CM Client Update

The Fed's Cautious Approach and Our Portfolios

During her speech on August 26 in Jackson Hole, Wyoming, Federal Reserve Chair Janet Yellen stated that "the case for an increase in the federal funds rate has strengthened in recent months," but that their decisions "always depend on the degree to which incoming data continues to confirm the Committee's outlook." However, she also said the Fed "continues to anticipate that **gradual increases** in the federal funds rate will be appropriate over time to achieve and sustain employment and inflation near our statutory objectives." **A "gradual increase" indicates to us that interest rates are likely to remain low for a significant period of time. Therefore, even if the federal funds rate increases before the end of the year, we believe it will be modest and have little impact on the long-term values of our various portfolios.**

We continue to believe that the Fed is in a box and will err on the side of inflation when it comes to raising interest rates. Each time the Fed has contemplated raising rates over the last several years, the dollar has strengthened. Because a stronger dollar makes dollar-based products more expensive overseas, the sales of multinational companies have suffered. Additionally, the stronger dollar has put downward pressure on commodity prices and the stock markets of countries with commodity-based economies. **Put simply, each time the market expected the Fed to raise rates, the dollar strengthened and the world economy weakened.**

To avoid short-circuiting a global economic recovery, the Fed will likely remain very cautious as it moves to normalize interest rates. In doing so, we believe the Fed will attempt to remain behind the inflation curve when it comes to raising rates, which should allow inflation to move higher. This cautious approach could have unintended consequences because, as history shows, once inflation starts to move, it can be very difficult to stop. **Inflation is something that we are monitoring very closely.**

If the Fed's cautious approach is successful, we will likely see a flat-to-slightly-lower dollar. However, should inflation rise at a faster pace than the Fed anticipates, we will likely see more downward pressure on the dollar. **Overall, we believe the Fed's cautious approach to raising interest rates will positively impact our current investments in the Materials (gold, silver, steel, specialty metals) and Energy sectors and our portfolios as a whole.**

Gold

The price of gold peaked at $1,907 per ounce in 2011 and then proceeded to decline over 45% during the course of the next four years before finally hitting bottom on December 17, 2015, at $1,049 per ounce. NYMEX continuous gold prices have since jumped more than 23% in 2016 through the end of August where it settled at $1,311. However, many individual gold mining companies and ETF's have appreciated significantly more than the commodity itself. **We believe that ultralow interest rates, a weaker U.S. dollar, slow global economic growth, terrorist attacks, nationalistic politics, and lower gold production continue to support higher gold prices. It is for these reasons that our portfolios continue to have a meaningful weighting to this sector.** (For those interested in reading more about gold, please see our Gold Valuation Analysis and our letter titled Inflation, Gold, & Gold Mining Companies on our website.)

Energy

While the price of oil and many energy-related securities remain volatile, we strongly believe that these securities will continue to appreciate, especially if you are willing to look out to 2017 and 2018.

Here are the facts as we see them:

- Non-OPEC oil supply (comprised of 80 nations but largely centered in the U.S.) is declining alongside a massive decrease in industry spending. According to consulting firm Wood Mackenzie Ltd., the energy industry has slashed spending for the 2015-to-2020

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period by $1 trillion through cutting staff, delaying projects, changing drilling techniques and squeezing outside contractors.

- OPEC has been pumping crude oil "all out," leaving very little spare capacity for the group. Creating additional capacity will take time, as well as additional capital, that few OPEC countries have.
- Global demand for crude continues to remain strong. The key drivers of this robust demand come from:
    - U.S. gasoline consumers (*we continue to see record miles driven in the U.S.*)
    - Chinese auto/gasoline
    - India
    - Global jet fuel
- Importantly, while it often reports headlines suggesting demand is softening, the International Energy Agency (IEA) has repeatedly revised historical demand figures higher for each of the past five years.
- High grading *(i.e. drilling the best and most productive wells with the best crews and best equipment*), as well as efficiency gains, have helped some oil producers reduce their costs and lower their breakeven levels. These factors have allowed some companies to book a profit at current oil prices. However, according to IHS Markit, a leading global research firm with over 5,000 analysts, approximately half the cost reductions have been a result of a strong U.S. dollar, which reduced the relative cost of materials and labor across the globe. The remaining reductions are thought to be from significant contractor discounts. However, comments from IHS Markit and large service companies like Halliburton and Schlumberger suggest that only one-third of the industry cost reductions are likely to be sustainable. In other words, as industry costs begin to move higher, so will the breakeven levels. Therefore, higher oil prices are likely needed for increased production to be economically viable.
- It is true that some companies can make a profit in the current oil price environment. However, looking out over the next few years, 20 million barrels of oil per day will need to be replaced as a result of the depletion of existing sources. According to Halliburton, this amount is the equivalent of adding two Saudi Arabias between now and the year 2020. We believe that the most expensive oil (a.k.a. the marginal barrel of oil), on average, will likely exceed $65 to $75 per barrel. It is this last incremental barrel of oil production that will inevitably set the price of oil over the long run and is the basis of our expectation that oil prices will rise. (See our CM Outlook For Oil-January 2016 and CM Energy Industry Update-April 2015 for more details regarding our energy investment thesis and research.)
- To the extent the U.S. dollar declines from near peak levels achieved late last year, this too would add support to the higher price of oil.

We must not pay attention to the short-term pullbacks in the price of oil and lose sight of the bigger picture, which is that **global oil supplies are falling and demand is rising**.

Sincerely,

Arnold Van Den Berg
Founder, Portfolio Manager

Scott Van Den Berg, CFP®
President, Portfolio Manager

James D. Brilliant, CFA
CFO, Portfolio Manager

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