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Quarterly Commentary

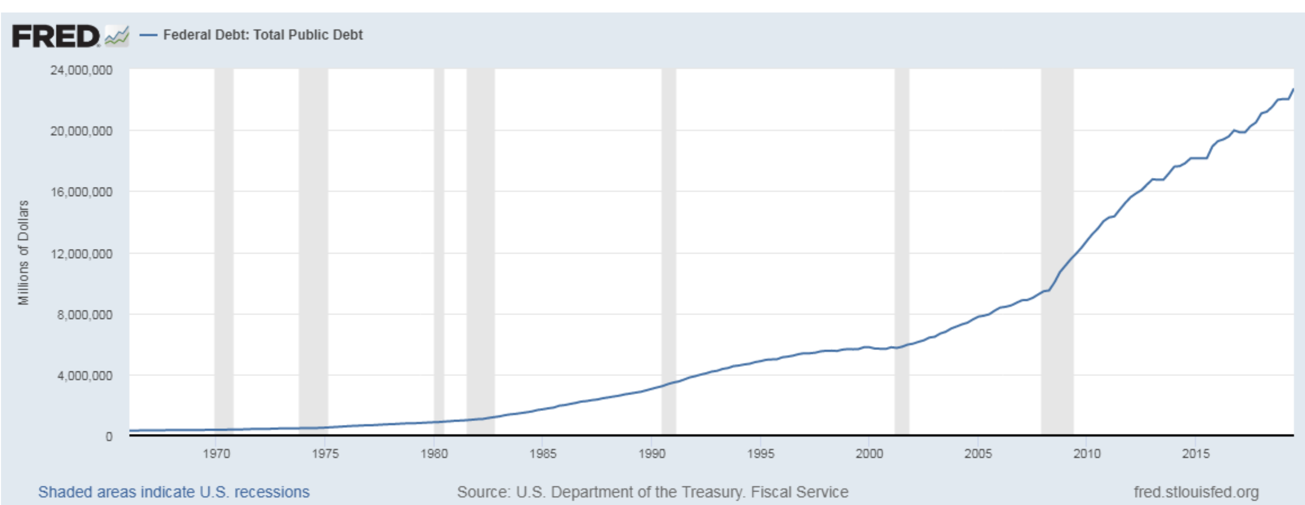
4th Quarter 2019

Playing Make-Believe

Part of everyone's childhood is, or should be, the game of suspending the believable and making of reality what you wish. For many little girls today, that involves imagining themselves as Anna or Elsa, the beautiful animated sisters in the Disney blockbusters, *Frozen* and *Frozen 2*. For boys, it is often donning the persona of a famous athlete. For one of us, it was going to a place in his mind where he was a starting pitcher for the St. Louis Cardinals (he had quite the imagination).

Today, policymakers and most of the general public seem to make-believe that the accumulation of debt at an accelerating pace by the U.S. Government is of no importance. When was the last time you heard a politician mention the debt or deficit? It rarely comes up.

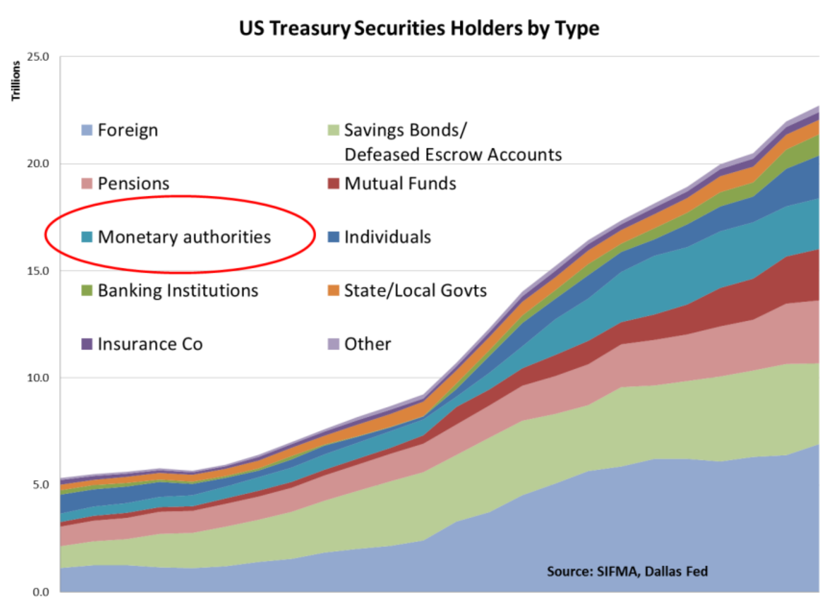
We noted at the mid-point of 2019 that the U.S. federal debt stood at $22.4 Trillion. We ended the year at over $23.1 Trillion (see chart below). That is an annualized rate of increase of 6.25%, more than double the rate of GDP growth. U.S. government debt as a percentage of GDP is now at its highest point since WWII and second highest ever. Why should we pay attention to this when no one else is? Why should we be the worry warts when everyone else is having a great time at the party, make-believing that we can continue to accumulate debt with no ramifications? Because the financing of the accelerating debt is the elephant in the room when it comes to interest rates.

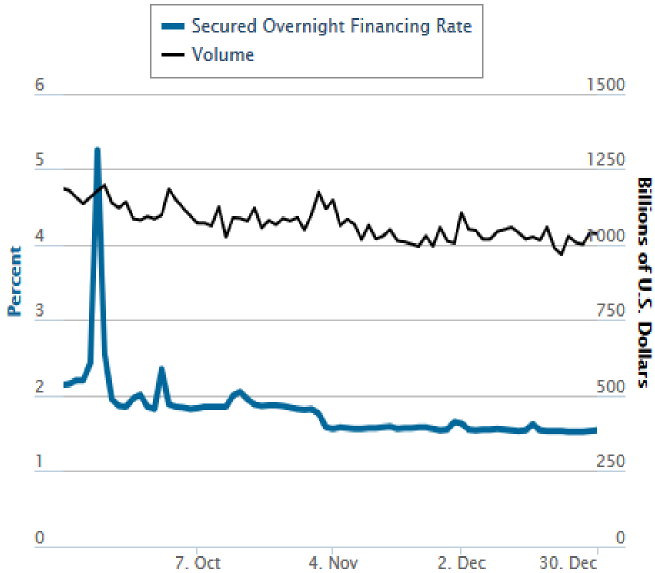


Interest rates at all-time historical lows have had everything to do with speculatively high asset valuations. The Federal Reserve's effort to create a "wealth effect" by inflating asset prices has worked. As we have stated before, we know of very few assets that are not at record valuation levels. The popular wisdom is that interest rates will stay low for a long time to come. That may happen. Our record of anticipating future interest rates correctly has not been so hot. However, there are some interesting changes going on that could hinder central banks' ability to maintain the low interest rate regime they have been able to impose.

While U.S. Government debt is increasing at a rapid rate (even in a growing economy), the make-up of the buyers of our debt is changing (see chart below). Foreign buyers still hold about 37% of marketable U.S. Treasury debt, but that is down from 43% in 2010 according to the Securities Industry and Financial Markets Association (SIFMA). This decrease came in spite of the fact that the U.S. dollar was up significantly against all major currencies during this period (e.g. up more than 28% against the Euro since the beginning of 2010). That currency appreciation should have made U.S. Treasury securities denominated in dollars **more attractive** to foreign buyers, not less. In other words, the decline in foreign holdings might have been even greater had it not been for dollar appreciation. The fact that the dollar declined throughout the 4th quarter of 2019 against most major currencies (except the Japanese yen) may portend that the long bull market in the dollar is coming to an end. It is certainly too soon to tell, but a declining dollar would have an ominous impact on the demand for U.S. Treasury securities by foreign holders with a corresponding impact on interest rates in U.S. markets.

The chart shows that the Federal Reserve (see "Monetary Authorities") is a large holder of U.S. Treasury debt. The Fed's ownership grew rapidly in "The Great Financial Crisis" (TGFC). Its relative ownership then began to slowly decline in 2015 as it began to let the balance sheet shrink slowly in accordance with the plan to return to a lesser and more normal role in propping up markets. However, the Fed reversed field in late 2018 when, in response to market conditions, it stopped its effort to raise (i.e. normalize) short-term interest rates. Then something unusual happened last September 16 and 17.





Source: Federal Reserve Bank of New York

Liquidity in the collateralized overnight funds market dried up, as you can see from the chart on the left. While the chart reflects that the **average** daily interest rate for that market jumped to over 5%, some trades actually spiked to almost 10%. The Fed jumped in with massive loaning in order to tamp down rates. Just as in TGFC, the Fed became the buyer of last resort. As liquidity has tightened, the Fed has continued to support this market, and their balance sheet is back to expansion mode once again. The large banks, historically the providers of liquidity in the collateralized funds market, have been hampered by increased reserve requirements since TGFC. Also, the ever- increasing demands on these banks' reserves in their role as primary dealers of U.S. Government securities has reduced their ability to support the collateralized overnight funds market. While there is talk of reducing reserve requirements to address the liquidity crunch, it remains to be seen how long the Fed will be required to support the overnight funds market.

A short explanation of the Fed's mechanics used to affect interest rates is in order. The Federal Reserve carries out its open market operations by purchasing or selling U.S. government securities with member banks. If they want to increase liquidity in the system, they purchase government securities from member banks, and if they wish to contract liquidity, they sell government securities to member banks. Thirty of the largest member banks, the primary dealers, are **required** to make a market in **all** debt issued by the Treasury. The Federal Reserve stepped in during TGFC and flooded the system with liquidity in order to manipulate the price of government bonds upward and interest rates downward. Their massive purchases of government securities (and for the first time, other types of bonds as well) greatly expanded the Fed's balance sheet. That action created bank reserves out of thin air and was referred to as "quantitative easing" during TGFC. A less deceptive and more descriptive term for such action is debt monetization. We view the recent Fed buying in the collateralized short-term funds market as monetization of the government's debt. The Fed's balance sheet is again expanding. They are the buyer of last resort in order to keep short-term rates at current low levels.

Almost immediately upon the Fed halting their interest rate normalization policy at the end of 2018, the gold market took off (as did stocks and bonds). As you can see from the chart on the next page, gold was up almost 19% during 2019, another indicator that the monetary shenanigans that the Fed and other central banks have been carrying out may be more difficult to pull off in the future. The world's monetary system is based on confidence in fiat currencies (currency backed merely by the credibility of the issuing government). When something happens to impact that confidence, the gold market usually takes notice. You can be sure that if the Fed continues to expand its balance sheet by monetizing the huge amounts of new debt that is being issued by the Treasury, gold market participants will continue to notice.

1 Year Gold Price History in US Dollars per Ounce

As we stated before, the conventional wisdom on interest rates is that they will remain low for a very long time. If the public continues to retain confidence in the dollar and other fiat currencies that could happen. However, reduced foreign financing of an exploding U.S. government debt, liquidity tightness in markets that serve to help finance that debt, resumed debt monetization by the Federal Reserve and a rising gold price all point toward the case that the game of make-believe may be coming to an end.

Speaking of Liquidity

Our position in gold stocks performed even better in 2019 than the price of gold (referenced above) and basically mirrored the return for the broad market. We anticipate that gold and gold stocks will be a safe haven and possibly even an appreciating asset in turbulent times. As this is written, we are experiencing such a time with the current dust-up in the Middle East with Iran. Also, gold should continue to provide us with a hedge against the radical monetary policies that central banks are employing around the world.

Gold stocks are vastly under-represented in most investors' portfolios today. Couple that with the fact that we are continuing to see declining levels of liquidity in the stock market, and our position in gold stocks could become a great additional source of liquidity for your portfolio whenever a market correction inevitably occurs (see our 2nd Quarter 2014 and 2nd Quarter 2017 for discussions of the mirage of liquidity in stock trading).

Most major gold companies are continuing to focus on reducing costs and providing attractive returns to shareholders in recent years after a long period of reckless capital spending in search of increased production (see our 1st quarter 2019 discussion). A rising gold price should only increase the attractiveness of their shares. Our largest position in gold mining, **Newmont Goldcorp Corporation (NYSE: NEM)**, just announced a 79% increase in its quarterly dividend to $.25 per share. Our other major gold company investment, **Barrick Gold (NYSE: GOLD)**, announced a 25% increase in its dividend in November.

Cheap, Cheap, Cheap

One of the most unloved companies we see across all sectors of the stock market is our holding in Teck Resources **(NYSE:TECK)**. Teck was highly levered during The Great Recession and found itself scurrying for cash and financing. Since then the company has turned itself around. Much like the gold companies discussed above, Teck has gotten balance sheet religion and has transformed itself into an investment grade credit with no meaningful debt maturities until 2035.

Teck trades at roughly 7.1 times trailing 12 months earnings per share, 50% of book value and 52% of tangible book value (there is very little in the way of intangibles on the books…we love that).

Headquartered in Vancouver, Teck is the largest domestic mining company in Canada. It is well diversified in four main businesses: metallurgical coal for steel making, copper, zinc (the world's 3rd largest producer) and a joint venture partner in the Fort Hills bitumen project in Alberta.

Teck's Fording River and Elkview metallurgical coal operations in British Columbia are world class assets. Teck has important access to 3 west coast port facilities for seaborn shipments and has long-term rail contracts with Canadian Pacific and Canadian National for delivery to those export terminals. Teck is the world's second largest shipper of metallurgical coal for export.

Copper is critical to the world's transition to electrification. Teck is currently a major producer of copper, and phase 2 of its Quebrada Blanca (QB2) project in Chile will easily put it in the world's top 10 and perhaps top 5. Teck owns 60% of the project which is projected to begin production in the second half of 2021. The other owners are Sumitomo Corporation (30%) and an agency of the Chilean government (10%). QB2 is a major undertaking, but it is enhanced by the fact that the deposit sits under the open-pit mine that was the first phase of Quebrada Blanca, allowing for easier underground access. Once in full production, QB2 will fully balance copper with metallurgical coal in diversifying the company.

Zinc has many uses that we do not often consider: for galvanizing steel and iron, in the production of brass and bronze, for casts used in producing various metal products, zinc vitamin supplementation and therapeutics, food fortification, crop nutrition, and batteries. Teck has zinc and lead mines in Washington state, Alaska and British Columbia, with a zinc and lead smelting operation at its fully integrated facility in B.C.

The most recent addition to the Teck portfolio of businesses is its 21% ownership of the recently developed Fort Hills oil sands mining and processing operation. Other owners of Fort Hills are Suncor (54%) and Total (25%). Fort Hills achieved its first oil shipments early in 2018 and it is now operating at full capacity. Teck also owns a 100% interest in the Frontier oil sands project (future development) and other interest in oil sands leases in the Athabasca region of Alberta.

Current Income and a Bright Future

We have written previously about our investment in Exxon Mobil **(NYSE: XOM)**. Since our purchase and subsequent increase of the position, the company has (in our view) improved its position while the stock has declined in price. Exxon has been distinguishing itself from its integrated oil company competitors by ramping up capital spending on a number of projects that it believes will boost future returns for shareholders. This inevitably reduces near-term cash flow, and so the market has recently penalized Exxon's stock. For us, that is a sign of the severity of the negative sentiment in the oil and gas industry. We would challenge our clients to point out another company with a AA or better credit rating, a 12-year average return on invested capital of over 15%, and a dividend yield of nearly 5% that is currently offered for less than 12 times full-cycle earnings (the average earnings since and including the last recession). We will be giddy to review any findings you pass along!

Exxon will have spent around $30 billion in 2019 exploring for oil all around the globe, building new pipelines and growing refining capacity. In 2018 Exxon had a proved reserves replacement ratio of 318%, meaning they added 3 times the number of barrels to their reserves than they produced. This compares to an industry-wide proved reserves replacement ratio of only 7% in 2018. Exxon has oil discoveries in offshore Brazil, the Permian Basin in West Texas and one of its greatest recent accomplishments in the waters off of the South American country of Guyana.

The Guyana discovery, announced by Exxon in 2015, is the industry's largest greenfield growth project in decades and at one of the lowest breakeven costs, around $25-$35 per barrel. The total recoverable resources from Exxon's acreage in Guyana are known today at more than 5 billion oil-equivalent barrels, of which Exxon is operator and owns the largest interest (45%) alongside partners Hess and China National Offshore Oil Corporation (CNOOC.) Exxon's progress in Guyana represents an impressive pace. The first discovery was in 2015 and Exxon announced the first production from the field this past December, less than five years after the initial discovery and well ahead of the industry average for deep-water developments. In 2018 alone they increased their estimated recoverable barrels in Guyana from 3.2 billion barrels of oil to 5 billion. We like to see a company with such an impressive track record of high returns on capital putting more capital to work investing in projects to boost future earnings. Already since our first purchase of Exxon, book value per share has risen over 9% despite the stock price declining around 6%. Oil prices are up around 50% over this same period. Exxon's valuation level reminds us that Mr. Market is not always rational and we are happy to capitalize on this fact for our clients by owning Exxon shares.

Milestones

Not much to report on the family side of things this year, so check this spot next year for any updates on that.

The implementation of portal access to client statements seems to have gone very smoothly. If that is not the case for you, or you wish to change how you are receiving your reports, please do not hesitate to contact us. You may have heard us state that we try to excel at the things we can control, and at the top of that list are service and communication. If you see a way for us to improve either, we want to hear from you!

We recently discussed at a staff meeting that many of you have done business with us for years without having ever darkened our door (such is technology today). If you are one of those, or if it has been too long, we hope you will come by and meet our entire staff (all 11).

As we hurtle into a new decade, we are so very thankful for those we have the privilege of serving. Your continued confidence in us and our work means everything. It is that trust and confidence combined with a healthy dose of patience that has allowed us to have great long-term success for our clients. Patience is a rare commodity these days, and we so appreciate that our clients are focused on the long-term.

From all of us at FRM, we wish you a healthy, joyful and prosperous 2020.

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