Adrian Day
ADRIAN DAY ASSET MANAGEMENT

PORTFOLIO REVIEW

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The tide has turned. The Federal Reserve may not have used the word "pivot", but they made clear that there was a significant change in policy: the rate-hiking cycle has ended, and rate cuts are expected this coming year. Markets reacted as one might expect: gold and bonds turned upwards, the dollar turned down, while stocks continued up, with both U.S. and global stocks closing the year within spitting distance of all-time highs. For 2024, we expect gold to continue up and the dollar, less dramatically, to be down; bonds could reverse, however, later in the year; while we expect significant rotation in the stock market, with value stocks and foreign markets outperforming U.S. growth. As with the tide, there will be ebbs and flows in this general direction.

■ Global stocks recovery in last quarter

Global stock markets performed well in the past quarter, with global markets showing signs of catching up with the U.S. The S&P was up 11%, just under half its gain for the year, while global markets (per the MSCI World ex-U.S. Index) was up 9.4%, more than three-quarters of its annual gain. Most of the markets in the Americas as well as in Europe were up in the low double digits, with Asia mixed; China, Hong Kong and other markets fell, and several others were up only modestly.

Although all our account types were up for the quarter, we underperformed the indexes. This was largely because we were out of the high-growth tech stocks that led the market this past year. As we discuss below, this past year saw the widest divergence between the median stock in the S&P and the index itself since the dot-com mania of the last 1990s. Although it can be painful to miss out on those gains, we feel the risk is increasingly high and we do not intend to chase them now. With the indexes up, a high cash weighting was also a drag, but again reduced risk. As a bubble bursts, it is always better to be early than late.

■ Resources were mixed, with gold stocks finally up

Resources were decidedly mixed in the last quarter, with the Bloomberg Commodity Index down almost 6%. The biggest winners were some of the agricultural commodities, wheat and coffee. Among the resources, most energy fell, by over 20% for oil and 15% for natural gas, while the metals were mixed, with nickel down 11%, copper up just 3.5%, and gold and silver both up, by 11.6% and 7.3% respectively. The gold stocks, which entered the quarter on their annual low, exhibited dramatic leverage, with the XAU index up 17.5%.

Although our resource accounts outperformed the index, our gold accounts did not. In the resource accounts, our low exposure to oil and gas helped, as did the overweight to gold and silver. For the gold accounts, however, there were three main reasons for our relative underperformance. First, our overweighting to juniors and explorers, which usually lag at the beginning of a bull market, was a drag. Second, we were not in the companies with the highest returns in the quarter. Typically, at the onset of a new bull market, highly leveraged companies have the biggest moves. However, these are more-often-

than-not problematic companies, perhaps with high debt or high costs. Third, a series of disasters hit three of our largest positions: the firing of a popular CEO in July which took the stock down significantly; a merger unpopular with many shareholders; and a foreign government closing a mine which was the company's largest asset; it was (very unusually for it) the second-worst performer among the 30 stocks in the index.

Looking ahead, however, this will all reverse. The juniors usually catch up as the bull market progresses, and do so with a vengeance; the leverage companies run out of steam as their high leverage evaporates; and the three specific losers will all, I suspect, recover in coming months. The one company is now pursuing the strategy advocated by the former CEO, and the stock is already up sharply; the merged company is pursuing a capital allocation strategy which is bringing in new shareholders; and the closed mine will likely re-open next year, while the sell-off in the stock is grossly overdone. So while lagging the index has been painful, we are comfortable with our holdings and expect the coming year to be a strong one.

■ The Fed changed direction dramatically

The Federal Reserve's pivot is clear. In September, a majority of Fed members, in their famous "dot plot", were calling for another rate hike in 2023 and some were calling for more hikes in 2024, while the weighted average forecast for rates this coming year was 5.2%. The rate hike did not come, and by December no members were seeing a hike this coming year, with the median forecast for 2024 rates of 4.6%. For 2025, the forecast is for 3.6% and down from there. That's a dramatic shift. And in his press conference following the December Fed meeting, chairman Jerome Powell took no pains to moderate the conclusions of the dot plot, but instead indicated rate hiking was over and cuts lay ahead.

What caused the change? It would be difficult to argue that economic reports between September and December demanded such a change in policy. A pause, to allow the impact of tightening to play out, as Powell had discussed, would be justified, but not the dramatic reversal of policy. There are only two reasonable explanations: one, the Fed has additional intelligence of a sharp deterioration coming in the economy; and two, political pressure was exerted.

We don't give much credence to the first, since the Fed's economic forecasting has historically been quite dismal, though they are seeing the same reports as we. But after Powell at the beginning of December said "it would be premature to speculate on when policy might ease", he became subject to a constant barrage of political pressure, starting with President Biden saying recent jobs reports "should not encourage the Fed to raise rates", a very unusual presidential intervention into interest rate policy and ending with Treasury Secretary Yellen appearing on CNBC literally minutes before Powell's press conference in which she forecast inflation declining to 2%, adding that that meant that rate cuts were now necessary.

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This was clear guidance if not direct marching orders for what was expected from Powell. With dovish Biden appointees already snuck under the tent, he did not have Fed support nor the fortitude to stand increasingly isolated. He declined all opportunities, including in specific questions from the press, to push back even a little on the growing market consensus.

Petty much everyone is foreseeing rate cuts this coming year, with the only questions how many and when they start. To get from the current 5.5% to the median 4.6% would need four 25 basis point cuts, which would be somewhat aggressive. The Fed is embarking on rate cuts when the inflation-fighting job is nowhere near finished. Core PCE, which is the Fed's favorite measure of consumer price inflation, has declined from over 5% to a latest reading of 3.2%. But that is still 60% above the Fed's own inflation target. Not so long ago, Powell was adamant that the Fed would not cut rates until the 2% target had been reached, though over the months he modified that. The Fed itself, per the "dot plot", does not see Core PCE at 2% until 2026 (though we would be surprised if it hit that target given the rate cuts the Fed members also project occur).

It is unusual for the central bank to cut rates when the CPI is so high, other than in a recession. By starting to cut rates soon, before inflation is vanquished, they risk a resurgence. Powell and Treasury Secretary Janet Yellen still talk about a soft landing, but it seems pretty clear that the economy is moving rapidly towards a recession.

■ Recession is still ahead

Many indicators point to a pending recession: credit card balances at all-time highs and deliquencies at more than a decade high; more auto loans underwater; continuing unemployment claims flat and high; bankruptcies up; manufacturing down across the country; sales of durables down; the savings rate now negative (for only the third time since after World War II); weakness in small business optimism; and so on. Yes, the unemployment rate is low, but so too is the labour participation rate, while most new jobs are either government or part time, and many people are either working two jobs or underemployed. So the jobs picture is not as rosy as it appears. And, as we have pointed out before, the unemployment rate is always at its low immediately before a recession. The tick-up in the rate, from 3.4% in April to 3.7% last month, is indicative of a looming recession.

As we have emphasized many times, monetary policy famously works with long lags. The distance from the start of this tightening cycle is only the average of the lag until the onset of recession in all tightening cycles back to the 1960s. We might expect the lag in this cycle to be above average, given that excessively low rates for so long after the financial crisis of 2008 allowed households and corporations to refinance debt at lower rates and extend maturies. Thus, higher rates have affected fewer people so far than would typically be the case. Rates only turned positive in real terms (net of inflation) in early summer. But the impact will become increasingly evident as more people decide to replace (and finance at higher rates) a car, or corporate debt matures and needs rolling over (at higher rates).

■ Most central banks will follow

Just as the Federal Reserve led the way among major central banks on the way up, so too it may lead on the way down. Although both the European Central Bank and Bank of England have been more hawkish in recent comments, we expect the ECB in particular to soften in coming months. Some headline numbers look reasonably positive, but it is only in comparison with very weak levels a year ago. Overall, the Eurozone economy is very subdued. The Bank of Canada has said it is likely to cut rates this coming year. By the end of the year, we suspect, the rate environment globally will have turned, except perhaps in Japan, where inflation is only now picking up significantly after years of ultra-loose

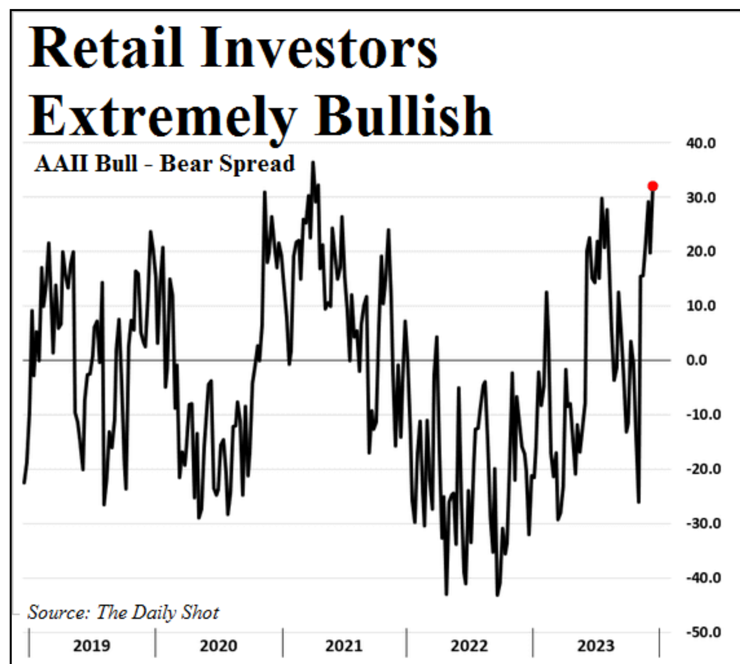
monetary policy, and China, where we do not expect any broad aggressive stimulus for the time being. This has significant implications for markets and asset classes worldwide.

Having said that, there are reasons to believe that the market exuberance in response to the last Fed meeting may be a little overdone. Some 88% of market participants are expecting one or more rate cuts by March, the second Fed meeting of the year, and a miniscule 0.5% are not expecting one by the third meeting, in early May, with almost three-quarters expecting two or more cuts by then.

I think the market is a little aggressive in its expectations. We shall see rate cuts this coming year, but I suspect the Fed will try to hold them off until the meeting in May. Having said that, once rate cuts commence, the surprises will be on more frequent cuts rather than the opposite.

■ Stock market at extremes

Stocks moved higher not only on the interest rate pivot but on the conviction that the Fed has engineered a soft landing and recession has been avoided. About 80% of global managers believe this. Not only managers but retail investors are exhibiting extreme bullishness, with sentiment indicators near the "greed" levels as we see the largest ever inflows into the S&P ETF.



But the underlying picture is not as rosy as the headline numbers and market action would suggest. The median stock return relative to the S&P return is the worst since the 1980s; more than 72% of individual stocks in the S&P underperformed the index return, and just seven stocks accounted for over two-thirds of the index gains in 2023.

Despite the overwhelming belief in a soft landing, analysts have lowered their earnings estimates for the 4th quarter of 2023, by almost 8% since their September estimates. That is a sharp decline for such a short period. We expect more earnings cuts in the coming year as the economy slows (hurting demand) while inflation remains stubborn (shrinking margins). If we look back at 1969, on the eve of the turbulent decade of the 1970s, the S&P was just a little less expensive and inflation just a little more than today; in the 1970s recession, earnings fell by 30% taking the Dow down by 35%. Corporate earnings have dropped in every recession since then, by as much as 44% following 2008.

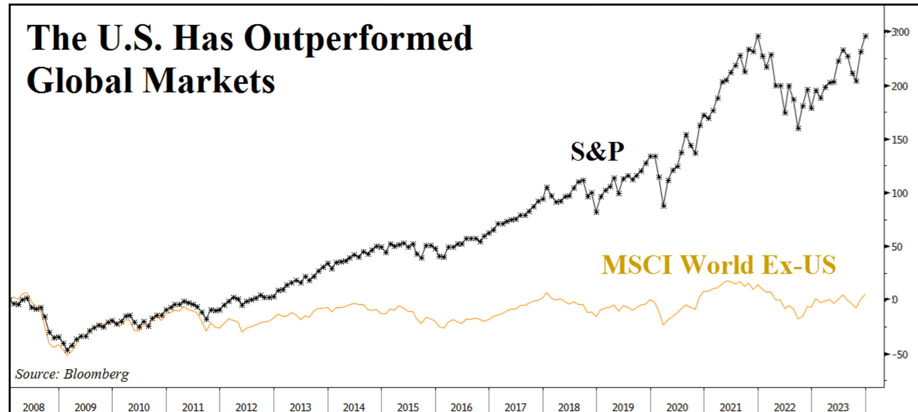
Although the S&P has risen in as many recessions as it fell since 1970—typically falling sharply at the onset before recovering as sentiment for rate cuts increases—on average, recessions have seen stocks decline, with the average in the four losing recessions almost 20%.

■ Risk has increased

It is worth noting that Fed pivots normally occur with stock prices depressed or, at minimum, not elevated. So a pivot usually produces significant gains. This time, the pivot comes with stock prices at extreme levels. James Stack notes that pivots in 1973, 2007 and 2001 also came when stock prices were

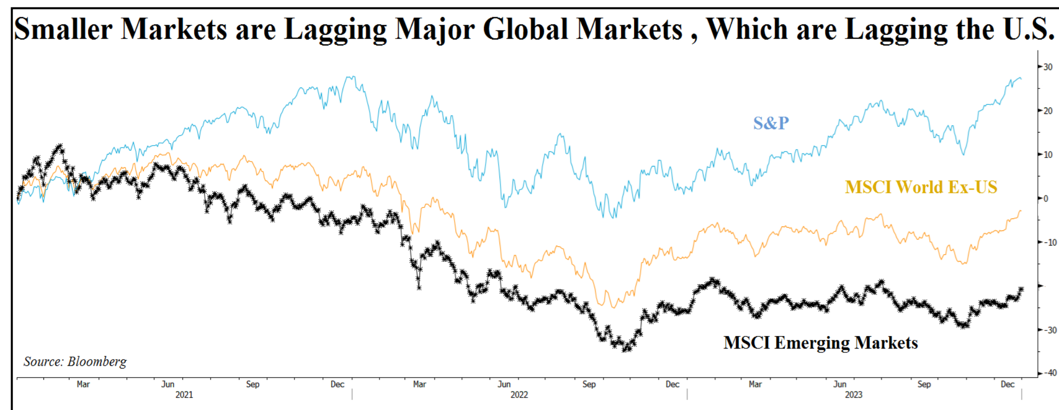
elevated and had, in his words, "horrible market outcomes". So it is by no means clear that the market continues to rise from here, at least not throughout the year. On a longer-term basis, too, the extreme one-sided bullishness in bonds is overdone, helped by the Treasury's reduction in long-bond issuances. When this reverses, as it will with more bond supply, then higher yields will also hurt the stock market.

In the shorter term, occasions when the S&P had been at least 7% above its 40-week average, or 4.5% above its 10-week average, as it is now, were usually followed by a significant decline.



So the risk is high, both on a short-term but also a longer-term basis. We are expecting some decline in the market, and at best a flat market for the year, while rotation out of the small number of market leaders, already underway, continues to the benefit of smaller cap and value.

Some of the same factors affect most major global markets, which are also overvalued as their economies head towards recessions. The concentration is not anywhere near as great, however, as in the U.S. Over the past three decades, the U.S. market has increasing dominated global markets, with U.S. stocks accounting for less than 40% of the world's market cap in 1995 to over 70% today. The trend has accelerated since the 2008 financial crisis. In fact, the seven U.S. market leaders alone have more-or-less the same weighting in the MSCI world index as do the entire markets of Canada, Japan, the U.K., China and France combined. This is an extreme anomaly that cannot last. Significantly, most of the increased U.S. market dominance has come from multiple expansion, as U.S. valuations became significantly richer versus the rest of the world.



So we expect the rest of the world to catch up. But the better macro dynamics as well as valuations are in the smaller markets, including the commodity exporters. They tend to benefit when inflation remains stubborn but also when the dollar declines. It may be too early to rush headlong into such markets, but as rotation out of U.S. market leaders picks up apace, the money will go somewhere and proportionately more will go into these smaller markets.

■ Supply constraints start to affect some commodities

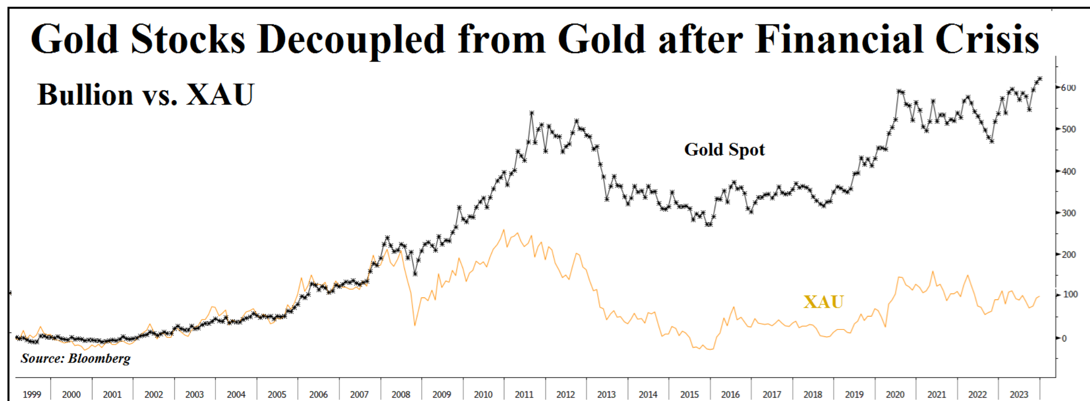
Commodities, as discussed, have been mixed in the last quarter, but for the year, they were generally weak. Oil and gas were both down, the latter by 45%; most metals were down, with nickel off over 45%, offset by gains in iron ore, and gold; while most soft commodities were also down. Reduced demand

from China, the world's largest buyer of most resources, was one major factor. The last quarter has seen an acceleration on the downside with oil but a recovery in most metals. Given our caution on the global economy in the year ahead, therefore, we are looking for bullish signals on the supply side of the equation, and for the near term, copper stands out. If there is a cold northern winter, natural gas should also do well. And both gold and silver will benefit from the reversal in monetary policy in the U.S. and much of the world.

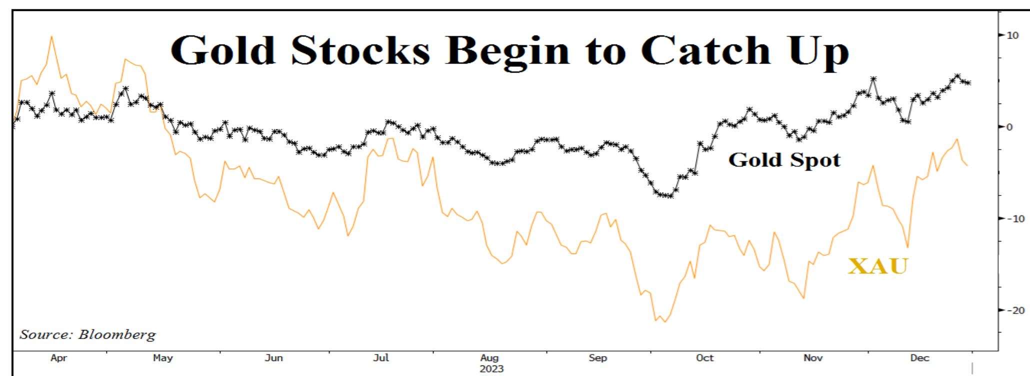
Sentiment towards copper has improved as demand from China has picked up. There, wire fabricators are operating at over 90% capacity for the first time since 2021, while local warehouse stocks are at decade-long lows. Importantly, however, as supplies dwindle while demand picks up, supply is hitting roadblocks. Anglo-American has cut its 2024 production estimates significantly, as others, including the largest producer CODELCO, are also cutting estimates. On top of that, the Cobre Panama mine, the world's eighth largest, has been shut by the government. We suspect it will reopen before 2024 is out, but in the near term, its closure will have a meaningful impact on supply. Quite suddenly, market expectations of a surplus in 2024 have reversed to forecasts of a deficit.

■ Gold lifts off, and the gold stocks lead

For nearly two years, we have been saying that gold will take off when the market believes that the Fed will change course on tightening before inflation is vanquished. We are at that point now. The Fed's pivot comes with the Fed's own preferred inflation measure at 60% above its own target. It is monetary factors, not geo-political that will see a sustained move higher in gold. Sentiment is changing—December saw flows into gold ETFs finally after more than a year of steady outflows—and technically the picture looks very strong, with $2,000 a floor rather than a ceiling.



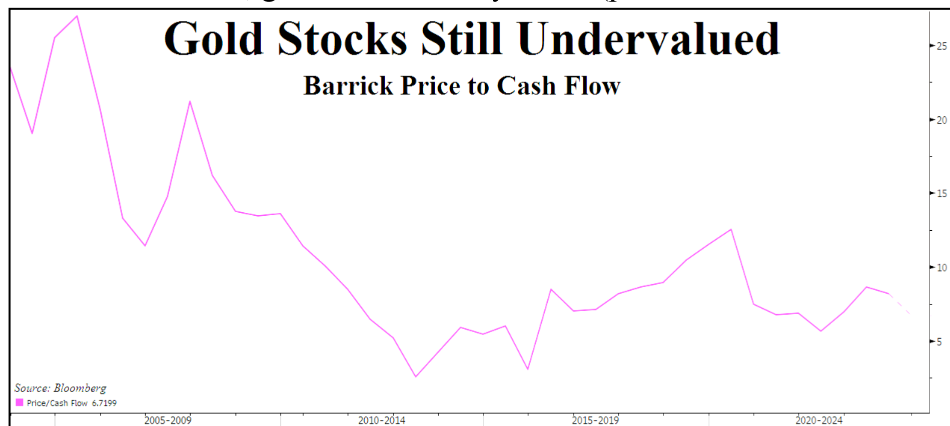
The gold stocks have lagged gold since the 2008 financial crisis, and even gold's powerful mover over the past year did not ignite the stocks, until right at the end of the year. This should not surprise, given that most gold buying was from central banks and very wealthy Mid East and Asian families more concerned about safety than speculation. But now the monetary factors are coming to the fore and gold stocks can do well. Notwithstanding a 17% move in the final quarter of the year, the gold stocks remain undervalued,



on both cash flow and asset bases, and under-owned. As gold stays above $2,000 for longer and convinces more and more investors, even small allocations into the gold stocks will see them move up sharply. We need only look at past moves in gold stocks to see how powerful they can be.

■ Moves in gold stocks can be explosive

From 1976 to 1980, gold stocks rose by 800% (per the Barron's Gold Stock Index). From 2000 to 2008, they quintupled (per XAU). From 2009 to 2011, quadrupled. In just seven months in 2016, they almost tripled. These indexes comprise the larger companies; the returns for the juniors can be far greater once the bull market gets underway. It is also true, of course, that selectivity is more important with the smaller stocks. With an emphasis on the better quality, larger mining and royalty companies as well as the better-financed junior and exploration companies, we are well positioned for the gold bull market we see developing in 2024 and 2025.



Overall, we are cautious on major global equity markets, including the U.S., holding a handful of global blue chips as well as undervalued growth companies in smaller markets. We do not expect to become aggressive on the broad equity market for some time, until there has been a correction bringing valuations to more realistic levels and clear signs of a rotation into more value-oriented stocks. We are holding a high exposure to gold, silver and other resources, however, as well as reasonably high levels of cash.

Review of Individual Accounts

■ Global Accounts

Our allocations in global accounts remained broadly similar to what they were at the beginning of the quarter, though cash levels declined slightly as we added some new global stocks, notwithstanding some selling of U.S. high yielding stocks.

We stepped up selling of the Business Development Companies as the stocks generally moved higher, still holding on average 8% of mid-risk accounts in this sector, and 15% in more conservative accounts. So we continue to have good exposure, but want to take advantage of the recent rally in the sector. Although, as we have discussed before, the better BDCs use recessions to upgrade portfolios, the stocks often fall at the beginning of that period on investor concerns as much as actual deterioration in results.

New global equities added

Perhaps surprisingly given our overall caution, we initiated four new positions in global equities this past quarter. One is a Canadian holding company we had held before but sold after a strong rally. We added two new U.K. companies, one a low-growth but consistently high-yielding company after a sharp

drop caused by a write off, and the other a financial company with solid financials. We also bought a Korean equity fund as discussions continue on liberalizing the market for foreign investors. At present, there are cumbersome regulations for foreign investors that act as a deterrent.

We are always on the lookout for bargains

Although our overall approach to global equities is cautious, we are always looking for good values around the world, whether in anticipation of growth or after a decline in a stock with strong fundamentals that we feel is likely to be temporary.

At the same time, we have just in the last few days started gaining exposure to the short side of U.S. markets. This is a hedge, with only a small allocation, but it will serve us well if the broad market declines early in the new year, following the recent strength.

Looking ahead, we expect to increase cash positions, selling into the overall market strength, while adding to special situations and smaller markets. Maybe not this coming quarter, but later this year, we anticipate a rally in gold stocks that will allow us to take some profits and raise some cash for global and more conservative investors.

■ Gold accounts

Our gold accounts remain fully invested, with the allocation among senior, junior, exploration and silver more-or-less where they were at the beginning of the quarter. The major difference is a reduction in the percentage exposure to the senior stocks due entirely to a sharp decline in the stock price of our largest position. I wish we could discuss in detail, but for some perverse reason, the SEC does not want us to discuss individual securities by name.

We are buying on market overreactions

This company, a royalty company, saw its largest asset evaporate when the underlying mine was ordered closed by a foreign government. The market overreacted, sending the stock down by almost 25%, more than 50% more than the value of the asset, even as peers appreciated. So this clearly hurt the exposure to senior companies. However, given the overreaction and given the quality of the company, its rock-solid balance sheet, and diversification of other assets, we feel very comfortable adding to positions.

In addition, we added another large mining company, whose stock had been crushed on cost overruns on a new mine build, trading down to only half its net asset value. After dilution and asset sales to raise cash to meet the shortfall, and as the new mine nears completion, we bought.

Among juniors, as always, we trimmed some positions to raise cash to add to others, either because of price differentials—selling on rallies and buying on declines—or simply selling lower conviction companies in order to buy higher conviction ones.

As discussed above, I feel strongly that we are on the cusp of a significant move higher in gold itself, which will see, if history is a guide, the gold stocks outperform.

Looking ahead, we anticipate remaining fully invested, while we also expect as the year and the bull market develop, to trim from senior companies in order to add to companies down the food chain, which typically respond later in the cycle but often more dramatically. We are very comfortable with our current mix of high-quality senior miners and royalties, solid second-tier producers, and well-financed exploration and generator companies.

Resource Accounts

We also remain fully invested in resource accounts, with our largest exposures to gold, silver, copper and natural gas, although we also hold several diversified royalty and exploration companies providing exposure across the resource spectrum.

In the last quarter, we added a pure-play U.S. lithium explorer, as well as a well-financed exploration company with strong sponsorship developing a potentially large copper-gold porphyry in South America. We added to a junior Canadian phosphate company.

We sold our uranium exposure, too soon, but will look for good opportunities to re-enter.

Looking ahead, we expect to continue to be fully invested, perhaps trimming the gold as that bull market develops and building positions in other resources, particularly copper, but also, when opportunities present themselves, in oil.

In sum, this past year was laying the groundwork for what we see ahead. We now stand at the commencement of a new year and anticipated fundamental changes to markets and asset classes. This includes rotation in the broad equity market into smaller cap, value and global markets; and a strong gold bull market. We have been waiting for these moves, and are well positioned for them. We look forward to the year ahead when we expect our patience will be rewarded.

Adrian Day, December 30th, 2023

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