PORTFOLIO REVIEW

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The long global bull market has clearly ended, as central banks begin to unwind their massive Quantitative Easing programs that followed the 2008 credit crisis. Several uncertainties, most importantly spreading tariffs and the threat of a global trade war, add to the unease. The impacts of central bank tightening and of rising inflation are underestimated by the markets, in our view. We are not expecting a collapse in markets any time soon; many markets managed to recover somewhat this past quarter after a weak first quarter which saw declines across the board. But the risk is increasing.

■ Mixed quarter for global stocks

U.S. stocks, continuing their volatile pattern, were up in the quarter just ended, more than recovering first-quarter losses. The S&P index rallied 3.4% (to close the six-month period up just under 2%). Global stocks, however, fell further, down almost 5% on the quarter (Morgan Stanley All ex-U.S. Index). Major markets held up better than did emerging markets, which were down almost 10% in the quarter alone.

All European markets are down year-to-date, with German, Sweden and Switzerland the worst performers down anywhere from just over 7% to almost 10%. Among emerging markets, China is down almost 15% (hurt most recently by the tariff war) while Brazil (with its own political problems) is down almost 19%. Most Asian markets are down, with Hong Kong a relative outperformer, down “only” 3.6%.

Global mutual funds, which can invest in U.S. as well as foreign markets, rose just over 1% for the quarter (per Bloomberg mutual fund index). Our global accounts outperformed handily after a weak first quarter. Our benchmark mid-risk growth accounts are up 7.5%.* (Performance numbers are preliminary.) Our outperformance comes from a significant underweight in European stocks (as well as emerging markets), and overweight in gold. Though gold and gold stocks did poorly this past quarter, our gold accounts did well (see below), so our gold allocation helped global accounts.

■ Gold down, commodities mixed

Commodities were barely in the positive column (with the Bloomberg index up 0.26%), though as usual there was disparity among various commodities, with oil up 17%, a leader, and most metals and agriculturals down for the quarter. Gold fell 5.4% for the quarter, while the XAU index of gold stocks was down less than 1%, outperforming bullion, which is significant. Gold mutual funds (per Bloomberg index) fell just under 1% for the quarter (and down 8.8% year to date).

Our resource and gold accounts also handily outperformed the indices again. Our resource accounts rose over 10% in the past quarter, while our gold accounts are up just shy of 12% for the quarter (and 7.4% year to date).

This outperformance is due to our underweighting of bullion and the senior mining stocks, as well as stock selection. A few of our exploration stocks had success this past quarter (and stock performance to reflect that success). I wish we could discuss specifics, so you could understand why we are locking in gains on some, but holding others despite outsized short-term moves. Apparently, this sort of analysis offends the SEC's sense on what is appropriate for investors to be told.

■ Tightening could hurt markets

The world's central banks have largely ended the extreme easing that followed the 2008 credit crisis and have belatedly starting tightening. Both the Federal Reserve and the European Central Bank are raising interest rates at the same time they are reducing the size of their balance sheets. Even Japan, which took easing to new heights, has slowed its pace. Indeed, despite talk of "Quantitative Tightening" for some months, it is only now that both the Fed and the ECB are net withdrawing liquidity from respective economies.

Both the Fed and the market appear to be underestimating the impact of tightening on both the economy and markets. The Fed is tightening into a weakening economy. Without risking turmoil in the economy and markets, they simply cannot be too aggressive given not only the state of the economy but also given the level of debt.

Both government and private debt levels around the world have been increasing, particularly of late in emerging markets. Debt to GDP is significantly higher than before the 2008 credit crisis, and it is likely to continue as banks step up lending, which slowed significantly after 2008. In the U.S., debt has gone from 60% of GDP in 2008 to over 100% today, and the U.S. is not alone. The biggest problem is that so much of this debt, particularly in the U.S. and other developed countries, is for welfare (government debt) and consumer spending (private), not for productive purposes.

Obviously, as rates increase, it makes debt more problematic, and this will act as a brake on the central banks' tightening.

■ Inflation taking root

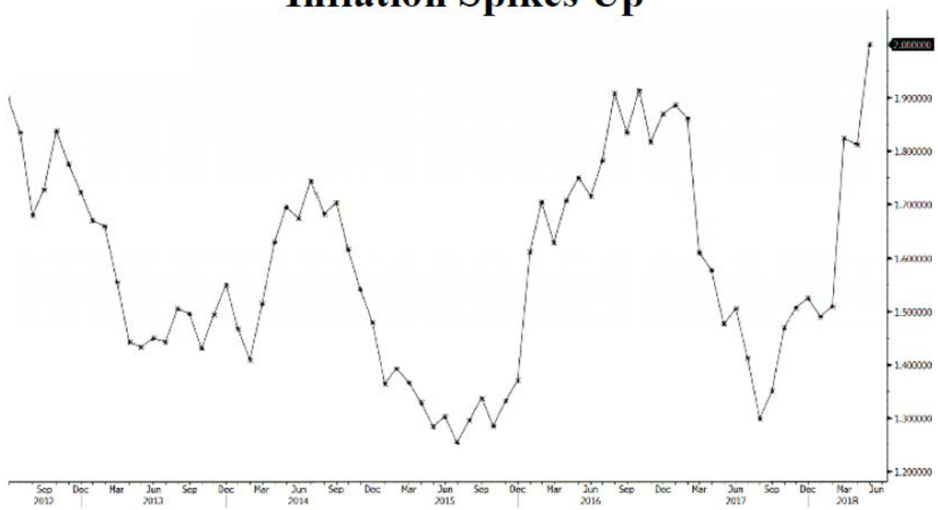
For now, the Fed is indicating further rate hikes, ahead of schedule, and the fact that inflation (per the Fed's favorite index, the "Personal Consumption Expenditures Index") is already running over 2%, ahead of the Fed's inflation target, and that real rates remain negative (nominal rates less than inflation) will only reinforce the Fed's determination in the near term.

Inflation often moves up slowly and haltingly until it takes hold. The most obvious recent example is from 1987, when price indexes started the year at just over 1% and ended it at 4.5%. (One might recall the market crash that year, not a coincidence.) This is what is happening now, with inflation trending up over the past year from very low levels. As banks pick up private sector lending, however, that could change dramatically. Since 2008, we have had unprecedented money creation, but that led to asset inflation not price inflation. Now that banks are lending again, we will start to see price inflation.

Just as the Fed and the market are underestimating the potential impacts of Quantitative Tightening, so too are they virtually ignoring the possibility of inflation. So the Fed, just as now, will continue to lag the rise in inflation, with implications for the economy and markets.

We suspect the negative impact of tightening (on the economy and on defaults) will become apparent before inflation rises significantly, with the possibility that the Fed will slow, or even pause, its tightening, and the reversal of policy will have very positive implications for gold in particular. It will also allow inflation to entrench itself. The market is expecting two more hikes this year, but the Fed might skip over the September raise, which would shake the complacency of steadily rising rates.

Inflation Spikes Up



The other wild card is the possibility of a slowdown in world trade caused by tariffs. This danger seems to have increased, though at least it is recognized and the possibility exists for targeted reforms (re. intellectual theft in China and government subsidies globally) without a wholesale trade war. But certainly, the increased tit-for-tat tariffs risk global trade and threaten global economies, as well as adding to pressure on the Fed to pause tightening. Tariffs also increase risk in the stock market, as we have seen with the manufacturing sector in recent weeks.

China stands to lose as much as any from a global trade war, albeit that the economy has been moving away from such dependence on exports. Tariffs and higher rates threaten that economy which had been slowly picking up again.

■ Dollar strong…for now

With the Fed (currently) out in front of global tightening efforts, the dollar has rallied throughout the quarter, aided by no little chaos in Europe, with no plan on Brexit though that's just a few months away, and an anti-Euro party in power in Italy. Growing international confidence in the U.S. economy—again, relative to other regions—has also helped drive the dollar higher, while the dollar has been the asset of choice as a safe haven, more so than gold.

This dollar strength has hurt many emerging economies, particularly those such as Argentina and Turkey, which borrow heavily in U.S. dollars.

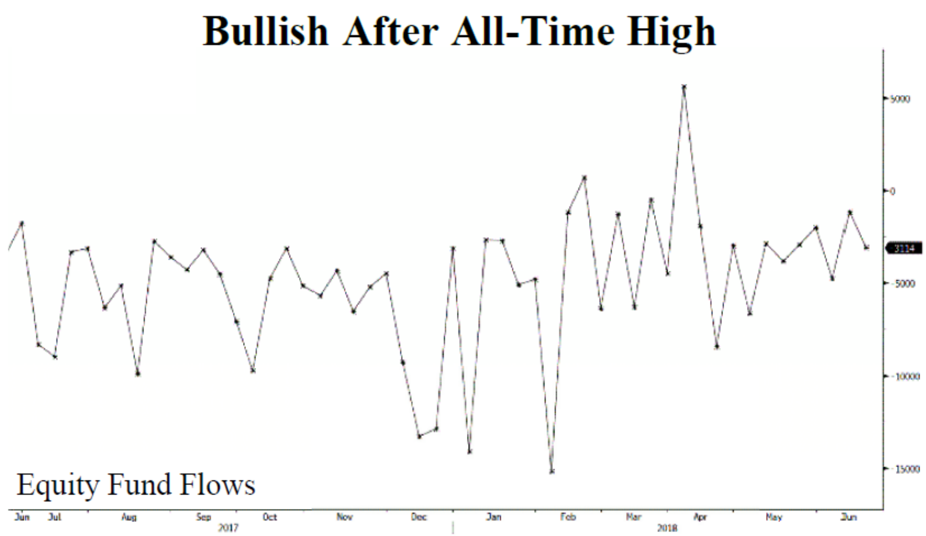
More recently, there has been a dramatic slowdown in demand for dollars from many governments, because of tariffs and other issues. Russia is said to have sold all its dollars, while there has been a reduction in China's holdings. Should this trend continue, the implications could be dramatic.

Without any such politically driven moves, tariffs and the result slowdown in global trade would tend to hurt the dollar in any effect. A reduction in exports to the U.S. means a reduction in demand for dollars. In addition, a widening of the budget and current account deficits has historically hurt the dollar. And lastly, should the Fed pause its tightening later in the year, this would also see the dollar decline, given that the tightening was the main reason for the dollar rally this year.

A weaker dollar would be both effect and cause of a softer stock market, while it would *ipso facto* boost gold. I suspect we'll see the dollar at lower levels by year end, but the next couple of months could see even higher levels, given the turmoil in the European Union.

■ Stock market risk increases

As we've suggested before, U.S. stocks are at the end of a long upward cycle; at 108 months, this has been one of the longest bull markets in U.S. market history. The S&P peaked January 26th, and has not been close since, despite a very strong quarter for earnings. The quarter just ended may well see earnings growth, but not as strong as the first quarter, so it will be interesting to see how the market reacts. When earnings declined in 2015 and most of 2016, stocks paused their strong growth and fell sharply towards the end. This year, stocks have been volatile, but largely flat, so weaker earnings later this year could see a decline, particularly with the market already trading at such high multiples (21 x earnings, 3.3 x book and yielding under 2%).



Not coincidentally, retail investor sentiment, which had been largely bearish throughout the long bull market from 2009, turned suddenly bullish in March. According to an analysis of sentiment indicators by Deutsche Bank, retail investors "seem to think this is the best time ever to invest in the market." The switch to bullish sentiment came right after the S&P peaked following an almost exponential move. Now, just a few months later, the same retail investors are suddenly bearish. Investors are dumping U.S. stock funds (only part of that attributable to moves into ETFs) and market declines are no longer seen as automatic buying opportunities.

One factor helping support stocks has been corporate buy backs, strong for years and given an additional boost by the new tax law, leading to record buy backs in the first quarter. The second quarter numbers will likely also be strong, but by year end, numbers will likely by lower than they are currently.

■ Resources fall again

Resources were mostly down this past quarter on the continued strong dollar, as well as, more recently, tariffs and the threat of a decline in global trade. Oil was the main exception, rallying strongly in the past couple of weeks to close the quarter over $72/bbl, up 17%. The oil price had been climbing most of the year, though it fell back in early June. In the last couple of weeks, however, oil jumped on the U.S. threat to impose sanctions on countries that bought Iranian oil, and on the decision by Saudi Arabia to restrict output, after a failed attempt to stifle U.S. shale production.

Though the oil price is likely to trend slowly upwards, the current move may be temporary, as most such moves based on geopolitical factors usually are. Though the major integrated companies represent reasonable value, and sport high and, for most, sustainable yields, the "second-tier", including the U.S. independent E&P companies, are not cheap, already discounting much higher oil prices. Energy stocks were the best-performing group in the S&P this past quarter, so are even more overvalued today than a quarter ago.

Copper has short-term challenges

Copper closed down for the quarter just over 3%—still far better than most base metals (zinc was down 13%)—but the single number masks the volatility of the quarter. After rallying throughout most of last year, copper held the $3/lb price this year, before rallying to a new high for the year over $3.30 in early June on fears of a labour strike at Escondida, the world's largest copper producer. It then promptly collapsed in the last couple of weeks on heightened tariff concerns, to new lows under $3.

There are conflicting factors driving copper, with many short-term factors negative while the longer-term outlook remains very positive. Near term, the strong dollar, tariffs, and a weaker Chinese economy all hurt.

Further out, China's housing market—more important for copper than the rest of the economy—remains strong; other Asian demand is also recovering. Asian, particularly Chinese, demand has been the main driver of copper prices over the past couple of decades. A new factor growing in importance is—irony of ironies—the use of copper in renewables (wind and solar) and electric vehicles.

Shortages ahead

On the supply side, there have been fewer disruptions than expected this year and some analysts expect a surplus this year after a deficit last. But beyond this year, there are supply shortages foreseen. There is a lack of new projects (other than Cobre Panama later this year, and Nevsun's Timok, perhaps in 2022).

The clarity on future supply allows us to confidently forecast a supply deficit (absence a sharp decline in demand) for the next four to five years. (Of course, when we speak of forecast supply deficits, we are really forecasting higher prices. Given supply and given demand clear at a certain price; tighter supply means a higher price.)

Copper is our favorite non-precious metal for the next few years, though many of the producers have one problem or another (be it political risk or high valuations). Although we do own some copper companies, including exploration companies, much of our exposure comes through diversified companies with a high copper exposure, including royalty companies.

On balance, we are slowly diversifying and building positions in selected resources, primarily copper, with little in oil.

Gold weak in short term

Gold remains our favorite metal for the current environment, on a risk/reward basis. It closed the quarter at the year's low, after a particularly poor month. It was down just 1% until early June. The widening tariff disputes boosted the dollar, which hurt gold. In the long run, as discussed, a trade war could hurt the dollar, but in the immediate term, the threat helps the dollar.

Short term, many factors are negative for gold: the strong dollar, monetary tightening, and the easing of tensions with North Korea. Gold is also in a seasonally weak period.

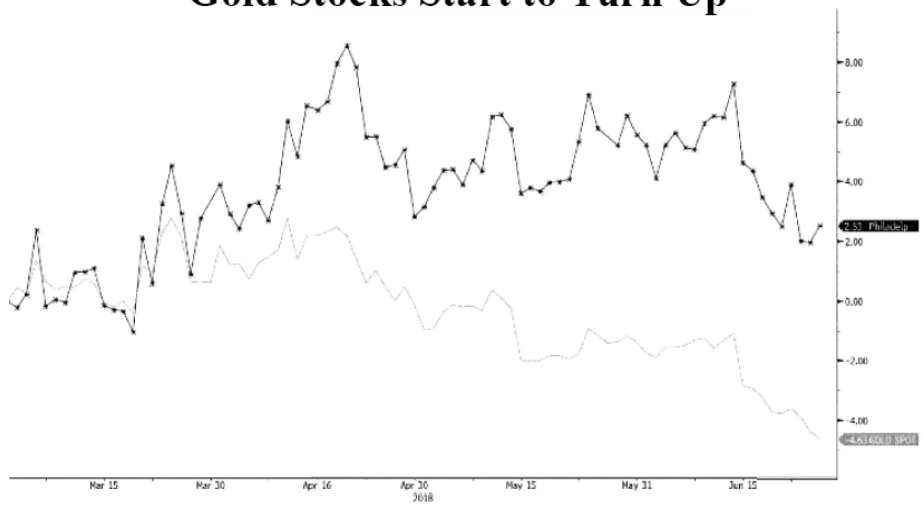
Further out, however, these factors change. First, gold has traditionally risen in August and September, after a weak July and negative May and June. Beyond that, the dollar is vulnerable; and the Fed may slow or even pause its tightening (as discussed above). A break in the stock market would also help gold. Already, institutional investors are beginning to hedge their equity exposure with bullion or gold ETFs. This is in sharp contrast to retail investors, as suggested by coin sales at 10-year lows.

■ Gold stocks outperform bullion

Significantly, gold stocks, which had been extraordinarily weak since the peak in 2012, have held up this year better than bullion. It suggests perhaps that the stocks are washed out and now in stronger hands. When gold moves up, the stocks are set up for a strong rally.

The big-name miners will move in a strong gold market, particularly initially. But mining is a difficult business, as we've discussed before; the higher the gold price moves, so too do costs move higher, and greedy government—excuse the redundancy—see easy pickings in assets that cannot be moved.

Gold Stocks Start to Turn Up



We favour royalty companies, large and small, and selected exploration companies. Small companies which own a deposit or exploration companies that find one are very attractive to major miners running out of pipelines. We have already seen a step-up in acquisitions this year. As gold moves higher, the struggle to add reserves will become more intense, and the winners will be the companies with deposits, not the miners who have to pay up for them.

In sum, we are slowly and steadily raising cash from broad markets when opportunities present themselves, as well as tightening stops on stocks that have moved up or that we feel are particularly vulnerable in a market decline. In gold and resource accounts, however, after having raised some cash earlier in the quarter, we are now topping up again, particularly favorite stocks in which particular clients are underweight, so accounts are pretty fully invested now.

Review of Individual Accounts

■ Global Accounts

Allocations in global accounts remain virtually unchanged from the end of last quarter, with each broad group within one percentage point of where it stood three months ago, except for cash, up from just under 6% to 7% (itself not a major move). This belies some movement, however.

We have been adding to Hong Kong stocks as that market declines with allocation the same but holding more stocks. Contrariwise, we have trimmed holdings in some of the Business Development Companies, even selling some completely, as that sector rose, locking in profits but maintaining a 12% position (more for conservative accounts, less for more aggressive ones). We hold a core position in the BDCs for appropriate accounts, but given the volatility in the stocks, we sometimes lock-in some of our gains, and buy back the same or other BDCs when they are cheap, trading around a core position.

Hedging with gold

We continue to hold a strong allocation to gold and other resources, both for their own profit potential and as a hedge on the rest of the account. We have also started buying some puts (a bearish "bet") for appropriate clients, again, for profit potential and as a hedge. Puts are quite expensive now (high time premiums), so we are not doing too much of this.

Going forward, we expect to maintain high allocations to both gold and BDCs and other income-oriented equities, while continuing to raise cash in global accounts. The volatility in the markets this year mandates a somewhat more aggressive trading approach, at least to the non-core areas of accounts. We are positioned fairly defensively; more and more going forward—for the time being—we do not expect to necessarily replace sales with other buys, so cash holdings, we expect, will increase further in the period ahead.

■ Gold Accounts

Allocations also remain broadly identical throughout the quarter for gold accounts. We hold approximately 30% each in seniors (including major royalty companies), exploration, and resources, with the rest in juniors and cash. Most of the allocation to seniors is in fact in royalty companies not the miners.

This quarter, the allocation to major miners and royalties slipped while that to exploration companies increased, in each case by a couple of percentage points, and mostly because of divergent price moves rather than particular buying or selling.

We have locked in some gains among the exploration stocks in particular, but quickly replaced them with other exploration stocks. Cash remains virtually identical, at 2%, so accounts—other than new accounts—are to all intents and purposes fully invested.

Fully invested

We expect to remain fully invested in the period ahead, topping up favorites as appropriate and as cash is available, but also expect some trading among exploration stocks as developments mandate.

We are also looking throughout portfolios to upgrade by selling laggards and replacing with favorites. Selling a stock does not necessarily imply that we do not think the stock will perform well on a gold rally; indeed, sometimes, the weakest companies (with high costs and high debt) are precisely the stocks that will do well at the onset of a bull market. It simply means that we think we can find better risk/reward in something else.

We are well positioned for a strong move up in gold, while in the meantime we have many stocks with strong potential without such a move. As discussed (and as predicted last quarter), we are beginning to see the stocks outperform bullion, and expect this trend to continue, particularly in a strong market. In a down market, of course, pretty much all gold stocks decline, though the royalties we hold have historically declined less than the overall market.

■ Resource Accounts

Though gold remains dominant in our resource accounts, we have been buying more of other metals over the past quarter, particularly copper. We expect this trend will continue.

We hold a large allocation to silver as well, and again expect to be building up positions in this metal in the months ahead. Though gold has a better risk/reward profile than silver, in our opinion, it nonetheless likely has better potential for short-term moves, particularly in the metals move up sharply or inflation moves up.

We continue to have low exposure to oil, thinking the price is ahead of fundamentals while the stocks are expensive. At some point this will change, but we do not think the risk/reward is particularly favorable right now.

As always, we hold many companies—particularly both royalty and exploration companies—with exposure to multiple resources, so our exposure to non-precious metals is far higher than it would at first blush appear.

Resource accounts are pretty fully invested, and as with gold accounts, we are trading a little more among the junior companies, either on success or replacing laggards. We expect to continue to be fully invested but do anticipate exposure to many resources—in particular copper—to increase in the period ahead.

Overall, we are raising cash in global accounts, but slowly, as the risk in the market increases, and holding defensive income equities as well as gold to mitigate the impact of any broad market decline. We are fully invested in gold and resource stocks, particularly as we see the beginning of outperformance of the stocks over bullion, and, while trading smaller stocks in particular, expect to continue to be fully invested for a strong period over the next six to 12 months or more.

Adrian Day, June 30th, 2018