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In today's Bulletin, we look at the overvalued U.S. stock market, and indications that it may be about to break. We also look at year-end financials from another royalty company.

THE RISK TO THE U.S. STOCK MARKET INCREASES

There is no denying that the U.S. stock market is trading at valuation extremes. By most metrics, it is trading today at its highest valuations since the dot-com mania at the end of the 1990s, and at levels considerably above average. The only exception was following the Covid pandemic, when earnings collapsed faster than stock prices, sending the p/e ratios spiking. Stocks today have the lowest dividend yield since 1999 and the highest price-to-sales ratio ever (except for that Covid anomaly).

Valuations are meaningfully higher than historical numbers: the index's P/E ratio, standing at over 25 times today, has been less than 20x for most of the past 20 years and averaged around 17x; the price to sales ratio, at over 2.9 times, is significantly above the previous peak of 2.25 in 1999, and twice the longer-term average.

Signs of a top abound

With profits also at near-record levels, there is a double risk to stock prices from both a slide in profits and multiple contraction. With the economy slowing and costs stubbornly high, are profits likely to *increase* from here? Unlikely. Companies cannot continue to pass on all of their cost increases during a longer period of even moderate inflation. Are stock multiples likely to go even higher? They can always move higher, but not much and not for long. Starting from high valuations means that stocks are likely to have modest five-and 10-year returns from here.

Many technical indicators are also near extremes. Only five stocks account for over 25% of the S&P market cap, the highest since 1964. Market breadth is particularly narrow relative to stock prices, and narrowing even as the market continues to move higher. Extreme concentration in this market is a negative sign.

Meanwhile, investor sentiment continues at extremes, with a 45-point spread between bulls and bears (just 15%), according to Investor Intelligence.

Looking at valuations and market internals, John Hussman writes, "We can't say with any certainty at all that stocks are at a market peak. We can also say with complete certainty that present conditions mirror what a market peak looks like." And that mirrors something I have said many times: an investment advisor is not in the business of making predictions, but rather assessing risk.

Nor should we expect lower interest rates to keep the stock market party going. Lower rates will be a reflection of a recession, which is negative for corporate profits and stocks. The last three rate cutting cycles—in 2000 to 2003, 2007 to 2008, and 2019 to 2020–-saw stocks decline.

<u>There are indications of smart money moving out</u>

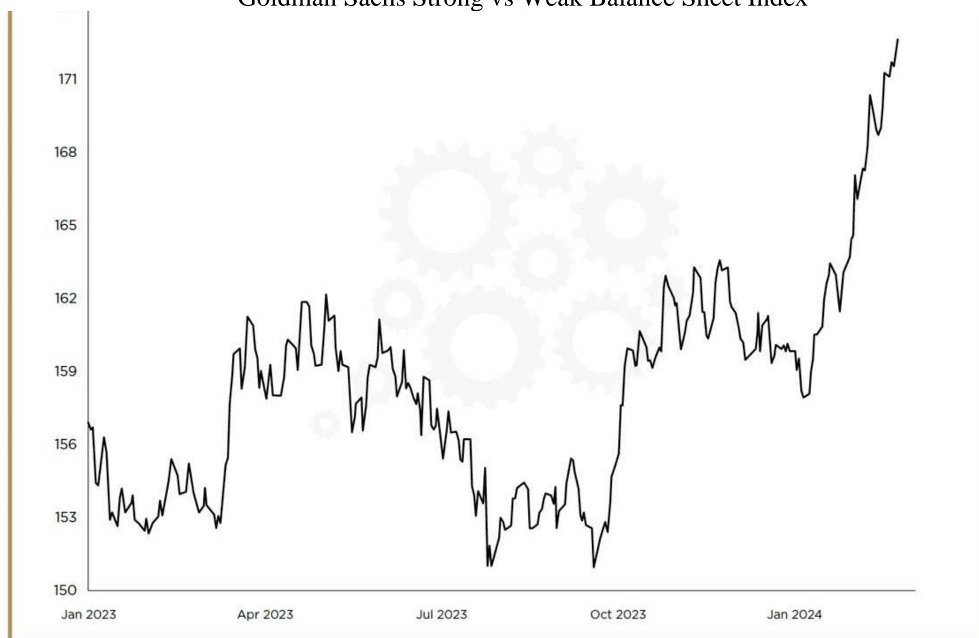
But now there are signs that the party may be coming to an end. Many astute investors are moving towards more defensive postures. Warren Buffett's Berkshire Hathaway famously has record levels of cash due to the lack of things to buy. Insiders, particularly in the tech sector, are ramping up their stock sales dramatically. This quarter, the ratio of sales to buys in tech has been almost twice what it was in the prior quarter.

The "Magnificent Seven" tech stocks that have driven the market's rally—each rose at least 49% last year–-are beginning to lose steam as they go their separate ways. Only four of the seven have outperformed the index so far this year, while two have declined, Apple and Tesla (the latter with the largest decline among the S&P 500 stocks).

Keen market commentator Stephanie Pomboy of MacroMavens writes, "You wouldn't know it to look at the broad market action, but (the) break for the exit looks to be starting already." She points to the "sudden and dramatic" outperformance of companies with strong balance sheets, adding "somebody's getting nervous."

Strong Companies Outperforming Weak Ones

Goldman Sachs Strong vs Weak Balance Sheet Index



Source: MacroMavens

Due to the extreme divergence in the market, while the market as a whole is at record valuations, the least expensive are actually undervalued on a relative basis, surprising given the long period of market strength, with the S&P up five-fold in10 years. According to Jeremy Grantham, the 20% most expensive stocks are in their 10% highest range relative to the market, while the 20% lowest valuation stocks are in their 7% lowest range. In many cases, of course, these stocks are still reasonably valued, but very undervalued relative to the market.

We have suggested before that when these leaders stumble, investors will rotate into the stocks that have been left behind, value stocks and high dividend payers, commodity stocks (including gold stocks). And globally, they will move from the U.S. to global markets, particularly to the laggards such as Japan and smaller markets, where valuations are generally reasonable.

Our list of "Current Positions" includes exposure to these groups, not only commodities and gold of course, but also to the other areas: global blue chip **Nestlé**, high-yielders **Ares Capital**, **Gladstone Capital**, and **Hutchison Port** (with yields ranging from 7% to 15%); and global value stock **Kingsmen Creatives**.

<u>Metalla sees royalty revenue jump, with more ahead</u>

Metalla Royalty (MTA.NY, 3.11) reported its year-end financials, with attributable gold received up nearly 50% on 2022, and exceeding its guidance. Nonetheless, the company recorded a loss of $5.8 million for the year, down from over $10 million the previous year. The decline in the loss was largely due to a one-time gain from the sale of some mineral claims. As of year end, Metalla had cash of just over $14 million.

It was a transformative year for Metalla, most notably the merger with Nova Royalty, and a new strategic plan, including the cancellation of its "At-the-Market" equity issuance plan; a doubling of the Beedie convertible loan facility to C$50 million; plans to reduce debt; and plans to pay dividends.

<u>New royalties to come on this year</u>

Three mines on which Metalla holds royalties are scheduled to begin production this year, Tocantinzinho in Brazil, and Côté and Amalgamated Kirkland, both in Ontario, Canada. Each royalty will see relatively little revenue this year as mines ramp up or move towards royalty ground, but increase in coming years. This is particularly true of Côté, where Metalla's royalty covers only a small part of that deposit, but all of the adjacent Gosselin deposit, which currently has a resource of 7.4 million ounces (indicated and inferred), and is currently undergoing an aggressive drill program. Operator IAMGOLD has not yet announced plans for when Gosselin will be mined.

The company also announced that Drew Clark, vice president of corporate development, is leaving the company. This follows the retirement from the board of E.B. Tucker in December. Both gentlemen had been instrumental in the company's growth for many years. Hold but look to buy.

TOP BUYS this week: due to the strong moves in many stocks over the past month, we are buying little. Buys include **Lara Exploration** (LRA, To., 0.53); **Hutchison Port Holdings** (HPHT, Singapore, US$0.126); and **Orogen Royalties** (OGN, To., 0.90).

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