GOLD’S LOVE TRADE

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There are two main drivers of gold demand across the world: The Fear Trade and the Love Trade.

The Love Trade, which this report focuses on, is the more important of the two. It’s what has driven our obsession of gold for thousands of years. Early peoples mined the precious metal not because they could turn it into tools or weapons. It’s far too soft for that. Instead, they dug it out of the earth because they were dazzled by its rich yellow hue and because it could be easily worked into fine jewelry, ornaments and other artifacts that enriched and added beauty to their lives.

That same obsession and love for gold is carried on today in countries where it’s customary to give gold to friends and relatives during birthdays and weddings and to celebrate holidays. The two most populated countries, China and India, also happen to be the two biggest consumers of gold—together responsible for half of annual consumption—largely because they observe religious and cultural holidays during which gold-buying and gifting is the norm for the vast majority of people. Even low-income families go beyond their means to fulfill this important cultural obligation.

China’s Lunar New Year, celebrated in late January or early February, is one such holiday. In December 2016, China imported 158 metric tons of gold from Switzerland, according to the Swiss Federal Customs Administration, in anticipation of the festivities. That amount was up more than 416 percent from the 30.6 tons it imported from Switzerland in November. Later in the year, in October or November, Indians celebrate Diwali, the Festival of Lights. Following that is the Indian wedding season, when it is considered auspicious to give gold to the bride. “No gold, no wedding” is an actual expression in India.

I should also throw in Christmas in December and Ramadan, the ninth and most venerated month of the Islamic calendar. In 2017, Ramadan takes place from late May to late June.

Altogether, these cultural events, observed every year by billions of people worldwide, account for so much gold demand that we can reliably see their effects on the metal’s price action at certain times throughout the calendar.

Take a look at the chart below. You should see two clear instances when gold has historically appreciated: at the beginning of the year, as we approach China’s Lunar New Year, and in the months leading up to Diwali and the wedding season. (As such, September has historically been the best month for gold.) During these two periods, Chinese and Indian retailers restock their inventories of gold coins and jewelry ahead of the holidays. That’s the Love Trade in action.

**Gold’s Average Monthly Gains and Losses, 1975 – 2013**

<table>
<thead>
<tr>
<th>Month</th>
<th>Gold Price</th>
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<tbody>
<tr>
<td>JAN</td>
<td>0.0%</td>
</tr>
<tr>
<td>FEB</td>
<td>-0.5%</td>
</tr>
<tr>
<td>MAR</td>
<td>1.0%</td>
</tr>
<tr>
<td>APR</td>
<td>1.5%</td>
</tr>
<tr>
<td>MAY</td>
<td>2.0%</td>
</tr>
<tr>
<td>JUN</td>
<td>2.5%</td>
</tr>
<tr>
<td>JUL</td>
<td>1.5%</td>
</tr>
<tr>
<td>AUG</td>
<td>2.0%</td>
</tr>
<tr>
<td>SEP</td>
<td>1.0%</td>
</tr>
<tr>
<td>OCT</td>
<td>0.5%</td>
</tr>
<tr>
<td>NOV</td>
<td>0.0%</td>
</tr>
<tr>
<td>DEC</td>
<td>-0.5%</td>
</tr>
</tbody>
</table>

Past performance does not guarantee future results. **Source:** LBMA, U.S. Global Investors
But there’s more to the Love Trade than holidays and festivals. The yellow metal’s dual role as the basis for fine jewelry and as financial security is perhaps nowhere more apparent than in India, where wives have sole authority over the disposition of fine gold jewelry and other gifts they receive throughout their marriage. This jewelry is theirs, and theirs alone, to use in the event of a divorce, the death of a husband or some other setback when having a portion of your wealth in gold might come in handy.

### Rising Incomes in Emerging Markets May Be Good for Gold

Of course, the more that disposable incomes rise in emerging countries such as China and India, the more rapidly stronger gold demand can be expected to grow. Members of China’s middle class already outnumber America’s and show no signs of slowing down. In October 2015, a Credit Suisse study estimated the size of China’s middle class at 109 million adults, America’s at 92 million adults. This spread will only continue to widen. According to consultancy group McKinsey & Company, the size of China’s working-class consumers between the ages of 15 and 59 will grow 20 percent between 2015 and 2030, adding 100 million new people. On a global scale, 12 cents of every dollar will be spent by this group in 2030, McKinsey estimates. And according to Boston Consulting Group (BCG) data, consumer spending in both China and India will soon overtake spending in Germany and France, and is on a trajectory to match Japan’s level of consumption.

### India and China’s Affluent Class Expected to Consume as Much as Some Major Countries by 2020

Total Private Household Consumption, in Trillions of Dollars

By 2020, the number of “affluent” households in China—those with annual incomes of at least $20,000—will grow to 280 million, equal to 30 percent of the country’s urban population. That’s quite a leap up from today’s 120 million households labeled as “affluent.”

India’s middle class is growing just as rapidly—perhaps more so—and is expected to become the world’s largest group of middle-income consumers by as early as 2030. According to the Brookings Institute, the country could lift over 1 billion new people into the middle class between 2011 and 2039.
The long-term investment case for gold looks just as compelling following recent bullish reports from PricewaterhouseCoopers (PwC) and Morgan Stanley. China and India are the world’s top two consumers of gold, as I said, and both countries are expected to make huge economic gains in the next few decades.

According to PwC’s models, China and India should become the world’s number one and number two largest economies by 2050 based on purchasing power parity (PPP). China is already the largest economy by that measure, but PwC sees the Asian giant surpassing the U.S. economy on an absolute basis by as early as 2030.

As for India, it “currently comprises 7 percent of world GDP at PPP, which we project to rise steadily to over 15 percent by 2050,” PwC writes. “This is a remarkable increase of 8 percentage points, gaining the most ground of any of the countries we modeled.”

Top 10 Economies Expected to Be Dominated by 7 Largest Emerging Markets in 2050
Gross Domestic Product (GDP) Based on Purchasing Power Parity (PPP), in Billions of 2016 Dollars

I think it’s also worth highlighting Indonesia, which is expected to replace Japan as the fourth-largest economy by midcentury. E7 economies, in fact, could end up dominating the top 10, with Mexico moving up to number seven and France dropping off.

Then there’s Morgan Stanley’s 118-page report, “Why we are bullish on China.” The investment bank sees a number of dramatic changes over the coming years, the most significant being China’s transition from a middle-income nation to a prosperous, high-income nation sometime between 2024 and 2027. This would make China one of only three countries with populations over 20 million that have managed to accomplish this feat in the past 30 years, the other two being South Korea and Poland.
This trajectory is dependent on a number of expectations, including, most importantly, Morgan Stanley’s confidence that China will manage to avoid a debt-related financial crisis, as some investors might now believe is forthcoming. The bank’s view is that the Chinese government will successfully provide “adequate policy buffers and deft management of the policy cycle” to ensure the growth of per capita incomes.

Other key transitions will additionally need to take place for the country to reach high-income status by 2027, including implementing meaningful reform of state-owned enterprises (SOEs). Although China is currently transitioning from a manufacturing economy to one that’s focused on consumption and services, the country will also need to emphasize high value-added manufacturing.

In any case, this all bodes well for the Love Trade.

A Few Words About the Fear Trade

As I mentioned at the beginning, gold demand has two drivers. Even though I’ll be exploring the Love Trade in this report, I would be remiss if I didn’t say a few words about the Fear Trade.

Whereas the Love Trade mostly occurs in China, India, Turkey and other emerging countries, the Fear Trade can more often be found in the U.S., Germany, Japan and other highly industrialized nations. In simplest terms, the Fear Trade is what you often hear about in the media and from doom-and-gloomers. It’s triggered when people feel as if they need to buy gold as a hedge against poor government or central bank policies that might result in currency devaluation, inflation, deficit spending and negative real interest rates. The real interest rate, I should point out, is different from the nominal federal funds rate in that it takes inflation into consideration. And when inflation runs so high that rates turn negative, gold tends to rise in that country’s currency.

To illustrate, let’s look at the 40-year relationship between gold and the real, or inflation-adjusted, two-year Treasury yield, which is influenced by both interest rates and consumer prices. What I did was subtract inflation, as measured by the consumer price index (CPI), from the two-year Treasury yield and charted this amount against the price of gold per ounce. You should immediately be able to pick out the inverse relationship between the two.

Gold and the Real 2-Year Treasury Yield
August 1977-August 2017

Treasuries are backed by the full faith and credit of the U.S. Government.  Source: Federal Reserve, IBA, U.S. Global Investors
Gold spiked whenever the bond yield fell below 0 percent, meaning investors were losing money on the two-year T-note. They were essentially paying the U.S. government to hold its debt instead of the other way around. This improved the investment case for the yellow metal. When gold climbed above $1,900 for the first time ever in intraday trading in September 2011, government debt was “returning” negative 3.6 percent.

This is one of the many reasons why we closely monitor the monthly CPI figures. Significant increases in inflation have historically boosted the price of gold.

In January 2017, inflation got such a jolt, rising as much as 2.5 percent year-over-year, the highest rate since March 2012. Led by higher gasoline, rent and health care costs, consumer prices advanced for the sixth straight month. Gold responded accordingly, closing above $1,240 for the first time since soon after the 2016 presidential election.

Why would an investor deliberately choose to lose money? But that’s precisely what happens to Treasury investors when inflation rises, as you can see in the table below:

<table>
<thead>
<tr>
<th>Treasury Yield</th>
<th>2-Year</th>
<th>5-Year</th>
<th>10-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.33%</td>
<td>1.77%</td>
<td>2.19%</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Consumer Price Index</th>
<th>2-Year</th>
<th>5-Year</th>
<th>10-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.70%</td>
<td>1.70%</td>
<td>1.70%</td>
<td></td>
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</tbody>
</table>

| Real Yield | -0.37% | 0.07% | 0.49% |

As of February 16, 2017. Source: Federal Reserve

Gold also correlates strongly to U.S. national debt, which might have already passed $20 trillion by the time you read this. According to the National Inflation Association (NIA)—which believes a period of hyperinflation in the U.S. could be imminent—there’s a 91.2 percent correlation between the price of gold and the national debt, suggesting the yellow metal could continue to surge over the long term as we add to the debt every year.

**91.2% Correlation Between Gold Price and National Debt**

Source: Treasury Department, IBA, U.S. Global Investors
At this point, it appears unlikely the U.S. will ever again be able to pay down its debt, let alone balance its budget. In its 2016 end-of-the-year report to Congress, the U.S. Government Accountability Office (GAO), the nation’s watchdog, warned that “absent policy changes, the federal government’s fiscal path is unsustainable and that the debt-to-GDP ratio would surpass its historical high of 106 percent within 15 to 25 years,” between 2030 and 2040. Yes, you read that right: “unsustainable.” The federal deficit increased to $587 billion in 2016, after six years of declining deficits. Spending increases were driven by entitlement programs such as Medicare and Medicaid, which surged 4.9 percent and 5.3 percent, respectively, during the year. Even though President Donald Trump seems outwardly interested in lowering costs and bringing some fiscal restraint to the government, there’s still the risk of increased deficit spending on his watch, led by massive tax cuts and a proposed $1 trillion infrastructure buildout package. All the more reason for some investors to have a portion of their wealth in gold and gold stocks.

But enough doom and gloom. Let’s talk about the Love Trade.

India’s Love Affair with Gold

Today, more than 1.2 billion people share a country that for half a millennium was subject to colonialism ranging from the Portuguese in the 15th century to the British as recently as the mid-20th century. This has given rise to modern-day India, one of the world’s most heterogeneous states. In 1961, a nationwide census reported the existence of more than 1,600 spoken languages in India belonging to two major linguistic families: Indo-European in the north, Dravidian in the south. Many of these languages have since gone extinct—up to a third, in fact, according to the People’s Linguistic Survey of India. About 80 percent of the population identify as Hindu, according to the 2011 census, but other major faiths include Islam, Christianity, Sikhism, Jainism and Buddhism.

With that said, one of the few shared traditions in all corners of India is the love of gold. Since before recorded human history, the people of the Indian subcontinent have had an insatiable appetite for the yellow metal, treasuring it not only for its flawless natural beauty and religious significance but also as a superb store of value. Because India has undergone countless political upheavals and natural calamities over the centuries, gold has been the most trusted way to preserve household wealth. In rural areas, gold has often been one of only two dependable stores of value available, the other being land.

This tradition carries on today, with India’s demand for gold jewelry in 2015 reaching more than 668 metric tons, nearly a third of total global demand and second in size only to China. Gold, in fact, is the country’s largest expense on its import bill after oil.

India and China Dominate Global Gold Jewelry Market

Demand, in Tonnes

Note: 1 tonne = 1,000 kilograms  
Source: Metals Focus, U.S. Global Investors
A 2013 survey conducted by the Federation of Indian Chambers of Commerce & Industry (FICCI) found that more than three quarters of Indians view the precious metal as a “safe investment.” The study also found that gold is a regular line item in most Indian households’ annual budgets, responsible for a little over 8 percent of household income—comparable to what they spend every year on medical expenses and clothing. Similarly, in a 2016 World Gold Council survey, 79 percent of Indians agreed with the statement that “gold will never lose its value over the long term.” Seventy-six percent agreed with the statement that “gold makes me feel secure for the long term.”

Who Owns It All?

It should come as little surprise, then, that Indian households have the largest private gold holdings in the world. Standing at between 23,000 and 24,000 tons the amount surpasses the combined official gold reserves of the United States, Germany, Italy, France, China and Russia. In 2015, the value of all this gold was more than $800 billion, which exceeded the $600 billion market capitalization of Apple, until recently the world’s most valuable company in any industry. (Google passed up the iPhone-maker in May 2016.)

The largest owners of gold in India are women, as it is auspicious to give them gifts of gold jewelry before their weddings. Because India lacks a formal social security system, it’s vital for women in particular to have some form of wealth preservation in the event of divorce or widowhood. This is what’s known as stridhan—a portion of a married couple’s wealth that is controlled exclusively by the wife and to which she alone is entitled, even after separation from her husband. India’s Supreme Court reaffirmed this tradition in November 2015, ruling that “neither the husband nor any other family members can have any right over the stridhan and [wives] remain the custodians.”

It’s said that gold tends not to leave India once it enters. Indeed, the country is flush with the yellow metal. The Reserve Bank of India reports having 557.8 tons, which amounts to $22 billion, the 10th largest official holding in the world if we don’t count the International Monetary Fund (IMF).

Coincidentally, that’s just as much as one Hindu temple reportedly owns in gold, coins, jewels and other treasures. According to the Christian Science Monitor, the loot discovered in Padmanabhaswamy temple, located in the far-southern city of Thiruvananthapuram, Kerala, “includes about 1,000 kilograms (2,205 pounds) of gold coins—some dating back 400 years—ropes of gold, sacks of diamonds, and a gold statue of the Hindu god Vishnu studded with precious gems, as well as an 18-foot solid gold ornament weighing 35 kilograms (77 pounds) and rare silver and brass platters.” Elsewhere, another temple has “enough gold to rival the riches stashed at the Vatican,” writes the National Post.

Several temples in India are true marvels to behold, exquisitely designed and girt in pure, fine gold. The Golden Temple of Sripuram, located in the southern state of Tamil Nadu, required the skills of literally hundreds of goldsmiths and decorators to install 1,500 kilograms (53,000 ounces) of the yellow metal, the most ever for such a project. Completed in 2007, the temple is something out of a dream, shimmering radiantly in the sunlight and illuminated brightly at night.
Monsoons, Diwali and Weddings

All around the world, the price of gold is driven largely by the Love Trade in India. Demand fluctuates year-to-year depending on several factors, the three most significant being the amount of crop revenue that’s generated as a result of the summer monsoon season; Diwali, also known as the Festival of Lights, which normally occurs in late October or early November; and the number of Indian weddings held in the fourth quarter.

The monsoon season is crucial to India’s important agriculture sector. During an average year, the Indian subcontinent can receive close to 80 percent of its total annual precipitation. When the monsoon fails to deliver, as we saw in 2014 and 2015, farmers suffer financially, food can become scarce—and gold purchasing drops.

About a third of Indian gold demand comes from rural farmers, who have traditionally converted a percentage of all crop revenue into the precious metal to be held for dire need. A GFMS/Thomson Reuters study conducted in 2015 found that, between 1985 and 2014, there was a strong positive correlation between Indian crop revenue and spending on gold in 21 out of 29 years.

Following the crop season, we have Diwali and the Indian wedding season to look forward to.

Diwali is arguably the most sacred holiday in Hinduism, celebrated by millions of people all over the globe as a victory of light over darkness—hence the prevalence of lighted candles, clay lamps, fireworks and sky lanterns. Much like Christmas, Diwali serves as a major shopping season. Families splurge on big-ticket items such as cars, appliances, clothes—and gold jewelry. In past years, the price of gold has ramped up in August and September as Indian merchants and jewelers restock inventories in preparation for the fall festival.

And then comes the fourth-quarter wedding season. It’s almost impossible to exaggerate just how massive this industry is, with one India-based research firm expecting it to hit 1.6 trillion rupees ($24 billion) by 2020.
I’m often asked why Indians reserve a specific time of the year to get married. The answer has a lot to do with certain behavioral restrictions during the four-month period known as Chaturmas, which takes place from mid-July to mid-November. The period coincides with the monsoon season, when disease and sickness were historically rampant. Chaturmas is a time of penance, atonement, fasting, and abstinence—it might be helpful to think of it as the Hindu version of Lent. As such, several behaviors are discouraged, including eating food cooked by others, drinking water from a leather vessel, sleeping in a bed—and getting married. What’s more, this period is also when Lord Vishnu, the protector and preserver, is believed to be asleep, and any ceremonies, weddings included, would disturb him from his slumber prematurely. Once Vishnu awakes in November, it becomes auspicious again to get married, which is why we see such a huge surge in weddings—and gold jewelry-buying—late in the year.

So how many weddings are we talking about, and how much gold? Let’s look at the numbers. According to the Indian government, there are 300 million Indians between the ages of 25 and 29 from now until 2021. During this period, a projected 150 million weddings will take place. And for each wedding, roughly 35 percent to 40 percent of total expenses will be devoted to gold in the form of bullion, coins, and jewelry.

Put another way, it’s estimated that the amount of gold jewelry purchased for a typical Indian wedding ranges between 20 and 2,000 grams—equivalent to a little over 70.5 ounces, or $95,500 at today’s prices. The wealthier the family, of course, the more gold they can afford to buy.
The Love Trade is expressed in a number of ways, including love of self and love of family. That's certainly the case in India. Friends and family members bestow gifts of gold jewelry on a young woman prior to her wedding because they want her to be not only decorated brilliantly in beautiful gold jewelry but also financially secure. In India, there’s really no other asset that’s quite up to the task aside from gold.

2017 Outlook on Gold Equities

Because of gold’s Love Trade and Fear Trade, you could say miners struck gold in 2016. The group, as measured by the NYSE Arca Gold Miners Index, finished the year up an amazing 55 percent, handily beating all other asset classes shown below.

Gold Miners Were the Best Performing Asset in 2016

Miners were followed by commodities at 25 percent and silver at 15 percent. Gold finished up 8.6 percent, its first positive year since 2012, when it gained 7.1 percent.

Throughout 2017 and beyond, the precious metal should continue to be supported by negative interest rates in countries such as Japan, Sweden, Switzerland, Denmark and elsewhere. Such policies hurt savers, who might very well decide to store their wealth in a real asset such as gold.

There’s perhaps no sign more compelling that investors have an insatiable appetite for gold right now than the growing demand for safety-deposit boxes. According to a June 2017 Bloomberg story, companies in Europe are scrambling to meet customers’ needs for a safe, inexpensive place to store their bullion in the face of negative interest rates and rising inflation. Two firms in particular have plans to build additional facilities capable of holding 100 million euros ($112 million) each in bars and coins.

Daniel Marburger, CEO of European coin dealer CoinInvest, told Bloomberg that he had just finished working with a German customer whose bank account was charged negative interest rates. To prevent this from happening again, the customer converted his cash into gold and silver, which he sees as a more reliable store of value.

Negative rates are “definitely a driving factor and will lead to more sales and also more storage clients,” Marburger said.
I always recommend a 10 percent weighting gold—5 percent in physical gold, such as coins, bars and beautiful gold jewelry; the other 5 percent in quality gold stocks, such as what we hold in our two precious metals funds, World Precious Minerals Fund (UNWPX) and Gold and Precious Metals Fund (USERX), and rebalance each year.

Take a look at the Morningstar ratings for these funds:

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<thead>
<tr>
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<th>Gold and Precious Metals Fund (USERX)</th>
<th>World Precious Minerals Fund (UNWPX)</th>
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<tbody>
<tr>
<td>★ ★ ★ ★</td>
<td>Overall/70</td>
<td>Overall/70</td>
</tr>
<tr>
<td>★ ★ ★ ★</td>
<td>3-Year/70</td>
<td>3-Year/70</td>
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<tr>
<td>★ ★ ★ ★</td>
<td>10-Year/45</td>
<td>10-Year/45</td>
</tr>
</tbody>
</table>

Morningstar ratings based on risk-adjusted return and number of funds
Category: Equity Precious Metals
Through: June 30, 2017

Morningstar ratings based on risk-adjusted return and number of funds
Category: Equity Precious Metals
Through: June 30, 2017
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Please consider carefully a fund’s investment objectives, risks, charges and expenses. For this and other important information, obtain a fund prospectus by visiting www.usfunds.com or by calling 1-800-US-FUNDS (1-800-873-8637). Read it carefully before investing. Foreside Fund Services, LLC, Distributor. U.S. Global Investors is the investment adviser.

Past performance does not guarantee future results.

The Morningstar Rating for funds, or “star rating”, is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product’s monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods.

Gold, precious metals, and precious minerals funds may be susceptible to adverse economic, political or regulatory developments due to concentrating in a single theme. The prices of gold, precious metals, and precious minerals are subject to substantial price fluctuations over short periods of time and may be affected by unpredicted international monetary and political policies. We suggest investing no more than 5% to 10% of your portfolio in these sectors.

The Consumer Price Index (CPI) is one of the most widely recognized price measures for tracking the price of a market basket of goods and services purchased by individuals. The weights of components are based on consumer spending patterns.

The NYSE Arca Gold Miners Index is a modified market capitalization weighted index comprised of publicly traded companies involved primarily in the mining for gold and silver. The index benchmark value was 500.0 at the close of trading on December 20, 2002. The Dow Jones Commodity Index is a broad measure of the commodity futures market that emphasizes diversification and liquidity through a simple, straightforward, equal-weighted approach. The S&P 500 Stock Index is a widely recognized capitalization-weighted index of 500 common stock prices in U.S. companies. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

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