Brace Yourselves

October 2021 **Letter No. 99**

Sometimes markets are easy to understand. They have distinctive trends that can be powerful and well entrenched. At other times, markets can give very mixed signals, the direction is ambiguous, and external factors can lead to utter confusion. I am not going to lie to you. I am finding the current environment extremely hard to read. There are many confusing and conflicting signals, and they are occurring at a time in which valuations on a lot of securities appear (to me) to be very over-extended.

If you are focused only on the near-term, as is generally the case for speculators and "day-traders," odds appear to be favoring significant volatility in the days and weeks ahead. More on this below. Such potential volatility should be welcomed by the speculating crowd, as wild price swings create the right environment for fast gains, provided they are on the right side of the trade. They are always looking for the next "shooter." As investors, however, we don't want to allow the lack of a currently identifiable trend and potential high volatility to throw us off the track of seeking to achieve the longer-term objectives of building capital and building a future income stream that will support future spending goals. Occasional disruptions and periods of high volatility are part of that journey. It is our job to use those periodic episodes of price disparity to our advantage and to capture opportunities most favorable to our long-term mission.

There is a phrase that describes the difference above in a concise way. I can't claim it as original nor do I recall who said this, but here we go: **"Trading is like dating, investing is like a marriage."** Of course, the implication here is that you should want to pick your long-term investments just as carefully as you want to choose your partner for life. Speculating and day-trading can result in flings, flirts, and flameouts. When the going gets tough in the markets, those who can see past the daily gyrations and the occasional air gaps and "waterfalls" of price action are more likely to have less stress and a much greater long-term satisfaction from their investing process. That said, let's consider where we are at this moment.

Over the course of this past year, the global stock markets have been all about a recovery following the brief (but painful) sharp declines that were a response to the many forced business and services shutdowns following the Spring of 2020. The lockdowns, the forced closures, and the promoting of "work from home" all conspired to heavily disrupt the former "just in time" inventory management that had become the de facto standard for many businesses. I'm sorry to have to report this, but there are many industries today that are still reeling from this massive disruption and I have seen several reports that this issue could easily last well into 2022, at a minimum. The cause was really two-fold. First came the shut-downs, followed by a surge in government financial support payments, which then allowed for the free and uninterrupted flow of continuing purchases by the mass of consumers. With no commensurate decline in the purchases of goods and services, more shortages resulted. This led to yet another issue. Back-orders and over-bookings led to upward price pressures because of basic Econ 101: Push/Pull Demand. Too much demand for too few goods and services results in higher prices. Inflation.

Our Federal Reserve (Fed) is calling the current level of inflation "transitory." There are many who believe it is anything but transitory, and if they are correct, this could become a bigger problem for corporate profits in the quarters ahead as nearly all of the inputs are heading higher. Higher wages, higher raw material costs, higher shipping costs, etc. This is already occurring at the grocery market level, and I don't need to cite examples. We all eat and we all shop. Looked for a new car lately? How about those menus at your favorite restaurant? My wife and I were at one about three weeks ago where there were now blanks where prices used to be. There are so many examples of sharp cost increases that could be listed here. I do not expect to see many of these increases decline to pre-2021 levels. I believe "transitory" talk should be met with skepticism.

If prices are rising but goods and services are harder to come by, would that necessarily imply that the economy could be slowing? That is an argument made by author and writer James Rickards *("No Recovery Until 2045?" Daily Reckoning, 9/14/21)*. He claims that in the aftermath of the big lockdown in 2020, economic recovery growth went from over 20% for a quarter to the mid-teens, then 6.7% annualized growth in the first half of this year but now down to an expected 3.6% annualized for the current quarter. He sees this trend as lower into 2022. Peter Schiff *(CEO, SchiffGold.com)* has written on his daily blog *("The Fed Is Failing; Stagflation Looms" 9/8/21)* that we have already entered a period of "Stagflation" wherein there is price inflation with a slowing economy. Maybe they are right, maybe not, but there is growing anecdotal evidence that might be supportive of those views.

By now, many of you might have heard business news coverage of a large and hugely indebted real estate developer in China by the name of EverGrande. It is being reported that they are the second largest developer in the world but number one in debts owed, and that they are on the brink of default. The debt amount of $300 Billion keeps popping up in these reports. If they fail to make their debt installments, it would follow that a major restructuring would need to take place. This can sometimes get done at dimes on the dollar, although it is too early in this case to know how this will go or whether or not the government of China will provide a full or partial bailout. This story is not new to the markets; there have been rumors of default going back several months and the stock and bond valuations of the company have already been deeply punished. The big unknown, as is often the case, are the counterparties who are owed money and what this means for how China chooses to deal with what could potentially be other large troubled developers.

I mentioned in the second paragraph that we should expect more volatility in the days and weeks ahead. I say this because the Volatility Index (symbol "VIX") has been on the rise again, and on Monday, September 20, it registered an unusually high 28.75, which was a jump of nearly 38% in one day. A sharp rise in the VIX is consistent with a sharp decline in the prices of stocks. On this particular Monday, the Dow Jones Industrials were down almost 1,000 points intraday before ending -614. The VIX has since retreated and is back around the 18 – 19 level as I write this (9/24), which is still considered to be quite elevated. This latest spike took us to a higher count than the two prior spikes in July and August, and nearly matched a spike up that occurred in May. Moves of this magnitude aren't typically "one-off" situations. It cannot be known until after the fact, but it would appear some large institutions are moving to shield themselves from some unknown future potentially disruptive event that could transpire sooner rather than later, and accept that they need to pay more for such hedging. I don't mean to be cryptic here, but the VIX chart is sending out signals that not all may be well with the world. Like I said above, the odds of more volatility ahead, based upon recent movement in the VIX, looks to have increased.

I want to conclude this letter with a further discussion of my current favorite asset, gold, and more specifically, the gold miners. Precious metals have been soft for many months in a row now, but by the charts, they are contained well within a longer-term trading range that doesn't appear to be broken. At least, not yet. Year to date gold is down by almost 10%. However, the miners, as measured by the **ARCA Gold BUGS Index** *(symbol "HUI" with BUGS as an acronym for "Basket of Unhedged Gold Stocks")*, is down nearly 30% in that same span of time. In fact, the HUI at the current level of 231 is the same as where it was all the way back in late 2003!! I can attest that in 2003, the price of gold was less than $450 per ounce, but today it is at $1,750. Further, I believe the industry dynamics and the balance sheets of many of these well-established and well managed precious metals miners are much better today than nearly 18 years ago, with many of them now generating dramatically higher cash flows, moving towards (or are already at) being completely debt-free, earning higher profits than before, and paying dividends (of which many miners are expanding upwards). For most of Wall Street though, this is a big "yawn." The "wow" factor is missing; this business grinds out slow and steady growth (great for investment!) while staying in the shadows of the shooters.

There is an entire new generation of stock market participants who are highly attracted to shiny objects. Brand new publically-traded companies that have yet to show any profitability (but have lots of jazz appeal!), SPACs (Special Purpose Acquisition Companies), companies involved in the new movement towards "Going Green," anything tech, "meme" stocks, and of course, nearly any company showing a recovery from the disasters of last year, are squarely in the focus of a lot of current market participants, particularly if the stocks are displaying powerful upward momentum. Extraordinarily high valuation levels? No profits? High multiples of price-to-revenue? Meh. It's kind of like dating.

The mining industry does not currently have the same appeal factor for this very large segment of market participants, yet I believe it is an industry that is moving in the right direction, and at current gold prices, can offer exceptional long-term investment value. You know, like in a marriage! Of course, the risk to this group is always the underlying price of the core asset, gold, silver, platinum, and other valuable resource commodities. On the other side of the coin though (no pun intended), all one has to do is step back and take a hard look at the very long-term chart of the per-ounce price of gold, and you will observe that the long-term trend has been, and continues to be … **<u>UP!!</u>** Take a good look at Figure 1 below, a chart of the symbol GC/1, the continuous "100oz GOLD" futures contract *(covering 2004 to current)*:

Figure 1: Gold Futures Continuous Contract (GC/1) 2004 – current ***(Chart courtesy of Refinitiv)***

From the far left, from nearly 18 years ago we start at a price of approximately $450 and on the far right we end at a price of about $1,750. The above chart pattern speaks for itself in terms of the long-term trend, but for clarification, each of the bars represent one month of price action while the multi-colored lines (red, green, blue) are various “moving averages” (MA), i.e. 20-month MA, 50-month MA, etc. They are all trending higher. However, let’s compare the long-term price trend of gold with the long-term price trend of that basket of gold miners, represented by the symbol HUI. (Figure 2 below):

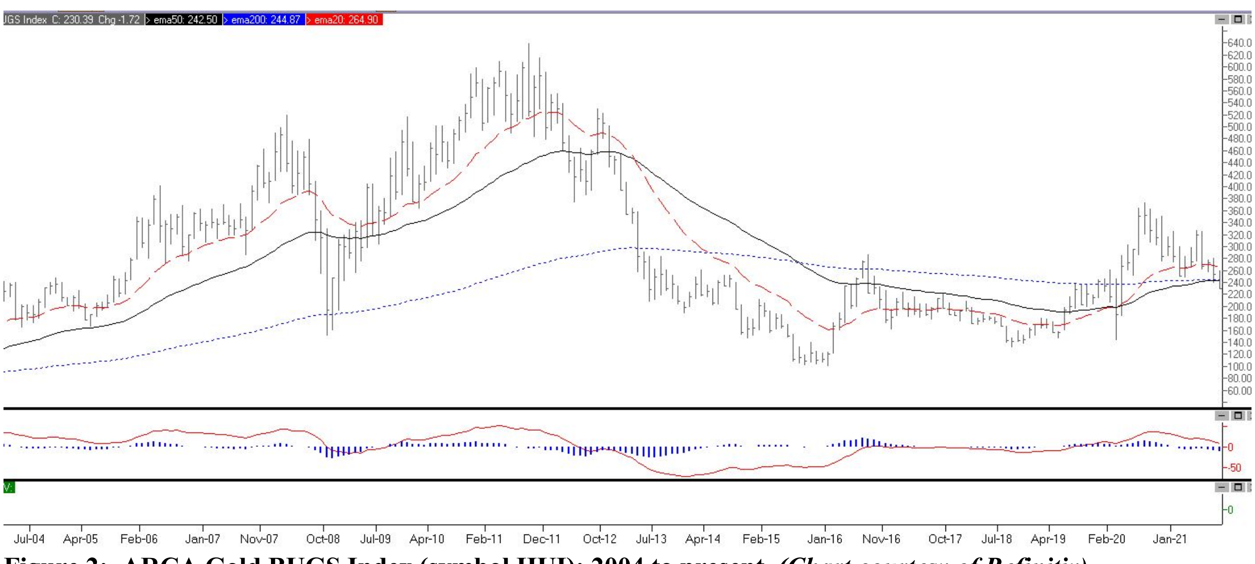

Figure 2: ARCA Gold BUGS Index (symbol HUI); 2004 to present ***(Chart courtesy of Refinitiv)***

On the far left, from nearly 18 years ago, we start at an index level of about 240, and on the far right, where we are today, we are at an index level of about 240. Hmmm, a long trip to nowhere. A lost decade. It should be apparent that gold and the HUI don’t reconcile with each other, but that sometimes happens in the markets. Here is the thing. The gold miners are the companies that own the gold in the ground and that will ultimately extract it at a cost that can readily be calculated within a fairly high degree of certainty. After a two-decade bull market in the price of gold, shouldn’t there have been at least some level of interest in the miners? I believe the answer is “yes,” but one must understand how markets work. While a new generation of traders may be chasing the current crop of shiny objects and “momentum” capturing a lot of their attention, the gold miners are building a business. This business is not without intrinsic value. There is a scarcity to gold, it has a significant place in our modern society (globally), and it has risen in price based upon its cost in U.S. Dollars. It should be noted that gold has risen even more sharply over this same stretch of years when bought in many other alternative currencies such as Yen or Euros. However, it will only matter when it matters.

I have said for years, and I remain convinced, that gold as an asset class (and the miners as a subset of this asset class) are simply not big enough to take on a crushing stampede of buyers in this space. I believe that there is potential for Wall Street to notice that the long-term price trend of this asset is growing. Additionally, the operational trends among the miners has been getting better and better. If the miners should start to display some long-sought upward momentum, then there is always the potential that such momentum starts to register on the algorithms of the high-speed computers of the hedge funds and day-trading crowd, thus potentially becoming the “new shiny object.” If this should occur, there may not be enough room for a lot of new money to come into this asset class without prices leaping materially higher.

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Indices are unmanaged and are not available for direct investment.
Past performance is no guarantee of future results.
VIX is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options.
The Dow Jones Industrial Average (DJIA) is an index that shows how 30 large, publicly owned companies based in the United States have traded during a standard trading session in the stock market.
The NYSE Arca Gold BUGS Index is a modified equal dollar weighted index of companies involved in gold mining. BUGS stands for Basket of Unhedged Gold Stocks. It is also referred to by its ticker symbol "HUI."
The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.