Abbington Investment Group, LLC

Quarterly Market Commentary

The Investment Case for Real Assets

July 2017

Dear Clients, Friends and Family:

In the following few pages, we plan to revisit a theme we first covered in January 2016. Back then, following a climactic sell-off in mining and commodity related stocks, we believed important investor capitulation was taking place. Since then, the aggressive move off those early 2016 lows in mining stocks and commodities has largely held (see Chart 1).

Chart 1: MSCI World Metals and Mining Index

Source: FullerTreacyMoney.com

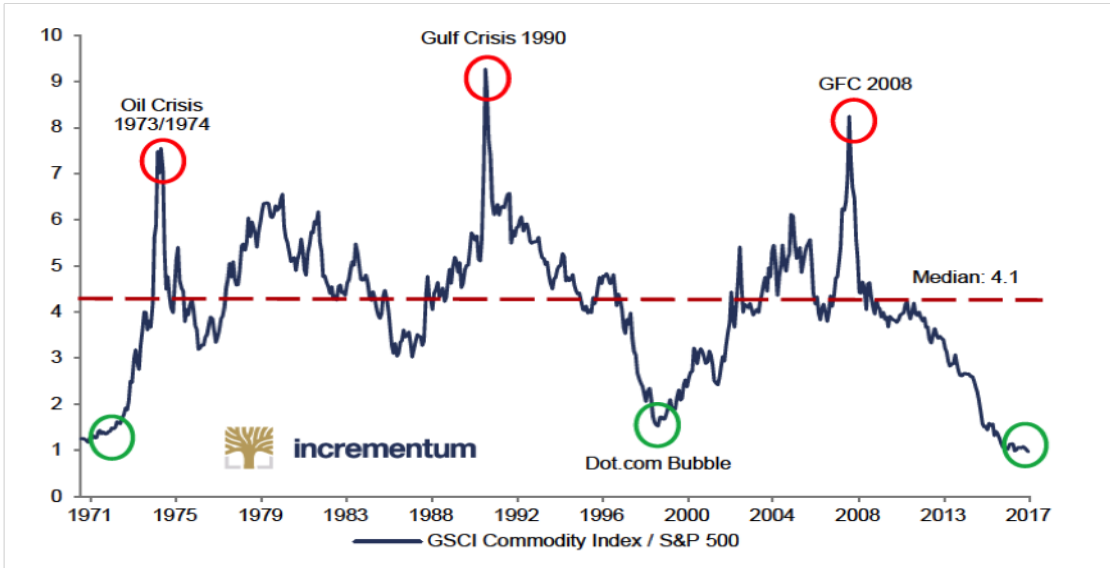
This brings us to today, when we again see many investors divesting from real assets. Their reasons for doing so include a belief in a stronger $US (a stronger $US is considered to be a negative for commodity markets), the ending of Central Banks' monetary accommodation and the perception of ample supply, relative to demand, in important markets such as oil.

In the following few pages, we will explain why we wish to swim against this investor flow by outlining why we like commodity-related real assets and why they offer great value at today's prices.

Real Assets are Cheap on a Relative Basis

If there is a set of visuals that we would like our readers to take with them, it is the following two charts (Charts 2 & 3).

Chart 2: GSCI Commodity Index/S&P 500 Ratio: Equities Expensive, Commodities Cheap?



Source: Dr. Torsten Dennin, Incrementum AG

Chart 3: Real Assets at All-Time Lows vs. Financial Assets

Source: BofA Merrill Lynch Global Investment Strategy, Global Financial Data, Bloomberg, USDA, Savills, Shiller, ONS, Spaenjers, Historic Auto Group. Note: Real Assets (Commodities, Real Estate, Collectibles) vs. Financial Assets (Large Cap Stocks, Long-term Govt Bonds)

Charts 2 & 3 say the same thing: real assets are cheap. But why has the price difference between real and financial assets moved to the extreme levels we see today?

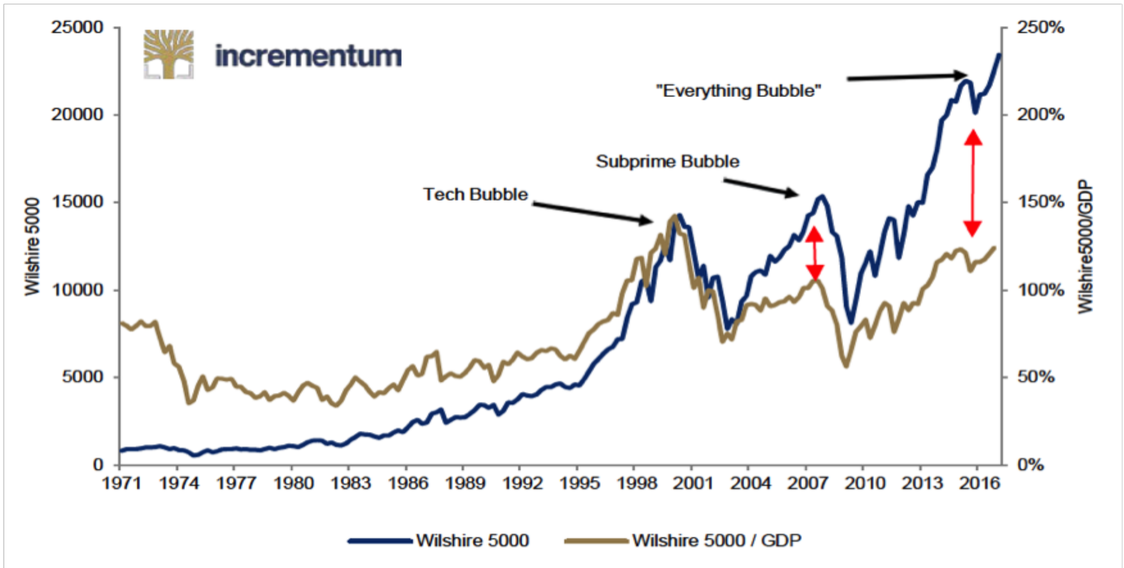
A key factor is investors' perception of risk and their recent experience of reward.

Investor Perception

Following years of zero to negative interest rates, investors have sought alternative yielding instruments. These alternatives involved investors going out the risk curve as they moved from bank-like deposits to longer duration fixed income and corporate credit, and finally on to dividend-paying stocks. This investor migration out the risk curve has provided them with a very positive experience. With rising financial assets, such as bonds and equities, investor perception has been conditioned, over the last eight years, to expect positive returns with each unit of additional risk they are willing to take. In turn, this has emboldened them to take more risk and so the cycle continues. This positive sequence of investor risk-taking and market validation has boosted asset prices continuously since the market lows in 2009.

In the following chart (Chart 4), we can see the impact of this investor behavior. Currently, the value of financial assets relative to the underlying size of the economy is at historic highs—even higher than in 1999 and 2008.

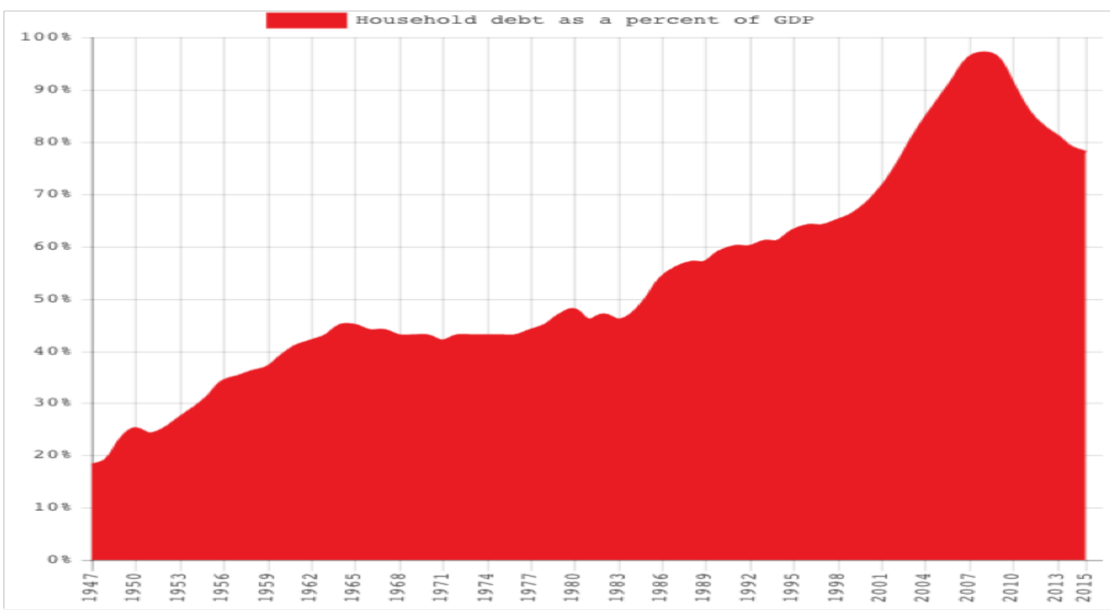
Chart 4: Wilshire 5000 Index and Wilshire 5000/US GDP Ratio



Source: Federal Reserve St.Louis, Incrementum AG, Kevin Duffy[8]

So where have the resources come from that have enabled investors to buy ever more expensive assets? The answer to that question is debt. In Charts 5 and 6, we can see how debt has exploded over the last number of decades, which in turn has flowed to asset markets such as stocks and real estate.

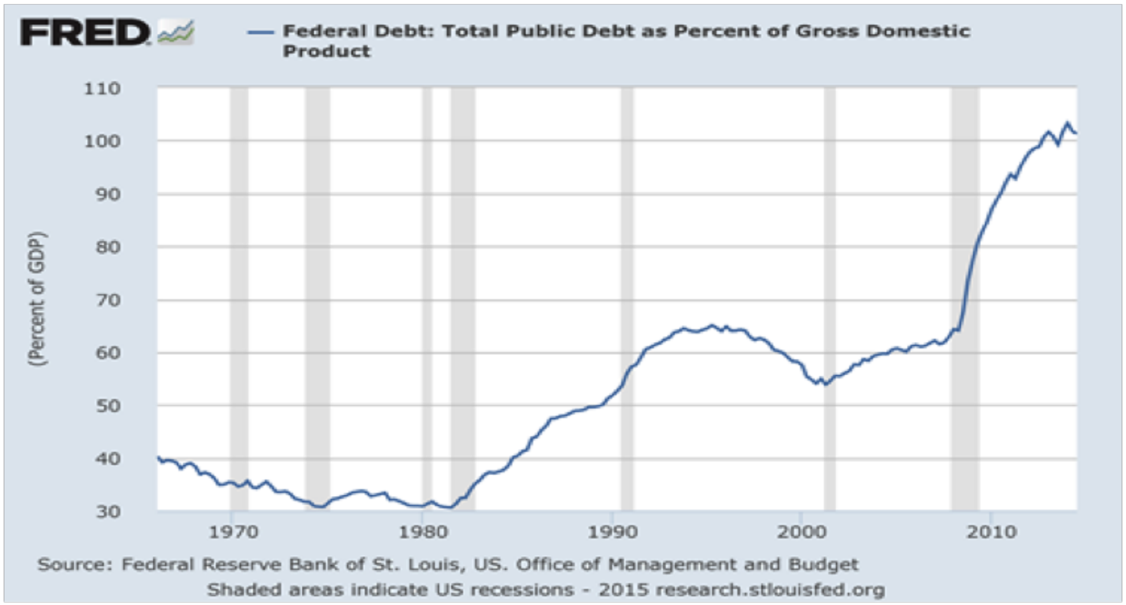
Chart 5: U.S. Per Capita Household Debt as % of Gross Domestic Product



Source: Federal Reserve Bank of St. Louis

There has been some deleveraging in the private household sector, but worryingly it has increased at the federal level.

Chart 6: U.S. Public Debt as a % of Gross Domestic Product



More recently, falling market volatility has masked the debt-related leverage underlying today's market (see Chart 7).

Chart 7: VIX Index - One of the Most Commonly Used Barometers of Market Risk

Source: FullerTreacyMoney.com

In short, the more recent experience of many U.S. investors has created a perception of stability, at the very time that the U.S. economy has never been so leveraged and the market so overbought.

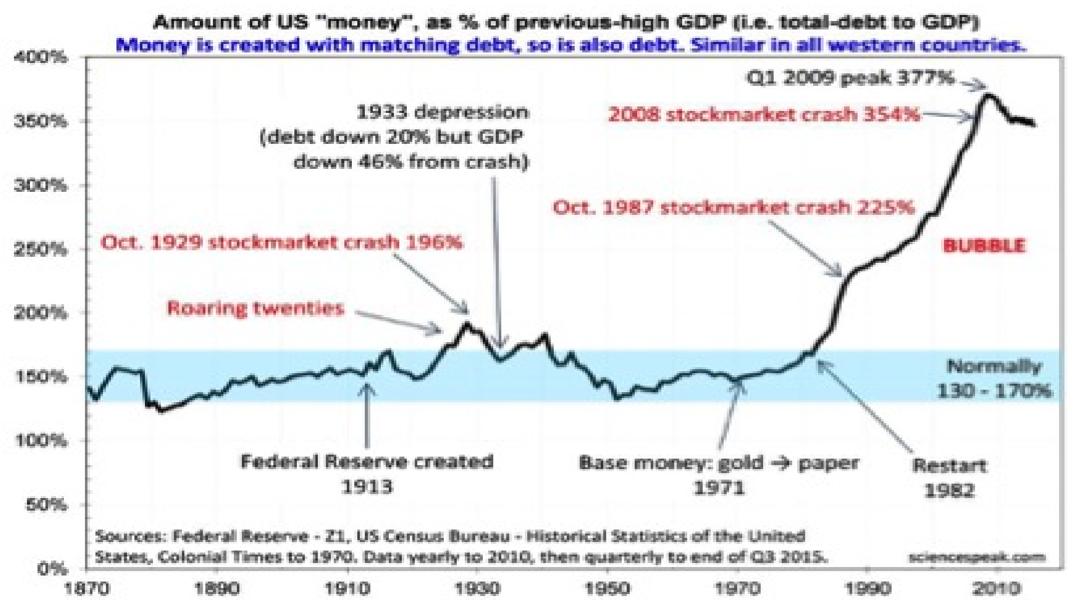
The Case for Real Assets

In the case of any investment or asset, the price of that asset is normally given in units of exchangeable currency or money. Furthermore, the value of any investment is determined, not only by the supply and demand factors for the asset itself, but also by the supply and demand fundamentals of the currency that is being used to exchange that asset.

With these factors in mind, it is important to look at credit growth or money supply to determine what dynamic is affecting price and what is the direction of that momentum.

Let us now consider the impact of additional money supply in the traditional markets, such as bonds and equities. In Chart 8 below, we can see the extent of the unprecedented increase in money supply since the early 1980s. Is it any wonder that this massive increase, which in turn has chased bonds and stocks higher, has resulted in an almost 40-year bull market in these assets?

Chart 8: U.S. Total Debt to GDP



What is more, additional leverage was financed and supported by falling interest rates.

Chart 9: U.S. 10-Year Treasury Yields

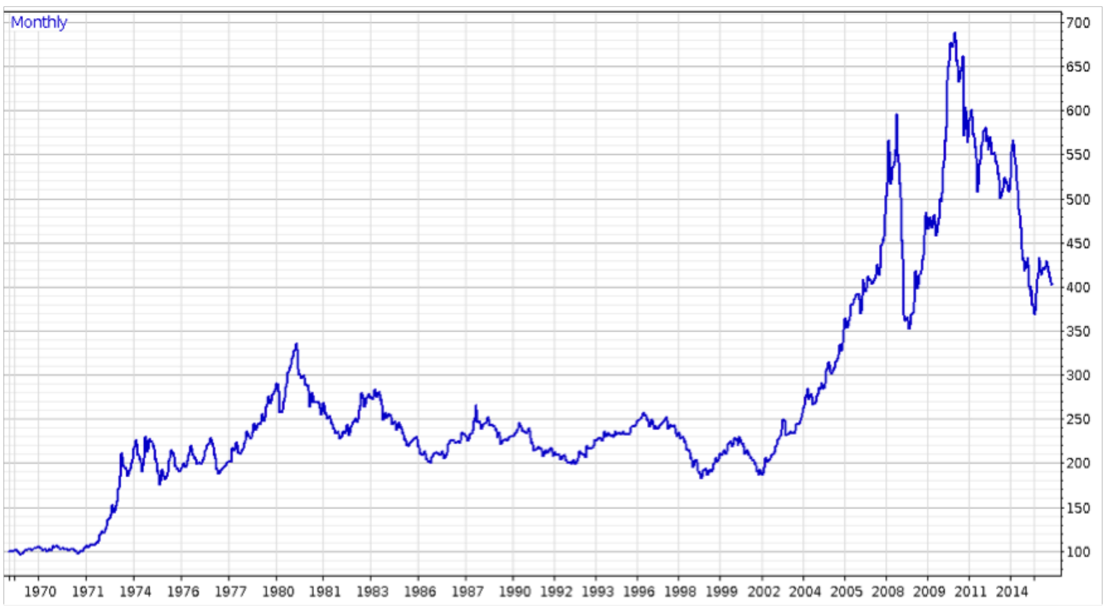
Source: FullerTreacyMoney.com

In many ways, the visual in Chart 8 also helps us understand the path of the financialization of Western markets and hints at how difficult it will be to reverse a trend that has existed for over 50 years. But history tells us that powerful financial trends do end, and, on occasions, abruptly.

Unfortunately, investors tend to give up too early: at the moment when their belief about the value of a certain asset is finally being proven correct, at the moment when a trend reversal is beginning to take place. We believe there are early indications that such a reversal may take place in today's real asset markets.

In the following chart (Chart 10), we see the price action of a broad basket of commodities. To reiterate a point we made back in January 2016, please note the 2007 break to a higher price range.

Chart 10: The Continuous Commodities Index (CCI)



Source: FullerTreacyMoney.com

Today, even with oil being far lower, the CCI remains well above its 2006 break-out point. Furthermore, we are starting to see evidence of tight supply dynamics playing out in a number of the more peripheral commodity markets such as Zinc and Wheat. The result of that restricted supply is far higher prices for both commodities (see Charts 11 & 12).

We will be keeping a close eye on these markets and others in an effort to spot the reestablishment of higher real asset prices.

Chart 11: LME Zinc Prices

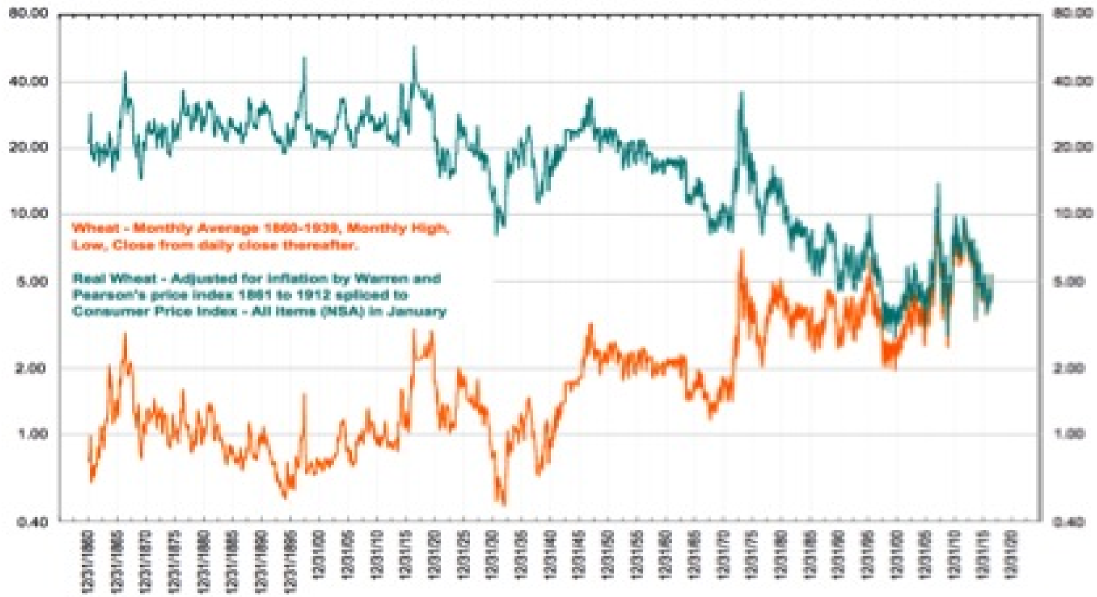
Source: FullerTreacyMoney.com

Chart 12: Wheat Prices (Kansas Hard Red, KW1)

Source: FullerTreacyMoney.com

Chart 13, below, provides an indication of the price risks involved in a commodity such as Wheat. Using a log scale visual, we can see that Wheat is remarkably cheap when compared to its longer-term inflation-adjusted price history. We understand the reasons for today's lower price range: the far higher productivity that comes from mechanisation, agronomy, the use of pesticides etc.; but to an impartially-minded statistician, and using the data that supports Chart 13, a five-fold increase in Wheat prices would represent no more than a mean reversion event.

Chart 13: Nominal and Real, Wheat Prices



Source: TheChartStore.com

Although a spike in the price of Wheat on such a scale may seem unlikely, the risk of it happening is real and the potential consequences are severe.

The following is a list of potential outcomes that would accompany a broader range of commodity price rises (Ref. Department of Agricultural and Resource Economics, University of California, U.S. Department of Agriculture, Goldman Sachs):

- Unequivocally negative consequences for urban dwellers
- Lower real incomes
- Rising wage pressures
- Lower income groups will be more negatively effected
- Lower consumer confidence
- Higher risk of stagflation
- Social and political instability

Understandably, the secondary effect of these outcomes on overbought and over-leveraged financial markets would be significant. So too would the flow of investments from financial assets to real assets.

With the continued backdrop of low interest rates and the current high levels of money supply, the risk of significant flows of investment from large financial markets, such as fixed income, to the far smaller, inflation-sensitive, commodity complex is substantial. If such an event were to happen, the recent 30% move higher in Wheat prices will prove to have been an early indicator of a broader trend.

Conclusion

With the debt-fueled financialization of investment markets over the last 50 years, individuals have been incentivized to borrow and invest those proceeds in higher yielding assets. Not only did investors get the yield and capital return on the asset, they were also able to amplify that return by leveraging that asset through the use of cheap credit.

Abbington believes that the end of the debt-fueled financialization of Western markets is imminent. Therefore, we have migrated an increasing portion of our risk budget to markets that are highly correlated to rising real asset prices.

At Abbington, we are always on the lookout for investments that have a high probability of positive outcome. We call them the “when” investments. By the time we find those investments we have already answered the how, the if, and the why parts of the puzzle. It is our opinion that today real assets are one of those “when” investment opportunities. They also happen to be assets which are cheap and thus have less distance to fall in the event of a broader market unwinding.

Thank you for taking the time to read this piece. We look forward to sharing our next one with you.

Peter Van Dessel

Chief Investment Officer and Co-Founder

Grace Y. Toh

Chief Executive Officer and Co-Founder

www.abbingtongroup.com