Adrian Day
ADRIAN DAY ASSET MANAGEMENT

# PORTFOLIO REVIEW

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**It was not an easy year, despite the economy recovering as we moved out of the worst of the covid epidemic, and markets hitting new highs. There are well-known problems in the economy, including inflation that seems less and less to be transitory; supply shortages; and businesses having difficulty finding employees. And in the market, fewer and fewer stocks are making the running, while many markets, sectors and individual stocks have losses for the year. As we look ahead, we see increased difficulties with inflation, in the economy, and with the Federal Reserve's attempts to tighten, while the market is increasingly vulnerable to a meaningful pullback. In this scenario, some foreign markets should do well while gold will finally emerge from its cocoon.**

## ■ U.S. stocks lead again

The U.S. stock market once again was a global leader, beaten for the year only by the U.K. market. The S&P was up 27% (the Dow and Nasdaq up somewhat less), while global markets outside the U.S. were up just 5% for the year. For the quarter, the S&P was up just over 10%, with only Switzerland doing better, while most of Asia, including Japan and Hong Kong, as well as Spain and Brazil fell. The world index rose just over 1% in the quarter, while the global equity fund index was up 4.7%.

Our global accounts recovered somewhat in the last quarter, outperforming the average fund, up 6.7% for conservative and mid-risk accounts, a little less for aggressive ones.* (Numbers are preliminary.) We underperformed for the year, however. The change from under- to out-performance was largely driven by gold stocks in the portfolios. In addition, we were very underweight U.S. stocks throughout the year, particularly the high-flying market leaders that drove returns for the first 10 months of the year. Value investors, as we have discussed, typically lag when markets are so grossly overvalued.

## ■ Resources and gold variable and volatile for the year

Resources had a wild ride. The Bloomberg Commodity Index, albeit an imperfect gauge, fell 1.6% in the last quarter but was still up 27% for the year, led by oil (up 55%) and gas (up 199%). The agricultural commodities also generally did well. In the last quarter, however, nearly everything gave back some of the earlier gains; only a handful of metals, including copper, nickel, gold and silver were up.

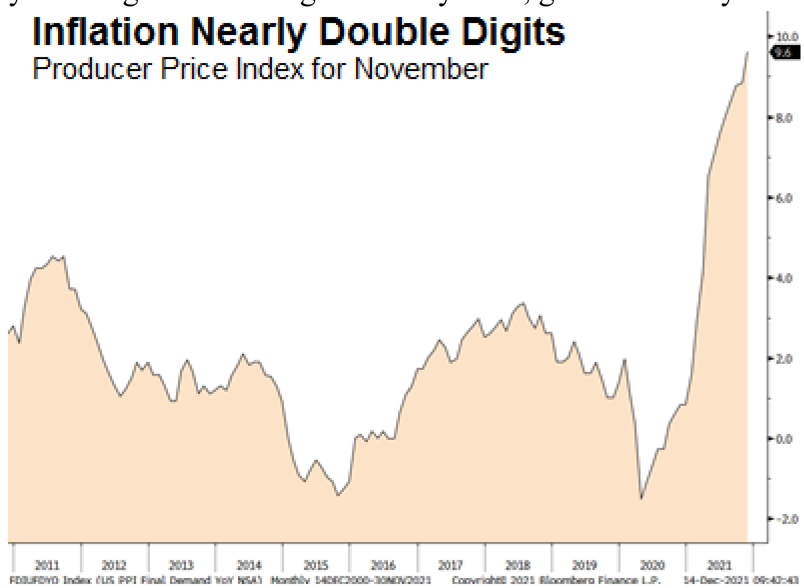
Gold rose just over 4% in the quarter, though ended the year down 3.7% for its worst year since 2015. The gold stocks swung broadly. The average gold fund, though up 7.5% in the last quarter, was still down nearly 8% for the year (basis Bloomberg Precious Metals Open-end Fund Index, and the best performer in the index for the year is not even a gold fund).

We outperformed a little in the quarter, with our gold accounts up 7.9% and resource accounts 8.5%, though underperformed for the year.* There were no dramatic reasons for the quarterly outperformance, but for the year, the exploration stocks which make up a significant amount of our portfolios generally lagged the larger caps until close to year end when gold started to move up. As gold itself appreciates, we would anticipate a greater interest in gold stocks, and the juniors typically start to outperform as investors return to the sector.

Overall, it was a good quarter capping a bad year. Looking ahead, we are underweight and defensive in the broad market so might withstand a market correction better than some (though everything gets hurt when the market falls); while our high weighting in gold stocks could reap rewards this coming year, as inflation continues and the monetary authorities stumble.

## ■ The Fed starts to move

The Federal Reserve finally has recognized what it had denied for so long, but what everyone else in the country already knew, namely that inflation will be a little more persistent than the earlier "transitory" narrative assumed. Producer prices jumped almost 10% annualized in the latest number; consumer price increases are running at the highest rate in 39 years. Fed chairman Jerome Powell has publicly said that the Fed should retire the world "transitory". Though the rate of growth may slow, given that the year-on-year comparisons start to get more difficult, we think higher prices will remain: input costs continue to rise, and wage rates are moving up (and they tend to be sticky). As a result, manufacturers across the board continue to increase prices. As this continues, consumers switch from delaying purchases because of higher prices to bringing forward purchases to avoid even higher prices in the future, adding to price pressures.




Increasingly Fed officials are calling for a more rapid rate of tapering and thence rate hikes. St. Louis Fed president James Bullard put the blame squarely where it belongs when he said that "a supply shock alone cannot cause inflation, it's a supply shock being accommodated by very easy monetary policy…(Inflation) has to be all the prices go up in tandem and that only comes about when monetary policy is accommodative."

Despite calls for a faster taper and a step up in forecasts of rate hikes in 2022 and 2023, it is important to note that tapering still means *adding* nearly half a trillion to the Fed's balance sheet before it's over, with interest rates still at historical lows levels.  Even if there are three rate hikes this coming year—as the more aggressive Fed members want—that will still mean a negative *real* yield. The Fed Funds rate today is deeper in negative territory than it was in the mid-1970s, on the eve of the sharpest jump in U.S. inflation in living memory.

## ■ Will the Fed blink?

I suspect that at some point the Fed will make a half-hearted effort at tightening in the face of persistent inflation, and when the market falls, the Fed will retreat, as it has before. That scenario, a Fed that backs down, would see the stock market resume its upward move and would be very positive for gold.

The composition of next year's FOMC, the committee that actually sets rates, is critical. Though arguably the known members of the new committee are slightly more "hawkish" than last year's crew, there are vacancies which President Biden has to fill, and these nominees could well tip the balance back to a more dovish fed. They likely won't change the current plan to end bond purchases by the end of March, but they will be far more likely to surrender if the market or economy react badly.

## ■ Just how strong is this economy?

The Fed is prepared to taper and plan for rate hikes because it judges the economy strong enough to sustain higher rates. Obviously, the base effect, that we heard so much about in downplaying the inflation numbers, comes into play with comparisons on the economy. It is not as strong as it appears on the surface. The supply shortages are well known as is the shortage of willing workers.

Strong retail sales have been highlighted, but economist Peter Boockvar suggests that all of retail sales growth in last six months is due to higher prices and not to an increase in volume, a negative sign. Having to pay more for the same goods is a reason that the savings rate has dropped again. Consumer confidence has fallen to its lowest level in a decade, lower than in March of last year when covid shutdowns were underway. Lower-income and older people were the most pessimistic, citing inflation among other concerns. Half expect real incomes to decline over the next year, and barely a third expect real incomes to rise over the next five years.

Employment is still struggling, with continuing claims rising. Apologists point to the decline n new claims, but that is not necessarily a positive indicator. With businesses struggling to find workers, even as labor productivity is declining, employers are reluctant to lay off any workers.   Wage gains likely to be persistent, even if the rate of growth in inflation slows.

Now housing starts have turned down, due to the difficulty getting materials and labor, and higher prices. Manufacturing is up, but the outlook has declined because of difficulties obtaining parts and materials

## ■ Global economies are playing much the same song

It is much the same story around the world, with inflation strong while economies soften, though there are different responses from various central banks. No major bank is as "hawkish" as the Fed, a frightening thought.

In Japan, the economy contracted 3% (annualized) in the latest quarter. Meanwhile, the producer price index was up 8% year on year, a worrying combination.

In China, the latest producer price index was up over 13%. But the economy has some dark spots. The default of the real estate developer Evergrande has had less spillover effect that some feared. The top six or seven banks have almost no exposure to problematic real estate developers, and there appears little exposure in Europe or North America.

More problematic has been the energy crisis, with the central government rationing energy, forcing factories to shut down. This affects the supply chain and it affects demand for commodities, with a potential impact on the global economy.

## ■ China seeking more sustainable growth

More broadly, China under Xi has been focusing on slower but more sustainable and more equitable growth. The government wants a less debt-driven economy, which is in line with the broad goal of slower but more sustainable growth with less risk. It also means more regulation and intervention, as we have seen in various sectors already. Some China watchers say the goal is to broaden the middle class and does not represent a return to a planned economy.

To paraphrase the old saying, when China catches cold, Southeast Asia and most emerging markets catch pneumonia, with a ripple effect globally. We are therefore cautious of things too exposed to China, particularly luxury goods and other forms of conspicuous consumption that will be frowned upon. (See, however, comments on China's stock market below.) The People's Bank continues to focus stimulus on specific sectors (such as real estate) rather than broadly across the economy. Last year, it was ahead of the curve in tightening policy, a reason stocks underperformed, and is now loosening slightly.

In the Eurozone, the ECB's Christine Lagarde has dug in her heels, repeatedly saying that there is no inflation, despite consumer prices up 16% year-on-year. Because of that, rates are expected to remain negative next year (in nominal as well as real terms), and there is no effort to scale back the accommodative monetary policy.

Many emerging economies are slowing, with Brazil now in a recession. Despite this, the central bank continues to raise rates aggressively, in the face of double-digit inflation, now the highest of any country in the world (other than the basket cases). The central bank raised rates by 150 basis points to 9.25% last month, and said another 150 basis point hike was coming in January. The rate was just 2% in March. And despite this, business credit growth has picked up over past year, after several years of slow credit growth. Whether this continues will help determine how short the recession is.

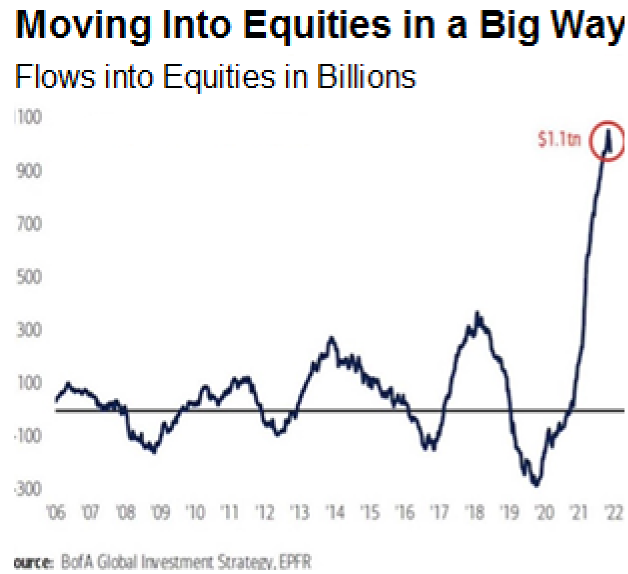
## ■ Stocks up around the world, but warning signs are flashing

U.S. stocks hit yet new record highs just after Christmas. Apple is closing in on becoming the first-ever $3 trillion company, with Microsoft not far behind. A month ago, *Barron's* columnist Ben Levisohn wrote, "it doesn't get any better than this…and that means it's time to bet on a rip-roaring rally." (He changed his tune a few weeks later, writing that the market might "freak out".) Au contraire, when things can't get any better, they can only get worse.

There are many reasons for selling stocks—bull markets always climb a wall of worry (though there is little worry in the stock market at present)—and right now, many look like legitimate concerns, but there is only reason for buying now: continuing easy money policies. Valuations are certainly not a reason to buy. Stocks are trading at their most extreme valuations in history on many metrics, which alone should give pause. One sign: 83 of the S&P 500 (that's one in six) trades at an enterprise value-to-revenue ratio above 10; at the peak of the dotcom bubble, "only" 38 did. Another: The ratio of U.S. market cap to GDP is *nearly 50% above levels that were ever observed prior to last year.* And insiders from

Blackstone to Elon Musk and Jeff Bezos are selling as rapidly as they can, some of it to get ahead of anticipated capital gains tax hikes next year, but some no doubt because of valuations.

Moreover, many technical and empirical warning signs of a market peak are flashing. Manager John Hussman recently said that he has never seen so many indications of a market peak all at once. We could look at sentiment, which might be thought of as "exuberant". Investors poured over $900 billion into equity funds in 2021, *exceeding the total from the past 19 years.* Not surprisingly, given this, household's equity allocation is at an all-time high of over 50%.




We can look at margin levels or new account openings, and they all point to exuberant sentiment. Many new companies, without earnings, are trading as though investors are expecting an "amazon-like" experience. Most will fail. It is only in retrospect that the few survivors look so obvious. Excessive speculation often occurs near the end of bull markets; any unwinding of extreme speculative positions signals that the broad market may be in for a rough ride.

## ■ It's not all good

We could look at internal divergencies in the market. The are many ways of assessing this. How broad is the advance? Not very: roughly two-thirds of the S&P 500's gain in the fourth quarter was attributable to just 10 stocks. The Advance/Decline Divergence Index is making new lows, signaling notable deterioration in market breadth relative to market gains over the past six months. Even while the indexes are making new highs, more stocks are hitting new 52-week lows than new highs. It's worse for the Nasdaq than the S&P: while 35% of the S&P are in a bear market (down 20% plus from their highs), for the Nasdaq, the figure is 67%. Although the Nasdaq is up over 21% on the year, if you remove the largest five stocks, the index is down by double digits. The S&P index is at a new high but two-thirds of the individual stocks are at 52-week lows. This is unprecedented divergence. As Evans Lorenz writing in *Grant's Interest Rate Observer* puts it: "it's been a great year for the stock market but a mixed year for stocks."

Deteriorating breadth has historically been one of the most reliable signs of trouble ahead for the stock market. When market breadth narrows, it signals internal weakness as investors grow more selective in their stock purchases. This was clearly seen at the end of the 1990s right before the dotcom bubble burst.

Inflation is not necessarily a negative for stocks, particularly in the early stages before central banks start to tackle it. With money losing its purchasing power and real rates negative, investors put their money into stocks, real estate and tangibles. There are two psychological drivers, which we have seen recently: TINA (there is no alternative) and FOMO (fear of missing out) have been driving the market.

However, history also tells us that low interest rates do not prevent a significant correction; the direction is more telling. It is broadly the case that so long as the Fed keeps printing money, much of it will go into stocks. But if some of that money is withdrawn, particularly as so much of the money in the market is on margin, or in the hands of neophytes who can't afford a loss, then we may well see money move out of the market. We may simply see a more volatile market, an even more selective market, or perhaps a meaningful pullback to the entire market; certainly the *risk* of that is now much higher than it has been. Along with this, we will see the demise of some highflyers with more money going to dividend-paying, value-type stocks. Trouble likely lies ahead for the market in coming months, or most certainly, the *risk* of such has increased. And the risk-reward for U.S. stocks is now pretty poor.

## ■ Global markets: Cheaper but not cheap

If global markets in generally are less expensive than U.S. stocks they are only less overvalued. There may be some rotation from the U.S., but if European stocks, for example, are trading at 19 times earnings amid a sluggish economy, it is difficult to see how much higher they could go.

There are better values in developing economies. Emerging markets significantly underperformed developed markets last year, with two large EM markets—China and Brazil—leading the declines. China's indexes are down amid high-profile regulatory attacks on various sectors. Foreigners have been pulling money out in recent months and sentiment is negative. China's stocks could be near a bottom and may perform well this coming year so long as the economy does not fall into a recession. One would need to be selective, avoiding luxury goods and government-controlled entities, but there are real companies with strong growth profiles at reasonable valuations. As always, we prefer to buy on the Hong Kong exchange. But given ongoing concerns (the Hong Kong crackdown, Taiwan, and regulation), we are certainly not going to be too aggressive.

Russian stocks are also inexpensive, again largely because of foreign antagonism to the country. Russia is the largest beneficiary of higher energy prices, however, and the windfall will spread to other parts of the economy.

Brazilian stocks were the weakest performers among the leading two-dozen markets last year, down 18% in U.S. dollar terms, aggravated by a falling *real*. Many of the stocks are quite undervalued now, with the market's forward multiples the lowest in a decade. A pick up in business credit growth and thence economic activity could lead to a good rally this coming year. The *real* remains a concern, however. A presidential election this coming year may also see market volatility. So the political situation, the risk of further economic decline, and the global macro all make us cautious, but much of this is discounted by undervalued stocks.

More of our stock buying will be in overseas markets, but overall, we are cautious and likely to be selling more than buying in the months ahead.

## ■ Resources end good year badly

It was a very mixed and volatile year for commodities. Strong returns for nearly everything, from natural gas and oil, to aluminum, cotton and coffee, mostly stalled in the last quarter, with U.S. natural gas falling by over a third, though a handful of metals (nickel and copper as well as gold and silver) rallied.

Oil and gas has been the most exciting ride, with global demand being reduced slower than global supply. Indeed, notwithstanding the increase demand for alternative energy, demand for fossil fuels increased last year fairy dramatically as global economies bounced back. On the supply side, new rules to constrain drilling, and many other factors constraining the industry (from bank loan restrictions to ESG investing mandates), companies naturally take a cautious approach to capital-intensive long-term projects. And this follows a long period of low prices which were their own disincentive for capital investment. Non-OPEC exploration spending is less than half what it was a decade ago. President Biden is now calling on OPEC and Russia to increase their production to make up for the U.S. shortfall. Saudi Arabia and Russia have far more pricing power today than they did a decade or two ago.

Emblematic of this attitude is the International Energy Agency, which many mistakenly think speaks on behalf of the global energy industry but is in fact the spawn of the IMF; it is now calling on producers to cease all downstream investment and says no new oil or gas fields are necessary.

In Europe, German regulators have delayed approving Russia's Nord Stream 2 pipeline. It's fine if they want to freeze over the winter, but let's not blame the Ruskies for that.

The oil and gas prices are likely to say elevated, even if the gas price retreats further once we get to spring. We have been increasing our exposure to the sector. At the same time, the global oil sector has significant spare capacity; the gap between capacity and production is the widest it has been in 20 years, maybe more. There are political obstacles as well as other pressures that will prevent some of that capacity coming back on any time soon, but the excess capacity is certainly a factor that makes us less than one-sidedly positive on the oil price.

## ■ Copper faces supply difficulties

We continue to favor copper. Ongoing economic growth and particularly EV demand, offset by tight supplies has seen the third straight year of copper price gains. A slowdown in China's economy will see lower demand from that source, but most other major countries are seeing increased demand. Chile's recent election, which saw a young leftist sweep to power with attacks on the mining industry, will be a negative for investment in that country, even if the reality will prove less damaging than the rhetoric.

## ■ Gold ending long consolidation period

Gold has had its worst year since 2015, as investors remain uninterested. Gold ETF holdings slid all year, down almost 10% by year end. This follows a strong period for gold; in the 12 months to the end of July 2020, gold was up over 60% (and the gold stocks much more, of course). So, to a large extent, the last year-and-a-half has simply been a consolidation following that strong move. In fact, gold has given back less than one-third of the up move, a rather modest pullback.


Gold investors are frustrated because they expect more from gold with inflation rising. Without cash flow or earnings, gold trades largely on sentiment, and with stocks and other assets doing well, sentiment on an asset that is primarily a hedge has been weak. So long as the Fed and other central banks pursue an accommodative monetary policy, there is less perceived need for "risk-off" assets, particularly gold which is viewed as a hedge and insurance.

But sentiment can swing dramatically. Since gold is a small market, even a small shift could see an explosive more in gold. We discussed in last *Review* that gold typically declines when the Fed starts <u>talking</u> about tightening, but has turned around when the Fed actually starts to <u>take action</u>. This is because, typically the Fed acts too little, too late, and actual implementation of policy, rather than the talk, shows that clearly. This time around may be no different.

### ■ Gold stocks are good value

Notwithstanding a 10% rally in the last two weeks of the year, the gold socks are very undervalued. The major stocks are trading close to historic low valuations, and now are trading at lower valuations than the S&P, which is a very unusual occurrence. The price-to-earnings for the XAU is 18 times versus 25 for the S&P, price-to-book value 1.7 times versus 4.9; and a yield of 1.6% versus 1.3%. Moreover, the XAU in aggregate is debt free, unlike the S&P.

When sentiment changes, and investors want exposure to gold stocks, the words "Hoover Dam" and "garden hose" come to mind. We are well positioned with a mix of senior producers, the more certain and first to move in a bull market; some intermediates and juniors, potential take-over candidates; and exploration companies with outsized potential on any discovery success. And we have a large exposure to royalty companies, large and small.

Overall, we are increasingly cautious on overvalued global stock markets, both because of valuations and because we are entering a phase when central banks may be less accommodative, however modestly and however temporary that may be. If there is a global market pullback, we will be ready to buy the more attractive emerging markets; it will be some time before the major markets are broadly attractive. In the meantime, we expect to be selling more than we are buying, with most of what we are holding being more defensive, good dividend payers, or a very specific bottom-up investment. We continue to have a high exposure to resources generally, particularly where the supply side of the equation is as compelling as the demand side, and to gold in particular for above-average, uncorrelated returns potential.

# Review of Individual Accounts

### ■ Global Accounts

As valuations and risk increased in global stock markets, we started selling positions, raising cash to around 3%, over 7% in more conservative accounts. Allocations to both global and income sectors increased a little, to 8% and 7% (again more in conservative accounts), but both were due to stock prices moving up even as we trimmed.

Last quarter, we said we were looking to raise cash. We cut about 15% of our global holdings, selling individual names on a client-specific basis without cutting any specific name completely. Despite this selling, the allocation moved up slightly, as stock prices generally continued to move up. We also added two names, one a conservative Europe-based global brand, the other an initial step back into Brazil.

We continue to hold large allocations to gold and other allocations, adding just a little as cash was freed.

Looking ahead, we expect cash positions to increase in coming months as we anticipate selling more than buying, while we are essentially very well positioned in gold and resources in our global accounts, so unlikely to add much more to those areas. We also anticipate moving from large global markets, in the U.S., Europe and Japan, into small markets as we search for value and depressed markets. But on balance, while holding out gold and resource, we anticipate cash levels increasing.

## ■ Gold Accounts

Our gold accounts remained fully invested, with cash levels declining even further to less than 2% of accounts. The allocation among seniors, juniors, silver, and exploration remained much the same, with minor movements, though seniors moved up to 27% of portfolios. Seniors typically move first when the metal moves and each of the larger stocks we hold saw their stock prices move up over the quarter.

We added a little to some major companies, as well as to silver, while selling a little in both the junior and exploration categories. It was at the margin however.

Among our junior producers, we sold one company that became the target of a takeover. Given the premium being offered, we sold in order to raise the cash to take advantage of other attractive buys that were available. We anticipate more acquisitions in the period ahead, and depending on the acquiring company, may sell in order to have cash to buy our preferred names.

### Upgrading portfolios by trading

We also sold one junior royalty company that had disappointed, and largely put the funds back into other junior royalty companies.

We also had the usual adjustments in our exploration portfolio, selling one that disappointed, and trimming a few that had good stock moves, adding to those that were down, especially on year-end tax-loss driven price declines.

Looking ahead, we expect to trim some of the stocks to which we recently added if we see early year bounces that are typical when tax-loss pressure is lifted. This will enable us to maintain exposure to particular names while putting a little cash in accounts. If we have a good move across the sector in the coming few months, we may see more movement in our gold accounts as we sell some laggards and rotate into favorites or new names, all the while maintaining a core in top royalty companies, a handful of senior miners, and select juniors. Although cash may increase a little, we would expect to remain pretty fully invested in the period ahead, reinvesting any cash raised fairly promptly at what we think is the onset of a new move up in the sector.

## ■ Resource Accounts

Resource accounts likewise remain fully invested, and major gold companies remain our largest single exposure, at 25% of portfolios. This is followed by silver, still at 11%, and then copper. We increased our oil and gas exposure modestly in the quarter. Uranium, platinum and iron ore, as well as various “green energy” investments, round out the portfolios.

### No new buys or sells

There were no major new buys or sells during the quarter, other than that discussed above under “gold accounts”. There was, however, as always some trimming and adding to stocks, particularly among the smaller companies, depending on price moves.

It is worth noting that most of our companies have revenue from more than one resource, Barrick Gold, for example, has about 15% of its revenue from copper. Franco-Nevada has nearly 20% of its revenue from oil and gas. Altius and Star Royalty, in particular, have heavy investments in “green energy” projects. And so on.

In selecting investments for resource accounts, we are always alert to gaining exposure to secondary resources, preferring, for example, one gold company to another because of the exposure to other resources it brings.

Looking ahead, we expect to remain fully invested, with gold, silver and copper continuing to be our top allocations. We expect to increase exposure to oil and gas. Overall, we are looking at resources that would be less exposed to a slowdown in China as well as resources with a compelling supply story as well as growing demand. Overall, though, absent significant developments to the global economic outlook, we will remain fully invested.

**In sum, we are increasingly cautious about global equity markets and expect more selling than buying in the period ahead, and any buying to be "bottom up" and more likely in small markets. The Federal Reserve's new moves increasing tapering and forecasting more rate hikes sooner, will, if they carry through, at some point prove too much for the stock market, and the Fed will back down. At the same time, we are increasingly confident about a new gold bull move and are well positioned for that.**

*Adrian Day, January 1st, 2022*