Adrian Day
ADRIAN DAY ASSET MANAGEMENT

PORTFOLIO REVIEW

PO Box 9024106, San Juan, PR 00902-4106 • 410.224.2037 First Quarter April 2024

Something is changing in the markets. Gold has moved up reflecting concerns about the underlying economy and financial system, and foreshadowing potential problems. The economy, interest rates, inflation and equity markets will all turn, some up, some down. There is a seismic shift underway in the economic and investment world as central banks prepare to loosen money again amid massive debt levels before inflation is under control. The broad equity markets will turn as the economy weakens, rotating from large-cap growth stocks in developed markets to value and dividend stocks, as well as smaller markets abroad. With little in the U.S. and major developed markets, and a high exposure to gold, other resources, and value stocks in smaller markets, our accounts are well positioned for the new environment. Indeed, despite not being in the high-flying tech stocks at all and hardly in the top-performing major markets at all, we succeeded in recording reasonable gains for accounts in the quarter just ending.

■ Global stocks continue up

Both the U.S. and global markets are ending the quarter on new highs. Most individual stock markets around the world were up this past quarter, led by Japan and the U.S., with the S&P up just over 10%, ahead of the Nasdaq and Dow indexes. European markets were mostly up in the upper single digits, while Asia was mixed. There were several markets that fell (in U.S. dollar terms) this quarter, however, including Switzerland, Sweden, Hong Kong, Australia and Brazil. Overall, world stock markets outside of the U.S. were up 3.9% (per MSCI World Ex-U.S. Index). As is well known, tech stocks, particularly in the U.S., led sectors. Bonds fell, with longer-term bonds down over 3% even including interest (per iBoxx 10-year plus Index).

Our global accounts had reasonable returns, with our mid-risk “growth” account up 4.8% for the quarter (numbers are preliminary).* So though we underperformed the U.S. market, we were ahead of global markets. Though the lack of exposure to U.S. tech leaders hurt, accounts were boosted by some of the Business Development Companies and by gold stocks. Conservative accounts rose just over 3%, lagging more aggressive accounts largely because of higher cash balances and lower exposure to gold stocks.

■ Commodities were mixed, with gold up

Commodities had a mixed start to the year. The Bloomberg Commodity Index rose less than 1%, but as always that hid broad discrepancies among various commodities. Though oil was up by double digits (the U.S. West Texas benchmark up over 16%), natural gas fell, by virtually 30%.

Among the base metals, copper and nickel had modest gains, while iron ore and steel fell sharply (28% for the former). As always, the agricultural commodities were mixed, with livestock and the so-called “softs” all up, led by cocoa (up 133% to the dismay of chocolate lovers), while the grains were mostly down. Gold and silver led the metals (up 8% and 4.9% respectively), though the gold stocks lagged the metal severely, with the GDX index up just 1.2% (though see our commentary below).

Our resource accounts had reasonable returns, outperforming indexes both for the broad resource accounts (up 6.6%) and gold accounts (up 6.1%).* Our gold accounts outperformed the gold indexes by a wide margin, largely because of stock selection. We held virtually no Newmont, for example, despite it being the world's largest gold miner; it fell almost 13% in the quarter. We did hold several outperformers (the SEC does not allow us to mention names), including some that recovered strongly from year-end weakness. This includes major miners and exploration companies, as well as royalty companies.

Looking ahead, in both our global and resource accounts we are well positioned for the likely shifts in the economy and markets. At minimum, we are avoiding the *risk* in the high-flying leaders of the prior bull market. In the gold accounts, we hold several stocks that are potential M&A beneficiaries in the year ahead.

■ Beneath the positive headlines are problems

The U.S. and to some extent the global developed economy and markets stand on a rotten foundation. The headline economic news ("new jobs creation beats estimates") and equity index prices (more new highs) paint one picture, but the economy and markets are built on shaky foundations, making the whole edifice fragile. As with the Francis Scott Key Bridge, a single accident can send the whole edifice tumbling down.

The Federal Reserve knows this, which is why, despite headline jobs numbers and inflation indicating delay––latest one-year core PCE is at 2.8%, meaningfully above the Fed's own target, and rising at a faster rate so far this year—they are looking to loosen policy and lower interest rates this year. Insightful stock market investors know this, which is why the stocks of companies with strong balance sheets are outperforming their weaker brethren. And somewhere—not in the ETFs, not in coin sales—but somewhere in the gold market, investors other than central banks are accumulating the asset that will protect them.

All these developments are linked, I believe, as insiders and astute observers increasingly recognize the fragility of the structure.

■ Easy money is the culprit

The fundamental cause of any fragility is the extremely easy monetary policy pursued way beyond expiration date following the Great Financial Crisis. This included zero (or in Europe and Japan negative) interest rates, which encouraged businesses and households to over-leverage and invest in all manner of ventures that would not have attracted capital in more sober times. Now all the excess money from the covid handouts is running out, both in the U.S. and in Europe, at the same time as the repo account approaches zero as money markets and other institutions withdraw funds to buy Treasuries. With the end of excess money and a depleted repo account, who will buy Treasuries (or more accurately, at what interest rate will they buy)?

As I have argued, the U.S. economy is not as strong as the headlines suggest. All the excess money lifted the reported GDP numbers, but that is not real growth.

* 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.

Problems in commercial real estate are well known, but they are not yet reflected on the balance sheets of banks and insurance companies, which are not marking down prices but deferring the inevitable. Many foreign institutions, particularly banks and insurance companies in Japan and Germany, have been writing down these loans, often the very same loans which U.S. institutions continue to mark at cost. But the problem can't be hidden and deferred for ever; just last week, S&P downgraded the credit on five regional banks with large exposure to commercial real estate. Likewise, high-yield private equity for the most part determines the valuation of the private loans and companies on its books. Where more than one entity holds portions of the same tranche, the recorded values can differ meaningfully.

The Fed knows this, and knows too that "higher for longer" threatens overleveraged businesses and households, and that increasing defaults would then threaten banks, insurance companies, and the private equity and high-yield markets. This is one reason that the Fed is going to start cutting soon.

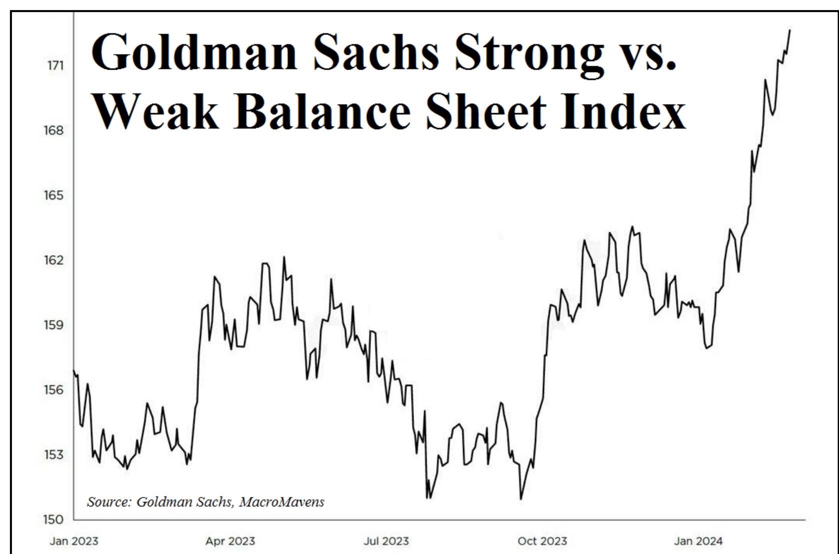
■ Fed to ride to the rescue of government

The other reason, of course, is the state of Federal government finances; as the Federal government debt continues to expand while interest rates have moved up, the interest burden on the debt has exploded and is forecast to reach $870 billion this year, up 32% from 2023, which was already twice the amount just three years ago. To put in context, interest expense is now more than the entire defense budget, and the largest single item in the budget other than the very broad "entitlements" category.

The debt service burden will continue to increase as more bonds issued when rates were low mature and need to be rolled over into higher-coupon debt. The Treasury is now issuing almost 85% of debt at the short end, a 20-year high, which may help in the short term. but not necessarily in the longer term. The Federal deficit is running above 6% of GDP at a time of a strong economy with full employment. If Washington will not reduce spending, then lowering interest rates is the only tool to help the fiscal situation. The Fed sees this and knows that it cannot continue to raise rates.

And so Fed members are still calling for three interest rate cuts during the balance of this year. Though the latest "dot-plot" shows members a little less dovish than previously, with one fewer cut in each of 2025 and 2026, the terminal rate they see is 2.6%, slightly higher than before but still less than half where rates now stand. It should be noted that non-voting as well as voting members participate in this; voting members right now are tilting towards waiting.

The U.S. may be leading the world in fiscal profligacy among developed nations, something it can do because of the dollar's reserve currency status, but other nations are exhibiting stress as well. Germany—the erstwhile workhorse of Europe, has stumbled dramatically. Three major landlords have been forced to restructure their bonds or delay repayments. Retail sales there fell, and unemployment remains high.



On the other side of the world, China's economy is notably weaker than it has been, with the real estate sector fracturing. We should not expect China to ride to the rescue of the global economy as in the past. Not

surprisingly, many central banks, including Switzerland, are already cutting their interest rates (though we should note that Switzerland has far lower inflation with rates still positive). The U.S. and Europe are yet to follow.

■ Stocks also flash warning signs

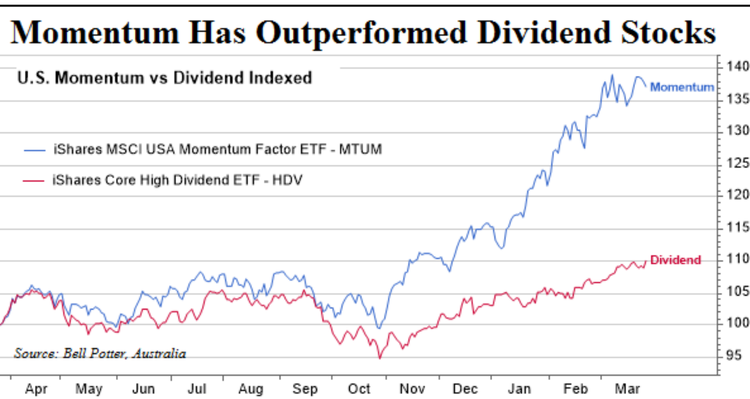
The same factors driving the Federal Reserve towards cutting rates and the wealthy to buy physical gold are leading astute investors towards more defensive postures. Warren Buffett's Berkshire Hathaway famously has record levels of cash due to the lack of things to buy. Insiders, particularly in the tech sector, are ramping up their stock sales dramatically. This quarter, the ratio of sales to buys in tech has been almost twice what it was in the prior quarter.

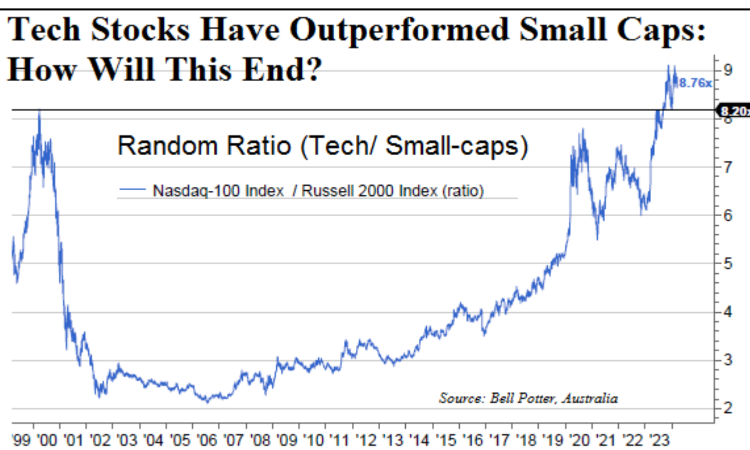
Keen market commentator Stephanie Pomboy writes, "You wouldn't know it to look at the broad market action, but (the) break for the exit looks to be starting already." She points to the "sudden and dramatic" outperformance of companies with strong balance sheets, adding "somebody's getting nervous." (See graph on page 3.)

■ Signs of a top abound

There are many reasons to be nervous, starting with market valuations. The "Schiller p/e" of 34 is in the highest 1% in history. With profits also at near-record levels, there is a risk to both a slide in profits and multiple contraction leading to lower stock prices. With the economy slowing and costs stubbornly high, are profits likely to *increase* from here? Companies simply cannot continue to pass on all of their cost increases during a longer period of even moderate inflation. Are stock multiples likely to go even higher? Starting from high valuations means that stocks are unlikely to have strong returns over the next five or 10 years.

Many technical indicators are also near extremes. Though market breadth itself is not at its most extreme, it is very narrow relative to stock prices, and worsening even as the market continues to move higher. That's a reflection of the extreme concentration in this market, and a negative sign.





Meanwhile, investor sentiment continues at extremes, with a 45-point spread between bulls and bears (just 15%), according to Investor Intelligence.

Looking at valuations and market internals, John Hussman writes, "We can't say with any certainty at all that stocks are at a market peak. We can also say with complete certainty that present conditions mirror what a market peak looks like." And that mirrors something I have said many times: an investment advisor is not in the business of making predictions, but rather assessing risk.

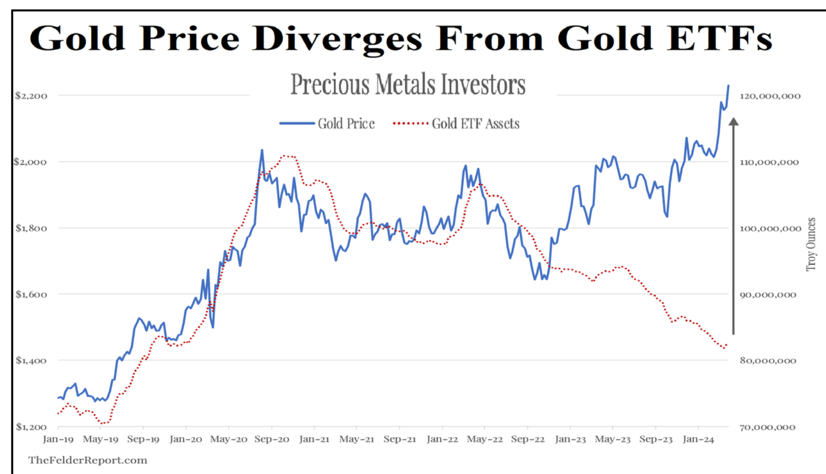
Nor should we expect lower interest rates to keep the stock market party going. Lower rates will be a reflection of a recession, which is negative for corporate profits and stocks.

The last three rate cutting cycles—in 2000 to 2003, 2007 to 2008, and 2019 to 2020—saw stocks decline. Due to the extreme divergence in the market, while the most expensive stocks are at near-record valuations, the least expensive are actually undervalued on an historical basis, surprising given the long period of market strength, with the S&P up five-fold in10 years. According to Jeremy Grantham, the 20% most expensive stocks are in their 10% highest range relative to the market, while the 20% lowest valuation stocks are in their 7% lowest range. We should note that the broad market is still overvalued on an historical basis. We have suggested before that when these leaders stumble, investors will rotate into the stocks that have been left behind, value stocks and high dividend payers, oil and commodity stocks (including gold stocks).

And globally, they will move from the U.S. to global markets, particularly to the laggards such as Japan and smaller markets, where valuations are generally more reasonable.

■ Gold too is warning of trouble

Gold is another beneficiary of the growing awareness of structural fragility in the financial world. Last year, the buying that drove the price higher was virtually exclusively from central banks. In the last month or so, new buying has come in, driving gold prices dramatically higher, to new (nominal) records over $2,200. Gold ETFs continued to see consistent net outflows even for the first two months of this year. This trend broke the correlation between ETF assets and the gold price that stretched back to 2004 when the first major gold ETF was launched. The gold ETFs have only just started to see some inflows (though as many days with outflows), while retail buying of coins and small bars similarly is barely offsetting ongoing selling.



The new source of demand does not appear to be either retail or traditional investors. Rather, we suspect, it is wealthy families and institutions, primarily in the Middle East and Asia but also Europe looking for an insurance asset to protect against financial calamity. Gold's strength in the face of factors that should be headwinds—a strong dollar, high interest rates, a (seemingly) strong economy, buoyant equity markets—suggests that it is not traditional investment demand.

Of course, renewed expectations of Federal Reserve rate cuts have also sparked the latest move in gold. We have said repeatedly over the past 18 months that the gold sector will move when the Fed cuts rates before it has quashed inflation, and investors now sense that we are very close to that point. But the hard data on ETF and other fund flows clearly indicate that this alone is not responsible for gold's recent move, again pointing to over-the-counter purchases by large buyers that are not clearly reported. Such buying is most likely from a relatively small number of very wealthy buyers. If these individuals are buying as an insurance asset, they too, like the central banks, will be long-term holders.

■ Gold stocks finally catch a bid

Gold moving over $2,100 has seen the gold equities finally catch a bid and indeed the major gold stocks have more than doubled gold's returns this month (basis XAU) after lagging for so long. One month does not a trend make, but the extremely low valuations in the face of high gold prices, a favorable outlook, and robust

margins suggest the buying will continue, while the extreme underweight of most investors suggest the move could be powerful.
As the stocks that have led the index for the past couple of years stumble, investors will look at what has lagged, not only global markets and value stocks, but resources, including gold stocks. The gold sector is small, famously only a fraction the size of single companies such as Apple or Microsoft. So when the interest returns to this sector, only a very small allocation from generalist investors will see the stocks move dramatically.

Oil, copper and uranium are also attractive

Gold is not the only commodity we like, but it is the one that stands to gain from more than one outcome. We also like oil and gas; copper; and uranium. Many assume that a global recession would be negative for resources. Of course, a recession means lower demand and is therefore negative, but only one factor. The prices of most resources, particularly the more capital intensive and longer-life ones, are determined far more by the capital investment cycle than the current state of the economy. And most resources have been starved of capital for the past decade and more, until very recently.

We also like oil and gas; copper; and uranium. Oil is rallying as production increases are curtailed. The U.S. rig count has declined in the last several weeks at the same time as Saudi Arabia has abandoned plans to increase its production. (Maybe it can't increase on a sustained basis because the reserves are not there.) The copper price has moved strongly, up nearly 10% in the last six weeks, as Chinese smelters, who produce over half of the world's refined copper, make plans for a reduction this year of 5% to 10%. In an already tight market, this will further boost the copper price.

Lastly uranium's correction has been cut short after Kazakhstan, the world's largest producer, reversed expectations of meaningfully higher production this year, saying not only would it not be increasing production but that output would be lower and the company *may* have to buy on the global market to meet supply obligations. For years, uranium had been in a tight supply/demand market, but large stockpiles prevented that tightness translating into higher prices. This changed when the stockpiles ran down, sending uranium prices higher and users scrambling for supplies. There are new mines coming onstream, including from NextGen and Denison, but these will not be producing for a few years, so the uranium price has room to move further.

Overall, we are increasingly concerned at the risk in global financial markets and cautious on major equity markets. We continue to hold a handful of quality global blue chips as well as high yielding stocks in the U.S., and selected value investments in other markets. We also have a high allocation to gold and other resources, for both protection and for gains in their own right.

Review of Individual Accounts

Global Accounts

As discussed above, we continue to be cautious of major equity markets, and have continued to trim positions as markets and individual stocks continue to move up. Our exposure to broad global equity markets remains low, at around 7%. We have reduced exposure to high-yielding U.S. stocks to 7% (and down to 11% for conservative accounts), adding to resource stocks for more aggressive investors and to cash for more conservative ones (now at 17%). All global accounts continue to hold a high weighting to resources, particularly gold.

As markets have risen, we are continuing to trim, both in global markets and in the Business Development Companies. We also sold one widely held company, a major European healthcare company. We bought when it tumbled on bad news and appeared oversold, but exited after the stock failed to sustain rallies.

We stepped into Japan

We have added one company, a Japanese value stock, to gain some exposure to the market that finally appears to be turning. The weak yen is a headwind, but that may not have much further to drop after reaching levels not seen since the Plaza Accord nearly 40 years ago.

Looking ahead, we expect to continue to trim positions as markets move up, adding to cash, while constantly on the lookout for markets or individual companies that offer value or are oversold for what appear to be temporary reasons. If the expected move in gold stocks materializes, we anticipate being able to book some profits in global accounts while maintaining exposure. Overall, we are well positioned for the stagflationary environment we see ahead, while being defensively positioned in the event of some financial accident.

■ Gold Accounts

Gold accounts remain fully invested, with broad allocations virtually identical to where they entered the year: 28% in senior miners and major royalty companies; 7% in intermediates; 33% in juniors and exploration; and 32% in silver and other resources.

The allocation balance between seniors and juniors has shifted moderately in favor of juniors, partly because that group has moved more than the majors (thanks to a few significant gainers), and also because we have added to a couple of specific juniors with near-term catalysts.

We are buying a new company

We have sold nothing on a broad basis, but have added one company. From the stable of a successful mining entrepreneur, it holds prospective exploration ground in the southwestern United States as well as a proprietary exploration technology it is licensing to other companies.

Apart from this, new buying has been largely focused on a small handful of juniors with near-term catalysts, including one with a royalty on a growing deposit in Nevada.

Looking ahead, we expect to remain fully invested with a mix of the best senior miners, major and junior royalty companies, intermediate miners, and junior exploration companies. With gold having moved strongly over the past year, and particularly over the past few months, the gold stocks have now begun to move. We expect the stocks to see very strong moves over the next 12 months. Some of the companies we hold could be acquired over the next year or so, but with no shortage of companies selling at very low valuations, we expect any M&A proceeds to be promptly reinvested.

■ Resource accounts

Like the gold accounts, the resource accounts remain fully invested, ready for the moves we anticipate this year. Gold, copper and silver remain our largest weightings, though we did exit natural gas (with one producer being acquired).

Much of our exposure to different commodities comes through diversified companies. We added another global major this past quarter, a successful U.K.-based producer and trader of a range of commodities.

Looking to buy cheap natural gas

We are looking to get back into the natural gas sector, given its depressed pricing, but will do so through producers. In the meantime, we added incrementally to our oil holdings. We have started buying back into the uranium sector on the recent correction, having exited (too early) last year.
We also have one new buy, a still-private royalty company run by a highly successful and experienced team, this time focused on strategic elements, both base metals and energy transition elements. Because the company is new and private, we have bought for only a handful of clients to date, but as it grows with new financings, and particularly once it goes public, we will build positions more widely.

Looking ahead, we expect to remain fully invested, continuing to focus on gold, silver and copper, while building positions in energy (oil, gas, and uranium). These are commodities that can stand up even if there is a global economic slowdown, for some because they are monetary metals, and others because of supply constraints.

In sum, we are increasingly concerned about the possibility of a financial accident and therefore cautious of major global markets. We continue to look for undervalued special situations, particularly those with solid dividends, while remaining fully exposed to gold and other recession-resilient resources. We expect cash in accounts to increase, particularly in more conservative global accounts. On balance, however, we feel very confident about the holdings in accounts.

Adrian Day, March 29th, 2024

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