ROSELINE CAPITOL ADVISERS
THIRD QUARTER 2017 MARKET PERSPECTIVE

Asset Class/Index	Q3 2017	YTD 2017	Asset Class/Index	Q3 2017	YTD 2017
US Equities			**Fixed Income**		
S&P 500 Index	4.48%	14.24%	US Treasury Bonds (GOVT)	0.33%	2.12%
NYSE	3.80%	10.42%	Investment-Grade Corp. Bonds (LQD)	1.39%	5.39%
NASDAQ	5.79%	20.67%	Low Quality Corporate Bonds (JNK)	1.66%	6.23%
Equal-Weight Indices			**Precious Metals**		
Value Line Geometric	3.18%	6.55%	Gold Bullion	3.08%	11.17%
Economically-Sensitive Indices			Silver Bullion	0.15%	4.72%
Dow Jones Transportation Index	3.67%	9.62%	Precious Metals Miners (GDX)	3.99%	9.75%
Hedged Equity Benchmark Index			**Commodities**		
HFRX Equity Hedge Index	3.21%	7.07%	Blooomberg Commodity Index	2.25%	-3.49%
International Equities			**Currencies**		
MSCI EAFE (Developed Markets)	5.40%	18.23%	US Dollar (DXY)	-2.66%	-9.20%
MSCI Emerging Markets	7.89%	25.42%	Euro (FXE)	3.28%	11.58%
			Japanese Yen (FXY)	-0.19%	3.45%

Sources: Kitco, Google Finance, Standard and Poors, HFR, StockCharts.

Data as of September 30, 2017.

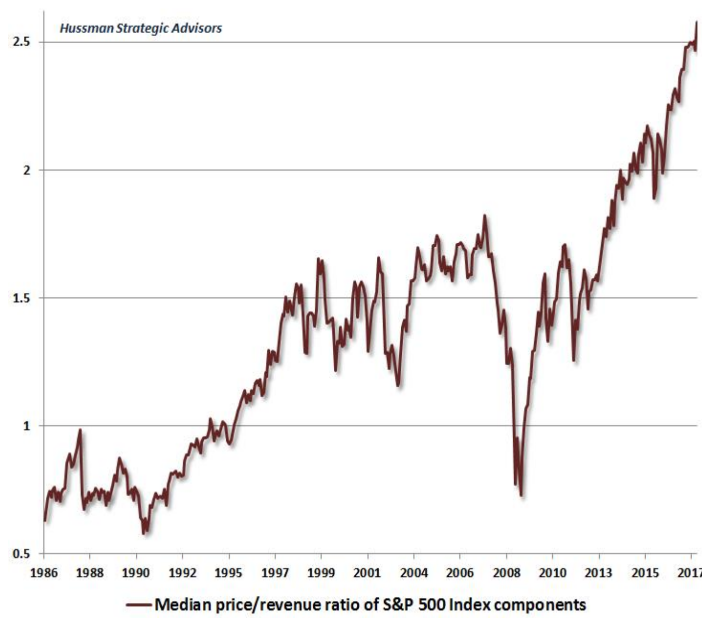
Quantitative Tightening and the End of Expansionary Monetary Policy

The Federal Reserve stopped creating new money more than two years ago. Since December 2015, it has lifted the funds rate by 100 basis points from zero percent.

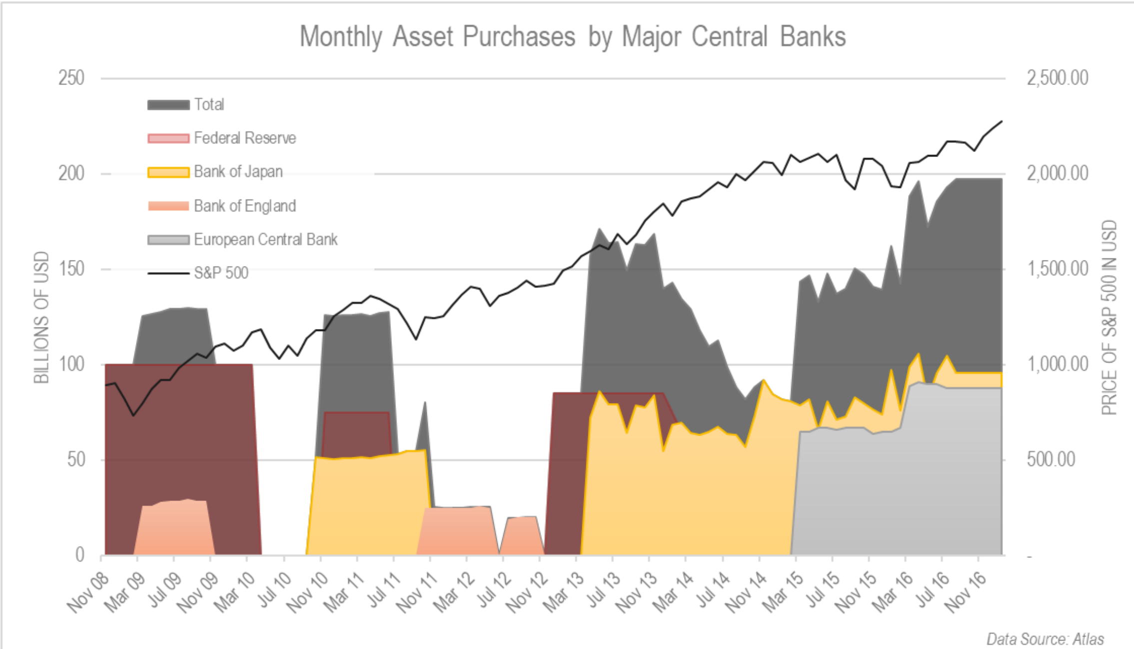
However, the Bank of Japan and Bank of England picked up the Fed's slack and continued printing. Global central bank money-printing reached a record level in the first half of this year (about $200 billion per month), exceeding printing during the 2009 financial crisis.

Despite these extraordinary efforts, reported core inflation generally remains below target levels, and yields are at historic lows. The longer expansionary monetary policy lasts, the greater the chance of overvaluation and intense price corrections.[1] And as expansionary monetary policy winds down, there remains little insurance against another crisis.

At right: the price of the median stock in S&P 500 relative to revenues is by far the highest in history.



The following chart overlays the path of the S&P 500 with liquidity creation by the global central banks.

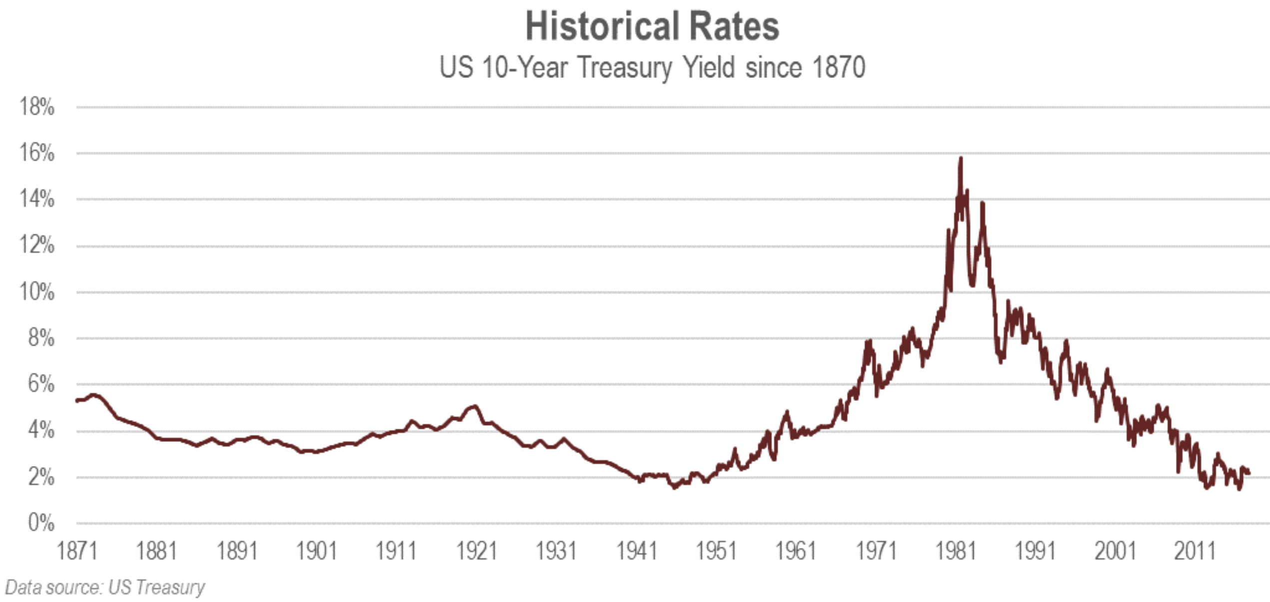


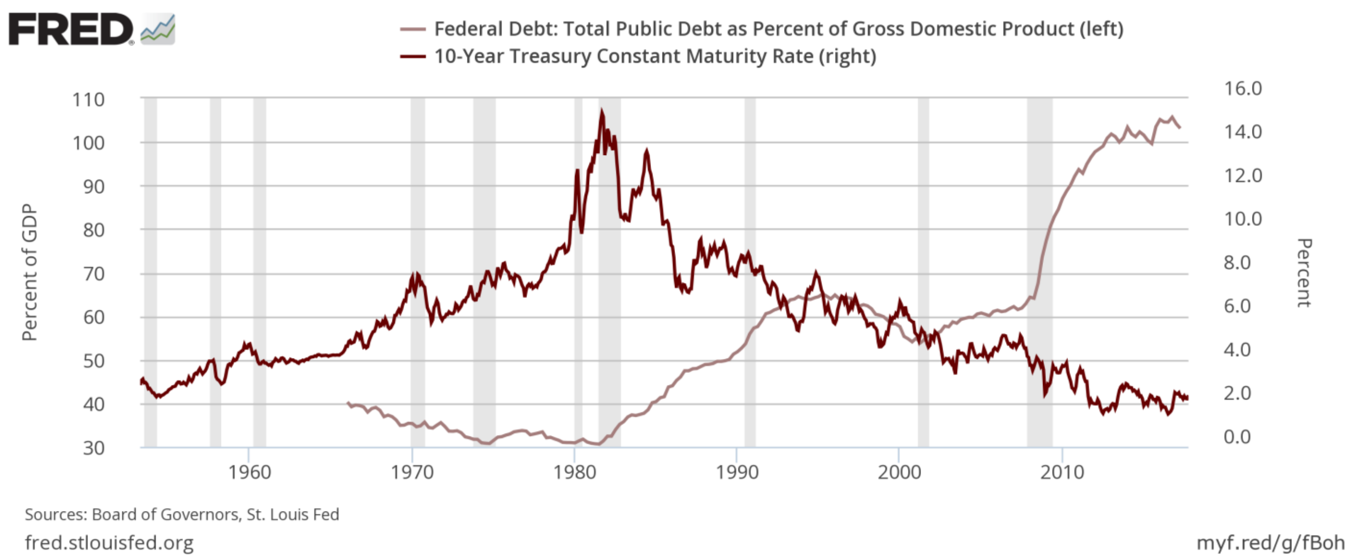
The Fed has formalized its schedule to reduce its $4.4 trillion balance sheet and, beginning in October 2017, will reverse the stimulus measures it has implemented since 2008. This entails not only continuing to raise rates, but reducing the balance sheet by $30 billion in 2017, $420 billion in 2018, and $600 billion per year thereafter.

Nov. 2008	QE 1 begins
Jun. 2010	QE 1 ends after Fed balance sheet reaches $2.1 trillion
Nov. 2010	QE 2 begins
Jun. 2011	QE 2 ends, maintaining $2 trillion balance sheet
Sep. 2011	Operation Twist begins, intending to lower interest rates
Sep. 2012	QE 3 (unlimited QE) begins
Oct. 2014	QE purchases stop after accumulating $4.5 trillion in assets

Along with the Fed's quantitative tightening, the European Central Bank's Mario Draghi is under intense pressure to reverse its programs. Not only are the Eurozone countries discontented with unprofitable levels of interest rates, but it is also likely the ECB will soon run out of bonds to purchase. This month, the ECB announced that it will gradually scale back its asset purchases, potentially bringing its holdings down from €4.4 trillion to €2.6 trillion by the end of 2018. Zero interest rates remain unchanged.[2]

The result of this long period of low global interest rates is the threat of debt explosion for governments, corporations, and consumers. Global debt levels (in relation to GDP) have increased since the 2007-2008 financial crisis, raising financial stability risks. The longer yields are restrained at historical lows, the more complicated and severe can be the readjustment to "normal" levels.[3]



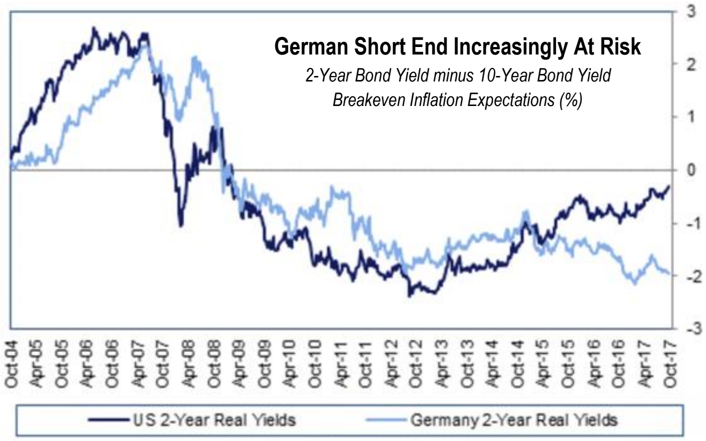


The reason for the financial volatility many see on the horizon is global liquidity reduction, according to Kyle Bass of Hyman capital.

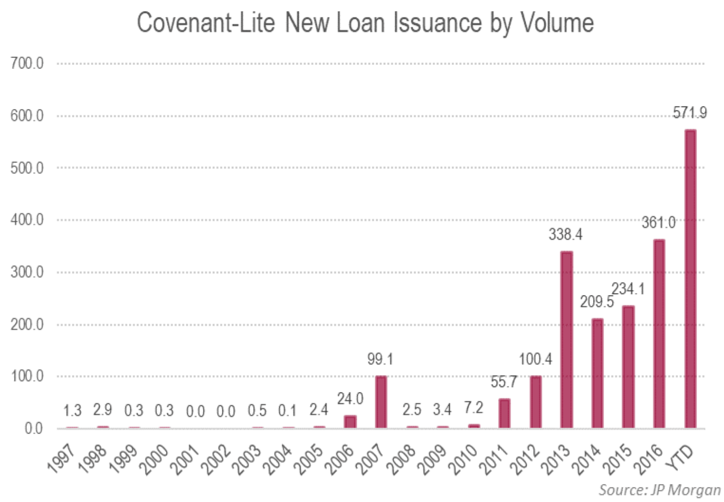
> *"The financial reason is the G4 central banks going from a period of accommodation to a period of tightening, net of bond issuance. It's important to think about accommodation going from half a trillion dollars of accommodation in 2016, to one trillion dollars worth of a draw in 2018 (or more, depending on how the ECB tapers).*
>
> *That will have a profound effect on various asset markets. That will have a profound effect on volatility, when you have a trillion-and-a-half dollar swing of capital coming out of markets in a two-year period. That, in itself, is worthy of spending a lot of time on as you think about asset allocation… Volatility is not going to stay at realized levels of 8 or 9 [percent] in a trillion-and-a-half dollar reversal of accommodation.*

With yet-unrelieved pressure on the European Central Bank, either German real yields need to rise, or these low euro-area yields may cause interest in the euro to decline further.

A critical consideration is the fact that approximately 75% of all corporate debt issuance is now "covenant-lite". Covenant-lite loans are leveraged loans absent traditional investor protections: borrowers face less restrictions on collateral, payment terms, and level of income.



Source: BMI, Bloomberg



The volume of covenant-lite loan issuance in 2017 (so far) increased 58% above the issuance total of 2016, and 170% above issuance totals of three years ago.

In the third quarter of 2017, the quality of high yield covenant loans hit an all-time low.[4]

We have to expect that when stocks do break down hard, central banks will have little option other than to bring interest rates back to zero. Quantitative tightening must reverse back to quantitative easing. QE 4 will be a last resort, and an embarrassing admission of defeat for the Federal Reserve.

From John Hathaway of Tocqueville Asset Management, on the effects of quantitative tightening:

> *Unsound monetary policy is the most important driver of our gold thesis. The exit from radical monetary policy will be difficult, if not impossible. On this point, we recently had an off-the-record conversation with a former governor of the Fed, who wholeheartedly agreed with this assessment.*
>
> *Gold is an efficient hedge against the real possibility that the Fed will be unable to exit its super-easy stance without triggering significant disruptions in financial asset valuations, imperiling already weak economic momentum, and destroying any pretense of fiscal sanity. A 1% rise in interest rates increases the federal deficit by 25% to 3.9% of GDP. The fiscal vulnerability is underscored by the fact that 50% of the debt matures in less than three years.*
>
> *The US debt-to-GDP ratio is now 106%, a level that has historically been economically destabilizing to other countries and that has often led to blatant monetary printing and currency destruction. It is not just a U.S. problem, world-wide global debt burdens are sufficiently high that only small rate increases are required to inflict significant economic and market damage.*[5]

Sources:

[1] Ewing, Jack. "As European Central Bank Eases Emergency Measures, Risks May Lurk". The New York Times. 25 October 2017.

[2] The Economist. "The European Central Bank starts its exit from quantitative easing". 26 October 2017.

[3] Kollewe, Julia. "Growing risk of 'debt trap' if interest rates stay low, say central bankers". The Guardian. 17 September 2017.

[4] S&P Global Market Intelligence: LCD News. "Covenant Quality Trend, Monthly". 30 October 2017.

[5] Hathaway, John. "Tocqueville Gold Strategy Third Quarter 2017 Investor Letter". Tocqueville Asset Management. 11 October 2017.
