating' but with $633 billion needed to pay interest, that would put a serious crimp in the budget.

A 2% rise and you're talking serious money—TARP-plus money.

Not good.

A 3% rise and we have a real problem as over a trillion dollars is required just to pay interest.

Does any of this look like a reason to dump gold yet, by the way? Just checking...

Where was I? Oh yes... a 4% rise in rates.

Well, clearly, at 6.2%, I believe the technical term is "you're screwed".

Maybe the King of Debt was right after all.

Now the Trump euphoria is predicated - it seems - upon a massive blitz of infrastructure spending which will supposedly stimulate the economy and get things moving in the right direction again.

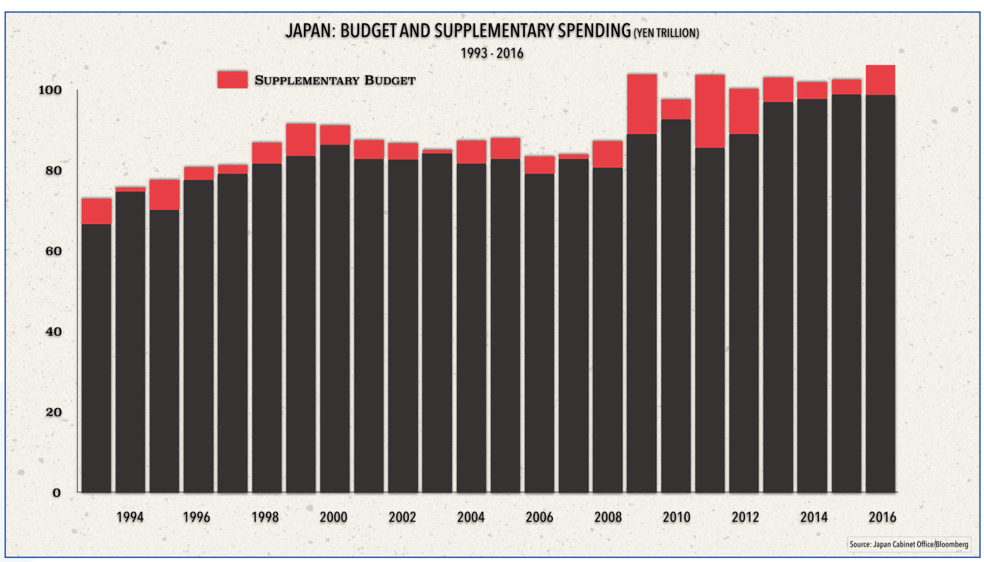
Luckily, we have a place to go to see how that idea might play out...or, for those of you old enough to remember the kids TV show Rainbow...we know a song about that, don't we boys and girls?

Yes, Japan!

The Land of the Rising Sun this year instituted its 26th dose of fiscal stimulus since 1990 - that's an average of one a year.

For 26 years.

And, perhaps unsurprisingly, Goldman Sachs recently published a report which determined that the initial sugar hit of the vast majority of these fiscal injections usually lasted ohhhhhh a little less than a month:



(Bloomberg): Prime Minister Shinzo Abe's "bold" plan to revive the economy with a $273 billion package leaves him traveling down a well-trod path: it marks the 26th dose of fiscal stimulus since the country's epic markets crash in 1990, in a warning for its effectiveness.

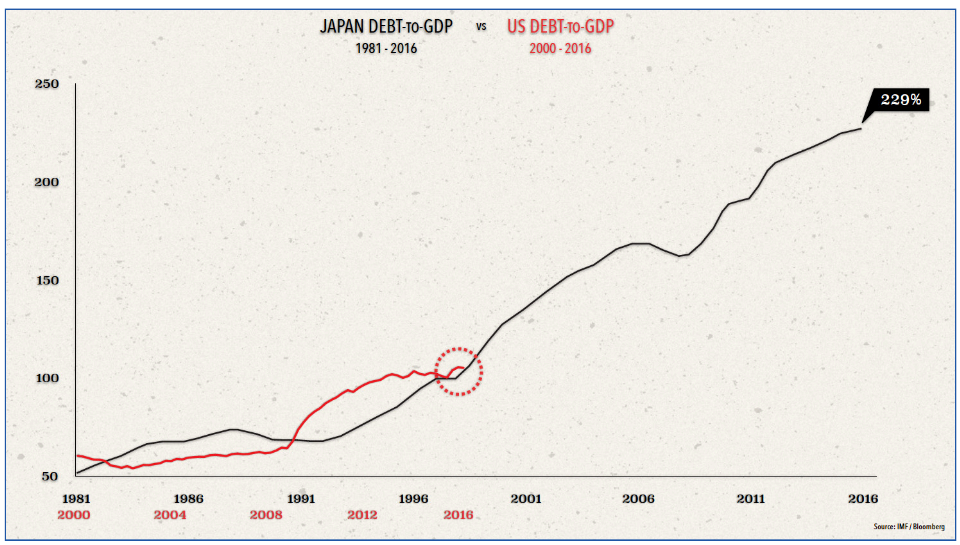
The nation has had extra budgets every year since at least 1993, and even with that extra spending, it has still had six recessions, an entrenched period of deflation, soaring debt and a rapidly aging population that has left the world's third-largest economy still struggling to get off the floor…

…if previous episodes are any guide, an initial sugar hit to markets and growth will quickly fade amid a realization that extra spending does little to cure the economy's underlying problems. A Goldman Sachs Inc. study found that markets gave up their gains in the first month after the cabinet approved the stimulus in 18 of the 25 packages it studied since 1990.

Coincidence that Shinzo Abe was the first foreign leader to meet the President-elect?

Maybe.

One of the reasons for Japan's continued failure to get the stimulus right is perhaps the fact that often, what the government promises, they don't always deliver on.



In each of the 26 cases of fiscal stimulus, the amount of new spending was significantly less than the amount pledged

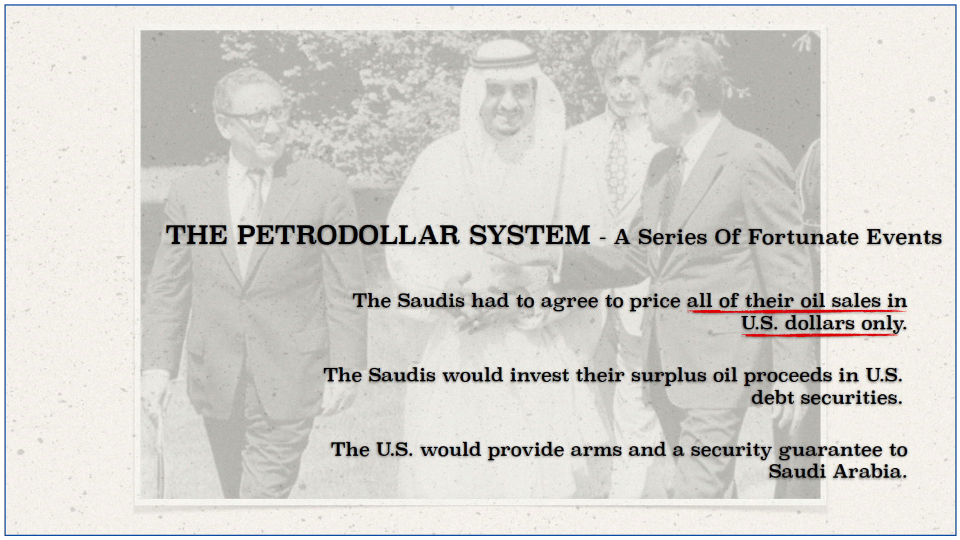
Broken government promises? Well I never.

Of course, where the Japanese *HAVE* been successful is in blowing out their debt-to-GDP ratio, which now stands at a world-beating 229%

Interestingly enough, with Trump having been elected and promising Japan-like infrastructure spending, the U.S. is *exactly* where Japan was 16 years ago and following a worryingly similar trajectory.

In short, don't blindly believe the hype about Trumponomics folks. Be patient and let's see what happens. There is much which can go wrong

But that's enough of Japan and Trump.



Suffice to say, I don't see his election or his plans as being anything close to as bearish for gold as the market reaction would suggest—quite the reverse in fact—but we need to navigate this short-term chop first and, as always, gold's performance has a habit of confounding expectations against the rosiest of backdrops.

As I promised, however, we have far more interesting things to get to today; things like the dollar...and oil... and, yes, gold.

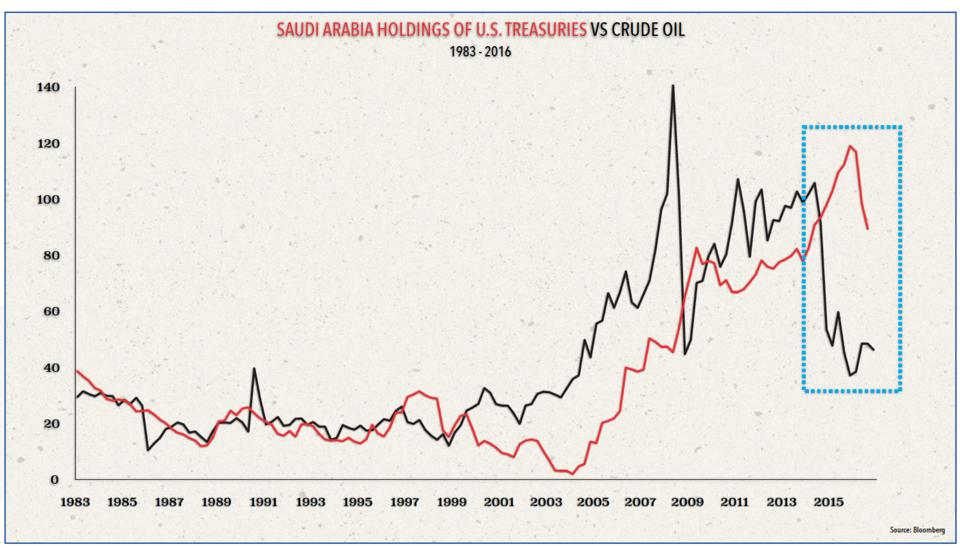
But it's not just interesting *things* we need to look at, but also a few interesting *places* like Saudi Arabia...and Russia and, of course... China.

Now, the rest of this presentation concerns a series of dots I have been trying to join for some time now and I recently came across a man in Cleveland, OH who helped join them for me.

His name is Luke Gromen and he writes a piece of research called Forest For The Trees.

Make a note of that.

When I'm done, I promise you're going to want to find out more about him and you're going to have a whole new dynamic to think about in the gold market.



The story begins in the 1970s when Henry Kissinger and Richard Nixon struck a deal with the House of Saud—a deal which gave birth to the petrodollar system.

The terms were simple

The Saudis agreed to *ONLY* accept U.S. Dollars in return for their oil and that they would reinvest their surplus dollars into U.S. treasuries.

In return, the U.S. would provide arms and a security guarantee to the Saudis who, it has to be said, were living in a pretty rough neighbourhood.

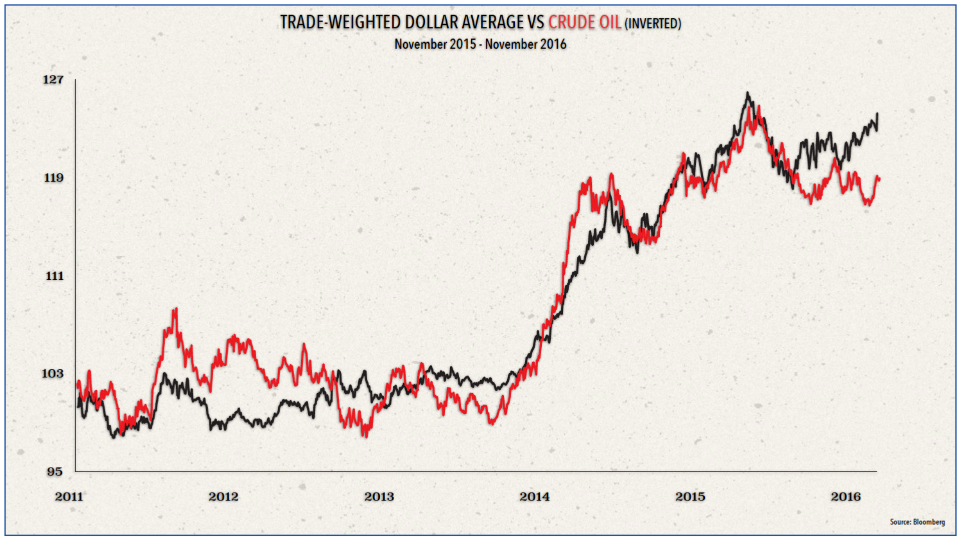
As you can see, things went swimmingly (chart, bottom of previous page).

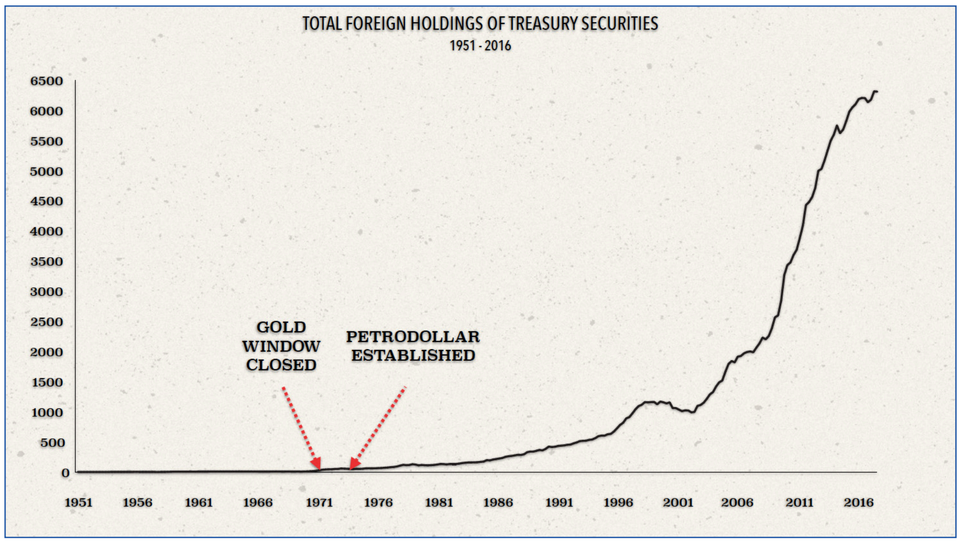
Saudi purchases of treasuries grew along with the oil price and everyone was happy.

(We'll come back to that blue box on the right shortly)

The inverse correlation between the dollar and crude is just about as perfect as one could expect (until recently that is... but again, we'll be back to that)..

And, as you can see here, beginning when Nixon slammed the gold window shut on French fingers and picking up speed once the petrodollar system was ensconced, foreign buyers of U.S. debt grew exponentially.



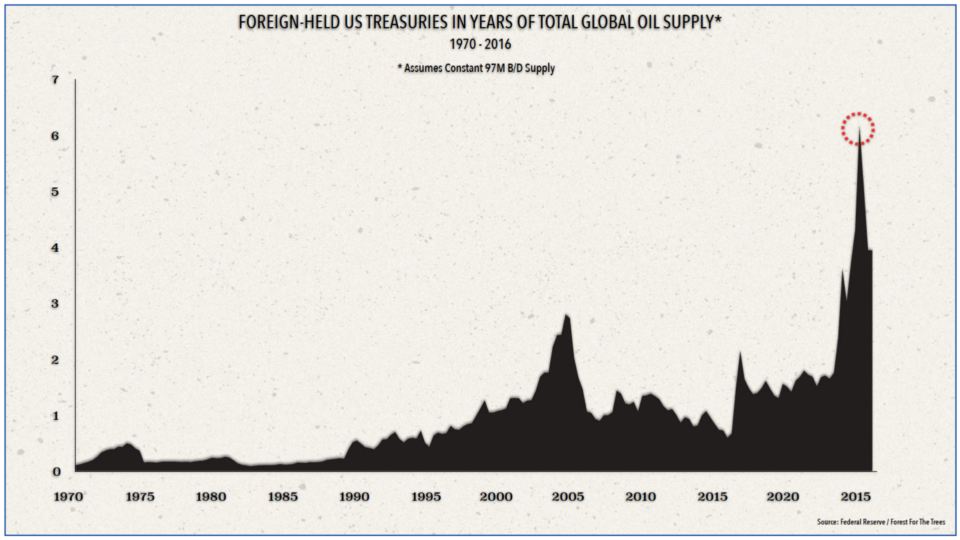


Having the world's most vital commodity exclusively priced in U.S. dollars meant everybody needed to hold large dollar reserves to pay for it and that meant a yuuuge bid for treasuries.

It's good to be the king.

By 2015, as the chart on the next page shows quite clearly, there were treasuries to the value of around 6 years of total global oil supply in the hands of foreigners (if we assume a constant 97 million bpd supply which I think is a pretty reasonable estimate).

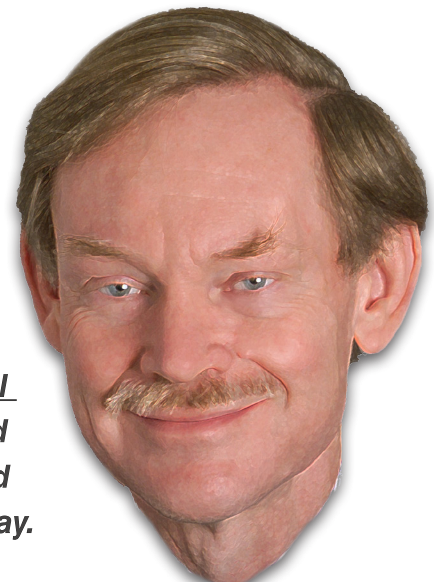
Now... with that brief background on the petrodollar system, here's where I need you to stick with me. I promise you it'll be worth the mental effort.



Ready? Here we go.

Now, back in 2010, then-World Bank President Robert Zoellick caused something of a commotion when he suggested that an entirely new global monetary system maybe wasn't such a bad idea.

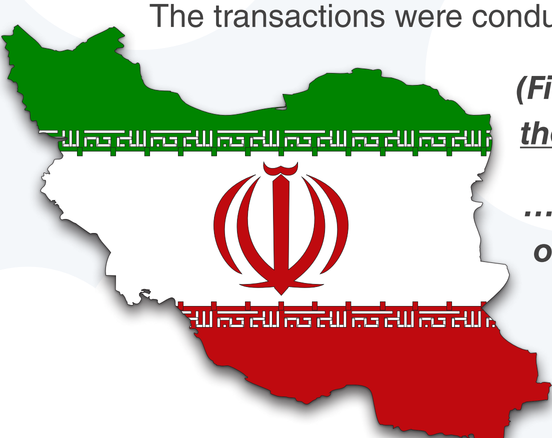
The system he had in mind involved a freely-convertible Yuan and, controversially was constructed around gold as its central reference point:



> ***(Robert Zoellick, November 8, 2010): …the G20 should complement this growth recovery programme with a plan to build a co-operative monetary system that reflects emerging economic conditions.***
>
> ***This new system is likely to need to involve the dollar, the euro, the yen, the pound <u>and a renminbi that moves towards internationalisation and then an open capital account.</u>***
>
> ***<u>The system should also consider employing gold as an international reference point</u> of market expectations about inflation, deflation and future currency values. Although textbooks may view gold as the old money, markets are using gold as an alternative monetary asset today.***

In seemingly unrelated news, two years later, Iran began accepting Yuan in payment for its oil amid US sanctions.

The transactions were conducted through Russian banks:



> ***(Financial Times, May 2012): <u>Iran is accepting renminbi for some of the crude oil it supplies to China</u>…***
>
> ***…Tehran is spending the currency, which is not freely convertible, on goods and services imported from China…***
>
> ***The trade is worth as much as $20bn-$30bn annually according to industry estimates…***

The renminbi purchases began some months ago…much of the money is transferred to Tehran through Russian banks, which take large commissions on the transactions…

Beijing has been trying to get its trading partners to use the renminbi, in effect transferring the exchange rate risk to its counterparties, since the price of crude is set in US dollars. It also frees Beijing of the need to hold as many dollars in its reserves.

The crucial part of this deal was that, by diversifying their purchases in this way, the Chinese had found a path towards not only needing to hold fewer U.S. dollar reserves, but to circumventing the petrodollar system altogether.

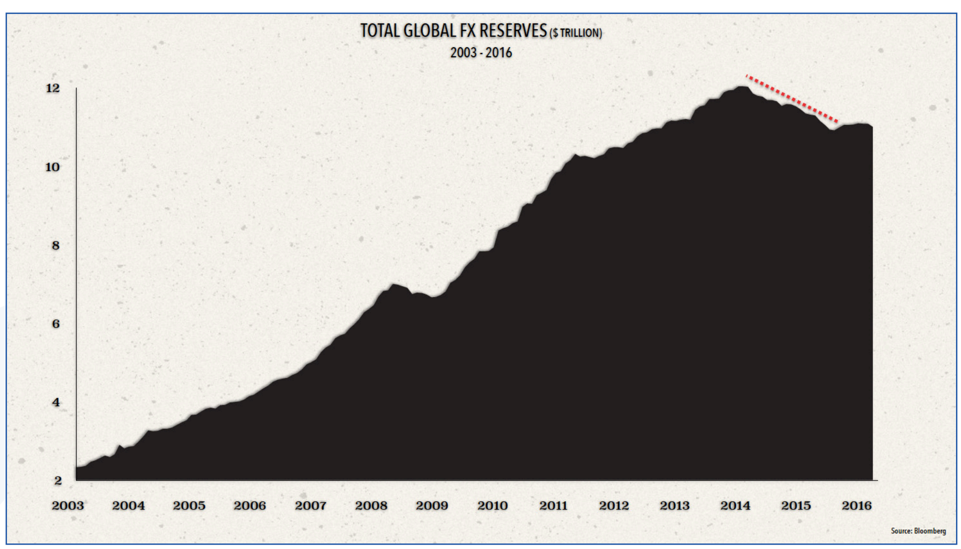
By 2013, the penny had clearly dropped at the PBoC who declared an end to the era of their accumulation of U.S. treasuries:

(Bloomberg, November 2013): The People's Bank of China said the country does not benefit any more from increases in its foreign-currency holdings, adding to signs policy makers will rein in dollar purchases that limit the yuan's appreciation.

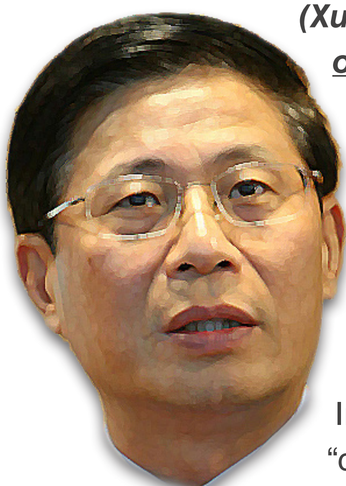
"It's no longer in China's favor to accumulate foreign-exchange reserves," Yi Gang, a deputy governor at the central bank, said in a speech organized by China Economists 50 Forum at Tsinghua University yesterday. The monetary authority will "basically" end normal intervention in the currency market and broaden the yuan's daily trading range

Yes, it was, apparently "no longer in China's interest" to accumulate foreign exchange reserves.

Sure enough, in 2014, global FX reserves began to decline at the fastest rate in 80 years as you can see from this chart:



That same year, another piece of the puzzle was laid in place when Xu Luode, the Chairman of the newly-founded Shanghai Gold Exchange, explained that gold would be priced and sold in Yuan as a step towards what he called the "internationalization of the renminbi" (for those of you confused by Yuan and Renminbi, just think of them as the Chinese equivalent of 'Pound' and 'Sterling'):



(Xu Luode, Speech to LBMA, May 2014): Foreign investors can directly use offshore yuan to trade gold on the SGE international board, which is promoting the internationalization of the renminbi…

Shanghai Gold will change the current gold market "consumption in the East priced in the West" situation.

When China will have a right to speak in the international gold market, pricing will get revealed…

Interestingly, Luode acknowledged what he accurately described as the "consumption in the East, priced in the West" situation and assured the world that the 'real' price of gold would become apparent once China took its rightful place at the centre of the gold market.

We can but hope he is correct. When that day comes, the change on the world's gold markets will be unprecedented.

In 2015, another announcement slipped by the world when it was revealed that Russia's Gazprom would also begin selling oil to the Chinese in exchange for yuan and that they were negotiating further agreements to use rubles and yuan to settle natural gas trading directly, without the need for dollars:

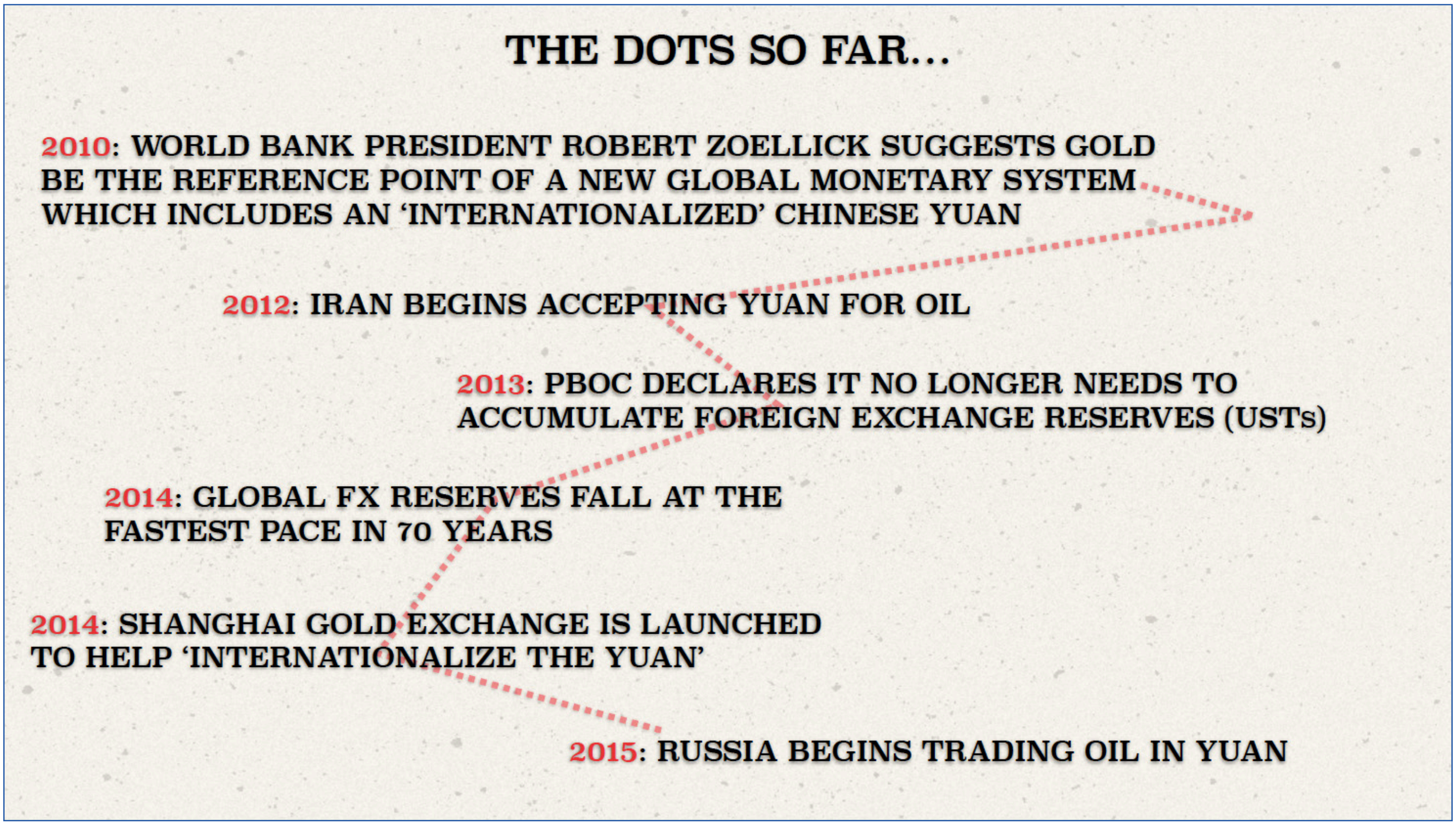
(Moscow Times, June 2015): "Two state energy companies, gas producer Gazprom and its oil arm Gazprom Neft, said they would use more Chinese currency in trade, while Russia's largest bank, Sberbank, has also promoted the use of the yuan…

Gazprom Neft announced that it began settling shipments of oil to China in yuan. And previously, the head of Gazprom, Alexey Miller, said in a TV interview that the company was negotiating with China to use yuan and rubles for gas deliveries via a planned pipeline in Western Siberia.

OK... hands up if you're still with me... great!

Oh... you're reading this so I can't see you but hopefully you're following the dots...

For those of you who aren't, here's a little recap of where we are so far to help you get things into the right order before we push on to the end:



Get it? Got it? Good.

So... here we are, in 2016 and, as it turned out, April was a hell of a month if you were paying attention.

Firstly, the Saudis threatened to sell almost a trillion dollars of U.S. assets—including over $300 billion of treasury bonds—should a bill be passed by the congress allowing the Saudis to be held responsible for the 9/11 attacks:

(NY Times, April 16, 2016): Saudi Arabia has told the Obama administration and members of Congress that it will sell off hundreds of billions of dollars' worth of American assets held by the kingdom if Congress passes a bill that would allow the Saudi government to be held responsible in American courts for any role in the 9/11 attacks.

Adel al-Jubeir, the Saudi foreign minister, delivered the kingdom's message personally last month during a trip to Washington, telling lawmakers that Saudi would be forced to sell up to $750B in treasury securities & other assets in the US before they could be in danger of being frozen by American courts.

In a rare show of bipartisanship, the bill was subsequently passed before being vetoed by President Obama who then had to watch in ignominy as he suffered the first veto override of his presidency.

Just days later, the Saudis were the cause of a seemingly surprise failure by OPEC to agree a production cut as the oil price languished in the low-$30s:

(Wall Street Journal, April 17, 2016): DOHA, Qatar—Oil producers that supply almost half the world's crude failed Sunday to negotiate a production freeze intended to strengthen prices.

The talks collapsed after Saudi Arabia surprised the group by reasserting a demand that Iran also agree to cap its oil production.

Oil prices had rallied in recent weeks on speculation that Saudi Arabia might successfully lead an initiative between members of the Organization of the Petroleum Exporting Countries and Russia, which joined the talks.

A deal would have marked a new level of cooperation between non-OPEC countries and OPEC members that producers hoped would keep prices above January lows of $26 a barrel.

Just 48 hours after that surprise, the Chinese finally launched their twice-daily gold fixing, setting the price at 256.92 yuan per gram:

(Bloomberg, April 19, 2016): China, the world's biggest producer and consumer of gold, started a twice-daily price fixing on Tuesday in an attempt to establish a regional benchmark and bolster its influence in the global market.

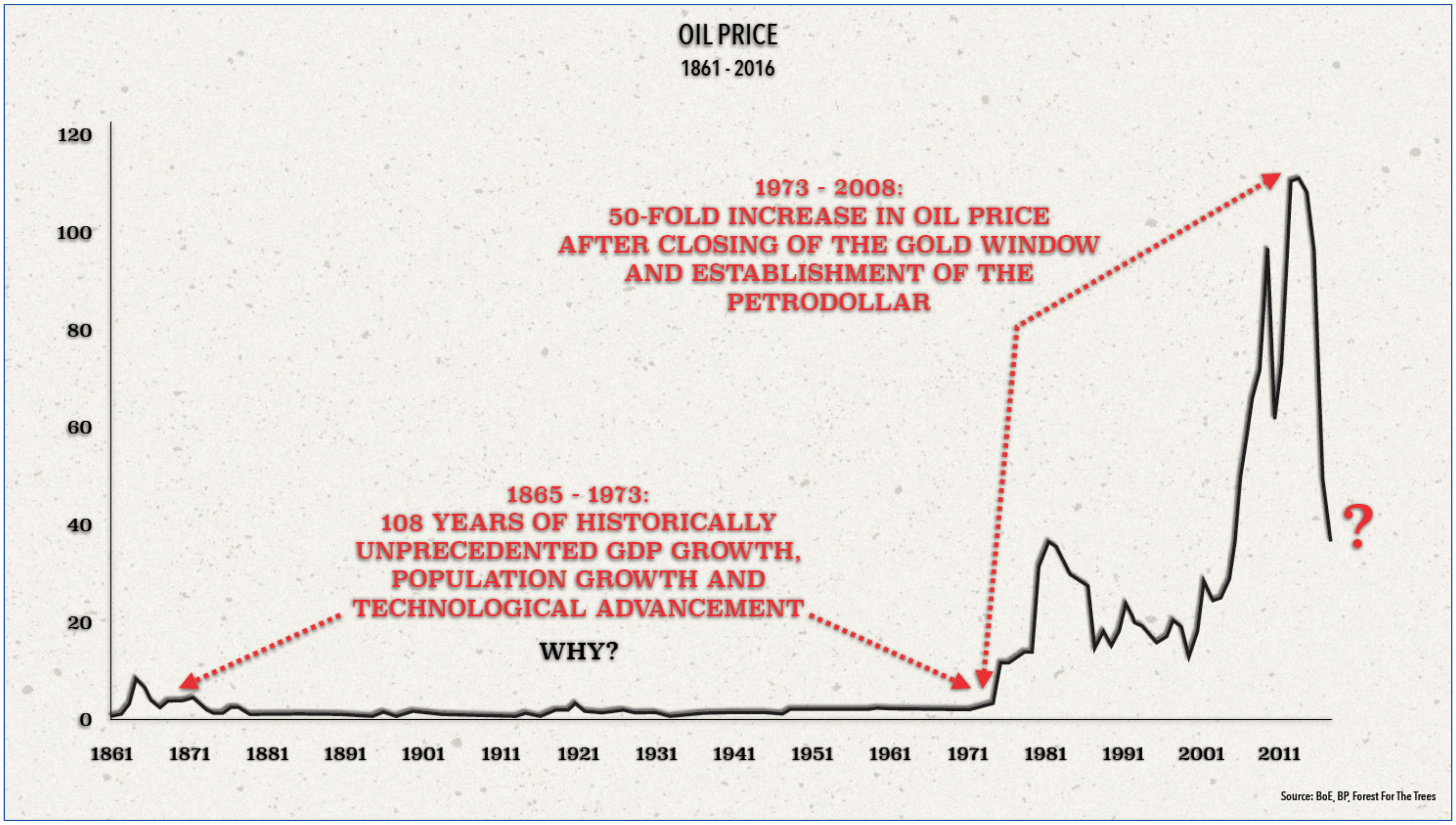
The Shanghai Gold Exchange set the price at 256.92 yuan a gram ($1,233.85 an ounce) at the 10:30 a.m. session after members of the exchange submitted buy and sell orders for metal of 99.99 percent purity.

"This is a very important development and will obviously be very closely watched," said Robin Bhar, an analyst at Societe Generale SA in London. "But as long as it exists inside a closed monetary system it will have limited global repercussions.

It could be a very important development if the new benchmark is a precursor to greater use of gold in the Chinese monetary system, Kenneth Hoffman…said by e-mail on Monday. It may also boost interest in the Shanghai free-trade zone, he said.

As Soc Gen's Robin Bhar correctly identified, if the ability to trade gold for yuan exists within a closed monetary system, its importance will be limited BUT, as Bloomberg's Ken Hoffman also correctly pointed out, if this was the thin end of the wedge, things could get very interesting indeed.

Now, this chart shows the oil price going back to before the U.S. Civil War:



Between 1865 and 1973, the price of oil was incredibly stable against a backdrop of perhaps the greatest simultaneous economic, demographic and technological expansion in human history.

How was that possible?

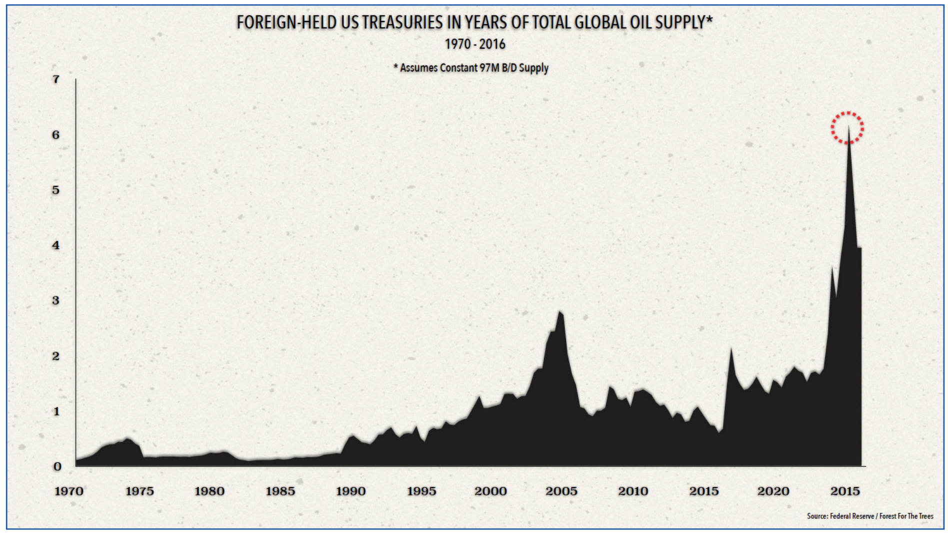
Well simply put, because oil was effectively priced in gold.

However...

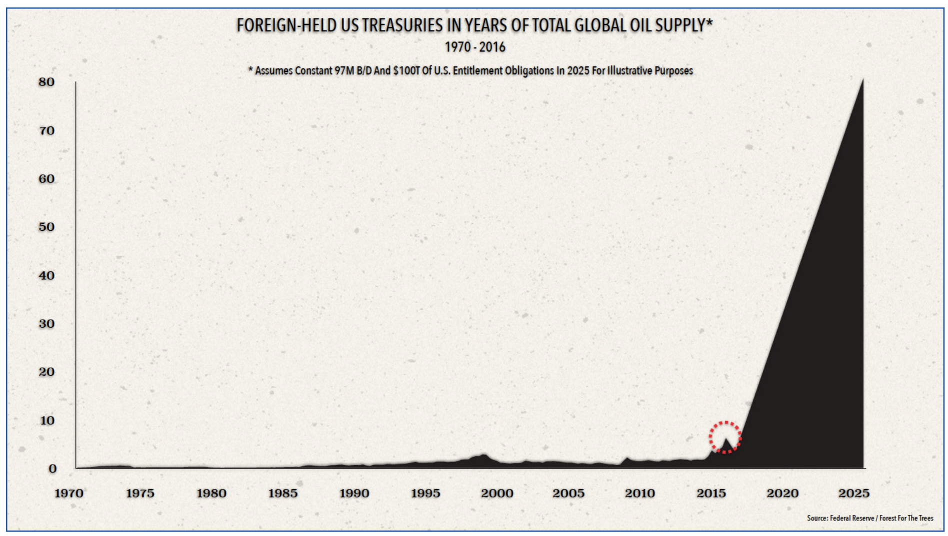
Once the gold window closed and the petrodollar system was implemented, the price of oil soared 50-fold in just 35 years.

The move on the right? With the question mark against it? We're getting there, I promise.

Now, you remember this next chart and the yuuuuuge supply of treasuries which exists compared to oil now?



Well, when we add in the roughly $100 trillion in boomer entitlements that will need to be paid for by issuing—you guessed it, more treasuries—the chart changes somewhat:

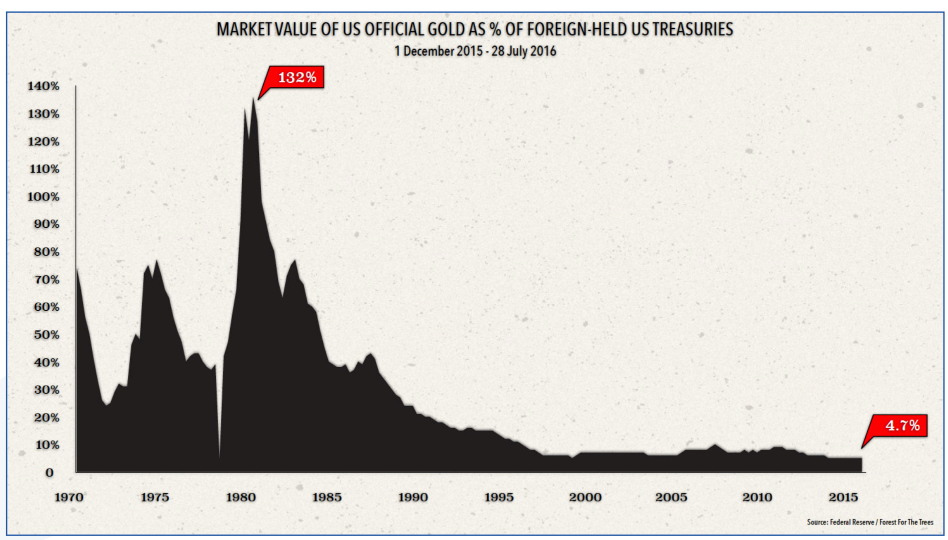


That red circle down at the bottom of the second chart is the spike you see on the first chart.

Ruh-roh!

It's safe to say that, relative to even oil, and without any infrastructure spending by Donald Trump, treasuries are going to be.... abundant in the coming years.

Conversely, if we look at the value of gold relative to foreign-held treasuries, we see an altogether different story unfold.

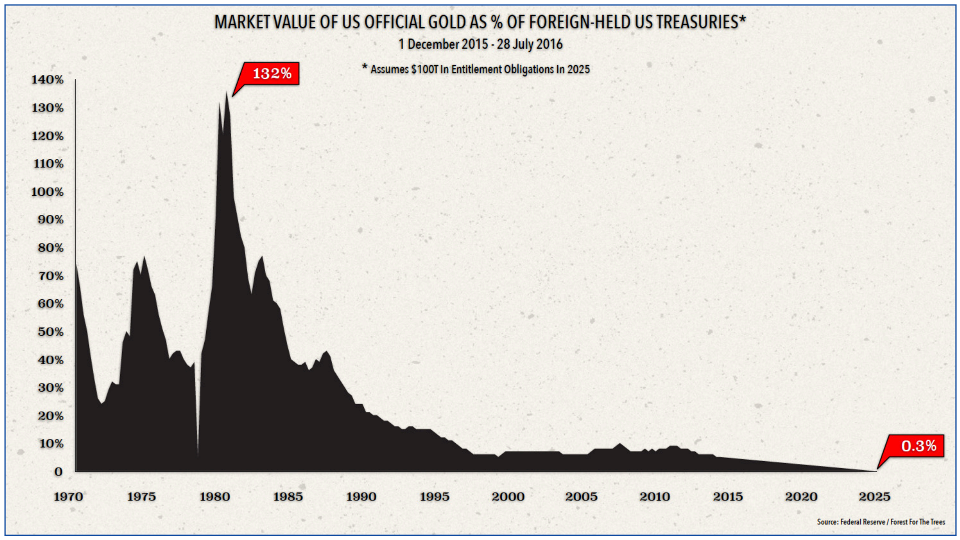


During Reagan's presidency, US treasuries were backed 132% by the market value of the country's gold reserves.

Today, that number has fallen to just 4.7%

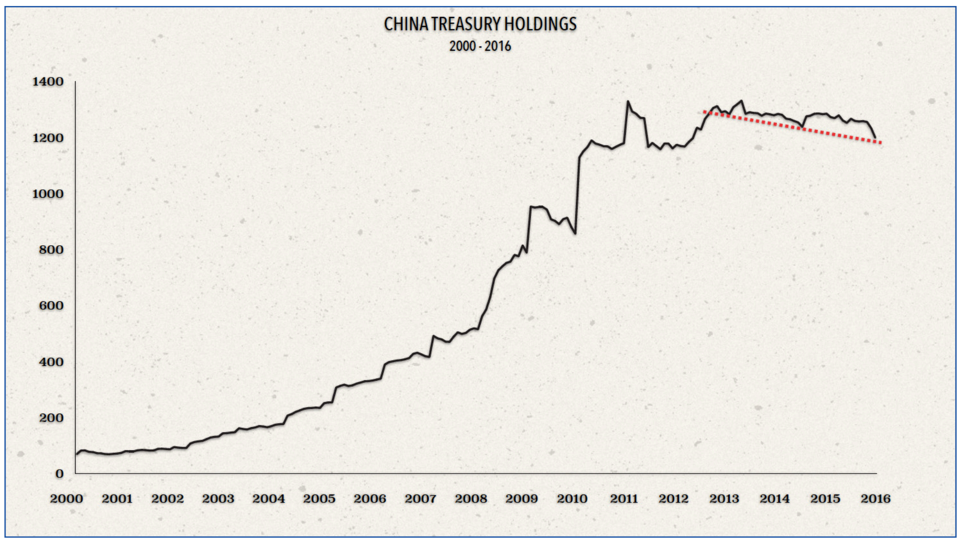
If we do the same thing and account for the $100 trillion in entitlement promises, as you can see from the chart on the next page, the number falls to 0.3% in 2025.

So the second chart (below, right) should come as no surprise to anybody.



Yes, the Chinese have started to do what they promised to start doing, when they promised to start doing it.

Now, this next part of the presentation was a rattle through a whole bunch of charts showing the recent activity in the U.S. treasury, corporate bond, agency bond and securities markets so you'll have to brace yourself.



The charts will appear on the next page.

Chinese sales of US treasuries (1) have been consistent for the last three years...

...as have their sales of US securities (2) since 2015 after plateauing in 2013 when treasury divestiture began

Concurrently, Chinese sales of corporate bonds (3) have accelerated over the same period...

...though agency sales (4)—despite a few periods of consistent selling—have yet to follow suit.

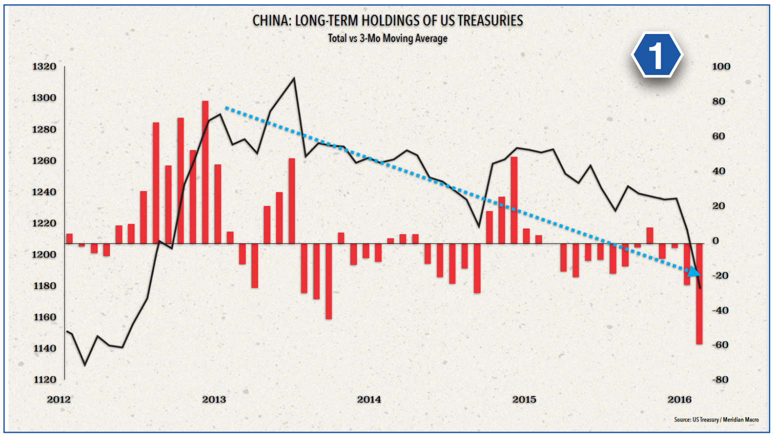
But now, as tensions rise and the cross-currents get harder to discern, guess who else has showed up as a seller?

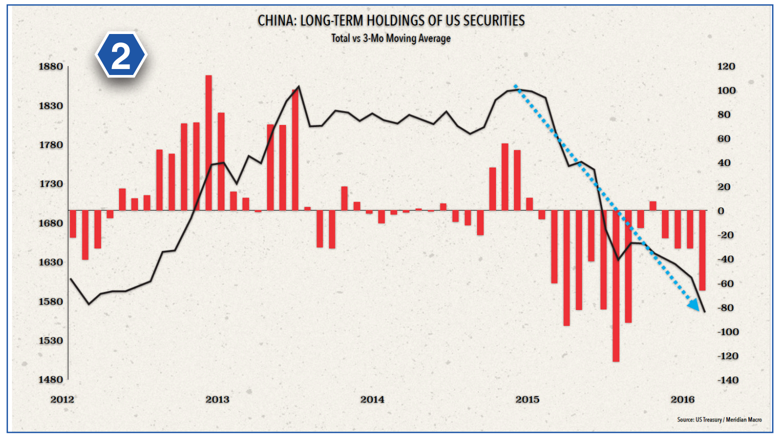
That's right, the Saudis are now steady sellers of US treasuries (5)...

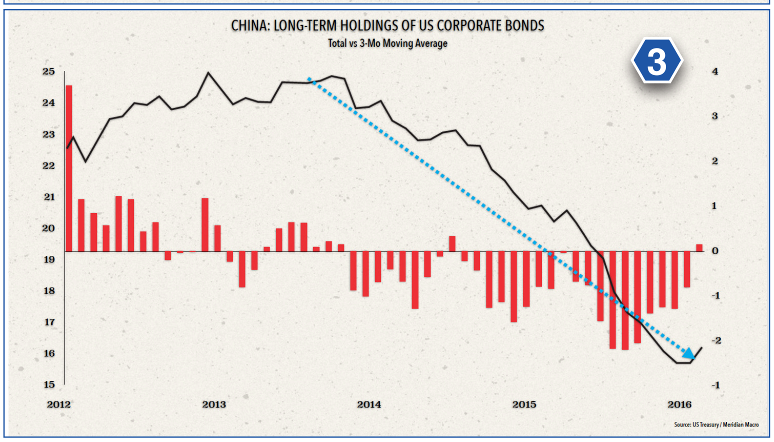
...and even more aggressive sellers of U.S. securities (6)...

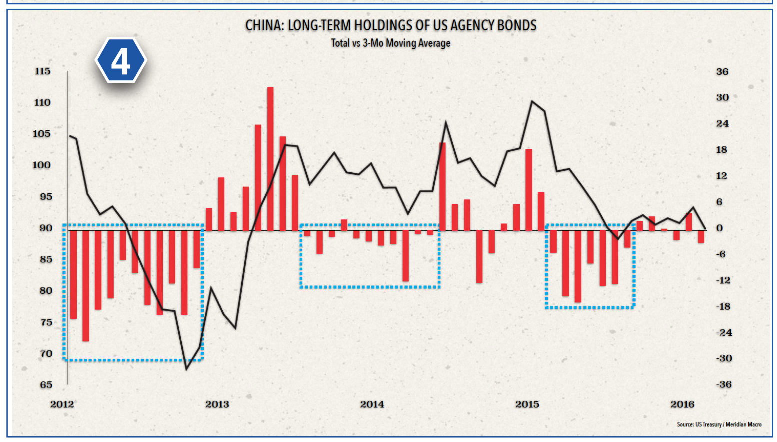
Meanwhile, taking a broader view, net foreign purchases of treasuries, according to the TIC data, have been in a clear downtrend since 2009 (7) and have been largely outflows for the last three years.

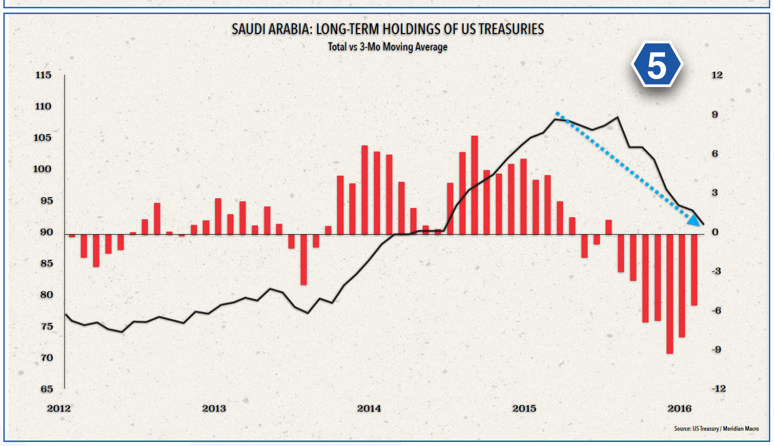
If we look at the 12-month sum of sales (8), we see an even sharper decline...

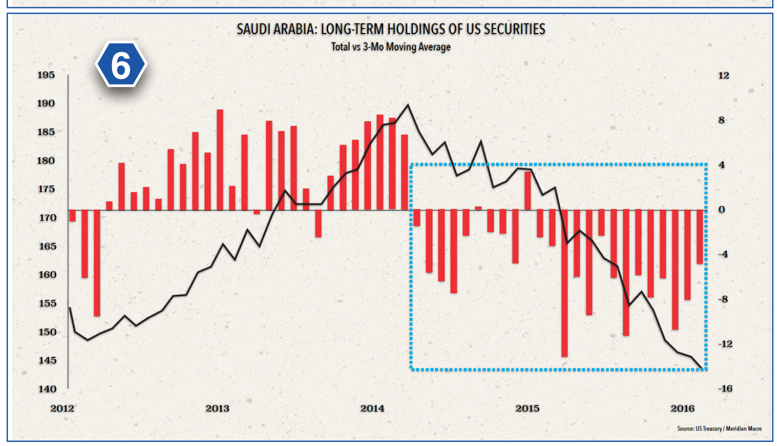

1
CHINA: LONG-TERM HOLDINGS OF US TREASURIES
Total vs 3-Mo Moving Average

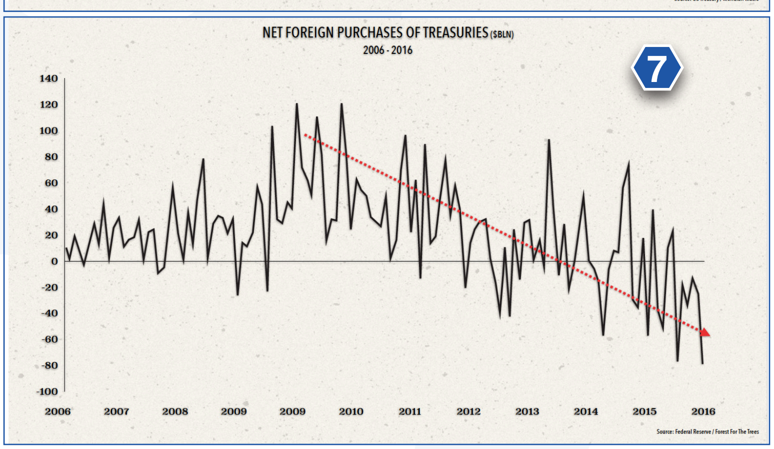

2
CHINA: LONG-TERM HOLDINGS OF US SECURITIES
Total vs 3-Mo Moving Average

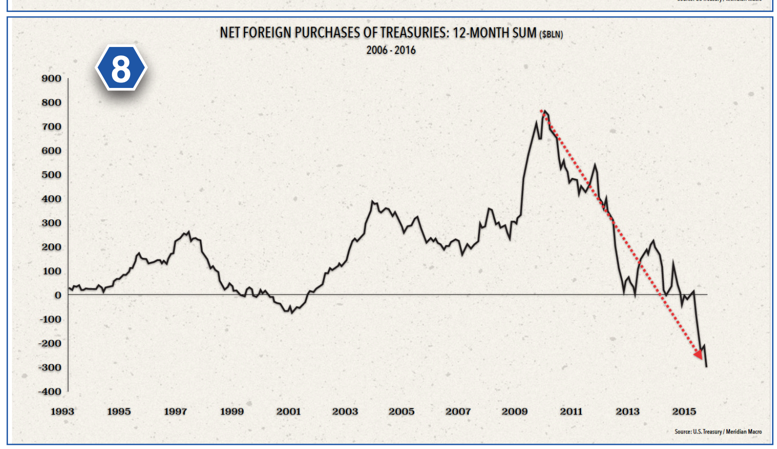

3
CHINA: LONG-TERM HOLDINGS OF US CORPORATE BONDS
Total vs 3-Mo Moving Average


4
CHINA: LONG-TERM HOLDINGS OF US AGENCY BONDS
Total vs 3-Mo Moving Average

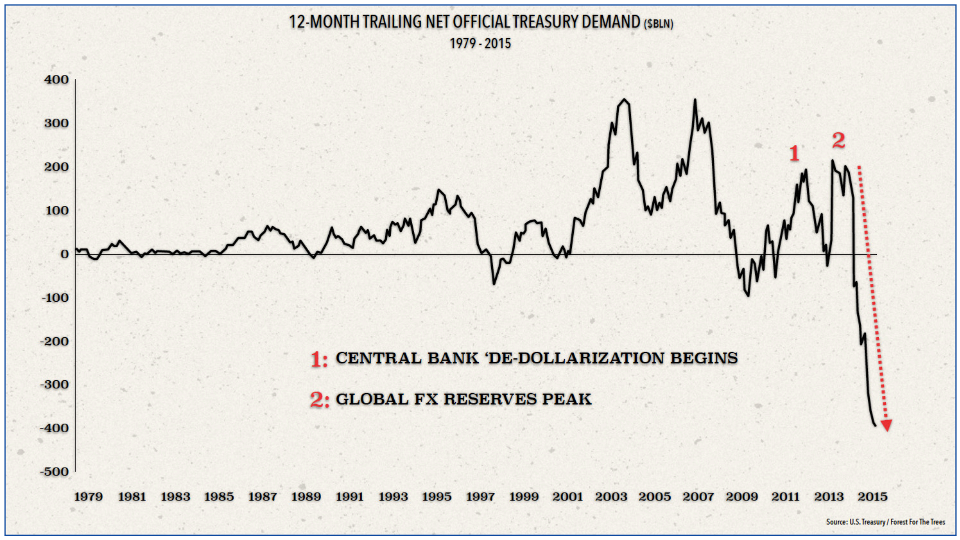

5
SAUDI ARABIA: LONG-TERM HOLDINGS OF US TREASURIES
Total vs 3-Mo Moving Average


6
SAUDI ARABIA: LONG-TERM HOLDINGS OF US SECURITIES
Total vs 3-Mo Moving Average


7
NET FOREIGN PURCHASES OF TREASURIES ($BLN)
2006 - 2016

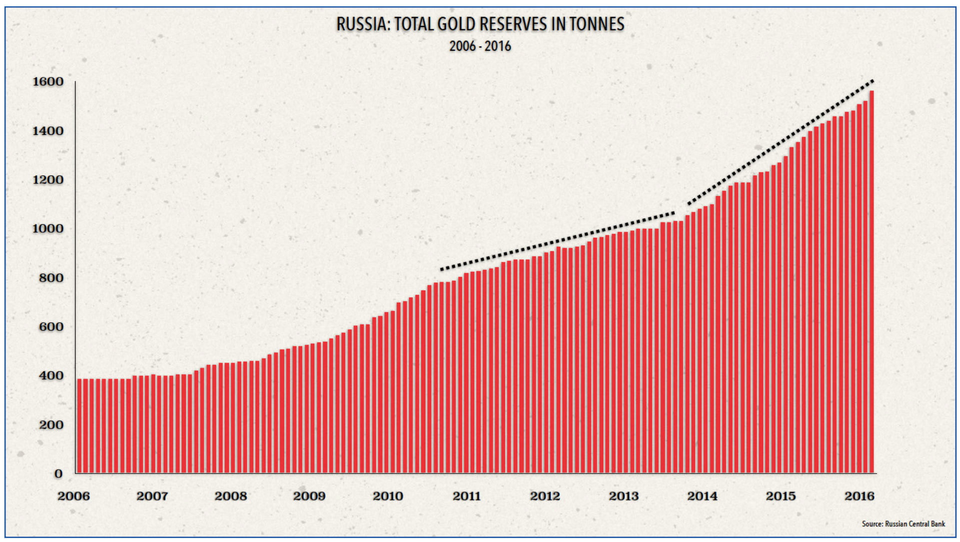

8
NET FOREIGN PURCHASES OF TREASURIES: 12-MONTH SUM ($BLN)
2006 - 2016

...and if we take the trailing net official demand chart for treasuries back to 1979, the scale and extent of the change is evident—as are the catalysts for the acceleration (and we're back on this page once again):

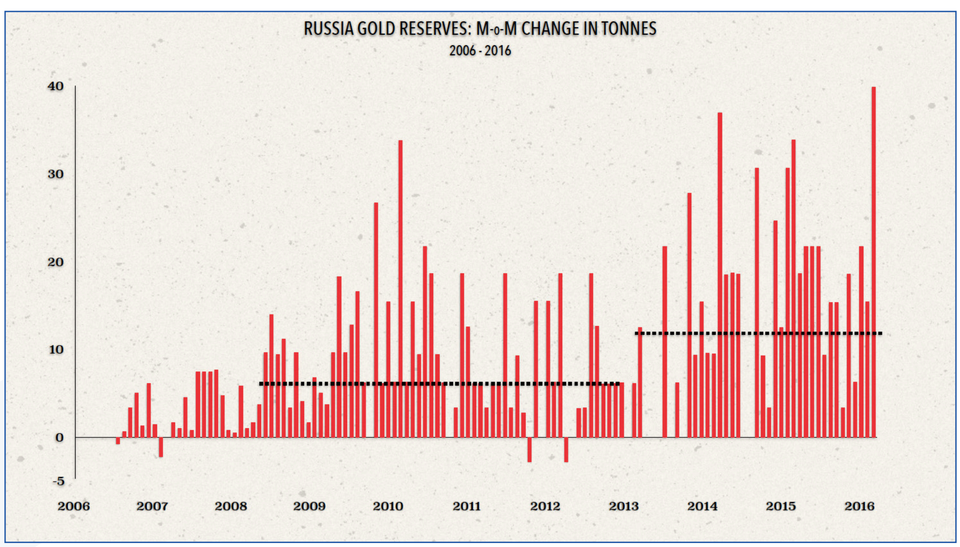


Take a long, hard look at that last chart folks—particularly within the context of the bond bull market and the 'bid' for treasuries we've seen throughout 2015 and 2016...

Meanwhile, the Russians—who, as we've seen are now selling oil for yuan to the Chinese, remember?—have been picking up the pace of their accumulation of gold reserves yet again, with the most recent monthly data setting yet another record...



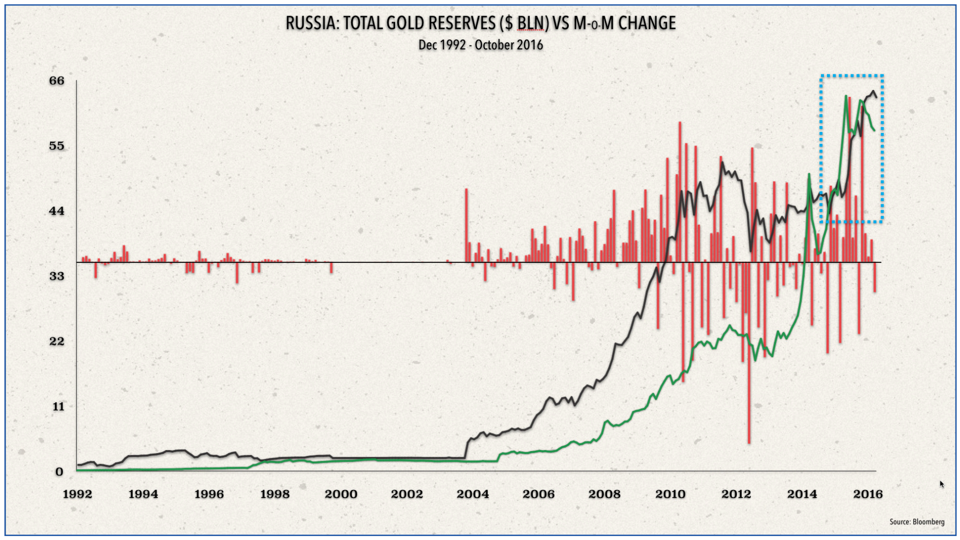
...and the pick up in pace is evident when we look at average monthly purchases prior to 2013 and post the agreements put in place around that time between the various parties.



Now, the next chart (top of the following page) is crucial to understand because a look at the ***market value*** of Russia's gold reserves shows just how crucial their ongoing accumulation of bullion has been for the country's finances over the last two years...

...and that increase in value has cushioned the effects of, amongst other things, the bailing out of the ruble.

As you can see from the green line, Russia's gold reserves in Ruble terms have soared as the country's currency has weakened—something which confounded all the doom-mongers who called Game Over for Russia amidst sharply declining oil revenues:



(Bloomberg, April3, 2015): Here's why Governor Elvira Nabiullina is in no haste to resume foreign-currency purchases after an eight-month pause: gold's biggest quarterly surge since 1986 has all but erased losses the Bank of Russia suffered by mounting a rescue of the ruble more than a year ago.

While the ruble's 9 percent rally this year has raised the prospects that the central bank will start buying currency again, policy makers have instead used 13 months of gold purchases to take reserves over $380 billion for the first time since January 2015.

Hmmm...

Now, crucially, being given the ability to sell oil to the Chinese for yuan and buy gold with that same yuan directly through the Shanghai Exchange has completely changed the game for the Russians and those changes are being reflected where they matter most—in the energy markets, the supply/demand dynamics of which are quietly morphing in plain sight.

By August of this year, Russia had overtaken Saudi Arabia as the largest exporter of oil into China...:

(Al Awsat, August 3, 2016): During the first seven months of this year, China imported about 30.5 million metric tons of Saudi oil, a 0.4% decrease than that of last year. Whereas, China imported about 29.5 million metric tons of Russian oil with 27% increase than last year.

...and that wasn't something the Saudis could take lying down:

Amid this fierce competition, it is important for Saudi Arabia to fortify its oil position in China with more political and strategic support

On the contrary, they rededicated their efforts to increase what they call "political and strategic support" for China.

Now, I hope you're all still with me because here's where we get to the final piece of this glorious puzzle—the piece that ties all these seemingly unrelated threads together: China's own crude oil futures contract, to be priced in Yuan and traded at the Shanghai International Energy Exchange—***a yuan contract which will be made fully-convertible:***

> ***(Bloomberg, November 5, 2015): By the end of 2015, China, the world's No.1 oil importer as of April, may start its own crude futures contract.***
>
> ***The idea is to establish a Chinese rival to the world's two most traded oil contracts: West Texas Intermediate, housed on the New York Mercantile Exchange, and Brent Crude Futures, owned by ICE Futures Europe in London.***
>
> ***The yuan-based contract will trade on the Shanghai International Energy Exchange and will be among the first Chinese commodity contracts available to foreign investors as China promotes global use of its currency…***
>
> ***Participation will be open to all foreign investors and the yuan will be fully convertible under the contract, according to Song Anping, the chairman of the Shanghai Futures Exchange.***

As you can see from the date of the article, this contract has been postponed several times—ostensibly for reasons such as stock market volatility in China, but perhaps there is more going on behind the scenes that is causing the delay because, once this contract is in place, things change.

Dramatically.

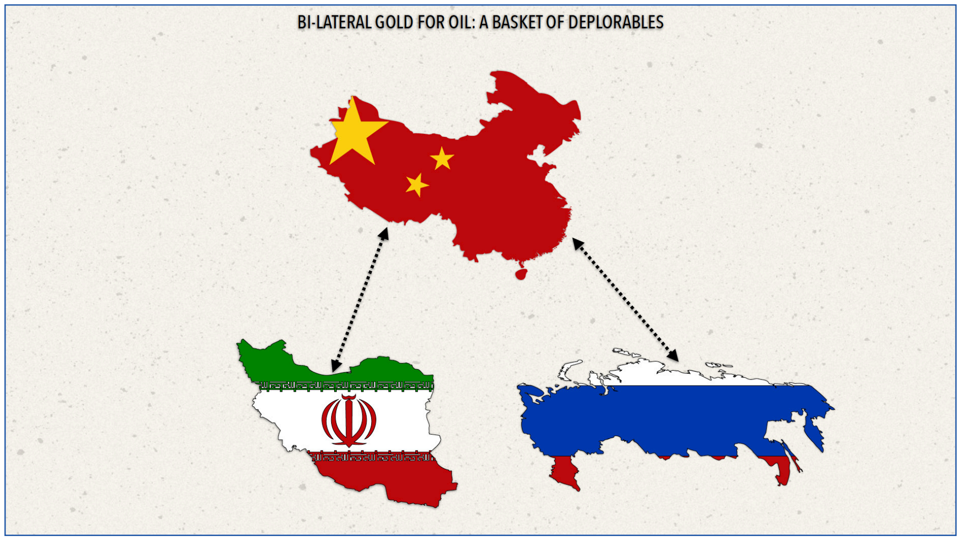
In the interim, China has supplanted the U.S to become the world's biggest importer of oil, which serves to increase both its importance in the oil markets and the likelihood of it launching its own yuan-denominated contract at some point in time:

> ***(Bloomberg, October 13, 2016): China is now the world's biggest oil importer, unseating the U.S. The country's crude imports climbed to a record 8.08 million barrels a day in September, a year-on-year increase of 18 percent, customs data released Thursday showed.***

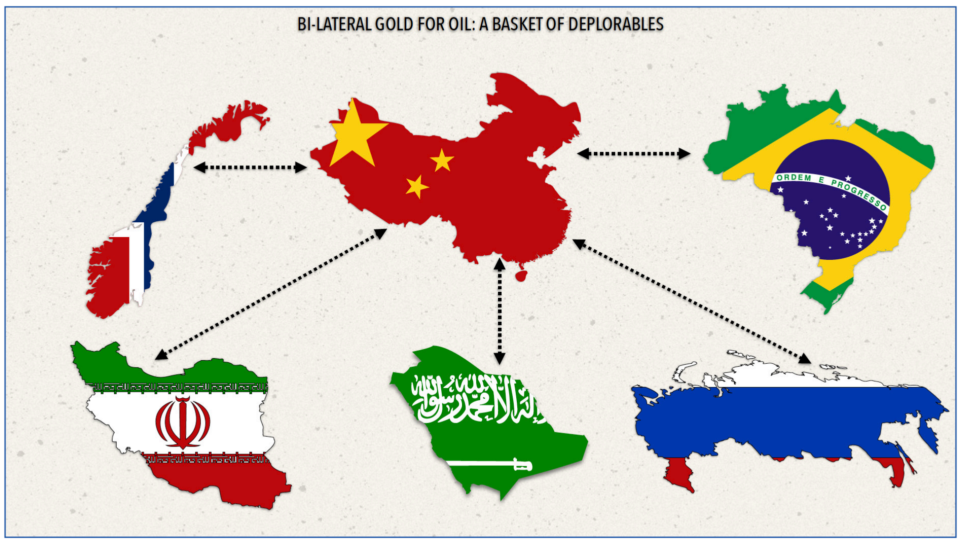
So, the world's largest exporter of oil is now dealing with the largest importer directly in yuan and it has the ability to convert those yuan proceeds into physical gold through the Shanghai exchange—which the data suggest it is doing as fast as possible.

Currently, the bilateral oil for gold trade is only available to what the U.S. would no doubt consider a 'basket of deplorables' in Iran and Russia...but just think what happens once that fully convertible oil contract is up and running...?

Suddenly, the availability to price oil in gold is available to everybody and, given rising Saudi/U.S. tensions and the Middle East nation's recent re-dedication to providing "political and strategic support" to China it's easy to see why this would be attractive to the Saudis, for example.



Whatever happens, opening that contract creates a market-wide arbitrage opportunity which affords anybody with oil to sell the ability to exchange said oil for gold and anybody wanting oil to acquire it cheaply by buying cheap gold in the West and shipping it to Shanghai or HK where it can be sold for yuan.



Already, places like Tokyo, Seoul and Dubai are opening physical gold markets and discussing linking their nascent markets for bullion to the Shanghai exchange which has rapidly become the largest physical delivery market in the world.

REUTERS Shanghai signs Dubai as 1st foreign exchange to use its gold fix for fut

FINANCIALS | Fri Oct 28, 2016 | 5:05am EDT

Shanghai signs Dubai as 1st foreign exchange to use its gold fix for futures products

Oct 28 The Shanghai Gold Exchange (SGE) has signed a deal to allow the Dubai Gold & Commodities Exchange (DGCE) to be the first foreign market platform to use its new yuan-based gold fix to develop derivative products, the Chinese exchange said on Friday.

The Dubai exchange will use the yuan-denominated gold price as a benchmark to launch a Shanghai gold futures contract, SGE said in a statement, the latest step in a broad push by top consumer China to increase its power and influence over bullion pricing in the global market.

Tokyo Commodity Exchange to launch Physical Gold Market

JULY 14, 2016 —BY VALENTINA KIRILOVA 0 COMMENTS

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The Tokyo Commodity Exchange Inc. **(TOCOM) has announced today that July 25th will be the start date of new Gold Physical Transaction**, pending regulatory approval. Gold is the most actively traded commodity at the Exchange with both futures and options contracts listed.

Simultaneously, TOCOM will introduce a delivery at settlement option for the Gold Rolling Spot contract. Originally a cash-settled contract, the change is expected to better serve investor needs.

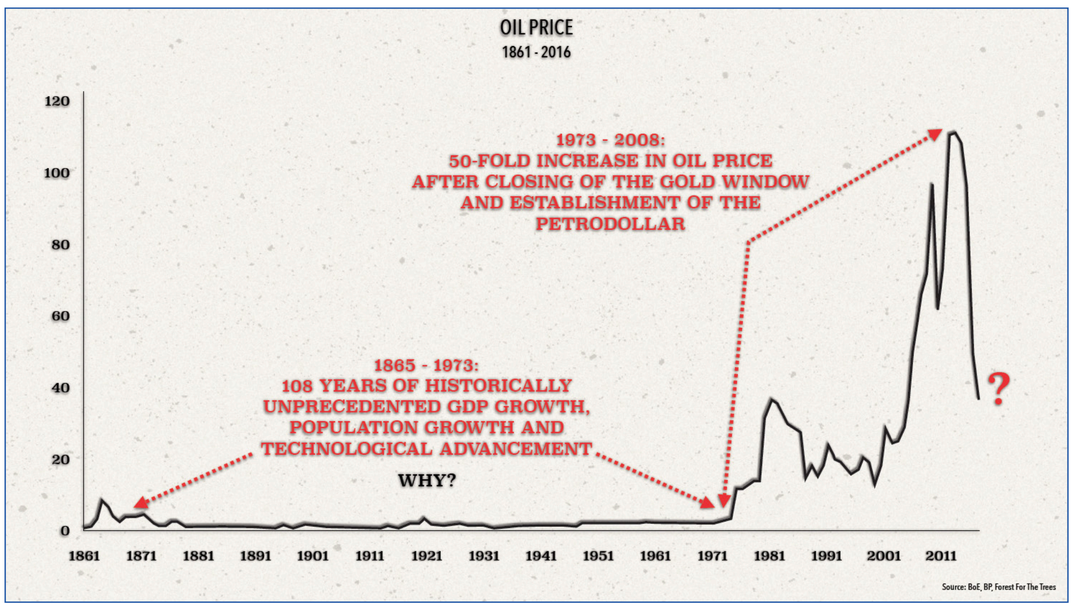
Now, were this arbitrage to begin happening in any meaningful size, with the market for oil far bigger than that for gold, it would immediately be evident in the ratio between the two commodities...

...which, interestingly, is precisely what has happened since the peak of global reserves in 2014 and the Sino-Russian agreement to essentially transact oil for gold.

With those conditions in place, the gold/oil ratio has broken out to its highest level in 80 years (chart, next page):

...which brings us right back to the question mark on the second chart which we left hanging like a matzah ball earlier in this presentation

The recent move in the oil price looks to me suspiciously like a sign that a move has started to return to pricing oil in gold.



That move, if indeed it is happening beneath the surface, allied with the endless possibilities enabled by the potential full convertibility of the yuan under the Shanghai-based oil contract leaves oil producing nations with a rather obvious choice for the first time in almost half a century—a choice made perfectly clear by the two charts on the next page:

If you are an oil producing country, do you...:

MINIMIZE your production in order to MAXIMIZE your holdings of one of the most abundant and easily-produced commodities in the world—U.S. treasuries—as has been the case for the last 40 years... knowing full well that, with the level of entitlements due in the next decade, more will need to be printed like crazy?

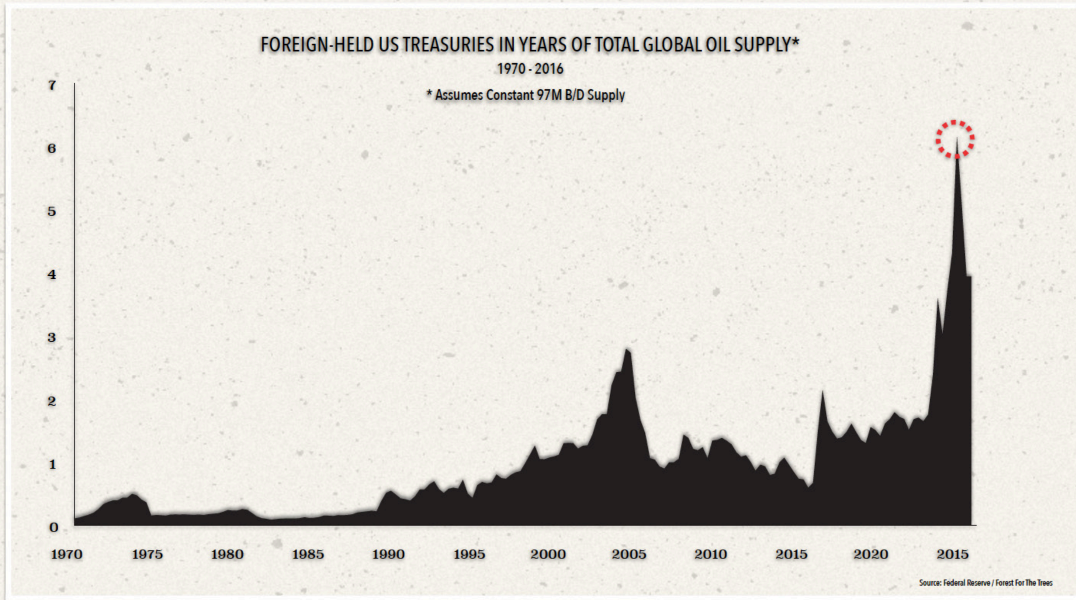
Or......

Do you MAXIMIZE production in order to gain the largest possible market share in the biggest oil market in the world and, through the ability to buy gold for yuan, thereby maximize your reserves of a scarce, physical commodity which is impossible to produce from thin air and which happens to be not only the most undervalued asset on the planet, but is trading at its most undervalued relative to U.S. treasuries in living memory?

Things that make you go hmmm

DO YOU:

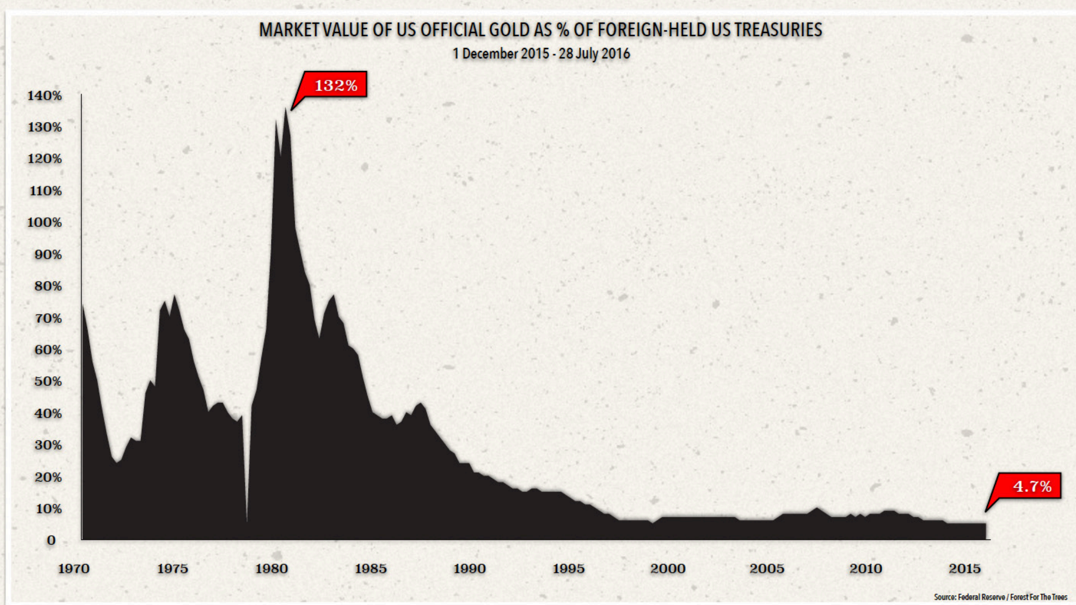
MINIMIZE OIL PRODUCTION IN ORDER TO MAXIMIZE U.S. DOLLAR RESERVES AND ACCUMULATE AN ASSET GUARANTEED TO DECREASE IN SCARCITY?



OR...

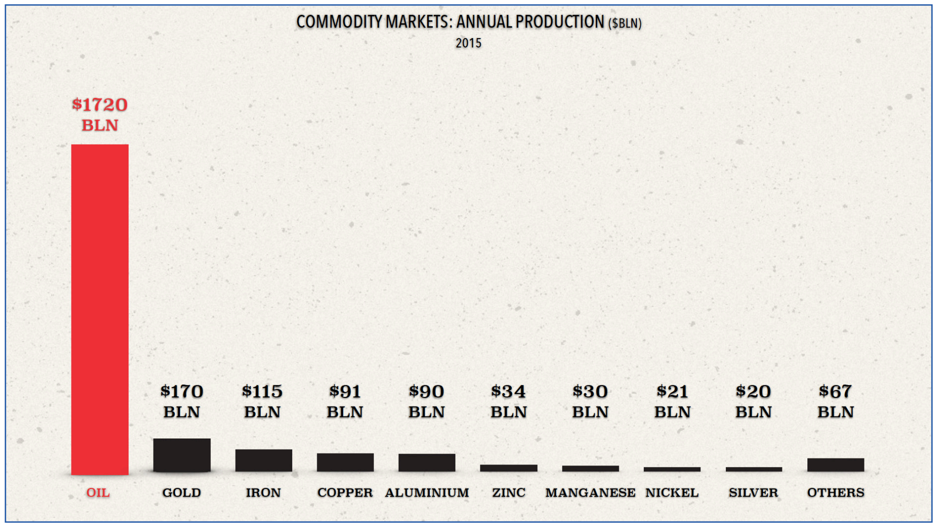
DO YOU:

MAXIMIZE OIL PRODUCTION IN ORDER TO MAXIMIZE MARKET SHARE IN CHINA AND THEREBY MAXIMIZE UNDERVALUED PHYSICAL GOLD RESERVES

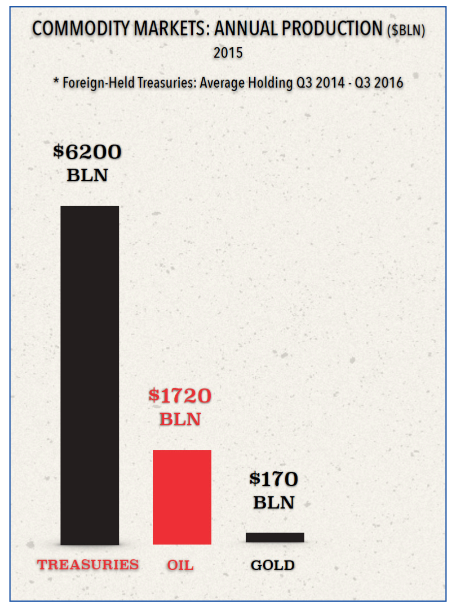


With an annual production of $170bn, gold is by far the largest metal market by value.

However, that figure is dwarfed by the oil market which is 10x the size of the gold market on an annual production basis.



If we throw in the average annual foreign holdings of U.S. treasuries over the last 2 years, we see that the 'other' commodity is at a different magnitude altogether.

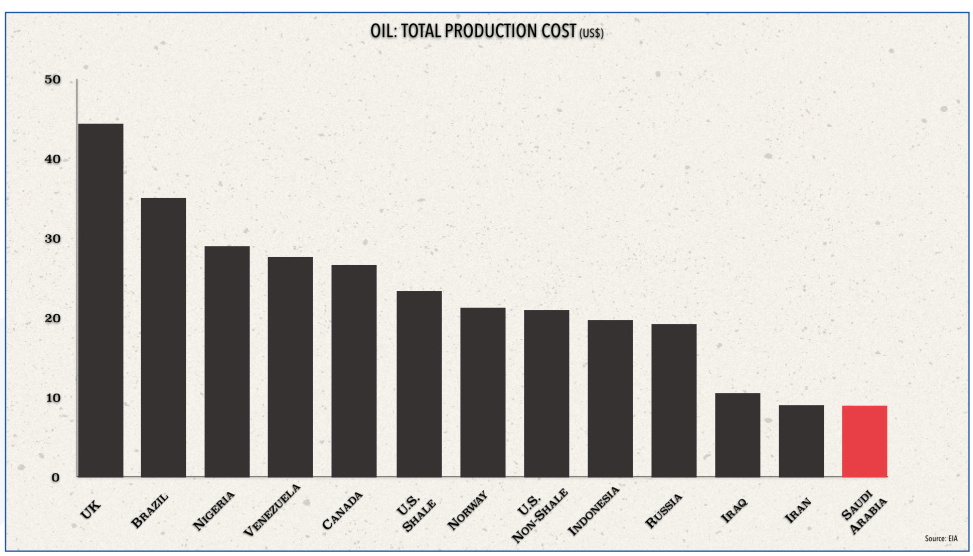


So, which one of these commodities has any scarcity value?

Given the choice, which one would you seek to maximize your holdings of?

U.S. treasuries which can be conjured out of thin air by the U.S. government and which, are described thus by The Securities Industry and Financial Markets Association:

> ***Because these debt obligations are <u>backed by the "full faith and credit" of the government</u>, and thus by its ability to raise tax revenues and print currency, U.S. Treasury securities – or "Treasuries" – are generally considered the safest of all investments. They are viewed in the market as having virtually no "credit risk," meaning that <u>it is highly probable your interest and principal will be paid fully and on time</u>.***



Or how about oil? Which the Saudis, for example, can simply ~~print~~ pull out of the ground at will at a cost of a little under $10/barrel?

Or gold? A commodity which is limited in availability, trading at its all-time low relative to U.S. treasury supply and is not only getting harder and more expensive to produce, but which is also catching the eye not only of the central banks of the world's two largest producers, but of the largest importer and largest exporter of oil?

OK.. so after taking the last publishing cycle off and at the end of that admittedly long but, as advertised, chart-heavy introduction, what else do I have for you today? Well, as it happens, plenty.

There's Trump, of course and a look at how he is changing the rules in the American business community as well as an article from Forbes which looks to be straight out of *The Onion*—but most assuredly isn't. There's the Italian 'no' vote, a return to France's conservative roots in the country's own election run-up, fears over the future supply of gold and what is very likely to be the first 'run' on a public pension fund—the same Dallas police & fire officers' fund we covered in these very pages just a few short weeks ago.

In China there are 450 million square metres of unsold housing causing a few headaches and the surge in liquidity in the Middle Kingdom is bringing back memories of wilder times. Meanwhile, Nomura explains why grey is the new black (and that's not good at all) and we return to Italy just long enough for the charming Charles Gave to uncharacteristically put the boot in.

We have charts of steadily falling classic car prices, "the scariest chart Albert Edwards has seen in quite some time" (which, if you know Albert, means it's one scary-ass chart) and a stunning offering from Eric Pomboy which charts the overvaluation of financial assets relative to the real economy better than anything else I've seen.

Lastly, we hear from Michael Lewis about his new book '*The Undoing Project*' which looks at the lives and work of the brilliant psychologists Daniel Kahneman and Amos Tversky, six of Real Vision's finest offer some thoughts about the various corners of financial markets in the post-Trump economy in the U.S. and yours truly chats with Preston & Stig at *The Investors Podcast*.

Hopefully this bumper edition will see you through the Christmas holidays and we can all reassemble in time for the New Year.

I have a feeling 2017 is going to be a doozy.

All that remains is for me to offer you all my sincere thanks and heartfelt appreciation for the support you have given me over the last twelve months and for the hundreds of wonderful emails you've sent me during 2016.

I make every effort to reply to each one of them so if I have missed any, I apologise and please don't be shy in resending anything you don't get an answer to.

Have a fantastic time over the holidays, one and all and I'll see you back here at the turn of the year.

UNTIL NEXT TIME...

ITALIAN PATRIOTISM WILL TEACH FOOLISH MARKETS A LESSON: *AMBROSE EVANS-PRITCHARD*

The blistering rally of Italian equities and sovereign bonds is a marvel to behold. Short-covering rallies are always the most glorious, and the most treacherous.

The market bounce after Brexit made perfect sense. Half the world immediately loosened policy to cushion an imaginary shock.

It even made more sense after the election of Donald Trump. His triple pledge of tax cuts, a building boom, and an imperial navy - if enacted - will flood the US economy with even greater fiscal stimulus than Reaganomics.

But it is hard to conjure any plausible story to justify a happy outcome from the turbulent events in Italy, at least for the holders of capital. “Nothing has changed for the better. You cannot find anything fundamentally positive about the referendum result,” said Lorenzo Codogno, former chief economist of the Italian Treasury and now at LC Macro Advisors.

“The whole world was short Italian banks, and everybody jumped to cover at the same time. That is what is this rally is about,” he said.

The government of Matteo Renzi has collapsed. The Italian establishment has suffered an earthquake defeat, more like the enveloping Bourbon downfall of the late 1850s than anything that has occurred in recent Italian history.

The electoral laws are in chaos. A once unthinkable Left-Right alignment of anti-euro parties is emerging with a real shot at power, perhaps as soon as early spring if the country’s president allows a snap vote.

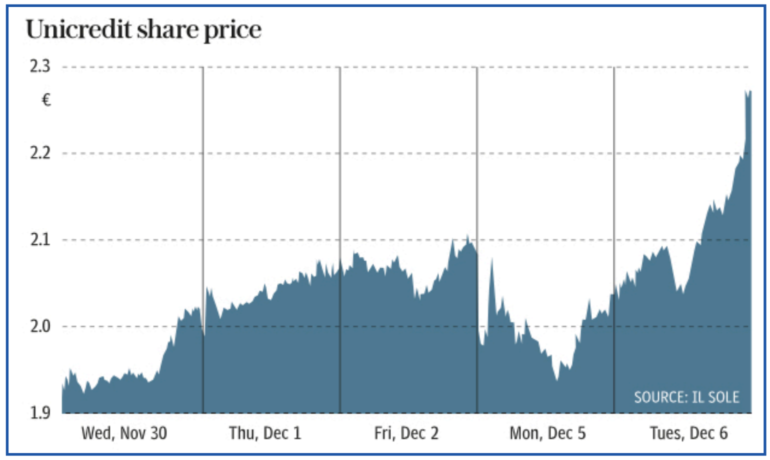
We could then have the spectacle of back-to-back elections in Italy, the Netherlands, and France, each dominated by the overriding theme of regime change and each posing an existential threat to monetary union. The tail-risks are colossal.

The Italian Treasury is preparing a “precautionary recapitalisation” of Banca Monte dei Paschi di Siena (MPS) for €2bn, a sign that a private deal with Qatar and Anglo-Saxon funds has broken down. Turning this into a bullish event takes imagination. What it surely means is that nationalisation is closing in on a string of Italian banks.

Yet the Milan bourse has surged by 7pc since the constitutional referendum went down in flames. Monte dei Paschi itself has jumped 15pc on the fumes of optimism, buoyed by a stay of execution from the European Central Bank.

Markets seem to be betting that a rescue by the Italian state - now thought imminent - will avert the worst of a bondholder "bail-in" under the EU's draconian new rules.

No doubt there is a straw of sorts to clutch in this convoluted story. Article 32 of the Bank Recovery and Resolution Directive (BRRD) allows some flexibility in cases of systemic risk, and the calculus is that the EU is so alarmed by the scale Mr Renzi's defeat that it will bend all rules. Italian banks will breath again.



Italy's biggest lender Unicredit is up 25pc in this froth of excitement, and never mind a non-performing loan book of €84bn and a capital shortfall of €9bn that must be plugged.

Mr Codogno said the fond hopes of investors will be dashed soon enough. "It is wishful thinking. The banks still have to abide by EU state aid rules and that means a bail-in," he said.

The dominoes will fall, and each one will cause a political storm. Some savers duped into buying junior bank bonds may be reimbursed one day: first they will suffer. Those who bought through pension or mutual funds will get nothing.

The corrosive effect will eat away at the credibility of Italian political order. Any attempt to put off the vote of reckoning until 2018 by recourse to a technocrat government - under the fourth unelected Italian premier in a row - risks feeding the mood of insurrection. And Italians have learned by now that the EU is the villain in this saga.

Antonio Patuelli, the chairman of the Italian Banking Association, says the EU authorities have themselves created a self-fulfilling crisis by endlessly raising the bar with pedantic stress tests that create generalized panic. "Europe's bureaucracy has a very strong responsibility for has happened," he said.

"In Italy everything can be sorted out, but as soon as we face an EU rule people react as if it were the Tablets of Moses. The stress tests have created an extreme mechanism leading to a chain-reaction of extremes," he said.

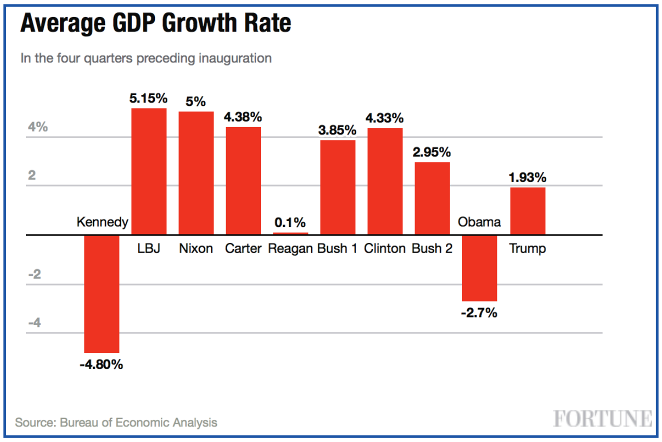
What sticks in the craw is that the EU has imposed stringent rules that prevent Italy defending itself - and let foreigners snap up distressed assets at firesale prices, Italians note caustically - yet the northern creditor powers have never delivered on their side of the bargain. There is still no joint deposit scheme or shared risk. The banking union remains a sham. "It is difficult to find anybody today who is willing to believe in Europe," said Mr Patuelli...

[DONALD TRUMP IS INHERITING THE BEST ECONOMY IN A GENERATION](): *FORTUNE*

Donald Trump had a rocky campaign. And the transition has been bumpy as well. But he looks to be rolling onto the presidency on the smoothest economic path of any president in a long time.

Data ranging from wage and job growth to manufacturing-sector indicators show that Donald Trump is getting an economy in better shape than any new president in a generation. Take a look at the following four indicators to see just how fortunate the President-elect is:

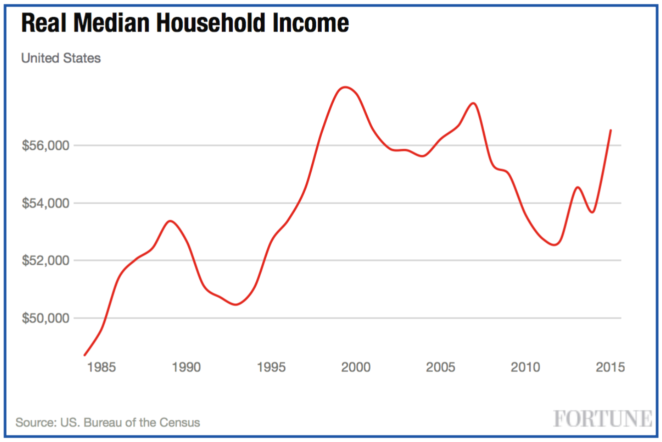
GDP Growth



The only indicator that shows Trump inheriting a generally weaker economy than is typical is GDP growth. As you can see from the following chart, while Trump will assume management of a much stronger economy than Obama did eight years ago, GDP growth over the past year has been historically weak.

This fact is mitigated somewhat by a more slowly growing population, which leads to slower overall growth than a quickly growing population does. (Although even per capita measures of real GDP growth show the U.S. becoming richer at a slower pace.) And the fact that growth has been picking up recently. The economy grew at a 3.2% pace in the third quarter.

Wage Growth



Despite the good economy, voter surveys show that a good portion of Americans were unhappy with the economy. And that's why GDP matters. It's much more common for the typical American's material situation to improve in an economy when overall GDP is growing quickly. So slow GDP growth has equally little or no raises. And that's resulted in unhappy workers.

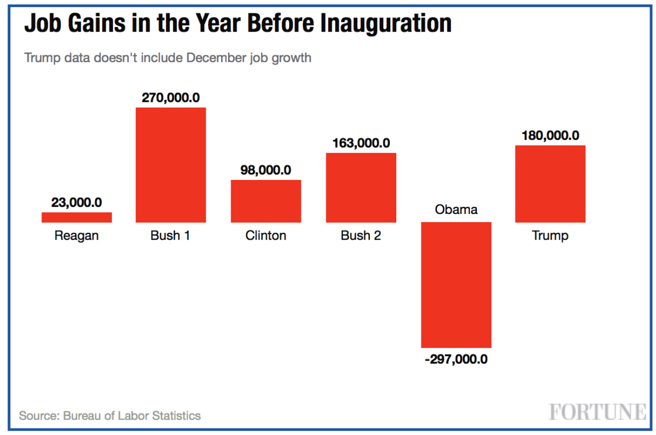
But that's changing too. Recently there's evidence that growth in wages is outpacing growth of the overall economy.

In 2015, the Census Bureau reported that the typical American saw the largest one-year increase in household income since it began surveying citizens on this question back in 1968. Other measures of wage growth, like the Employment Compensation Index and the average hourly earnings metric released by the Labor Department also show the average pace of wage gains increasing of late.

Given that take-home pay is the way most Americans interact directly with the economy, the trends in these statistics bode well for worker attitudes toward the Trump Administration.

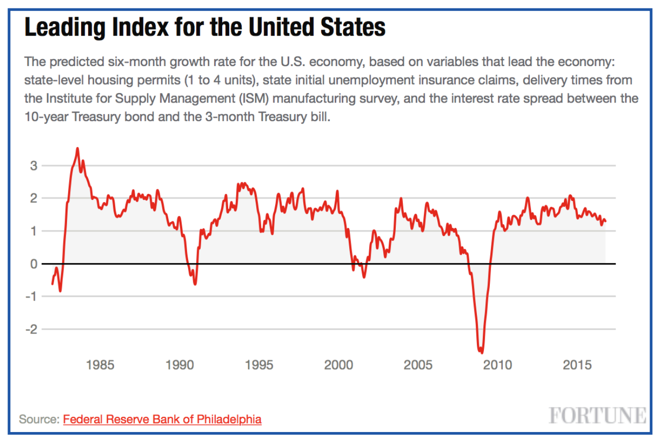
Jobs

Economists point to the declining employment rate and the steady creation of new jobs as the drivers of wage growth. Indeed, the U.S. economy has been adding new jobs at a healthy pace, with job growth over the past year posting the highest monthly average in an election year since George H.W. Bush won in 1988:



Manufacturing, Housing, and Other Leading Indicators

The difficulty in projecting how economic trends will affect an incoming presidential administration is due to the tendency of recessions to unexpectedly materialize. The economy was booming, for instance, when George W. Bush took office in the winter of 2001. Growth had averaged more than 3.5% in the previous 3 quarters. But by March, the economy was in contraction, and stock markets began to falter following the Sept. 11 attacks later than year. The malaise of the dot-com crash set in in 2002, even as economic growth began again.



Although recessions are notoriously difficult to predict, there were warning signs at the turn of the millennium. The Federal Reserve Bank of Philadelphia produces a leading index which predicts the current 6-month growth rate for the U.S. economy. As you can see from the chart below, this index correctly predicted the past three downturns. This year: It is predicting modest growth between 1% and 2% this year. Nowhere near flashing the sort of recession signals that greeted President George W. Bush or Barack Obama.

That doesn't mean that President Trump shouldn't tread carefully. His more experimental policies, like his tough talk on trade and the institution of tariffs, have the potential to trigger a recession on their own. But the above data show that Trump is one of the luckier President-elects in recent memory, when judged by the economic conditions he is inheriting...

FEARS RISE OVER FUTURE SUPPLY OF GOLD: *FT*

"For the first time in history, gold supply into the future is under enormous pressure." The warning from Mark Bristow, chief executive of London-listed Randgold, encapsulates the gold mining sector's woes.

Bullion's only modest price recovery this year compared with other commodities has led the industry to cut spending on exploration dramatically to less than $4bn from almost $10bn in 2012.

Petropavlovsk, a gold miner with assets in Russia, is a case in point. It has cut its exploration budget by two-thirds.

"There is a chronic shortage of exploration money and as usual the gold price is not acting in the way everyone thought it would do," says Peter Hambro, chairman of the company.

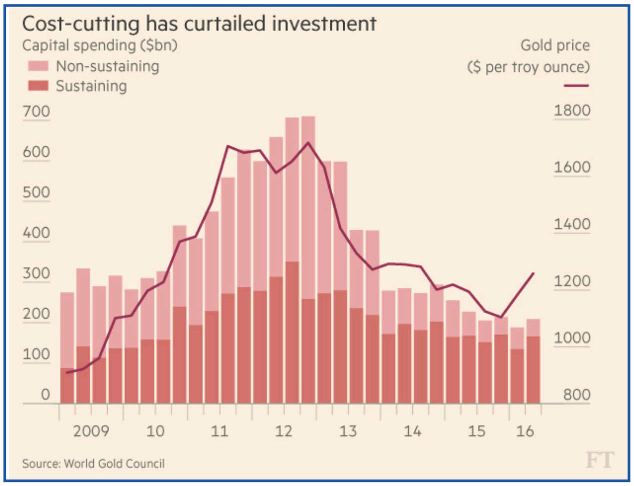
This backdrop has left many in the industry forecasting a supply shortage by the end of the decade.

Mr Bristow believes this supply shortage will be inevitable unless some major discoveries of large, high-grade ore bodies are suddenly made. "Which frankly seems a remote possibility."

Across the world, miners have instead spent their cash expanding existing deposits, improving efficiency or cautiously looking at acquisitions.

Canada's Barrick Gold, which also does not expect to increase its total production of gold over the next four years, is in the process of selling its noncore assets. China's Minjar Gold, a subsidiary of property company Shandong Tyan Home, is currently bidding for its Super Pit gold mine in Kalgoorlie, the largest gold mine in Australia.

A focus on free-cash flow generation and dividends is also in evidence. In August Newcrest Mining, the largest Australian gold miner, announced its first dividend payment for more than three years.



The new approach is largely being backed.

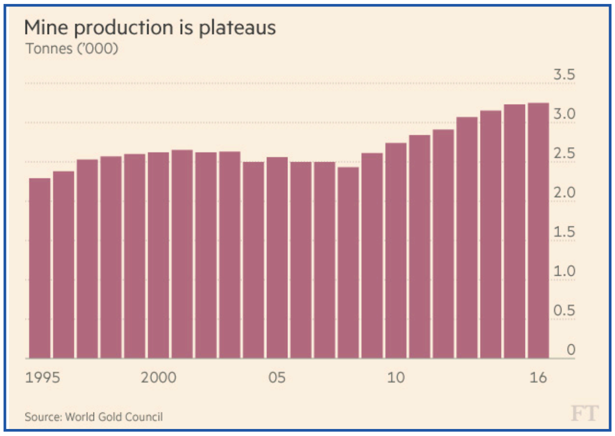
"They've got a little bit more breathing room this year but not much and the market is very discriminating about giving capital to these companies until they can demonstrate returns on investment relative to the risk," says Joe Wickwire, portfolio manager at the Fidelity Select Gold Portfolio.

With fresh debt in short supply, capital spending by the 16 gold miners tracked by Moody's Investors Service has fallen to less than half its $25bn peak in 2012. The rating agency expects gold miners to start spending "in a measured way" this year.

"Spending will probably focus on extending existing operations and phased development, rather than large-scale greenfield projects," Moody's adds.

Colorado-based Newmont Mining is charting this course. It has been spending to expand its Long Canyon project in Nevada, which it acquired in 2011, as well as the Merian project in Suriname. Both started production this year.

Mr Bristow says miners also face declining grades for their gold reserves, which have fallen by half the level they were in 2005. Grade measures the proportion of gold found in the ore of a mine.



"There are a lot of big producers that are surviving on very mediocre ore bodies," he says.

However, some have seen the downturn as a chance to spend on exploration at the bottom of the cycle.

Brad Gordon, chief executive of London-listed miner Acacia Mining, says over the past few years the company developed an exploration pipeline with over 60 targets in Africa.

"You're seeing production profiles falling off a cliff in a few years — and that's why strategically we've swum against that tide," he says.

With analysts at BMO Capital markets predicting a peak of gold supply in 2019, acquisitions may not be the focus now, but will be required longer-term, they say...

HOW DONALD TRUMP IS CHANGING THE RULES FOR AMERICAN BUSINESS: *ECONOMIST*

His inauguration is still six weeks away but Donald Trump has already sent shock waves through American business. Chief executives—and their companies' shareholders—are giddy at the president-elect's promises to slash burdensome regulation, cut taxes and boost the economy with infrastructure spending. Blue-collar workers are cock-a-hoop at his willingness to bully firms into saving their jobs.

In the past few weeks, Mr Trump has lambasted Apple for not producing more bits of its iPhone in America; harangued Ford about plans to move production of its Lincoln sports-utility vehicles; and lashed out at Boeing, not long after the firm's chief executive had mused publicly about the risks of a protectionist trade policy. Most dramatically, Mr Trump bribed and cajoled Carrier, a maker of air-conditioning units in Indiana, to change its plans and keep 800 jobs in the state rather than move them to Mexico. One poll suggests that six out of ten Americans view Mr Trump more favourably after the Carrier deal. This muscularity is proving popular.

Popular but problematic. The emerging Trump strategy towards business has some promising elements, but others that are deeply worrying. The promise lies in Mr Trump's enthusiasm for corporate-tax reform, his embrace of infrastructure investment and in some parts of his deregulatory agenda. The dangers stem, first, from the muddled mercantilism that lies behind his attitude to business, and, second, in the tactics—buying off and attacking individual companies—that he uses to achieve his goals. American capitalism has flourished thanks to the predictable application of rules. If, at the margin, that rules-based system is superseded by an ad hoc approach in which businessmen must take heed and pay homage to the whim of King Donald, the long-term damage to America's economy will be grave.

Start with the confusions in Mr Trump's philosophy. The president-elect believes that America's workers are harmed when firms move production to cheaper locations offshore. That is why he wants to impose a 35% tariff on the products of any company that moves its production abroad. Such tariffs would be hugely disruptive. They would make goods more expensive for American consumers. By preventing American firms from maximising their efficiency using complex supply chains, they would reduce their competitiveness, deter new investment and, eventually, hurt workers' wages across the economy. They would also encourage a tit-for-tat response.

Precisely because tariffs would be so costly, many businessmen discount Mr Trump's protectionism as mere rhetoric. Plenty of them see the focus on individual firms as a politically canny (and thus sensible) substitute. If Mr Trump can convince American workers that he is on their side using only a barrage of tweets and a few back-room deals like the one with Carrier, there may be no need to resort to tariffs. To profit from a business-friendly bonanza, the logic goes, clever executives simply have to make sure they stay in the president's good books.

That looks like wishful thinking. Mr Trump's mercantilism is long-held and could prove fierce, particularly if the strong dollar pushes America's trade deficit higher (see article). Congress would have only limited powers to restrain the president's urge to impose tariffs. More important, even if rash protectionism is avoided, a strategy based on bribing and bullying individual companies will itself be a problem.

Mr Trump is not the first American politician to cajole firms. For all its reputation as the bastion of rule-based capitalism, America has a long history of ad hoc political interventions in business (see article). States routinely offer companies subsidies of the sort that Indiana gave to Carrier. From John Kennedy, who publicly shamed steel firms in the 1960s, to Barack Obama, who bailed out car companies in 2009, all presidents have meddled in markets.

And Mr Trump's actions so far are not exceptional relative to his predecessors or by international standards. Britain's prime minister recently made undisclosed promises to Nissan, a Japanese carmaker, to persuade the firm to stay in Britain despite Brexit. The French government is notorious for brow-beating individual firms to keep jobs in France. The most egregious crony corporatists, from Russia to Venezuela, dish out favours to acolytes and punishments to opponents on a scale that would bring blushes even in Trump Tower.

Nonetheless, Mr Trump's approach is worrying. Unlike the Depression, when Hoover and then Roosevelt got companies to act in what they (often wrongly) saw as the national interest; or 2009, when Mr Obama corralled the banks and bailed out Detroit, America today is not in crisis. Mr Trump's meddling is thus likely to be the new normal. Worse, his penchant for unpredictable and often vindictive bullying is likely to be more corrosive than the handouts most politicians favour...

FRANCE RETURNS TO ITS CONSERVATIVE ROOTS: *DER SPIEGEL*

The nave of Église Saint-Lambert de Vaugirard is dark, with only the crypt bathed in yellow candlelight. Every Wednesday evening at 8:30, young Catholics meet here in Paris' 15th arrondissement for a prayer circle. The party headquarters of the Républicains, the conservative political party, are just 500 meters away.

The priest doesn't want journalists to ask questions in the church, and certainly not any that have to do with politics. "This is a private gathering, please go," we are told.

But some of the young men and women there do have something to say -- outside in front of the church walls. "I think François Fillon is a good choice," says Pauline, who has wrapped her thick blue scarf around her head. "I think he's credible, also on moral issues," says Marine, 29, who adds that she is opposed to gay marriage.

"Of course I voted for Fillon," mumbles a young man, his hair carefully parted on the side. "He is the only sensible choice for a Catholic," he adds, before turning up the collar of his overcoat and disappearing into the dark night.

With the choice of François Fillon two Sundays ago as the Republicans' candidate for next year's French presidential election, a France has spoken that is, at its core, much more conservative and Catholic than is readily apparent from the outside. They may be a numerical minority, but their concerns and aspirations are shared by many French.

Whether or not Fillon, the 62-year-old former prime minister with a predilection for bright red socks, will ultimately win the election, the Republicans' experiment with holding public primaries was certainly successful. Whereas the socialists surrounding President François Hollande are currently tearing each other apart, the upstanding Fillon has taken up the battle against the inflammatory Marine Le Pen, head of the right-wing populist Front National.

Fillon's success has caused a commotion in France's political establishment, and not just because it was so unexpected. The excitement primarily results from the widespread feeling that a long-time political vacuum has suddenly been filled.

France's center-right -- which spent years bickering over leadership questions, party finances and the constant escapades of former leader Nicolas Sarkozy -- is back. After losing the presidency to Hollande in 2012, the conservative camp lacked both leadership and ideas as it bumbled through the societal debates of recent years. But now it once again has a leader who seems to know the direction in which he would like to take the party.

Both the Républicains and their predecessor, the Gaullist party Union for a Popular Movement (UMP), long neglected the country's Christian conservative milieu. But it is a powerful element in French politics, something that the Front National and the identitarian movement have both recognized and profited from. Now, that milieu has propelled Fillon to a clear victory.

In a survey taken among the almost 3 million people who voted for Fillon, 72 percent said they come from a Catholic background. These voters look on disapprovingly when the country's highest administrative court, as it did in early November, rules that city halls in the country are only allowed to display pre-Christmas nativity scenes under certain conditions so as to maintain the separation between church and state. They don't want another president like Sarkozy, who unabashedly fumbled around with his mobile phone during an audience with the pope. Or a president like François Hollande, who rode his scooter to his lover's apartment and then provided journalists with intimate details.

An important factor in Fillon's success thus far is that conservative voters don't see him as someone who will engage in such antics.

Fillon, who went to a Jesuit high school and was once, at 27, the country's youngest member of parliament, has been married to the same woman for more than 30 years and has never kept silent about his Catholic roots.

In his book “Faire,” which can be loosely translated as “action,” Fillon emphasizes his religious upbringing: “I am Catholic. I was raised in this tradition and I have maintained this faith.”

Historian Denis Pelletier agrees that conservative Catholics have played a significant role in Fillon’s rise. Speaking with the French daily Le Monde, Pelletier defined this non-homogenous group as being efficient, extremely active on social media and quick to mobilize. He says one reason they are particularly active is that they feel as though they are a minority in the ongoing debate over the allegedly increasing Islamization of France. Of particular importance to these Fillon supporters, Pelletier says, is their feeling that they must defend themselves and their values.

Just a few weeks ago, this conservative bloc demonstrated the power it can exert on short notice. In mid-October, several thousand people took to the streets of Paris waving banners reading “I’m Voting Family in 2017.” At the concluding address in the Trocadéro neighborhood, participants -- including numerous families with small children -- waved pink and light-blue flags. It was a warning to the political class currently in office -- or, one could almost say -- a public threat.

The demonstration was organized by “Manif pour tous” (“Demonstration for all”), a movement that began in 2012 as a reaction to the planned introduction of gay marriage, a proposal known as “mariage pour tous.” It has since become a registered political party. Some 65 percent of the French support marriage between same-sex couples, but when the law -- known as “Loi Taubira” after the justice minister responsible -- came up for a vote, hundreds of thousands of people took to the streets to voice their disapproval...

A DALLAS PUBLIC PENSION FUND SUFFERS A RUN: *ECONOMIST*

Bank runs, with depositors queuing round the block to get their cash, are a familiar occurrence in history. A run on a pension fund is virtually unprecedented. But that is what is happening in Dallas, where policemen and firefighters are pulling money out of their city’s chronically underfunded plan, and Mike Rawlings, the mayor, is suing to stop them.

At the start of the year the fire and police pension fund had \$2.8bn in assets. Since then nearly \$600m has been withdrawn from the plan, of which almost \$500m has been taken out since August 13th. That is an alarming acceleration; in 2015 total withdrawals were just \$81m.

Even at the start of 2016, the plan was just 45% funded, and was expected to become insolvent within 15 years. When some workers take out their money, they get the full value of their benefits; leaving a smaller pot to be shared among the remaining members. (The city estimates that the funded ratio has fallen to 36% after the withdrawals.) As in a bank run, it seems rational to withdraw your money if you worry that all the benefits won’t be paid.

The crisis is the result of three linked issues: overgenerous pension promises; the flawed nature of public-sector pension accounting in America; and some bad investment decisions. In order to pay the generous benefits, the scheme counted on an investment return of 8.5% a year, absurdly high in a world where the yield on ten-year Treasury bonds has been hovering in a range of 1.5-3%. So the scheme opted for riskier assets in private equity and property. But the strategy did not work; the value of its investments declined by $263m in 2014 and $396m in 2015, thanks largely to write-downs of those risky assets.

It is not unusual for state and local-government pension schemes in America to be underfunded; the average scheme was 73.6% funded at the end of 2015, according to the Centre for Retirement Research at Boston College. A more conservative accounting approach, as is required of private-sector pension plans, would bring the ratio down further, to 45%.

But the Dallas fund has a particularly big problem. It operates a deferred-retirement option plan (DROP) which allows police and firemen who have qualified for retirement to keep working, while their benefits are kept in a separate account earning an interest rate that has been 8-10% a year. More than 500 Dallas DROP accounts are worth more than $1m; the average account is worth nearly $600,000.

In addition, since 1989, retirement benefits have been upgraded using an annual cost-of-living adjustment of 4%. The city estimates that benefits are now 15-20% higher than they would have been had they been upgraded in line with the consumer-price index. Together, the DROP plan and cost-of-living increases make up around half of the scheme's total liabilities.

There are only two possible solutions to the shortfall: put more money into the fund or cut the benefits. A 1984 referendum limits the maximum amount of city contributions—a limit that the city has reached this year. The 2015 scheme report suggested that total annual contributions to the pension fund would need nearly to double, from 37.6% to 72.7% of payroll, in order to close the deficit, and even that would take 40 years. The pension scheme has asked that the city make a one-off payment of $1.1bn in 2018, which the city says would require it to more than double property taxes. Both Fitch and Moody's, two ratings agencies, downgraded Dallas bonds in October, citing the pension issue.

Instead, the city has proposed a plan that involves rolling back some of the accrued cost-of-living increases and interest payments on the DROP accounts. But Sam Friar, the pension board's chairman, has called the proposal a "non-starter"; any attempt to reduce past benefits will almost certainly end up in the courts. As The Economist went to press, Mr Rawlings's suit was on hold while the pension fund's board was to consider whether to block withdrawals itself. But that would be a short-term solution to a crisis that has been building for decades and that is not confined to Dallas alone...

WHAT CHINA IS DOING ABOUT ITS 450 MILLION SQUARE METERS OF UNSOLD HOUSING: *WADE SHEPARD*

I'd like to introduce some of China's new ghost cities: Nanguan, Kerqin, Yuhong, Saihan, Yijinhuoluoqi, Dongling. They were uncovered by a Peking University study that used Baidu big data to find cities with large housing developments that the search engine's users just weren't going to very often. The rationale was that if nobody is going to these places then there is a good chance that they could be vacant — new "ghost towns" systematically built at the height of China's urbanization boom.

Although when I looked at the list of places something stood out. Besides having under-populated new areas these cities also have something else in common: nobody's ever heard of them before. Most are relatively small, relatively unimportant cities floating beyond the peripheries of China's main economic powerhouses.

When we talk of China's ghost cities we are no longer really talking about places like Shanghai's Lujiazui, Guangzhou's Zhujiang, and Zhengzhou's Zhengdong New Area, who were once the recipients of international mockery for being under-populated. For the most part, these places have filled up and have become the economically vital engines they were envisioned to become -- even Ordos Kangbashi now has 100,000 people. The places we're focusing on now as having gluts of unsold homes are mostly diminutive new developments that were built by relatively minor cities. Oftentimes, these places are dusty, obsolete mining towns in the north of the country that are trying to develop new industries to become anything other than dusty, obsolete mining towns.

That said, there is a big difference between empty apartments that have been sold and unsold inventory. Purchased housing that's empty for the short term — as is very common in China — isn't a sign of any kind of economic calamity: the developers got paid, the local government collected their land sale and tax revenue, investors were often able to resell properties for a higher price than they paid. Beijing itself is technically 20% empty. But in China, just because an apartment is empty doesn't mean it's not being used. Vacant property in this country takes on multiple functions, from being a place to store savings to being a future home for offspring to move into when they get married, to a degree that's unprecedented in the West.

Although there are also real ghost towns in China. According to the National Bureau of Statistics, the country currently has 450 square kilometers of unsold residential floor space, which is nearly enough to completely blanket Boston twice. This is an issue that has shot straight up to the country's highest echelons of power.

President Xi Jinping himself has declared the excess inventory of residential property one of the country's "four battles of annihilation" that need to be won in order to for the economy to continue progressing, and the destocking of unneeded housing has become a national priority.

So what will China do about all of its unsold homes?

A real estate developer in Heyuan, Guangdong province recently made headlines by tearing down 100 villas that remained unsold for a decade. While the cost of this demolition was reportedly upwards of $18 million, this allows the developer the opportunity to build something else that can actually be salable in their stead.

When we look at the recent wave of new city building that has overtaken China in the past fifteen years what we essentially see is a rough draft of urbanization. By law, developers cannot just sit on the land they buy and wait until a new area is built-up and the market matures around it. No, they must build something almost immediately — it is called urban construction land for a reason. As they take out freehold leases on residential land for 70 year periods and the buildings themselves hardly last half this long, developers essentially have multiple attempts to build something that can ultimately make a profit.

So when we look at China's seas of empty apartments rest assured that if they don't sell they will be knocked down and something else will be built in their place before crumble to ruins. Development land in China is just too valuable to allow unprofitable buildings to interminably take up space.

Municipalities and developers in China are very aware of their unsold housing stock and are often willing to take measures to remedy major imbalances. One of the ways they do this by applying simple supply/demand theory: the less new residential properties going on the market the higher the demand for the available stock.

Local municipalities in China control how much new land they make available for new residential constructions and developers can decide whether it's in their interest to add to the existing housing stock or to hold off and sell what they already have. The big, unchecked urbanization boom in China is now over, and in places that currently have an excess of unsold housing we're seeing a drastic cutting back of new inventory being added to the market.

I remember the ominous words of a property developer that I once met in Nanhui, a new city that was built to support the Yangshan Free Trade Zone 60 km outside of Shanghai. I asked him how he would fare in the event of a catastrophic crash in the property market, to which he replied, "Don't worry, the government will take care of it. The government will lose a lot of money but we will be fine."

In many ways China has a contrived economy. Municipalities, the banks, and many companies are all run by the same organization: the Communist Party of China.

So when we talk about things like debt it doesn't really mean the same thing as it does in the West. The communist party is also an organization that tends to value what it perceives as long term stability over short term profits, and they are often more than willing to bail themselves out — especially when it comes to the real estate market that so many of the country's other industries depend on.

Guangdong province is currently in the process of enticing some large state-owned enterprises to buy up a large amount of its unsold housing stock, according to the SCMP. Over the next three years, Guangzhou has committed to reducing its unsold commercial housing by 20 million square meters through a program that will see unsold apartments being converted into public rental housing...

CHINA'S LIQUIDITY FLOOD STIRS MEMORIES OF THE MONGOLS AND MAO: *FT*

When Marco Polo went to China he discovered something better than alchemy. Rather than turning base metals into gold, he marvelled that the Chinese were creating money out of paper. But what the 13th-century Venetian traveller could not know was how perilous a paper currency would prove for the country that invented it.

At intervals in their history, Chinese rulers have succumbed to the temptation to pay off spiralling debts simply by rolling the money printing presses. Inflationary scourges ravaged dynasty after dynasty, with both the Mongols and Mao Zedong's Communists seizing power in a country eviscerated by depreciated paper.

Such episodes sound uncomfortable echoes for Beijing as it wrestles to control its latest bout of monetary exuberance. The current tussle to ward off a financial crisis pits the world's most powerful authoritarian system against the propensity of money to resist control as it seeps and flows like water through unattended apertures.

China's problem this time is not inflation, at least not yet. It is rather that Beijing has again sent its printing presses into overdrive, creating what is almost certainly the biggest pool of domestic liquidity in history to help stimulate its economy and finance a crushing debt burden. The danger is that if the renminbi loses value internally or gushes out of China, a wave of unpaid debts could precipitate a crisis.

The dimensions of China's liquidity splurge are startling. Ousmène Jacques Mandeng, formerly with the International Monetary Fund, has calculated that between 2007 and 2015 China created 63 per cent, or $16.1tn, of the growth in the world's supply of money.

China now has more money coursing through the arteries of its economy than the eurozone and Japan combined — and almost as much as the US and the eurozone combined. Since the financial crisis, commentators have focused on the efforts of US, European and Japanese central banks to print money through "quantitative easing", but China's output has eclipsed them all.

Marco Polo would have been impressed. He noted with awe China's capacity to print off as much money as it needed: "It may certainly be affirmed that the grand khan has a more extensive command of treasure than any other sovereign in the universe".

But for China's modern rulers, the effusion of liquidity presents as many problems as it promises to resolve. The main issue is that debts are piling up almost as fast as China generates money to service them, creating what Jonathan Anderson of the Emerging Advisors Group calls a "debt funding bubble".

In his analysis, China's crunch point will come when there is a disruption in the supply of money needed to pay total debts that amount to about 250 per cent of China's gross domestic product, the highest level among any large emerging market.

Mr Anderson sees peril mainly in the form of a "madcap proliferation" of flaky financial institutions that lend out money they have raised by issuing debt. The potential for something to go wrong is considerable among a "chaotic hodgepodge of banks and non-banks" that are fuelling China's credit boom.

Officials also see another source of vulnerability. They fear that Chinese corporations and citizens will decide en masse that they would be better off taking their money abroad to buy companies or invest in gold, stocks or real estate. Such capital flight could sap the liquidity that is required to keep China's bubble from popping.

These concerns explain Beijing's plans to restrict outbound foreign investment. People familiar with the plans told the Financial Times that China intends to scrutinise acquisitions of overseas companies costing more than $1bn if they are outside the investors' core business scope. Meanwhile, state-owned enterprises will not be allowed to invest more than $1bn on a single real estate transaction abroad. Gold purchases are also being curbed.

With outbound investments from Chinese corporations running at $150bn in the first 10 months of this year, up from $121bn last year, such outflows are increasingly being seen as part of a complex of problems that have also driven down China's stockpile of foreign exchange reserves from almost $4tn in early 2014 to $3.12tn in October.

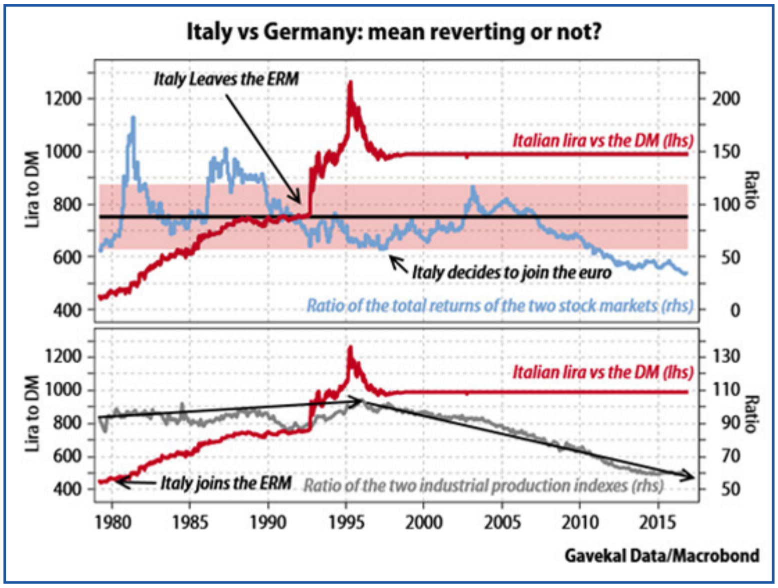
Outflows of even as much as $1tn may not seem too debilitating when set against China's proven capacity to generate plentiful supplies of money. But the fact that Beijing is taking action reveals the knife-edge upon which Chinese policymakers are balancing.

So engorged with easy money have they become that Chinese banks are on average four times larger today than they were just eight years ago. But riskier still is the fact that several of its midsized banks rely for funding on so-called wholesale operations — a euphemism for issuing debt to re-lend.

The folly inherent in such a form of alchemy has been understood for at least 800 years. Ye Shi, a Song dynasty adviser, warned that issuing "kongqian" — or "empty money" that is not backed by assets — would stoke inflation and reduce people's incomes. His emperor did not listen, triggering economic chaos that enfeebled China before the Mongol invasion...

PUTTING THE BOOT INTO ITALY: *CHARLES GAVE*

Matteo Renzi has joined a long line of Italian prime ministers who failed to "reform" their country. This is another way of saying that he could not wave a magic wand and make Italy competitive with Germany. The grim reality is that no Italian leader stood a chance of changing their country once the fateful decision was made to peg its currency to Germany's. At the time of the euro's launch in 1999, I argued that the risk profile of Italy would change from being an economy where there was a high probability of many currency devaluations to the certain probability of eventual bankruptcy. Sadly, that moment is not so far away.



The chart [right] tells the story of Italy's recent economic history in two parts, namely, (i) March 1979 to March 1999, and (ii) March 1999 to the present. Italy joined the Exchange Rate Mechanism in 1979 at 443 lira per deutschemark, yet by 1990 frequent devaluations meant that rate had slid to about 750 lira. By the early 1990s, the Bundesbank was overseeing a newly unified German monetary system and in order to fight inflation it had driven real interest rates to 7%. By September 1992 the stresses on the system caused the UK, Sweden and Italy to exit the ERM, which meant another huge currency devaluation, pushing the lira as low as 1250 against the deutschemark, but delivering a huge tourist boom to boot.

Still, from 1979 to 1998 Italian industrial production outpaced that of Germany by more than 10%, while Italian equities outperformed German equivalents by 16% (this indicates that Italian firms were earning a higher return on invested capital than those in Germany).

Then came the euro. By 2003 it was clear that Italy was uncompetitive and subsequently, Italian equities have underperformed German equities by -65%, reversing the previous half century's pattern when Italian equities outperformed on a total return basis. Similarly, since 2003 Italian factory output has lagged Germany's by 40%.

The diagnosis is simply that Italy has become woefully uncompetitive, and as a result, is not solvent. This much is clear from the perilous state of its banking system, which is always the outcome when banks lend to firms that have been rendered uncompetitive by some reckless central banker. Short of imposing Greek-style slavery on Italy, there is not much hope of solving the problem, but I rather doubt that the Italian electorate will be as patient as its neighbours across the Ionian sea.

As such, the relationship between Italy and Germany is radically different from that in the 1945-99 era when a natural return toward equilibrium was achieved through exchange rates adjustments. The only possibility on the current trajectory is that the Italian and German economies keep diverging, which is why a "normal" resolution cannot be achieved.

Hence, an Italian sovereign default of some variety is now a near certainty. While a central bank can address a liquidity problem, it cannot fix a solvency issue, especially one as large as Italy's. The only remedial action that can now be taken is to throw good money after bad, which is exactly what I expect Mario Draghi to do, especially as he played such a key facilitators' role in getting Italy into the euro system in the first place. Such actions – possibly to be announced on Thursday at the European Central Bank's policy setting meeting – can of course merely postpone the day of reckoning, but will solve absolutely nothing.

The rational approach for investors is to shun Italian financial assets such as bank equities or government bonds until such time as exchange rates are once again market determined prices. This has to be the most well-telegraphed, and now inevitable, national bankruptcy that I have seen in my 45-year career. There is no reason to be dragged under the steam roller as there are many other markets and assets to play in...

NOMURA HAS 10 'GRAY SWAN' RISKS THAT COULD ROIL MARKETS IN 2017*: BLOOMBERG*

Markets' black swans are rapidly turning gray.

Brexit, the election of Donald Trump, and a faltering bull market in bonds have all helped elevate analysts' 2017 tail risk predictions from the status of colorful festive reading to a cause for sleepless nights.

Things that make you go hmmm

Analysts at Nomura are the latest to throw their hat in the ring — warning investors to be prepared for "unlikely but impactful events" including the possibility of capital controls in emerging markets, a long-elusive pick-up in Japanese inflation, and a Federal Reserve at loggerheads with the U.S. government.

"Needless to say, none of them are our base case," the analysts caveat. Of course, investors scarred by the turmoil of 2016 know that doesn't necessarily mean that they won't happen.

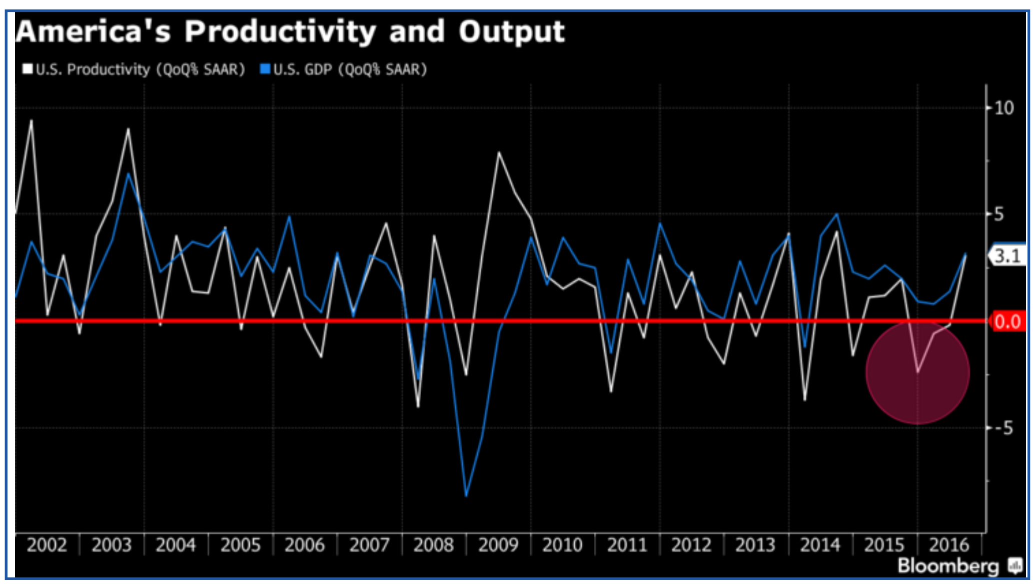
Here are Nomura's 10 events that could end up roiling your 2017.

1. Russia on the warpath

A staple of gray swan lists since Vladimir Putin's annexation of Crimea two years ago, Russian military aggression in eastern Europe remains one of the big risks for 2017. While an actual military invasion is unlikely, the foundations may be laid next year through anything from changes to U.S. foreign policy to the election of populist leaders in Europe, according to Nomura. Position for risk by going long credit-default swaps of any of the Baltic nations, shorting credit and trading Poland as a negative proxy.

2. A surge in U.S. productivity

As Fed officials make the case that the president-elect's fiscal stimulus should be targeted at increasing productivity, Nomura says a pick-up in research and development investment could already be laying the groundwork. Like the tech boom of the 1990s it would catch forecasters unaware, but could have implications ranging from a faster series of rate hikes to a sustained boost to equities if it materializes.



3. China floats the yuan

As recent outflows suggest, a balance-of-payments shock could follow hasty moves to liberalize the currency regime of the world's second-largest economy. The probability China gets to that goal in the next 12 months is "very low," Nomura analysts assert, but prepare for yuan weakness if it happens.

4. An exit from Brexit

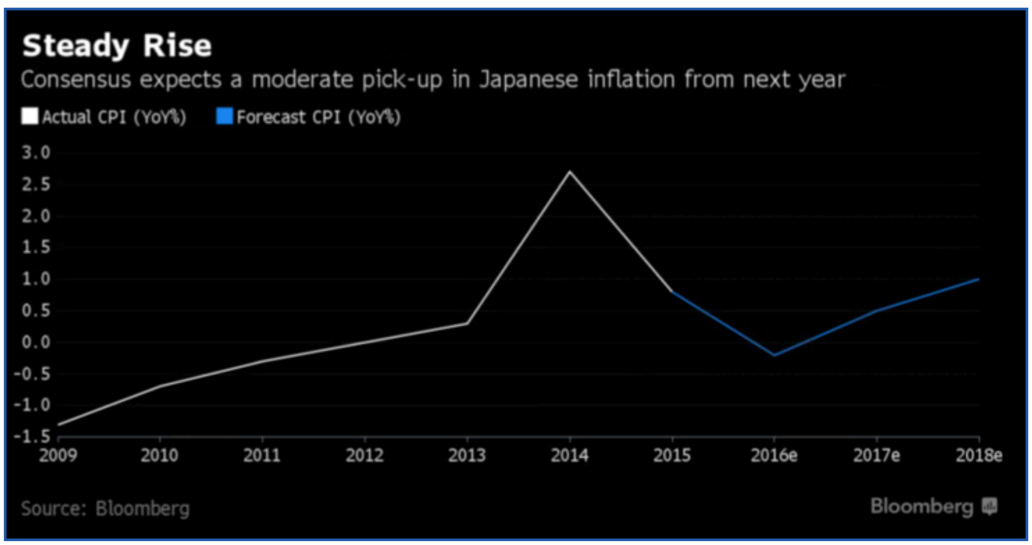
U.K. Prime Minister Theresa May said she'll trigger the process of leaving by March of next year, and her favored "Brexit means Brexit" catchphrase makes it sound like she means it. But there are two big upsets that could appease the 48 percent: the case being heard by the U.K.'s Supreme Court might trigger a general election, were it to galvanize pro-EU sections of parliament, while — in an attempt to assuage further break-up — the EU could also grant the country face-saving concessions.

5. Capital controls in emerging markets

Emerging markets may face "pronounced outflows" in 2017 if Trump's planned stimulus spending sends U.S. yields higher and further strengthens the dollar. That could prompt policy makers to take action, and they might even coordinate in a collective rebellion against the U.S. Countries most at risk are those with volatile currencies, low currency reserves and relatively low rates.

6. Japanese inflation jumps

What if the market is wrong to price in a moderate pick-up in Japanese inflation next year? A sharp rise — potentially triggered by the collision of higher oil prices and a weaker yen — could prompt the Bank of Japan to take action by lifting its 10-year yield target of zero percent. Such a shift could have a global impact because both inflation and global core bond yields are highly correlated.



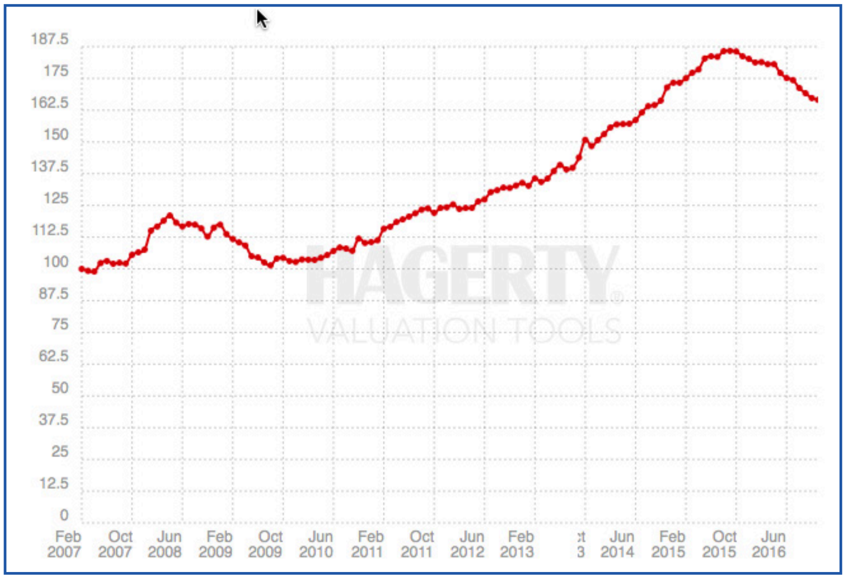
7. A clearing house crisis

The systemic risks that stem from the clearing houses that were themselves introduced to contain systemic risks aren't new to regulators: financial stability watchdogs are already taking measures to deal with any potential fallouts. "The interplay between struggling banks, collateral squeezes, sharp market moves in an overpriced market with central counterparties at the center" could potentially lead to a crisis, in Nomura's worst-case scenario...

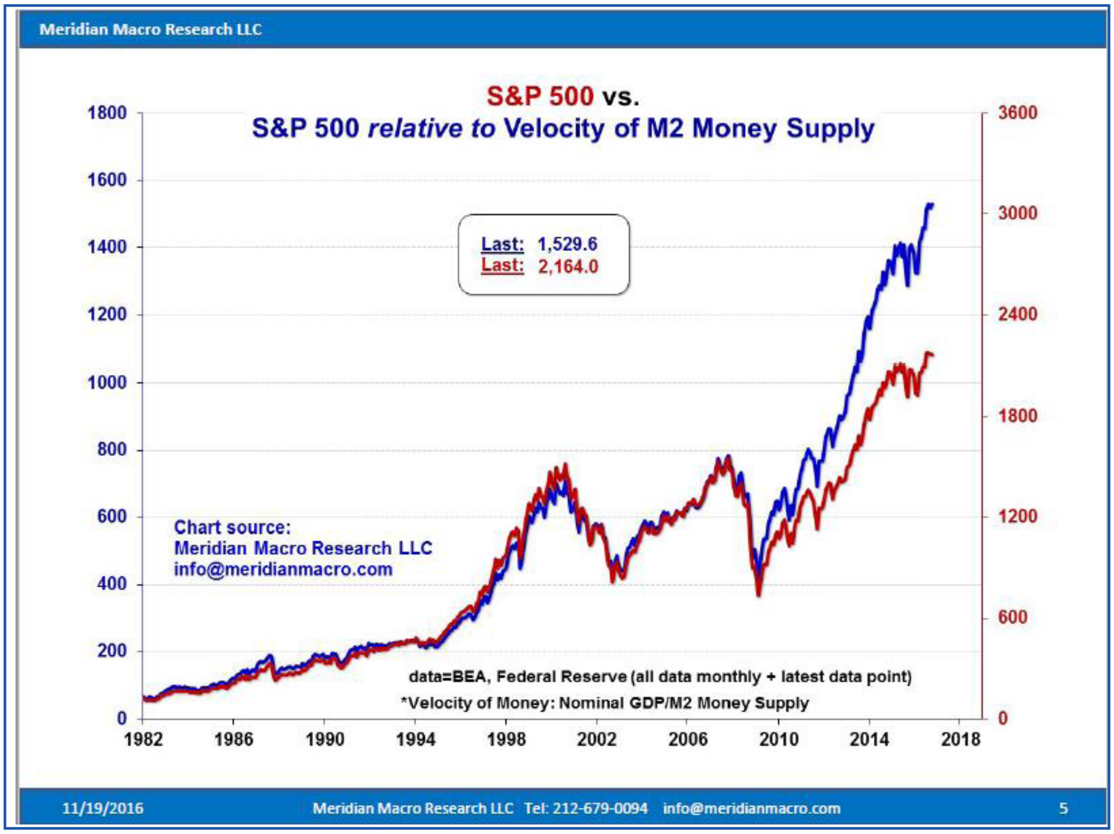
CHARTS THAT MAKE YOU GO HMMM...

The Classic Car market has been under pressure for 18 months now. Here is a look at the latest report from Hagerty:

> ***The Hagerty Market Rating experienced a very minor decrease of 0.02 points, falling to 66.89. Although slight, this is the rating's fourth consecutive decrease, and continues the gradual slowdown we have seen since May 2015.***
>
> ***Largely thanks to the change in date for Barrett-Jackson's Las Vegas sale, auction activity actually rose for November. Otherwise, all but one of the metrics that make up the Hagerty Market Rating are down for November and all of them are down significnatly over the last 12 months.***
>
> ***Average sale price on the private market is down 8 percent over the last 12 months, although public sale prices haven't dropped as much. Hagerty Price Guide values for average #3 vehicles have only risen by 1 percent over the past year.***
>
> ***The number of insured value increase requests for both broad market and high-end cars continues to fall, confirming the basic trend being recorded in sale prices.***
>
> ***Expert sentiment dropped after a slight increase last month, and is now the lowest it has been since 2010. Most observers, however, report that the market is still increasing overall, just at a very low rate.***
>
> ***October's reported rating was revised from 67.27 to 66.91 due to newly released inflation numbers.***



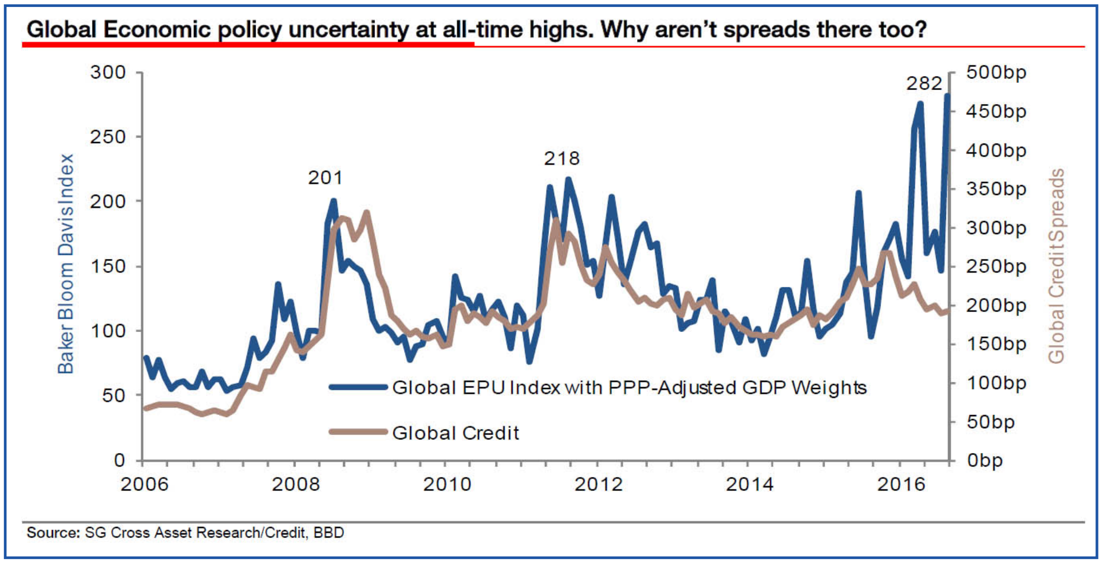
Market Index	Value	Date
Current rating:	166.56	Nov 2016
All-time high:	185.86	Sep 2015
Five-year high:	185.86	Sep 2015
Five-year low:	123.61	Feb 2012
1-month change:	-0.71	Oct 2016
12-month change:	-17.15	Nov 2015
36-month change:	+18.18	Nov 2013
60-month change:	+42.57	Nov 2011



This spectacular chart comes via two of my favourite analysts; Paul Brodsky of MAI and Eric Pomboy of Meridan Macro. Paul uses Eric's chart demonstrating asset price misallocation in his most recent piece '*The Grift*'

> ***...This sets up Eric's stunning final graph (Graph 5 below). As he explains: "we wanted to determine just how far asset prices (represented by the S&P 500) have de-coupled from economic activity (represented by the velocity of money). We overlay the S&P with an S&P / Velocity of Money ratio. As the chart shows, there is a very tight historical relationship between stocks and the velocity of money as they move together during the ebb and flow of economic cycles. This relationship held firm…right up until the 2009 market bottom and has completely broken down since. In sum, the chart shows a record gap between asset prices and economic activity."***
>
> ***The gap separating the blue and red lines in Eric's graph above implies the degree to which capital markets are not forming capital or producing sustainable wealth. It cannot exist in perpetuity. US equities are currently very negatively convex; they will fall much more than rise given an equal change in underlying economic activity. On a purely objective risk/return metric, US equities seem to be a great secular short.***

LINK



Global Economic policy uncertainty at all-time highs. Why aren't spreads there too?

Source: SG Cross Asset Research/Credit, BBD

"I sometimes feel like 'The Grim Reaper', scouring the research savannah in a ghoulish quest to harvest bad news with a forceful sweep of my scythe. Imagine then my perverse delight when our credit team produced what is one of the scariest charts I have seen for a very long time. Markets shrugged off the Brexit vote in a couple of days. They shrugged off Donald Trump's election in a single day. They shrugged off the Italian Referendum result in a couple of hours. Heck, in this mood they would shrug off an alien invasion of planet Earth. But global political risk is now at such elevated levels that investors must surely be on another planet."

- Albert Edwards

Has the reflationary blow to bond markets from "Trumpflation" and the euphoria in global equities tempered Soc Gen's Albert Edwards' decades long "Ice Age" bearishness? Not a chance, as he explains in his latest note "Presenting our credit team's most frightening chart". In contrast, Edwards admits to the "perverse delight" at his discovery of the aforementioned chart which reassures him that global risk is at such elevated levels that "investors must surely be on another planet."

While our take has generally been that it's central bankers that are on another planet - the rest of us merely forced to play on it - we know what he means.

The chart above was created by Edwards' colleague in EM credit, Guy Stear, who the former describes as "unlike this author he is a normal, well-adjusted person not prone to uncontrolled outbursts of bearish hyperbole. And people actually like him!" It shows the comparison between Global Economic Policy Uncertainty (EPU) and Global Credit Spreads.

Along with global credit spreads, the EPU peaked in 2008 and 2011, but the correlation has broken down.

LINK

Things that make you go hmmm

WORDS THAT MAKE YOU GO HMMM...

A fantastic interview with Michael Lewis as he discusses his new book 'The Undoing Project' which looks at the lives and work of famed psychologists Daniel Kahneman and Amos Tversky.

After a captivating discussion about the incredible work of thse two legendary observers of the human mind, Michael offers a few thoughts of his own on President-elect, Donald J. Trump...

CLICK TO WATCH

For those of you who haven't subscribed to Real Vision (and those of you who have but who missed this), here is a chance to watch a group of experts (and yours truly!!) discuss the effects of Donald Trump's surprise election victory on a variety of different areas of global financial markets.

Watch Paul Krake on Asia, Raoul Pal on currencies, Julian Brigden on the bond market, Pippa Malmgren on geopolitics, Marcus Ashworth on Europe and me on central banks all in one video...

CLICK TO WATCH

I was recently extremely flattered to be asked to join Preston Pysh and Stig Broderson on The Investors Podcast.

In a wide-ranging discussion, we touched on the possible end of the bond bull market, gold, the importance of position-sizing, the potential for a (re)distribution of wealth and we even had enough time for the Dynamic Due to entice me into disagreeing with a couple of investing legends!

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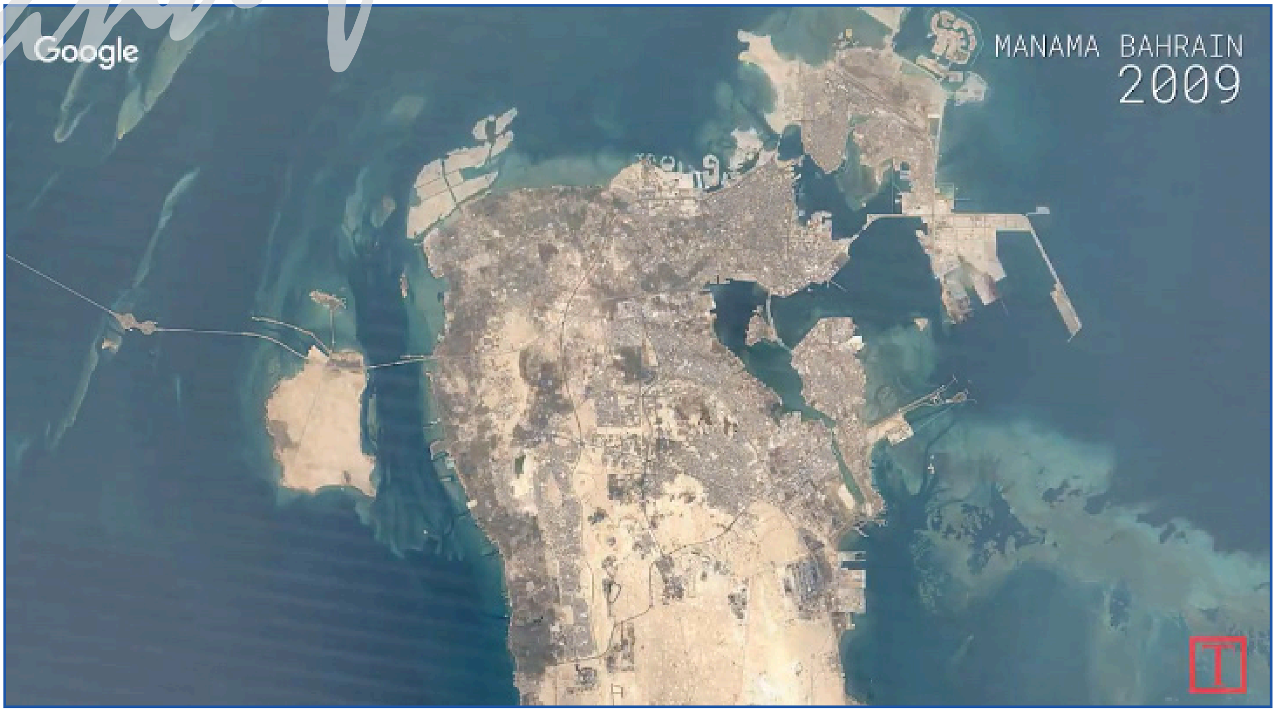
AND FINALLY...



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Since 1972, the Landsat satellites—a rotating fleet of four different spacecraft—have been circling the Earth and scanning the surface for the incremental ways the human population is changing the only home it's got. They've been aided since 2015 by the European Space Agency's Copernicus Program and its Sentinel-2A satellite.

In the years all of the satellites have been flying they've taken millions upon millions of high-definition images, which NASA and the U.S. Geological Survey (USGS) have collated and assembled into something of a flip book that reveals the slow but steady alteration of our world. What the two science agencies started, the folks at Google have finished, turning the usually choppy, sometimes-hazy images into smoothly streaming videos, revealing decades of topographic changes in 10-second sweeps...

About The Author

Much to his chagrin, Grant Williams has reached 30 years in finance.

Over that period, he has held senior positions at a number of investment banks and brokers including Robert Fleming, UBS, Banc of America and Credit Suisse in locations as diverse as London, Tokyo, New York, Hong Kong, Sydney and Singapore.

From humble beginnings in 2009, *Things That Make You Go Hmmm...* has grown to become one of the most popular and widely-read financial publications in the world.

Grant is a senior advisor to Vulpes Investment Management in Singapore and also one of the founders of *Real Vision Television*—an online, on-demand TV channel featuring in-depth interviews with the brightest minds in finance.

A regular speaker at investment conferences across the globe, Grant blends history and humour with keen financial insight to produce unique presentations which have been enthusiastically received by audiences wherever he has traveled.

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