PORTFOLIO REVIEW

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The U.S. reigns supreme, as the U.S. dollar, stock and bond markets all rose in the latest quarter, almost alone. Global equities, foreign currencies and gold fell amid deepening emerging market crises and a worsening U.S.-Chinese tariff war, threatening growth and trade in many parts of the world. Steadily rising interest rates in the U.S., amid a world of low and negative rates, have pushed the dollar higher and not yet derailed the U.S. economy or stock market.

■ U.S. Stock Market almost alone

U.S. stock markets rose in the latest quarter, with the broad-based S&P up over 10%. For the year to date, all U.S. indices are up, 9% for the S&P and over 16% for the tech-heavy Nasdaq. They are almost alone in the world. Other than Japan's Nikkei, up 5% year to date—though broader Japanese indices are down—and a handful of small markets (led by Mexico up 5%, followed by Thailand and Taiwan both up, less than 1%), virtually all markets large and small around the world are down so far this year in U.S. dollar terms. It is only marginally better calculated in local currencies. European markets are mostly down in the high single-digits, much the same for Asia, though China's markets have plunged 20%.

In aggregate, global markets outside the U.S. are down 6.6% for the year, after falling almost 2% in the latest quarter. Global managers have done better this year, mostly by overweighting the U.S., with global funds up nearly 5% in the latest quarter, 3.5% for the year (per Bloomberg Global Equity Fund Index).

■ Global accounts lag

Our global accounts have not performed well this year, with our mid-risk accounts down half a percent for the year so far, well outperforming market indices, but lagging global funds.* Unusually, both our more conservative and more aggressive accounts fell more. (We discuss reasons in our "Global Accounts" review below.) An underweighting in the U.S. market, and even more so in technology stocks, meant we missed out on gains, while an overweighting to Hong Kong (which is down sharply this year after leading performance last) and to gold stocks (which stumbled severely after a reasonably strong start, added losses in many of the portfolios.

■ Resources and gold soft

Commodity markets are mixed, as usual, though broadly up a little in the latest quarter (2.6%) and down (3.4%) for the year to date (per Bloomberg Commodity Index). Energy of various types counts for around 30% of this index, which also includes various agricultural commodities. (There is no good resource proxy.) Our resource accounts underperformed in the latest quarter (down just over 4%) but have outperformed for the year, up marginally. The relative performance is largely attributable to the gold stocks, which fell sharply in the latest quarter, and an underweighting to oil stocks throughout the year.

■ Gold stocks plunge after good beginning

Gold fell another 4% plus in the last quarter, bring the year-to-date decline to 8.5%. The gold stocks, however, leveraged these losses, plunging almost 19% in the latest quarter for a year-to-date loss of 23% (per XAU index); many junior companies did far worse. The typical manager (per Bloomberg Precious Metals Fund Index) lost 20% in the latest quarter, 13.5% for the year. Against this background, our gold accounts have held up relatively well. Despite a 3.7% loss in the third quarter, the accounts are still up 3.5% for the year so far.

Our significant outperformance in both shorter and longer periods is attributable to both an underweighting among larger miners, and stock selection among the group, with a handful of big winners among the smaller and exploration stocks, on either M&A activity or strong exploration results. We cannot name these stocks nor let you know why we are still holding them, per the SEC. But looking ahead, as discussed inside, we are looking for a gradual recovery in the sector overall, with continued strong outperformance from a small number of exploration stocks.

■ Deja vu

This environment is reminiscent, though to a lesser degree, of 1999, when our accounts lagged (though, again, we are ahead of the relevant indices), avoiding the dot com mania and heavily into both Asian and gold equities. There is perhaps no need to remind you what happened next. Looking ahead, we think the U.S. market, particularly the tech sector, is vulnerable, while gold is turning the corner with the gold stocks on the cusp of a strong rebound. For Hong Kong, much depends on how goes the tariff war, though the stocks are cheap and will rebound on any easing of tension.

■ Higher rates not hurting…yet

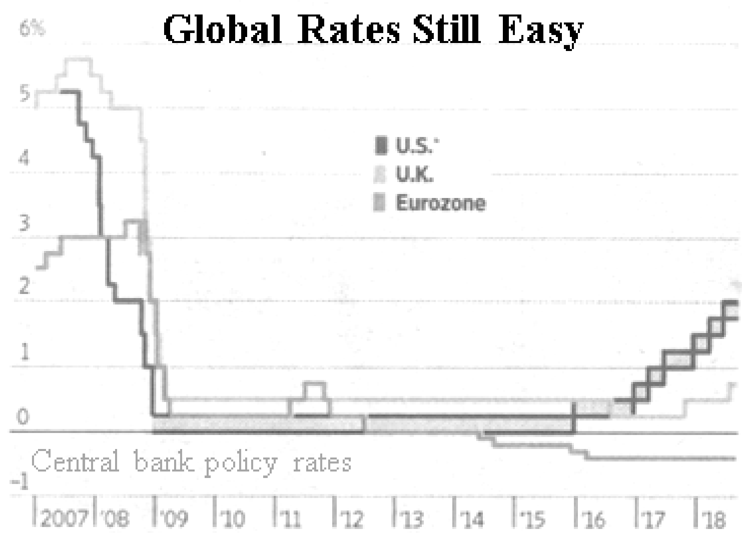
The Federal Reserve is raising interest rates even as rates in most of the world—with specific emerging markets being the exemption—remain exceedingly low or even negative. See graph opposite. This has resolved to the benefit of the U.S. dollar and U.S. assets including stocks). However, although interest rates receive all the publicity, the Fed has shrunk its bloated balance sheet by only about 6% since it switched to "quantitative tightening" last year. Some tightening, particularly in light of the enormous increase in the years since 2008!

This gradual approach has helped keep the excesses in the stock market going. Helped by President Trump's pro-growth policies (taxes and regulation), the economy has picked up steam and there has been some trickle down from the top 1% (notably absent in the "recovery" years after 2008). But the Fed has stated its intention to keep increasing rates, and with high debt levels in many sectors of society (except the corporate sector), higher rates will at some point become a problem.

At the same time, as discussed last time, inflation pressures are beginning to mount, albeit modestly. But inflation has a tendency to increase slowly and then accelerate sharply. This is certainly a possible scenario in the year or two ahead, given all the money created by the Fed over the past decade that is only now beginning to get into the real economy.

■ How will mid-term elections affect the markets?

One other factor requires discussion and that is the mid-term elections. Usually, stocks rally after the mid-terms as the President pushes pro-growth policies to help his (or his party's) re-election chances. Right now, there is an expectation for the Democrats to take control of the House, though we think it will be much closer than most anticipate; "experts" have consistently under-estimated Trump and his appeal.



Source: Wall Street Journal

A divided Congress—with Republicans keeping control of the Senate as most expect—would likely boost spending, including infrastructure spending (though not for any walls!), and generally be negative for any budget control, with each side swapping its spending preferences for those of the other (not that the Republicans have controlled spending lately). But a divided Congress would hurt the chances of additional tax cuts. It would also lead to an even more divisive atmosphere as we could expect House investigations of all things Trump. Overall, this could be marginally positive, on balance, for the markets, at least in the short term.

A Democratic sweep of both Houses would give us all of the bad—perhaps even attempts to roll-back existing tax cuts—without much of the good, and would likely be negative for the market. There would be some sector rotation, with defense stocks hurt and healthcare and infrastructure receiving a boost

If Republicans were to keep control of both Houses, though the divisiveness would continue, we could see further tax cuts (for individuals this time, please!) and other generally pro-market policies, keeping the market rally going a little longer.

■ U.S. stocks out ahead, in performance and valuation

As mentioned, U.S. stocks have led the pack over the past year or more. With a price-to-earnings of over 21x, price-to-book of over 3.5x, and dividend yield well under 2%, the U.S. market is certainly expensive, both on an historical basis and compared with other markets. P/e's are at their highest since a brief artificial period in 2009 when earnings collapsed before stock prices had time to catch up.

These valuation metrics compares with a 16x p/e for European big caps, which sport a price-to-book only half the number for the U.S. and a yield fully twice that of the U.S. Broader market measures in Europe are even cheaper. Hong Kong has a p/e of only 10 times, with a price-to-book little more than a third that of the U.S. and, again, a dividend yield twice as high. So the U.S. market is an outlier both in recent performance and its valuation levels.

Market vulnerabilities

Though the dollar remains reasonably strong as does the U.S. economy, there are some warning signs for the U.S. stock market, in addition to valuations:

- At 111 months, this is one of the longest bull markets on record.
- From 2008 on, money creation flowed first to the stock market, but with the Fed's policy changing, that flow will cease.
- The market has bad breadth, with an ever smaller number of stocks outperforming the index, while a mere handful make most of the running.
- The market has been heavily supported by corporate buybacks, resulting in fewer stocks to buy; the money spent on buybacks is now two-and-a-half times capital spending.
- Market leaders, particularly social media companies, may face increased regulation, following a series of data breaches and other problems; when the aura around stocks whose main appeal is "vision" and "the future", rather than cash flow or earnings, gets pricked, the downturn can be rapid (again, visions of dot com).

Global outlook is mixed

If we look around the world, we see nearly half of all non-U.S. stocks yielding more than 3%, and specific markets with very attractive valuations. The macro environment is uncertain, however. The European Central Bank remains very cautious, and is likely to remain so as long as the issues of Brexit and the new Italian government remain at the forefront. When it changes policy, however, it could tighten from its extremes of negative rates rather more quickly than has the Fed.

China has been making significant progress in structural reforms, and is moving the economy away from a reliance on cheap exports. This takes time. And now the tariff war is impeding this progress, driving down the value of the yuan. We can expect additional devaluation if this continues, pushing up the prices of Chinese imports and further impeding the strategic economic shift.

This has driven down stocks by about 20% this year, though after a steady rally in the two years previous. The broad market is now relatively inexpensive, trading at 12 times earnings, and yielding 2.3%. Remove the high-flying tech stocks such as Alibaba and Tencent, and the valuations for the broad market become even more attractive. We prefer to buy China through the more-opaque Hong Kong market, however, where valuations are even better. (We are cautious on the outlook for Hong Kong over the very long term, but that is a story for another day.)

Several emerging markets have been hit by crises in recent months, seeing currencies spiral downward. The stories in Turkey and Argentina are well known. Brazil also faces a potential crisis, with very high foreign debt and an economy hurt by low commodity prices, ahead of a divisive election. In my view, stocks in none of these markets are cheap enough to buy yet.

Is the dollar turning?

To some extent, the dollar has been the leader because of the problems with most other currencies; there is no need for us to do a tour of the world and its problems for the point to be clear. However, economic growth, strong enough to raise rates, is also an attraction for the dollar.

However, the dollar now seems priced for perfection while perhaps some other world currencies face exaggerated pessimism. Certainly, market sentiment is one-sided, often an indication of a turn. The dollar hit a high in early August, and any slippage in the U.S. economy or market could see the dollar fall further. It could also fall simply from exhaustion and a lack of new buyers, as is often the case with markets.

■ Resources set to rally?

A drop in the dollar would certainly boost the resource complex, particularly gold; the dollar has been the largest single determinant of gold's price in the last couple of years. For now, resources remain mixed, with oil up over 20% for the year, while most base metals are down—copper by 14%, zinc 21%, nickel a modest 1%. In varying degrees, all share some characteristics: supply boosted amid uncertain global demand, particularly from China.

Along with oil, uranium has been one of the few resources up this year; after an initial decline, it has seen steadily higher prices, up 35% from its April low, 14% for the year so far. Uranium saw a jump in production precisely at a time of suddenly declining demand following Japan's Fukushima disaster. At the spot low of $20, some 95% of the world's production was being produced at a loss.

Then, the world's largest national producer (Kazakhstan) cutback its production followed by suspension of the world's largest mine (Cameco's McArthur River). These actions brought supply and demand more into alignment and perhaps more importantly boosted sentiment. But these supply reductions are artificial and production could come back as quickly as it was cut on any sustained price rally. There is still a fundamental over-supply, and we need both demand to pick up and years of low prices to work into lower production to see meaningfully higher prices on a sustained basis.

This is a time to pick away at the better companies on extreme weakness and trade the stocks, on balance accumulating positions but certainly not aggressively chasing prices.

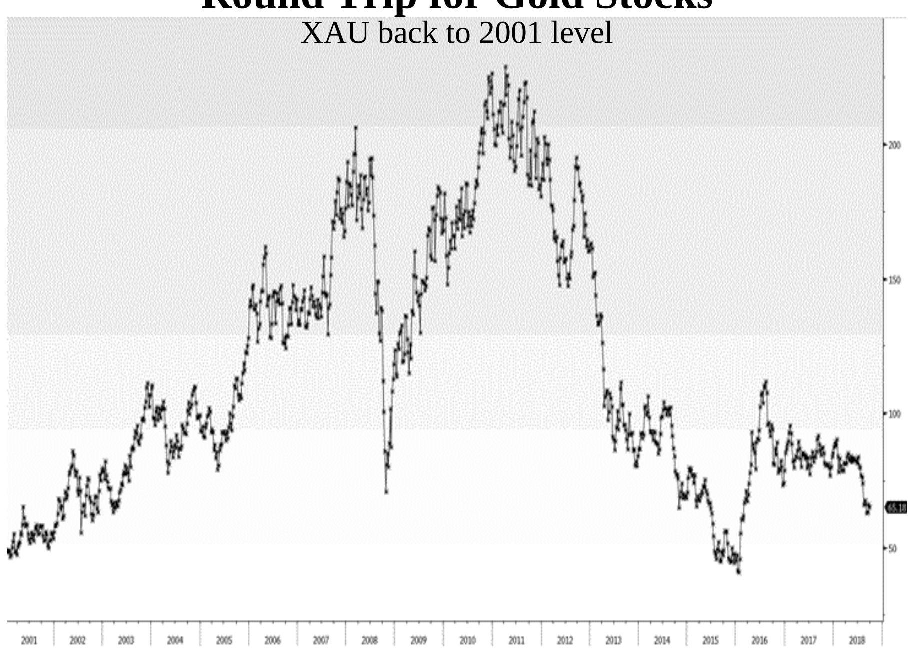
■ Gold: Waiting for the dollar

After declining steadily since April, gold has pivoted around the $1,200 level for the last several weeks, with its price this year tied very closely to the dollar. This month is the sixth consecutive monthly decline for the metal, the longest streak since 1989. Apart from a strong dollar, gold has been struggling against a strong stock market and rising interest rates.

As we have discussed before, there are reasons to be positive. Higher interest rates need not necessarily hurt gold provided *real* rates (that is, nominal rates less the rate of inflation) do not turn meaningfully positive. Real rates remain very low at a time when inflationary pressures are slowly mounting. With sentiment at extreme negative levels—as evidenced in ETF sales, low coin purchases, and record Comex net short positions—a turn could be powerful.

Round Trip for Gold Stocks

XAU back to 2001 level



Source: Bloomberg

Gold stocks at extreme lows

This is all the more so for gold stocks, where sentiment is even weaker. Apart from "gold investors", there is hardly any interest in gold stocks. Unlike 10 or 20 years ago, when pretty much every fund owned some gold names, today hardly any generalist fund owns a gold miner. Gold stocks, in terms of price, are back to the levels of 2000 when gold sold for $250 an ounce, just a fifth of where it trades today. (See graph page 5.) Relative to the broad stock market, gold stocks are also back to where they were at the beginning of the century.

The last two months have seen additional pressure from the revamping of the Vanguard Precious Metals Fund into the Global Capital Cycles Fund. The largest PM fund in the U.S.—at $2.5 billion, almost twice the size of the second-largest—will now hold just 25% of the fund in precious metals. How much selling has already been done is unclear, but there has certainly been some, and is likely the reason for the extreme weakness in many stocks. Remove that selling pressure and the stocks could jump. This is a contrary indicator for the ages.

M&A picks up

An added reason to be positive on the gold mining sector is the increased M&A activity, culminating last week in the merger of Barrick Gold and Randgold, to create a combined company with a market cap of almost $20 billion, a quarter higher than the next largest. Size of course is not everything, but increased mergers often signal the bottom of a market.

The market response recently to various M&A activity, including senior companies taking stakes in juniors, as well as to strong exploration results, signals increased interest in the sector, if only among traditional gold investors at present. A year ago, strong drill results would have been met with a yawn while mergers could have seen some stocks go down.

We believe we are on the cusp of a strong rally in gold stocks. The stage is set, and we simply need the dollar to decline to begin the action. We are well positioned.

In sum, we see both the U.S. economy and U.S. equities at increasing risk, though we are not expecting a collapse any time soon. We are, however, taking note of the increased risk and reducing exposure to U.S. stocks, while maintaining exposure to the better-value Asian stocks as well as gold and other resources. If accounts may lag somewhat in the near term, we are set up to minimize the effects of any decline while also to profit from a rotation into market and sector laggards.

Review of Individual Accounts

Global Accounts

Allocations in global accounts remain more-or-less where they were at the beginning of the quarter, with high allocations to non-U.S. stocks, mostly in Asia; U.S. income stocks; and gold stocks, and low allocations to the broad U.S. market and Europe. More conservative accounts have higher allocations to income stocks and less to Asia.

The underweight position to the U.S., particularly to tech and social media, has hurt our relative performance, but we feel that this market is overvalued and vulnerable. As in 1999/2000, this may yet prove to be the appropriate stance.

We have been steadily trimming exposure to Business Development Companies, but the allocations remain the same as the sector has rallied.

In Asia, especially Hong Kong, we have trimmed a little where stocks look particularly vulnerable, and added on extreme weakness, but are mostly holding until the region and market stabilizes. In Europe, we have added some low-risk value stocks, but at the margin.

Holding gold

We maintain a full allocation to gold and resources in our general global accounts, mostly royalty companies and specific exploration companies, which are both lower risk than miners.

Conservative accounts have been particularly hurt this year both two specific stocks, both significant holdings. One cut its dividend, sending the stock down sharply. The other, a large global holding, entered the year at a high, so we show a loss for this year. In both cases, the current price is significantly higher than our average cost basis, though lower than at the beginning of the year, hurting this year's performance.

Looking forward, we expect these broad positions to remain reasonably similar, though we do expect to raise funds in most sectors, in some cases as markets rally and in others to minimize downside.

Gold Accounts

The allocations in our gold accounts remain reasonably similar to where they have been, with most differences attributable more to relative price movements than to broad buying or selling. Senior stocks, including royalty companies, represent about 27% of accounts, slightly down despite more buying during the quarter.

Conversely, exploration stocks now account for 33% of accounts, up slightly despite some selling, its appreciation due to just a few of the companies. Likewise, appreciation of one or two resource stocks has pushed allocations up to 28%. The rest of accounts are in junior producers and funds, with cash down to just 2%.

We are fully invested, well positioned for the rally in the entire sector that we see ahead. There has been considerable repositioning in accounts, however, with selling of laggards and of stocks being acquired. With the cash, we have added to some favorites that particular clients under own, especially among the senior stocks that have fallen the most and will be the first to move in a recovery.

Favor royalty companies over miners

Among senior companies, we continue to prefer the royalty companies, while among exploration stocks we prefer prospect generators. In both cases, our preferred vehicles are lower risk; we have topped up positions where cash is available.

Looking ahead, we have a couple of situations targets of acquisitions. With the cash, we will add to favorite stocks under-owned by particular clients. Thus, we will upgrade the overall quality of portfolios. Given the amount owned by clients of one of these acquisitions—currently our largest position—we may end the quarter with more cash than present. This is not a reflection of our view of the market but a happenstance of the timing of this buyout. On balance, we want to be pretty fully invested for the recovery we see ahead.

Resource Accounts

We are also nearly fully invested in resource accounts, with high allocations to gold, silver and copper, as well as diversified resource companies, and underweight to oil. As with the gold accounts, we are emphasizing the lower-risk royalty companies over major mining companies, and have a high allocation to better exploration companies.

The growing scarcity of high-quality projects in gold, silver, copper, and other metals means that companies that make a discovery will be at a premium.

Copper shortage ahead

We believe there is a supply shortage for copper ahead, and we are already seeing a scramble by mining companies to acquire good copper projects. But many copper companies are problematic for one reason or another. We have exposure to mining companies with by-product copper; to royalty companies with copper exposure; and to exploration companies.

We are also accumulating better quality second-tier copper mining companies. Much the same holds true for uranium, though we see the shortage as further out and are buying more slowly and still selling on rallies.

Looking ahead, resource accounts hold one particular stock currently in the process of being acquired, and this will put significant cash into accounts. As with the gold accounts, we will put that cash to work adding to favorites for specific clients, but expect to end the quarter with more cash, awaiting better opportunities both in the oil sector and base metals.

In conclusion, we are raising cash in global accounts, slowly, waiting for better opportunities in most global markets. Overvaluations and vulnerabilities in the tech sector as well as the U.S. market generally, as well as uncertainty about the impact of the tariff war, and possibility of fallout from the crisis in many emerging markets all lead us to be cautious in buying global equities right now. We will continue to hold positions in defensive income equities, which pay good dividends. And we remain fully weighted to gold as well as holding other resources, sectors we expect to do very well when the dollar turns.

Adrian Day, September 29th, 2018