PORTFOLIO REVIEW

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As we move into the last quarter of the year, markets have resumed their rallies, responding to another round of lower rates and easy money around the world. U.S. equities, global stocks, bonds and gold, all moved up, adding to first half gains. Significantly, for most markets, the pace of gains was meaningfully slower; global markets in aggregate barely inched up. Markets are accustomed to, and demand, additional stimulus—and the central banks meekly comply—but it requires more and more stimulus for the markets to respond. But with rates already so low—and indeed negative in much of the world—there is limited room for additional stimulus on the rate front. As we discuss below, we are moving inexorably towards the next stages in easy money and the destruction of the value of the currency, with potentially dangerous consequences far beyond the economic.

■ Everything up, some barely

For now, markets were up. Stocks were up around the world, led by the U.S., with the S&P up 1.7% on the quarter. Global markets in aggregate inched up by less than half-a-percentage point for the quarter, while some markets, including Germany and, not surprisingly, Hong Kong, fell sharply. Global equity mutual funds (per Bloomberg index) were up by just 0.7%.

For the year to date, the U.S. market also leads, with the S&P up over 20%, while the average global mutual fund is up 11.5%.

Our global accounts outperformed both U.S. and global equities, with mid-risk global accounts up 2.7% for the quarter.* (Numbers are preliminary.) For the year to date, our global accounts are in line with the S&P, returning from 18.6% to over 22%, but nearly twice the returns of global funds.

We outperformed because we were not in the formerly high-flying "unicorn stocks", which fell sharply as investors rotated out of momentum and growth stocks into value. We had also exited Hong Kong stocks for the most part, concerned that the protests there would not evaporate and would eventually have an impact on the stock markets. (See discussion last quarter's *Portfolio Review*.) Lastly, an overweight position in gold and gold stocks helped accounts this quarter.

■ Volatile quarter for resources

Resources had a very volatile quarter, on balance weak, taking away most of the first half's gain, with the Bloomberg Commodity Index falling over 2% for the quarter, to close the year-to-date period up less than one and a half percent. As always, there were wide discrepancies among various commodities, with oil up 12% on the year from the January lows, but down on the quarter, while natural gas fell over 20%. Iron ore and nickel led the resource pack, up over 60% and 40% respectively, while copper, aluminum and others fell. (The agricultural sectors, which are in the index, were also mixed, pushed down by cattle and cotton, down by the mid-teens.)

Gold resumed its rally after a summer sell off, up over 4% on the quarter, taking it to a better-than 14% gain for the year. Interestingly, though gold equity indices returned more than the metal, the average gold fund (per Bloomberg precious metals fund index) underperformed, up 3.5% for the quarter, less than 12% for the year to date.* (We discussed the reasons why indices often do better than funds and managers in the early stage of a bull market in our last *Review.)*

Our resource accounts well outperformed the indexes, however imperfect they may be, up over 3% on the quarter and 20% on the year to date. The main reason for this is our overweighting in gold and silver which have been among the leaders this year. We are also underweight oil, where the stocks did not respond in a lasting way to the rally in the commodity.

Although our gold accounts lagged in the latest quarter, they outperformed for the year to date, up 18.5% on average, 50% more than the average fund.* We lagged in the latest quarter because of our large exposure to exploration stocks that as a group have not yet participated in the new gold bull market, while we also did not hold some of the highly leveraged companies which tend to outperform at the onset of a bull move (as discussed last *Review*). We have added to quality major and intermediate miners, however, and expect to at least match the averages in this current quarter.

■ Whither monetary policy

Some central bankers are beginning to call for a halt to ever-lower rates and more money, but so far they are losing the argument. The Federal Reserve, after cutting rates again, added another $180 billion to its balance sheet in the last few weeks, as the repo market suddenly became unstable. (That is a story in itself, of idiotic and conflicting regulations. There is more than sufficient liquidity in the banking system, but regulatory restraints on how it can be used, including fees on the banks on the extent of their repo lending, limiting their ability to make funds available in the repo market when needed.)

Over $16 trillion of bonds around the world trade at negative yields, a new record. That equates to one-third of all outstanding senior debt securities in the world. Despite the actions, even the majority is beginning to see that existing monetary policy may have reached a brick wall. See European Central Bank president Mario Draghi's plaintive plea that the economy has not responded to a decade of lower and lower interest rates…"so let's do more". Some are beginning to have second thoughts, of sorts. After all, following a decade of historically low rates and massive monetary injections, one can hardly claim the intended results in the world's economies, with mostly anemic growth and stubbornly low inflation. (Having a *higher* cost of living as a goal demonstrates the perversity of central bank policy.)

There is clearly less room to maneuver on the interest rate front. Notwithstanding Alan Greenspan, there *is* a significant different between positive 0.01% and negative 0.01% returns; zero is *not* just another number.

A few countries are actually raising rates, most, like Argentina, with specific urgent reasons to do so, but others, mostly smaller countries, too. And some have stopped cutting; Canada, after *increasing* rates twice last year, has kept them flat. And among the major central banks, there is a growing sense that the current policies cannot continue indefinitely. The Bank of Japan wants a steeper yield curve, albeit with short-term rates remaining ultra low. Yield curves in all major economies are very flat, arguably surprising considering how low short-term rates are. Only in Europe are 30-year rates noticeably higher than one-month yields (negative 0.75% compared with zero). Elsewhere, 30-year rates are the same as, or even lower than one-month rates.

■ Governments to the rescue

The ECB's Draghi, after his farewell "gift" of massive new injections, has said that it is now time for the fiscal authorities to take over. Fed officials have also made this call, less explicitly. What exactly does that mean? It means that central banks realize they are close to the end of what they can do on the interest rate front, and buying assets with increased money creation also has its limits. They want governments to go on unbridled spending binges with the implicit pledge that they will accommodate the spending with increased money creation, so that treasury departments do not have to worry about balancing budgets or the debt. (Balanced budget? What's *that*?) The U.S. government has indeed been doing its bit towards destroying the value of money with a current deficit of over $1 trillion. But Europe and Japan have room to expand this dubious fiscal policy.

Indeed, bank officials have been saying they want more help from fiscal authorities for some years, but whereas 20 years ago, it meant they wanted fiscal prudence, now they mean the opposite. And if government will not cooperate, there are increasing calls for more indiscriminate QE to avoid the wealth gap widening effects of previous QE (which went mostly to the government and to big banks), along the lines of Ben Bernanke's infamous "helicopter money". Such "policies" if we may dignify them with the term are beginning to sound suspiciously like Modern Monetary Theory (or as I prefer to call it Magical Mystery Twaddle). Along with this, we are hearing more calls for a debt jubilee of some type, most loudly for the government to assume all student debt and wipe it out. And if not student debt, why not medical debt? Why not losses on housing debt?

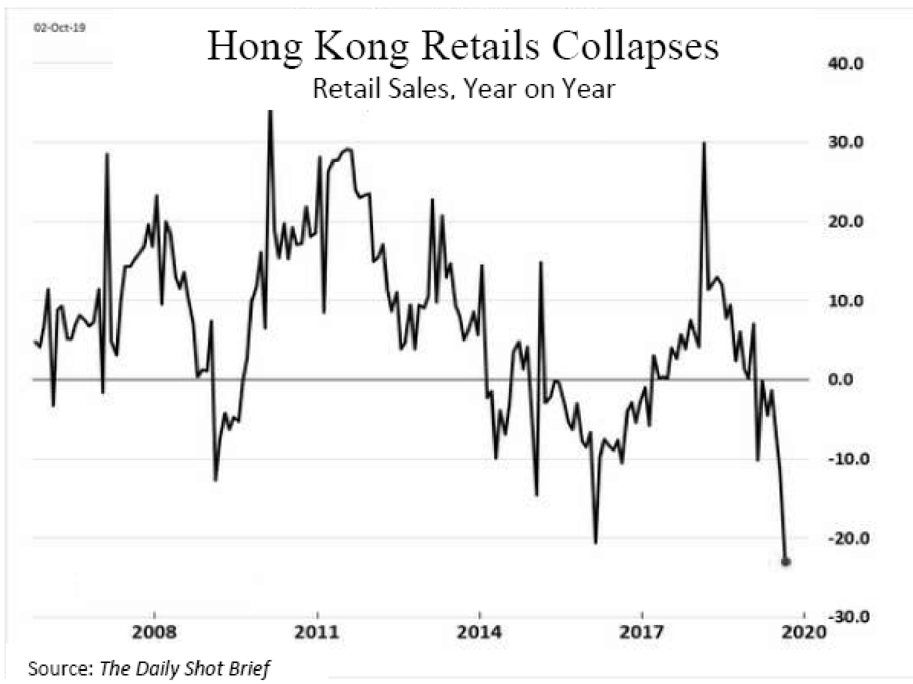
■ Where will it lead us?

We are approaching a *denouement* in the story of ever-easier money. Throughout history from Dionysius to the Jin Dynasty, the early Stuart kings to the Weimer republic, extreme easy money and high debt has had disastrous consequences and not only economic. The fall of the Roman Empire, the invasion of the Mongols, the English Civil War and the rise of Hitler all had many causes, but the destruction of money, whether by coin clipping, debasement or hyperinflation, in all cases was a central factor. The Fed's easy money has already led to a widening wealth gap and increased social hostility. We should be afraid, very afraid, of pursuing these policies too far.

■ Economies mixed around the world

Such developments are far more important than quarter-to-quarter shifts in the economic outlook. For the short-term, however, recent economic developments around the world have been mixed, but with a weaker bias. In the U.S., the housing market has generally recovered from the earlier slump, with sales and prices up. But mortgage applications and re-financings are weaker. The employment picture is decidedly mixed. New hires are reasonable, but soft if government and part-time jobs are excluded. Unemployment remains at long-time lows, but it's not so positive against the background of a low labor participation rate (and those part-time jobs). Initial unemployment claims are up, largely the effect of the trade dispute. Average weekly earnings remain flat. Most dramatically, the manufacturing sector saw another unexpectedly large decline, per the ISM Manufacturing Index.

In Europe, the positive news is that unemployment fell again, albeit slightly, to a still-high 7.4%, but well off the 2011 highs of over 12%. Other than that, the reports are mostly weak. France's consumer stats all fell, while the German GDP has been slowing, and is expected to report flat for the third quarter. The industrial sector in particular has been weak, largely because of the global trade dispute. Economic confidence across Europe continues to inch down.



Although China's official statistics have remained flat or ticked up recently, after earlier weakness, elsewhere in Asia the impact of the trade dispute is becoming very apparent, with manufacturing down in Japan and South Korea, and particularly in Singapore. Trade figures from Singapore, and, not surprisingly, Hong Kong are very weak, as is retail spending there. (See adjacent graph.) China is likely to expand monetary stimulus in the year up to the 2021 centenary of the founding of the Chinese communist party, the party that still governs the country. They will also be increasingly wary of the violent protests in Hong Kong, not wanting that to mar the celebrations.

■ Stocks up on monetary stimulus

Stocks remain expensive but buoyed by easy money, as well as the lack of attractive alternatives, while negative fundamentals, such as the trade war and declining corporate earnings, are largely ignored. This can continue for quite a while, as we mentioned last time. But one recent development may signal the end of this bull market, at least a temporary end or significantly slowing, and that is the shift from momentum stocks to value stocks, particularly the move out of high-flying, so-called "unicorn" companies. The gap between the valuations of value stocks and growth stocks reached all-time highs this summer, topping the previous high of 2000 at the peak of the 2000 dot.com mania, and before that in 1973 at the apex of the Nifty Fifty boom. We know what followed these peaks (Kodak, Xerox anyone?).

Along with the decline in value has been the decline in active investment, with, again this summer, assets of passive equity funds exceeding those of actively managed funds. This move is partly because passive funds often have lower fees, but over the long term, returns from actively managed funds have exceeded those from passive funds. Moreover, active management can accommodate investors' particular needs, whether it be for the avoidance of certain types of companies or for tax efficiency. As value investing overtakes growth investing, as it has for much of the past 100 years, then active investing will also come back into vogue. Passive investing can work in strong bull markets, but rarely does so when markets become choppy or sectors rotate.

■ This bubble is burst

The trigger for the sudden and violent shift was the WeWork would-be IPO, with its "community-adjusted" EBITDA metric, one fantasy too far. Companies going public have increasingly tested investors' rational senses, with 80% of companies going public having negative earnings (up from 40-50% in the 18 years after the dot.com bust). But WeWork garnered increasing skepticism. When the IPO was postponed, it initiated a shift from momentum to value investing, with value outperforming growth for the first time in more than a decade. It is too soon to say if this trend will continue, though the rash of ever-more fanciful unicorns coming to market may be at an end (until the next time).

If you invest in a money-losing company on the basis of increased volume (like the "number of eyes" of the dot.com boom companies), with hopes of free cash-flow, let alone earnings, at some indefinite point in the future, there is no logical limit to how high the multiples on such stocks may go. Value stocks, by definition, can only move so far, so fast before they cease to be value.

Having said that, the legitimate fast-growing high-flyers like Amazon and Netflix, even Apple, that experienced heart-pounding growth over the past decade, must duplicate and exceed such growth in the decade ahead to justify their current valuations, a tough proposition indeed.

■ Global markets sluggish

Most global equity markets slowed significantly in the third quarter, for the most part barely inching up. The ongoing trade dispute between the U.S. and China is largely responsible. Given the generally high multiples on major markets, this may continue, though emerging markets are trading at far lower multiples—a much wider gap than usual—reflecting both the greater impact on these markets of the trade dispute as well as the impact on many of lower commodity prices. When one or other of those turns, however, these smaller markets could play catch up in an explosive manner.

In general, we are continuing to reduce exposure to global equities, holding value stocks as well as high-dividend payers, including the Business Development Sector in the U.S., which has responded well to the move down in interest rates. It is too soon to jump into emerging markets, while larger Asian markets will continue to suffer from the trade dispute.

■ Commodities mixed

Commodities, as discussed above, were mostly weak this past quarter in a very volatile and mixed quarter. Oil had a bounce after the attacks on the Saudi facilities; the attacks cut Saudi output by 50%, if only briefly. Moreover, Saudi Arabia has about 2.3 million barrels of spare capacity out of OPEC's total of 3.2 million. Other, non-OPEC countries of course also have some capacity, notably Russia. But the attacks demonstrated the vulnerability of the global oil market as well as the Saudi facilities. The oil equities had a very short-lived bounce, suggesting to us that that sector is not yet at the bottom.

■ Gold is resilient

Gold recovered quickly from a sell-off in early September. The pullback was not caused by any discernable fundamental reasons but simply because the market had moved too far, too fast. That the pullback was shallow and brief in such circumstances is a very positive indicator of a fundamentally strong market, and indicative of buying power on the sidelines. Its resilience in the face of what might be considered negative news for gold is also very encouraging. When the recent jobs report came out, Bloomberg had a headline: "The big loser from today's jobs report: gold". Gold fell $12 within minutes of the report hitting the screen, but ended the day unchanged.

The major miners equally have recovered from the early September sell-off, particularly the stronger companies. Among the major miners, there is a new-found discipline and conservativism, in M&A ("not just to get bigger") and in reserve reporting and assessing new projects, with many companies using price assumptions under $1,300. The gold equity move, however, has generally not reached down to the exploration companies, other than those where there has been an important piece of positive news. That alone is encouraging, since a year or two ago, any positive news was often used as an opportunity to sell. Now, at least, these stocks respond. Other exploration companies, however, particularly those that have undertaken one dilutive financing too many, have actually declined, sometimes significantly. It will be some while before the entire junior sector joins the party, but stronger companies with positive developments will increasingly be rewarded.

We are holding the senior stocks, and indeed adding to the better-quality ones on pullbacks, as we have been doing over the past year. We are also buying juniors that are extremely depressed, provided the balance sheet is strong, prepared to be patient; but we are also trading these stocks more, looking for good opportunities to raise cash for other buys, or simply getting out of laggards unlikely to move (though conscious of not selling at the bottom) and into more dynamic stories.

In all, we remain cautious in our approach to the markets, looking for opportunities to sell everything from global blue chips that have stalled to exploration companies that have no particular catalyst. We are holding on to global value stocks, and strong dividend payers, as well as continuing to look opportunistically around the world. Our exposure to gold remains high, though less so to other resources in a deteriorating global economic environment. We expect this pattern to continue through the end of the year.

Review of Individual Accounts

■ Global Accounts

Despite dramatic market movements, our broad allocations ended the quarter more-or-less where they started. This apparent stability also belies some management decisions during the quarter. We added to value stocks in the U.S., increasing allocation to that market. Global markets contribute about 12%, down from close to 14%, with half the decline attributable to relative declines in stock prices (that is, global equities appreciated less than the U.S. market and gold stocks), and half to selling, mostly in Asia.

We had already exited most of our Hong Kong positions as the protests started, even though initially stocks were little affected. That market fell sharply, however, as the protests continued and got more violent. This past quarter, we sold a little more in Hong Kong as well as in Singapore and other Asian markets.

Rotating within sector

Exposure to the high-yielding Business Development Companies in the U.S. increased marginally, despite some trimming of individual stocks that had moved significantly above long-term valuations. This was partly because the sector generally moved up nicely in the quarter, as interest rates resumed their downward path. But we were also able this quarter to rotate, at the margin, from overvalued stocks to undervalued ones within the sector.

Gold remains a significant component of global accounts, around 25%, excluding diversified and exploration companies, since we see gold as a hedge on the rest of the portfolio as well as a sector that continues to be undervalued with solid long-term potential.

Long volatility

We also went long volatility; given the risks in the market, it is surprising that volatility has declined so low, and we are trading it from the long side. We can't say exactly which vehicles we are using, because the SEC has prohibited us from discussing individual securities, but we can say we are going long volatility in a reasonably low-risk manner.

Otherwise, instead of buying equities outright, we have stepped up our selling of below-market puts, where we are finding quality securities with high premiums available on short-term puts. This enables us to put some cash into accounts, and sometimes have stocks put to us at below market levels. This partly explains the high cash level in accounts, over 10% currently, though it also reflects an overall cautious approach to markets.

We are, for the most part, holding what we own, until there is a reason to sell, but adding little. We do, as always, however, continue to look for opportunistic buys, and found them this past quarter in European value and depressed special situations. I wish I could discuss specific stocks so you could better understand my rational for buying. Given valuations, we are tending increasingly to sell puts rather than buy stocks outright. And we continue to hold gold, and cash. We expect to raise more cash in the period ahead, while holding gold, dividend-payers, and quality global equities. But we do not expect—at this point—to be jumping into any markets aggressively any time soon.

Gold accounts

Allocations among sub-sectors remain very similar to where they were at the beginning of the quarter, with more than a quarter of accounts in senior mining companies and large royalties; 10% in intermediates; 38% in exploration (up from 36%); and 20% in silver and other resources. Cash has already increased marginally to just under 4%. We also hold physical and ETFs.

Among the seniors, we sold the more marginal companies which had had strong moves. Later in the summer, as the stocks pulled back, we started adding again but to the stronger companies. Among the exploration stocks, we cut some laggards without a near-term catalyst, as well as those undertaking excessively dilutive financings, often to fund G&A.

However, we also added to dynamic exploration and development companies so our allocation to non-producers actually increased on balance.

We continue to hold core positions in the major royalty companies, strong senior producers, and quality exploration companies. We want to be exposed to the long-term bull market and will ride out volatility in this group of core companies. We have also been cutting positions among more marginal producers and trading some exploration stocks. This approach will continue for now, and we plan to remain pretty fully invested.

Resource accounts

Again, there have been few broad changes in resource accounts, with gold miners and royalties remaining our largest sector, representing over one-third of accounts. Many of these companies, however, have significant exposure to other commodities, mostly copper and silver in the case of the senior producers, and nickel, silver, copper and oil—even cobalt—in the case of the royalty companies.

Accumulating other resources

After gold, our largest exposures are to silver, copper and diversified companies. We increased oil holdings, including the depressed service companies, focusing on those with strong balance sheets and modern fleets, but overall oil still represents just over 1% of portfolios. We do not believe there is a need for urgency.

We started the quarter with almost 7% in cash after the early-year sale of one of our largest holdings. As anticipated in the last *Review*, we have been putting that cash to work and now hold only 2.4% in cash. We have been buying a heavily depressed silver company, global copper stocks (which we have been trading with a long bias), and a little uranium. We still think it's too early to be an aggressive buyer.

Looking ahead, we will maintain our core positions, in gold, silver and copper (building positions in those most able to survive the downturn). We expect to add to oil, but slowly, and overall, for accounts to remain fully invested.

In sum, we remain cautious on global equities and are slowly raising cash as opportunities arise. We are particularly cautious on new buying, focusing on depressed value stocks, and on special situations, preferring the sale of under-the-market puts to buying outright. Our exposure to gold will remain high, though we may trim to keep positions at reasonable levels. In gold and resource accounts, however, we expect to remain fully invested, even if our trading activity picks up.

Adrian Day, October 5th, 2019