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Quarterly Commentary Q2 2023

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The second quarter saw global markets reappraise the likelihood of an imminent US recession. Recent inflation data from the US has given pause to the bond market, with participants becoming less certain on the prospects of a hard landing. At the time of writing, the spread between the US treasury 2- and 10- year notes is 85bps, yet during the quarter the spread fell as low as 110bps, an inversion not seen since 1981. That said, amid a surprisingly strong first half of the year for equity market indices, the so-called 'most forecast recession in history' remains the base case for most commentators.

Within this context, the quarter saw continued market divergence. Cyclically exposed parts of the portfolio underperformed the benchmark as companies that promise growth - whatever the economic weather - outperformed those that have more traditional economic exposures. The Nasdaq rose 15.2% in US dollar terms over the quarter and is now up 38.7% for the six months to 30 June 2023. More specifically, over the quarter the US market contributed around 85% of the MSCI ACWI's return with large cap tech stocks again leading the charge. If this observed trend represents what journalist and author Ed Conway refers to as the 'ethereal world'[1] – that of Artificial Intelligence (AI), platform companies, the cloud, and so forth – it is worth noting that the portfolio has a bias toward the 'material world'. Approximately three-quarters of the portfolio is invested in companies with a direct link to the 'real' economy (for example, banks, miners, energy companies). Whilst these material world investments exhibit short-term economic sensitivity, over the longer term that should be trumped by favourable capital cycle characteristics. Five of these ethereal world stocks: Microsoft, Nvidia, Apple, Meta and Tesla, comprising c. 11.3%[2] of the MSCI ACWI, rose between 18-52% in US dollar terms over the quarter. As such, the underweight to these five stocks accounted for around half the portfolio's relative underperformance during the second quarter.

The other major market focus over the quarter has been the response to the US banking crisis which played out towards the end of March. Whilst we remain vigilant, the crisis - perhaps better characterised as a 'crisis of certain banks' - appears to have been an example of an event

accelerating a trend, rather than changing its course. The large US banks have been beneficiaries of deposit share gains from smaller banks and the well-capitalised 'winners' performed strongly over the quarter.

A broader question for the banking industry remains whether the failure of Silicon Valley Bank was a one-off or augurs a larger sectoral issue. Much will depend on the depth of the forecasted recession, should one transpire. Unlike the Global Financial Crisis, where over-leveraged households went through a major credit cycle, the troubling areas today appear to be off-balance-sheet items and non-traditional lending / private equity. How these credits make their way back into the banking system is a key focus.

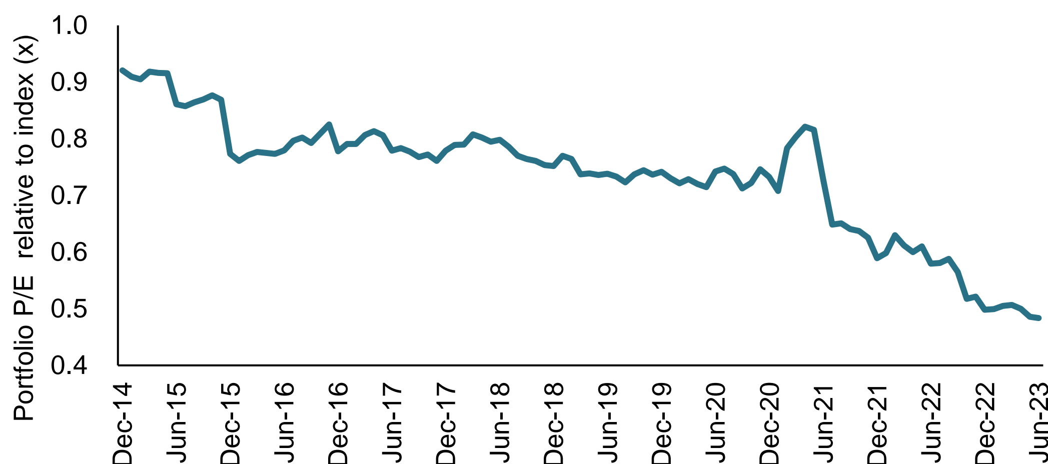
As described in recent quarterly reports, the portfolio's exposure to Japan has increased over the last twelve months and a number of our Japanese companies have performed well this year. In lock step with the US, the rally here has been led by racier companies; the Nikkei was up 18.4% in the second quarter (in local terms) reaching 27.2% year-to-date which compares to the broader Topix which has posted 21.0% over the same time period. Meanwhile, the portfolio's c. 10% exposure in Japan is mostly (but not exclusively) made up of companies exhibiting value characteristics. Many of our holdings have struggled to grow following historic mismanagement and are straddled with inefficient balance sheets, sometimes with cash balances and non-core investments so large that the franchise is for free.

Japan, as a country, is in the early stages of a broad push towards capitalist norms. The reasons are multifaceted but in essence an ageing population needs to be funded, and an efficient capital market in which savers receive dividends and recycle their profits into innovation (the age-old promise of the borse) provides a solution. At the start of the quarter the Tokyo Stock Exchange issued an edict asking constituents to 'urgently' assess their cost of capital and address valuations trending below book. This went alongside a record AGM season with companies subject to June

AGM proposals up 18% year-on-year. Cajoled by the government and regulators, minority shareholders are finding their voice. Inevitably only a handful of the proposals passed, but we have been encouraged by (often significant) increases in capital return targets announced across companies we own and the wider market. This is a long game, but we are not alone in our enthusiasm. Indeed, net flows from foreigners totalled $70bn over the quarter, a pace not seen since Abe was elected prime minister for the second time in 2012.

The increase in our basket of Japanese companies this year is emblematic of the broader approach. Over the past decade the portfolio has increased its value tilt as the proceeds of sales from expensive US equities were recycled into more attractively valued companies. This process has been ongoing and has seen the valuation of the portfolio fall from c. 0.95x the market P/E to 0.5x : a function not just of sell-high, buy-low portfolio decisions but also a stock market that has become increasingly expensive.

Portfolio P/E relative to index[3]



Amplifying the increasingly value nature of the portfolio additions is an increased exposure to capital cycle investments that are likely to benefit from an environment which starts to recognise the value of the tangible world. Of note this quarter, we continued to add to our offshore driller exposure. Like

most of the oil industry, the offshore driller sector is cyclical, trades at a discount to replacement value, and has witnessed a significant decline in investment spend over the past decade. Indeed, in the wake of the last oil supercycle and amplified by the COVID crisis, the industry has undergone a sustained period of asset scrapping (60% of floaters scrapped), market consolidation (to only seven major listed players) and almost a full house of Chapter 11 restructurings. Having destroyed $50bn of enterprise value between 2014-2019, close to no new orders for an offshore rig have been placed for a decade. This supply-constrained outlook is proving a powerful tailwind for day rates and therefore company earnings. Keep an eye out for the next Hosking Post on this subject (and please also see our recent back catalogue available on our new website).

All in all, it has been a tough first half of the year for many market participants in active fund management with Hosking Partners no exception. Our diversified portfolio of lowly-valued equities is skewed away from the US large cap market darlings, and we continue to recycle capital into unfashionable mid and smaller cap names across the world. It is at times like this that a disciplined investment philosophy and focus are all important. As the relative valuation elastic gets stretched ever further, our capital cycle lens enforces persistence and enhanced presence in these under-admired areas. In short: frustrations are tempered by opportunities. Your team continues to seize them.

[1] "Material World" by Ed Conway
[2] Average weight over Q2 2023
[3] Source: Hosking Partners, FactSet. Rep account as at 05 Jun 2023. Index – MSCI ACWI.

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