Adrian Day
ADRIAN DAY ASSET MANAGEMENT

PORTFOLIO REVIEW

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The second quarter saw a pause in some of the new trends that I see in the markets: gold was essentially flat after China reported no purchases in May; some economic reports suggested a pick up in growth in the U.S.; global stocks markets slowed while many emerging markets were down, even as U.S. markets drove higher; and expectations of a rate cut from the Federal Reserve were pushed back. In many cases these are illusions: half of the U.S. stock market's gains this year have been driven by a single stock, for example, while lifting the hood on many economic reports presents quite a different story. We discuss this below. The reasons for higher gold and resource prices; the shift from U.S. stocks to global and particularly smaller markets; and the vulnerability of the economy: all these trends remain intact. By raising cash; by being underweight the U.S. stock market, and shifting to more defensive positions as well as smaller global markets; and by having a large exposure to gold stocks, we are well positioned for the period ahead.

■ A mixed report card for equities

Although the U.S. markets continued up this past quarter, many individual markets around the world gave back some of their first quarter gains. U.S. led the world, with Nasdaq up 8.5%, though a single stock, Nvidia, accounts for half of the market's gain this year. Only Hong Kong stocks did better; they rebounded strongly after declining for the past two years, bouncing 9% for the quarter. In aggregate, world markets outside the U.S. were up 2.4% (per the MSCI World ex-U.S. Index), but most individual markets in Europe and Latin America, as well as some in Asia, fell.

Our global accounts were up in the second quarter, ranging from 6.5% for conservative accounts to just under 2% for aggressive accounts.* More conservative accounts, therefore, significantly outperformed global markets, while more aggressive ones moderately underperformed. Conservative accounts generally did better this past quarter because of a higher weighting to more defensive, income-oriented stocks, and fewer resource stocks (which, other than gold, did poorly this quarter). Relative to the global indexes, our accounts were significantly underweight the U.S., acting as a drag on performance. However, we were also underweight other global markets which lagged, including Mexico, most of Europe, and Japan, while our largest allocations, U.K., Switzerland, and Hong Kong, were among the top global performers.

■ Resources saw gains slowing

The commodity complex, as always, was mixed, with the Bloomberg Commodity Index up 1.5% for the quarter. Oil was up less than 1% after giving back most of its earlier gains. Strongest performers included copper, up 8%. Despite giving back some of its gains in the last month, gold was up over 3%, while silver was a top performer, up almost 22% on the quarter.

Our accounts were mixed. Resource accounts fell, just 0.25%, giving back some of the first-quarter gains, while gold accounts were up over 9%.* Resource accounts somewhat underperformed the index, while gold accounts marginally outperformed the golds indexes (with the XAU up 8.5%). The oil and copper stocks

generally fell slightly during the quarter accounting for the resource account losses. We outperformed the gold index for two main reasons: a high weighting to silver, and the meaningful gains in a few of the smaller stocks in portfolios.

As mentioned above, we are well-positioned for the changing environment. Gold stocks and smaller global markets, undervalued as sectors, have strong potential in the period ahead, while, in avoiding the leading sectors, markets, and individual securities of the past period, we are minimizing the risk which continues to grow.

■ The Fed waits as debt increases

The Federal Reserve has postponed its initial rate cut, wanting more evidence that inflation is under control. The danger of course is that the longer it waits, the greater the risk of a turn up in the inflation numbers. Indeed, Fed members themselves, in their estimates of future economic activity, have actually increased their expectations for inflation this year, while chairman Jerome Powell is hedging his "strongly commitment" to getting inflation to 2% by referring to "greater confidence" that inflation "is moving towards" 2%.

Arguably more important was a Treasury announcement made at the same time as the last Fed rate decision; perhaps they were hoping no one would notice. The Treasury said that the government's deficit for May was $347 billion, up from $240 billion in May last year. The Congressional Budget Office which just four months ago projected this year's annual budget deficit (fiscal year 2024) would come in at $1.5 trillion, now is estimating it will be $1.9 trillion. So not only is the situation bad, but it's rapidly getting significantly worse. According to the Congressional Budget Office, debt to GDP for the US will increase to 155% by 2050. This is up from 35% as recently as 2007. Spending rose 22%, led by net interest payments on the debt, up a staggering 44% in one year. This will not be the end of the rise in debt service payments, as the Treasury steps up its bill and bond issuance. Notes issued five years ago with yields under 2.5% will be rolled over at 5%.

■ Debt at all levels is a major issue

More significantly, debt service costs are now 16% of the federal budget. That is more than Medicare, health and defense and every other single item in the budget (except Social Security, which is supposed to come from a trust fund). It is likely to continue to increase as the government's low-coupon notes from 5 and 10 years ago roll over into higher yielding bills and notes, with no signs that either the administration or congress as a whole has any willingness to actually reduce spending. This, more than a slowing economy, will drive Fed decisions. Already, it has dramatically slashed the pace of QT (reducing its bond holdings) to help the Treasury with its bond sales.

This is against a background of an economy that is nowhere near as strong as many headlines would suggest. If you look under the hood, you see the problems. We have discussed this before. Two key areas would be employment and consumer spending.

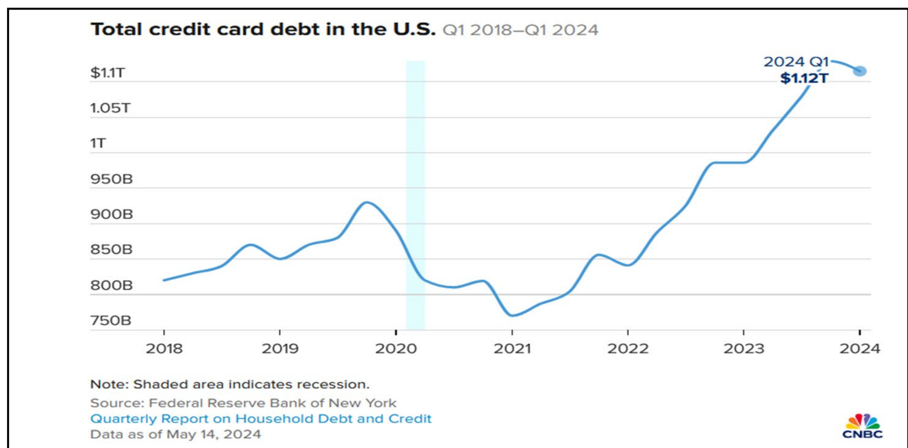
* Please note: **Past performance is no guarantee of future results.** For complete information on our past performance, including factors to be considered in viewing past performance and other disclosures, please contact our office. Specific stocks mentioned herein are intended solely as illustrative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

The unemployment rate is low and new jobs creation strong. But as we all know there is a huge gap between the Payrolls Report that generates the headlines and the Household Survey, something even Fed head Powell was forced to acknowledge last month. The labour participation rate is near 40-year lows, reducing the denominator. The number of people being forced to work two jobs to make ends meet is not a sign of strength. The percentage of new government jobs is rising. In fact, there has been a loss of over one million full-time, private- sector jobs over the past year. That is not a sign of a strong labor market.

■ Consumer debt climbs even as spending continues

Consumer spending continues to increase. But spending has increased at a lower rate than prices have accelerated, meaning the consumer is buying less in terms of volume or reducing perceived quality by shifting from Neiman Marcus to Walmart. The reduction in savings and the rise in credit card debt and defaults means the spending is sustained, not by income, but by debt and that is not sustainable.

Household debt now stands at nearly $18 trillion, according to the latest Quarterly Report on Household Debt and Credit. Mortgage balances are the bulk of this at over $12 trillion, but auto loan balances and credit card balances are also high. The latter, at $1.12 trillion is up from $900 billion pre-covid, and a low of $760 billion in early 2021. Typically, credit card balances increase with unemployment, as would be expected, so it is concerning that it is so high when unemployment is so low. Nearly 9% of credit card balances and 8% of auto loans (on an annualized basis) became delinquent in the first quarter; again, we would expect this to increase in coming quarters.



Another sign of stress is the 30% surge in early withdrawals from retirement accounts. Though these represent an available source of cash, and the only source of cash for many consumers, such withdrawals are usually a last resort given the tax penalties and such withdrawals are a sign of stress. According to a report in The Wall Street Journal, nearly one in seven Americans has borrowed against their retirement accounts.

These are just two areas. Overall, the economy is not as strong as headlines suggest, certainly not for the 50% of the population in the lower half by assets or income.

■ Inflation remains stubborn

Even as there are increasing signs of stress in the economy, inflation is not quashed, far from it.
The Fed and the government looks at this or that particular rate of inflation—core PCE seasonally adjusted or whatever—and the rate is coming down. But in the past four years, prices are up by 22%, according to the government's own numbers. And who believes that the Bureau of Labor Statistic's numbers accurately reflect the reality of inflation?

The reported inflation numbers have come down, though "Core PCE" (for those who don't eat or use any energy) at 2.75%, and 3.3% for the rest of us, is still running significantly above the Fed's own arbitrary 2% target.

But inflation is not over. Other things being equal, we will start to see some higher numbers in the fall given the comparison will be with lower year-ago numbers. The rally in the price of oil from $73bbl in early June to over $84 today, will feed into all goods in the CPI. Though we are not looking at runaway inflation, inflation will remain stubborn.

■ The Fed has a dilemma

The Fed faces a dilemma: cut rates too soon and risk a resurgence in inflation, or keep higher for longer and kill the economy and make the government's ability to service its debt more difficult. This comes into sharper focus as fewer foreign governments are willing to buy US bonds – China is a net seller, Russia is out, and Japan will likely reduce purchases as domestic rates slowly inch up and the yen strengthens, making buying foreign bonds relatively less attractive for Japanese institutions. At the same time, U.S. banks are buying fewer bonds to hold to maturity, and the Social Security Trust fund has more outflows than inflows.

Already the Fed Reserve is by far the largest holder of Treasury debt, holding more than China and Japan, all mutual funds and banks combined. But with other buyers pulling back from the market, the Fed has already sharply cut its planned program of reducing bond holdings. A quite likely outcome, if the executive and legislative arms of government cannot reduce spending and therefore reduce the required treasury issuance, is that the Fed, even as it starts to cut interest rates, will buy up government debt, in effect monetizing the debt and thereby creating more problems for the future.

Again, the economy is accelerating its decline into recession, while inflation remains high, with stagflation then the likely scenario for next year.

■ Debt and inflation high around the world

Globally, we see the same signs of stress, though with variations among regions and individual countries. The IMF proclaims that the global inflation rate is falling, but it remains high, estimated at 5.9% for this year, nearly 3 times the arbitrary target most major banks employ.

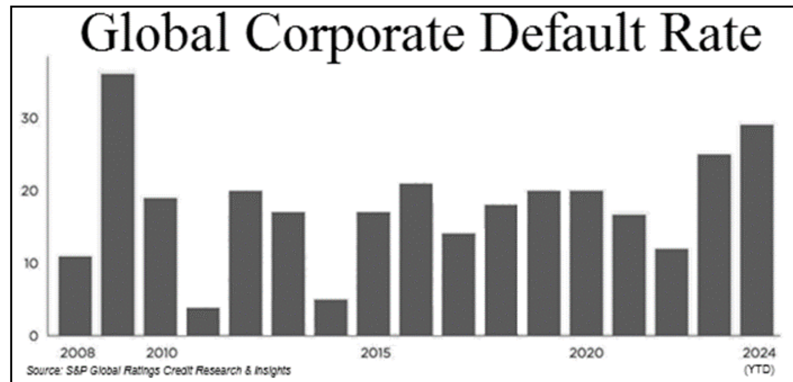
But worse than the state of economies and of inflation is the fragility of the global economy caused by debt. More than a decade of excessively easy monetary policy, with ultra-low interest rates meant excessive debt was taken on for marginal enterprises, creating distortions, what Austrians call malinvestments. Most developed world governments have debt to GDP levels near or exceeding 100%.

In a rather ironic move, the largest Japanese agricultural bank, Norinchukin, announced it would sell $63 billion of government bonds, replacing them with corporate bonds. "We will reduce (sovereign) interest rate risk and diversify into assets that take on corporate and individual credit risk," the bank said. We hope that they are careful in their selection. Globally, corporate bankruptcies are the highest since 2009, with the year only half over.

The traditional way to look at debt service for non-U.S. countries is to take debt service costs as a percentage of export earnings. For Europe and Latin American, that ratio is in the high teens, but for many countries is it meaningfully higher. For Brazil, the ratio stands at 30%, meaning that almost one in every three real earned in exports goes simply to service the government debt. The same for Panama, while outliers include Pakistan at over 40%.

Households and businesses also burdened by debt

Households and, in many countries, corporations, also have their own looming debt crises. Globally household debt has risen as a percent of GDP from the mid-60s prior to the 2008 financial crisis to the 95% today. The numbers for households are lower than for corporations and for governments, but of course households generally have less flexibility and must pay their debts from their income.

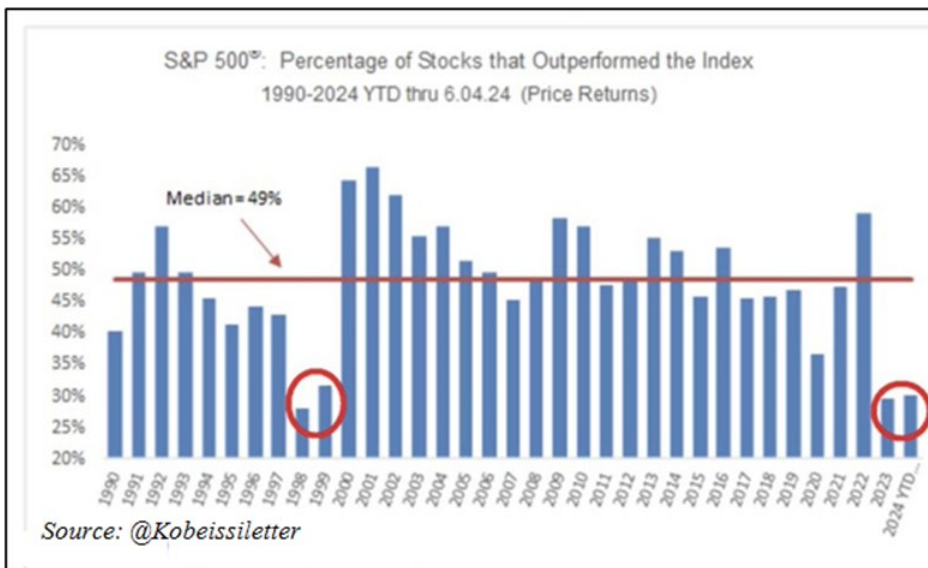


Globally, nonfinancial corporate debt has increased from just over 100% of GDP in 2007 to 155% in 2022 (the last year for data). Canada, China and parts of Europe are among the worst.

In response, many global banks have already started to cut interest rates, including the European Central Bank, as well as banks in Canada, Switzerland, and Sweden. In moving ahead of the U.S., where inflation has been stickier and the economy still stronger, this has boosted the dollar again. The next direction, however, is clear: with excessive debt levels still climbing, rates have to come down or risk a surge of defaults.

Stocks: are we close to a top?

U.S. and major global stock markets continue to move up, but again, not everything is as positive as the headlines appear. Market breadth is deteriorating rapidly. This year to date, fully half of the market's rise is due to a single stock, Nvidia. Without the so-called "Magnificent Seven", the S&P is up about 4 to 5% this year, and some of the seven are beginning to roll over. In addition, there have been more new lows than new highs, not a sign of a strong bull market, even as the indexes hit new highs.



So extreme valuations are combined with negative market breadth and other weak internals to suggest that the upside from here is limited, while the risk is significant. As we know, valuations alone do not signify market tops, but they do suggest the potential gains and the level of risk in a market. According to John Hussman, the estimated returns for the S&P above current Treasury yields over the next 12 years is now negative, and the lowest since 1928. He made the point well when he said that this may not be a market top, but this is what a market top looks like.

Better values abroad

Many major global markets are also vulnerable, if not quite so overvalued as the U.S., while the best value is in smaller markets. Hong Kong, for example, despite a better-than 20% move up this year, is still only at

60% of its early 2021 peak, with valuations to match: P/Es in the high single digits are two-thirds longer-term averages, with the forward p/e, the lowest in over 10 years; the yield of 4.5% is 50% above the 30-year average, and apart from one brief period in 2008 when stock price collapsed, the highest over that period; with stock selling below book value, they are also very close to a decade-long low on this metric. If Singapore stocks are not so depressed—the Straits Times Index is not far from its highs—they are still undervalued, trading at only 10 x price/earnings, trading just above book, and yielding almost 5%.

So we are moving out of the U.S. and other major developed markets into selected smaller markets, while selecting individual stocks on a bottom-up basis.

■ Resources mixed but some attractive outlooks

As discussed, most resources gave back some of their first quarter gains, though most remain up very respectably for the year. The outlook for major resources remains very strong, based on powerful demand and limited supply growth.

■ Restrained U.S. growth boosts oil price

Oil fell sharply for the first half of the quarter, and then recovered strongly to trade today within a dollar of the high for the year. A decline in the number of drill rigs in the United States, down nearly 20% from a year ago, has led to a slight fall off in production, as many of the prolific shale fields that saw a renaissance in U.S. production have peaked, along with a hostile permitting environment. Those shale fields allowed the U.S. to go from net importer to net exporter, meeting 100% of global demand growth since 2010. That is now slowly changing, with suspicions that past high grading will prevent continued growth. A change in administration after the elections will likely make permitting easier, but it remains to be seen to what extent that might translate into significantly higher output.

Given the significance of U.S. production over the past decade, and a global market broadly in balance, any decline in U.S. production could see higher prices ahead, assuming global demand stays relatively high. The major integrated oil companies as well as the large independent E&P companies, though not at depressed levels, are reasonable value.

■ Where is the copper coming from?

The copper price roared to new highs as Chinese smelters, which account for over half of the world's supply of refined copper, cut output as lower ore supply led to unprofitable processing fees. The situation became self-correcting, and the copper price fell back 10% since the late May peak though still above prices throughout the last two years.

The supply/demand situation for copper is still very favorable, with strong demand from data centers and electrical grids around the world in addition to electrification of both the grid and transportation. This demand comes as production from the world's major mines declines—Chile's national copper company Codelco, the large producer in the world, saw monthly production in April at an 18-year low—while major new mines are scarce. And it takes time to develop, permit, finance and build a major copper mine. From discovery to production is now an average of 30 years, up from half that length in the early part of the century, and even after a production decision, it can take five or more years until the first ore is produced. So with a shortfall in production, there is no quick fix and, if demand is anywhere near projections, higher prices are next-to inevitable.

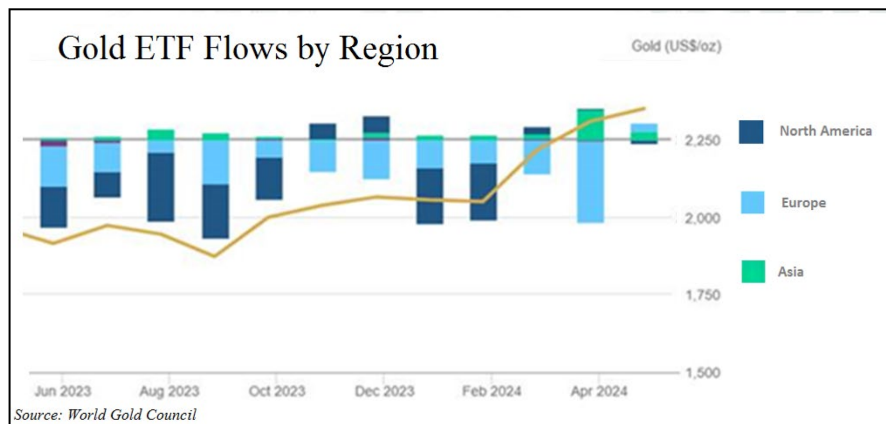
■ Strong silver demand growth

Silver remains a monetary metal but with important differences from gold. The industrial demand for the white metal is strong and growing rapidly, particularly in electric vehicles and solar panels. The latter has

seen demand more than double in the last two years, with projected growth of another 20% this year. A projected shortfall representing 20% of total supply is expected this year, and with minimal and shrinking stockpiles as well as a maximum of 30% of production coming from primary production, the shortfall is unlikely to be met by higher supply but rather by higher prices. Though many of the familiar names among silver miners actually generate more revenues from gold and other metals, they will respond to higher silver prices.

■ Why is gold up in a difficult economic environment?

The gold price has stabilized after strong appreciation in March and April, capping 18 months of steady appreciation. The macro economic environment is not what has been driving the price. High interest rates, low inflation, a strong economy, a strong dollar, and a strong stock market: that is precisely the macro environment that should be weak for gold. So why is gold going up?



Source: World Gold Council

We know that central bank buying, led by China, has been the main driver of higher gold prices over the past two years. We know why central banks have been buying.

And we know that behind them have been Chinese investors and savers, worried about their economy, afraid of their banking system, not wanting to buy local stocks, down 40% in three years in a relentless slide, afraid to put money into real estate, the traditional Chinese destination for savings, and prohibited from buying crypto. None of this buying has anything to do with the macro economic environment.

■ Strategic buyers boost price

But there are other buyers. It is not western investors and institutions. All the indications are that Western investors are still eschewing gold. Coin premiums are low and shipments from the mints down, suggesting investors are not lining up to buy gold, something substantiated in conversations with dealers in both the U.S. and Europe. The gold ETFs outside of Asia have seen ongoing new outflows for most of the year, even continuing into May and June when the gold price was moving up.

Totaling the buying and selling that is reported—central bank buying; Shanghai Exchange trading; Hong Kong imports; ETF outflows and more—we know there has been other buying. Indications are that relatively few wealthy and savvy individuals and institutions are buying physical gold heavily.

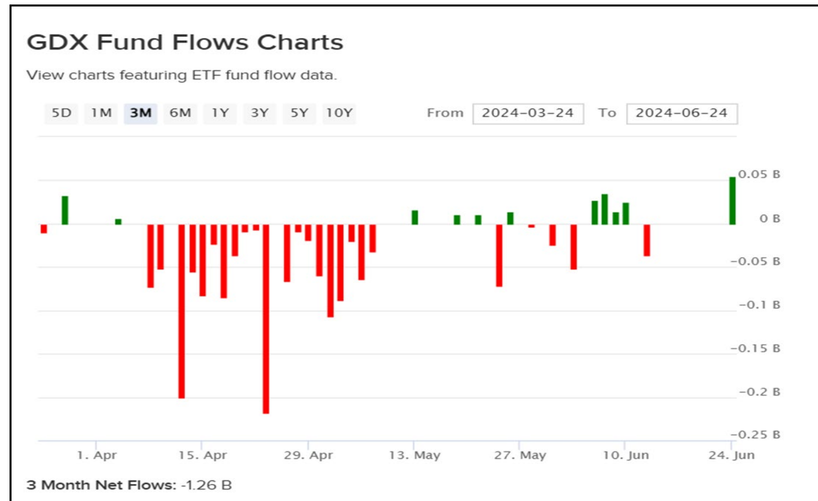
These are people who see the fragility of the system and are buying to protect themselves. This buying is over-the-counter and not reported, but as the World Gold Council puts it, "OTC buying by investors, while opaque, is reflected in the pace and scale of the price rise."

This explains why gold can move up even though gold ETFs continue to see net outflows. The same phenomenon is occurring with the gold stocks, why gold stocks have moved 38% since March even though gold mutual funds and gold miner ETFs continue to see outflows. In the last three months, there have been a total of only nine days showing inflows into the GDX, with a net almost $1.5 billion of outflows.

■ Gold stocks: cheap and unloved

Despite the nearly 40% move in the equity indexes, valuations remain close to their lowest levels for many years. Strong first-quarter cash flows, of course, reduced the valuation multiples.

So Agnico Eagle is selling close to its lowest price to free cash flow multiple in 40 years, virtually its entire history. Barrick is trading close to its lowest price to NAV in 40 years, again virtually its entire history.



Gold stock valuations are more attractive than they are for the broad stock market, an unusual circumstance, with stronger balance sheets and higher yields.

With the gold price at record levels, margins are strong, and the outlook positive, making the low stock valuations all the more out of place. What will change this and get investors—retail investors, institutions—buying again?

A reversal of one or more of the macro factors discussed earlier would set off the move: unemployment moving meaningfully higher; clear indications of weakening economy; interest rate cuts; a weakening dollar; the stock market rolling over. Each of these will see more Western investors move into gold and gold stocks. And one other factor: the second quarter results, to be released later this month, should be very strong. Remember it was only in March, at the end of the first quarter, that gold moved meaningfully above $2,000, for a first quarter average price of $2,070. Gold is now $250 higher than that while cost inputs are not significantly higher: oil a little higher, while commodity currencies are mostly lower. So the second quarter cash flows should be very strong. Two back-to-back quarters of strong cash flows should also garner some attention from attentive investors.

■ A small market can move quickly

It won't take much new buying to see higher equity prices given how small the gold stock market is relative to the broad market. The value of all gold stocks around the world is little more than twice what Nvidia can move in a single day. Western investors today have, on average, less than half of one percent of their assets in gold, and that is concentrated in relatively few hands. A return towards the U.S. historical average of 2% or the global average of around 4%, will see gold stocks move dramatically, as they always do.

Right now offers a very unusual and attractive buying opportunity. Normally, at the beginning of a bull market, the stocks move significantly higher very quickly. In 2001, the XAU jumped almost 50% in the first three months of the bull market as bullion rose a respectable 12% leaving stock investors scrambling to catch up, both to prices and valuations. The opportunity now is to buy gold stocks while they have barely outperformed gold, and while valuations remain very undervalued. This opportunity won't last.

Overall, even as we reduce holdings in the broad U.S. and developed equity markets, we are increasing exposure in smaller markets, and in particular, building positions in resources, not only gold and silver, but particularly copper and oil. Together with a large cash position, ready to take advantage of market declines, we are in a good position for the period ahead.

Review of Individual Accounts

■ Global Accounts

Our allocations to various sectors remained broadly the same at the end of the quarter as of the end of the first quarter, with a slight reduction in U.S. income stocks and a slight increase in cash, now around 5% for all global accounts and 18% for conservative ones.

We sold one U.K. holding that we had only started buying for accounts earlier in the year when a takeover offer was received and "viewed favorably" by major inside shareholders. We decided to take advantage of the price increase to sell.

Switching among the BDCs

We added two more BDCs, one among the most conservative of the sector that fell after it acquired one of its own private funds, giving us an opportunity to buy. The allocation to the sector remains much the same as at the beginning of the quarter, since we continued to trim a large holding that had moved up, as well as a smaller company trading above net asset value.

Looking ahead, we anticipate continuing to raise cash, including from the resource stocks on good moves, even as we will continue to look for opportunities to buy in global markets, and continue to hold a high weighting to gold in particular. While missing out on gains in the U.S. tech sector, which we feel has a high risk now, we are well positioned for the environment we see ahead of a slowing economy, monetary easing, and continued inflation.

■ Gold Accounts

Our gold accounts remained fully invested and continued the slight shift from senior miners to both juniors and silver stocks, though largely because a couple of junior stocks had strong moves, and the silver stocks generally moved more than the seniors. There is certainly not broad move out of the major companies. We are broadly one-third each to senior miners and royalty companies; juniors and exploration; and silver and resources.

We sold one "gold-in-the-ground" company after gold's strong move. Generally, we are not a fan of this type of company, but the stocks can be good trading vehicles. We bought several new exploration companies, but very selectively for a few clients (more aggressive ones with cash) since they are thinly traded.

Overall, though both sectors and companies remained much the same, we did some trading, trimming or even selling some stocks on rallies and adding to favorites, including a couple of seniors that are lagging, and a junior that could be a takeover candidate (and we like anyway).

Looking ahead, we expect to remain fully invested in gold accounts, though will take advantage of strong moves in particular stocks—or laggards that disappoint—in order to have cash available for new stories or favorites that offer buying opportunities. With a mix of seniors and explorers, miners and royalty companies, accounts are well positioned for a rising gold market as well as, potentially, more dramatic movers.

■ Resource Accounts

As with the gold accounts, our Resource Accounts are fully invested. The main sectors to which we have exposure remain gold, silver, and copper, plus oil and uranium. Many of the companies we hold have broad

exposure to the commodity complex, so in resource accounts we have some exposure to pretty much all the base metals, many minerals and rare earths, and agricultural commodities.

The main changes during the quarter were the purchase of a major global miner with a dominant position in iron ore, as well as another large independent E&P company in the U.S. We also bought back most of the uranium that we had sold earlier (and too soon).

Looking ahead, we expect to continue to be fully invested, and will look for opportunities to add to copper and oil, taking advantage of particularly strong moves in gold and silver to trim holdings in order to raise some cash. Gold and silver will remain our largest weightings since both, particularly gold, can move even in economic conditions that are not favorable to other resources. But we do believe that the entire complex, having been starved of investment capital for more than a decade, could see strong moves as demand begins to exceed supply.

In sum, we are increasingly concerned about the fragility of the financial markets because of excessive debt, and this makes us cautious about major equity markets which are, in any event, overvalued. We will continue to raise cash all the while looking for special situations and opportunities in global markets, focusing at this time on high-quality defensive companies. We will continue to have high exposure to gold stocks which can act as a hedge on accounts while offering the prospect for outsized moves in their own right.

Adrian Day, July 5th, 2024

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