PORTFOLIO REVIEW

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The Trump era is underway…and the markets apparently like it. With only a brief pullback after the failure of the Obamacare repeal-and-replace, the U.S. stock market has continued its upward march. Virtually every global market is up as well on the heels of the U.S. rally. Gold too is up, though as usual with greater volatility along the way. With high valuations following a strong five-month rally, the stock market is increasingly vulnerable to a correction. Meanwhile, inflation, already stirring before trump took office, could be the surprise of 2017, boosting gold significantly.

■ Solid performance all round

Most global stock markets are up so far this year, with the U.S. among the laggards; the S&P is up 5.5%, compared with 8.4% for the rest of the world (MSCI World ex-U.S. Index). There is no broad pattern to the leaders and laggards. Mexico is the top-performing major market, up almost 18%—who would have guessed? Spain is the leader in Europe, and India among leading Asian markets.

U.S-based global equity funds are up 6.2% on the quarter, keeping pace with the markets. Our accounts are up similarly, with our conservative accounts up 6.4%*. (Account numbers are preliminary.) Our mid-risk global growth accounts, unusually, underperformed conservative accounts, rising 4.9%.

■ Gold up, oil down

Commodities overall are down, with the Bloomberg Index falling 2.5%, driven down by oil which has dropped this year by virtually 10%, despite a strong rally in the last week. Gold is up over 8%, while the gold stocks, unusually, underperformed, with the senior stocks up just over 6% on the quarter (basis XAU Index). The average gold mutual fund was up 6.2%. Our resource accounts outperformed, up 6.8% on the quarter, while our gold accounts slightly underperformed, up 5.8%.

Overall, our accounts performed in line with indices and relevant funds. Our conservative accounts outperformed more aggressive ones largely because of the high weighting in the former to the Business Development Companies, which performed well during the quarter. We were generally underweight Europe. Obviously, building cash in portfolios is a drag on performance, but we gave up a little upside for more downside protection. Better to sell early than just a little too late.

Our resource accounts are severely underweight oil, helping them outperform the indices in the last quarter. Our gold and resource accounts were hurt by one stock, Nevsun, which plunged over 17% this quarter. (See “Resource Accounts” for reasons.) Nevsun entered our accounts when it purchased Reservoir Minerals; even after considerable selling, it remained our largest single position as we entered the year. So this decline clearly hurt overall returns.

■ A Tale of Two Trumps

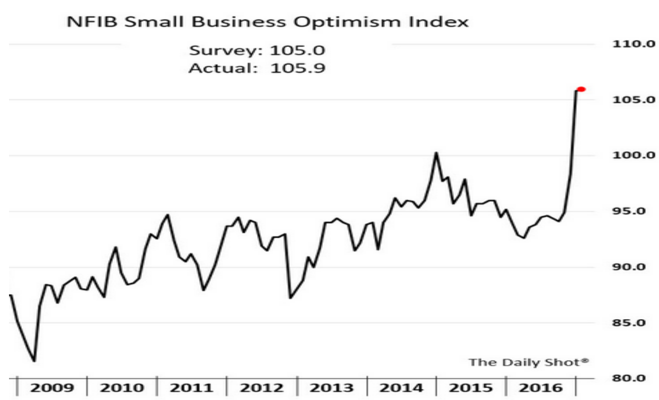
It could be the best of time. It could be the worst of times. If we get only "the best of Trump"—lower and simplified taxes, fewer regulations, less government spending, repeal of Obamacare, a government "that works"—the economy would boom and stocks zoom. That scenario would likely also be positive for the dollar because of inward investments, and bad for gold. But what are the odds?

If we see "the worst of Trump", however—with a failure to enact the positives, but with negative immigration policies, verbal conflicts with friendly neighbors, protectionism and a trade war—we could see the economy stagnate, stocks fall along with the dollar, and gold (the "anti-politician" asset) soar.

The saga over Obamacare repeal shows how difficult it can be to get things through Congress, at least expeditiously. There will be battles on lowering tax rates—*where is the offset revenue coming from?*—on the budget—*can't increase spending for the military without cutting it elsewhere, and let's not cut my pet project*—on infrastructure—*how it is going to be paid for*?—on simplifying taxes—*let's not eliminate that deduction*. And so on. Governing is not easy. It doesn't help to pick fights with members of your own party.

One problem is that much of the positive requires legislative approval, while the negative can come through executive action in many cases.

■ Optimism on economic action



It was the prospects for speedy action on many of the economic promises that caused optimism to shoot up, particularly among small business owners (and spurred the stock market move). U.S. corporate tax rates are almost the highest in the world (United Arab Emirates *are* higher), and the highest in the developed world. Costly regulations are stifling small business and not only in the financial and health-care sectors, leading to a collapse in new business start-ups, even as the internet makes it easier in practical terms to start a business than even before; under Obama, for the first time, more businesses closed each year than opened.

Despite a long recovery, this has been one of the most sluggish recoveries ever, with an increase in consumer debt even as consumer spending stagnates; and a decline in business investment. The stock market's boom has been based on optimism for future policy changes; it has not been a reflection of current conditions. The longer it takes for those policy changes to be enacted and flow through to the economy, the more vulnerable the stock market becomes.

■ Inflation, it's a'coming

Despite a sluggish economy, inflation risks are increasing. Indeed, we have already seen inflation stirring over the past year. The probability of rising inflation this year and next is high in any event, but some of the proposed policies of the Trump administration run the risk of accelerating that trend.

First, the trend towards loosening bank regulation and encouraging banks to lend more risks unleashing inflation in the real economy. The Federal Reserve has created massive amounts of money over the past eight years—with the money supply up 80%—but this money for the most part has not got into the real economy and, therefore, not caused prices to increase. But the money created out of thin air has not vanished back into thin air. Banks have borrowed from the Fed and put much of the funds back on deposit with the Fed, earning a small but risk-free return. More of the money has gone into assets—stocks, bonds, real estate.

But if the government encourages banks to lend more, then there will be an increase in the supply of money in the real economy, pushing up prices. The inflation was caused years ago when the Fed created the money out of thin air, but the inevitable effect on prices will come when banks lend it out instead of hoarding it.

As this process takes hold, inflation may increase quite suddenly, perhaps next year more than this. This is how many great inflations have started in the past, with a long, steady increase in the price level until an exponential blow off. Think of the 1970s when the CPI inflation rate jumped from a relatively benign (seemingly benign) 2.9% in 1972 to over 12% just two years later.

Second, the protectionist policies that Trump threatens—which would be disastrous for the economy—would push up prices of imported goods. Similarly, the lower dollar that he proposes would also make imported goods more expensive. Third, Trump's budget plans and infrastructure spending could increase the deficit; plans to increase spending on military hardware and "our boys in uniform" are more likely to be passed by Congress than the various cuts proposed to offset those hikes.

Price inflation does not step up in nice steady increments; it increases more geometrically than arithmetically. We are in the early stages of that process, but one that is underway and likely to accelerate.

■ Fed behind the curve

It was the increase in inflation that has already occurred that moved the Federal Reserve to raise its short-term Fed Funds rate by another (measly) quarter-point earlier in the month. It is worth emphasizing that even after this increase, the current rate is still well under the rate of inflation. So the

Fed is behind the curve and likely to stay that way until inflation numbers can no longer be ignored. Given the state of the economy; given the interest burden on the federal government debt; and given the dovish bias of Fed chair Janet Yellen, meaningfully higher rates are not likely any time soon.

U.S. stocks after the post-election rally are by no means inexpensive, with the S&P selling at 22 times earnings and over 3 times book. Though not the bubble levels of the dot-com era, these are higher valuations than those at which the U.S. stock market has traded for 90% of the last 100 years. Investors justify these valuations by optimism on taxes and regulation. At the very least, the valuations and the reasons for them call for caution. Given the momentum, we are using trailing stops, as stocks move upwards, but buying little.

■ Inflation and politics in Europe

Inflation is also picking up in Europe, as is talk at the European Central Bank of an end to easing. Inflation was negative early last year and has shot up in the last few months, to a high of 2% in February. The European Central Bank has talked about ending QE sooner than expected, but has been slow to action.

This is not surprising given the political concerns that continue to weigh on the continent. Though the "moderates" won the Dutch election, there are several more elections that at minimum indicate caution. The first round of the French election takes place later in April, with the second round a month later. In September are the German federal elections, followed early next year by Italian elections. Amid all this are the increasingly fractious Brexit talks, as well as negotiations on Greece's next bailout package; it runs out of money again this summer. Even if the government wins the elections—and Merkel is hardly popular personally for the "refugee" fiasco—the stances on Brexit and Greece are partly coloured by impending elections. Particularly with Greece, she will not want to be seen as too "generous" with taxpayer money to a country that many Germans feel is at fault for its own problems.

Stocks, which have rallied more-or-less in lock step with the U.S. market since November, are hardly inexpensive. Big cap stocks across the continent are trading at over 20 times earnings, which analysts justify by expectations of a 30% increase in earnings in the year ahead. Others are more expensive. The Italian stock market, which has jumped over 25% since the end of November, has negative earnings. So while there are some quality companies at reasonable prices, the overall market is not cheap and unlikely to provide similar further gains this year, while numerous opportunities for crisis remain. We are watching for any crises—and the lower stock prices they will bring—to buy quality stocks for short-term trades.

■ Asian stronger and less expensive

Asian economies continue to emerge from a slowdown. As elsewhere, rates remain low, but so too does inflation, as the central banks avoided printing wildly unlike the West. Savings remain high, and demographics (outside of Japan and China) are far better than in Europe.

China remains the lynchpin of the region; but it seems to have escaped the collapse many were predicting last year. Although much of the old economy (heavy industry) remains in a slump, the internet, healthcare and other "new economy" sectors are doing very well. Overall, growth seems to have bottomed. We remain quite sanguine about China.

Asian markets, including China, have also rallied since November, but in most cases less than the U.S. and Europe, and in most cases also with valuations remaining far more reasonable, with most major markets trading in the low double-digit price-to-earnings multiples and better yields. (Singapore, for example, is trading at 13 times p/e; yielding 3.4% and trading just above book, much the same as the Hong Kong index.) Many markets are also trading at the low end relative to their own history.

This is where we are focusing on attention for longer-term buys, given the valuations and the superior economic prospects. A lower dollar and higher inflation tends to be positive for Asia. The biggest thing to watch for would be a move towards implementation by the U.S. of protectionist trade policies, which would hurt Asia more than most.

In sum, we continue to hold most of our global equities, but are slowing selling as valuations become stretched or risks increase. The European equities are considered shorter-term trades because of the heightened risk profile, but for most stocks we are employing stops, moving up as the stocks advance. We remain alert to buying opportunities but have been selling (albeit slowly) trimming more than buying, and likely will continue to do so for now. If anything, selling is likely to increase.

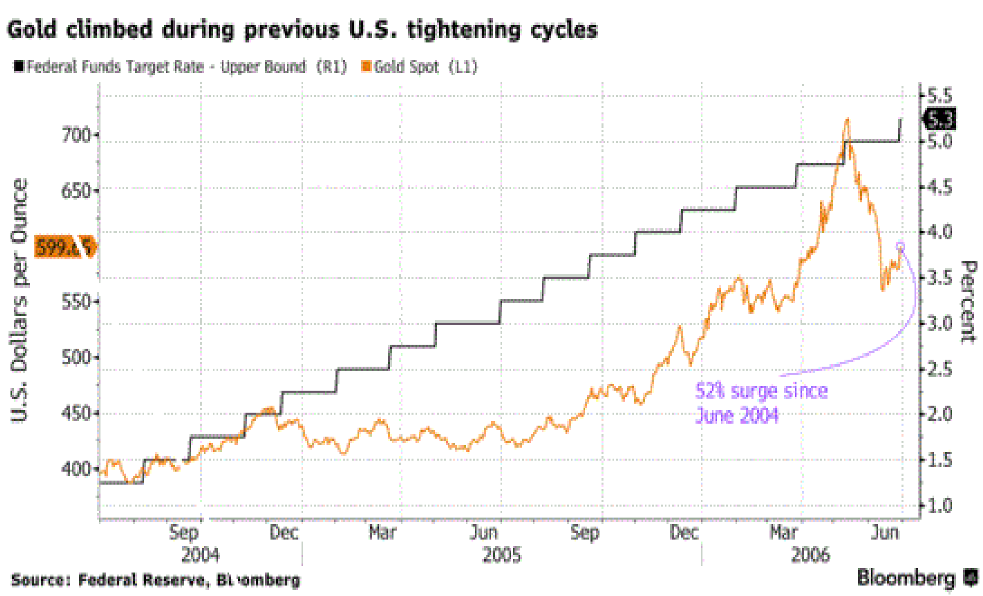
■ Resources mostly up

Resources generally have performed well since the Trump election, both for expectations of higher infrastructure spending (copper, iron ore) and on concern about a lower dollar and higher inflation. Oil has been a bit of an exception among major commodities, rallying over 20% from the November lows before giving most of it back (until another strong rally in the last few days).

Copper has been among the strongest performers, up 30% from its lows and holding on to those gains. It would be a prime beneficiary of infrastructure spending and a generally improving global economy, of course. But also, strikes in Chile and the temporary cutback in mining at Grasberg, amid tendentious talks between Indonesia and Freeport about changing its contract, show just how fragile supply is. We continue to favor copper though picking entry points in this volatile sector, as always, is important.

■ Economic policies will help gold

The economic and political themes we have discussed are to the favor of gold. Potentially higher government spending and a larger deficit help gold. Protectionism, in as much as it would hurt the dollar and dent the U.S.'s image as a stable country, would help gold. Inflation obviously would ignite gold. The slow pace of rising interest rates, with rates lagging inflation, would help gold. The general uncertainty and sense of unpredictability surrounding the U.S. administration helps gold. And the political tensions in Europe and geopolitical flashpoints around the world also support gold.



This year could see gold move up sharply, certainly to last year's highs, but possibly breaking out above that. The stocks meanwhile for the most part remain undervalued. With a 15% rally from the November lows (ref. XAU), compared with 10% for bullion—and underperformance this year—the stocks are not exhibiting their usual leverage, especially at a turn. The juniors as a group have generally done better, though their performance has been more volatile and far more selective.

In sum, we have topped up gold accounts, and continue to hold both core positions in both senior miners and exploration companies, and short-term trading positions among more speculative situations.

Overall, we are generally riding the global bull market, though on a tight lead. In Europe, we are for the most part attempting to trade the various crisis-induced markets sell-offs, while accumulating positions in Singapore and Hong Kong on dips. We hold full allocations to gold, which we believe will perform well this year, while also acting as a bit of hedge on broad markets should there be a market sell-off later this year. Overall, though slowly, we are building cash in accounts for such an eventuality.

Review of Individual Accounts

■ Global Accounts

The major move in global accounts this past quarter has been an increase of cash as we slowly sell into market strength, as expected in our last *Review*. Cash in accounts has risen from 8% to almost 12%.

Cutting back after merger

This selling has been across the board, though particularly strong among the Business Development Companies. They remain a significant holding—10% across global accounts, and higher in more conservative accounts—but we have been selling, particularly after the **Ares Capital/American Capital** merger made us overweight in that single company.

Other sells in the sector have been client-specific and based on valuations, not for any change in our view on the companies. We have also started buying a laggard, **Medley Capital,** for appro-priate clients; it is a higher-yielding BDC, and we bought it to replace **Pennant Park**, another more risky company in the sector. We bought after Medley cut its dividend, reducing our risk.

Reducing European exposure

Other sector weightings remain much the same. We own more in Asia than in Europe, particularly as we have been selling some of the companies we picked up around the Italian referendum sell-off. These include solid companies such as **Roche Holding** which had recovered well above previous levels.

These were intended to be short-term recovery trades, and largely performed their task. We may well see more opportunities to buy Europe on sell-offs throughout the year.

A quick profitable Trump trade

We have also been selling the **Mexican ETF** on strength. As we outlined last quarter, we thought the Mexican market and currency were oversold after the U.S. election, though the strength of the recovery has surprised us.

Going forward, we will continue to sell as stock valuations get stretched; as the risk increases; or as certain stocks hit their trailing stops. We fully expect to increase our cash position in coming weeks and months, absent a meaningful market pull-back. We are ready to buy global equities on any correction. Opportunities may come amid political upset in Europe, or political disappointment in the U.S. Absent the introduction of protectionist measures, we do not expect to see sharp sell offs in Asia, but are buying select companies on dips. At the same time, we are maintaining our high allocation to gold and gold stocks, now topped up.

■ Gold Accounts

As indicated last quarter, we continued putting proceeds from earlier sales to work, reducing cash from a little less than 6% to around 4% (and less if new accounts not yet fully invested are excluded).

Balance in portfolios

The percentage of senior miners dropped down another notch, from 31% to just under 30%, though this was the result of relative market moves rather than any sales of seniors. We are continuing to buy second-tier and junior producers, now around 6% of portfolios, though valuations in this segment are not the most attractive.

One such company we have started buying is **OceanaGold**, an Australian based company, with operations in New Zealand, the Philippines, and now in South Carolina, with the start up of the Halle Mine, acquired in 2015. It is cheap because of the problems in the Philippines.

Taking profits after good run

On the sell side, the major change has been in selling some **Osisko Mines.** In most cases we sold only part of positions after the stock saw an outside move. We still like the company, but development of its Windfall project will require additional capital, and we do have exposure through our large holdings in **Osisko Gold.**

As always, there has been ongoing trimming of various companies, on stock rallies, and client specific, as well as additions to existing holdings on declines. We purchased more **Miranda Gold**, for example, after a strong joint-venture hardly moved the stock price.

Going forward, we expect to continue to be fully invested since we are positive on the gold price in the period ahead, and our allocation will remain similar to what it is today: seniors and exploration about 30% each, with additional allocations to junior producers, and non-gold, mostly silver, companies. We will be watchful of stock prices that value companies fully, and other situations where risk increases, rotating out of such stocks into undervalued or "new" stories.

■ Resource accounts

We have put cash to work in resource accounts, with cash dropping from 12% of accounts to around 5%, and we expect that to drop further as we look to invest in the oil sector. Indeed, much of the cash is set aside for potential exercise of puts we have sold. Unrestricted cash is around 2%. Right now, we are underweight oil, and this has served us well. We are more fully exposed to gold, silver, copper, and energy (ex-oil and gas).

What happened to Nevsun?

The accounts are up nearly 7%, and that despite a significant drop in our largest holding, **Nevsun Resources.** Nevsun came into our accounts when it acquired **Reservoir Minerals,** but despite ongoing selling, it was still the largest position as we entered the year.

We sold another 20% of our holdings earlier this quarter on concerns about the metallurgy in its new zinc-copper expansion, which concerns fully came to realization mid-quarter after the company announced its year-end results. The stock plunged from a high over $3.50 to a low of $2.33 (before recovering slowly to $2.56).

A target itself?

At this level, in fact, we think the stock represents good value (mainly for the assets it bought from Reservoir), and is indeed a potential take-over target itself; we have bought small positions for new clients. But the significant stock decline in our largest holding obviously hurt account performance this quarter.

A new buy

We have added one new company, **Niobay** which is developing a niobium project in Ontario which will be well-placed to compete with the global giants when it comes into production. We also added significantly to one of our top silver companies, **Fortuna Silver**, particularly after the stock fell following the announcement of a rather arcane challenge by the SEC to its financials. Fortuna is a solid company, well run, with a strong balance sheet, and which has recently acquired a gold project in Argentina and options a copper-gold project in Serbia.

We sold some **Ivanhoe Mines**, after the stock ran to $5, from the low $2's at the beginning of the year. Given the risky locations of its projects (Congo and South Africa), we thought it sensible to lock-in some of our gains at the somewhat lofty valuation.

We are looking to add some oil companies to our accounts, but by and large, the best companies are not cheap, and the cheap companies are not the best. Generally, the sector is not at attractive levels unless the oil price moves us. But we expect to increase holdings here.

Going forward, we continue to hold both senior miners and royalty companies, which are most likely to move with the sector, as well as exploration companies for extra leverage. We expect to continue overweighting gold, which stands to benefit from many factors not all of which would be beneficial to other resources. But given the prospect of inflation and a lower dollar, as well as increased infrastructure spending in the U.S., and a recovery in China, we are increasing exposure to base metals.

In sum, we are slowly raising cash in global markets as valuations become stretched and risks increase, even as we accumulate positions in the undervalued Asian markets, look for trades in Europe, and maintain exposure to gold, both for its own merits and as a hedge on the broad markets. Most of our non-resource equities are strong dividend payers, so overall the portfolios offer a combination of good upside as well as downside protection. We expect to end the quarter with higher cash levels, absent a sharp sell-off in broad markets that would see us buying again.

Adrian Day, March 31st, 2017