Adrian Day
ADRIAN DAY ASSET MANAGEMENT

PORTFOLIO REVIEW

PO Box 9024106, San Juan, PR 00902-4106 • 410.224.2037 Third Quarter October 2022

The Great Reckoning is upon us. After more than a decade of easy money and excessively low interest rates, which boosted asset prices beyond reason and drove debt to excess levels, the time for reality is here. Stocks and other assets, across the board, continued their declines in the 3rd quarter, many aggravated by the strength in the dollar. It has also been a period of increased volatility in both economies and markets; what is written in the morning is out of date by the afternoon, making writing a quarterly report more difficult, but all the more necessary.

Nearly everything was down this past quarter

This quarter and year to date, pretty much every asset is down; even short-term U.S. notes (three- to five-years) are down almost 9%. Bright spots were few and far between and quite disparate: U.S. dollar cash; Brazilian, Turkish, and Indonesian equities; natural gas; and a handful of agricultural commodities are about the only assets in positive territory. Stocks added to their first-half losses during the quarter, with the S&P ending down almost 25% and world markets outside the U.S. down over 28%. Almost all markets were down, most firmly by double digits. Most of Europe and much of Asia is down over 30% year to date. All numbers above are in U.S. dollar terms.

This is reflected in the performance of global equity funds, down virtually 28% for the year. Our global accounts also added to early losses, with our mid-risk growth accounts down 20.7%, while our conservative accounts have dropped 17.2%.* (Performance numbers for our accounts are preliminary, while mutual fund index numbers are as of 27th.)

So our global accounts lost meaningfully less than the global markets and funds, though they still fell significantly. Although our gold exposure was a drag on performance, our higher cash levels helped, as did our country selection. In Europe, for example, we held stocks only in the U.K. and Switzerland, which, though both down, were the top two performers among major European markets. Similarly in Asia, where we held stocks in Singapore and Hong Kong, both among less-bad performers and the former the top performer after only Indonesia.

Looking ahead, we expect rebounds in gold, U.K. and Hong Kong equities which should benefit accounts.

Which commodities to measure?

As always, it is difficult to measure resources. There is no resource fund index, while the commodity indexes all have different component weightings, and include agricultural commodities. The Bloomberg Commodity Index is up 11% for the year, with gas (up over 80%) and some agricultural commodities (wheat, corn, soybeans) the top performers. Among the metals, only nickel remains up for the year. Our resource accounts are down 27% for the year; we do not trade commodities and have been underweight oil and gas (though it should also be noted that the performance of oil and gas equities is far lower than that of the commodities themselves).

We have been reluctant to chase oil and gas stocks, but, looking ahead, if we see a short-term decline in prices, then we shall be looking to add exposure to that sector.

■ Gold stocks down sharply, but turn ahead?

Gold is down just over 9% for the year, less than the gain in the dollar, up over 17%. As the dollar has pulled back in the last week, so too has gold moved up. Gold stocks, per the XAU index, fell 16% during the quarter, down 22% for the year to date. Gold funds did worse, down over 19% for the quarter and over 29% for the year to date, even after a strong, 11%, rally in the last week.

Again, we lost less, down 10% for the quarter and nearly 24% for the year. Stock selection accounts for the difference in performance, though we had no particular outstanding winner; such were very few and far between indeed. Among the 30 stocks in the XAU, we held none of the worst seven performers, and half of the top 10. Generally, the royalty companies, where we are overweight, held up better than the miners.

Looking ahead, we expect a strong rebound in the gold equity sector generally, while the royalty companies, less exposed to inflationary pressures, should continue to do better than miners, especially those with new projects.

Overall, it was a bad quarter following a bad first half. We will not say that the bottom for assets is in, though we do see gold and gold stocks strong for the balance of the year and next, while there are trading opportunities in the broad market.

■ Central Bank actions are key again

The markets continue to be driven by central bank actions. The Federal Reserve and European Central Bank, along with other central banks, raise rates and talk tough, although their actions are still considerably lagging what is needed. The dilemma is that banks are not being sufficiently aggressive to kill inflation, but moving too rapidly for economies to withstand. The central issue is that banks were far too easy for far too long, and there is no way to kill the inflation they fostered and allowed to reach such lofty levels without causing a serious recession, aggravated by over-indebtedness and a strong dollar, again both of which their policies encouraged. Already, with the rate of change in rates unprecedented, many respectable voices are warning that the Fed is moving too far, too fast.

The central cause of higher consumer prices is the creation of excess money, but many central bankers refuse to see the connection. Fed chairman Jerome Powell, in fact, last month said that the money supply "does not play an important role in our discussions" (on monetary policy), an astonishing statement. If one does not understand the cause of a problem—particularly if one is responsible—then it is all the more difficult to solve that problem. We know that both Powell and Treasury Secretary Janet Yellen have consistently been wrong, and grossly so, on inflation (despite Yellen's claim she has "spent many years studying" it).

■ Where is the QT?

Although the Fed and other central banks have increased interest rates, there has yet to be any meaningful Quantitative Tightening (QT). In many ways, this is the more important policy both in creating the excesses and now in attempting to regain sanity. The Fed has failed miserably to come close to even its own QT plans (which, as we discussed in the last Review, are inadequate).

It said it would reduce its balance sheet by $42.5 billion for the three months beginning in June, and then, starting in September, by $95 billion a month, which would involve actual selling and not only roll offs of maturing bonds. In those first three months, it managed barely one-third of its own target; for the first three weeks of September, it has managed just $13 billion. It beggars belief that they reached $95 billion by month end. The amazing thing is that hardly anyone is discussing this; Powell never gets asked about it after blithely reconfirming the plan earlier this month.

The truth is that the Fed will simply not be able to withdraw over $1 trillion of liquidity from the economy over the next year without seriously affecting the economy. It may be that there is no intention of so doing. Recall, Powell doubled the level of Fed reserves relative to GDP from what was already their highest level ever. Now, he says that the Fed won't return reserves to their previous levels because "the current system (of ample reserves) works well". *This* is working well?

And Powell still thinks he can engineer a soft landing. At the Cato Monetary Conference in early September, he noted that, although "recessions chronologically followed the conclusion of a tightening cycle…the recessions were not apparently due to excessive tightening of monetary policy." Does he really believe that?

■ The Old Lady provides a foretaste

And just last week, across the pond, we had perhaps a foretaste of what is to come when the Bank of England postponed its plans for selling bonds to commence QT and immediately started buying again "in response to market conditions". The trigger was several U.K. pension funds indicating they were insolvent as rates rose. Because of the ultra-low levels of interest rates, these pension funds had been buying U.K. gilts (bonds) on margin in a misguided attempt to juice returns so they could meet their liabilities. Who thought buying bonds on margin at their highest prices ever could possibly be a good idea? I guess it was alright because everyone was doing it. In that memorable phrase of Warren Buffet's, "when the tide goes out, we'll see who's been swimming naked". Well, U.K. pension funds were, but they won't be the last ones exposed.

In an effort to justify reinstituting QE before it had even started QT, the Bank of England asserted: "These purchases will be strictly time limited. They are intended to tackle a specific problem in the long-dated government bond market...The purchases will be unwound in a smooth and orderly fashion once risks to market functioning are judged to have subsided." *Right!*

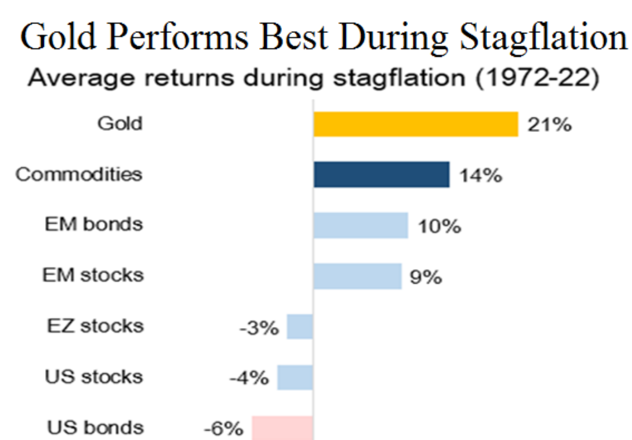
I suspect that in coming months we shall see more banks around the world reinstitute bond and asset purchases for one emergency excuse or another. Europe's self-made energy crisis, anyone? A likely scenario over the next year or more will be for the Fed and other major banks to keep interest rates higher while at the same time stealthily continuing to inject more liquidity into the economy all as governments continue to spend. This would be an unprecedented situation, essentially a little science experiment on the economy, whose outcome is unknown. What we do know is that it will not end well.

■ Powell vs. Volcker

Powell likes to talk tough and relishes his newfound hawkish reputation. He likes to summon the ghost of Paul Volker who vanquished inflation in the early 1980s. Although I have long written and spoken that I did not expect the Fed to pivot rapidly—one of my well-informed and astute friends a year ago said he expected this to be "the shortest tightening period ever"—nonetheless, I do not expect Powell to accomplish the task of squashing inflation. There are several differences between today and 1979 which suggest the task is now more difficult.

- In 1979, the debt-to-GDP was at a reasonable 32% while today it stands at 124%, meaning interest rate hikes have a dramatically greater impact on the economy.
- In 1979, while inflation stood at 8.5%, interest rates were already higher, at 10%. Today, rates are 3%, only just a little more than one third the prevailing rate of inflation. This makes the task today so much greater.
- Subjectively, I do not see Powell as having the fortitude of cigar-chomping, growly Volcker. Powell is very concerned about his legacy, by all reports, and while he does not want to go down as another Arthur Burns who allowed inflation to fester, nor too, I suspect, will he want his legacy to be of the man who caused the second Great Depression.
- Equally, Volcker was supported in his efforts by President Regan, in the full knowledge that they would cause a recession. Once unemployment starts moving up and businesses go bankrupt, will Biden have the courage to tell Powell to keep on going?

One thing is as certain as anything, and that is that inflation cannot be squashed by monetary means without provoking a serious recession. There is no evidence at all that this administration will help out by fiscal policy (i.e., cutting government spending). Indeed, this government seems to think that the way to fight inflation is to spend more. I suspect that there will be a meaningful change in direction at the Fed before too long. It may not be a pivot, as we saw in previous hiking cycles in 2001, 2006 and 2018, but a quiet re-introduction of QE even as interest rates stay high and while the administration continues its massive spending programs.



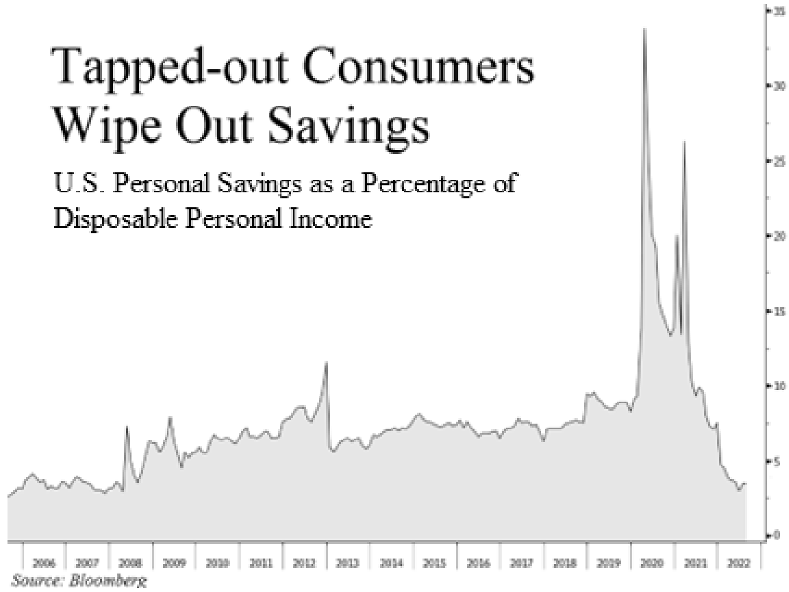
Note: Chart compares real average yearly returns on selected asset classes during past stagflation regimes since 1972. Source: Numera Analytics.

This would be a recipe for stagflation (or worse), and in such an environment, typically, gold, gold stocks, commodities, and smaller equity markets perform well, while major market stocks and bonds perform poorly.

■ Economy weakening, despite mixed signals

For now, there are mixed signals on the economy, even as the preponderance of reports show a deteriorating economy. Significantly, the Leading Economic Indicators Index has been warning of a recession for several months, and that is one indicator that is right more often than not. Already, there have been two back-to-back quarters of negative GDP activity, and we may see a third, but there is still some resilience in certain parts of the economy. In particular, the Fed and government like to point to the low unemployment number as evidence of a strong economy. While the unemployment rate is low, so too is the labor participation rate, which reduces the unemployment rate. There is a wide divergence between business surveys and consumer surveys, indicating that, though employed, many are not employed in a job they want (part time, temporary or underpaying).

And most importantly of all, the unemployment rate is always at its trough immediately at the onset of a recession. This is true for every recession since World War II, so we should be wary of touting a low unemployment rate as evidence of a strong economy. That's looking backward.



Instead of looking at reports on what has happened, the Fed could stick a few of its 400 economics PhDs sitting at desks in the Eccles Building onto company conference calls where they would hear CEO after CEO (from 3M and Ford to Facebook and Amazon) talking about hiring freezes or plans to cut their workforces.

The consumer is tapped out. In a few short months, he has completely depleted savings to levels not seen since before the 2008 credit crisis, while also running up credit card debt to record levels, this on top of a surge in the use of buy-now, pay-later services. The result is clear: consumer spending will necessarily start to decline.

■ Foreign banks raising rates, but many wobble

Most foreign central banks are also raising rates (and talking tough), but the major ones continue to lag the Fed, so the interest rate differential continues to favor the U.S. dollar, a primary reason the dollar has been so strong. Global finance ministers are finally beginning to step up to halt the relentless rise in the dollar which, for the most part, is playing havoc with their economies, especially emerging economies. My sources suggest that many finance ministers have made pleas to the White House and Fed to halt the dollar's rise, some even suggesting another global conference and intervention agreement, similar to the Plaza Accord of the mid-1980s.

Being rebuffed, some countries are now taking action, with China reportedly intervening in the currency markets, and Japan, not only intervening, but threatening to offload its treasuries to dampen the dollar. Now comes a report that China, in the face of the largest decline in the yuan since 1994, has instructed state-owned banks to prepare to dump their dollar holdings.

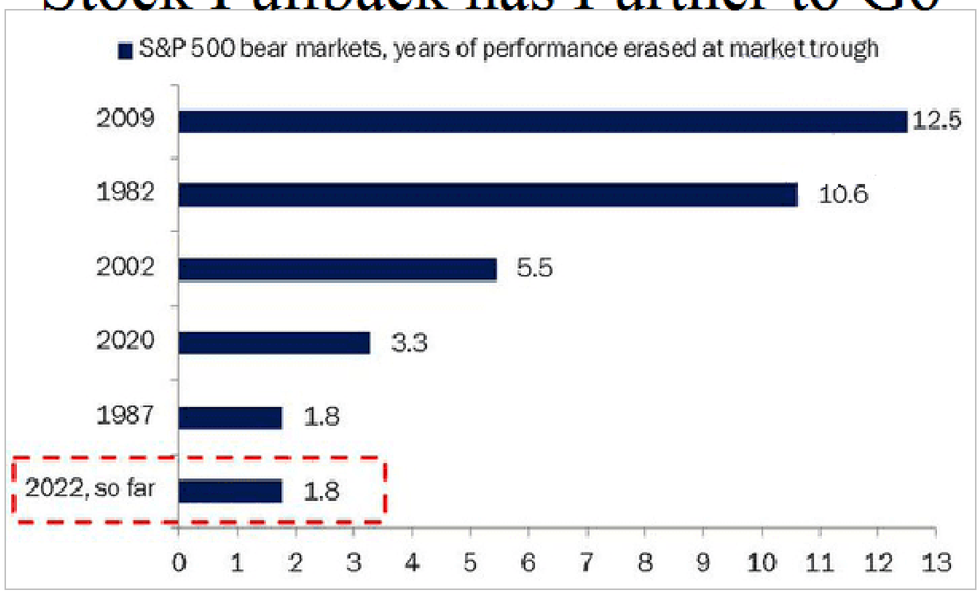
Moreover, the sentiment is now so overwhelmingly lopsided—and the negative impact on global economies so strong—that I suspect we may have seen the top in the dollar, and the decline could be quite rapid as positions are unwound. A weaker dollar generally favors not only gold and commodities but also smaller market equities, feeding into the stagflation outlook.

■ Global stocks are in bear market

Most global equity markets saw their third consecutive quarter of negative returns. Most saw meaningful rallies in the summer, peaking in mid-August, but markets have since turned down to make new cycle lows. All major indices are now below their 200-day moving averages. Institutional investors have been offloading stocks at an increasing pace, while retail investors remain the biggest buyers, though in select sectors. Even there, sentiment is at extremes—some indicators show only four or five percent of investors are bullish—and this suggests a fairly violent, if short, rally could be in the offing.

However, it is important that we realize that this is a bear market, and so long as the Fed (and other central banks) continue, however tentatively, to tighten, it will continue to be so. Although sentiment is undeniably bearish, investors are still holding the majority of their portfolios in equities, suggesting there is a lot more potential selling remaining.

Stock Pullback has Further to Go



Source: @WolfvRotberg , The Daily Shot Brief

Bear markets are rarely one-decline events, but rather a series of waves, with each trough lower than the last. So far, stocks have retraced only a fraction of what previous bear markets gave back. And 1987 and 2020 were not really bear markets, but rather short, if sharp, drops. If this is a bear market—as I believe it is—then there is much more to come on the downside.

■ Valuations high amid analyst optimism

Valuations remain high; even at today's S&P low, the p/e multiple is nearly 18 times. Though valuations metrics have declined over the past year, it should be emphasized that they remain well above longer term averages. The price-to-sales metric, for example, at a current 2.08, has averaged just a little over 1.5 times over the past 30 years.

Remember, when one buys a stock at a high valuation, the expected returns are lower than buying at a low valuation. If history is a guide, buying the S&P at today's valuations implies a negative return over the next 12 years.

The analyst consensus remains for higher S&P earnings over the next year, an over 10% increase. Third quarter earnings could see some negative surprises, given higher inflation and a global economic slowdown, both of which were more pronounced in the last quarter just ended than in the second quarter. This will affect earnings in the quarter just finished but equally company outlooks. So the potential for lower prices, both on earnings disappointments and on multiple contraction, is real.

In this environment, rallies should be sold, and any buying very selective, in terms both of sectors and individual stocks, as well as price. Meanwhile, as negative sentiment has led to hedging and outright buying of puts as speculation, premiums are high and selling of puts can see attractive returns.

■ Resource markets are fooling investors

Resources gave back most of their earlier gains, with most individual resources falling into negative territory for the year. Other than some agricultural commodities, it was only the energy complex that remains positive for the year. (Nickel is also up, less than 2%, but all other metals are negative.)

Investors have fled resources given concerns about the global economy. But the more important cycle for commodity markets is not the economic cycle but the commodity capital spending cycle. Given that most resource projects have large capex and last for many years, the supply picture today is framed by decisions made over the preceding several years. And for many years, really since the peak in 2011, there has been underinvestment in most resources, in bringing new projects onstream as well as exploring for new deposits.

As projects that came onstream in 2010 and 2011 in many cases start to deplete without being replaced, then we are facing undersupply in many resources for years to come. This is a situation that cannot be changed quickly; it takes many years to bring a new project into production even after the deposit has been found. Thus, commodity cycles do not overlap economic cycles, and it is quite possible for commodities to be strong during economic downturns. This was true most notably in the 1930s, when not only gold, but base metals and oil stocks did very well.

■ Bullish on oil and gas, but not quite yet

We are bullish on oil and gas on a multi-year basis, but cautious in the near term. There is price risk if the war in Ukraine were to end and sanctions lifted. Certainly, Europe would like to see Russian oil and gas flowing again, even if some other sanctions remained. That could see a sharp drop in prices in the immediate term which would be our cue to buy. Although the prices of the oil and gas stocks have not kept up with the commodity prices, they too would fall back if the war were to end, if only as a knee-jerk reaction.

Fundamentally, we are bullish on oil and gas. The price move this year has not translated into an exploration boom, with most of the higher rig count (higher compared with last year, but below pre-covid levels) in DUC (drilled but uncompleted wells) and in proven regions (brownfields). The world has reduced the supply of fossil fuels in its pursuit of the green energy fantasy, and policies reduced the incentive of companies to invest in future supply, long before it has cut demand. Capital investment by the global majors is 30% below what it was in 2019, despite higher prices, and this is a direct result of the aggressive ESG policies pushed by major banks and investment companies as well as the hostile attitude of governments.

As for OPEC, most Arab producers have little spare capacity. The Saudis themselves have said they have little room to increase production in the near term, as have the UAE. Global inventories are at their lowest level in 15 years.

Oil stocks are trading at a large discount to the rest of the market; oil companies account for 12% of the S&P's earnings but only 4% of its price. Insiders are buying in the market as aggressively as ever, certainly for the past 20 years. At the right time, we will be aggressive buyers.

We remain very bullish on copper, given the inability of supply to meet expected increases in demand over the next three to five years. With the copper price down over 20% this year amid concerns about the global economy and particularly China—and the copper stocks down even more—this is a good time to be buying.

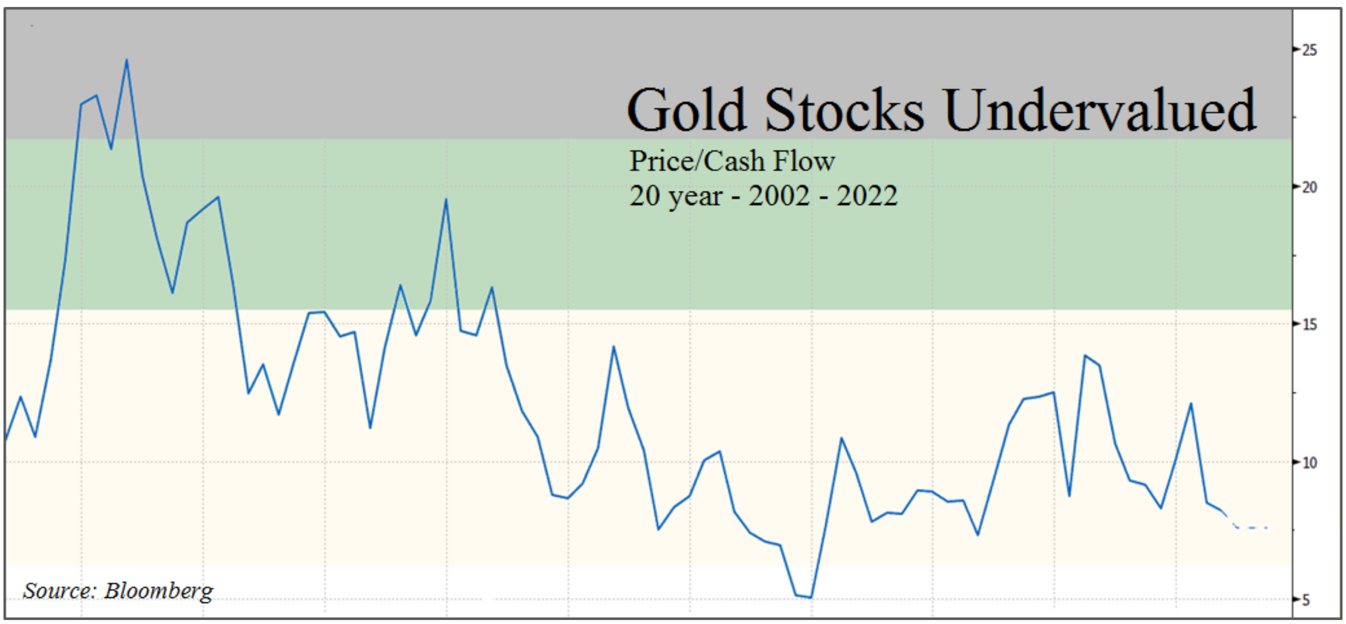
■ Gold: The turn is near

The gold price has held up reasonably well in the face of the strong dollar, even though its performance has disappointed many who think only that inflation means higher gold prices. The macro conditions are developing into a very strong scenario for gold, but it is not (only) inflation.

We have commented before that gold prices will move up either when the dollar drops, or when investors begin to realize that the Federal Reserve cannot tame inflation without causing a major recession, and that, therefore, it will pause before that. As for the dollar, we saw the strong move in the miners last week when the dollar retreated just a little from its peak.

As for the other, for now, investors are buying the Fed's narrative, with investor expectations for 2.6% inflation next year (and 2% longer term), almost identical with the Fed's own forecasts. When this no longer seems achievable, gold will turn.

Despite a gold price that is high on an historical basis, despite a strong outlook, despite high margins, the gold stocks are selling at the low end of their historical valuation levels. The major gold and silver



companies (per XAU index) are trading at close to their price-to-cash flow levels in the past 20 years, for example, only worse in 2015, when gold traded down to $1,057; it is now 60% higher!

We know that moves in gold and particularly gold stocks can be explosive, particularly off bottoms, and all the more so now, with gold stocks close to historical low valuations amid extreme under-weighting for most investors. Indeed, most institutional and retail investors have zero exposure, so the potential for a dramatic turn in prices is very real as investors decide that a little insurance might not be a bad thing. There are many indicators of extreme levels, including the ratio of gold stocks to bullion; of juniors to seniors; and of silver relative to gold, all at long-term extremes.

Overall, we are continuing our cautious approach, particularly to equities in major global markets, where we are very underweight. We have exposure to high dividend-paying U.S. stocks and also to gold equities, which, as we have mentioned before, have the ability to move contrary to the broad market and also to have outsized moves. We expect this position to start to pay off in the next few months. Meanwhile, we will on balance continue to raise cash, while always on the lookout for short-term trading opportunities.

Review of Individual Accounts

■ Global Accounts

As expected, cash in global accounts increased during the quarter. We entered the quarter with very low cash levels, just 1% in mid-risk accounts, after buying in anticipation of market rallies, and increased cash modestly throughout the quarter. Mid-risk accounts ended the quarter with 5% cash, while more conservative accounts hold over 12%. We expect to build up additional cash before year end.

Allocations among various sectors remained reasonably stable, with major global markets at 7% and U.S. income at 10%, holding steady as we added on price pullbacks. In fact, during the quarter, we not only increased exposure to existing companies, but added two new Business Development Companies, both conservative senior, secured lenders with yields over 9%. One of these we had sold earlier at higher prices.

We also added one new company, a Canadian holding company, a value-oriented company with an attractive yield. We did not exit any stocks during the quarter, though reduced positions in some.

Looking ahead, we expect to raise cash further before year end, though also to be alert to trading opportunities. In particular, as mentioned above, the sale of puts can yield attractive premiums in the current environment. We expect our high allocation to gold to pay off in coming quarters.

■ Gold Accounts

Gold accounts ended the quarter as they began, essentially fully invested. Our allocation to senior companies—miners and royalty companies—increased a little to 30%, while exploration remained at 29%. Intermediate companies as well as silver and other resources make up the balance.

Although we exited two companies this past quarter, one a major miner with jurisdictional problems, the other an intermediate company that was acquired, proceeds from these sales went back mostly to add to existing positions in senior companies. When gold turns, these will be the first to move as well as the more certain to move.

Throughout the quarter, we continued to trim certain positions for various clients, mostly to raise cash to buy other stocks, upgrading the portfolio and, where relevant, generating tax losses.

Looking ahead, we expect to remain fully invested. We expect gold to turn soon, as discussed above, and since moves off bottoms can be quite strong, this may result in some selling. However, with an anticipated tax-loss selling season that could be rough, that also may present some buying opportunities later in the month. In all, we are holding both seniors and juniors, upgrading the portfolios where appropriate, and ready for the move in gold that is not far off.

■ Resource Accounts

Resource accounts also remain fully invested; gold, at 34%, remains the largest single allocation, followed, as before, by silver and then copper. Many of the large companies we hold have exposure to multiple resources; Franco-Nevada for example, has almost 20% of its revenue from oil and gas.

We exited no companies completely, though have reduced positions in order to add to others. We bought one new energy company, in the oil service sector.

One of our companies has agreed to sell all of its assets, with the proceeds to be distributed in three tranches in coming months.

Looking ahead, we expect to remain fully invested, looking for opportunities to add to oil and gas exposure. We are also adding to copper stocks after the recent pullback. Although we may trim gold stocks if we see the rallies we are anticipating, nonetheless we expect gold to remain our largest single allocation.

In sum, we are not sanguine for the global economy nor for the ability of the Federal Reserve and other central banks to tame inflation without provoking a serious recession. Already, we are seeing various sectors in trouble from higher interest rates, and as the process continues, we expect more things to break. We thus remain cautious of major global equity markets, though as the dollar starts to decline from its 20-year highs, we will be looking among the smaller markets that typically do well in stagflationary periods. We will also be alert to trading opportunities, since bear markets are never without periodic rallies. Lastly, we continue to have a high exposure to gold which can move contrary to the broad market as well as experience strong moves. We expect our gold holdings to pay off in coming quarters.

Adrian Day, October 1st, 2022
Adrian Day Asset Management