PORTFOLIO REVIEW

PO Box 9024106, San Juan, PR 00902-4106 • 410.224.2037 Fourth Quarter January 2020

The year just ended was a year when virtually everything was up, U.S. and foreign stocks, bonds, precious metals—almost every major market and sector except commodities (outside the precious metals) and energy stocks. It was quite the reverse of 2018 when, due to the late-year sell off as the Federal Reserve started its short-lived tightening phase, pretty much everything ended the year down. The Fed's U-turn early this year re-ignited the markets, showing once again that easy money has been the primary driver of the markets recently. How long that will continue is likely to determine to a large degree how long the bull market will last.

Up and Away

Global stocks soared, with U.S. stocks (per the S&P) up 29% to record highs. Though many global markets remained below their highs of 2007—or 1989 in the case of Japan—many inched to new highs right at the end of the year. They have started to play catch-up, rising 23% this past year (per MSCI World ex-US). Other than Hong Kong, every major market rose by double digits and most by more than 20%, an incredible year.

Smaller markets were also up, but far less. The MSCI Emerging Markets Index was up 12% on the year, with Russia and China the best performers, while a handful with particular reasons, such as Chile, fell.

Our global accounts were up over 25% or more in all risk categories—28% for our mid-risk global growth accounts—outperforming global markets, though slightly underperforming the S&P.* Our gold exposure helped boost returns, while our relatively high cash levels was a drag. In the late stages of a long bull market, we want to avoid jumping abroad, but rather wait and pick opportunities. As usual, for clients (at custodians) where authorized, we sell below-market puts on stocks we like, setting aside cash for the potential exercise of puts, so the cash is not "idle". This strategy adds cash to accounts, boosting returns.

Gold shot up, though most resources flat

Resources were mixed, with the precious metals up strongly, oil having a strong rally, and a handful of others—such as palladium, nickel and iron ore—having very strong years, though many metals, resources and commodities languished. While oil rose for year (22% to 35%, depending on the contract), natural gas fell sharply (24% to 44%, again, depending on the contract). Aluminum, steel and several agricultural commodities were down on the year. Across the board, commodities were up over 6% (per the imperfect Bloomberg index).

Gold and other precious metals shined; gold was up 18% on the year—it's best annual performance since 2010—though it traded largely within a range since September, only moving up again over $1,500 in the last few weeks, and still below the September high.

The gold stocks had a stellar year, with a strong rally in the spring, a retracement in September, and another strong year-end rally. The XAU Index of senior gold and silver stocks rose an incredible 49%, but as discussed previously, the index is not a good reflection of what investors obtain. Most gold mutual funds were up 22% (per Bloomberg PM Fund index), a very solid return though significantly below the equity indices, but a better reflection of investor returns.

Gold account had good year

Our gold and resource accounts had a good year. After lagging somewhat in the third quarter, they zoomed towards the end of the year, closing up 37% for the resource accounts and 36% for gold.*

We outperformed in resources because of a high exposure to gold and silver, with very little to other resources, including oil; although that commodity rallied, most energy stocks barely moved. In gold, we underperformed the index because we were not fully invested in large miners, including the highly leveraged ones, which tend to perform well at the onset of a strong move in bullion. We well outperformed the average gold fund, however, largely because of stock selection among the seniors; we also experienced strong rebounds from a couple of stocks that had fallen earlier in the year for company-specific reasons. The exploration stocks, to which we are heavily exposed, have not, for the most part, yet moved, but after November/early December declines on tax-loss selling pressure, many are beginning to recover nicely.

We anticipate that global markets will catch up with the U.S. market, though there is increasing *risk* in the market at these levels. Positive developments on the trade front, and higher commodity prices, will help most smaller markets, which should be better in coming years. We also expect gold and gold stocks to continue to do well in the year ahead, while other resources will firm but lag.

Easy money a mixed blessing for the economy

The economy—and markets to an even greater extent—are relying on monetary stimulus. With the renewal of Fed easy money, cutting rates at the beginning of the year and new money injections more recently, the U.S. economy has been improving again: services have turned around after a brief slowdown; there is an increase in business expansions (less so on new business starts, which remain muted with lack of capital and regulation the culprits); the housing market is up—the builder survey is strong, with sales and prices in most regions reasonably firm; and the job market has improved, with the unemployment rate falling again, job openings down, and wages finally moving up. Finally, consumer confidence has risen again to a new high for the year.

But it's a mixed picture. The manufacturing index in most regions continues to fall. Although the jobs situation appears healthy on the surface, initial jobless claims have been moving up for the last several months, and new jobs continue to be dominated by lower-paying jobs, including part-time, often filled by young or retired workers.

Similarly, housing is mixed, with new home sales down, several months in a row, though the longer-term trend from the low in 2010 remains up and sales are now back to a 25-year average. Again, mortgage applications are down, though still higher than year-ago levels.

Easy money can have perverse effects on the economy. Consumer credit is a good example. Because of lower interest rates and easy money, more funds are available to consumers to make loans to buy cars, and they are more likely to take such loans.   However, the boom in auto loans means more loans are going to lower credit consumers with the inevitable result that delinquencies are up. And some loans now have a

* Please note: **Past performance is no guarantee of future results.** For complete information on our past performance, including factors to be considered in viewing past performance and other disclosures, please contact our office. Specific stocks mentioned herein are intended solely as illustrative of strategies and types of stocks we are buying or selling,and are not intended as indicative of entire portfolios or of any individual client's portfolio. The numbers mentioned represent our composite averages. They represent all accounts that fall within the stated objectives which have the ability to buy and sell options; they exclude accounts under $25,000 and accounts with significant limitations or restrictions that would make them unrepresentative of the account type. Performance figures for composites reflect the deduction of administrative fees, but do not take into account any performance fee that may be charged for the period stated. The performance of any individual stock or stocks does not take into account fees. Performance numbers include dividends; dividends are not reinvested. Commissions charged may vary depending on the brokerage firm at which an individual account is held. All accounts are managed individually and are therefore different, even within the same broad objective. Factors such as an individual's circumstances, the size of the portfolio, and the time the account opened can affect specific buy and sell decisions. Factors such as price movements and security liquidity can affect whether any trade is made for all accounts. Global Strategic Management, an SEC-registered investment advisor, does business as Adrian Day Asset Management.

longer life than the anticipated life of the car. Because of the availability of credit, more consumers are buying new cars, meaning the inventory of used cars has risen and prices have fallen. So consumers with loans are finding it more difficult to get out of them because they can't sell the cars for the balance of the loan.

■ The Fed is at it again

But the Federal Reserve and other central banks don't seem to understand that their policies and meddling can have unintended consequences. Though rates, both official bank rates and market rates, have moved up from the extreme levels of August when over $17 trillion of bonds around the world were trading at negative yields, a quarter of all outstanding senior securities, they remain easy, of course. Significantly, the Swedish Riksbank, the first bank to go negative, has now raised its short-term rate to *zero*. Many bank economists are questioning the implications of negative rates.

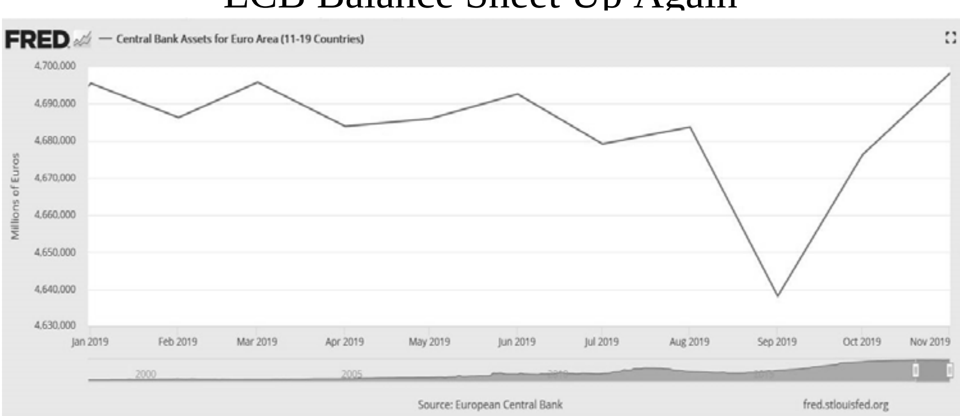
As rates around the world have stopped falling (for now), we are seeing a return to balance sheet expansion. The Federal Reserve's intervention in the repo market is now averaging over $100 billion per month. This temporary emergency measure—remember, it's not QE, just as Bernanke's "strategies" in 2009 were not to be considered QE!—shows no signs of ending. In fact, in the most recent week, the Fed added $41.5 billion, $114 billion by the third week of December.

■ Europe in love with increased money

Other central banks, particularly the European Central Bank and the Bank of Japan, are also expanding their balance sheets dramatically again. The ECB, whose balance sheet grew almost five-fold since 2008, was set to reduce it in 2019. But it declined just a tad over 1% until Mario Draghi's dramatic exit program, since when it has shot up again. The ECB, in particular, has sent a clear signal to governments that if they increase unfunded spending, they, the ECB, will accommodate with new money.

In Germany, the workhorse of Europe, the economy was on the edge of recession over the summer, driven by a slump in car production. But as the Christian Democrats lose political control, it appears they are considering stepped-up spending to regain popularity. In the U.K.—outside the ECB, of course—Boris Johnson was profligate in his promises of increased spending.

ECB Balance Sheet Up Again



If lower interest rates did not boost inflation much—we've discussed before why the fed's policies overall did not drive banks to lend more (interest on excess reserves, increased supervision)—increasing bank balance sheets may well do the trick. To measure inflation, the

Fed uses the PCE gauge, ex food and energy, which emphasizes manufacturing and downplays housing and healthcare. Most other inflation gauges have been above the Fed's 2% target for most of the year, and even the Fed's measure is beginning to move up.

> *Former Federal Reserve Chairman Paul Volker, who was responsible for taming the inflation of the 1970s, died earlier this month. He famously criticized inflation-targeting, asking, "Shouldn't a central bank target stability?"*

Economies soft on trade

In Europe, business confidence is up, even though Germany's economy, as mentioned, has been soft. Industrial production is now falling, year-on-year for 11 consecutive months. The economy continues to be on the brink of a recession. In the U.K. some indicators have improved already, after Boris Johnson became PM and promised Brexit; jobs are up, for example. Now the election is over and there is more clarity on policy, including an end to Brexit uncertainty, we expect other sectors of the economy to pick up, including manufacturing. The U.K. may soon be the strongest economy in Europe (the continent).

Asia remains weak, largely because of the trade slowdown, and uncertainty the dispute is causing. Hong Kong is in a recession following the months of protests, with every indicator falling. In Japan, though unemployment is down, so too is production, while inflation is up. Korea's industrial production is down again.

The foreign selling of U.S. notes and bonds is slowly picking up speed, with sales of a net $16.7 billion in October, bringing year-to-date sales to $99 billion, driven by liquidations from the Chinese and Japanese. These are relatively small numbers, but the change from buying, to holding, to selling is significant, and the pace is likely to increase. The lack of foreign buying, and now net selling, is finally having an impact on the dollar's value, falling back to levels last seen in June, and not far off lows for the year.

Renewed stimulus boosts stocks

Monetary stimulus has had a clearer impact on the markets than on the economy, and stocks in the U.S. have been hitting new highs. The greed level, measured by various indicators, is near extremes. The ratio of call to put buying is near highs, while the volatility index has sunk to new lows. Yet much of the trading is institutional, with the public still cautious of the rally; we are a long way from euphoria among retail investors.

The market may get wobbly over coming months, particularly since it appears corporate profit margins are being squeezed, after wages have rallied without for the most part higher costs being passed on to the consumer. The fourth quarter and particularly the first quarter should tell us the story.

The results of the Fed's easy money policy and the extreme complacency of institutional investors is also seen in the bond market. Low quality junk is now trading for less than two percentage points above investment grade, an abnormally low premium for the risk. This is also true of governments, where Greece has actually been able to borrow at negative rates.

The same is true globally

An improvement on trade, and more certainty on Brexit, along with the new round of monetary stimulus, is helping stocks globally. European stocks had a strong first half, after a very weak 2018. The stocks paused for the summer until outgoing ECB chairman Mario Draghi, as discussed last *Review*, introduced a massive package of monetary stimulus, with calls to governments to increase unfunded spending. The markets took off again, boosted by M&A activity.

Markets in Asia were soft on concerns about the China-U.S. trade talks, China's economy, and the Hong Kong protests. Optimism on the trade talks as well as a weakening dollar towards the end of the year will likely help these markets into 2020. For the year, although they generally underperformed the major markets, performance was not lacklustre by any means. Singapore could be a particular beneficiary of an improvement in trade at the same time there is continued Hong Kong turmoil, which is causing firms and individuals to consider moving.

Elsewhere around the world, small markets saw several administrations change, including Brazil, Mexico and Argentina. Where the governments are sound, we could see these markets start to catch up: valuations are better and a low dollar, trade deal, and rising inflation all help these markets, while stronger commodities help the commodity-export countries.

Resources are beginning to turn

Resource markets were particularly affected by the U.S.-China trade dispute, as well as slower global growth, a strong dollar, and geopolitical concerns. A resolution to the trade dispute which would help global trade and growth, and a drop in the dollar, may finally help the beleaguered resource markets. For many individual metals, the supply and inventory picture is now quite positive, as the new supply that followed the strong price rallies in the early 2000s have finally worked through the system. So a pick-up in demand would have an immediate positive impact on prices.

Oil to have good 2020?

The oil market may finally be turning, after a long period of oversupply, driven largely by U.S. shale as well as global shale, and slowing growth in China. U.S. growth, especially in shale, had been the major driver of the increase in global supply in recent years; this growth is now slowing. Drilling has slowed, with the rig count down 25% year-to-date from already low levels.

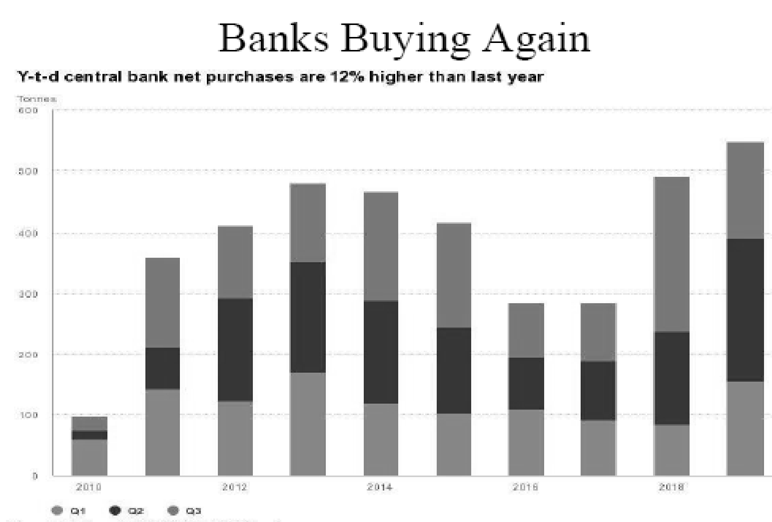
Oil rallied strongly, up 26% on the year (per WTI crude), with a strong rally at the beginning of the year and another sharp spurt since October. But negative sentiment has seen the oil stocks dramatically underperform in this rally. Sentiment remains negative, though is slowly changing, and valuations remain low. The energy stocks, those with good balance sheets, may finally be set to move.

The risks remain geopolitical: the U.S.-China trade deal may yet fall apart, hurting trade and demand; while any improvement of relations with Iran could see sanctions lifted, with the potential to boost supply meaningfully.

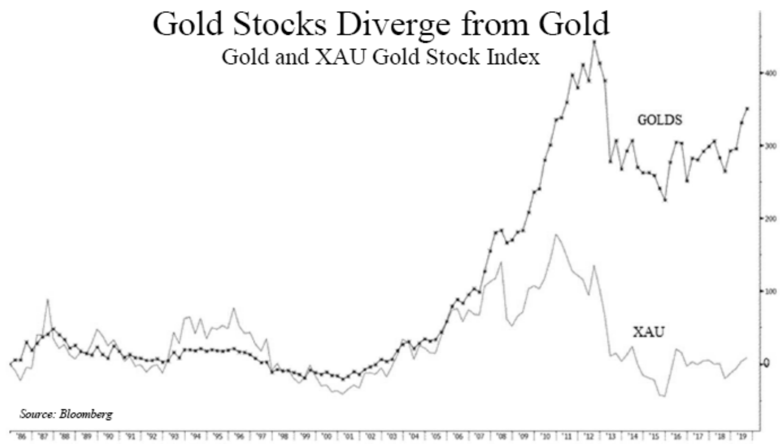
New factors boost gold, with strong year in offing

Gold resumed its bull market after months of trading in a range following the strong spring rally. A decline in the dollar and pick-up in inflation, as well as the renewed expansion of the Fed's balance sheet, are all factors driving gold higher. These factors, as well as overextended financial markets, and central banks that have lost control, will all support gold next year.

The gold mining stocks have not benefitted as much as one would expect from the recent gold rally, especially given that the oil price and most 'commodity currencies' remained soft (until recently). A low currency means low local costs including labor. Energy and



labor are the two largest cost components of a mining operation. This current quarter—results in the New year—will be telling. Profits should be up even as the S&P profits begin to get squeezed.



Notwithstanding all this, the prices of gold mining companies relative to the commodity they product have rarely been lower, and then only marginally and for brief periods. In particular, since gold peaked in 2011, the stocks have seriously underperformed, dropping far more significantly while lagging on the way up. Valuations of the miners also remain well below their historical averages, and, again, are not reflecting the recent move in gold.

In all, we remain increasingly cautious on our outlook on the markets, thinking there is serious risk in coming months. Meanwhile, the small markets look set to outperform; valuations are better and the macro-conditions turning in their favor. We continue to have a high allocation to gold, believing it will do well in the current environment, while other resources are slowly turning and we are cautiously adding to them. On balance, we will likely see more selling than buying, but we are not aggressively or indiscriminately selling.

Review of Individual Accounts

Global Accounts

The biggest change in our global accounts has been the reduction in cash from around 10% to just over 4%, as we have more global equities in Europe, and dipped a toe back into Hong Kong—the worst performing major market this past year—and emerging markets; as well as added to top gold and resource stocks. For more conservative accounts, the cash allocation is higher.

The exposure to non-U.S. markets remains around 13% of accounts. That it did not increase despite our buying is due to the relative performance of different segments, particularly gold.

Strong dividend payers do well

The exposure to dividend-paying Business Development Companies moved up to 12% of accounts, more for more conservative ones. The stocks as a group have performed well this year, and particularly since September, on, first rate reductions, and then money printing. We are mostly holding though have undertaken a little trimming of positions for particular clients. If no longer bargains, by-and-large valuations are by no means extreme, particularly in the current low-interest rate environment.

Gold higher

The biggest change in allocations has come with gold, up from 25% to over 30%, and most of that due to recent performance of the gold stocks. We have sold little, certainly among the larger miners, as we believe we are on the cusp of higher prices. We will, however, look to reduce allocations for certain clients (more conservative clients with too large a position), if prices move up significantly during the traditional first-quarter rally.

In the U.S. market, we continue to look for opportunities to sell puts, where we like the under-lying company and the premiums are attractive. Such opportunities do present themselves from time to time.

Treading lightly in Asia

We expect also to be adding to Hong Kong, though very selectively avoiding companies fully exposed to Hong Kong real estate and retail, and in selected emerging markets, primarily in Asia but also in Latin America. We do not think the Brazilian stock market fully reflects the positive economic changes that are coming from new President Bolsonaro, and have been looking for the right time (and price) to increase positions.

Trim gold on rallies

Given an expectation to trim gold exposure for global accounts over the coming quarter, our cash level may well increase again.

In the near term, however, we are mostly holding what we own, unless there is a reason to sell. This will change as economic and market conditions turn, but for now our selling is slow. We have large exposure to BDCs with their high yields, and gold stocks which have the potential for outsized gains in the period ahead. As mentioned, we do expect to trim positions in gold and resources back to allocation levels as prices move higher. We are always looking for quality companies whose stock prices have fallen, for some—temporary—reason. Any buying however, will remain cautious and methodical at this point in the cycle.

Gold Accounts

The broad allocations to various segments of the gold mining industry remain more or less the same as they were last quarter, with a little over 25% in large mining and royalty companies; 10% in intermediates; 37% in exploration; 23% in silver and other resources (up from 20%); and with cash down from nearly 4% to under 2%.

Several new buys

This belies some activity, however. We have added to positions in one particular senior miner for clients who are underweight; and have added to a couple of intermediate names, and purchased one mid-sized royalty company. We have also bought one new high-potential exploration/development company.

Most of our buying however has been focused on adding to some favorite exploration stocks which had been beaten down by tax-loss selling. These have only just in the last few days started to firm and move back up.

The buys were offset by a few sales, primarily in the junior and exploration segments of companies that have lagged and appear unlikely to turnaround any time soon.

We continue to hold the major (and junior) royalty companies, which we believe continue to offer very attractive risk-reward even in a strong market. The larger mining companies are likely to continue to be the leaders for the near term, as gold moves up again. But as the market progresses, buying will start to be focused on intermediates, then juniors, and eventually exploration companies with strong projects—potential acquisition targets—or exciting exploration results. As we move into the New Year, and the renewed bull markets, we will be looking to exit stocks that are likely to lag for the foreseeable future, while, as always, looking for profit opportunities, all the while holding the best companies for long-term exposure, as well as the most exciting exploration or intermediate companies. We anticipate, on balance, to continue to be virtually fully invested.

Resource accounts

Allocations among sectors and different resources remain about the same as it was when we entered the quarter, with gold stocks remaining the largest component, at a little over 40% (including senior and junior miners and larger royalty companies). Silver, copper and diversified miners account for about 25%, with energy a little over 1%, while cash has fallen even further, from under 2.5% to just 1%. Exploration accounts for about 25%.

Many of the large gold mining companies also produce some copper, while the large royalty companies included in our “senior gold” segment also have exposure to copper, silver, and other resources, including oil, so the exposure to gold is not quite as “lopsided” as it would initially appear.

Adding new resources

Over the quarter, the most significant move was in adding to copper miners and development companies. We think over the next few years, copper will be in a supply shortage, and if the U.S.-China trade dispute is settled, and global trade picks up again, the price could move sooner.

In October, I said I "expect(ed) to add to oil, slowly" and we have started to do that. In coming months, I anticipate building positions in the major integrateds, the large E&Ps, and larger exploration companies.

The coming period will continue to see a focus on gold, silver and copper, but slowly beginning to accumulate other resources, including oil and uranium. Our sales will be company-specific, selling laggards to raise cash for more exciting buys, or stocks that reached their targets. I anticipate that accounts will continue to be fully invested.

In sum, we remain cautious on global markets, particularly the larger markets, while our focus for buying will be on value stocks in smaller markets as well as gold and recourses. Where authorized, we will also be active in selling puts as market volatility picks up and with it the option premiums. Such a posture will help to mitigate from any broad market decline, and even benefit from it. At the same time, we are well positioned to continue to benefit from a rising market.

Adrian Day, January 1st, 2020