PORTFOLIO REVIEW

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Stock markets and other assets reversed course after the Federal Reserve and other central banks faced market declines…and blinked. With an end to monetary tightening, stocks, commodities, bonds all rallied, recovering the losses of the previous quarter. The U.S. market had its best start to the year since 2002. In fact, other than currencies, very little indeed was down this past quarter. Wheat, natural gas and silver are about the only assets of importance that declined. A market that rallies only because of monetary injections, however, is not on sound footing. While this may continue for a while, there exist the threats of a slowing economy, rising inflation, and declines in real terms.

■ Everything up on easy money

Stock markets rose this past quarter around the world, recovering virtually all that was lost at the end of last year. The U.S., led by Nasdaq, was followed by Asia, led by China, then Europe, led by Italy (?!), and emerging markets, led by Brazil. No major markets fell. The U.S., per S&P, rose just over 13%, while global markets outside the U.S., per MSCI, rose 9.5%. Most sectors also rose, with a few former laggards, such as energy, near the top of the pack. Global funds appreciated a commendable 12.5% on average for the quarter.

Our global accounts appreciated 13% plus, depending on how aggressive they were.* (Numbers for accounts are preliminary.) Our marginal outperformance was due to our overweighting in Hong Kong (a proxy for Chinese stocks) and underweighting the worst major markets, such as Japan.

■ Gold and resources up

Resources were mostly up, though as usual, there was quite a disparity between top and bottom performers. Oil and copper led the pack, while natural gas and silver were near the bottom. The Bloomberg Commodity Index was up nearly 6%, but this includes many soft commodities.

While gold was up only 1%, struggling, and failing (so far), to stay above $1,300, the gold stocks did better. While the XAU Index rose 8.3%, this is a little deceptive since one of the largest components of the index, Freeport Copper, is not even a gold company; it jumped 25%, distorting the index. The average precious metals fund rose 7.6%, per the Bloomberg index, but this is also deceptive, since the top-performing fund in the index, Vanguard's "capital cycles fund" is no longer a gold fund. Without that fund, the average gold fund rose less than 7%.

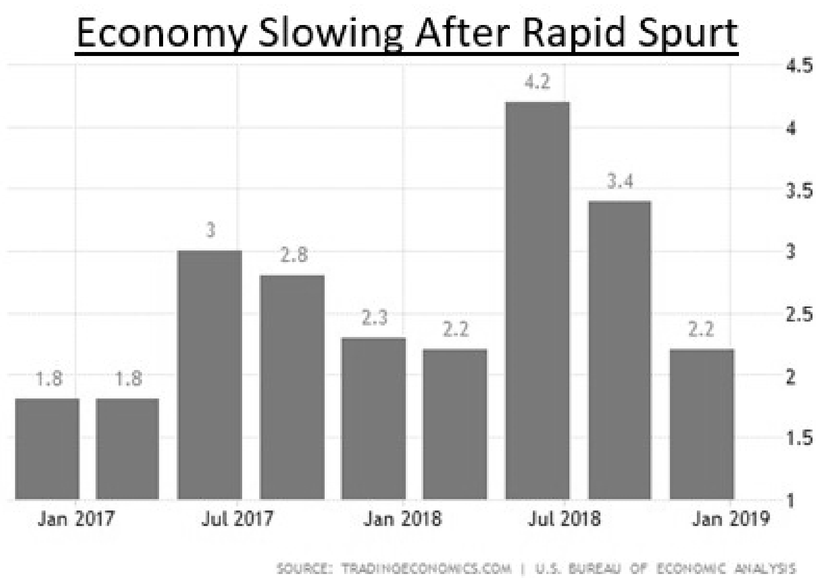
Our gold and resource accounts well outperformed, with the resource accounts up over 12% and the gold accounts up 11.5%.* The main reason for our outperformance was stock selection. While we did not hold any of the top few performers, accounts widely held seven of the top 15, and only two of the bottom 15. (Note: we have recently purchased some of the laggards, but we did not hold throughout the quarter.) We also held widely one or two juniors that had very strong outperformance, but, as before, we cannot name them, nor discuss the why, how, or wherefore.

■ QT: We hardly knew you

No sooner had the unfortunately named Quantitative Tightening started, than the Federal Reserve and other central banks started ending it, with the Fed saying that there would have to be a *need* for any future interest rate hikes, and a cut was as likely as an increase, while the unwinding of the Fed's bloated balance sheet would end later this year, much sooner than previously announced, with the balance sheet still more than four times larger than it was in 2008. The end of tightening had a significant and immediate effect on the markets, though any impact on the economy will be delayed. The economy was already slowing, partly in response to the increase in interest rates over the previous two years.

■ Economy slowing, unevenly

Though U.S. economic data has been mixed, the overall trend has been of a slowing of the rate of growth, partly because of rate hikes and partly as the stimulative effect of Trump's corporate tax cuts abates. The employment picture is mixed. New job growth has been volatile, but small businesses are beginning to see layoffs even as the rate of wage growth slows. That the unemployment rate has remained static is largely because the labor force has shrunk, not a good thing. Although re-fi's picked up dramatically as mortgage rates fell back, other indicators of the housing market are less positive. In most parts of the country, it is still a healthy market, but in many places, houses are taking longer to sell. At the same time, price increases are slowing. Commercial real estate conditions are also slowly deteriorating in key markets such as Manhattan.



Most noticeably, perhaps, retail sales have continued to decline after a weak holiday season. Another significant factor is the rapid increase in corporate debt to rival government and consumer debt. Nonfinancial corporate debt stands at a record more-than $9 trillion (as of November 2018), representing nearly half the economy. Previous peaks have coincided with the onset of recessions. More important, over half of this debt is scheduled to mature over the next four years, and rising rates obviously would not help with rolling over debt, or indeed with debt payments on variable rate loans.

All in all, though the economy continues to grow, and though the U.S. economy is stronger than most other major economies, there are discernable signs of a slowing. Notably, the yield curve has flattened, that is short-term rates are more-or-less the same as longer-term rates, often a sign of an impending recession.

The Federal Reserve could see this—as well as the impact of higher rates on the federal government's debt, which we discussed last time—just as it could surely connect the dots from QT to a weaker stock market (however much it denies any connection). The Fed is concerned about its lack of manoeuverability in the next recession should it start with rates at only 2.5% and a still bloated balance sheet, yet it also surely recognizes that hiking rates now would only increase the odds of that recession. It is truly boxed into a corner.

■ Europe weakening, while China picks up modestly

At least the Federal Reserve raised rates a few times and did refrain from rolling over some assets before abandoning QT; the ECB abandoned it before it had even started. And no wonder, with the Eurozone's largest economy slowing—Germany's GDP growth is forecast below 1%--while Italy is now in a recession. Manufacturing across the continent is slowing amid stubbornly high unemployment around 8% (and with a low participation rate). Interest rates remain negative in much of the continent. The Swiss National Bank acknowledges that their policy is designed "to keep the attractiveness of Swiss franc investments low"; what a perverse policy for a country's central bank.

And this is before we even touch on the politics. It is not widely acknowledged, but many countries in Europe—including Germany and France—stand to lose far more in trade from a deal-less British exit than does Britain. And at this difficult juncture, there is a changing of the guard, with long-time leaders including German Chancellor Angela Merkel and ECB president Mario Draghi--no comment on the *quality* of their leadership—on their way out. (Would that there were a changing of the guard at the top of the U.K. government, but that's a different matter!)

Across the globe, China's economy is bucking the trend and seems to be showing some signs of improvement. Many indicators have picked up albeit modestly, including business optimism and new orders. The continuing worry, of course, is whether an agreement will be reached with the U.S. on trade, and that remains uncertain. Other countries are also seeing modest upticks, including Singapore, whose economy had been soft for the last year or more.

Overall, the global economy remains positive, but is slowly and unevenly trending downwards, while an abrupt end to the China tariff talks could accelerate the process. (On balance, I am not expecting this.)

■ Stocks: Warning signs after strong rebound

Investors were already beginning to come back into the stock market after a weak fourth quarter took it to oversold levels. Then the Federal Reserve paused its tightening, setting the stage for a flood back into equities. The first quarter was the strongest quarter in a decade and the strongest first quarter in two decades.

As the market rose, sentiment improved, now with the widest gap between bulls and bears since early October, before the market started to tumble. Of course, sentiment often simply follows the market, so is not necessarily a good predictive tool.

Although the stock market likes the fact that the Fed has stopped tightening, it is ignoring *why* the Fed stopped, namely a weakening economy, and it is ignoring how they will handle another recession. This is in contrast to the bond market, which is predicting a weakening economy ahead, if not a recession. Which is right? The bond market traditionally has been a better predictor, though the stock market has a shorter-term view and may just be "going along for the ride".

How long will this last? Often the second quarter is soft, particularly after a strong first quarter. An added factor now is the blackout on companies buying back their own shares around earnings releases, and buybacks have been a significant factor in boosting the market. So we could see a wobbly near term, particularly if earnings come in weaker than expected. The analyst consensus at the beginning of the year was for 9.4% earnings growth this year, which certainly seemed high, given the economy and consumer spending. Now analysts have started slashing estimates, with the latest estimate under 5%, more realistic but still likely to see some disappointments. The less-than-stellar performance of new IPO Lyft, 20 times oversubscribed but still below its opening price, is a warning sign. The immediate term outlook could be soft, though we don't think it's necessarily the end of the bull market yet.

■ Global markets also rally, and still better value

Virtually every stock market around the world participated in the first-quarter rally, with the exceptions, other than Argentina, being tiny markets that for the most part had appreciated in the prior period. And the rallies were strong across the board. As with the U.S. market, most have now recouped what they lost at the end of last year. Valuations, while not extremely stretched, are no longer bargains. In Europe, big-cap stocks are trading at 17x earnings, though Asian markets are somewhat better value with Hong Kong trading as 12x earnings and yielding 3.3%, and Singapore 13x earnings and yielding over 4%.

But given the strong rallies, and given the *risk* of a failure in the China-U.S. trade talks which would significantly hurt these markets, we are not buying much right now, though largely holding. As always, we are on the lookout for specific markets or companies that drop for some temporary reason and we have found these recently in China and Japan, but are buying cautiously until prices and valuations are more attractive.

■ What might make the dollar decline?

One major factor affecting global market valuations is the dollar, now in the longest bull market since Ronald Reagan was president. With the strongest economy among developed countries and more importantly the highest yields, the U.S. remains an attractive destination for global investors. There was some selling at the end of last year as rates moved up—as yields climb existing bonds decline—and foreign appetite flattened, though domestic investors continue to buy. Now that the Fed has paused hiking rates, we may see that foreign demand return (when the numbers are released). Certainly, this year, the dollar has trended higher.

To some extent, however, the U.S.'s advantages are priced in, so the dollar is vulnerable. As always, however, for one currency to decline, other currencies must advance, and it's difficult to make a strong case for other major currencies right now. However, the move could come from stock markets. If global markets improve relative to the U.S., then that of necessity would involve more buying of foreign currencies, just as when the U.S. market is strong, it involves buying of U.S. dollars.

The prospect of Trump impeachment proceedings, which would hurt the dollar, has receded for now, though Democrats in the House continue to investigate anything and everything to do with Trump.

However, if that prospect has declined, there are elections next year, and campaign rhetoric can have an impact on the market or individual sectors, and on the dollar.

Interestingly, this year, many of the more important emerging market currencies, including the Russian ruble, the Brazilian real, and the Chinese yuan have appreciated against the dollar. It's too soon to call for a sharp decline in the dollar, but there may not be too much strength remaining.

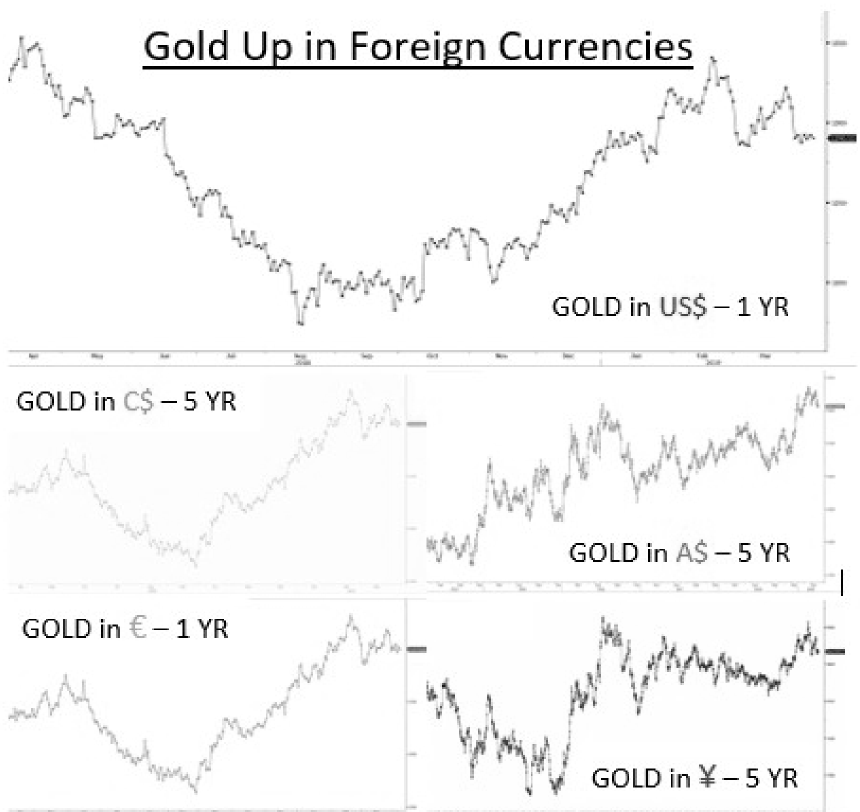
■ Resources up on supply and demand

Resources would certainly benefit from a lower dollar. They enjoyed the best quarter in nearly three years, on the back of supply concerns and low inventories, as well as hopes for improved demand on the back of easier money. Given that China remains the dominant buyer of all commodities—as much as 50% of world copper, for example—the health of that economy is important, and it's too early to call all-clear. If China's economy is not yet firing on all cylinders, at is true, then supply considerations become more important, and the picture is varied. Copper, as discussed before, looks most attractive on this basis, given the lack of major new projects expected to come on stream in the years ahead.

Oil had a particularly strong start to the year, the best since 2002, at the onset of the resource "supercycle". OPEC continuing to keep supplies tight is the major factor, but that can reverse at any time for a variety of reasons, as we saw last year. After a long drought, the better oil companies, both producers and service companies, have learned to live with lower prices, and they can be profitable at $60/barrel oil. We see that as a reasonable price before OPEC would pump more oil into the market.

■ Gold: Rates and the dollar to help

Gold was one of the few assets that appreciated at the end of last year, primarily on buying as a hedge against declining stock markets. Although inflows into gold ETFs have stopped as markets have recovered, we have not yet seen significant outflows. This suggests that the memory of last year, and the perceived need for insurance, remains. Like other assets, gold has been supported by the Fed's about face on tightening, while the prospect of a lower dollar would also be very positive for gold.



Certainly, declining rates did not help gold, particularly from 2011 to the end of 2016. However, a central bank that lowers rates because it *can't* raise them is a different matter. Concerns about a slowing economy and particularly the impact of higher rates on the massive amounts of debt—at the government corporate and consumer level—will keep rates low and this remains very positive for gold. Debt, not just in the U.S. but globally, remains a major problem, as discussed above, and this is positive for gold because of the policy *response* to high debt.

Moreover, a recession need not be bad for gold. Indeed, during the seven recessions since 1973, gold rose in each case, according to a recent study by Deutsche Bank. In one case, the rally was just 1%, but in three cases it was up by double-digits. Each case is different, with different circumstances. The oil-crisis induced recession of 1973, saw gold start the period at a depressed low, and the fear of inflation saw it jump nearly 80%.

Right now, three factors are holding gold back. First, the recovery in global stock markets, as discussed, has certainly reduced new insurance buying. But a stumble in the stock market now would likely see that buying resume. Second, the uncertainty over the China-U.S. trade talks and Brexit is supporting the dollar and not gold. A conclusion to those issues would help gold.

And lastly, the dollar remains the major factor holding gold back from long-term price appreciation. As discussed above, while we do not expect the dollar to tumble any time soon, absent a black swan, we do believe that there is very little room for additional strength, so the stage is set. The fact is that in terms of almost every currency in the world, other than the U.S. dollar, gold is already at highs (see graphs). An easing in the dollar's strength, will kick-start gold in dollar terms too.

■ Gold stocks playing catch up

Though gold has rallied since August last year, the gold stocks have played catch up since October. It has mostly been the larger miners so far, and this is a typical pattern for the beginning of a bull market. As gold resumes its up-move, we expect the junior miners to take over the leadership role, followed later by the exploration companies.

As a group, the gold stocks, including the large miners, remain very undervalued on a long-term basis relative to both gold and to the broad stock market. When gold breaks convincingly above $1,300, the stocks can move dramatically before they reach anything approaching long-term average valuations.

The recent mega-mergers—Barrick buying Randgold, and Newmont in the process of buying Goldcorp—have focused some attention and added excitement to the sector. While we do not think that consolidation is over for one second, the next round of M&A may involve junior producers, or companies developing a single attractive asset. Though we rarely buy a stock solely because we think it could be acquired, there are certainly several stocks in portfolios that could be reasonable targets in the months ahead.

In sum, we are concerned about the potential for a slower U.S. economy, as well as a pullback in global equities, at least in the near term. While we are holding most of the stocks we own, we are buying little and slowly trimming opportunistically. Many of our favorite stocks and sectors, while still reasonable value, are no longer bargains following recent rallies. We are holding our exposure to gold and resources, though, as always, with some trading among specific positions. Trimming positions now means having the cash available to buy when stocks get meaningfully cheaper.

Review of Individual Accounts

■ Global Accounts

The biggest change in our allocations in global accounts has been a significant increase in cash, as suggested last quarter, now over 12% of accounts, though some of that is set aside against puts sold.

Raising cash

Nonetheless, after buying aggressively at the end of last year on the market volatility (see last *Portfolio* Review) and continuing to buy early this, in recent weeks we have been selling some specific stocks—can't name them or discuss why, per SEC—and also trimming other positions. We have cut back on Hong Kong stocks following the significant rally, and also been trimming holdings in Business Development Companies, as foreshadowed last quarter.

Though we continue to like the sector and the companies we hold, and they remain good value, nonetheless after the rally they are susceptible to negative news, on rates or the economy. We have focused our selling on more aggressive accounts or accounts that are overweight a particular stock or the entire sector. Nonetheless, we still hold over 12% of global accounts in this sector across the board, and it remains a favorite sector.

Buying little, holding favorites

We also continue to have large exposure to gold stocks, both as a hedge on the overall portfolio but also because the stocks remain undervalued and have the potential for outsized gains.

We have been buying little, mostly adding to a few specific stocks we already own, both in Europe and Asia, which experienced unjustified price declines for what seemed temporary reasons.

We expect our cash holdings may increase even more in coming weeks, but that will put us in a good position if the overall market falls. We continue to hold the best of our companies, quality companies selling below their intrinsic values, particularly if they pay good dividends. So, we are continuing to participate in the rising market, but should not be so exposed to any sudden market sell off.

■ Gold Accounts

Cash in gold accounts also increased a little on some sells in recent weeks. Most of the cash, now 5%, however, is set aside against sale of puts, and unrestricted cash is less than half that. The allocation to senior miners dropped marginally (from 34% of accounts to 31%) mostly on some selling among seniors that had rallied significantly or in one case was disappointing.

Rebalancing with new buys

Most of our buying was in a couple of exploration stocks. This sub-sector has not moved recently, and the bounce off tax-loss selling lows in December was disappointing. This group is often the last sector to move, and when it moves, the moves can be dramatic. What we are buying now are companies with very little downside—stock prices protected by cash and hard assets, for example—but with the potential to move dramatically on good news.

We will likely increase cash a little in coming weeks, as we cut laggards, giving us some dry powder to buy new positions as well as be ready in any general pullback. We are also selling puts on companies we would not mind owning while we wait, picking up a little income. We are however very well positioned in all groups—the royalties, major and junior miners, and exploration stocks, so will participate fully when the sector moves.

■ Resource Accounts

Cash in resource accounts also increased, largely because of a company that was acquired, for cash, and we have not yet fully invested the proceeds.

We have also trimmed a few positions on rallies, with the result that about 9% of accounts on average is held in cash. Again, much of this is held against puts sold.

Gold, both major and junior, continues to be the dominant position in our resource accounts, but we have been buying fairly aggressively in recent weeks both silver companies and copper. We have little exposure to oil, mostly major integrated companies, thinking the recent rally will be temporary. And we have been trading uranium stocks, thinking it's still too early for a sustained rally.

We expect to put much of the rest of the cash in accounts to work, primarily in silver and copper, where stocks are still good value, while we maintain our gold exposure. We continue to look for opportunities to buy energy companies, and expect to have a little more exposure, certainly by year end.

In sum, we are slowly raising cash after the rallies in stocks and commodities, wanting to be well positioned to buy in any market or sector decline. In the meantime, we are selling puts on quality companies that are undervalued, where we can pick up good premiums. We continue to have good exposure to dividend-paying stocks in the U.S. and globally, particularly the Business Development Companies and Hong Kong growth stocks, as well as to gold. We continue to anticipate a good year for gold stocks, and as we know from experience, gold stocks, when they move, can recover years of weakness very quickly.

Adrian Day, April 5th, 2019