Adrian Day
ADRIAN DAY ASSET MANAGEMENT

PORTFOLIO REVIEW

PO Box 9024106, San Juan, PR 00902-4106 • 410.224.2037 Third Quarter October 2024

Just as the Federal Reserve finally initiated its rate cutting cycle, on the other side of the world Chinese authorities launched a multi-faceted stimulus program, sparking equity rallies in both markets as well as spurring gold and other commodities upwards. U.S. stocks and gold moved to yet new highs (until gold fell back on the last two days of the quarter), while Chinese and Hong Kong stocks, reversed from an almost four-year slump which had seen prices cut in half; the CSI 300 index jumped 18% in one week moving into the green for the year to date. The medium- and longer-term direction of these markets may diverge, but the clear winner over the next year or so is likely to be gold.

■ Most everything was up in the quarter

The quarter just ending saw most assets in most markets up, particularly after the end-of-quarter rallies that followed both China and the U.S. easing monetary policy. In the equity markets, every major, and most smaller, markets are up; the Nikkei is up in dollar terms, though down in yen, while Mexico is up in pesos but down in dollars. The U.S. markets were distinctly middle of the pack, with the S&P up 5.8% compared with 8.5% for world markets outside the U.S. (basis MSCI World Ex-U.S. Index); both include dividends reinvested. Hong Kong and Chinese stocks were the leaders for the quarter, up almost 20%.

Our global accounts outperformed both the U.S. and world benchmarks, with the mid-risk accounts up 13.4% (account numbers are preliminary).* The reason for our outperformance is two-fold. First, our lack of exposure to U.S.-tech sector helped as many erstwhile highflyers such as Nvidia and Microsoft were flat or fell during the quarter. Second, our high exposure to gold equities, which were leaders this quarter, helped.

■ Gold and gold stocks lead the pack

Though the commodities in aggregate had lacklustre returns, with the Bloomberg Commodities Index up less than 1%, as always returns were mixed. Oil fell sharply (WTI Crude down over 16%), while natural gas was up; though nickel and iron ore fell marginally during the quarter, other metals were up; and the agriculturals, as always, were mixed.

Gold, up 13%, was the leader, adding to first-half returns. And the gold equities finally exhibited some leverage to the metal, with the senior stocks up over 18% (basis XAU).

Our resource accounts, being heavily invested in gold, silver and copper, and underweight oil, well outperformed the index with a 14% gain for the quarter.* The gold accounts were also up a very respectable 14%.* That we lagged the index for the quarter is largely due to our holdings in intermediates and juniors which generally lagged the seniors; the Index does not include the smaller stocks. For the year to date, however, our gold accounts, up over 30%, have outperformed the index.

As we look ahead, we see the main factors that helped our global accounts this past quarter continuing to do so, while the intermediate and junior gold stocks will begin to provide a tail wind over the next year or so.

■ Easing again before inflation conquered

It was not just the world's two largest economies that have cut rates recently, but many others including Canada and Switzerland. These moves come before inflation is firmly under control. Indeed, the Fed's favored inflation gauge ticked up in September, after the rate cut. We see inflation likely to remain relatively high and volatile in the period ahead, not only in the U.S. but in much of the world. Central banks may not be adding to the massive injections of money over the past two years, but nor are they withdrawing that money. Current inflation numbers may have declined, but the previous price increases remain in the economy; most workers' wages have increased less than have prices over the past four years.

As we and others have commented, the Fed faced a dilemma where further tightening was necessary to quash inflation, while both the economy and the government budget required easing. In truth, rates were left high long enough to hurt the economy but not sufficiently high for long enough to conquer inflation. The Fed's answer to this dilemma was to alter the goal. No longer is it inflation at the 2% target but rather it is inflation "on a path to 2%". The result, as we have discussed, is likely to be a deteriorating economy amid continued inflation. Given the lack of household savings—the net savings rate has now turned negative for only the third time since 1955 (the previous two occasions were at the onset of the Great Financial Crisis and the Covid pandemic) the resultant slowdown may not only be worse than usual, but the government response is likely to be even more stimulus.

■ Easing may not help stocks for long

If history is a guide, the resultant stagflation is an environment likely to be positive for gold, for other commodities, and for emerging market equities; negative for bonds and major equity markets. As the economy slows, corporate earnings will be squeezed, despite ongoing rate reductions. Initially, on the rate cut, equity sentiment increased, with now fewer than one-quarter of investors expecting a correction. While not at extreme levels, sentiment has returned to a very positive posture.

Historically, stocks are not always strong amid a rate-cutting cycle, particularly if the cuts start amid strength in the market. According to InvesTech of the past 100 plus years, if the market had risen more than 10% in the 24 months before a first cut, then it rose on average by just 2.6% in the 12 months after. I would add another factor: if the economy moved into a recession, the performance tended to be worse.

The important point is that most investors, large and small, are not positioned for a recession, so the risk symmetry is skewed.

* 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 internal dynamics of the market continue to deteriorate, however, most notably the market breadth, with more 52-week lows than highs even as the market hits new highs. We expect a meaningful pullback in the U.S. market in the relatively near term, accompanied by rotation out of the overvalued erstwhile leaders into smaller cap, into value, and into sectors that have lagged. Market direction is never certain, and nor is timing, but astute analysts such as Jeremy Grantham and John Hussman note that these are the conditions from which a bear market would start.

■ Chinese and smaller markets attractive

Much the same applies to European markets, if to a lesser degree. But Chinese (and Hong Kong) stocks remain undervalued. The entire Hong Kong market (where most of the leading Chinese companies trade) is selling for only 10 times earnings, barely above book, and yielding almost 4%. By contrast, the S&P is trading at a P/E two-and-half times as high, a price-to-book ratio four times as high, and yielding less than one-third. Chinese stocks, we suggest, will not only benefit from local stimulus but will garner attention from global investors looking for a place to put money which is undervalued relative to the U.S. with upside potential. With the CSI Index moving from a 52-week low to a 52-week high in just eight trading sessions, Chinese and Hong Kong stocks may have moved a little too far too quickly. But that is a short-term assessment; any pullback would be a good time to get invested.

■ Selected resources may see strong rally from undervalued levels

Commodities sharply recovered after China introduced its stimulus program, with the complex, which had declined 13% since mid-May, recovering over half its losses in two weeks (basis the Bloomberg Commodity Index). As always there were divergencies among the different index components, with copper and steel up along with gold and silver.

Despite this however, fund managers have the lowest allocation to commodities in seven years (according to Bank of America), even as commodities languish at their lows relative to financial assets for over a century. We are positive: Chinese and U.S. stimulus; greater demand for electrification; and supply shortages after more than a decade of underinvestment make a compelling case for a meaningful recovery in the medium term. We are most positive on those resources where the potential for supply shortfalls is greatest, such as copper and uranium, as well as the monetary metals, gold and silver. An additional factor will boost the latter, and that is increased demand from solar and electrification uses.

We remain cautious on oil, especially after the Saudi decision to increase production to win back market share after generally failing to get other producers to restrict output to boost the price. A Trump win in November, in easing permitting and otherwise encouraging drilling, may help the producers but not necessarily help commodity prices. There is a lot of hype about the amount of electricity used in AI, but I would not use that, and certainly not that alone, as a reason to buy oil assets. One thing we can be reasonably sure of however is that for the foreseeable future, energy demand will exceed renewable capacity.

■ Gold the main beneficiary

Gold is the surest beneficiary of the new stimulus. For the last two years, as discussed, the gold price has moved consistently higher on the back of both central bank buying and Chinese consumers. With barely a mention in the financial media, gold has outperformed U.S. stocks, for the past one, two and three years, as well as since the start of this century. This buying has been for idiosyncratic reasons of each, detached from the global macroeconomic environment. It is noteworthy that the central bank buying is pretty diffuse; even since the Peoples Bank of China paused purchases in May, net bank flows have remains strongly positive.

Private sector buying is also broadening. We are now seeing large non-official purchases from India and Saudi Arabia, in addition to China. But Western investors, until just the last few weeks, largely shunned gold, though not completely illogically. The macro environment, with high interest rates, (apparently) low and declining inflation, high real interest rates, and a (seemingly) strong economy is precisely the environment that is not conducive to gold.

As for gold equities—which have also silently outperformed the S&P for the past one, two and three years—one additional factor suppressed interest, and that was the strong broad stock market.

■ Things are turning for gold, encouraging investors

All that is beginning to turn. The first rate cut from the Fed in a new cycle has, for the past 40 years, always sparked a gold rally, and this time was no different. In addition, it is increasingly obvious that the U.S. economy is not as strong as the headline reports suggest, indicating additional rates cuts ahead. In turn, this could lead to further, significant weakness in the dollar. Currently at a two-year low, the dollar remains above its levels for the two decades prior, so it can weaken considerably on lower rates, a weaker economy, and ballooning deficits.

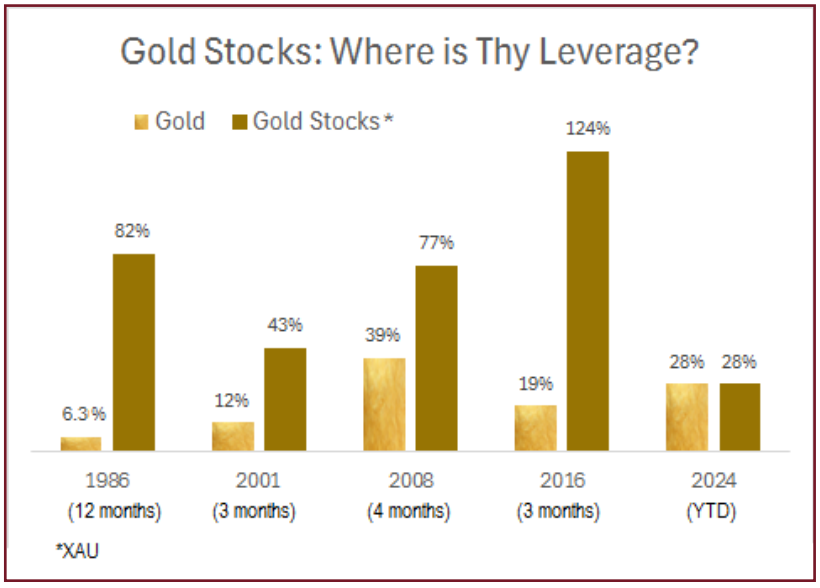
The change in macro conditions is being reflected in fund flows. Whereas the past six months, even through August, saw consistent outflows from both the physical gold ETFs and from gold equity funds, there has been a turn this past month. In September, the GDX saw about $440 million of net inflows, compared with net outflows of $406 million in the prior three months. Both sentiment and the macro environment are turning in gold's favor, with much more to come.

This is just the beginning. Overall, investor sentiment remains weak, however; U.S. investors on average hold only about 0.5% of their portfolios in gold, compared with longer-term averages of about 2%. In terms of price, while gold is at new all-time (nominal) highs, the stocks are significantly below the 2011 highs; the HUI index (which excludes the royalty companies and is called "the gold BUGS index") stands at barely 50% of that high.

■ Gold companies in better shape yet stock more undervalued

And if gold remains undervalued relative to the money creation of the past 15 years, so too the stocks remain undervalued relative to their historical metrics, indeed on many metrics close to their multi-decade lows. Importantly, the gold miners are not only undervalued relative to their historical metrics, but the industry is in far better shape, with stronger balance sheets and better financial discipline than at previous gold highs.

Significantly, though the major gold stocks (per XAU) are up a very respectable 28% this year, the reality is that they have not yet exhibited the kind of leverage to bullion that is typical, particularly at the start of a bull market. The nearby graph shows how typically gold stocks have multiplied the returns of gold after gold bottoms. The current disparity reflects that gold has gone up over the past two years for reasons quite distinct from the normal economic factors that make gold move.



Now that the Federal Reserve has embarked on a rate cutting cycle and flows started to enter the market, we may see that leverage exhibit itself. In addition, this quarter's results should be strong, since the average gold price is about $160 an ounce higher in the third quarter than in the second, even as the price of oil (the main cost input for mines) has declined. A third consecutive quarter of high and rising cash flows should garner some investor attention.

Having said that, after such a strong move, with the Fed rate cut now in the rearview mirror, and China closed for the rest of this week (for "National Day" holidays), we may see a pause or even a pullback in gold. We are not going to try to be too clever and time pullbacks, but will ride them out.

Overall, we are cautious about the U.S. and other developed stock markets amid overvaluation and slowing economies; cautious on U.S. Treasuries, amid increasing supply and declining global demand; reasonably positive on undervalued Hong Kong and other smaller market

stocks which typically do well as rates and the dollar decline; reasonably positive on the commodity complex, selectively, amid a recovery in Chinese demand; and most positive of all on gold equities, undervalued and yet to fully respond to gold's move.

Review of Individual Accounts

■ Global Accounts

Per our overall assessment on market risk, we have slightly reduced our exposure to global markets and to high-yielding U.S. equities, while slightly increasing cash in accounts, now over 2% in mid-risk accounts, over 16% in conservative accounts. (Larger accounts will also tend to have a higher cash exposure than smaller ones, due to management dynamics.)

We have only one new buy this quarter, De La Rue, famed British manufacturer of bank notes as well as passports, driver's licenses and other security papers for markets around the world. As demand for bank notes and traveler's checks has declined, demand for other security products has increased; the company is a potential takeover.

We shifted balance among high-yielding stocks

We have also added to some favorites that had what appear to be temporary price declines. Among the Business Development Companies, we added meaningfully to Golub Capital, one of the more conservative, which fell after a merger with one of its private funds providing those investors with an exit; it currently yields over 10%. At the same time, we have been trimming two others held in portfolios. We also sold under-the-market puts as short-term speculations on some stocks that fell sharply.

Mostly, though, this past quarter saw more selling than buying, including a London property developer, as the new Labour government there threatens higher taxes; while trimming some stocks that had done well, including even, for selected clients where we had recently added to positions, some Hong Kong stocks as they moved to 52-week highs. In more conservative accounts, we have also locked in some of our gold stock profits while maintaining exposure to that sector.

Looking ahead, we expect to continue to move out of the U.S, and major developed markets while adding to smaller markets as appropriate, all the while looking for short-term special opportunities. We continue to hold a high allocation to gold and other resource stocks, which we expect to do well in the stagflationary environment we see ahead.

■ Gold Accounts

Our gold accounts remain fully invested, and the allocation among sub-sectors remains virtually the same as it was at the beginning of the quarter (a little over one-quarter in the seniors; about one-third each in juniors and silver; with the balance in intermediates). This does not mean, however, that there was not activity in the accounts over the past quarter.

We sold two stocks widely held in portfolios, a senior which has started producing from a new mine (to which we remain exposed through royalty companies), and a small exploration company which saw management changes and has failed to progress meaningfully.

Trimming on rallies, adding on declines

On the buy side we have one new Canadian exploration company (we don't like to name thinly traded companies that may change from one quarter to the next). Mostly though, as usual, we saw some trimming of certain positions and adding to others, that either had lagged or had exciting developments that increased the value proposition.

Going forward, we expect to remain fully invested, even as activity is expected to pick up, as some stocks move to fully valued prices or else are acquired in the ongoing M&A activity. We expect any proceeds from sales to be reinvested fairly quickly as there is no lack of good quality companies that remain undervalued.

■ Resource Accounts

Similarly, our resource accounts continue to be fully invested, with top allocations still in gold, copper and silver. We also hold some uranium, agricultural commodities, and other metals, though are significantly underweighted right now in energy. Most of our exposure to small minerals such as lithium and the rare earths is through larger more-diversified companies.

Early in the quarter we sold one large global producer, specializing in iron ore (though we retain exposure through two royalty companies to what we think is their best mine). And we have been adding incrementally to our favorites that remain undervalued or where we believe there is a near-term catalyst. In particular, we have been buying the company that owns Canada's largest undeveloped phosphate deposit (that mineral was recently added to Canada's Critical Minerals List, meaning not only are grants available but permitting should be streamlined).

And we are buying for qualified clients, into an idled steel mill about to be restarted as a low-cost operator.

In sum, while increasingly concerned about financial markets in the U.S. and Europe amid slowing economies, we see opportunities in smaller equity markets as well as, as always, special situations that may be short-term investments in oversold companies. And we continue to be fully exposed to gold, even if that means trimming positions for more conservative investors. Overall, this coming quarter could be volatile in the markets and we are prepared with some hedges as well as gold and cash. We have a balance of defensiveness to protect accounts and holdings that can provide meaningful upside in the coming period.

Adrian Day, September 30th, 2024

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