Adrian Day
ADRIAN DAY ASSET MANAGEMENT

PORTFOLIO REVIEW

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Global stock markets zooming ahead amidst historic unemployment and economic contraction is surreal. Half of the U.S. has been locked down, with economies virtually shut, a second virus wave appears underway, yet the stock market is almost back to February's highs (the Nasdaq is at all-time highs). And this is not only in the U.S.; Brazilian stocks are up 35% in the past six weeks amid a deepening virus crisis. We know that central bank money creation is the primary cause, but this dichotomy cannot continue indefinitely, at least without a meaningful correction. We discuss this below. Meanwhile, gold—for sounder reasons than stocks—has outperformed and, notwithstanding anticipated volatility, will, we think, continue to do so.

■ Stocks roar back around the world

Global stock markets roared back in the 2nd quarter, though in virtually all cases remain down for the year to date (the Nasdaq and China being the only two major exemptions). The S&P Index closed the second-quarter down 4% for the year to date, while global markets (ex-the U.S.) are down over 12%. Global equity funds (per the Bloomberg Precious Metals Fund Index) rallied 21% in the second quarter, but are still down well over 4% for the year. Such wide swings were common in most markets. Pass the Rolaids…or maybe the Xanax.

Although there is wide dispersion among markets even within a given region, in general Asian markets are more-or-less on a par with various U.S. indices and faring better than the rest of the world. European markets are all over the map from a negative 3% for Switzerland to around negative 24% for Spain and the U.K. Latin America is faring worst of all; despite some recent rallies, markets are down from the mid-20s to almost 40% for the year to date.

■ Outperformed the indexes

Our global accounts well outperformed in both the second quarter—with mid-risk "growth" accounts up nearly 40%--to close with positive numbers for the first-half for all global risk categories (from over 2% for conservative accounts to over 7% for aggressive accounts).* (Numbers are preliminary.)

This significant outperformance for both the second quarter and the first half is due in large part to our high allocations to gold stocks (more in aggressive accounts, less in more conservative ones). Despite not being exposed to the high-return Nasdaq tech stocks, we were light on global equities going into the crash, and had some positive trades after the lows. We have no exposure to Latin America, very little in Europe (the worst performing sectors), some in Switzerland and Asia (the relative better performers).

■ Gold up, though most resources negative

Resources generally were negative in the first half, not surprisingly, given the shutdown of economies around the world. The Bloomberg Commodity Index closed the first-half down 22%. As mentioned before, returns for commodity and resource indexes can vary depending on allocations. There was wide disparity among components, with oil down 35%, and most resources, except the precious metals and iron ore, also down, copper by a surprisingly little 3%.

Gold recovered from the mid-March panic drop, up 13% in Q2 to end up 17% for the year to date. Gold stocks had a powerful rally in the second quarter, with the XAU index up (14% for the year so far), but again underperforming the metal itself. Gold managers did better (per the Bloomberg Precious Metals Fund Index), up 50% in the second-quarter, closing the first half up 19%, outperforming the index and edging ahead of the metal.

■ Gold was very strong

Both our resource and gold accounts outperformed. Our resource accounts are up 11% so far this year. We outperformed because of a dominant gold and silver position, and very light exposure to oil and most other metals.

Our gold accounts were up over 60% in the second quarter, recovering all of the first-half losses and more, to close up over 20% for the year to date.* Our modest outperformance is due to some small stocks that delivered outsized returns. A few long-term exploration holdings were up 50% to 100%, justifying our reasons for holding

So despite concerns about the global economy and notwithstanding the crash-in-all-things in mid-March and hesitance about market valuations, it has been a satisfying year so far for investment returns. Looking ahead, we are concerned about the lasting economic damage that will result from the lockdowns, and even more concerned about the monetary response around the world, but particularly that of the Federal Reserve. We are wary of global stock markets, and not interested in the bond market. We continue to look for quality companies that are inexpensive—and may find more in coming weeks—and for special situations. But most of all, we believe the gold rally is fundamentally-based and sustainable, as we discuss below.

■ Uncertain Outlook

The keyword for the economic outlook is uncertainty. With economic reports jumping all over the place—well illustrated by June's 4.8 million jobs increase following April's 20.5 million jobs loss—it is difficult to get a clear grasp of how the economy will fare as the economy opens. The economy cannot resume the level of January after months of closures, not in anything like the near term. Month-to-month comparisons of GDP increase, employment, sales and so on of course look strong but not for long, we suspect. Some sectors will do well, but others will be very slow to recover—office space for example, or malls (as of mid-May, only one-fifth of mall tenants nationwide had paid their April rent). Many small businesses, such as restaurants, will try to do the job with fewer people.

* 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.

Real unemployment is probably higher than the headline numbers suggest. The Bureau of Labor Statistics, which publishes employment numbers, classifies individuals as employed, unemployed, or not in the labor force. Those who have been "furloughed" for three months or more are not classified as unemployed; about 5.4 million people classified as "employed" are not at work. Many will eventually be recognized as unemployed. And economists estimate that perhaps 30% of recent job losses will be more permanent losses from "allocation shock" of sectors and individual businesses hurt by the shifting work and spending patterns after the pandemic and economic shut down. Significantly, restrictions from layoffs in the government payroll protection loans ended at the end of June. Companies that received loans are now free to layoff workers as necessary.

There's uncertainty about a second wave of the virus and potentially resumed restrictions on businesses. We are already seeing this, and each conference cancelled or restaurant that limits capacity has ripple effects throughout the economy. Already, as of the end of June, 40% of the U.S. population is seeing announced reopenings on hold or reversed.

There is as much uncertainty on the supply side of the equation as the demand. Both will shrink, which is why I do not think we shall see deflation as much as stagnation and a shrinking economy.

■ Fed policy will destroy the capitalist economy and more

One cannot discuss the economic outlook without discussing the Federal Reserve and other central banks. The dramatic decline in short-term interest rates; the huge explosion in the Fed's balance sheet, moving from $3.8 trillion to $7.1 trillion over the past year, with Fed credit raising at a 700% rate in the last three months; and the moves by the Fed in rapid success to buying investment-grade bond funds, then junk bond funds, then individual bonds, raise the question of what comes next. Are negative rates ahead on the next downturn? Where does QE Infinity take us? And is the Fed going to start buying equities next? And then we shall start to see selective "debt jubilees", with the government forcing different lenders to forgive certain types of debt.

The Federal Reserve is buying bonds of companies such as CocaCola, Apple and Berkshire Hathaway; that hypocrite who wants to raise our taxes is happy for the government to buy his bonds. And they are buying bonds of some foreign companies including Daimler. Why? This unprecedented—and illegal, by the way—move by an arm of the government into the private financial markets is not receiving sufficient attention, in my view. It is the beginning of a very slippery and dangerous slope indeed.

As the ancient Roman said, "those whom the gods would destroy, they first make mad."

Swiss money manager Felix Zulauf puts it this way: "we have forgotten that recessions are a natural part of the business cycle." By attempting to eliminate the business cycle…and by failing to raise rates and shrink its balance sheet during good times…the Fed is causing other problems and making the eventual correction all that much worse. There has to be a day of reckoning and it will come via a major crash or a long period of economic stagnation and decline, but come it will.

■ Greater and greater intervention necessary

As with the drug addict who needs ongoing and increased injections to keep the high going, so too with a market dependent on easy money. The longer this continues the more devastating will be the consequences. We have seen this in the last quarter century, starting with the precedent-setting and disastrous decision to bail out Long-Term Capital, a hedge fund run by the "smartest guys in the room", each successive crisis has seen sharper cuts in rates and bigger injections of money. That 1998 response was less than 2000, which in turn was less than 2007 which in turn was far less than 2020. Fed apologists will say the epidemic was unforeseen and they had to respond. But the truth is that the Fed was already boosting credit recklessly when Corona was just a Mexican beer. From September to February, Fed credit was growing at the fastest rate ever. We would have reached the current state eventually.

And if the Fed stepped back and opened its eyes it would see that each Fed easing, never cut back in the good times, leads to the next crisis. The housing bubble was fueled by the easy money of the early 2000s, just as surely as the easy money policy following the credit crisis—*and the failure to pull back after the recovery*—led to the bubble in bonds and equities that greeted the start of the year. It was a bubble in search of a pin, and had the virus not come to these shores, there surely would have been another crisis and the Fed would surely have reacted similarly. When thinking of the Fed, one is put in mind of nothing as much as the saying, "when you are a hammer, everything looks like a nail."

■ No return to "normal"

And all along, with easy money, low interest rates, and "the Greenspan put" that essentially said to the big banks, "take risk, heads you win, tails you don't lose", the obvious consequence was higher debt, with rates so low that companies borrowed money to buy back stock, and individuals were driven to take higher risk (including buying on margin and leveraged products) to earn the kind of returns they need for retirement. As the world entered this crisis, total debt-to-economic output was more than twice as high as in 2007. We learned nothing.

And if the Fed was unable (or unwilling) to return to normal after the dot-com bust, and despite pledges as early as 2014 to "return to normal", pitifully unable to do anything like that after QE1, 2 and 3, how can we possibly think they will do so after QE Infinity and after buying bond funds and junk bonds without causing massive distortions if they tried. And FedHead Jerome Powell still pleads with us not to call current policy "QE".

Powell has already stated that the Fed is "not even thinking about thinking about raising rates", while there is no intention of ever reducing the Fed's balance sheet. He said the Fed would, when the time came, likely "freeze" the balance sheet and let is shrink relative to GDP as the economy grows, adding that that was years away.

■ MMT fuels unrest and leads to chaos

All of this has dramatic effects not only on the economy and investments, but on society itself. It will lead to reduced economic activity and eventual inflation; an erosion of the value of the dollar and erosion of savings; a further explosion in debt. More and more the economy will be dependent on government spending and individuals on government transfers. Monetary policy will distort prices, and therefore distort asset allocation, lead to excess risk taking and further debt. And it will, as it has in the decade after the credit crisis, further exacerbate the wealth gap, leaving behind a growing underclass and destroying the middle class, leading to protest, radicalized politics and social unrest. It increases government power, and with it the tendency to abuse that power, and reduces individual freedoms. And as we have discussed before, "Modern Monetary Theory"—not modern, not purely monetary, and not much of a theory—which is now well and truly ensconced as official government and Fed policy, leads ultimately to social division, violence, chaos and ultimately war or (by so weakening and dividing a society) by invasion. Extreme debasement of the currency always and everywhere throughout history has done so.

Reduced economic activity everywhere

The U.S. is not alone. Around the world, economies have experienced reduced economic activity on the different restrictive measures introduced. But many of the crucial second quarter economic statistics are not out yet, and it is they that will tell the story of the economic impact of the shutdowns and other restrictions, as well as provide clues to the lasting impact.

East Asia generally has fared better than the rest of the world. Hong Kong's unemployment has risen from 3.4% to 5.5%--would we be so fortunate—and they also have other things going on. In response to the virus, there were restrictions on inbound travel, widespread testing and contact tracing, and isolation of suspected cases (as well as a cultural acceptance of wearing masks). But in the most densely populated city in the world, one with little sense of personal space, there were fewer than 1,000 cases and just four deaths. And the city never closed; restaurants and stores remained open throughout.

Certainly those countries that experienced the corona virus earlier are now in recovery mode and rebounds have been powerful. In China, for example, the manufacturing purchasing managers index jumped from 36 in February to over 50 in May, a strong rebound indeed. But the economy was effectively in shutdown in February, and numbers are still well below where they were a year ago.

Europe is weak, LatAm fragile

In Europe, as we know, the impact of the virus varied widely among countries; overall Eurozone GDP was down around 3% in the first quarter, a rather modest number given that Italy and Spain had already experienced shutdown by then. But as everywhere, we await second quarter numbers.

Europe is structurally weak with the weakest banking sector of any major region; the single-currency Eurozone reduces flexibility. Debt, particularly corporate debt is high. In the U.S., corporate debt as a percentage of GDP stands at an already high 75%. But in Europe it is higher, from 95% in Germany to 200% in France (where also the banks are weak). The Euro has greatly exacerbated the wealth-gap between north and south, while the virus also hit the south proportionately harder than the north (other than Belgium). In the face of this disparity, the single currency faces a very tough test in the months ahead.

Latin America, where different countries have their own problems, from Argentina's latest default (not paying agreed terms on sovereign debt is a default) to Chile's protests, but the virus has been particularly virulent in the region. (The reason for that are outside the scope of this letter.) The economic pain will be great. Brazil reported negative GDP in the first quarter, and that was before the virus crisis. Argentina reported GDP of less than 1%, down from 13% in the fourth quarter (and that's in a rapidly declining peso). Again, the second quarter will be far worse in this region.

It's the same response

In most countries and regions, governments have responded with aggressive monetary and fiscal stimulus. Programs differ, but everywhere governments have introduced measures that are extreme by that country's standards.

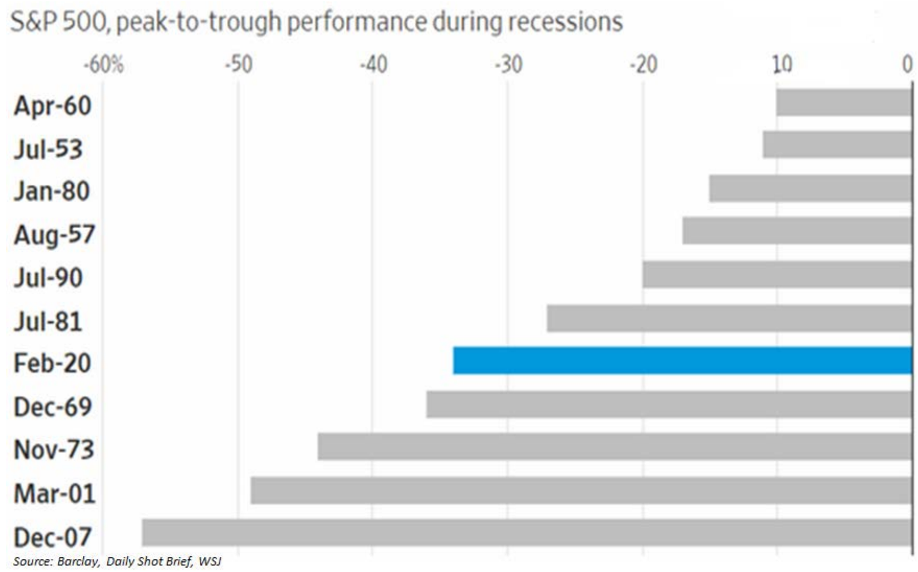
Overall, we have only an inkling of the extent of the damage done to economies around the world by the economic shutdowns, and how long-lasting it may be. The second-quarter reports in coming weeks will tell us more. It was always unrealistic to expect a "V" shaped recovery; more likely, of all scenarios, will be significantly reduced economic activity in most regions, with sustained higher unemployment, but because of the policy response, gradually increasing inflation, the classic stagflation.

Why are stocks ignoring the economic damage?

The market (per S&P) had the fastest 30% drop in history, followed by the strongest 50-day move ever. The dichotomy between a contracting economy—with high unemployment and business closings—and the zooming stock markets around the world is stark. The reasons are clear:

- With interest rates so low around the world, traditional places to put money for safety and income, such as bank CDs and bonds, do not look attractive; stocks benefit.
- Some are looking ahead and see a recovering economy. They think the worst is behind us. Stocks are forward looking.
- And most importantly, when central banks create excess liquidity (by definition, liquidity in excess of the requirements of the economy) that money must go somewhere; there is excess liquidity beyond the wildest dreams of Greenspan and Bernanke. It has gone largely into equities.

Arguing against higher stock prices are two simple related issues. We will see weak economic news for the second quarter, and the economy, particularly employment, may not recover to where it was at the start of the year any time soon. And stock market valuations are high. They were already high in February, but, despite reduced analysts' expectations, the U.S. market (per S&P) is selling at 25 times forward earnings. That would be a high number in the strongest of economies, but now, with sharp declines likely to be reported in coming weeks, with sluggishness for the next several months, and with a great deal of uncertainty, that number is extreme.



The market decline we saw in March, though rapid, is mild compared with declines in periods of economic contraction in the past (see table). And even at the March lows, the market was by no means cheap. It is possible that central bank liquidity trumps all other considerations. That may be true over the medium term. But it is almost inconceivable to think that the decline we saw in mid-March is all we are going to experience.

We agree with Mohamed El-Erian, astute chief economist for Allianz, who says, referring to central bank money printing, "I don't feel comfortable investing on that basis."

The stock market is dependent on the Fed

The truth is that the market has been very dependent on Fed stimulus for years now, both expecting and demand it. Each attempt, however timid, at tightening has been met by a market hissy fit and more stimulus. How much more can the Fed do after QE Infinity? In the near term, second-quarter corporate earnings season, coming soon to a theatre near you, could produce some shocks and provoke a sell-off in stocks. At minimum, we expect individual stocks to be hit hard, and we anticipate volatility over this period. And further out, we would not be surprised to see further, more protracted declines to new lows, perhaps after a year or more. This is not an unusual pattern after very sharp short-term rallies, as experienced most notably following the 1929 crash.

■ Market props are removed

And there are other negative factors. Companies that took loans or grants from the government are generally prohibited from buying back stock until their loans are repaid. Given that major companies borrowing money in many cases to buy back their own shares had been a major factor supporting the market, the removal of that support could see some stocks drop sharply. Similarly, many corporate recipients of government largesse are prohibited from raising dividends; that, and the economic pressures forcing others to cut dividends, makes stocks even more overvalued on a yield basis. The gap between valuations of the high-multiple and low-multiple stocks in the S&P is now the widest it has been since the dot.com bust. Such divergence often presages a market decline.

Individual investors generally remain bearish, and when they capitulate it will be a dangerous indicator. But we have seen another phenomenon recently, equally a warning sign: a surge of neophyte investors pouring into risky sectors of the market, the so-called "Robinhood" effect after the trading platform. It was largely such new investors that were buying bankrupt Hertz's ill-fated secondary stock offering, or rushed into airline stocks just because they were low. There are YouTube videos galore of these people saying things like "It's sooo easy, and I don't really understand this, but you can make even more by buying options or letting the broker lend you the money."

Though U.S. stocks may well be higher a year from now, we do not like the valuations, we do not like the risk-reward, and we do not like to invest dependent on government actions. With earnings covering the lock-down period ahead and the volatility we expect from that, we are very cautious on U.S. equities right now.

■ Global markets have also rallied, but remain better values

Global equities markets have rebounded strongly, with world markets ex-U.S. around 35% from the March lows, strong but lagging the U.S. Equally, global markets are not as expensive as is the U.S., trading at around a still-high almost 20 times earnings. Generally, Europe is trading at just over 20 x forward earnings, and one can argue that this coming year's earnings estimates have not been reduced sufficiently. The current market level is 20.6 times last year's reduced earnings and 20.2 times next year's estimates. That hardly seem a large enough reduction.

Asian markets are trading at significantly lower multiples. Singapore for example, is trading at 14 times a far more realistic earnings estimate, less than book, and yielding 4.8%, more than double the U.S. market.

Emerging markets are the cheapest of all, with low currencies making them cheaper yet for foreign investors. For now, however, the high levels of U.S. dollar debt, as well as the virus yet to play out, we are holding off. But in the environment of higher inflation and a declining dollar that we expect ahead, emerging markets usually perform very strongly. So the time will come to invest in these smaller markets.

In sum, we are for now very cautious on equities around the world, buying only special situations and generally trading them at that. Over the next year or so, we expect to see valuations retreat to where we can be more aggressive, looking for quality companies whose stocks will have overreacted on the downside, stocks we can buy for the long term. We may even find some of them in the weeks ahead following earnings releases. But we are in no rush.

■ Resources hurt by shutdowns

Not surprisingly, most resources took it on the chin from the contraction in economic activity following the lockdowns and restrictions. Oil was the most hard hit as demand was slashed amid a glut in production. The OPEC deal with Russia, as well as plain economic reality in North America, has seen a reduction in supply and a firming of prices. But the outlook for demand does not auger well for oil companies, and most will lose money this year. When even oil bulls are expecting prices to end the year in the $30s, that's either a contrarian's dream or it's too early to be aggressive on the sector. We strongly suspect it's the latter.

Copper, "the metal with a PhD in economics", has not been as weak as one might have thought looking only at the economy and trade. Prices did drop to their lowest level in three years, but for the year-to-date are down only 3%. The main reason has been the significant supply interruptions, particularly from Chile, where covid problems have caused the shut down of the smelter and refinery at Chuquicamata, the world's largest open-pit mine (and it is a breathtaking sight), keeping supply and demand closer to balance. If the mines can resume full production before the global economy resumes its growth, then copper could fall further.

We are strong fundamental bulls on copper over a three- to five-year period, based primarily on the shortage of major new mines coming onstream while production from older mines inexorably declines. Given the long lead time for new copper mines to come onstream, there is a high degree of clarity on potential future production five years into the future. Absent a meaningful and sustained decline in the global economy, copper will be in shortage in the years ahead, meaning higher prices.

Given the near-term outlook, however, and the strong rallies in many copper stocks, we have reduced exposure and will wait for new entry points. We have very little exposure to other resources (including oil and gas) believing there is no rush to invest in the sector.

■ Gold up for solid reasons

Gold, however, is a different story. Completing a seventh consecutive quarterly gain, concluding with the best quarter in four years, gold is bumping up against $1,800 for the first time since 2012. Analysts have started falling over themselves with higher predictions, with Bank of America famously calling for $3,000 gold in a report headlined "The Fed Can't Print Gold."

We can discuss central bank buying, declining new production, Chinese jewelry demand and other supply and demand factors. We can discuss real interest rates, volatility in the financial markets, and the dollar. But at core it does come down to the Fed and other central banks. Gold is the "anti-fed", a reflection of the loss of trust in central banking. As banks continue with their deliberate policy to debase the currency, gold will continue to do well.

Gold is undervalued—relative to the money supply, and relative to financial assets—and it is under-owned. Given that gold is a very small market relative to global stocks and bonds, even a small move by investors into gold can have a significant effect on the price. That is what we are beginning to see now, with emphasis on "beginning". As more and more investors, small individual investors and large institutions alike decide to put a part of their assets into gold, the price will move up significantly.

Gold stocks still cheap; corrections to be bought

As gold is undervalued, gold shares are undervalued against gold itself. And, despite the recent strong rally, they remain in the lowest 25 percentile in terms of price and valuations. As gold moves up, especially in an environment of low oil prices and generally low currencies (the two largest cost inputs in a mining operation), much of that increase flows to the bottom line. Mining companies, with a new-found discipline and a more favorable environment, are generating free cash flow for the first time in many, many years.

We remain somewhat cautious about a pullback in the price of gold; given recent trading action, gold needs a breakout, above $1,800 in the near term, I believe, to avoid a correction. I do not anticipate that such a correction would be particularly deep or long-lasting, but a pullback in gold itself would see meaningful corrections in the mining stocks, particularly after such strong short-term appreciation. Certainly, if we see a broad stock market decline in coming weeks, the gold stocks could initially fall with the market.

Generally, gold stocks have been more vulnerable when the following conditions are present: the market drops sharply in a short period of time; there is a liquidity panic; gold drops; and the stocks are expensive entering the correction. Generally, gold stocks have been less vulnerable when the broad market decline is slow and protracted; when it is more selective; when gold does not decline; and when gold stocks are not overvalued. Based on those criteria, we may see a relatively short and shallow pullback, but it will be neither a crash nor the start of a long period of lower prices. We are already fully invested in gold and silver stocks, but would use any near-term pullback to add to positions.

In all, we see a lot of uncertainty in the economy ahead and believe most analysts and markets are overly complacent based on faith in the continuation of Fed credit creation. We certainly believe the Fed will continue, but with both economic uncertainty and equity valuations so high, we are wary of being too aggressive in buying or holding equities. We are looking for quality companies that have fallen too much as well as special situations, looking aggressively but buying cautiously, selectively, and in a disciplined manner. We are fully invested in gold stocks, however, and expect to continue that exposure for the foreseeable future, so long as current policies continue.

Review of Individual Accounts

Global Accounts

The biggest change in global accounts was an increase in cash, as we trimmed some of the positions we had added after the mid-March market collapse. Cash levels picked up significantly in both absolute and percentage terms, accounting for over 12% of accounts on average, up from 9% at the end of March and back to the levels at which we entered the year. The increase was greater for more conservative accounts, with over 20% in cash.

The increase in cash is the result of selling in all sectors, including the U.S. and global equities, as markets recovered. We now hold just 7% in broad equity markets, down from 9% at the end of March, and another 8% in Business Development Companies, down from over 11%.

We sold add-on positions

Last quarter, we said we expected to cut back on recent additions not only in global markets and BDC space, but in energy and even in gold, which we did for more conservative global accounts.

The exposure to BDCs is a good example of the changes. As per our last quarter's *Portfolio Review,* we had added significantly to our favorite stocks in this sector when they dropped far more than the market in March. As the sector rallied, we trimmed all we had added, plus a little more. Our *purchase cost* is down 20%, back to where it was at the beginning of the year, but the *current value* is down only 5%.

Added little

In both U.S. and global markets, this past quarter we not only sold some of what we had added, but we also bought more of a few of our favorite stocks, quality companies still very undervalued with good longer-term prospects. We only added one new name, a British pub chain, bought in the depths of the despair over pub and restaurant shutdowns. Now pubs have opened again, on July 4th, nicknamed "Britain's Independence Day", we shall be looking to sell, at least some of our holdings.

We have also increased our hedges on the market, whether by buying volatility or buying puts on overvalued and vulnerable stocks. Such remain a small part of accounts.

Looking ahead, we expect to maintain high exposure to gold equities and a solid cash holding. Much depends on whether we see a meaningful correction in the broad market. If we do, we will likely add to positions, but it will be, as this stage, selective, cautious and disciplined. We are not afraid to have cash in the accounts. We will continue to use that cash to sell puts, where authorized by clients, and this allows us to add cash to accounts while selling below-market puts on stocks we would not mind owning (but at lower prices). Overall, we do not expect dramatic changes in coming months, but will remain watchful for opportunities.

■ Gold Accounts

The gold accounts had a stunning rally in the second quarter, up over 60%, enabling us to raise cash in recent weeks to 5% of accounts, up from 0.5% at the beginning of the quarter. Much of this, however, comes from new accounts that are not yet fully invested. For existing accounts, the increase was less, up to around 2.5% cash.

Shift towards juniors

The other major change over the last quarter was a reduction in exposure to senior mining companies and major royalties, down from 32% of accounts to 23%. That is a huge percentage drop. We actually added to positions in the seniors (mostly for new accounts), but, unlike in the first quarter, in recent weeks the seniors underperformed more junior stocks, "underperformed" in this case being very much a relative term.

In addition, assets have increased by over 20%, but we have added only half that to the seniors. For existing accounts, the drop (*relative* decline, in percentage terms, not in absolute dollar amounts) was far less, from 34% to 30%, and that reflects a little selling as well. New accounts also have an exposure to gold and gold equity funds, awaiting opportunities to deploy into individual stocks.

Although the number of dollars invested in exploration stocks was the same as a quarter ago, the value increased significantly, by almost 80%, and the allocation in accounts picked up from 34% to 37%. This was due to some judicious buying and selling, trimming winners and buying others rather than the entire sector moving up by that amount.

Trimming to lock in gains

We did a little selling because some stocks were well ahead of themselves and we wanted to lock in gains, as well as wanting to have some cash available for new opportunities. The selling was across the board in large cap and exploration, sometimes simply for management reasons because an individual stock had risen to too high a percentage of a portfolio's value, example. More often, it was sampling selling some of the additional shares in a company we had bought. Overall, the selling was very much at the margin.

We wrote last quarter that we expected to raise some cash, including from selling some of our add-on positions. Offsetting the selling, we added three newly public royalty companies as well as a couple of new exploration and development names (new for us). We also, as always, added to some existing positions that we thought cheap or set to move, while trimming others, both winners and laggards.

Looking ahead, we want to remain nearly fully invested, but also want to make sure we lock in profits, particularly in the more volatile junior companies. Having some cash is never a bad idea, either for the possibility of broad correction in the sector (which, as discussed above, we would expect to be short and shallow) or to be able to take advantage of new opportunities. We do not expect allocations among seniors, intermediate and exploration to change much in the period ahead, other than through relative performance.

■ Resource accounts

Much the same commentary as above for gold accounts could be said about the resource accounts. We entered the quarter fully invested (0.4% cash) and ended with 5%, the result both of selling some positions and new accounts not yet fully invested.

Major and intermediate gold miners remain our largest weighting, now up from 40% to 42% of accounts, despite fewer dollars; followed by silver stocks (which finally caught a bid, and now represent over 10% of accounts); copper; and diversified companies, with smaller exposures to alternative energy and uranium. In resource accounts, many of our individual stock selections, such as a royalty company or an exploration company, may be involved in resources other than gold, so our exposure to different resources overall will be higher than it might at first appear.

Copper trimmed while energy sold

We sold down our copper exposure, including all of one company, because we think the sector is vulnerable in the near term, as discussed above. We also reduced our energy exposure sharply; we had added after the March sell off and expected to cut back, but the sharp decline in prices combined with our selling means exposure to the energy sector is negligible. It is still too soon to be aggressive in this sector.

Looking ahead, we expect to remain reasonably fully invested, and do not anticipate much change in our sector allocation in the period ahead, given the economic outlook disfavoring base metals and oil, while the monetary outlook favors gold.

In sum, we are concerned at the possibility of a sharper and longer-lasting economic contraction than the consensus, and particularly that markets are not pricing in that possibility. So the risk-reward in the broad market does not seem compelling and we have very little exposure overall. Absent a sharp market decline, or declines in individual stocks, that would lead us to deploy some cash, we would expect to reduce global equities even more in the coming months. Otherwise, we expect cash levels to remain high along with a solid exposure to gold stocks across all accounts. We will remain patient and disciplined, however difficult that can be. It will protect us on the downside in the near term, and, we believe, reward us well in the longer.

Adrian Day, July 4th, 2020

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