Adrian Day
ADRIAN DAY ASSET MANAGEMENT

PORTFOLIO REVIEW

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The party's over. Increasingly, for the past decade and before, America and much of the world have been living beyond their means, with the economy, living standards, and markets fueled by excess money creation. Now it's time to unwind the masquerade. As interest rates move off 4,000-year lows—with negative interest rates consigned to the dustbin of history—and money injection goes into reverse, so too must the economy, living standards and markets go into reverse. The central question is how long this tightening process will continue before the masters of the fiat system get weak knees. It will be impossible to tame inflation without provoking a recession. Markets have collapsed. The world has changed and our investment strategy must change with it, to protect and preserve being the primary objective, as well as building for the longer term.

■ Declines in Almost Everything, Everywhere

Over the last quarter and for the year to date, everything is down, except many commodities. Bonds, a naturae, have declined as rates have increased; the classic 60/40 stocks/bonds portfolio had its second-steepest drop in over a century (since 1900, to be precise)! In 2008, while stocks fell, bonds rallied, offsetting the pain. Not so this time. Other assets, from home prices to cryptocurrencies—suddenly exposed as speculations without inherent value—have dropped, in some cases sharply. Halfway through the year, virtually every asset class has fallen into either a correction or bear market.

Global stocks fell sharply in the second quarter to add to the losses of the first, ending the first half down virtually 20%. The S&P fell 19.97% for its largest first-half decline in 60 years, while markets outside the U.S. did ever-so-slightly better, down 19.7%. Virtually all markets closed in the red, the only exception being Jakarta. In the Americas, major Latin markets did better than their northern neighbors, with Brazil down less than one percent—it was still in the black on Wednesday—the least bad. In Europe, most markets were down in the mid-20s, with the U.K., down "only" 13%, the best performer, while in Asia, Singapore, down less than 4% and Hong Kong down 7%, were the top performers among the major markets. It was a broad and deeply negative period. Global equity mutual funds fell 21%.

■ Global Accounts Down

Our global accounts gave back all of the first-quarter gains and more, yet finished ahead of the indices and funds.* Our mid-risk growth account fell nearly 13%, while the aggressive and conservative account did better, the latter down "only" 7%. (Numbers are preliminary.)

Though still negative, we outperformed the indices and funds because of our geographic allocation, underweight Europe and the U.S., and overweight the U.K. and Hong Kong and Singapore. In sectors, we were underweight tech and growth generally. On the other hand, our high weighting to gold did us no favors this quarter.

A mixed period for commodities

Commodities fell in the second quarter, but remain up for the year to date, by some 18% (per Bloomberg Commodity Index), led by oil (42%) and gas (54%). The metals were mostly down, though iron ore was up 18%. The agriculturals were also mostly up. Copper ended the half-year down 15%. Although many commodities remain positive for the period, they are all down from the 52-week highs, over half more than 20%. So it is a decidedly mixed picture. And equities did not match any positive returns in the underlying commodities.

Gold was essentially flat for the year-to-date though, though silver fell 13%. The XAU index was down over 15% for the period.

Our resource accounts are down 19%, underperforming because of a drastic underweight in oil stocks. Our gold accounts are down a little over 15%, very slightly outperforming the XAU.

Global Tightening Cycle Begins

The cause of the carnage is clear: the central bank tightening cycle is underway. Many smaller economies, from Brazil to Hungary, were ahead of the curve and are pursuing policies that could legitimately be called "tightening". The Federal Reserve's rate hiking is underway and it is about to start to reduce the size of its balance sheet. Or so the Fed says: the balance sheet actually increased again in June. Tightening credit conditions and the withdrawal of liquidity from the economy must have negative effects on economic activity and market prices.

It is important, however, to remember some factors.

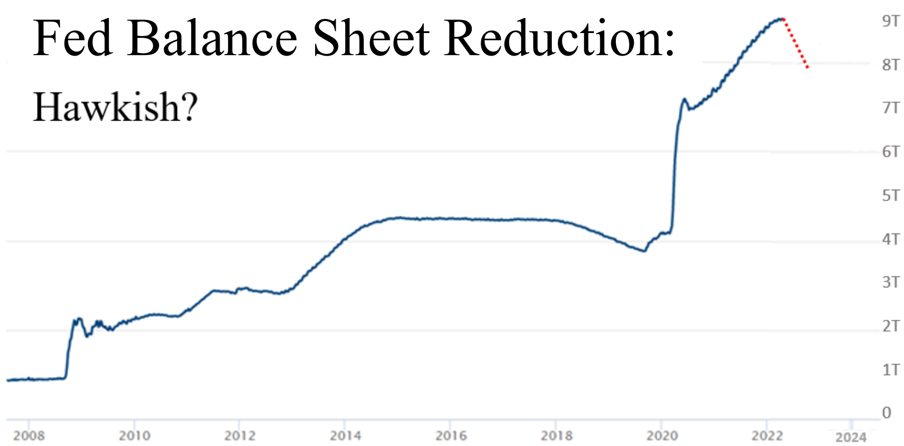
- The Fed's policies so far are not hawkish. They have not even started to sell any securities from their bloated balance sheet, despite months of talk. (See graphs page 3 and 4.)
- The economic environment—debt levels, asset prices, and so forth—are far worse than in previous tightening periods, including the Volcker era.
- The Fed will be unable to tame inflation without a recession, which is all-but inevitable.
- The Powell Fed is unlikely to continue to pursue tightening policies until inflation is under control. The question is when will the Fed surrender.

Money supply growth and Fed bank credit are both now slowing; the former is up only 1.3% for the last three months, compared with 8% over the past year. Many think Powell will pivot soon; indeed they are surprised he has continued until now! Powell says that the Fed's commitment to bring inflation down to 2% is "unconditional". But the rhetoric is ahead of the actions. The Fed may last longer than many think (at least until the mid-term elections are behind us, says the cynic). There are three main reasons to think this might be so.

- Now, unlike 2018, 2015 or 2013, previous attempts to tighten, there actually is a dragon (inflation) to slay.
- If the Fed wants to maintain whatever shred of credibility it still retains, it must fight the good fight for a while.
- Powell has been given his marching orders by President Biden who told him that inflation must be the Fed's top priority, and, by proclaiming the Fed's independence, Biden has not-so-subtly announced that the Fed is responsible for any failure.

The recent jobs report, showing more new jobs than anticipated, provides cover for the Fed, while the continuing growth in the rate of inflation, again higher than establishment economists expected, provides a target. And Biden gave Powell the will.

It should be remembered that higher consumer prices on a broad scale are due to the creation of excess money. Of course, specific developments (such as war) can cause shortages of goods that can exaggerate and distort prices for specific products, but excess money is the root cause of higher consumer prices. The end of the war in Ukraine, stabilization in China, and other developments may ease supply—and therefore prices—of specific products, but they are insufficient to bring down the CPI to the Fed's 2% target. The Fed is forecasting the terminal rate of rate hikes to be under 4%. But rates need to get above inflation to bring it down.



The red dotted line shows where the Fed's balance sheet will stand one year from now, if their more aggressive plans for reducing the balance sheet are executed.

When will they cave?

This Fed is not overly concerned with asset prices or even, broadly, with the economy. They have even proclaimed that they want lower stock prices and concede the need for higher unemployment. But significantly higher unemployment, to the point where that became a higher concern for voters than rising prices, or a perceived systemic risk, would cause the Fed to reverse course.

For most of the past two decades, companies have borrowed too much because of ultra-low rates, making rash investments because of excess money. Households have too. We know that removing the liquidity from the economy will see some things break, we just don't know where, when and how much.

Certainly, different sectors will experience considerable difficulties. The high-yield sector (otherwise known as "junk") yielded just 4% when this year began. These same companies, when time comes to roll-over their debt, must pay more than double that. Earnings-free companies that can survive paying 4% may not be able to survive paying 8.4%, especially in a deteriorating economy. At some point, however, if tightening continues, some company or sector, deemed systemically important will be on the brink. The Fed will see that and likely blink.

At some point too, it is likely that the Biden Administration will want to step up spending, whether cancelling student loans or subsidizing this or that or perhaps new benefits for this or that group. These programs will only add to the inflation they claim to want to stop. Indeed, they are already doing this. It takes a special kind of politician not to see the dichotomy.

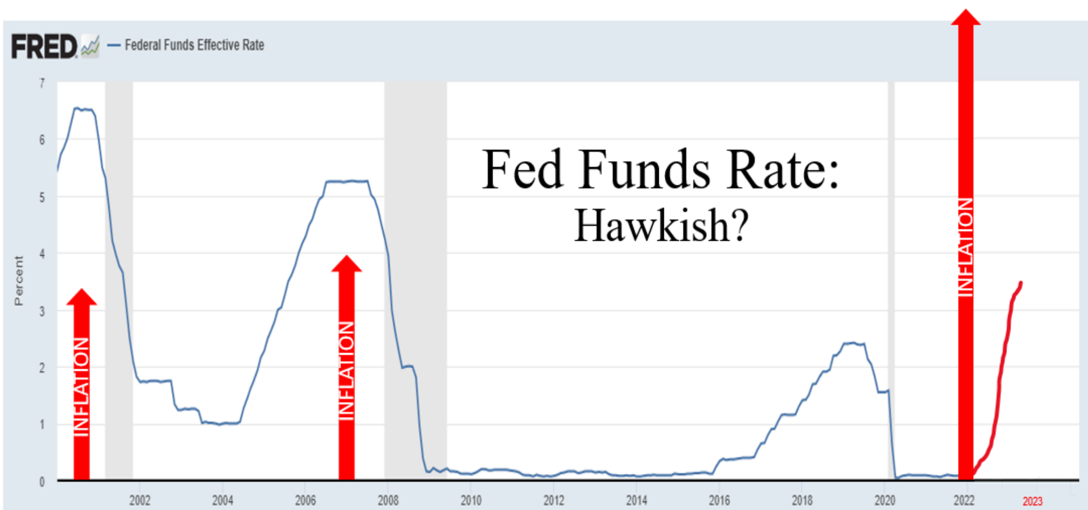
FedHead Powell still insists that, with the economy in "strong shape", the Fed can reduce inflation to 2% while maintaining a strong labor market and avoiding a recession. He later qualified this by saying "we hope" growth will remain positive, this even as he said the Fed will move "expeditiously" to a restrictive monetary policy.

Why does the Fed get it wrong?

How can the Fed, with its 400-plus PhDs in economics, get it so wrong so often? Look back to the last meaningful recession.

- From November 2007 to June 2008, the Fed was saying that there was no recession, it's all irrelevant noise.
- From July to September 2008, they said the risk of recession was rising, but it was all under control.
- From October 2008 to May 2009, they admitted there was a recession, but the Fed would fight it.
- In June 2009, it was official: the U.S. actually entered a recession in November 2007.

The above is just one example. We could look at Bernanke's comments on the housing market, or this Fed's evolving inflation narrative, from "transitory" to "peak" and they still have it wrong. Treasury Secretary and former Fed chief Janet Yellen now admits she was wrong on inflation, but at the beginning of last year asserted, not without some hubris, "I've spent many years studying inflation. And I can tell you we have the tools to deal with that risk if it materializes." Her latest prescription to fight inflation is that the government should help lower costs for consumers with more spending on housing, education and various other programs. This is ignorance beyond that of any first-year economics student.



If the Fed's plans to raise rates over the next year are implemented, rates will still be significantly below inflation, quite unlike 2001 and 2007.

There are two main reasons that the Fed gets it wrong. First, the models they employ tend to be static. Second, the Fed, at least since Bernanke, has been "data dependent"; they want to see how their novel policies affect the economy. This inherently means looking in the rearview mirror. Thus the Fed, in its commentary accompanying its latest rate hike, can say "overall, economic activity seems to have picked up", this even as ordinary Americans can tell them otherwise. The University of Michigan's Consumer Confidence Index plunged last month to its lowest reading on record.

■ The economy is already slowing

The economy is already slowing. Leading Economic Indicators have dropped for the third straight month, and a rash of individual statistics and reports confirm that the economy is slowing. For example, the red-hot housing market is turning; there are now months of new house supply on the market, as mortgage rates move above 6%. The jump in mortgage rates on top of an overheated market puts the "housing affordability" index at its lowest on record (back to the early 1980s).

We have seen an increase in new unemployment claims in recent weeks as companies are beginning to lay off workers as recession fears become more widespread. This is likely to only pick-up pace in the months ahead. Similarly, personal spending was down in the latest report, only marginally, but a decline nonetheless. Added to higher prices, that means consumers are buying less than they were a year ago. And the Atlanta regional Fed has just announced that it shows GDP fell in the second quarter.

Yet even now, amidst all these developments, the Fed remains optimistic. The latest Fed "dot-plot", wherein members estimate various economic indicators over various time frames, though more negative than the previous one in March, nonetheless is wildly optimistic as well as contradictory. The Fed expects inflation to be at 2% by 2024, with positive GDP growth all along. They are still forecasting 1.9% GDP growth for this year which implies some not-inconsiderable growth in the second half.

The Fed's minutes from a year ago (May 2021) included this classic statement of decisiveness: "A number of participants (said) it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases." If instead of beginning at some point to discuss a plan to adjust…they had just stopped asset purchases, things would be not so bad now. But then they did not see inflation a year ago, transitory or otherwise, because they were looking in the rear-view mirror.

■ Global Banks start to raise rates

Central banks in many smaller countries started tightening earlier than the Fed and have been more aggressive. But among the major central banks, the Fed remains the most "hawkish", even though most others are beginning to tighten or talk about it, with the Bank of Japan being the notable exception. The BoJ is stuck with its yield curve control experiment which has seen the yen drop to 30-year lows. Japan's policies, including massive and consistent asset purchases, and more recently a yield-curve control experiment, have seen the Japanese economy stagnate, with no net growth in 30 years, with the yen now plunging to a 30-year low.

Other than Japan, however, we are beginning to see the end of the egregious easing of recent years. Even the Swiss National Bank has raised rates, now at only a negative 0.25%! The European Central Bank, likewise, is reducing the negativity of rates. It says it may continue to raise rates, but promises to do so gradually. The ECB's biggest concern right now is what it calls "fragmentation", that is, yields on the debt of nations-formerly-known-as-PIIGS rising too far above those of Germany and other erstwhile fiscally prudent nations. But with inflation in the southern countries higher than in the northern—Spain's CPI rose 10% in the last report, compared with 8.1% for the eurozone overall—higher yields in those countries might appear not inappropriate.

The Bank of England, following the government's wild abandon in spending, has raised rates to the highest level in 13 years, from a full quarter of a percent to 1.25%. That'll show 'em! Meanwhile, the Bank is forecasting that inflation will end the year at 11%.

China is somewhere in between, targeting certain sectors, rather than blanket tightening. Its inflation is far lower than other major economies, while a strong economic rebound from renewed lockdowns earlier in the year is anticipated; over 6% GDP growth is forecast for the second half of the year. The money supply has been essentially flat over the past year, in contrast to other developed nations. Elsewhere around the world, however (except for Japan), the direction is the same: tighter conditions.

Economies the world over are showing declines in activity, with manufacturing reports (for example) just this past week showing declines in the U.K., Eurozone, Japan, Korea, Vietnam and yet more countries. Economic reports across the board and in all countries are clearly showing growing weakness.

■ The dollar remains high on rate differentials

The U.S. dollar is within a whisker of the new 20-year highs it hit earlier in the month, as U.S. rate increases widen the interest gap with other major currencies. More fundamental, however, is the loss of willingness on the past of foreign official holders to buy dollars. Indeed, foreign investors overall have been net sellers of Treasuries. And now China is building a yuan currency reserve together with five other, mainly Asian nations, and the backing of the Bank for International Settlements. This is to allow the yuan to eventually compete with the dollar as a reserve currency. Western sanctions on Russia, which included confiscating most of that country's reserves, was only the latest and most dramatic development prodding countries to exit the dollar, both in reserves and as a medium of exchange. This trend, though it may ebb and flow in the short term, will only accelerate in coming years.

■ Stocks: What goes up, must come down

There is plenty of room left for earnings disappointments. Given the S&P is still trading at over 19 times earnings, the market could be hit with a double whammy. Stocks tend to fall more than the economy (and go up more) because of multiple contraction (and expansion) as well as lower (or higher) earnings. If we make a conservative projection of S&P earnings being precisely the same as last year (rather than the 14% increase analysts are expecting), and a p/e ratio of 17x, still above the median for the decade ending 2016, that would imply another 25% drop in the S&P. We are nowhere near bargain valuations yet. It is important to keep reminding ourselves just how expensive U.S. stocks were entering this year.

The U.S. market may rally near term however. Sentiment is at extremes. CFTC positioning is at an all-time low, while retail bull-bear indicators, are close to lows: Bank of America's Bull-Bear indicator sits at zero; it literally can't get any lower. Anecdotally, two separate friends who are short the S&P rejected my suggestion this week to take profits. The end of June saw very heavy retail selling; coming after the market had already declined, that looked like panic selling, and may signal a near-term reversal. It will be only a rally within a bear market, however, and, given the seeming consensus calling for the S&P to rally to 4200, it will most likely fall short of that. To date, rallies have been very short-lived (late January, mid-March, mid-May, late-May, and mid-June; none has lasted more than 11 days).

In a period of rising interest rates, value stocks perform better than growth stocks, which typically have higher debt as well as earnings sometime into the future. Right now, value is far less expensive as well, making the switch from growth to value very timely. We are looking at companies with entrenched customer bases as well as strong balance sheets.

■ Global stocks are less expensive

The global forward p/e is now under 14 times, down from over 18 a year ago. The current level is reasonable and some markets and individual stocks are at good buying levels. Hong Kong has experienced a stronger economic recovery than many nations while its valuations remain attractive, with single-digit price-to-earnings, a discount price to book, and a yield over 3%. We were early into this market, but may see a recovery over the next few quarters.

Ideally, however, we would like to see the dollar turn as that is generally positive for smaller global markets, which we favor in the current environment. Major developed markets are unlikely to rally meaningfully in any sustained way if the U.S. market continues to decline.

We are cautious on global equities overall. We are focusing on value stocks in smaller markets, but will also look for top-quality stocks that experience sharp declines, as well as opportunistic buys of stocks that get oversold and may see a recovery rally. This will mean generally more cash and more shorter-term investments.

■ Bad quarter for resources, but still up

Commodities are down sharply, in the worst quarter since 2008, with base metals down an average of 25%. But most remain the only assets that are still up this year, led by coal and oil. The recent fall is due to fears of a pending recession, and the demand destruction that would entail.

A lot of attention has been on the oil and gas market due to the issues surrounding Russia. Most of Russian oil is being rerouted and continues to be sold, albeit at a significant discount, but production has still dropped by at least 1.5 million barrels a day. The giant Sakhalin in the Arctic is virtually shut down. There are various issues apart from finding buyers: shipping insurance is one as is absence of western service companies. The lack of this technology will have an increasing impact on productivity and therefore output as long as the war and sanctions remain.

But at some point, the war will end and sanctions will be lifted. That would see an immediate drop in many prices, especially but not only of oil and gas. We should not forget that the invasion was not the only reason prices moved up over the past year.

■ Insufficient oil ahead

Global crude oil cover, already well below 30 days, is expected to decline to record lows as summer continues. There is some space capacity in OPEC, but not near term for most countries. In the U.S., the increase in production has been much less than expected, and has come mostly from reopening of DUC (drilled but uncompleted) wells; new exploration and investment has been far less. Although the rig count is up from the lows, it remains below the level of 2019.

Last quarter, we discussed the political inhibitions to higher capital investment. With the White House hostile to the industry, and wanting to phase it out by the end of the decade, it is not surprising that companies are reluctant to spend large amounts of money on long duration projects. The pipeline of new prospects is limited. With increased LNG facilities in Europe to compensate for Russian gas, much of North American gas will flow to Europe; with only modest increased production, North American prices will start to converge with higher international prices.

An end to the war would see prices give back some of their recent gains, but the fundamental imbalance between supply and demand will remain.

■ Gold holds its own

Year to date, gold is down marginally, though essentially flat. But this shows that gold has retained its role as a store of value during times of economic and geopolitical uncertainty. Investing in gold won't make you a billionaire, but it could help stabilize your portfolio when everything else is crashing. That gold has managed to stay positive since the start of the year, skirting pressure from surging yields and a strong U.S. dollar, is impressive, particularly when, as mentioned, nearly every other asset class, including gold's supposed replacement, the cryptocurrencies, has fallen.

The major gold stocks have underperformed gold recently, falling in sync with the broad market. This is not unusual behavior; indeed the gold companies, being far smaller than the average Dow or S&P company, and the stocks inherently more volatile, usually fall more than the broad market.

However, they often recover sooner and more rapidly than the broad market (1987, 2000, 2008), so the recent action should not be too distressing. And they are extremely inexpensive, trading unusually at better valuations than the S&P, and at low historical valuations. Given the extreme levels of frustration we are seeing among gold investors, and quite a bit of panic selling, we could be near a turn.

Overall, we are taking a cautious stance, but equally do not want to dump stocks after a decline. We continue to look for opportunities to buy, either undervalued quality companies or oversold situations that may be good for a recovery. We continue to hold gold assets, both because they can act as a hedge or at least a stabilizer on an overall portfolio, and also because they offer the prospects for strong returns in the current environment.

Review of Individual Accounts

Global Accounts

Cash holdings in global accounts fell during the last quarter, surprisingly, as we bought global equities in recent weeks on anticipation of a stock market rally, while we did not sell the gold stocks into expected strength, which did not come. Mid-risk accounts ended the quarter with just about 1% in cash (2.6% for more conservative accounts). This is a low level of cash, but due somewhat to the happenstance of the calendar. We held more cash a month ago and expect to be raising cash over the coming quarter, as we sell some of the recent rally buys, and also gradually reduce exposure to global markets.

Indeed, our exposure to global markets slid to 6%, while U.S. income remained at 8%. (For conservative accounts, the numbers are 13% and 21% respectively. Conservative accounts have less exposure to gold and resources.)

Buying for a rally ahead

We exited some global stocks in the past quarter, a Singapore transportation company and a small Canadian technology company. We bought several U.K. companies, undervalued and all the more so in U.S. dollar terms on the pound's weakness. This is in expectations of a rally given the global stock markets are oversold, at least for the short term.

We also added to our Business Development Companies and other income-oriented companies on weakness. Concerns about their performance in a recession, while not completely invalid, are overdone, in my view. Our two main holdings each have large cushions of undistributed income available to meet any temporary shortfall. Both continued to pay dividends during the covid-lockdown period.

Looking ahead, we expect to be selling most of the stocks we bought for an anticipated rally, and given strong moves even take some profits on the gold stocks for clients who would then be overweight. With developed markets weak, we are looking for value in smaller markets, though always alert to quality companies that have been oversold.

Gold accounts

As expected, cash levels in gold accounts fell sharply, as we continued to add to different stocks, large and small, that were particularly undervalued; accounts are essentially fully invested. Allocations among sectors remains more-or-less where they stood at the beginning of the quarter, with senior stocks at around 27% and exploration at just under 29%.

We had no new buys or sells during the quarter, but that should not disguise a fair amount of selling for individual clients and buying additional positions in our favorites. Two of our holdings have been the targets of friendly takeovers, one large and widely held, the other a smaller company. Both should close in coming months, and in both cases, we already hold the company doing the acquiring.

Looking ahead, we expect continued opportunistic trimming of some positions and adding to others, while remaining overall fully invested. It is only a matter of time, in my mind, before gold reacts to the monetary dilemma facing the Federal Reserve and other central banks, and gold stocks will follow, if history is a guide.

Resource accounts

Our resource accounts are also essentially fully invested, as we added to positions across the board. As before, gold is our largest allocation, up to 34%, with silver second around 10%. Copper remains our third largest. As before, much of our exposure to different sectors is inside larger, more diversified companies, including large gold companies, such as copper in Barrick Gold and oil and gas in Franco-Nevada.

We took some profits early in the quarter on spikes caused by the Russian war, but have re-invested all proceeds primarily in silver (the allocation remained the same despite the new buying because silver fell more than gold during the quarter); as well as adding to favorite companies in all sectors. We also have a new buy of a major oil service company, we bought after the pullback in oil prices and equities.

Looking forward, we expect to remain fully invested, though as always we are alert to opportunities to trim positions in order to raise cash for other buys. We expect gold and silver to remain our top positions, since they seem to have the best risk-reward profile. We will hold copper, which is in structural deficit, and will look to increase exposure to oil and gas on further pullback.

In sum, we feel that the Federal Reserve and other central banks have an impossible task, albeit one very much of their own making. A recession is unavoidable if the Fed attempts to bring inflation down to anywhere near 2% through tightening. This is a negative for stocks and bonds generally, but a stagflationary period, or a reversal by the Fed would be very positive for gold. We are increasingly cautious of global equities, particularly in developed markets, looking for value in smaller markets as well as shorter-term trading opportunities where stocks, individually or collectively, become very oversold. We will hold our gold positions, both as assets that can perform well while the broad market is languishing but also as assets that can give outsized returns in the right conditions.

Adrian Day, June 30th, 2022