PORTFOLIO REVIEW

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These are difficult times for investors who believe in value. With the S&P trading at higher valuations than it has for 90% of the last century, it is hardly a time to pile in. Yet the market continues to move up. Indeed, almost all assets and markets are up, in perhaps one last hurrah as the Federal Reserve prepares to remove the punch bowl and the party starts to winds down. There will be a reckoning, leaving many casualties in its wake, but meanwhile the cautious are left behind.

■ Everything up, in last hurrah

Almost every market and asset was up in the last quarter, with exceptions mostly disparate and isolated assets including the Argentine peso, the Tel Aviv stock market index, and U.K. notes, and even those losses were minor. The S&P was up 4% on the quarter, bringing its year-to-date gains to over 12%. Foreign markets were up by about the same on the quarter, but remain meaningfully higher for the year to date, reversing the pattern of recent years. European markets are leading the way, with most up in the low to mid-20% range, as are some Asian markets. This is part of the fundamental shift out of U.S. assets into foreign stock markets and gold we've discussed previously.

For the quarter just past, the average U.S.-based global equity fund was up just a sliver over 3%. Our conservative global accounts were up, in aggregate, a touch under 3.4%*, while our mid-risk growth accounts were up just over 2%. (All numbers are preliminary.)

We got some markets right—such as Hong Kong, the best-performing major Asian market, where we are overweight—but we have avoided the best-performing sectors such as U.S. technology and financials, and are severely underweight the high-performing European markets. We are overweight gold in our global accounts, more so in the less-conservative accounts. And we have been building cash, which is obviously a drag when markets are doing well. We have sound reasons for such actions, but whether they prove to have been correct remains to be seen.

■ Beat benchmarks

Resources reversed and moved up this past quarter (with the Bloomberg Commodity Index up 2.25%), though still down for the year. Energy did well, as did many of the base metals. Gold itself rose 3.2%, with the stock indices up more, though the average gold mutual fund was up 2.5% for the quarter, once again, unusually lagging the indices.

Our resource accounts were up 3.7% and our gold accounts 3.3%, beating respective benchmarks. Though our accounts included a heavy allocation to junior and exploration stocks, which generally underperformed, we have had a few individual stocks that experienced outsized returns, with a couple the object of takeovers. (We are prohibited from naming them, due to SEC rules.) This, and generally avoiding the worst performers among the larger companies, helped us outperform this past quarter.

■ Change in Direction at Fed

The Federal Reserve has begun the process of monetary tightening, with three rate increases, albeit hesitant, and a plan for reducing the size of its balance sheet. The Fed's assets increased from under $1 trillion in 2007 to $4.5 trillion, and it now plans to cut back to $3 trillion by 2021, initially by simply not reinvesting all of the proceeds from maturing bonds. This will still be more than three times the size of its assets in 2007, again showing the same hesitance we see in the Fed's interest rate actions. In addition, the Fed has announced it expects to end the rate-hiking cycle much sooner than usual, and sooner than previously noted, with rates at 2.75%.

Another rate increase is expected in December, after the Fed passed on one in September. This is already reflected in market prices, we suspect, so if they skip again it will be negative for the dollar and positive for gold.

The reduction in the balance sheet will have a significant impact on the bond market, initially by removing a buyer and eventually adding a seller, particularly so in the mortgage-backed securities market where the Fed holds $1.7 trillion out of a total market of $7.5 trillion.

■ How will it end?

Tightening cycles usually end badly, and this is true enough when the Fed is simply raising rates to stop the economy overheating. This time the economy is far from overheating—not so strong that it can withstand much higher rates—while the Fed will also be selling securities. The markets are particularly vulnerable—the bond market (per above), while stocks have soared the last few years on the back of easy money. When that stops, stocks could stumble.

The Fed is acting cautiously, and seems to think it has things under control. Two things could sideswipe the Fed's cautious plans: a recession and rising inflation. It would be interesting to see how the Fed reacts to either or both of these developments, both of which, in our view, are more likely than not.

■ Stock market not clear, despite gains

Though the U.S. stock market continued to advance—up a respectable 4% on the quarter for the S&P 500—with growing momentum in the last six weeks, and some major companies down meaningfully (GE, for example, down another 10% in the past quarter, on a stock that's lost a quarter of its value this year amid record highs for the index). Market breadth is poor and increasingly so, a negative indicator for the market.

As portfolio managers, we are not in the business of predicting the future, but assessing risk and reward. Risk in the stock market seems high and growing, notwithstanding that the market indices could continue to move higher for the rest of the year, particularly if the tax reform measure advances.

Some of the indicators typical of market tops are absent. There is no euphoria; short selling is high; the economy is growing without an impending recession apparently; corporate earnings are increasing (though 3Q growth will likely be lower than 2Q); and cash-heavy corporate balance sheets suggest buy-backs could continue.

How Far Down?

	Price to Earnings	Price to Book Value	Dividend Yield
Today's Multiples*	21.7x	3.2x	1.95%
Long-term Averages**	14.7x	2.7x	4.3%
Bear Market Lows	8	1.2	6.5%
Market Move to Average	-32.4%	-15.6%	-54.7%
Equivalent to Dow	15,323	19,120	10,277

October 4, 2017 Dow 22661 S&P 2,537
***Median, Source: S&P Dividend & Price Earnings from 1870, Price to Book Values from 1999*
HIGHS: DOW10/4/17: 22,661.64, S&P 10/4/17 2,537.74

On the other hand, there are plenty of reasons to be cautious. This is the second-longest bull market in history. Stocks are expensive on any fundamental basis, one of the most expensive markets in history. The market had moved higher on easy money, which is now reversing, boosted by stock repurchases which were aided by abnormally low interest rates. The mood is one of complacency. All this argues against a significantly higher market.

Growth stocks have outperformed value for the last few years, and such a run often marks a turning point. We can say the risk has increased, particularly for individual stocks. From here, the multi-year returns would be low, even if there is no overall market decline.

So on balance we are being cautious buying U.S. stocks, and, though not in any rush, have continued to steadily sell and increase cash positions.

■ Better value abroad, as fund flows shift

Global markets have continued to outperform the U.S. as a move from the overvalued U.S. market to better-value assets, including global markets, continues. Despite the much stronger rallies this year—over 20% for most European and Asian markets—they remain better value than the U.S.

European stocks are trading at 18 times earnings, somewhat less than the S&P's 22x (and even cheaper on yield and book value bases). But given the high expectations that are built into European stocks, with analysts calling for over 17% earnings increase over the next 12 months, and strength in the Euro which will hurt European exporters, we are cautious on European stocks.

Asia is far better value, with Hong Kong trading at 14 times growing earnings and yielding 3.6%, while Singapore trades at an 11 earnings multiple, yielding 3.2% (though earnings are expected to decline in the coming 12 months).

Overall, we retain good exposure to Hong Kong, but are primarily bottom-up investors in other markets, looking for quality companies with positive outlooks, selling at low multiples, regardless of the market or sector. In general, though, we are more selling than buying, raising cash amid historically overvalued markets.

■ Commodities up, but still too early

Commodities reversed in the third quarter from 1H losses, with energy and base metals particularly strong. Oil was up 17%, and among the metals, zinc led, up 14% on improved China demand, a lower dollar, and some supply disruptions.

The energy stocks rallied about 10% from their mid-August low, recovering some of the earlier losses, but lagging the commodities themselves. We think oil will continue in a trading range, so we are not yet aggressive on oil stocks, but buying very selectively and often for short-term trades.

The metals have moved too far, too fast; some of the mining shares followed, so we are waiting for a pullback. Though we do think China's demand will recover and supply shortages become more apparent, these are multi-year stories and not imminent. Moreover, after a sharp decline for most of the year, the dollar has turned up in recent weeks and could continue that recovery for a period.

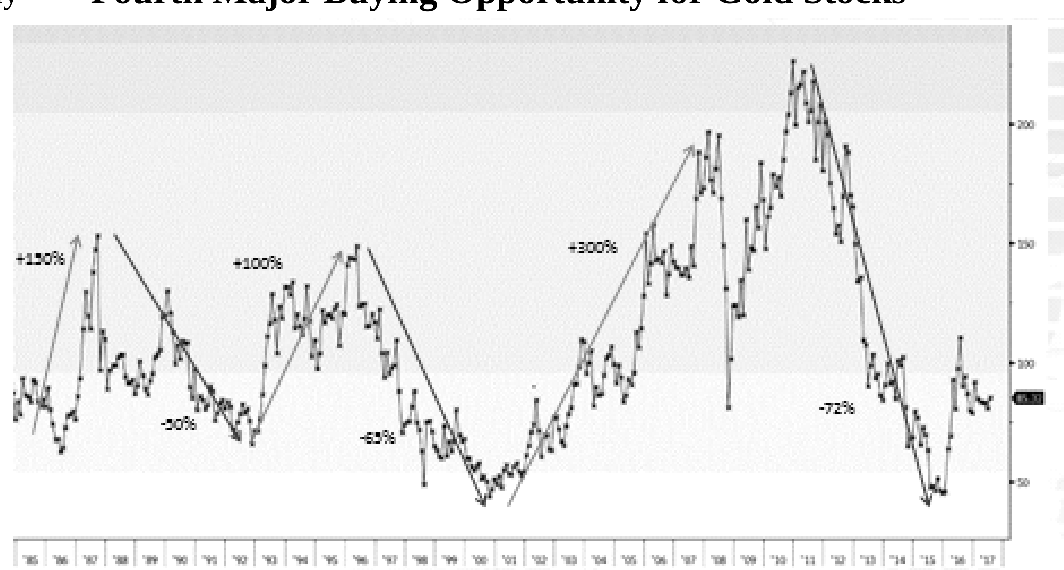
We own few metal-specific companies, but generally gain exposure to various base metals through other companies we own.

■ Gold volatile, but moving up

Gold broke out of its trading range to burst through $1300 and hit a peak of $1,350 in early-September, before falling back to the top end of its range, at $1,275 as I write). It is up for the quarter and year to date, however. It broke out of its range on concerns about the North Korea situation, but retreated on the conviction of an interest rate hike in December, which boosted the dollar.

There are many reasons to be positive on gold. The North Korea situation is far from resolved. A December hike is already in the gold price, but the arguably more significant news from the Fed, lowering their long-term rate forecasts, was overlooked.

Fourth Major Buying Opportunity for Gold Stocks



On price, gold is undervalued against the broad stock markets, while gold stocks are undervalued against gold. On valuation, the gold stocks are trading below average multiples on most metrics, and near the lows on several. M&A activities have stepped up recently as miners see the need for additional reserves in the years ahead which they are not finding themselves. They need to acquire projects from exploration companies and junior producers, and we expect to see many joint-ventures from the seniors in the months ahead. This will keep the exploration stocks active.

We are expecting a mini-recovery rally in the dollar. That, and seasonal factors, suggest gold and gold stocks may weaken in the near term, but we expect a major low sometime before the end of the year, most likely in mid to late November. So we have raised a little cash and are poised to get fully invested again before the end of the year.

We are focusing on producers with better returns; royalty companies large and small; junior producers that could grow or could be targets of M&A; and exploration companies, particularly those with low risk (strong balance sheets) or specific catalysts.

Overall, there has been quite a bit of activity in accounts this past quarter, as we slowly raise cash from selling global equities, including reducing allocations to the Business Development Companies sector (which we bought heavily at the end of last year). We have been slow to reinvest, so generally are increasing cash in global accounts. We also sold some trading positions in the gold and resource accounts, and trimmed overweight positions, to raise some cash for buying opportunities later in the quarter, though remain heavily invested in that sector.

Adrian Day, October 4th, 2017