CPM Group
SWP Strategic Wealth Preservation — Cayman Islands —
Precious Metals Quarterly
Special report for Strategic Wealth Preservation and its clients.

## Investing In Gold and Precious Metals

28 March 2017

This report is an introduction to CPM Group and its way of thinking about gold. Strategic Wealth Preservation have entered a strategic alliance in which it will make CPM Group's research and outlook on gold, silver, platinum, and palladium available to SWP clients. Since this is the first report, we want to spend part of it introducing you into CPM's overall approach toward gold, and to a related degree, other precious metals, as investments.

CPM's view is that **gold and silver respond to a complex set of financial, economic, and political developments.** These precious metals serve many functions for investors. They are long-term stores of value and can be shorter term tools for capital appreciation. We view investing in precious metals as actually establishing and managing a series of precious metals sub-accounts with differing objectives.

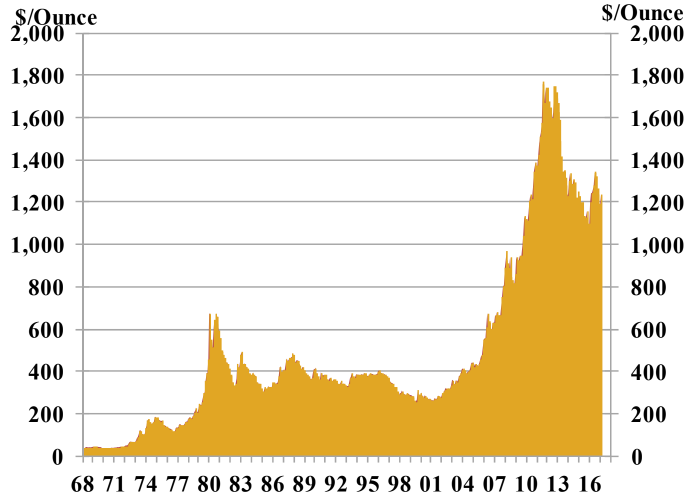
Many people think of gold as a one-trick pony. There are those who think gold prices only respond and correlate to the U.S. dollar. Others will say that all you need to know about gold is inflation. Neither of these beliefs hold up to historical experience and statistical scrutiny, but that does not keep people from strongly believing them. Many people incorrectly see gold as only being useful as protection against economic or financial catastrophes: as a hedge against a collapse of the U.S. dollar, the Treasury bond market, the euro, the European monetary system, the global banking system, or hyperinflation.

We disagree with both the view that gold only responds to one or two economic factors and the view that gold and silver only make sense to investors in the face of collapsing financial conditions. **Gold and silver can and do serve investors well in preserving wealth, diversifying investor portfolios, and generating additional wealth across a range of economic and financial market conditions, and not just in the event of a catastrophe.** This report is about what you really should know about gold and how you really should think about it.

Before we delve more into the why and how of precious metals investments let us first serve the steak, what all the readers of this report really want: Where does CPM see prices going for gold, silver, platinum, and palladium. The layout of this report will be to discuss where CPM expects prices to go, briefly highlighting the reasons behind the price conclusions. We will discuss some of fundamental trends in supply and demand behind these price conclusions. After that we will return to the longer term theoretical and practical aspects of why and how to invest in precious metals.

**The Price of Gold**

*Monthly Average London PM Fix, Through February 2017*




### Price Outlooks

**CPM Group expects gold prices to rise to record annual average nominal prices within the next three or four years.** First, however, we expect prices to trend somewhat higher in the second quarter of this year, accelerating in the second half of 2017, before rising even more rapidly in 2018—2021.

The main reasons we expect prices to rise are economic, financial, and political. CPM expects a hostile economic environment complicated by counter-productive political developments in the United States, Europe, and Russia. These political and economic trends will cause investors to continue buying gold at historically high volumes.

The first quarter of this year has seen some investors focus on the dream of an effective U.S. government introducing massive infrastructure spending programs and reducing excessive regulatory oversight, freeing up the U.S. economy to grow strongly. Others, perhaps more jaded in their views of government, assumed there would be massive tax cuts for corporations and the wealthy, which would see money pour into the U.S. stock market. Both sets of expectations focused on the prospects for rising U.S. stock markets. Rising U.S. stock prices would

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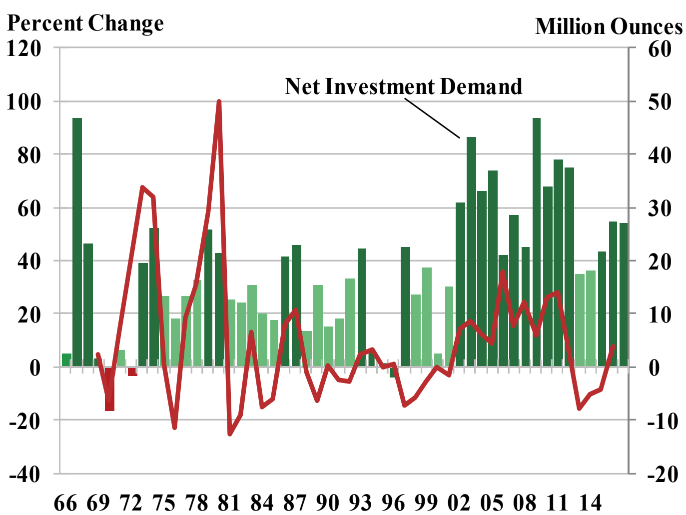
attract foreign investors who would boost demand for the U.S. dollar in order to participate in the stock market run, further distracting investors away from gold. On top of this the Fed would be raising U.S. interest rates. To some extent these trends have happened.

CPM Group's economic basis for its precious metals price outlook was that by the middle of 2017 disenchantment and political realism would combine to put a lid on U.S. stocks and the dollar. Attention would turn to the likelihood of unfulfilled promises in an increasingly mature economic environment facing greater possibilities of a recession in 2018 or 2019 instead of stronger real growth. In that environment investors would begin to refocus on gold and silver. Prices would start to rise more forcefully in this scenario. To some extent this scenario has been playing itself out, perhaps at a slightly faster pace than CPM had anticipated.

**Gold Investment Demand**

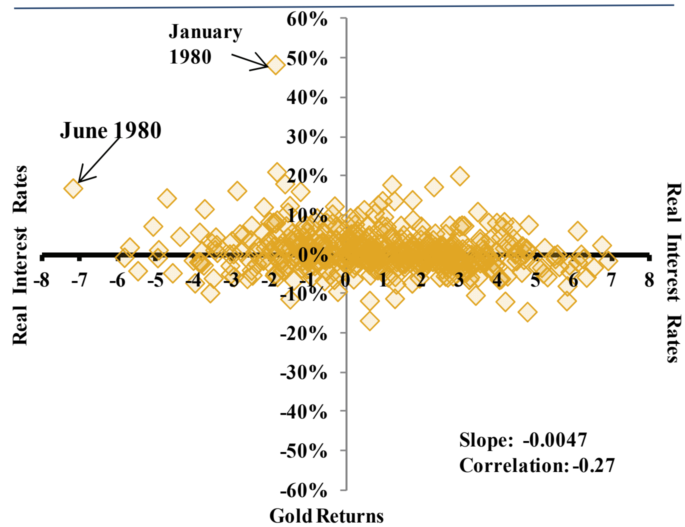
*Annual, Investment Demand Projected Thru 2017, Prices Thru 2016*




In this environment gold would be relatively quiet in the first half of this year, and stronger later. The key fundamental driving prices, as always, would be investment demand. Investment demand for physical gold, shown on the chart on the left, rose to historically high levels from 2002 through 2012. It fell sharply in 2013 and 2014, but has risen back over the past two years. This trend, toward historically high investor demand for physical gold, is projected to continue and expand over the next few years.

The chart below, meanwhile, is a scatter plot of changes in real gold prices and real U.S. interest rates. The overall historical correlation since gold prices were floated in 1968 is negative 27%. The chart illustrates the extent to

**Returns on Gold in Different Real Interest Rate Environments**




Note: Monthly data from May 1968 through December 2016. Gold returns are based on changes in monthly average gold prices. Changes in real interest rates are U.S. 3-Month Treasury bills minus U.S. Consumer Price Index. Gold prices are the dependent variable and real interest rates are the independent variable. Data points in black are for those between January 2007 and December 2016.


CPM Group

Commodities Research and Consulting,
Asset Management, and Investment Banking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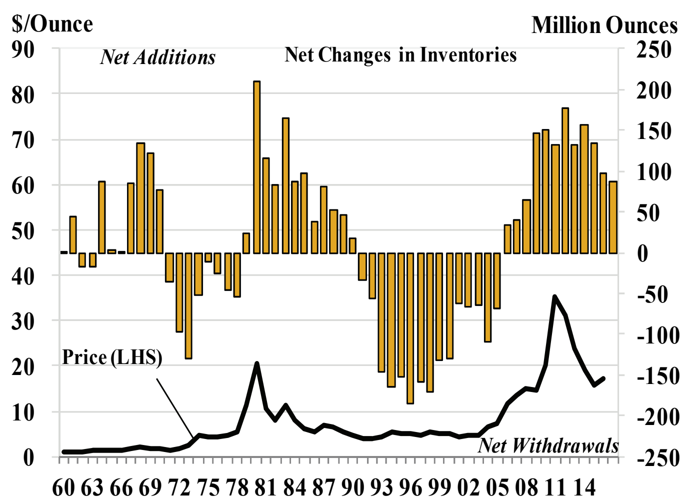
which higher or rising interest rates do not necessarily mean gold prices will decline. More often than not that does not happen. What is more important than whether interest rates are rising or falling is why they are moving: What is behind the change in interest rates. Also, the actual levels of interest rates matter. Rising interest rates in the 1980s and early 1990s, when nominal rates were around 7% - 10%, were much more likely to cause investors to shift from gold to debt investments. Increases from 0.25% to 1.0% are less compelling and attractive to investors. Given the untested theories behind the current Fed desire to raise interest rates and the low levels at which the changes are occurring, interest rate hikes at this time are not expected to have any major negative impact on gold prices. The events of actual increases may push gold prices lower for a short period of time when they occur, but gold prices are expected to bounce back each time, as they have during the past three rate increases since December 2015.

**Silver Market Balance**

*Annual, Investment Demand Projected Thru 2017, Prices Thru 2016*




The first chart on page 2 shows how investors stepped up their gold purchases in 2001—2002. Since that time there has been what economists call a secular (semi-permanent) upward shift in the investment demand curve. More investors in more parts of the world have been buying more gold at higher prices for a longer time than ever before in history. They have been doing so because since 2001 the world has been confronted with one after another major economic, financial, and political challenge and crisis, often combining and compounding the risks for individual investors. As mentioned earlier, investors pulled back cyclically on the amount of gold they were buying and adding to their stocks in 2013 and 2014, but already they have gone back to historically high levels of net additions to their holdings over the past two years.

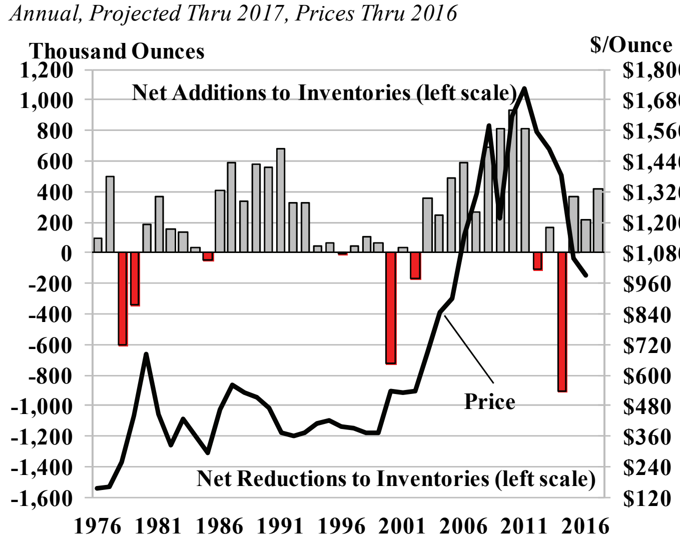
Longer term, high and strong levels of investment demand, stimulated by economic and political problems, will combine with continued strong levels of buying interest from central banks, mostly those of Russia, China, and Kazakhstan, to put pressure on physical gold supplies. Mine production appears to be peaking in the 2017—2019 period, meanwhile, and seems likely to decline after 2019. As investors compete with central banks for more gold in the years ahead, they will be confronted by declining supplies of newly refined gold.

### *Silver*

CPM has a similar outlook for silver, although it is not as bullish on a long-term basis. We expect silver prices to rise modestly during the first half of this year, accelerate during the second half, and continue to rise. Investors have been buying a great deal of silver, which is the major factor behind the strength in silver prices.

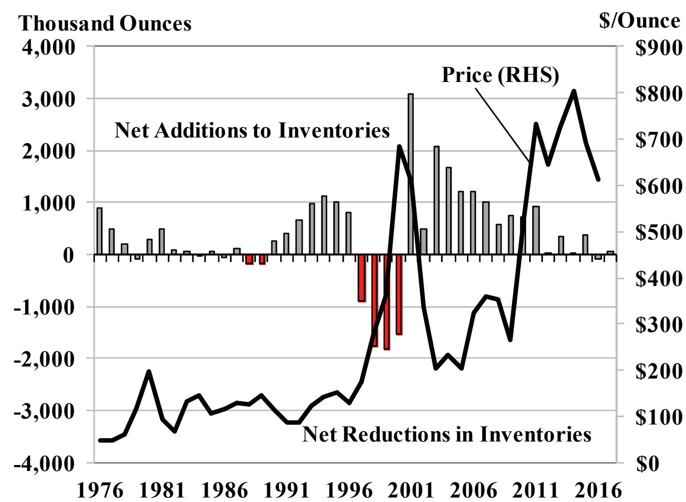
**Platinum Market Surplus/Deficit and Prices**

*Annual, Projected Thru 2017, Prices Thru 2016*




**Palladium Market Surplus/Deficit and Prices**

*Annual, Projected Thru 2017, Prices Thru 2016*



Industrial demand, more important for silver than gold, is less dynamic at this time. Silver prices may rise sharply over the next few years, but they may not reach record levels in the way we expect gold prices to rise.

The chart of the ***Silver Market Balance*** on page 3 shows the extended period of large-scale silver accumulation by investors since 2006. Silver and gold are financial assets more than they are commodities; their supply and demand balances function differently from those of industrial commodities like copper and aluminum. Periods of 'surplus' of newly refined silver over fabrication demand typically are caused by investors buying more silver, as has been the case over the past 12 years. Investors bid up the price of silver to get the metal they want.

### *Platinum and Palladium*

Platinum prices seem most likely to move sideways for several years. The platinum market is struggling with oversupply and South African producers have been slow to rationalize their output. Prices may remain weak for the next five years.

Longer term South African producers will have to shutter excess capacity, which would be expected to lead to much higher prices. But this may take a few years to unfold given the political realities of South Africa today. For investors today, platinum is a long-term game.

We are more positive on palladium than platinum. It has some of the same headwinds, but has stronger demand considerations. In fact, some of the weaknesses being seen in platinum are good for palladium. This includes the shift away from platinum to palladium in some diesel auto catalysts and the broader shift away from diesel to gasoline, since internal combustion engines use palladium intense catalysts instead of platinum.

With a tighter balance between new supply and industrial demand, palladium has a better market balance. This is reflected in the fact that palladium prices have shown greater strength than platinum in recent years and are historically high compared to their sister metal's price.

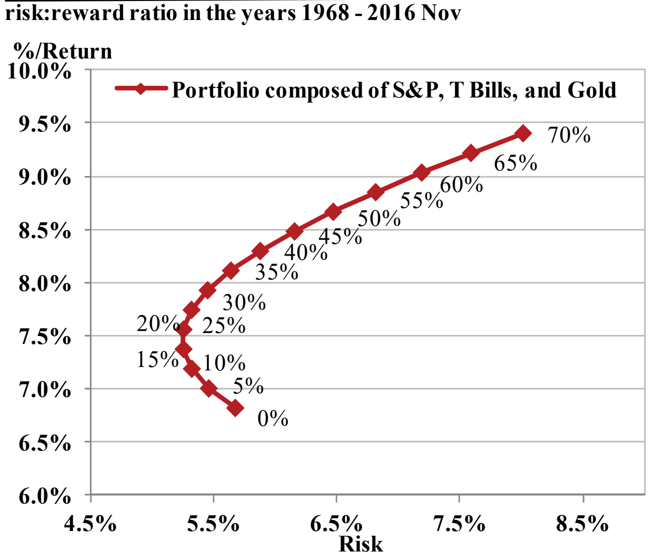
The limiting factor to price for palladium is the existence of large inventories built up over the decades. While this might seem problematic, it should be noted that these inventories did not preclude the sharp increases in palladium prices over the past decade or two.

### Why Own Gold and Silver

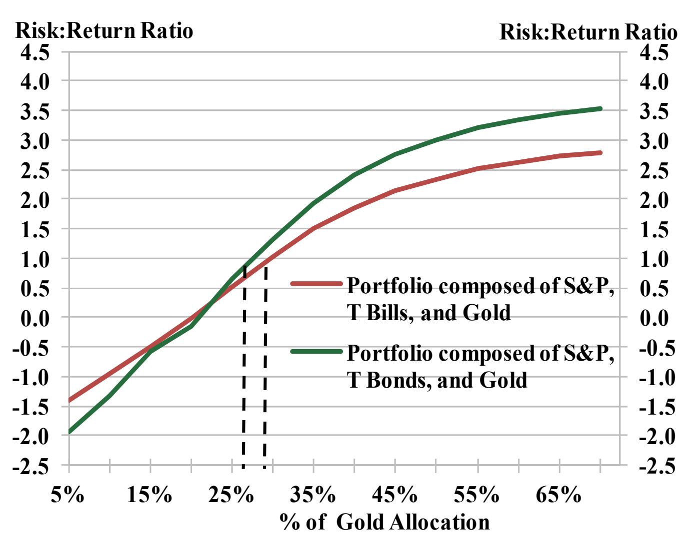
The preceding discussion focused on why gold and silver, and to a lesser extent platinum and palladium, made sense for investors to buy and hold today. This section returns to the theme we set out at the beginning: **Gold and other precious metals make enormous sense and offer investors tremendous opportunities for both capital preservation and capital appreciation across a wide spectrum of economic scenarios.** You do not have to expect the global financial system to collapse in order to have several good reasons to own gold and silver.

The two charts below show how adding gold to a diversified portfolio of stocks and bonds helps improve the returns of such a portfolio over time while reducing the risk or overall portfolio volatility. The chart on the left computes the optimal amount of gold that a portfolio should have held from 1968 through November last year in order to have the best risk:reward profile. Surprisingly, the optimal gold allocation should have been 27% - 30% over the past 48 years. That seems high compared to the usual

**A Portfolio with 27%-30% of its assets in Gold had the best risk:reward ratio in the years 1968 - 2016 Nov**




**Reduction of Risk per Unit Reduction in Return for Given Incremental Increase in Gold Allocation**



rubric that one should have 5% - 10% of one's wealth in gold. There is a simple reason for this difference. The 5% - 10% portfolio allocation was calculated using the same data and formula as used here, but in the early 1980s, using data from 1968 to 1980. Since that time there have been several gold bull markets, including an 11-year-long one from 2000 to 2011. There also have been several stock market crashes and bear markets, and an extended period of time when interest rates were virtually zero. Given all that has happened in the past half century, it ought not to be surprising to anyone that gold should have played a more prominent role in wealth preservation than many mainstream financial commentators thought.

**How to Invest**

CPM's investment philosophy is that one should own gold and silver all of the time. Even when you believe the future is beautiful, with no economic, political, or financial problems on the horizon for either you personally or your nation or the world… you should buy and hold gold and silver.

You should own gold and silver as part of an effort to diversify your wealth. You should not have all of your wealth denominated in just one or two currencies. Currencies rise and fall: The only currency regime that has not failed is the current one. All previous currency systems fell apart at some point. — and almost all of them were backed by gold or silver. The reality is that currencies come and go, international financial regimes and rules change. One should diversify the nature of one's wealth, and not hold everything in assets denominated by a single currency.

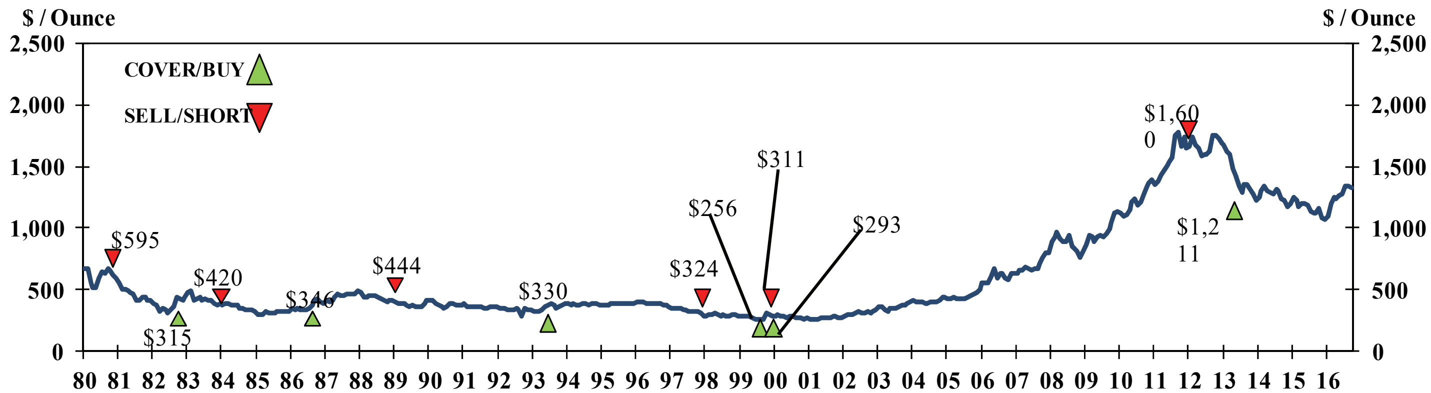
In addition to that, one should diversify one's portfolio. An investment portfolio is a subset of one's total wealth.

CPM advised clients to think of precious metals as a series of separate investments.

1. One part of it is ***insurance***, against both catastrophic financial and political events, but also against smaller problems and dislocations that arise.
2. A second part of one's precious metals holdings should be a ***core portion*** of one's wealth.
3. A third part should be more ***investment*** oriented, rising and falling as a proportion of one's portfolio depending on economic cyclical shifts.
4. A final portion might be a shorter term, more speculative or ***opportunistic investments***.

The final exhibits in this report present the results of some CPM Group intermediate term and shorter term investment recommendations, as examples of what can be accomplished with precious metals investments. The charts and table on this page show CPM Group's inter-

## Published Research Recommendations For Gold





## Gold Investment Rate of Return Comparison

| | Portfolio 1<br>Bought and Held Gold | Portfolio 2<br>Bought and Sold Gold | Portfolio 3<br>Bought, Sold, & Shorted Gold |
|---|---|---|---|
| Initiated Positions | $1,000,000 | $1,000,000 | $1,000,000 |
| Value as of Oct 2016 | $2,031,516 | $30,511,226 | $111,272,198 |
| *Return as of Oct 2016* | *103%* | *2,951%* | *11,027%* |
| **Annualized Rate of Return** | **2.8%** | **12.2%** | **17.1%** |

mediate term buy and sell gold recommendations since December 1980.

You can see that for around 62% of the time from 1980 until November 2000 CPM was recommending that investors either do not buy or actually sell gold. In November 2000 we issued a gold buy recommendation, saying that at that time we thought the economic and political environment would be more hostile to conventional investments for many years, propelling gold to prices above the previous $850 record price in January 1980.

We reversed that recommendation only on 5 January 2012, in a report titled "A Time To Sell."

The bottom chart and table, on the previous page, compare the returns on just having bought and held physical gold throughout the ensuing 36 years to the returns that theoretically could have been achieved either by just following our buy recommendations, or by both buying and selling based on our published recommendations.

It is clear from these theoretical calculations that gold is good for capital appreciation as well as capital preservation, but that one needs to consider where in the economic cycle one is at any given time, what the financial and political prospects are for the future, and what the gold market's fundamentals suggest prices may do. In short, thoughtful analysis can have its rewards.

The table at the bottom of this page shows a much shorter term strategy CPM supplied its clients. In early October 2016 we stated we thought gold prices would rise sharply into the U.S. election and then sell off, regardless of who would win. We structured the long butterfly call spread shown below and advised clients to put it in place using Comex futures options. On 9 November we advised them to unwind the positions. The positions actually yielded a gross return of 125.5% in just a few weeks.

In short, CPM advises investors consider gold, silver, and platinum and palladium as useful investment assets capable of generating both capital preservation and capital appreciation. We suggest investors view their precious metals holdings as belonging in several buckets or tranches: A long-term buy and hold insurance policy, intermediate term investments, and shorter term opportunistic investments.

Many investors imbue gold with mystical powers to protect them from inflation, currency depreciation, stock and bond market crises, and all sorts of other depravations. **In the final analysis, however, gold is a versatile financial and monetary asset that if it is used properly with careful thinking can insulate and insure investors against loss of financial wealth while also providing them with opportunities to greatly increase their wealth.**

**Per Ounce**

| | | | | | |
|---|---|---|---|---|---|
| **Initial Trade** | | | **Closed Out Position** | | |
| **7 October 2016** | | | **9 November 2016** | | |
| Dec16 options - Expiry 22 November | | | | | |
| | Actual Pricing | | | Actual Pricing | |
| | $1,256.00 | | | $1,303.00 | 8:40 AM |
| Priced at | Strike | Premium | | Premium | Change from Initial Trade |
| Buy Call | $1,300 | -$9.20 | Sell Call | $17.50 | $8.30 |
| Sell Call | $1,350 | $2.80 | Buy Call | -$4.00 | -$1.20 |
| Sell Call | $1,350 | $2.80 | Buy Call | -$4.00 | -$1.20 |
| Buy Call | $1,400 | -$1.10 | Sell Call | $1.10 | $0.00 |
| Premium Paid | | -4.70 | Premium Received | $10.60 | |
| | | | Net Gain/Loss | | $5.90 |

| | | | |
|---|---|---|---|
| Value Per 100 - oz Contract | -470.00 | $1,060 | **$590** |
| Gross Profit | | | **125.5%** |