Aden Sisters and Axel Merk on THE DOLLAR, GOLD, CURRENCIES & MARKETS

The Aden Sisters Exclusive Interview with Axel Merk

Will there be a stock market crash? What will happen to the dollar, gold, bonds and currencies? Recently, at the New Orleans Investment Conference, Pamela and Mary Anne Aden, known as the Aden Sisters, sat down with Axel Merk: each of them have decades of experience helping clients navigate the markets. You don't want to miss this exclusive interview:

Pam: Let's start with you and how you're feeling about the economy right now.

Axel: Great to chat with you. It's an honor. I think we all know that global economic growth isn't quite as exciting as people would like it to be. People don't feel like things are going fine. I think ***one of the fundamental challenges is that we've based this recovery on asset price inflation***. As a result, of course, the ones who have assets, they have been doing OK and the ones who don't have assets are not doing OK.

Which is a challenge because if for whatever reason, and we can talk about that later, asset prices may come back down, that's going to cause significant economic headwinds. I'm of the camp that says, well, things aren't quite as great as they seem to be, and in particular we're going to have very limited abilities of the Federal Reserve side in particular to tighten at some point, to raise interest rates.

So as long as we're in this muddle through environment, we'll be OK. But that's not very sustainable either.

Pam: It does seem like we'll be muddling through for a while longer, like into next year.

Axel: I don't think so, actually. Let me expand on that a little bit. We can argue whether the money printing has "worked" or not. But I think the one thing that QE has achieved is QE has compressed risk premium.

Now that sounds very fancy but what it means is that risky assets don't appear risky anymore. Junk bonds don't yield anything anymore, Portuguese debt doesn't yield anything anymore, and for example the stock market is not perceived to be risky anymore. The volatility index, the VIX index, is very low.

When volatility comes back to more normal levels, stock prices have to be lower, bond prices have to be lower, causing those headwinds that I just talked about.

We saw in late September, early October, that we have a little bit of a hiccup in the markets and everybody's panicking right away.

It's because we have this extreme situation where we've got everybody so hooked on the cheap money.

Anything can cause that. It can be the Fed having an exit. It can be a journalist figuring out that the Scots are voting even though it was known forever that the Scots would vote for independence. It can be Ebola. It can be anything.

When volatility is below its historic average in any asset class, investors are piling into an asset class not aware of the risks.

The moment the risk comes back there's, "Oops, I didn't know this was risky." They run for the exit. We saw it a year and a half ago in emerging market local debt products and so forth; it happens over and over again.

What framework do you put this in in your own work when you look at these same sort of issues?

Pam: We clearly look at the major market trends and correlations. That's very important for us to see how interest rates move with the gold market, for example, and the bond market, and how the big trends are evolving. For example this year the trend has clearly favored bonds, so we have been invested in bonds. We still think bonds are a good investment going into next year and this coincides with the deflationary forces that are currently dominant.

We go a lot on the flow of the market and why that market is flowing. We feel that interest rates, for example, could trend down to possibly the 2008 lows on a 30 year yield basis. Maybe not go straight down but over the next six months to one year.

We can see the pressure on interest rates still going on. We wouldn't be surprised to see gold consolidate and stay firm, but we think eventually ***looking out into the year ahead that we'll start seeing gold head up more forcefully.***

Mary Anne: Just to add to what you said, we're completely in agreement with the muddle through economy. That's very clear. What the Fed has done, it has boosted assets, but the average person is worse off than they were say six, seven years ago.

Really since the 2007, '08 crash, or the recession, things have never come back the way they have normally done following a recession. The QE isn't working, it isn't having the desired effects that the Fed was hoping for.

It has helped, but I think you're right. Every time there's a hiccup, people get fearful. They're very nervous.

The risky investments have become more mainstream because people are desperate just to get some yield and they're not getting that. In the meantime, the Fed is not able to raise rates because the economy couldn't withstand it. Therefore ***we think the rates are going to stay low, and that will be good for the bond market.***

Despite the fact that the 10-year yield is only 2.20 or 2.30%, we think it's going to go even lower. As one of the speakers here said, if you're comparing that with what you're getting in most other countries, it looks pretty good.

Axel: Great thoughts. We also study correlations very closely. As you know, aside from precious metals markets we look at the currency markets. But one of the things we look at is how these correlations are morphing.

In the short term, for example, there's this notion, that when there's a crisis there's a flight to quality and the dollar benefits. Well, if you look at the third quarter of this year, equity prices were rising and at the same time the dollar was rising. The dollar had a huge rally.

Conversely at the end of the third quarter and the beginning of October, when equity prices were behaving erratically, coming down quite sharply, the dollar was actually falling simultaneously, so these correlations are certainly not stable.

Importantly, I think with regard to correlations the biggest game changer that we saw was in the summer of 2012. We published a piece called "Draghi's Genius" in August 2012 after he had given his statement he'll do "whatever it takes."

What happened is that until the summer of 2012 we had this pendulum where 'when risk was on' you knew exactly what assets would rise and when 'risk was off' you knew exactly what assets would plunge.

Then Draghi stepped in and made the euro less risky. The euro wasn't safe, but it was less risky, and it was cheap, maybe for the right reasons. Suddenly when 'risk was on,' money came towards the euro.

The money fled out of emerging markets, but it didn't go to the US, where it's supposed to be going. It went to Ireland; it went to Portugal; it went to Spain.

To me, this means that even when we're in this muddle through environment, we are flooded with liquidity, the money wants to go somewhere and it goes where it perceives there to be value. It doesn't mean everything is great over there.

I think ***investors have to be very mindful in this environment that they don't just buy conventional wisdom and what ought to happen.*** Not just with interest rate rises, but also which asset classes are going to benefit.

With regards to the bond market, I take a chapter from Warren Buffett's approach to the markets. Warren Buffett didn't invest in tech stocks in the '90s and he did just fine. Similarly, ***I'd rather not touch bonds with a 10 foot pole, but realizing I might miss out on a rally.***

Mary Anne: Most people feel that way, and we've had people say, "How in the world can you say bonds are still good? They're in a bubble. They've been rising for 30 years. Interest rates have been declining."

But in spite of all that, bonds have been the top performers this year, gaining 30%.

But we couldn't agree more with you, many things don't make sense. If you try to be logical, like, "Gee, this market should go up because of X reason," a lot of things are happening that are just the opposite.

Axel: The follow up question of course is, and I have some views on it, but I'd like to hear your view on that first. What does it mean for investors?

Mary Anne: For investors it's a very confusing time.

Pam: A lot of investors are feeling like, what in the world are we doing here? Because there is no logic at the moment. In our newsletter, we are telling them and it sounds trite just saying it, but we are going with the trends that are going up... The flow of the market is very important, and where the liquidity is.

Axel: I'm sure you have your own set of indicators you look at, but one of the most traditional ones is of course the 200 day moving average in the Dow Jones. We came back up, but when we broke through that did that concern you? Is that something you looked at? Or did you look at other indicators?

Mary Anne: I know a lot of people follow the 200 day moving average, and we do, but the one we really put emphasis on in our work is the 65 moving average for the stock market and the S&P didn't break it, the Nasdaq didn't break it, so it was an isolated incident. That's where you have to take the market trend, which has been up since early 2009 in the case of stocks. It broke it.

It was just quick and then it came back up.

The other market indicators did not break. There were quite a few there that we follow, and sure enough they all bounced back up. For the moment the trend is still intact and it's up, and we're still invested in stocks.

That's where, as Pam said, we have found that ***it's far more profitable to let the markets tell us what to do and not us tell the markets what they should be doing.*** It's made a big difference and for the most part we've been on the right side of the trends.

Pam: Then in the gold market's case it's not out of the woods yet. It could maybe have one more leg down but here too, we'll let the market tell the story.

Axel: I would be the first to agree that this market is driven much more by technicals than in the past. Because if you try to do investments based on fundamental analysis, well, you're almost certainly wrong because the market is not really related to fundamentals.

Conversely what it also means to me is that because, and we have more people appear to be looking at similar indicators, I am very concerned that when we do break a trend that everybody could be piling in then on the downside as well. The market has been rising on good news, has been rising on bad news.

Well, the market can fall on good news and can fall on bad news. Once the technical picture doesn't look so great anymore, we can have a problem.

The one indicator that I have looked at in my investment career as the best bubble indicator is complacency.

It's not one you can time the markets with very well.

I indicated earlier that in the S&P volatility is low and asset prices are rising.

Well, weak hands might be going into the S&P 500 and that makes it vulnerable. But when it comes to gold, for example, we think that's one of the better indicators. For example, when the price of gold is rising and volatility comes down it means that momentum players are starting to pile into gold. That's usually when we take some chips off the table.

We like it when there's volatility and the market comes down because that shakes out the weak hands. Then of course it depends on what our long term view on gold is. Since we think that long term we can't really afford positive real interest rates, we like it when the price of gold does come down.

Pam: What do you think about the dollar? Do you think it's going to stay firm because the euro, for example, area is very weak? That's what it's looking like. Actually, we were thinking that it wasn't so much the dollar has been strong since July. It was more that the euro has been very weak.

Axel: The currency markets are in many ways fascinating because everybody has an opinion about them, and very few people know anything about them. Now we've studied the currency markets for a long time and we don't claim to know everything about them either. But we do know that most of the myths about the dollar are flat wrong.

You mentioned the good economy. **Who says that you need to have a good economy to have a strong currency?** Look at the Japanese yen. The more dysfunctional their economy was, the stronger the yen was.

Pam: That's right, it soared. But it was their safe haven.

Axel: There is a reason why, and obviously the yen behaves a little differently from others, but I like to use the yen as a wakeup call. When the earthquake happened in Japan now three and a half years ago, the yen zoomed up. A few weeks later, the New Zealand dollar plunged when there was an earthquake in Christchurch in New Zealand.

The difference is that in Japan there was, I'm talking about past tense, there was a current account surplus. That's why everything was backwards in Japan. In New Zealand, there's a current account deficit. A country's Current account balance is not a good predictor of exchange rates but it tells you a lot about the dynamics of how a currency might act.

We talked about correlation earlier. We study, for example, whether the yen is perceived to be a safe haven by the market? Whenever Abenomics appears to be working, the yen does not act as a safe haven, and when Abenomics appears to be failing, the yen is regaining some of its safe haven characteristics.

Then of course the question is, our view is that, well, Abe's going to double down when things don't work until he's kicked out and then let's see what damage has been created.

Because what Abenomics is creating is he is eroding the current account surplus. So now the yen is trading more like just another currency.

Now going back to the euro that started this, in our experience the euro is a tiny bit sensitive to economic growth, but not really. The US dollar a little bit more so, although everybody thinks the dollar rises as interest rates rise, but it's flat wrong. If you look at the data, during early to mid phases of a tightening cycle by the Federal Reserve, the dollar tends to decline. The reason is that foreigners own a lot of US debt and that debt tends to decline in value because of the interest rate risk in that debt. It's in the late phases of a tightening cycle that the dollar tends to appreciate in anticipation of the next bull market in the bond market.

Now I would be the first to admit that we are not in a regular interest rate cycle here. But more to the point of where we are right now with the dollar, what happened in the third quarter was that the perception was the US would have this tremendous exit, have high rates and whatnot. Mr. Draghi, the head of the ECB, was throwing the kitchen sink at the euro bulls and saying, "I'm going to have rates lower for longer. I'm going to print us all this money, I'm going to do anything to weaken the euro."

Well guess what? When somebody throws the kitchen sink at you, you duck. The question, though, is where are we now? We are at a situation where a lot of stuff was priced into the dollar and in the euro, and to me, I like to be a contrarian investor, not for the sake of it.

But to me that means, well, hasn't the market gotten a little ahead of itself because didn't we just say the Fed is not going to have an exit?

Mary Anne: Are you a buyer of euro then right now?

Axel: It depends on the strategies. ***Longer term, I don't think that the dollar can outperform the euro over the next couple of years***. Now at the same time Mr. Draghi has been convincingly irrational, and who knows what else he's going to do? We've got to watch him very, very closely.

On a short term tactical level, one does have to these days focus far more on risk management than anything else because everybody now, and I say everybody because as of just recently even the Federal Reserve has piled in that they want to have a weaker currency as well.

Mary Anne: That's why the currencies are so important, because they, all these factors you mentioned are going to affect the other markets. If we have a strong dollar, for example, that's going to keep downward pressure on the gold price.

Axel: It might. But what it also will do is it's going to mess with corporate earnings in the US, and that's going to give the Federal Reserve a signal to maybe not raise rates quite as quickly.

What we have is an environment where people thought, "Oh, we'll have this grand exit," but we get all these headwinds and we've discussed a bunch of them and there are more. Then things will be, maybe if we're lucky we'll be in the muddle through thing. But we listened to **Alan Greenspan earlier who said, "We're sitting on this box of tinder."** When you have this cliff something could go wrong. Let me go back maybe to my original question. What should investors do about it? You said you use trend following methodologies; do you tend to focus on the stock market, on specific securities and gold? Or what other things do you recommend investors do?

Pam: Depending on the market, but when it's a time to invest in the currency markets we'll recommend certain currencies, or in the bond markets, the gold market, the other precious metals, the gold and silver shares, and the stock market of course.

Axel: Good. The way we look at that is, because we ultimately have a slightly, kind of a bigger picture or a 30,000 foot view on that. Our view is that central banks have inflated asset prices. When you own assets of course that's been good, but at some point the glass is going to be perceived to be half empty and asset prices might come down.

The question is, well, **how do you diversify in that sort of environment?** The classical diversification is of course you have stocks and bonds. You've made a good case that maybe bonds are going to be doing just fine.

In fact, bonds have been doing just fine. Now many people are still not comfortable putting money into bonds. So what do you do if you don't want to put all your money there? Then of course what people have been doing is they've been reducing the duration of the bond portfolio, they have been chasing credit, so to speak. In fact, if you look at some of the bond funds that are being offered by some of the biggest institutions, they're not bond funds anymore. They hold MLPs, master limited partnerships. They hold dividend paying emerging market equity stocks, and they're just selling them as bond products.

Our view is that you should really look beyond stocks and bonds and find ways to get things that have a low correlation to the stock market. We talked about gold earlier.

Well, gold is one of the alternatives that is easier to understand. People love it or hate it. It's fairly straightforward. We happen to think long term it is a good investment. Gold, by the way, if you adjust with perfect hindsight would run a portfolio optimization, it has been a great diversifier. People should have much more gold in their portfolio than many people recommend.

Pam: How much do you recommend a person have in it?

Axel: If you just use stocks versus gold, if you've had 30 percent in your portfolio either since the beginning of the last decade but also since 1970, or for the past 100 years, not that you could have held gold all the way through, something like 30 percent would have been giving you a better risk adjusted return than just holding stocks. Now we're not recommending people necessarily do that. I personally have that much and more, actually, in gold.

What people should look at is not about gold per se. It is about **adding a component to a portfolio that has a low correlation and potentially positive returns.**

Mary Anne: That's exactly what we do. The diversification on the allocation. **We've been for a long time recommending 20 percent in metals related investments.**

But at this point since the bonds have been the better performer this year, we've had 35 percent in bonds and 30 percent in stocks. We still have our 20 percent in gold exactly for the reasons you just said, as a diversification.

Axel: What I like to caution and it assumes you're doing that is it's not just the correlation that you think it has, but the correlation it actually has more than you think it might have. Because people think, "Oh, I diversified to these and these different sectors and everything is going to be dandy." Well in practice that hasn't worked. When everything goes up in tandem, things might also go down in tandem.

We take it a step further and advocate currencies. Because currencies, if you use a basket of **currencies or a managed basket of currencies, they historically have a low correlation to other asset classes.**

You can even go a step further and **treat currencies as an alternative asset class** by deploying a long/short currency strategy. You can, for example, buy the Australian dollar and sell the New Zealand dollar; when you do that you're almost certain that the returns that you generate will not correlate to anything else in your portfolio.

That's the great thing about alternatives. The disadvantage of alternatives is that they're often difficult to communicate and then also sometimes they're difficult to implement. If you have a long/short equity strategy, well, in a crisis you may not be allowed to short the stocks.

So at the same time I do think **this is an environment where investors should very seriously consider to have a substantial portion of their portfolio in alternatives.** Many alternatives tend to be at the lower end of the risk spectrum, so you've got to have quite a substantial amount if you want them to have an impact on your portfolio.

Mary Anne: Exactly. So you think hedging is good then on a specific currency. Well, I call it hedging like long one thing and short another.

Axel: Great question. Because you're saying should you hedge your currency exposure? Most people may not be aware of that when you invest internationally, you have currency risk. That might sound very simple, but you're already allocating a risk budget, so to speak.

We're telling, well, why don't you allocate it smartly?

Why don't you think about how you allocate it?

What people are not aware of is that about **30 to 50 percent of your returns in international equities are due to currency moves.** If you leave it in, the currency risk, you're taken for a ride. If you take it out, you're leaving chips on the table.

Our view is, well, **you've got to actively manage that risk.** When you do that, you can actually add significant value to your portfolio.

Pam: We agree with that. We like currencies very much. We follow them closely as well and we think they're very important. We follow their correlations. We have the ratios that we see on an ongoing basis, every week we're always updating those correlations.

Axel: We are very much a believer in actually acting. But what we see a lot is that people listen to folks like you or to us and then they don't do anything. They just said, "Oh yes, that's all fine, listen to these correlations, listen to what you say about bonds, listen to this and that," but they don't do anything about it.

Then they say, "Well, I'll do something when the dollar goes down," for example. Yeah, well have you looked what the dollar has done since the last 15 years, the last 30 years, the last 100 years?

Similarly, as investors say, "I'll get out as needed," and so I happen to think that the time to take chips off the table is when the markets are up.

Well, do you want to just tell everybody what you do in your work before we wrap it up?

Pam: Yes. We've been writing a 12 page monthly newsletter for 33 years, and we have a weekly update and trading service. We cover all the major markets and we go over them and show a lot of our charts that we produce in house. We really enjoy that. We feel that the markets are much like art.

Axel: Is there a website people should go to for more information?

Mary Anne: AdenForecast.com. There they'll see a sample issue. We have a lot of proprietary technical indicators that we've developed over the years and they work. We've weeded out the ones that don't work.

It's always something that we're following, but it's not just a technical letter. It's a technical and fundamental letter. We discuss the economy, global effects and provide specific investment recommendations. Like you said, the fundamentals aren't as good as they used to be but we try to marry the two and then we feel good about a particular market, especially when things do make sense. But so often these days they don't. But anyway, it's been good and we're proud of it.

Pam: Please tell us more about your products.

Axel: Sure, yes. We manage four mutual funds and an exchange traded fund. The mutual funds have a currency focus and a bit of a gold component. Then the exchange traded fund we have is a gold exchange traded fund.

We also publish a newsletter. We don't publish on a strict schedule because the main thing we do is manage money.

But we write when we think something important happens and we discuss things like what's happening in the economy, The best place to get information on us is at MerkInvestments.com. We also tweet actively. That's really the best place to get instantaneous interpretation of the news. I have a Twitter handle, twitter.com/Axel-Merk, and so that's one of the other ways that people can stay in touch with us. Then obviously check out our website for information on our funds as well.

Pam: Perfect.

Axel: This was great. Thanks for having me.

Pam: It's been such a pleasure.

Axel: That was a great joint interview.

About the Authors:

Mary Anne and Pamela Aden are two of the most influential and well known investment analysts, writers and lecturers in the world. They are the co-editors and publishers of The Aden Forecast, a monthly investment newsletter, which specializes in the U.S. and global stock markets, the precious metals and foreign exchange markets, as well as U.S. and international interest rates and bonds.

The Adens are the Directors of Aden Research, based in San Jose, Costa Rica, and they are professional money managers. They have authored dozens of reports and articles and have spoken at investment seminars around the world. Their work has been featured in newspapers in several countries, in such publications as Business Week, Forbes, The Wall Street Journal, Money Magazine, Smart Money, Barron's, The London Financial Times, as well as CNBC and the international television documentary, Women of the World.Mary Anne and Pamela Aden are sisters and they've lived in Costa Rica since 1974.

You can subscribe to the Aden Forecast at www.adenforecast.com

Axel Merk is the President and CIO of Merk Investments, manager of the Merk Funds. Axel Merk is a sought after speaker and author on topics ranging from the economy, gold and currencies to sustainable wealth and personal finance, as well as a regular guest and contributor to the business media around the world.

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