PORTFOLIO REVIEW

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As complacency gave way to concern, the global bull market came to an end, as we suggested last quarter it might. It has been a volatile quarter for most markets and assets, but in the end most declined for the quarter. This is just the beginning of the unwinding of the "global bull market in all things", induced by massive global money creation. As central banks tighten, albeit hesitantly, and the blind faith is broken, it will no longer be a one-way street for markets and assets, with more discrimination among assets, bear markets for bonds and "new economy" stocks, and a bull market in gold.

■ Most markets down this quarter

Other than a handful of markets, all stock markets around the world fell this past quarter. Exceptions include tech-heavy Nasdaq, still up despite recent losses. We do not expect to be saying that at the end of the year. Italy (of all places) was the only major market in Europe to see positive returns this year, following the extraordinary election results. And in Asia, Singapore, Hong Kong and China were the only major markets up, the latter two only marginally and declining at quarter end; Japan was flat. Most Latin American markets were also up, led by Brazil, up 12%, the global leader this quarter, on the ongoing anti-corruption move. In aggregate, global markets outside the U.S. fell almost 2% (Morgan Stanley World ex-US index).

Our global accounts were also down, with the mid-risk "global growth" down 5.6%.* (All performance numbers are preliminary.) We underperformed because, since we were underinvested throughout, we missed gains in the first part of the quarter, and our high allocation to gold stocks and resources hurt this quarter.

It might be worth noting that we have outperformed over the past month, with our accounts up 2.6% compared with losses on the S&P, Nasdaq and global index (down 1.75%, 2.61% and 0.4% respectively). As the indiscriminate bull market ends, value investors like ourselves are better able to pick individual winners and avoid major losers, and outperform indices.

■ Gold and resources fell

It was a poor quarter for commodities and particularly gold. Commodities were (as always) mixed; oil was up 8%, copper down a similar amount, with the Bloomberg Commodity Index down 0.8%. It is a peculiar index—as are all commodity indices—with gold futures its largest single component (12% of the index, though multiple energy futures total more); gold was up 1.8% in the quarter. Most commodity indices hold agricultural futures, which we do not.

Although gold was up marginally, the gold stocks sunk after a January spurt, with the XAU index of senior gold and silver stocks down 4.6%; the average precious metals mutual fund (per Bloomberg Index) was down 5.7%.

Our resource accounts fell just under 5%, somewhat less than the equities of gold and base metals miners. Our gold accounts, though also down (4.1%), did better than the index and the average gold fund. We hold more juniors than the index (by its nature), and generally the juniors underperformed this quarter. Our modest outperformance was due to stock selection both among the seniors and the juniors, rather than any specific winners (which we could not tell you about anyway).

Looking ahead, we are expecting a stronger market for gold, and—finally—for gold stocks (for reasons discussed below), and in such an environment we are anticipating that more of our exploration and junior holdings will have outsized returns as they make discoveries that are rewarded in the market, or are targets of mergers or acquisitions.

■ Rising rates and rising inflation ahead

The Federal Reserve and other central banks around the world have embarked on a tightening phase, though as I have commented many times, moves may be very cautious and hesitant, at least for now. Inflation nearly everywhere is below respective central bank targets, and banks are unlikely to be aggressive in raising rates while this remains the case. (The perversity of a central bank trying to boost inflation is a phenomenon upon which we shall not comment at this point.)

Banks Lag Inflation

Country	Inflation*	Interest Rate**
United States	2.10%	1.75%
Canada	1.90%	1.25%
Australia	1.90%	1.50%
China	1.80%	4.35%
Japan	1.00%	0.10%
Britain	3.00%	0.50%
Belgium	1.71%	0.00%
France	1.40%	0.00%
Germany	1.60%	0.00%
Italy	0.80%	0.00%
Netherlands	1.30%	0.00%
Sweden	1.70%	-0.50%

Source: Bloomberg, *CPI **Central Bank Rate

Despite this, inflation has been trending, somewhat unevenly, upwards over the past nine months. In the U.S., the latest report, for February, showed inflation up 1.8% year-on-year, though 2.4% (annualized) on the latest month, and these are the highest numbers in the past year. Most of the recent gain is from services, but as the price of oil inches up so too does the cost of transportation, and eventually the price of goods, so we expect higher CPI numbers in the months ahead.

What matters for markets (including gold) is the *real* interest rate, that is, the nominal rate less inflation. Now, in every major economy except one—China—the latest rate of inflation is above the prevailing short-term interest rate. See table above.

■ Debt burden vulnerable

Even moderately rising interest rates will, however, have a negative effect on two major areas of the U.S. economy, namely, Federal government debt and household debt, if only at the margin. The U.S. government has been increasingly financing its now $21 trillion of debt with shorter-term loans, and as long-term debt matures and is replaced by short-term bills, that average maturity continues to shrink. Over all, the federal government is now paying 2.24% average on all its outstanding debt (including 30-year bonds issued 29 years ago with higher coupons).

However, since the Fed starting increasing rates at the end of 2015, interest payments by the Federal government on its outstanding debt have soared 38% (according to Palisades Research). This is a combination of higher debt levels, higher rates and some extending of maturities. As rates increase, there is more incentive to lock in rates for the long term, even though longer-term rates tend to be higher than short-term ones. So as rates move up, we can expect the interest payments by the Fed to ratchet up even more aggressively.

Household spending is up, but so too is consumer credit. Households have been borrowing 90 cents on every incremental dollar spent, up from 40 cents just four years ago (according to top macro-analyst Stephanie Pomboy). This growth in credit appears to have suddenly changed, with most of the savings from recent improvements in household income as well as from the Trump tax savings going to pay down debt. If interest rates continue to move up, we should expect this new trend to continue as paying down debt becomes more urgent and saving more attractive, with near-term negative effects on the economy and stock market.

So, overall, we expect inflation to continue to move up unevenly, rates to continue to move up cautiously, and at the margin, but increasingly, this to have negative effects.

■ Seismic shifts in market

The negative effects will be felt by the stock market. The global bull market since 2009, and particularly since 2011, has been driven primarily by massive injections of money by the world's central banks. Money and artificially low interest rates led to a large increase in stock buy-backs, but very little capital investment, and at the investor level, in a huge increase in margin debt, above 1999 and 2007 historic levels.

There has been a belief that markets would go up forever, and every dip was met with buying, as bad news was brushed off. The election of Trump with his promise of lower taxes, a regulatory roll-back, and massive infrastructure spending gave the market another, perhaps final, boost. Now the spell is broken and as time goes on, bad news will have a larger and larger effect, while positive news will be overlooked. One only has to look at the dramatic change in sentiment towards Facebook and Tesla to see how this can play out.

The sharp declines in technology stocks demonstrate a major fault in indexing, so popular as the market went up. One is in effect a momentum investor, buying more of the things that have gone up the most, until a handful of stocks make up an oversized part of the index, increasingly vulnerability to declines in ever fewer stocks. With technology accounting for over one-quarter of the S&P—and five stocks alone virtually 15%—a decline in those stocks or that sector have an outsized effect on the index.

Around the world, most stock markets are trading above their own historic valuation levels. The S&P is trading at over 21 times earnings, over 3 times book, and yielding less than 2%. Whatever accommodation one makes for a low interest-rate environment, these are high numbers, higher, as we said last time, than those at which the U.S. market has traded for 90% of the last hundred years.

The numbers are even higher for the Nasdaq index, and even more so for the "new economy" stocks. High valuations do not always trigger bear markets, but they do suggest that ensuing bear markets could be deeper.

■ Value around the world

Europe appears less overvalued—15 times earnings, 1 1/2 times book, and yielding over 3% (these numbers are for the better-valued larger companies)—but they are rich by European standards (other than the last few years). And although Asian markets can also be said, for the large part, to be trading above long-term historic averages, they are relatively significantly less expensive, with Hong Kong, for example, trading at 12 times earnings, 1.4 times book, and yielding 3.4%, and this is a region where underlying economic fundamentals have improved over the years. They are less dependent on volatile commodities and exports to the U.S. than ever before.

It is in Asia where we are finding most value. Even China, if you exclude the internet stocks, is trading at reasonable valuations. Typically, higher inflation, a weaker dollar and global growth are positive for Asian markets. As the dollar weakens and inflation picks up, the outlook for Asian markets appears positive so long as global growth continues, however anemic it may be.

The obvious major risk for global growth, and export-oriented Asian economies in particular, is of a trade war. It would appear that the seriousness of the risks are appreciated; in Washington there is significant pushback against broadening the imposition of tariffs, while China is taking a restrained response, and other nations, however frustrated, are waiting to see what's next.

For now, Asian companies are seeing significant earnings growth, and are increasing capital investment. Banks generally will be slower to raise rates because the economies are earlier in the economic cycle. So for now, the outlook for Asian stock markets appears positive, and we continue to build positions, however cautiously.

■ Should the dollar be stronger?

The direction of the dollar is certainly something that will affect not only Asian stock markets. The dollar moved almost in lock-step with interest rates until the Fed started more seriously increasing rates at the end of 2016; the dollar is down about 10% since then. Of course, other factors come into play as well.

To start, there are plenty of reasons to think the dollar should be going up. The U.S. economy has improved, more so than other economies. The U.S. is increasing rates at a faster pace than other major economies (thus making U.S. debt more attractive). The repatriation of billions of dollars held overseas following the Trump tax measure (some of it already held in dollars, of course) should also have boosted the dollar.

But the opposite has happened. Almost to the day, the dollar has declined since Trump's inauguration. For some, that is all that needs saying, and of course the uncertainty created by the Trump administration is not a good thing for a safe-harbour asset. But it's not that simple. The dollar was arguably overvalued both in the immediate term and longer term when Trump took office, particularly after the strong rally following his election.

There is also a lack of confidence in the Fed to unwind its balance sheet and raise interest rates without hurting the economy and assets; the Fed is also seen as somewhat lagging in its rate policy. Having waited so long to raise rates, however, the Fed now has the classic dilemma. This is not to suggest that the European Central Bank or the Bank of Japan, among others, get particularly high marks. But again, if the dollar is meant to be the world's reserve currency and a safe-harbour asset, confidence is even more important than for other currencies.

On balance, we think we could see a near-term modest rally—as high as 95 or even 98 on the index over a few months—but beyond that, a weaker dollar as the Fed either acts cautiously and lags inflation, or more aggressively and hurts the economy and markets.

■ Resources mostly down this year, but outlook good

Certainly the direction of the dollar is one major factor affecting the prices of resources. Other things being equal—and they never are—the dollar price of a commodity will go down when the dollar itself goes up. Thus, the strengthening dollar this year has, among other things, seen most resources, particularly the metals, retreat from last year's strong moves. Many have started to move up in the last week or so, and year-on-year are still up meaningfully.

Copper, which has fallen from $3.30 to $3.00 this year, is still up from $2.55 a year ago. Copper inventories have been building the last few weeks, suggesting we may not see a near-term rally, but further out, supply shortages are almost inevitable (as we have discussed before).

■ Resource stocks mostly weak

Equities of metals producers are also down this year, anywhere from 8% (Rio) to 38% (Sherritt). We have exposure to copper through diversified and royalty companies such as Altius, but will be looking for the right time to start building positions in producers, particularly in copper and uranium (another resource with looming shortages, though in uranium's case, they depend on expected demand more than supply shortfalls).

Oil has been inching up, from $60 to $65 this year (and up from $45 a year ago). We expect oil to continue to trend slowly upwards, trading within a fairly narrow band, as demand increases. But we do not expect any dramatic move soon (absent a sudden geopolitical event), since there is a lot of oil, particularly U.S. shale and Saudi crude, that can be turned back on quickly in response to higher prices. The major integrated oil companies represent reasonable value and we have been buying, though the large E&P companies are discounting higher prices in our view, and we are looking to build positions, but at the right price and without urgency.

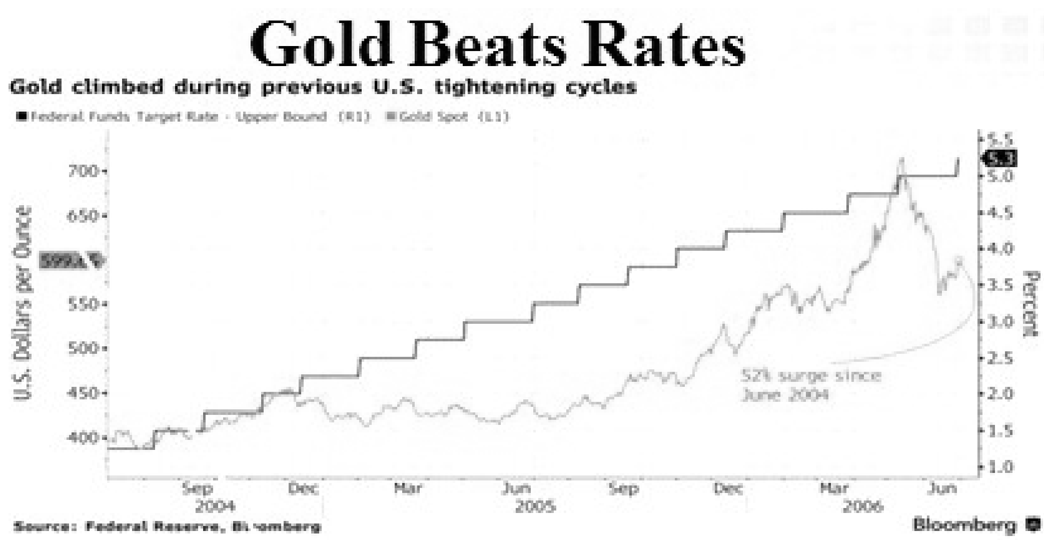
■ Gold outlook for continued strength

Gold, unlike most of the metals, had another positive quarter, holding up while most metals retraced some of last year's gains. Its somewhat lackluster gains nonetheless were group-leading, other than nickel and tin. There are many reasons to be positive on gold, some of which we have discussed in detail in recent *Reviews*.

First, as mentioned above, the Federal Reserve's interest rate moves are lagging inflation, and while inflation does not appear much of a threat now, it has been increasing and will likely start to compound. The monetary conditions have already been created, without doubt. For gold, *real* rates are what matters. We can cite many examples where rates have increased, sometimes dramatically, but where rates were behind inflation, gold also increased.

Look, most recently, at 2016 and 2017, where gold, after having declined significantly in the years before, turned around and appreciated 25% as the Fed raised rates five times. (A 25% rally over two years in an asset such as gold is a meaningful move, but hardly anyone seems to be watching.)

Before that, from the end of 2004 to the middle of 2006, the Fed raised rates in tiny steps 15 times (yes, 15 times in less than two years). Gold, after firming for about a year, took off, jumping from $450 to $700. See graph.



And of course, the classic case would be in the second half of the 1970s. Inflation (as measured by the CPI) moved from under 6% to over 13%; rates moved from 5% steadily upwards. For most of that period, rates lagged inflation, and gold moved from $130 to $850, an over six-fold increase. It was only after Paul Volker became Fed Chairman and ratcheted rates up as high as 20%, well above the rate of inflation, that gold fell, and fell sharply. Whatever virtues Jerome Powell may have, I do not see double-digit short-term rates in our near-term future. So, gold investors, don't fear higher rates in and of themselves.

■ Disputes with Russia and China, and lack of discoveries, positive

Other positive factors are the uncertainty in Washington and ongoing global tensions. Notwithstanding the easing of friction with North Korea, relations with Russia and china are increasingly fractious, while the Middle East remains a hotspot.

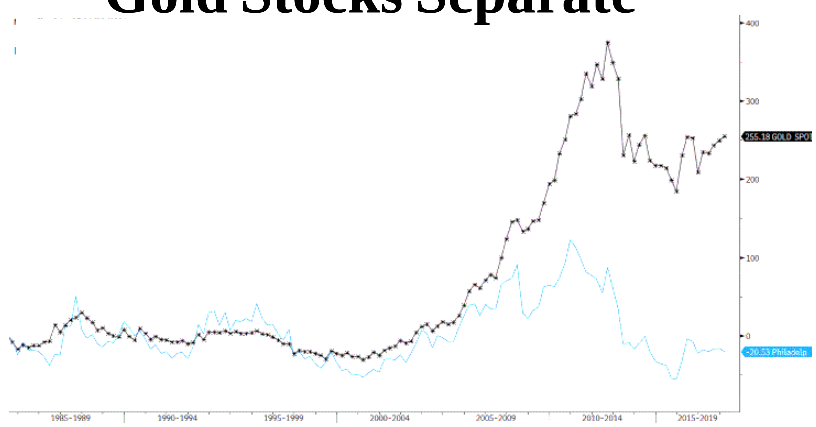
Importantly, also, other financial assets, which performed so well for most of the last decade that investors increasingly saw little need for gold, are no longer the one-way street they were considered. The 10-year note is approaching 3%, a level many bond investors consider a "red line", while stocks are down this year amid a sudden increase in volatility. This augers well for gold as an insurance and alternate place to put some investment funds.

Lastly, we have arguably hit "peak gold" at least for the time being, as the declining discoveries of the past 20 years show up in production numbers. The next few years may well see steadily declining global production, just as demand starts to increase.

■ Gold stocks languish, but turn ahead

As for the gold stocks, the gap between bullion and the stocks continues to widen. Other than the end of 2015, the gap is the widest in 30 years. See graph. Valuations are well below long-term average multiples on most metrics. If this was true a quarter ago and a quarter before that, it is even more so today. As my friend Rick Rule is fond of saying, "just because something is inevitable, it does not mean it is imminent."

Gold Stocks Separate



To some extent, the discount to bullion and the low valuations are justified. First, it is today far easier to buy gold (physical as well as the ETFs) than a decade ago. Also, there is a growing awareness of the problems inherent in gold mining, exacerbated by management blunders. The proof is in the pudding; gold miners have a *negative* return on capital of over 9%, one of the very worst of all industry sectors, while the gold stocks are lower today than in 1984. To say gold stock investors are disillusioned would be an understatement. So we may not see a return to the lustre of the early part of this millennium (and before) when gold stocks sported multiples that would be the envy of the no-earnings high-tech companies of today.

But the move is overdone. If gold itself continues to move up, at some point the producers of gold must eventually reflect that. And for juniors and exploration companies the outlook is even rosier. With declining production at most of the seniors and holes in the pipeline (remember, gold mines are depleting assets and companies must forever be replacing the ounces mined just to stay static), those juniors with solid mines or new discoveries or even high-potential land, will see investments by the reserve-hungry seniors.

Indeed, after a spell with hardly any investments other than by a handful of companies such as Franco-Nevada, we have started to see major producers step up with investments, joint-ventures and some acquisitions. Given the dearth of good deposits, we expect to see this turn into a wave of investment at some point in the not-too-distant future, and expect many of the juniors we hold to benefit handily.

In sum, we are holding the best of the seniors for when the sector makes its move, and adding to positions of drops, while building positions in prospective exploration companies.

Review of Individual Accounts

Global Accounts

Though we can no longer discuss specific securities, why we sold a particular stock, for example—thanks to the *diktat* of SEC examiners—we can discuss generally what we are buying or selling.

This quarter, our exposure to the broad U.S. stock market declined, though this was mostly if not entirely due to a sharp decline in one particular widely-held stock. Unfortunately we cannot explain the reasons, put in context or provide comfort for the outlook. This, together with other sales and the initiation of some short-side positions, means our net long exposure to the U.S. market has declined.

Income and Asia up, gold the same, rest down

Our exposure to U.S. income stocks, mostly the Business Development Companies, has increased however, from around 10% to 13%, mostly in more conservative accounts. These stocks are yielding anywhere from 7% to 10%, with dividends covered by earnings. The group we believe can survive higher interest rates if there is no deep recession or credit crisis. Each company has its own nuances, of course. We have been adding to positions on weakness in particular stocks, adding to three different names this month.

We reduced exposure to Europe after taking some profits, while exposure to Asian equities, primarily in Hong Kong and Singapore, inched up as we continued to add to positions slowly.

Allocation to gold and resources in global accounts remained more-or-less static. We hold a high exposure to gold both as a hedge on the rest of the market and for outsized potential in their own right.

Our cash holdings fell, somewhat surprisingly. We did add some put positions, but more so have picked up put selling (on stocks we want to own) as volatility has returned to the market. We expect cash positions to pick back up over the next quarter as we look for opportunities to raise cash, either from harvesting gains, protecting profits, or exiting potentially vulnerable positions in the new market environment.

Gold accounts

Our exposure to different segments of the gold sector remained broadly in line throughout the quarter. Exposure to seniors (miners and royalties) declined slightly to just over 30% of accounts, mostly due to some selling and to significant moves down in our two largest positions. We are holding and adding to these particular stocks.

Exposure to juniors (producers and near-term producers) remains around 10%, despite some selling. We also were buyers of two companies: one a producer whose stock fell sharply on unfounded concerns; the second, the holder of a large deposit not reflected in its share price.

We added but also sold some explorers

Exploration stocks moved up to just under 30% of assets. This was partly because of relative moves in different sectors and partly because we added to this sector over the past quarter. We also trimmed some positions on stocks that moved up on good news. Given the volatility in these stocks, and the relatively illiquid trading, it's important to take at least some profits when you can, and this does not (necessarily) mean we have changed opinions on these companies.

Looking ahead, we expect the seniors to finally react to higher gold prices, though we will mainly be looking to select the most prospective junior and exploration companies that may benefit from the senior miners' hunger for ounces. We expect to remain fully invested—current cash levels across gold accounts are less than 2%—though we may shuffle individual positions, reducing laggards, particularly on a broad rally in the sector, and adding to favorites.

■ Resource accounts

At present, resource accounts continue to hold the majority of their funds in gold, including in major royalty companies, major miners, and exploration companies. Many of these companies, however, have meaningful exposure to other resources.

Over the past quarter, we actually cut exposure to copper because of the sale of one company, but we continue to have exposure through miners with large by-product production, and exploration companies. As mentioned, we will be investing in copper producers when the time and the prices appear right.

We added to silver equities this past quarter, not aggressively. We do not expect silver to meaningfully outperform gold in the near term, though it does have that potential if only for short periods. When silver moves, the silver stocks can have outsized moves partly because there are few of them, and we have been slowly and selectively building positions.

As mentioned above, we have only small exposure to oil, mostly through one particular major global integrated company. We are looking to add, but again, when the prices are right.

Cash positions remain low in order to have exposure to the broad sector. If we see copper or oil (or other) sectors we want to buy, we can readily reduce the gold exposure in order to raise the necessary funds. We expect cash to remain low in the coming quarter, and are not expecting any wholesale change in allocations in the coming months.

Overall, we are increasingly concerned about the broad stock market, and will continue to raise cash, while holding defensive, mostly high-yielding, positions as well as gold and other resources. We anticipate the gold stocks finally beginning to reflect some of the gains we have already seen in gold, as gold itself continues to move up.

Adrian Day, March 31st, 2018