# PORTFOLIO REVIEW

P.O. Box 6643, Annapolis, MD 21401 • 410.224.2037 Fourth Quarter January 2018


**The year of the "bull market in all things" is coming to an end, and with it, we suspect, the broad, indiscriminate bull. Global economies are all up in sync, but this might give pause; the last time we saw this was in 2007, ahead of the credit crisis. We are not suggesting a sharp recession and market crash are imminent. But some economic disruption and a market slowdown are possible, and some discrimination among markets and sectors more than possible.**

## ■ Everything is up

For now, pretty much all stock markets around the world are up for 2017, and all major markets, in North America, Europe, and Asia up in the mid-20% range. Emerging markets (per MSCI Index) are up 34%. Indeed, the S&P 500, at a positive 19.6%, is one of the laggards among the major markets. Bonds are up, notwithstanding declines towards the end of the year, and gold and gold stocks are up, as are hard assets of all type ($450 million for a possible Da Vinci?). Crypto currencies are up. The strength and breadth of the bull market is the result of too much money being created over the past 10 years and not being lent into the real economy.

Not surprisingly, when stretched valuations stretch ever more, value investors tend to lag the market. As David Collum (a chemistry professor at Princeton who writes a great annual market letter) puts it, "Prudence disappoints investors in the final stages of a market cycle." Our Global accounts have lagged this year, but for the latest quarter are up between 4.2% and 7.3%, mostly outperforming the average global mutual fund (per Bloomberg index), up 4.4%.* (All performance numbers are preliminary.)

## ■ Gold up

Commodities finished the year barely positive following an imperceptible decline in the latest quarter. Our resource accounts, up over 5% for the quarter well outperformed the broad index.

Helped by a year-end spurt, gold appreciated 1.7% on the quarter, closing above $1,300. The major gold stock indexes did a little better. Our gold accounts were up 3.5% for the quarter, well outperforming the average precious metals mutual fund (per Bloomberg index) which barely budged (up 0.13%).

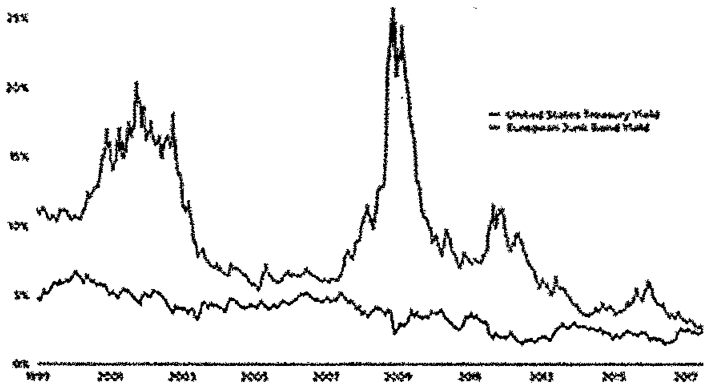
The reason for our relative performance in global accounts this past year is simple: after lagging earlier in the year as indexes roared ahead while we were far more cautious, in the last quarter, divergence in the broad market has become more acute, so we have begun to catch up. In addition, we are overweight Hong Kong stocks, which were best-performing major market last year. In gold accounts, we had some successes in individual stocks, particularly in silver stocks.

## ■ Rates remain low, distorting economies and markets

Notwithstanding the Federal Reserve's talk of Quantitative Tightening, as well as rumblings from the European Central Bank, interest rates around the world remain very close to all-time historic lows. Despite the tick up in rates, some $7 trillion of bonds trades at negative yields; these are bonds *guaranteed* to lose money for the purchaser. Ireland is the latest to join the crowd issuing “return-free” bonds.

And beyond the lunacy of bonds with a negative yield, there are other examples of craziness. Italy last year issued 50-year bonds yielding 2.8%. The bonds are denominated in Euro, a currency which did not exist 50 years ago, and which a majority of Italians want to leave. One only has to think about that country’s history over the past 50 years to appreciate just how crazy this is.

**Euro Junk Yields the Same as Treasuries**



And even worse: Argentina, that paragon of fiscal rectitude, has issue 100-year bonds with a yield of 7.1%. The bonds were four-times oversubscribed when issued, just one year after the country settled its latest international bond default. There have been multiple defaults over the past 100 years—going backwards, in 2014, 2011, 2005, 2001 and so on. Will the country be able to repay these bonds, in dollars, when they mature a century from now? Well, the 1914 peso has declined from one to the dollar to (adjusted for various re-sets) 72 trillion per U.S. dollar. It may be a smart move by the new (sensible) administration to sell the bonds, but I wouldn’t want to bet on Argentina a century from now.

And more prosaically, Euro junk bonds are now yielding the same as U.S. treasuries. Say what you will—and we have—about the Federal government’s finances, this defies common sense.

## ■ “Tightening” will be slow

So rates remain abnormally low, with many anomalies in the market, and central banks will be cautious in raising rates and reducing balance sheets. They will have to. Global debt has increased by over 35% since the credit crisis, and as rates increase, some debtors will find difficulties, among them the U.S. government.

The Federal government is paying just 2.2% on all its outstanding debt today, less than one-third of its 40-year average. As rates increase, the amount the government will pay in servicing its debt will increase dramatically, to almost 30% of the total budget a decade from now, using the Congressional Budget Office’s numbers. This is a major reason why the Fed will want to move rates up slowly.

As for reducing its balance sheet, it will also be cautious. Just as the Fed’s buying caused dislocations, so too will any selling. The Fed holds 25% of all mortgage backed securities. How can it reduce that with their not being serious consequences?

## Global Economies Improve

As mentioned, global economies are all growing together, an unusual experience. Europe has exhibited a strong improvement in growth, albeit from low levels, and this is likely to continue into next year. Partly this is due to a rebound in the economies of France and Italy, two of the big four European economies which had significantly lagged; and partly to a pick up in global trade, helping exporting countries. Unemployment remains high, particularly in certain regions, but is beginning to come down 8.8% across the eurozone, down from 9.8% a year ago). Conversely, inflation has been picking up but remains at low levels.

Asia (ex-Japan) tends to do better when the dollar is not strong and when interest rates are low (or not rising rapidly). This overall environment together with capital inflows and firmer commodity prices helped drive earnings growth across the region, up 22% last year, far better than the global average. Should the dollar continue soft, this growth could continue, if not at the same pace.

China's easing of monetary and fiscal policies has been effective in generating growth. Leading indicators and analysts are looking for growth in the year ahead of just under 7%, which would be very solid given stability in yuan and inflation. Strong inward foreign investment also played a role and will continue to do, unless there is a crackdown by the government. Debt levels remain the largest risk, though they are concentrated in certain areas (such as real estate). Moreover, the level of debt denominated in foreign currencies is quite low, minimizing to some extent the risk.

## Stock market valuations very stretched

On the 10th anniversary of the pre-crisis stock market peak, U.S. stocks (per S&P) are up 63%, notwithstanding the 2008 collapse; they are up almost 300% from the 2009 lows. Almost all sectors have participated, though financials, telecom, gold stocks and energy stocks remain below the pre-peak highs.

Despite that rally, we don't think the U.S. stock market is in a bubble, but valuations are definitely stretched, with the market rarely this expensive on fundamental metrics, the last time being in 1999 at the peak of the tech bubble. Market sentiment has also moved to extremes, with optimism at highs not seen since, again, the tech bubble. And volatility—a gauge of fear or concern—at lows since—you guessed—1999. With the "fear gauge" at over 50% a year ago, the investing public, to borrow a phrase from Merrill Lynch, have "capitulated into equities." The percentage of household wealth in equities is now in excess of the 2007 highs. Cash levels in brokerage accounts are at lows, while margin debt is at highs. Much of this, of course, is because bonds and bank CDs have hardly any yield, so even retirees are stretching for income.

The traditional fundamental metric of price-to-earnings, dividend yield, and price-to-book-value all show the U.S. market well above its historical averages—with a decline of over 30% to return the market to average p/e levels—and leading the global market overvaluation table. Other measures of the market also show an overvalued market:  stock market-to-GDP is back to levels reached in the dot com bubble record highs. The median stock-to-revenue is at new highs, 30% above levels of the dot com (the last record).

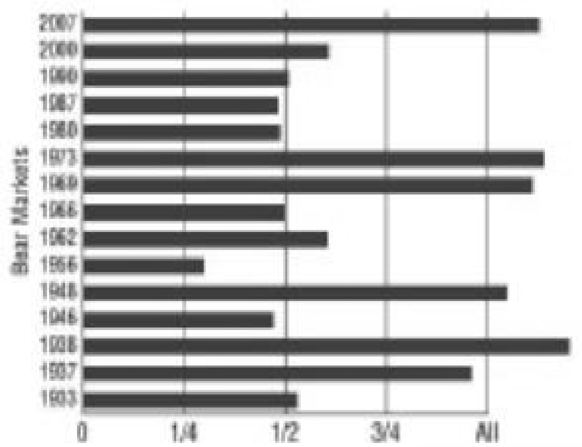
And the market breadth is dangerously narrow. An astonishing 0.2% of the stocks in Nasdaq—you know which they are!—account for 45% of the gains this year. The average stock—and more typical therefore of investors' actual performance—is off 20% from their highs. In the Russell 2000 index, some 30% of the companies are losing money.

## ■ Risk in stocks is high

Thus, the risk is high and has increased. This is particularly true of certain sectors, such as some tech areas, where valuations are not supported by reality, so we could see sharper pullbacks in specific sectors or individual stocks. The sharp decline in November in the high-yield sector perhaps is an indicator of things to come.

So, though there are reasons for the market to have appreciated in the last year, the *risk* has increased. How significant is that risk? Top market analyst James Stack has looked at every bear market over the past 100 years, 15 in all (and we are, therefore, well overdue for another one). Two-fifths of them gave back all the gains of the previous bull run, while virtually all gave back at least half. That would be at least 730 points off the S&P or 8,800 off the Dow.

How Much Given Back in Bear Markets




*S&P. Source: Peak Prosperity*

We want to avoid that kind of decline in accounts. Though trailing stops will provide some protection, as will defensive and non-correlated assets, the best defense is some cash. That is why we have been slowly raising cash in accounts as the market rallies. Cash will also allow us to pick up depressed stocks after any market decline.

## ■ No reason

Some commentators think that market corrections have to be provoked by a cause, by a recession, profits contraction, or aggressive rate increases. But sometimes markets just run out of buyers. Certainly, the recent tax bill will boost the economy (at least in the short term), and particularly boost corporate profits, and likely lead to an increase in capital investment (now deductible) and M&A activity. All this supports stocks.

But much of this has to already be in the market, which rose and fell over the past six months as optimism on the passage of a good tax bill waxed and waned. Valuations, as discussed, are high.  And sentiment has moved from complacent to downright confident, a danger sign.

Albert Edwards, the astute if notoriously bearish analyst for Societe Generale, notes that corporate debt is excessive, and companies with weak balance sheets have started to lag those with strong ones, often a harbinger of a bear market.

## ■ Raising cash, holding selectively

On balance, though we do not see an imminent crash, and indeed think another surge is possible, the risk has increased, particularly in certain sectors. So though we are holding on to most of what we own in the U.S. market—and even buying quality, dividend payers on dips—we are also looking to protect gains, especially on companies with over-ripe valuations, and have been selling specific stocks, either as rallies run out of steam or risks increase.

Increasingly, investors have turned to index funds; one commentator said index funds had "won the argument". But index funds inherently tend to perform well in strong, broad bull markets, with the bull and index ETF feeding on each other. By their nature, invest equally in all stocks, good and bad, appropriate for an environment or not. The longer this continues, the more distortions arise and better opportunities there are for stock pickers. In a bear market, index funds will no longer be the winners, and, given their popularity in recent years, will likely see massive outflows at such a time. We continue to prefer, and feel safer, owning reasonably valued, high-quality companies throughout this period.

## ■ Catch-up by global markets

At the beginning of the year, we discussed that global markets, which had underperformed the U.S., would likely catch up. That they have been doing, even though the U.S. has continued strong. Institutions have been putting new funds to work overseas more than in the U.S., while retail investors—as reflected in mutual fund flows—have been net selling U.S.-equity funds and buying global and emerging funds.

Despite the strong rallies outside the U.S., this market remains the most expensive of the major stock markets. The S&P 500 trades at an average 22.5 p/e, compared with 18-19 x for European markets, and low teens for Asia. (China, at 18 x, is the most expensive of the Asian markets.) This same league table holds for other valuation metrics, with the U.S. far more expensive than other markets, Europe second, and Asia third.

The consensus is for earnings to increase in virtually every major market except Singapore. An almost 30% anticipated decline in earnings per share could be a red flag for that market, though it's already in the market, trading at just 11 times earnings, while dividend yield and book are not expected to change much, making it an attractive market. When we look at individual stocks we see far more good values in Asia than in Europe (and the U.S.), so continue to hold more stocks in that region, and, particularly, add to holdings there.

## ■ Commodities recover

If the entire complex has been mixed, with orange juice (as an example) slumping to near annual lows, the metals have been on a tear, led by copper as well as aluminum, nickel and zinc. A soft dollar, improving global economy, strong demand from China, and supply disruptions (mine closings in China on its anti-pollution fight) have come together to drive most metals prices higher. Copper, aided also by supply interruptions at the large Grasberg mine in Indonesia, ended the year at highs not seen since the beginning of 2013, after the best run in the metal in 30 years.

The shares of metal producers for the most part have moved significantly, and are vulnerable to a pull back. We hold little outside of gold and silver (though we do have exposure through some diversified royalty and exploration companies).

## ■ Oil still range bound, inching higher

Oil rebounded in the second half of the year, recovering all it had lost in the first half and more, closing right at $60/bbl. Natural gas up sharply at end of year on cold weather, but given that storage has been building, this is only temporary.

Oil has moved up on the improved supply demand picture, as OPEC and Russia remain firm on their production cuts as demand, particularly from China, recovers. U.S. storage has been in a downtrend all year.

However, it is clear that higher prices are dependent, for now, on production cuts. As the price inches up, the changes of slippage in the production discipline increase. Moreover, higher prices should see some of the shut-in oil come back, and it can come back quickly.

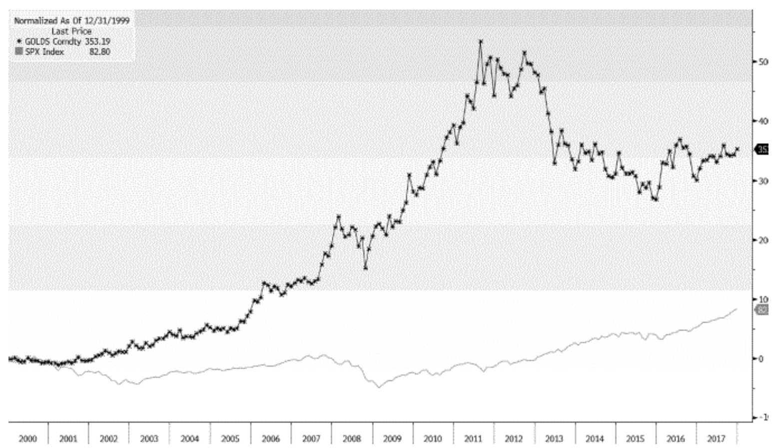
So we see the oil price continue to be range-bound, probably moving slowly higher on balance, needing significantly higher demand to move the price meaningfully higher on a sustained basis.

Meanwhile, the stock prices (for the most part, particularly among the larger E&P companies) are discounting higher prices and do not look attractive.

## ■ Gold to overcome headwinds

Gold is up around 13% this year, though you might not realize this by listening to CNBC and mainstream critics. Nor would you know that gold has outperformed the stock market since the beginning of this century (see graph, adjacent).

Gold certainly has faced headwinds this year and continues to do so: a stronger economy; a rising stock market; the new tax measure; rising interest rates; and competition from Bitcoin among many. Inflows to gold ETFs have slowed, and coin sales, particularly in the U.S. and Europe, are stagnant.




However, all these objections can be overcome. We have discussed our views on the economy and stock market. The increasing valuations of stocks are causing some to look at gold for a hedge, and a correction in the market would certainly see some rotation into gold. We have also discussed why the slow pace of rate increase we foresee, and from such low levels, is unlikely to derail gold. Inflows into ETFs picked up at the end of the year, as did bullish bets on the futures exchanges. And a major correction in Bitcoin may lead some to consider returning to the real thing. Importantly, a stronger economy, high stock prices, and rising interest rates are already discounted in the gold price we feel, so any reversal will help gold.

## ■ Europe and geopolitics to support gold

There may be support for gold from developments overseas. Europe could get messy again, with the important and contentious Brexit trade negotiations about to start; an uncertain German government; growing stridency by Poland and Hungry to the annoyance of France and Germany; upcoming Italian elections, with polls showing a majority want out of the Euro; and more Greek debt talks as old debt rolls over. All in all, in the coming year there are many things that could turn to the support of gold.

And around the world, there are many potential hotspots, including Saudi Arabia, Ukraine (again), and of course Korea. All in all we are looking for a stronger gold price in 2018, if perhaps not a dramatic spurt at the beginning of the year, but perhaps a more sustained move up throughout the year.

Gold stocks remain undervalued, selling well below historical average multiples on most metrics. We are fully invested in gold stocks in both gold and global accounts, and, though always aware of short-term profit-taking opportunities, we are adding to positions where cash is available. The coming quarters, however, are more likely to be a period of harvesting, and we suspect we will be raising some cash from gold positions over the next several months.

Overall, we have continued slowly raising cash in global accounts, particularly more conservative ones, as stocks hit trailing stops, or the outlook turns negative. We have been slow to reinvest, though we have added a few stocks in Hong Kong, but overall simply making up for what we had earlier sold. We have also added to some of the Business Development Companies, focusing on the best-quality ones where the prices have declined, again making up for sales earlier in the year. We remain fully invested in gold accounts, with a similar balance of about 30% majors, 40% exploration, and 15% each to junior producers and silver and other resources. Across all categories, we hold a large position in royalty companies. We do not see this overall allocation changing.

***Adrian Day, December 29$^{th}$, 2017***