PORTFOLIO REVIEW

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The Federal Reserve made clear that it was now on a dovish path and the markets responded strongly, including the gold market. This was hardly the first signal that the Fed had finished its "tightening cycle" and that the next move in rates would be down; that had been clear since December. But markets can be like that. The shift, particularly for gold, came suddenly and swiftly. There is, however, a contradiction between the markets and the economy. The reason for the shift in Fed policy that the markets are celebrating is itself a reflection of growing weakness in the economy.

■ Stocks and other assets sharply up

Stocks around the world were up this past quarter, and year to date, responding to the Fed policy shift and brushing off the apparent lack of real progress in the U.S.-China trade talks. Although the U.S. market saw very solid appreciation—up 17.5% for the year to date, after it reversed at the end of May for the best June in decades, the S&P since 1955 and the Dow since 1938—the U.S. is by no means the top performer. Every region had a stronger performer, with Switzerland up over 18%, Canada up over 19%, and China the top performer among major markets, up over 27% this year. All numbers quoted are in U.S. dollar terms. Few markets are in the red this year, and they are mostly smaller markets down for their own particular reasons, markets such as Panama, Malaysia, Pakistan and Sri Lanka.

Despite this, the *average* non-U.S. market, up a little less than 12%, trailed the S&P. Interestingly, the average U.S.-based global equity fund underperformed, up less than 11% (basis the Bloomberg fund index; note, the index returns are through June 25th). Your managed accounts built on the solid first-quarter returns, outperforming the fund index, if not the S&P, with returns ranging from just over 15% to over 18%, depending on the risk category.* (Numbers are preliminary.) The outperformance to the funds is a little bit puzzling, especially given our severe under-weighting to the U.S. We did, however, have a reasonable exposure to China, through Hong Kong stocks, for much of the period, as well as to gold stocks which had better returns than the broad market.

■ Gold and resources mixes, with funds lagging

Gold and the resources had an interesting period, with returns all over the map. The Bloomberg Commodity Index—again, like all commodity indices, a very imperfect indicator of resources, but the best one we have—fell just under 2% in the last quarter for a year-to-date return of 3.8%.

As always, individual commodities were mixed with oil (the highest weighting in the index) up 23%, copper up a modest 2.3%, with gas and various soft commodities down.

Gold is up virtually 10%, just a tad more than in the first quarter. Another way of looking at it is that essentially all of the gain took place in June, after gold gave up all its first-quarter gains before turning around, to close the quarter at the highest levels since 2013.

Gold stocks—per the XAU index of senior gold and silver stocks—matched gold's first-quarter returns, but leveraged recent appreciation to end the quarter up almost 20%. The misleadingly named VanEck Vectors Junior Gold Miners Index—Kinross are Gold Field are juniors?—rose just under 16%, while genuine juniors performed far worse, with many hardly budging and still well below even last year's highs. The average gold mutual fund (again, per Bloomberg fund index) barely inched up in the second quarter, to close the first half up just under 8%. It is unusual for the gold funds to lag the indices by so much, although of course when gold stocks move, indexes capture *per se* the entire move, while funds lag because of cash and cash inflows at higher prices. Interestingly, though gold is at a six-year high, the XAU is only back to the levels it saw at the end of last year.

■ Why did we outperform the funds?

Your resource accounts well outperformed the Bloomberg index—up over 16% year to date—while your gold accounts, though they underperformed the XAU Index, well outperformed the average gold mutual fund, almost doubling the return, with year-to-date gain of 15.6%* (Again, our numbers are preliminary while fund index numbers run through June 25th.)

We have already indicated why our accounts lagged the XAU: cash and exploration stocks were a drag in the strong recent rally. Why we outperformed the gold funds by such a wide margin is less clear, especially since funds typically do not hold as many exploration stocks as do we. Perhaps it is more a reflection on how poorly the average fund did than how well we did!

■ Does the Fed know what it's doing?

Clear indications that the Federal Reserve had truly ended its so-called tightening cycle and was ready to start cutting rates again sparked the market rally, even as it reflects growing underlying weakness in the economy. Each tightening cycle of the last 30 years has been to lower highs and lower lows. In the 1990s, rates peaked at just under 10% and bottomed just under 4%; the latest rate hiking cycle—if one can call it that—didn't even come close to the 1990s bottom!

Just how dramatically Fed thinking has changed is clear from the projections of the Open Market Committee—the body that actually sets rates. At the end of the year, a clear majority of FOMC members—11 out of 17—thought the fed funds rate would end this year at 3% or higher. Now, just six months later, not a single one thinks rates will end the year over 2.75% and all but one predict 2.5% or lower. Remember, these are the same people who set the rates. Their audacity is a subject for another day; their lack of predictive ability on their own actions is the topic at this minute.

It is not an original observation to note that to embark on cutting rates now, when the economy is reasonably strong and inflation low, gives very little manoeuverability when the economy retracts, as indeed one day it will.

But central bankers are doing what central bankers do, and what it seems is all they know to do, namely print money and provide stimulus (though the next president of the European Central Bank, should it be the man in line, Bundesbanker Jens Weidermann, would change that, precisely why he is likely to be sidelined).

■ Negative and low yields dominate

Other countries, if they have not yet embarked on a new round of rate cuts, have also clearly stopped raising them. Negative interest rate bonds around the world have increased again to a new record, with 40% of government debt around the world now trading at negative yields. Even some corporates in Europe are issued at prices below U.S. Treasuries. A stunning example of how crazy the interest rate world has become is that Austria has just issued a 100-year bond at 1.17%, and it was four times oversubscribed, while a 5-year at a negative yield was eight times oversubscribed. Think of it, a scramble for a guaranteed negative return with most would-be buyers disappointed. I don't want to bring up unpleasant history, and Austria is one of my favorite countries, but one only has to think of the *last* 100 years in Austria to ask if 1.7% is reward enough, reward enough for any country indeed.

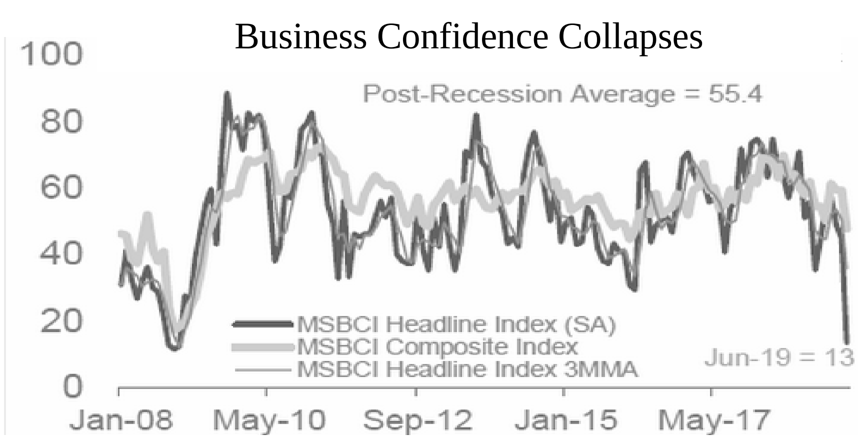
In the U.S. treasury, auctions have not been so stellar, with a distinct lack of foreign participation, and the erstwhile two largest participants—China and Russia—noticeably absent. Most of the buying has come from insurance companies and pension funds, which are distinctly price insensitive, while traders who buy are not enticed by 1 and 2% secure yield, but rather are looking to clip a capital gain.

■ U.S. economy is slowing

What is overlooked in the market euphoria over the shift in rate policy are the *reasons* for the change. It is precisely because of indications that the U.S. economy is slowing, not a positive sign. Most notably of course trade indices are down, including the freight indices. But the trade dispute is beginning to have its impact on the domestic economy. Many sectors are mixed. Though the headline unemployment remains low and demand for labor strong, the employment utilization number is down while initial unemployment claims are creeping up. In fact, the size of the labor force has fallen by more than the number of new jobs added in recent months, and that is what drove unemployment to the lowest number since 1969. Again, wage rates ticked up but the number of hours worked fell.

Manufacturing has been particularly weak, though now the services sector is beginning to follow with declining growth. The combined Markit index is now at a three-year low, and the business expectations number is at the lowest since mid-2016.

Among consumers, though the confidence number rose on "expectations", spending intentions fell even as retail sales slipped again. And even in this indicator, confidence among under 35s fell sharply—25% in one month—to its lowest level in three years. Confidence is highest among over 55s. Perhaps this reflects that older people tend to own more stocks which have gone up. Business confidence, however, has collapsed this year, largely on concerns about the effect of a trade war. (See graph to right.)



Source: Morgan Stanley

Of course, the long period of ultra-low rates has led to an increase in debt, among consumers, with credit card companies now sharply increasing interest rates, and also among corporations, especially among more risky firms. The Fed's Jerome Powell has recognized this, but has not recognized—publicly, at least—that it was the Fed's own easy money policies that enabled and encouraged excessive debt.

And amid all this are signs that inflation is picking up again after declining at the end of last year. The Producer Price Index has been consistently above 2% for nearly two years. The PPI of course includes a lot of raw materials. The Consumer Price Index is beginning to follow, trending up this year. The Fed is still worried about low inflation—a perverse worry for a central bank charged with preserving the purchasing power of the money—but the Fed is focused on one particular index, PGE, which is dominated by manufactured goods, which have declined in price, and Medicare and Medicaid (at the cost of private insurance), which are price controlled by the government. So, the Fed thinks inflation is much lower than do people going to the grocery store every week.

■ Overseas economies mixed

European economies have been improving this year, most of them and quite strongly, led (surprisingly) by France, but for many of them, GDP is still lower than in 2011. In Germany, the erstwhile warhorse of Europe, growth is well under 1%, with manufacturing down in the face of a slowing Chinese economy; China is Germany's largest trading partner.

Chinese policy is for targeted stimulus without inflation, and in general terms it is still delivering. Retail sales growth has declined sharply but is still growing at a better-than 7% annual rate. Similarly, loan growth has declined, but remains high. So, it remains to be seen whether the recent slowdown in growth, caused in large part by the U.S. tariffs, will accelerate, or whether economic growth will simply find a new, lower, but still high, steady state.

It is, therefore, the end of tightening, in Europe as well as the U.S., and not strong economic indicators, that have provoked the global market rally. This is concerning, because stimulus alone has diminishing returns on both the economy and the market, and besides, there is only so much further that policy makers can go.

■ Stocks are expensive

Stocks are already trading at high multiples. In the U.S., the S&P, closing the quarter just a smidgeon below the all-time record it hit earlier in the quarter, is trading over 19 times earnings, yielding less than 2%, with a price to sales of 2.2 times. These are high numbers, particularly for the market average; many sectors and individual stocks are trading well above those multiples. It remains to be seen what the impact of tariffs has been on companies' earnings in the second quarter. Initially, when tariffs are threatened, there can be distortions as companies rush to import ahead of new taxes. Second-quarter results, once released, will provide a clearer guide.

Of course, now Presidents Trump and Xi have called a truce and we may yet see an agreement in the near term. Trump realizes that tariffs are hurting his voter base while Xi knows that he may be under more pressure should the Democrats gain the presidency next year.

We are underweight the U.S. market in accounts. Most of the stocks we hold are high-dividend paying companies trading at reasonable multiples, and in line with their own sector's historical valuations. We also own a handful of good value stocks and look for opportunities to sell below-market puts on solid companies which have stumbled for some reason, where the premia are high. We are also protecting against volatility which would accompany a market drop.

■ Global stocks better value

In Europe, stocks are also trading at high valuations, far higher than the historical average, with price-to-earnings over 17 times. However, with the recent economic recovery—see above—analysts are looking for earnings growth of 25% over the next 12 months. That would put the p/e multiple into a more reasonable range, though it is also an optimistic estimate, in my view. Equity yields across the continent are a little over 3%, below historical norms but attractive in a negative-yield environment.

We have a few stocks in Europe, mostly solid global blue chips we are holding for the long term, though trimming at current high prices, and high discount holding companies. We are looking for any bargains that may be thrown up as Brexit reaches its *denouement*.

■ Asia cheaper, hit by trade war

Asian stocks are generally better value, but also above their historical averages. In Hong Kong, for example, even after the recent weakness, stocks are trading at 11 times earnings, slightly above the long-term average, but yielding only 3.4%, considerably below the average. Part of this is due to an increase in listings from high-growth, low-yield Chinese companies, but it also reflects a market that is not selling at bargain levels. Asia countries also are suffering from the U.S.-China trade dispute, but a settling of that issue, would see their economies and markets recover more rapidly than other global markets.

Mostly, we hold stocks in Singapore and Hong Kong, the two most developed markets outside Japan in the region. We took a defensive move as the recent Hong Kong protests took hold and sold most of our stocks there. In the end, the government suspended discussion of the controversial extradition measure that had sparked the protests and the market appeared to bottom. Nonetheless, we avoided the *risk* of a significant market decline that could have resulted had the protests continued. We are looking for the right time to get back into the market, cognizant that the specific issue that sparked the protests, and more broadly China's control over Hong Kong, has not gone away.

Overall, we are underweight broad-market equities, mostly holding blue chips, dividend payers, and undervalued companies, while always looking for short-term trading opportunities, often through selling puts. We are slowing trimming positions when valuations get extreme or stocks start to stumble, raising cash for better buying opportunities ahead.

■ Resources mixed, but gold shines

Given that the Federal Reserve's new dovish stance results from concern about the economy, it is logical then that gold did particularly well in the period just finished whereas copper and other base metals generally did less well. Copper, in fact, ended the first half of the year up a modest 2.3%, very meagre given a strike at the major Chilean mine (just ended). Though longer-term copper is a supply story, in my view, this year it has been weak demand keeping a lid on copper prices.

Demand from China, the world's dominant source of demand, was down as one would anticipate with the decline in trade from the tariff dispute. But a global decline in world auto sales also saw copper demand down in Germany, South Korea and the U.S. There was also destocking due to trade war concerns. This came against a fall in world copper output, with refined copper down 6.5% in the first quarter. Mine output fell not only in Chile and also Indonesia as the big Grasberg mines moves underground, cutting output in the near term.

<u>Gold Rises with Global Negative-Yield Bonds</u>

Source: Bloomberg, Barclays Bank

Gold continued the move which started last August, though with a pullback at the beginning of the quarter as the stock market rally took off, reducing the perceived need for gold as a hedge. But when the Federal Reserve made clear that its policy direction had changed, gold took off, up virtually 10% in the last month, taking back everything it had lost in the previous two months.

■ Gold acts as hedge

Gold is now viewed as a bond alternative, as Bloomberg puts it. Gold famously does not pay any interest, as its critics never tire of saying, but no yield is better than a negative yield. If one is buying bonds now for capital appreciation, then gold looks an attractive alternative. The graph above illustrates this.

The change in Fed policy coincided with the Iran incidents, and gold captured a geopolitical premium. The most important factor we think is that sentiment has now changed. Suddenly, everyone is bullish, Morgan Stanley, Goldman Sachs, Bank of America, Standard Chartered and other major banks, as well as more lowly scribes. This means that gold will respond to bullish factors in a way it has not for the last few years.

We are heading into a traditional weak seasonal period for the metals, and if that coincides with a China trade agreement and an easing of tensions with Iran, perhaps also with the Fed not cutting rates at their July meeting, gold could pull back. The market is pricing a 100% probability of a rate cut in July, but I am not at all that certain. But with a change in sentiment, gold will respond to positive developments.

■ Major miners led the rally

The major gold stocks leveraged gold's move when gold took off, and the intermediates did well also. Less strong were the developers and exploration stocks. Despite a few very strong performers—again, indicating that with a change in sentiment, stocks will respond to good news—overall most are well below last year's highs and many barely budged in the recent gold rally, as can be seen from the table nearby. This is typical at the beginning of a bull move, as also is the fact that the highest-cost and most-leveraged companies—what one can reasonably think of as "the worst <u>companies</u>"—see the stock prices move the most. This again is logical, though such moves usually do not last. As a bull move develops, then typically the smaller companies one by one take the lead. The change in sentiment means that an exploration company with a positive development can see the stock price respond strongly as opposed to the yawn—or excuse to sell—that has been the case for the last several years.

<u>Bigger Stocks Go First</u>

Sub Group	Past Month	2019 YTD	Past 12 Months
Sr. Golds	+ 25%	+ 27%	+ 35%
Int. Golds	+ 19%	+ 12%	+ 10%
Jt. Prod	+ 20%	+ 12%	- 16%
Developers	+ 9%	- 2%	- 18%
Explorers	+ 2%	- 2%	- 12%

As of June 21, 2019. Source: Paradigm Capital

Not only do prices remain below recent highs, valuations also remain attractive. For the miners, on some key metrics, valuations remain well under multi-year averages. For example, the price- to- sales multiple today is under 2.5x, though up from a low under 2x. But as recently as 2009, that multiple was over 4, and peaked over 5 times. Of course, with gold (and other resource companies), when the price of the commodity goes up, the denominator in valuation metrics goes up, so valuations can remain reasonable even as stock prices move.

We are continuing to accumulate the copper stocks—though they are not reflecting the current weakness in the metal; buying the better depressed silver stocks; picking away at depressed oil and oil service companies; and maintaining our high exposure to gold stocks.

In all, our approach to the broad market is somewhat cautious, though, as we have said before, recognizing that the bull market could continue further. But we are also watching for companies that stumble, stocks that get too extended, and, broadly, maintaining a large position in high dividend stocks, and also continuing to hold our high allocation to gold stocks. Selling puts in this volatile market generates good income. Overall, these tactics generate income, while providing exposure to potential strong gains and maintaining a hedge on the overall portfolio.

Review of Individual Accounts

■ Global Accounts

The biggest change in allocation was the sharp decline in Hong Kong exposure, from around 5% of portfolios at the end of the first quarter, to barely 1%. (See discussion above.) This led to a fall in allocation to global equities generally, from 12% to 10%, with Hong Kong sales offset by some new positions and strong appreciation in some holdings.

In other respects, allocation was almost identical at the end of the quarter to what it was at the beginning. Cash, as expected, inched up from 12% to almost 13%. Income stocks, particularly Business Development Companies, remained over 12%, while gold and resources moved up incrementally on the rally.

Selling Hong Kong

We were in fact already reducing exposure to Hong Kong stocks in the first quarter, before the protests, but that was primarily because of moves up in the stocks. We will certainly look to buy back in this market, a proxy for China in addition to its own attractions, but the market did not fall as much as we anticipated, given developments there. By and large, the stocks are not *that* undervalued so we will wait in this notoriously volatile market.

We did a little selling of BDCs, mostly trimming positions of stocks that were overvalued or vulnerable, but, unlike in the first quarter, recently we were also able to rotate into undervalued BDCs. For the most part, we are long-term holders of these high-yielding vehicles but trimming when they are expensive and adding to positions on declines, which can add to the overall returns.

Though we want to maintain a high exposure to gold stocks in global accounts, we expect to be cutting back as the stocks rally to avoid gold overwhelming global equities.

We are for the most part holding what we own, but with a bias towards selling as individual sectors or stocks get overvalued or vulnerable. At the same time, right now, we see little to buy, though we continue to undertake short-term trades and sell puts. Thus, on balance, the tendency will be to raise cash, albeit slowly, in the months ahead.

■ Gold Accounts

Allocation to various sub-sectors in the gold accounts remained reasonably constant, with one third each in major miners and in exploration; and another third split between intermediate gold companies and resources. In the last quarter, cash inched up to just over 5%**,** as we used the rally to take some profits. Exposure to the intermediate sector fell, as we sold one of our holdings which is in the process of being acquired at a healthy premium; this also added to cash.

We mentioned last *Review*, that “we know from experience (that) gold stocks, when they move, can recover years of weakness very quickly.” Though we have seen very strong moves, particularly over the last month, this is only the beginning.

As the senior stocks rallied more than the rest of the sector, we trimmed a few, mostly more marginal positions and are holding on to our favorites. We have added to some intermediates and exploration stocks, though incrementally, mostly adding to favorites that remained undervalued while exiting a few of our short-term trading positions.

Selling puts and calls

In addition to the puts we have sold, we also took advantage of the rally to sell calls, mostly on our more marginal (non-core) positions where premiums were attractive. In most cases, we sold above-market calls, so these may well not be called away absent another strong move.

We are holding on to our core positions, among royalty companies, senior mines and exploration companies; we want to hold these stocks for long-term exposure to the gold bull market we see ahead. But we also want to profit from strong moves by trimming positions, selling (or selling calls on) secondary positions, and undertaking short-term trades as opportunities arise. We expect to remain fully invested, though cash may increase for short periods for various reasons (such as a takeover of a company we hold).

■ Resource Accounts

Allocation in resource accounts saw a few more changes than other account types. We entered the quarter with a high cash holding, over 9%, mostly the result of the sale of one of our largest holdings. We have been putting that money to work, and though, at something less than 7%, cash remains high, that figure belies the cash set aside for the potential exercise of puts sold. Our largest allocation remains to the senior gold mining companies, at about 30% of accounts.

We have been buying our top silver miners aggressively while prices are depressed, and though percentage allocation has not changed much, the amount of silver shares we now hold for clients has increased meaningfully. We have also increased exposure to the energy stocks, mostly through service companies, but the allocation remains very low. We continue to accumulate copper stocks for what we see as a strong multi-year market, but generally prices were not low enough to do much buying, despite the lackluster copper price.

We will continue to hold strong positions in senior gold mining companies, including the major royalty companies; in silver and copper miners; and in diversified exploration companies. We anticipate exposure to energy, while remaining low, to slowly increase. As with gold accounts, we want to maintain exposure to core companies for the long bull market, while continuing to lock in some profits by trimming stocks that have moved too far, undertaking trades, and, as always, cutting those where risk has increased. Overall, however, we expect cash holdings to continue to decline as we put funds to work.

In sum, we are slowly raising cash across the board while maintain the bulk of our holdings. But the bias is for more selling than buying, and we expect cash in global accounts to increase, absent unexpected buying opportunities. In gold and resource accounts, however, we expect to remain fully invested even as activity picks up.

Adrian Day, June 29th, 2019