PORTFOLIO REVIEW

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Nearly all asset classes are up this past quarter, everything up together in a last hurrah for the global post-crisis stimulus. Of course asset prices go up when money is pumped to Wall Street and rates kept ultra-low, allowing the wealthy to borrow and buy. Global markets overtook the U.S. in growth, and money has been flowing into emerging markets. Bonds, gold and real estate all rose. Many commodities—even iron ore!—were up. The U.S. stock market is showing internal signs of stress, and we expect a rotation out of the U.S. market into some lagging global markets, emerging markets, and gold in the period ahead. But with monetary policy globally moving, albeit hesitantly, to a more restrictive stance, it will be a more subdued period ahead for most assets.

■ U.S. lags global markets

Most global equity markets experienced strong rallies in the second quarter, notwithstanding a modest dip at quarter end. Asian markets led in the first quarter, European in the second. All major markets, and virtually all minor markets, are up year to date, with global markets (per MSCI World "Free" Index) up almost 10%. The U.S. is now a laggard. Among major markets, only resource-oriented Australia and Canada, and scandal-plagued Brazil underperformed the S&P.

Global markets added to their earlier gains for a 12% gain year-to-date. Our global accounts have underperformed, up between 3% and 7%* for growth and conservative accounts respectively. (These numbers are preliminary.) We discuss the reasons for this, and why we remain sanguine, below

Overall, commodities have had a poor year so far, with the broad sector, losing 5.6% (per the Bloomberg Index), led down by oil and gas. The metals, including gold and copper, were up. The stocks have lagged, with the XAU index of major gold companies up just 2.8% for the year so far. Our gold accounts are a little behind, up 2.6%, while resource accounts are up 3.4%, outperforming their index.

■ Why the underperformance?

What accounts for the discrepancies in performance between our accounts and benchmarks? In global accounts, we have been cautious, so are underinvested in expensive equity markets, and not invested at all in the so-called FANG stocks (Facebook, Amazon, Netflix and Google, which account for a significant part of the U.S. market gain this year). Shades of the dot-com era? European markets have been the top performers this year, and we have had little exposure there, both because of valuations and concern about the political and economic outlook. Time will tell if this caution has been correct.

Gold accounts underperformed. Certainly some of the individual stocks we hold have under-performed. Among the seniors, we added to both Yamana and Newgold, both on valuation grounds and because of expectations they would be added to the GDXJ index. (That whole saga proved a damp squib in the end.) They are both down on the year.

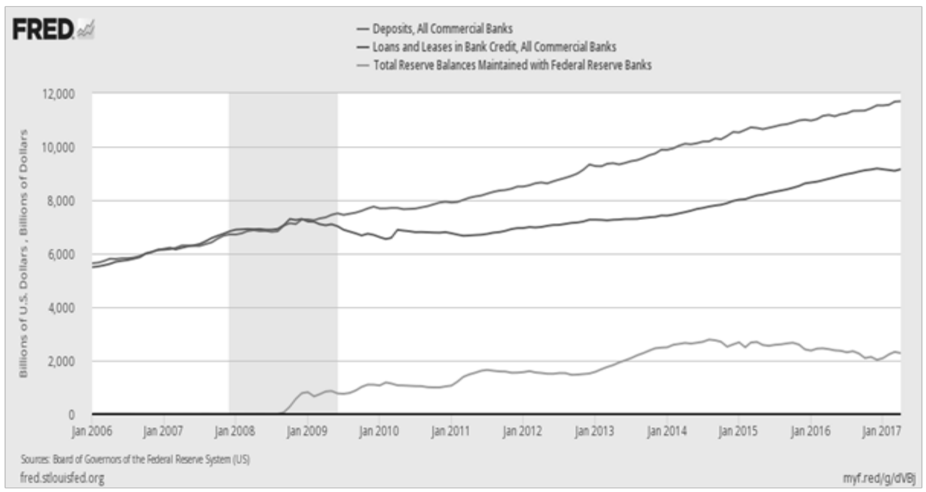
More importantly, some of our major holdings in resource and exploration stocks fell sharply, including Nevsun and Lara. (We should note that the outsized gains in Lara and Reservoir—acquired by Nevsun—helped contribute to strong outperformance in 2016.) In addition, the exploration sector generally has been weaker this year than senior and second-tier companies and we have a high weighting to such stocks. Some of our largest holdings, such as Midland Exploration or Riverside Resources, have declined this year, albeit modestly so. But when a major holding has a small decline against a background of a higher sector, it hurts relative performance significantly. We are comfortable with all these companies, and of course these smaller companies can experience sharply higher stock prices in a stronger market.

Resource accounts outperformed, notwithstanding the large declines in Nevsun and Lara, mentioned above, largely because we have avoided oil which is the largest component of most commodity indices.

■ Sluggish growth in the U.S.

The U.S. economy is not as strong as headlines make it appear. All sorts of indicators suggest growing weakness. Reports from just the last three days, for example, show commercial real estate weakening (from $160 billion of activity in the first quarter of 2016 to $95 billion in the last quarter)…total real estate loan growth down from 8.5% at the end of 2016 to 4.5% last month…the Chicago Fed "National Conditions Index" slipping into negative territory after a rally from mid-2016…the New York Fed's "nowcast" forecast for economic activity down from 3% in March to 1.6% forecast for the third quarter. We could go on. All the while, the net worth of the bottom 50th percentile remains below that of 2007 even as consumer debt reaches new highs. This is not a healthy economy.

Bank Lending Not so Strong



One factor affecting growth has been the low level of bank lending to small and middle-market companies. Even though total bank lending has increased since 2008—as would be expected—it remains below previous levels from the early 2000s; loans have mostly been to larger companies and large commercial real estate; and, significantly, loan growth has been far below the growth in total deposits. The gap has been made up by increasing amounts held as reserves at the Fed.

More lending: Higher growth and inflation?

Lending standards for small business are "tighter than ever", according to John Allison, the former CEO of BB&T Bank. By easing regulatory restrictions on such lending, as well as by the Fed reducing what it pays on bank funds on deposit, banks would lend more to Main Street giving a tremendous boost to the economy.

It would also boost inflation in price levels. The money created out of thin air by the Fed over the past 10 years has laid the groundwork for inflation, but by mainly keeping that money on deposit, banks have prevented it getting into the real economy and raising price levels. Instead, asset prices have appreciated as investors borrow at ultra-low rates. If banks step up lending to small business, that money will flow into the real economy, and, eventually, lead to an increase in the price level. That, I believe, could be the big unrecognized economic story of the next few years.

Bad breadth increases risk

Meanwhile, U.S. stocks are increasingly vulnerable. Corporate returns have been reasonably good, with positive quarterly financials this year for the first time in nearly four years. M&A activity and increased activist investing has also boosted stock prices.

But valuations are well above normal (by some measures, higher than 90% of the last 100 years), even as retail investors pour into the market, taking sentiment into extreme levels. Market breadth is increasingly negative. These are all warning signs.

A very small number of stocks, led by the FANG stocks, plus Apple and Microsoft, have led the market. Since early 2015, these stocks have risen over 50% while "the S&P 494" is up just 4.5%. The discrepancy has widened this year, with just 10 stocks responsible for over half the S&P's gains. Significantly, as with many distorted markets (think the go-go funds of the 1960s, or the dot-com mania of the last 1990s), these stocks for the most part have a lot of air under them. Who is waiting on the sidelines to buy Facebook on a 10% price dip because it would represent good value? When these stocks turn, they could drop significantly, and take the market down with them.

Such would be an opportunity for value investors and stock pickers to shine again. Passive investing is largely a bull-market phenomenon and a self-fulfilling one. In a bear market, one must select one's targets far more carefully.

Global Equities Lag

Source: Things that Make You Go Hmmm…

■ World grows slowly amid rotation

The world's economy is growing but at a slow pace, with the U.S. tepid and momentum in Europe slowing, but China stabilizing. The pace of trade has been improving but very slowly. Global stock markets, however, are trading at unprecedentedly low levels relative to the U.S., lower than at other extremes, in the early 2000s, lower even than early 1970s. This has more to do with high levels in the U.S. than bargains throughout the rest of the world, but there are *relative* values, and we anticipate a continuing rotation out of U.S. stocks (and bonds) into global equities, including emerging markets (and global high-yield markets). The decline in the dollar this year and anticipation of further declines will accelerate this move.

■ Europe: Optimism despite uncertainty

In Europe, after a growth spurt, the momentum has turned down meaningfully. Under-employment, despite a modest improvement this year, remains significantly above 2007 levels. The main problems Europe faces in the months ahead are political: talks over new a Greek debt package during the summer; German elections in September; a pending Italian election, perhaps as early as September; and increasingly contentious Brexit talks.

The timing of the Greek talks is ominous, coming right ahead of Germany elections; many taxpayers in Germany feel "enough is enough" while the IMF wants more austerity of which the Greeks have had enough. Italy faces more bank bailouts as well as polls showing a majority want to leave the Eurozone. And many in the European bureaucracy want to punish Britain for its temerity in wanting to leave the European club, as well as *pour encourager les autres.* (So far, the European "negotiating stance" has been that Britain should continue to pay fees to Europe, continue to be subject to the European Court, and continue to accept immigration from Europe. Why leave?)

Amid all this, European stocks are reflecting the recent economic growth uptick. Estimated price-to-earnings are reflecting 30% earnings growth over the next 12 months. That sounds optimistic to me, and given that stocks are already relatively expensive—with big caps at 20x p/e—European stocks do not appear especially compelling.

■ Strong finances and cheaper stocks in Asia

Better values can be found in Asia, which has stronger economic fundamentals. Government finances, household savings rates, and bank liquidity are all strong in most countries in the region, and stronger than in the U.S. and in Europe.

In China, there is a mini-credit crunch, with an inverted yield curve (often an omen of an impending recession). But the long, slowdown in economic growth—never forget, it is still *growing* at a 6.5% rate—may be coming to an end. Recent economic reports have been modestly positive, in particular the latest Purchasing Managers' Index, which showed a slight acceleration; PMI is a key indicator of future manufacturing strength. The increase in the iron ore price, entirely due to Chinese imports, tells the same story.

A stronger Chinese economy will boost Hong Kong and the rest of the region. Singapore has bounced off very low growth in 2016. Most Asian economies are on the upswing of the cyclical growth curve, including Taiwan and Indonesia. (Indeed, most emerging markets are on this part of the curve, including Russia and most of Eastern Europe, and much of Latin America, those you would care to invest in, at any rate.)

The decision by Morgan Stanley Capital International to include some Chinese shares in its benchmark emerging market index (up from frontier market status) is a positive for this market. Other markets remain undervalued: Singapore and Hong Kong shares both trade around 13 x earnings, 1.3 x book, and yielding well over 3%, for example, are among the least richly valued of non-emerging markets.

Overall in global markets, we have been raising cash particularly in the U.S. and Europe, while largely holding our high allocation to Hong Kong and Singapore. Overall, we expect cash levels to increase in coming months, though we are ready to invest on meaningful price declines.

■ Some bright spots in weak commodities sector

Commodities have had a poor year so far, with the Bloomberg Commodities Index down nearly 6%; it fell pretty much throughout the year until a quarter-end rally. It was a decidedly mixed period for different commodities, however, with some (gold, copper) up nicely, others very volatile.

Oil (and gas), major components of commodities indexes, hurt overall performance, with both falling throughout the period. Oil entered the year at its high ($57), closing after a rally in the last 10 days to $46. Gas was extremely volatile, against the background of a multi-year collapse, but closed down around 17% for the year. The problem for both commodities is oversupply. Oil storage is still building, and remains well above five-year average levels, though recent weeks have shown a slower trend. Production remains soft in many markets (including the U.S.). We expect gas supply to decline on lower production; no-one is making much money at current levels.

Overall, though, the outlook does not look particularly positive in the near term—absent some disruption in the Middle East—while valuations, particularly among the larger and mid-tier companies, are not particularly compelling.

■ Uranium and copper: Coming soon

Uranium has ended the period much where it started after a failed early-year rally. Though China's huge reactor build remains on track, and Japan is slowly restarting reactors six years after Fukushima, the former is well priced into the market while the latter is slower than expected. There is devastation in the sector, with spot prices (other than a dip in December) at 12-year lows, many producers losing money, and power plant builder Westinghouse pushed into bankruptcy.

Many long-term contracts are coming due in the near future. There is no appetite among producers to sign long-term contracts anywhere near today's spot prices, but with excess inventories and new supply there is no bargaining power. We expect a slow recovery as production slowly cuts back and new demand comes on stream, but the key word is slow. It's too early to be aggressive on this sector.

We like copper. It has been very volatile this year, but is up year-to-date (around 7%), close to two-year highs. Given mines in development and the difficulties in getting some of them into production (e.g., Resolution in Arizona), we see an impending supply shortfall, starting around 2020. Markets anticipate, so we are building positions in copper, on individual stock weakness.

■ Gold: Uncertain uptrend

Gold has also been volatile, ending the period up nearly 8%. This is remarkably strong performance given the Fed has engaged in a tightening phase and stocks continue to perform well. We have seen a series of higher highs and higher lows, a positive pattern, though the last few weeks, where a bounce has reversed, gives some pause; the next few weeks should provide a clearer technical picture.

Fundamentally, however, we remain positive: the dollar has topped, and though a near-term rally may be in the offing, it is likely to be weaker going forward; though rates around the world are likely to move higher, the pace is cautious; and inflation in both the U.S. and Europe is slowly moving up. Political uncertainty in the U.S.; geopolitical tensions (in Korean and Syria); and a contentious period in Europe all lend support to gold.

■ Gold Stocks Hesitant

The stocks remain undervalued, and have significantly underperformed the metal this year. After a strong start, the stocks have not moved much, even on gold rallies, suggesting investors are hesitant to jump on board until the trend is firmly established. The gap between gold and gold stocks has widened since February, suggesting the stocks have some catch-up to do if gold does break out. And gold stocks are particularly under-owned among investors.

The major miners are cheap not only relative to gold but on their own historical valuations as well, close to multi-year lows on many metrics. Absent a breakout and a firm trend higher in the gold price, the sector needs either more M&A activity or, for juniors, meaningful exploration success. Individual stocks still respond well to such events, but with little impact on the rest of the sector.

Gold Stocks Are Lagging Gold

We are fully invested in gold stocks, but as always, alert to opportunities to raise cash (from selling some of our short-term trades, for example), we are continuing to buy, particularly building positions in some second-tier producers, in select exploration companies, and in royalty companies large and small. We anticipate we will remain fully invested in the foreseeable future, notwithstanding occasional sales.

Overall, we are raising cash, particularly in U.S. and major global stock markets and expect to finish this quarter with higher cash levels in all accounts. We continue to hold a high allocation to gold, and are looking to add to that sector, selectively, as well as undervalued global equities, particularly in Asia.

Review of Individual Accounts

■ Global Accounts

Taking advantage of some price declines, particularly of sell-offs in some Business Development Companies, our cash levels in global accounts fell from something shy of 12% to just over 9%, though it remains above where we entered the year. Our allocations among various sectors remain broadly similar to where we entered the quarter, with BDCs now accounting for a little over 10% of accounts (more for conservative accounts, less for aggressive), up from a little under 10%; Asian equities are more-or-less twice European; and fully invested in gold and resources.

Rotating BDCs

Our buying was focused on the BDCs, adding one new name—**Hercules Capital**, which fell sharply after an ill-judged plan to move to an external manager, but which we think is fundamentally sound, with a 9.4% yield—and adding to several of the stocks which experienced sharp drops in the quarter, often buying back the same companies we had sold earlier at higher levels.

This increase in exposure came despite selling much of our **Gladstone Capital.** We sold purely because of valuation levels, and, with the stock trading at a meaningful premium to NAV, the risk of an equity raise that would punish the stock. I might say we should not have sold quite so much had we not already had a large exposure to the Gladstone Group (through Investment and Land); and we will buy back on any meaningful drop.

Other than Gladstone, our sells this past quarter were stocks held by few clients, **Orkla**, **SJM**, and **United Overseas**, all sold for valuation reasons. Mostly, in global accounts, we *held* positions in Asian equities, which neither moved far enough into overvalued territory to sell, nor fell enough to be good buys; most of our Asian stocks pay good dividends.

Going forward, I fully expect to see the cash levels move back up as we look for opportunities to reduce exposure to vulnerable global equity markets, while maintaining our exposure to gold and continuing to be ready to buy specific stocks that look undervalued, focusing our search right now on major Asian markets.

■ Gold accounts

We continue to top-up gold accounts, with cash levels now down to just 3%. Allocation to seniors moved up to 36%, though we added very little; it was primarily because of better performance than the exploration stocks.

Weighting to the second-tier producers—a group that could outperformers because of growth prospects as well as a greater chance of being acquired—increased meaningfully, from just under 6% to over 9%. But this is somewhat misleading, since we moved some long-held stocks—such as **Pretium**—into this category. (Pretium had its first gold pour at its Brucejack Mine in late June.)

Buying junior producers

We continued to add to second-tier producers, including the aforementioned Pretium, as well as new-holding **Oceanagold**. We also bought **Sandstorm Gold**, a junior royalty company. This was after it agreed to buy our holding **Marianna Resources** at a significant premium. We were able to sell Marianna at an attractive profit and pick up Sandstorm when the arbs knocked it down (as they often do).

Taking advantage of rally

We trimmed a little **Osisko Gold** into a good rally after it acquired a royalty package that transforms the company. It should be noted that we had been adding to Osisko on previous weakness even though it was already one of our largest holdings, which it still remains.

As always, there was some trading among our exploration stocks, trimming a few names and generating some good short-term gains when stocks popped for no good reason, and added to favorites on weakness, as well as adding one or two new names. As usual, we don't name these stocks since they are very thinly traded.

Going forward, we expect to remain fully invested and with a similar allocation, holding large exposures to royalty companies large and small; well-financed and disciplined exploration companies; and second-tier producers. If we see risk increase or limited potential for a particular company, we will sell down in order to raise cash for new companies or opportunities that arise. But with no shortage of undervalued quality companies, we expect to remain fully invested.

■ Resource Accounts

There has been very little change in our resource accounts this past quarter, with main exposure still to gold, silver, copper and energy (ex oil and gas). We have little exposure to other base metals or bulk commodities (other than through diversified companies), little to uranium, and are still waiting for oil (either for the sector to look more compelling or for valuations to come down). Cash levels, as expected, fell, now at 2.4%.

We had only one sell this quarter, **Platinum Group Metals**, amid weak platinum prices; though we lost money on the investment, we escaped further declines in the stock.

Adding to copper and silver

We have added both to copper and silver, focusing on **Freeport Copper** when the stock was particularly low; and on **Fortuna Silver** and **Golden Arrow.** Of the two silver companies, the former is one of our favorite producers; the stock was hurt by an SEC review, which now resolved in the company's favor, the stock is recovering. The latter is undervalued given an attractive joint-venture with Silver Standard; once the company starts to receive revenue from the venture, I believe the market will begin to understand the transaction and the stock will recover.

Going forward, we expect to remain fully invested, and expect our mix of commodities to remain relatively constant. As always, we are alert to selling opportunities, but in the coming quarter this will likely be company-specific, either because of a heightened risk or an overvalued situation, rather than any broad selling.

In sum, we have been slowly raising cash in global markets as valuations become stretched and the risk increases, and are likely to continue doing so. This is despite occasionally finding good valuations in Asian markets, in U.S. income stocks, and in gold and other resources. Often these opportunities arise because of short-term declines on either company-specific developments or macro-events affecting an entire market or sector. Such purchases may be short-term trades as the stocks recover. Overall, we believe a rotation is ahead from the most expensive global markets, including U.S. equities, U.S. bonds, and European big-caps, to undervalued or ignored global markets, including emerging markets and gold. We are well positioned in more defensive dividend-paying stocks, as well as global equities and gold.

Adrian Day, June 30th, 2017