Adrian Day
ADRIAN DAY ASSET MANAGEMENT

PORTFOLIO REVIEW

PO Box 9024106, San Juan, PR 00902-4106 • 410.224.2037 Second Quarter July 2023

The end is nigh. The end of the Federal Reserve's rate hiking cycle, that is. But it is not here yet. We can still expect additional rate hikes, at least this year, which will have their impact on the markets. Meanwhile, the "long and variable lags" in monetary policy mean that the full impact on the economy of the most aggressive rate of interest rate hikes ever has yet to be felt. The economy here is moving inexorably towards recession, as it is in Europe, the U.K. and elsewhere. Though the end is not here yet, it is likely that the Fed will halt its rate hiking before inflation hits its magic 2% target as the economy enters recession. The result is stagflation, an environment when we can expect gold, other commodities, and emerging market equities to perform well, while developed market stocks and bonds do badly. We are positioned for that eventuality.

■ Most assets gave back some earlier gains

In the quarter just ending, most markets and assets gave back much of their first-quarter gains, though still remained up for the year to date. There were exceptions. U.S. stocks appreciated meaningfully this quarter, while commodities remain down for the year.

U.S. stocks were up handsomely in the quarter with the S&P rising over 8%, the tech-heavy Nasdaq over 13%. Outside the U.S., however equities were more subdued, up less than 1% (per MSCI "World ex-U.S." index, up 0.69%). For the quarter, the U.K., Hong Kong, China, Australia and Mexico were all down, while the Nasdaq and Mexico rose by double digits. For the year, all markets are up, except China and Hong Kong. The U.S. rally has been a very narrow rally, with five leaders accounting for 80% of the S&P's gains, all of them tech stocks, before a slight broadening last week. Companies involved in AI led the moves. When tech leads the market, the U.S. tends to outperform.

Though still up for the year to date, our global accounts had a weak quarter, down between just over 1% for conservative accounts to over 4% for mid-risk accounts.* (Numbers are preliminary.) The difference in performance can be explained by three main factors: we are underweight the U.S. stock market; we do not have exposure to tech or AI; we have a high weighting to gold and resource equities. The more conservative accounts tend to have fewer resource stocks, hence the better performance.

■ Gold leads a weak resource sector

Resources have had a weak quarter. For the quarter, only U.S. natural gas was positive, recovering some of its dramatic earlier plunge, while for the year, only gasoline and gold were up (the latter by just over 5%). Oil is down around 12% for the year. Gold stocks (per the XAU) fell over 8% in the quarter, though remain barely positive (0.28%) for the year. The average gold fund fell 8.7% for the quarter, while remaining up just over 1% for the year to date.

Though negative for the quarter, our gold and resource funds outperformed the relevant benchmarks. Our gold accounts fell just over 6% during the quarter (that's 42% better than the average gold fund)

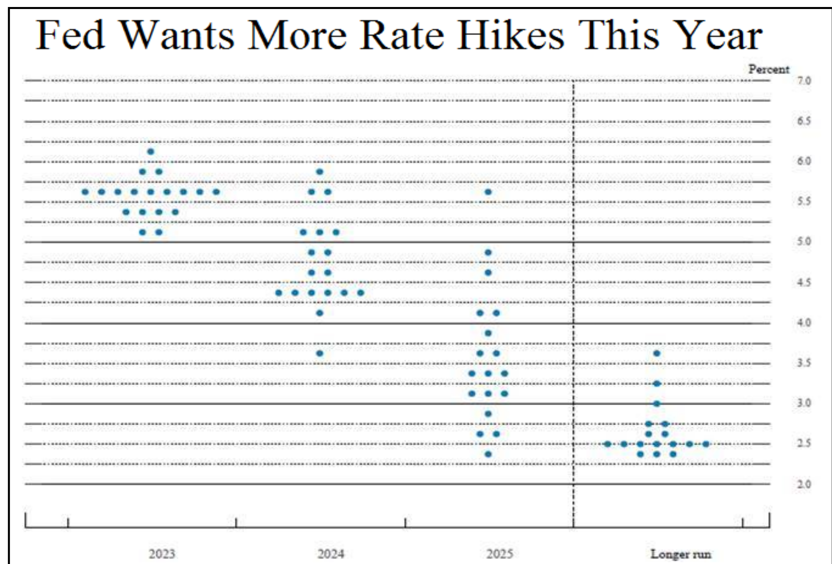
while the resource accounts are down 6.4%.* For the year, however, resource accounts are up just over 2% while gold accounts are up 3.8%, well outperforming.

The relative returns can be explained by an underweight position in oil and an overweight position in copper in the resource accounts. As for the gold accounts, the difference is largely attributable to individual stock selection, with a couple of major royalty companies (in which we have high weightings) essentially flat for the quarter, while many of our junior stocks held up in the period. Being flat this past quarter is outperforming.

Looking ahead, as we discuss below, we believe there is risk in the U.S. and major equity markets, particularly the high-flying tech stocks, while the environment we see ahead will favor smaller overseas markets, value stocks, and resources, particularly gold. We are early but we are positioned for that environment.

■ The Fed is not finished yet

As everyone knows, the Federal Reserve decided not to raise rates at its meeting earlier this month, while also indicating strongly that further hikes lay ahead. The markets seemed to react as though the Fed decision was *the* pause with many analysts concluding that there would be rate cuts before the end of the year.



I do not agree. The Fed statement was very clear, and the Fed "dot plot", showing the individual assessments of Fed members as to where rates should end the year, was also hawkish, showing a median of 0.6 basis point hikes this year, with no member showing a cut. Fed chairman Jerome Powell laid out why the Fed had decided to skip hiking in June, saying that what the Fed had already done over the last year was aggressive while the full impact had yet to be seen. He also noted that credit conditions were tightening. This all makes sense.

As for more hikes, he reiterated that controlling inflation remains the Fed's top priority. He noted that "core PCE", the Fed's favorite measure of inflation, had not declined as rapidly as they had expected,

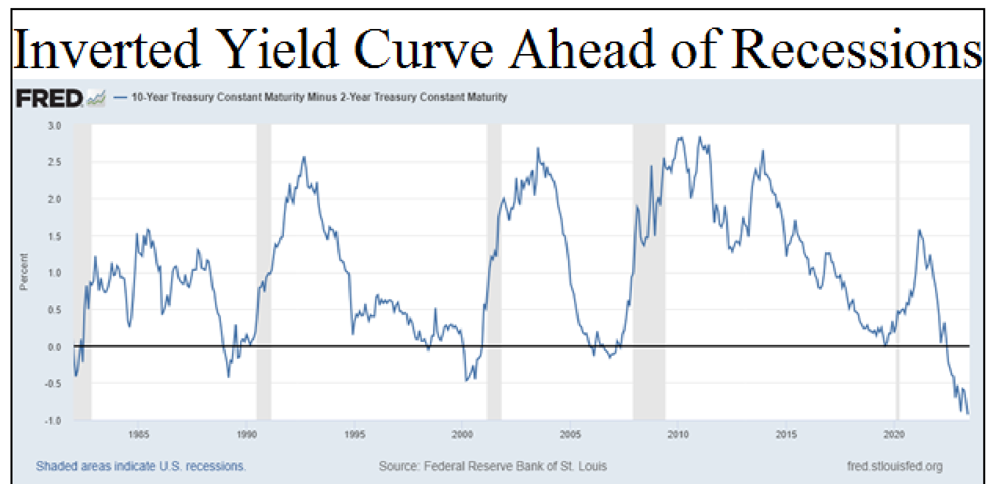
* Please note: **Past performance is no guarantee of future results.** For complete information on our past performance, including factors to be considered in viewing past performance and other disclosures, please contact our office. Specific stocks mentioned herein are intended solely as illustrative 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.

and remained stubbornly high. After the Fed meeting, there was a modest decline, but it is still up 4.6% year-on-year, well over twice the Fed's arbitrary 2% target. Core CPI is plateauing over 5%. Powell said "there is a long way to go."

I am far from an apologist for the Fed or its chairman, but it seems to me that, based on inflation numbers and based on Fed forecasts, we can expect one or two additional 0.25 basis point increases in coming months. There is no more determined teetotaler than a reformed drunk, and Powell is determined to burnish his inflation-fighting credentials. The markets have recently swung towards strongly expecting another hike at the next meeting in July (87% after last week's inflation data, according to the CME). What we can say, perhaps, is that we are at the beginning of the end.

■ Recession draws closer

On a 5% rate, another 50 bps is not a lot, though every incremental increase brings more households or businesses to the brink, while keeping rates higher for longer does the same. The economy is already sliding towards a recession. All important indicators, including the Leading Economic Index and the inverted yield curve, are forecasting a recession. Every time the yield curve has inverted, a recession has followed, and today the curve is more inverted than at any time since at least the early 1960s. The yield curve has a very strong predictive value, but also works with a long lag.



Important economic indicators, including jobs and retail sales, are also turning. The "household survey" is showing a decline in the rate of jobs growth for the third month in a row, and indeed, an absolute decline in the latest monthly report, contrary to the "establishment report." They can't both be correct. In addition, initial claims for unemployment has been moving up dramatically, from a little over 180,000 a year ago, to 260,000 earlier this month before a decline in the latest weekly report. (That decline could be due to the "June-teenth" public holiday.)

As we have discussed before, retail sales growth is not keeping up with price increases, while credit card debt, and defaults, are increasing. Though some headline economic reports remain positive, lift the hood and everything is pointing to a slowing economy. The strong likelihood is that the economy will be indisputably *in* a recession before we see a 2% inflation rate, while the Fed will pause, if not cut rates, again before their target has been achieved. This scenario suggests a stagflationary environment, with at best a sluggish economy and persistent inflation.

■ Who will buy all the Treasuries?

For now, however, there are more rate hikes ahead and a massive issuance of Treasuries—some estimates are as much as $2 trillion before the end of the year—as the Treasury plays catch-up from the lack of issuance before the debt ceiling was raised. This means a withdrawal of liquidity from the

system, and just as the extra liquidity helped markets in the first half, it will weigh on them in the second half. At minimum, we can say that the markets are not pricing in further rate hikes.

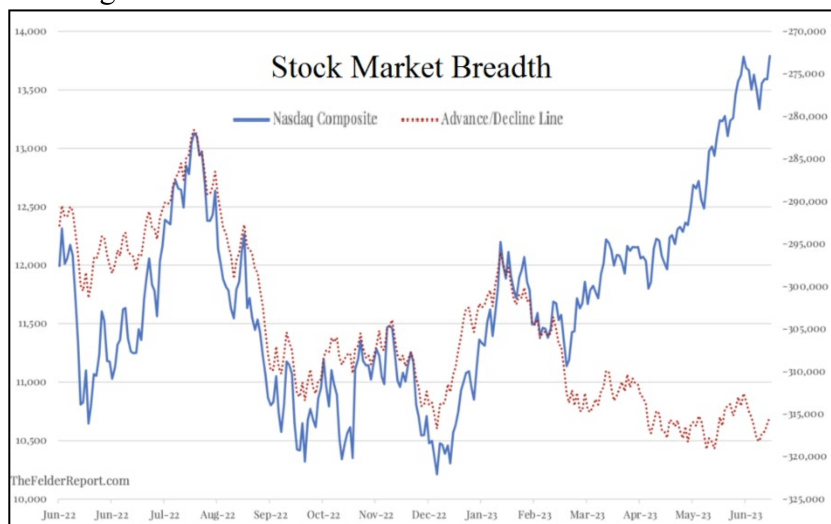
It should also be noted that market rates may move up given the large Treasury issuance ahead when the traditional largest buyers—China, Japan, the Federal Reserve and U.S. banks—are not going to be in the market as before. This large issuance comes at a time when the Federal Reserve is planning to reduce its Treasury holdings by $60 billion a month; not all of that will come from expiring maturities. There will be buyers, of course, including pension funds and insurance companies, but without the participation of the erstwhile largest buyers, rates may have to be higher to clear.

■ Major global economies in similar situation

Overseas, many central banks, including in Europe, the U.K., Canada and Australia are playing catch-up, continuing to hike rates even as the Fed temporarily pauses. Most of these countries, particularly in the EU and UK, are also moving into recession, while inflation remains high. Though the rate of change in interest rates is now against the dollar, in absolute terms, U.S. dollar yields are high, far higher than they have been for a decade. The fact that the dollar, while volatile, is down this year, and particularly since March, is telling. As global rates move up ahead of U.S. rates, we expect this trend to accelerate, driven by the long-term move away from the dollar as the major global trade currency and leading central bank reserve currency. These trends have been in place for some time, of course, but are slowly coming to a head. As economist Rudiger Dornbusch put it, "in economics, things take longer to happen than you think they will, and then they happen faster than you thought they could."

■ Bullish stock sentiment despite high valuations

A stagflationary environment along with a weaker dollar is not a positive environment for major global stock markets. In the U.S., sentiment remains positive, with equity ETFs seeing massive inflows, $40 billion in the latest weekly number, the sixth largest weekly inflow on record. At the same time, mutual funds saw net outflows, of $7 billion, so not only is money flowing into the market, but it is shifting into passive vehicles. A pause in the Fed rate hiking as well as moderation in inflation numbers seem to be the catalysts for the latest increase.



Barron's recent cover story was "The Next Bull Market is Here. Don't Miss Out", while a week after that the headline was "No reason to stop pushing higher". *Barron's* may not have the inverse predictive power of *Business Week* or *The Economist,* but nonetheless for a contrarian it should elicit caution.

This extreme bullishness comes at a time when the market is very overvalued, with the S&P trading at a price/multiple over 20 times, which is 30% above the historical average, and yielding only 1.5%. Consensus analyst estimates are for the S&P earnings to decline by less than 1.5% over the next 12 months, which, with persistent inflation (hurting cost inputs) and slowing retail sales, is optimistic. Nasdaq, as one would expect, is even more expensive.

The market is very concentrated

The market remains highly concentrated, with 10 stocks accounting for over 30% of S&P, and even fewer accounting for most of its gains this year. As the market soared higher in the last four months, the advance decline line (the number of stocks moving up versus the number moving down) has moved steadily lower. This is not healthy.

The Federal Reserve withdrawing liquidity will hurt equity markets, though the stock market does not seem concerned about higher rates. On balance, we think there is very high risk in the U.S. market right now, and are buying only conservative high-yielding stocks and special situations. In addition, taking some positions on the short side, as a hedge on the longs, is warranted.

Risk outweighs reward in global markets

The same conclusion holds for most major stock markets. Japan and China have their own characteristics right now, but for Europe and many other major markets, the story is the same: high valuations amid persistent inflation and slowing economies. There are some markets with far better valuations, but in each case there is a risk that overrides all else: for Hong Kong, the whole China threat (increasing interference and relations with the U.S.); for the U.K. an increasingly shambolic Conservative government. So, again, we are buying very little in major global markets.

Better value is found generally in smaller markets, though of course one has to distinguish among them. But one can find countries with stronger balance sheets, economies with greater resilience, and markets that are far less expensive. Typically, these markets outperform when the dollar is weakening, inflation strong, and major economies weak, precisely the outlook we see. We are looking at various countries around the world, including Singapore and elsewhere in Asia, as well as Brazil and other beaten-down Latin markets. We are being methodical and discerning in this buying however, and in no rush.

Commodities weak all year, with gold the leader

Commodities have been weak this year, with the Bloomberg Commodity Index down over 10%, and even there most of the winners have been in untradable (for equity investors) commodities including sugar, soybean and gasoline. Gold, up over 5% so far this year, is the winner among the resources.

Oil has been very volatile, but trending lower, down 12% for the year. It did receive a fillip from the Saudi decision in early June to cut production unilaterally, but that was short lived. A slowing global economy is hurting demand, while some countries (including Russia) are pumping all they can. We have very little exposure to oil. However, we are more positive further out, as U.S. shale, the top source of non-OPEC growth in the last decade, is topping, including from the prolific Permian Basin. This goes beyond the lack of drilling.

Natural gas, particularly as a short-term investment, looks far more compelling, as the northern world moves into peak air-conditioning season. We did not see a heating-driven boost this winter, in Europe or North America, but the sector is now very cheap and the risk-reward favorable.

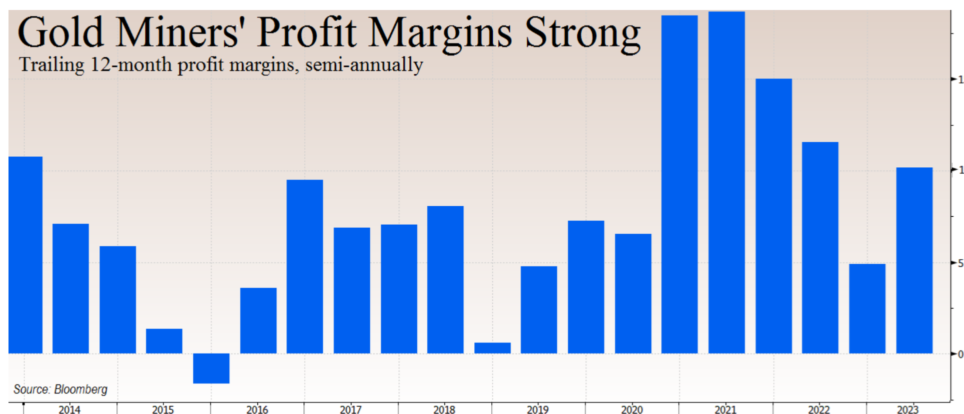
Gold: Near term negatives, longer term positive

Gold is facing cross currents. The continued global move up in interest rates is hurting, as is the Treasury's massive bill issuance program. On the other hand, a slowly weakening dollar is positive, as is the connected central bank buying of gold, with massive widespread buying in the fourth quarter of last year and first of this. However, in April there was net selling, led by Turkey and several of the Eurasian

states. Since central bank buying has been a powerful force supporting the price over the past year—gold ETFs have seen consistent outflows this year (totaling $31 trillion), with very heavy selling over the past month—then there is a risk that that source of buying dries up, if only temporarily. The near-term outlook is uncertain.

Longer term, central bank buying is likely to continue as there is an increasing amount of global trade conducted in currencies other than the U.S., including Saudi selling oil to China in renminbi. This is important, because it means that countries such as Saudi Arabia and Brazil are building renminbi reserves, from selling products to China, which, unlike dollars, they are not prepared to hold. So some of those reserves will go into gold. And central bank buying tends to be price insensitive.

In addition, the underlying monetary argument for gold is becoming increasingly strong as central banks, most notably the Fed, approach the end of their rate hiking as economies slow while inflation remains high. For the Fed to pause would be a very strong signal for gold.



While gold is up this year, silver is down; since the peak at the beginning of April, silver has doubled the loss of gold. Silver, of course, has different fundamental characteristics than gold, with more industrial demand and less primary supply, as well as an absence of large stockpiles. Though silver will likely lag at the beginning of the next leg up, it can catch up rapidly with greater moves than gold.

■ Gold stocks are well positioned, and undervalued

Despite a very bullish long-term outlook for the metals, the stocks remain very undervalued, despite being in far better shape than they have for a decade or more. Balance sheets are stronger, and margins are healthy. The stocks, however, are undervalued relative to gold; relative to their own history; relative to the broad market, and even in absolute terms. We continue to hold large positions in the better gold companies which, as we know, can move very rapidly when bullion appreciates.

Overall, we continue to be cautious on global equity markets, particularly the larger developed markets, and avoiding fixed income other than very short-term Treasuries for holding cash. We are holding some equities: solid global blue chips; high-yielding U.S. stocks; and special situations. We are also selling puts where appropriate and pocketing the premium. We continue to be overweight resources, particularly gold, which can move contrary to the broader market and stand to gain in the economic environment that we see coming.

Review of Individual Accounts

■ Global Accounts

We continue to be very cautious on global equities. If cash allocations have declined again, to now essentially fully invested 1.3% of accounts, it is partly because we have recently bought some short

positions on the market (both on the index and on individual companies), and partly because we have increased positions in some companies (mostly in the resource sector) with high short-term potential.

Similarly, if our allocations to major global markets and to U.S. income has stayed the same as it was, it is because we have seen appreciation in those areas as we have been selling down. We have raised more cash in conservative accounts, however, now at 15%.

Continuing to lighten exposure

We bought no new stocks this past quarter, but have continued to reduce global positions. In particular, this past quarter, we have continued to lighten our U.K. exposure, due to increasing concern about the shambolic Conservative government, as inflation remains stubbornly high, rates continue to rise (hurting homeowners who do not have the stability of 30-year fixed mortgages), and the economy slips into recession.

We are also selling down a couple of our Business Development Companies, ones with more risk in a weaker economy, as well as trim a little on rallies in this notably volatile sector.

Going forward, we expect to continue to sell global equities, and while we continue to search markets for good values, we see cash building over the balance of the year, certainly the next few months. Global accounts will continue to have a high allocation to gold stocks, both as a hedge and as stocks with high growth potential. This overall approach will, we believe, pay off as the U.S. economy moves into a stagflationary environment.

■ Gold Accounts

Gold accounts continue to be fully invested, with senior, exploration, and silver and other resource companies each about 30%, with intermediate gold making up the difference.

There have been no new buys in portfolios this last quarter. Among the seniors, we have been buying more of our favorite miners and large royalty companies on dips, and trimming a little from overweight positions as we need the cash.

Among the exploration stocks, however, we have sold a couple of laggards in order to raise money to add to some of our long-term favorites and higher-potential, shorter-term plays. This has been all at the margin however as we work to upgrade the portfolio.

We have good exposure to the senior stocks, miners and royalties, that will be the first to move when gold turns decisively up again. But we also have high exposure to the more speculative stocks that can generate outsized returns when the market rally is underway.

Looking forward, we expect to remain fully invested, again, trimming if any specific positions become overweight while adding to top long-term favorites as well as to those with shorter-term potential with excess cash. We are not anticipating any widespread selling, though a few of our holdings are potential M&A candidates that could lead to cash inflows into accounts. We would however expect to reinvest any cash in this environment.

■ Resource accounts

Resource accounts remain fully invested, and gold continues to be the dominant exposure, about around 35% of accounts. As before, recall that many gold companies have significant exposure to other

resources, including Barrick with about 25% exposure to copper and Franco Nevada with about 20% to oil and gas. While silver and copper remain our second and third largest exposures, we have been adding to the silver names in recent weeks as those stocks fell significantly.

Added to natural gas and uranium

We have also added meaningfully to natural gas companies ahead of the high-demand Northern air-conditioning season. Already these stocks are seeing good moves off the lows. We were early in buying at the end of last year, since the winter in Europe and North America proved relatively mild. Now, if we see strong summer rallies, we expect to be selling toward the end of this coming quarter. We also added to uranium early in the quarter, though have trimmed positions on the recent rally. We continue to be significantly underweight oil as well as base metals other than copper.

The only sale this quarter, other than a couple of gold laggards, per above, was one copper developer that had moved too far too fast. We reinvested into other copper companies, including a global major, and a royalty company.

Looking ahead, we expect to continue to be fully invested, though, as with gold, we hold stocks in some companies that could be acquisition targets and that therefore might add cash to accounts. In this notoriously volatile sector, any cash would likely be reinvested before too long. We anticipate that gold, silver, and copper will continue to be our highest weightings. The long-term outlook is positive while the stocks are generally undervalued.

In sum, we continue to be increasingly cautious of major global equity markets where the risk has risen along with valuations. Though we are looking for good opportunities in smaller markets, we have been buying little, awaiting better prices. We continue to be overweight gold, a sector that has historically performed well during the type of stagflationary environment we foresee, as well as one that can move contrary to the broader market. We expect cash to increase, particularly in the global markets.

Adrian Day, June 30th, 2023

Disclosure: Adrian Day Asset Management ("ADAM") is an SEC-registered investment adviser located in San Juan, Puerto Rico. ADAM and its representatives are in compliance with the current filing requirements imposed upon SEC-registered investment advisers by those states in which ADAM maintains clients. ADAM may only transact business in those states in which it is registered or qualifies for an exemption or exclusion from registration requirements. (Note: Global Strategic Management, our legal name, is registered, or qualified to accept clients from all states and territories, including the District of Columbia.) A direct communication by ADAM with a prospective client shall be conducted by a representative that is either registered or qualifies for an exemption or exclusion from registration in the state where the prospective client resides. For information pertaining to the registration status of ADAM, please contact the SEC or the state securities regulators for those states in which ADAM maintains a notice filing. A copy of ADAM's current written disclosure statement discussing ADAM's business operations, services, and fees is available from ADAM upon written request. (Note, all clients receive this document prior to opening and account and are offered it annually.) ADAM does not make any representations or warranties as to the accuracy, timeliness, suitability, completeness, or relevance of any information prepared by any unaffiliated third party and takes no responsibility therefor. All such information is provided solely for convenience purposes only and all users thereof should be guided accordingly. Past performance may not be indicative of future results. Therefore, there can be no assurance (and no current or prospective client should assume) that future performance of any specific investment or investment strategy (including the investments and/or investment strategies recommended or undertaken by ADAM) made reference to directly or indirectly by ADAM will (i) be suitable or profitable for a client or prospective client's investment portfolio or (ii) equal the corresponding indicated historical performance level(s). Different types of investments involve varying degrees of risk. Historical performance results for investment indices and/or categories generally do not reflect the deduction of transaction and/or custodial charges, the deduction of an investment management fee, or the impact of taxes. (Note, any performance number provided for Adrian Day Asset Management accounts is after the deduction of all transaction costs and fees.) The material contained herein is provided for informational purposes only and does not constitute an offer to buy or sell or a solicitation of an offer to buy or sell any option or any other security or other financial instruments. Certain content provided herein may contain a discussion of, and/or provide access to, ADAM's positions and/or recommendations as of a specific prior date. Due to various factors, including changing market conditions, such discussion may no longer be reflective of current position(s) and/or recommendation(s). Moreover, no client or prospective client should assume that any such discussion serves as the receipt of, or a substitute for, personalized advice from ADAM, or from any other investment professional. ADAM is neither an attorney nor an accountant, and no portion of the content provided herein should be interpreted as legal, accounting, or tax advice. Rankings and/or recognition by unaffiliated rating services and/or publications should not be construed by a client or prospective client as a guarantee that he/she will experience a certain level of results if ADAM is engaged, or continues to be engaged, to provide investment advisory services, nor should it be construed as a current or past endorsement of ADAM by any of its clients. Rankings published by magazines, and others, generally base their selections exclusively on information prepared and/or submitted by the recognized adviser.