*Adrian Day's*

# Global Analyst

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*In today's Bulletin, we discuss the new Fed chairman Kevin Warsh, some developments at companies on our list, and answer your questions.*

## NEW FED CHAIRMAN OFFERS SWEEPING CHANGES, MORE SIGNIFICANT THAN NEW HAWKISH TONE

Markets and commentators noted the supposed "hawkish" tone of new Federal Reserve Chairman in his first meeting and subsequent press conference this past Wednesday. The decision to keep rates static was not a surprise, but the brief statement and the dot plot were, along with many comments from Warsh.

- The Fed's release removed the comment suggesting that the next move in rates would be down, and ended with the straightforward comment: "The committee will deliver price stability."
- Fully half of the Fed members indicated that they expected interest rate hikes both this year and next.
- In his comments, Warsh hardly mentioned the labor market but emphasized the rise in the CPI.
- He emphatically stated that he intended to get the CPI rate down to the Fed's 2% target, stating that the Fed has missed its target for the past five years. The market interpreted this to mean a hawkish monetary policy.

Unlike under Powell, I do not think we should expect a stream of Fed officials, and the chairman himself, reinterpreting what he had said in light of the market reaction, so we may have to wait until the next Fed meeting (at the end of July) for a meaningful update to Fed policy. Of course, Warsh pointedly observed that the market should react to economic data and not to the Fed's interpretation of economic data, and there will certainly be plenty of economic data over the next five weeks.

### The market had already changed view on rate cuts

The market expectations on rates have reversed dramatically. In January, Fed Funds futures were pricing in a 94% probability of a cut and zero probability of a hike in 2026. Now, almost half way through the year, they are pricing in an 80% probability of a hike, and zero of a cut.

The shift started before Warsh's first meeting because of concerns about the inflationary impact of higher oil prices, but it accelerated after Warsh's first meeting. Most significant was that Warsh did not blame the oil price for the latest pick up in the CPI, but

referred more than once to how the Fed had failed over the past five years. *Real* interest rates are now negative, but Warsh may not allow this to continue for long.

Some important, and positive, things from Warsh

Yes, one could say there was a more hawkish tone, but other things stood out to me.

- The clarity of the brief Fed statement (130 words versus 341 for the last statement).
- An acknowledgement that the Fed's own monetary policy is responsible for inflation; this was in stark contrast to the last Fed's repeated "transitory" comments blaming higher CPI on covid, or war, or oil, on anything and everything except the Fed itself.
- Warsh noted that the data that the Fed has relied on is old data by the time it is collected and released. He commented that CEOs have more accurate and up-to-date information than the statistics released by the government (reflecting criticism of Fed reliance on backward-looking data).

I am no fan of the Fed. It is attempting something that is impossible (how a group of nine people, mostly academics, sitting in Washington can possibly know what is going on in the economy and what is right for the economy; Hayek clearly expounded how this central planning is doomed to failure). It has indeed failed over its 100+ year history, overseeing and indeed responsible for both the deepest recession and the worst inflation in U.S. history. It should be abolished.

A major criticism of the recent Fed has been its reliance on data that is, by its very nature, backward looking and frequently out of date by the time the Fed considers it. I have suggested that the highly paid economics PhDs that the Fed has on its staff could be more usefully employed listening to company conference calls.

Warsh understands the economy and markets

But Warsh was a breath of fresh air. He made clear and straightforward comments, delivered professionally with conviction, based on a deep understanding of markets rather than the academic backgrounds from recent Fed officials. (Neither Yellen nor Bernanke has ever spent a day in the private sector.) His comments that the Fed should listen to markets (as they interpret economic news) rather than markets listen to the Fed was revolutionary in its own way. So, at the risk of appearing naïve, I see Warsh as a positive for the economy (if not necessarily, at least in the short term, for the markets!)

Market reaction to hawkish tone

The Fed's new hawkishness affected all markets, the bond market most of all, with rates moving up (bonds down), but also the stock market, down before a recovery, as well as gold. The stock market is remarkably complacent; margin debt shot up again, 9% in May, to reach almost 4.5% of total invested, a new all-time record.

By contrast, with gold, we saw a pick up in outflows from both the physical and equity ETFs, as well as Commodity Traders turning net short, and most astonishingly, we see the bull/bear index on gold equities report extremely low bull ratio (7%), with one day last week a stunning zero bull ratio. From a contrarian point of view, this suggests we are close to a sell-off capitulation.

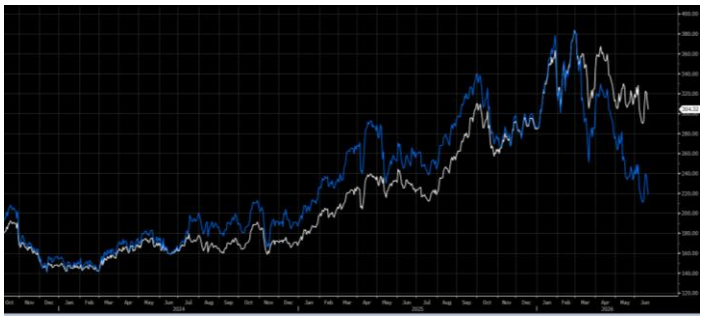
This comes when *valuations* of the gold stocks are very close to multi-decade lows. Agnico Ealge's price-to-free cash flow multiple, for example, is within a whisker of its low. Last week, partly because of these valuations, I indicated it was time to buy the gold stocks again. Indeed, the ones I mentioned are up over the past week, some appreciably. But now, this week, things have changed and the next move for the gold stocks is likely down, so we would hold off buying for the most part; this may be only very temporary.

Cobre inches close to restart in positive development for Franco

**Franco-Nevada** (FNV.NY, 219.26 ) received some potentially positive news when a Panamanian commission reported that the Cobre Panama mine shut down by the government over two years ago was broadly well operated with no major deficiencies, but recommended enhanced oversight and reporting. The report suggests that the government will not try to replace First Quantum as the mine operator, with the next step negotiations over a new financial agreement, making a reopening sooner and smoother than otherwise. Franco, of course, owns a stream on the mine, which was its largest single revenue source before the mine was shut.

Separately, Franco said it is appealing a Burkina Paso court ruling nullifying its stream agreement with a local company that challenged the agreement on the Karma mine. Franco said it is pursuing legal remedies under the provisions of the agreement. This is a small mine, and not material to Franco's revenue.

A restart of revenues from Cobre is not fully in the stock price and would be meaningful when restarted. The chart shows how Franco's price-to-book ratio has broken down from its close correlation with the stock price. (Franco's stock price is in white, in Canadian dollars in the graph, and the price-to-book in blue). Franco previously wrote off its investment in the mine, so its book is not reflecting any value for it. Franco is a buy for those who do not own it.



Fortuna advances next mine

**Fortuna Silver** (FSM.NY, 9.26) has received the key environmental approval for its Diamba Sud gold project in Senegal, as it completes its feasibility study, with a view to a construction decision mid this year. First production is expected in the second half of 2028 and is central to the company's growth pipeline, representing about 15% of company net asset value.

Fortuna is trading at only about 60% of its NAV, below peer group average. The uncertainty in the gold price suggests that the stock could retreat after its recent rally, but certainly would be one to buy on a pullback.

**TOP BUYS this week,** in addition to above and below, given my near-term caution on buying following the Fed meeting, include **Agnico Eagle** (AEM.NY, 166.66); **Lara Exploration** (LRA, To., 3.89); and **Kingsmen Creative** (KMEN, Singapore, 0.55).

# *Answers to Your Questions*

***Q.*** *I, like you, remain concerned about the private credit market yet you continue to have Ares Capital on your recommended list. What makes you like Ares when you are concerned about the sector? B.Z., Colo.*

***A.*** I believe there is a significant difference (in general) between the private Business Development Companies (BDCs) and other credit vehicles on the one hand and the public BDCs on the other. The significant issues we have seen in private credit in the last 12 months have been in the private funds. There are obvious reasons for this. Unfortunately, many of the private funds play games and "extend and pretend" hoping something will come along and prevent real issues. In the public markets, there is more scrutiny.

Why Ares is better than most

Not all public BDCs are the same quality of course. I would avoid most today. **Ares Capital** (ARCC, Nasdaq, 18.03), as I have discussed several times in the newsletter, is one of the oldest, largest and most conservative of the BDCs. It distinguishes itself in several ways:

- Not only is its dividend more-than covered by net investment income (as are most of the other public BDCs), it also has large spill-over income (undistributed NII) amounting to nearly three quarters of dividends. This means that if the company failed to earn the dividend for one or two quarters, it has a cushion to maintain the dividend (as it did during covid). Although failing to cover the dividend but paying out of cash does not change the reality, it would support the stock, since a BDC that cuts the dividend normally sees a sharp stock reaction.
- It is extremely broadly diversified, with only one company representing over 3% of its assets (just) and the average being less than 0.5%. If anything, one might argue that it is too broadly diversified!
- It has low leverage, right now less than 1.1x asset value.
- All its loans are independently valued. It uses four independent valuation firms which each value each loan at least once a year on a rotating basis. Of course, we know that independent valuation firms can still misvalue assets (think Moody's in 2008) but using four different firms is a good practice, best in class. And it beats firms doing their own valuations and then suddenly having to make large changes when things go dramatically wrong. Ares moves things into and out of its different credit rating categories, but, to my knowledge, has never had a case of a company top rated that went into default on its loans.
- It tends to be proactive, most recently by hiring an independent evaluation of its software exposure. Again, this does not guarantee the accuracy of the study, but demonstrates they are looking at these issues and doing it with outside firms.

I am very comfortable with Ares Capital. This does not mean that there could not be another several quarters where it does not meet its dividend, but it is unlikely to run into financial difficulties and less so to do so suddenly and unexpectedly. It also does not mean that the company would not cut its dividend as rates are reduced *and* spreads tighten. This concern had caused many BDC stock prices to

drop in recent months, but the new Federal Reserve chairman would seem to have removed that concern for now.

## Biggest risk to stock price

The bigger risk, I think, would simply be a matter of market perception to the entire private credit space in the face of difficulties at some high-profile firms. In particular, ARCC's sponsor is Ares Management which is not as conservative as Ares Capital, and has already limited withdrawals from one of its private funds. Difficulties at "Management" would hurt Ares Capital's stock price.

Ares Capital, down from nearly $23.81/share in early last year, is now approaching its three-year low ($17.45 at the end of March this year). It is trading at low valuation metrics: 0.92x book and yielding 10.7%. Other than briefly during Covid and again in the Great Financial Crisis, this is Ares' highest yield in 20 years, while its price-to-book is close to its low (high of 1.24x and low of 0.88x). Capital appreciation over the next 12 to 18 months may be limited, but for someone willing to ride out perhaps sharp volatility but hold for long-term dividends, then it should be held. **Buy.**

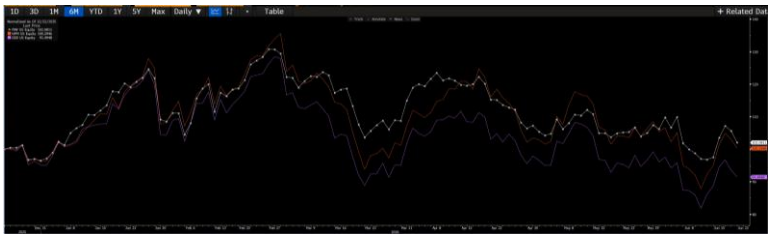
## Is a Cobre Panama resumption already discounted in Franco's stock price?

***Q.*** *I'm a little bit confused. You used to conclude that the potential reopening of Cobre Panama was not discounted in the share price. Now, in early May, you see downside risk, partly because the restart of Cobre* is *already in the share price, despite FNV chronically lagging the rest of the pack (the distance to Wheaton grows by the day). Could you explain that for me with a little more detail please? J.R., Copenhagen*

**A.** The simple answer to this is that stock prices fluctuate and what was true in December, with Franco trading under $210 was not true in early May, with Franco over $240, but is true again now, with Franco back under $220. The move in the gold price and gold stock sector (GDX, for example) over this period does not explain Franco's moves. Hence, Franco was low relative to the GDX in December, but moved more strongly than the GDX to trade at a premium in early May.

Above, we note how Franco's price-to-NAV has meaningfully broken down from earlier in the year, indicating there is now *relative* upside if the Cobre mine reopened.

Whether or not Franco is "chronically lagging" other gold stocks, specifically FNV



depends on the time frame at which one is looking. This was true for the three years till the end of 2025. This year, however, Franco is leading Wheaton (just), while both are leading the GDX. The graph, with Franco in white, Wheaton in orange, and the GDX in purple, shows this.

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