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Quarterly Commentary Q2 2022

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With an almost clean sweep of asset classes posting negative real returns, the quarter ending June 2022 re-set records. Deutsche Bank estimates it to have been the worst first half performance for US Treasury bonds since 1788 (!), as well as the worst first half in equity markets since the inception of the MSCI ACWI index in 1990[1]. With inflation at a 40-year high, and the Fed set to raise rates at the fastest pace since the early 1990s, markets are adjusting to a new regime: step-change higher discount rates, persistent energy and commodity shortages and the potential for a central bank-induced recession. With six crypto-related liquidations (and counting), a technical Russian sovereign default and ballooning eurozone-periphery spreads, market participants are understandably as bearish as at any time in the last decade.

We attempted to define this setup in our Hosking Post "New World Order" which was published in April. The argument put forward was that 'events', such as Russia's shocking invasion of Ukraine, are unlikely to change these trends. Rather, events reinforce existing dynamics which are deflating bubbles from prior cycles and accelerating a new regime. Most importantly, industry capital cycles are now presenting clear opportunities – albeit we are in the early stages of this process. For instance, after a decade of market adulation it is not surprising that 'Big Tech' – in the form of the FAANGS – spent c.$140bn+ in capex in 2021. In contrast, the capital-starved resource and energy sectors have capex running close to all-time lows, when measured by capex per unit of production.

The growing volume of environmental and social constraints in recent years on mineral and energy producers, combined with shareholder-imposed capex discipline, have compressed the supply of the commodities they produce to the point where prices – particularly in the energy complex – are clearly signaling real shortages. Could it be that policy makers and asset allocators will look back on the past decade as an era characterised by a degree of naivety? In our last Hosking Post and Q1's Active Ownership Report, we outlined how a more nuanced approach to ESG issues is starting

[1] https://www.reuters.com/markets/rates-bonds/brutal-first-half-puts-bonds-line-worst-year-decades-2022-06-30/

to emerge which recognises that if we want both ‘E’ and ‘S’, we also need to prioritise energy affordability and security throughout the energy transition. With energy costs accounting for over 10% of Western consumers’ income, this will likely become a political necessity.

With the energy sector posting its best first-half performance since the 1980s, the importance of the price signal re-emerging in this essential sector is hard to overstate. For much of the past decade the market mechanism was frustrated – low commodity prices and low valuations of commodity companies combined to persuade capital allocators that the sector was declining into obsolescence. Whilst the return of the price signal is manna from heaven for our long-term approach, in the short term the rapid rise in the price of oil to $120 per barrel has caused recessionary concerns which have weighed on returns. At the same time, US mortgage data is showing steep declines in refinancing activity and new lending as consumers adjust to an average 6% 30-year mortgage cost. One US consumer sentiment indicator published by the University of Michigan in June posted its weakest result since records began in the late 1940s. In spite of these indicators, we retain our long-term focus, acknowledging that whilst in the short-term central banks may induce a recession to get inflation under control, in the longer term no central bank can print copper or oil!

With respect to performance over the quarter, the rapid rise in the oil price benefited the exposure to the Energy sector. Inversely, the recessionary threat from high oil prices and the Fed’s determination to use monetary tightening to tame inflation held back the performance of economically sensitive areas of the portfolio. Our largest sector overweight, Financials, had a negative effect but the real hit came in our non-energy commodity exposure. The allocation to the Materials sector underperformed, with copper, nickel and zinc down between 20-25% over the quarter. With supply constrained and the undeniable importance of these commodities to the energy transition and net zero commitments, and the unwavering resolution to wean the Western world off legacy internal-combustion-engine vehicles, we remain confident that the pricing environment for these metals will remain strong over the coming years, albeit our ability to forecast short-term price

fluctuations is limited. Whilst a Fed-induced recession would hit profits in the short term, the reality is that China represents 50% of all commodity demand. After two years of suppressed economic activity it is unclear what the exact pace and extent of a China re-opening will be, but a return to anything like normal is unlikely to depress commodity prices. On an earnings basis, the Material companies are as cheap as they have ever been against the wider stock market, selling at an average of 6x next year's earnings. A recession of some kind appears to have already been priced in, as it has been in the base metals pricing discussed earlier.

The fund's China exposure provided an area of positive absolute performance during the quarter and we took advantage of these low prices to add to these names over the quarter. Elsewhere, positive contributions came from a cluster of oil product shipping companies – demonstrating the benefit of a capital-cycle approach in this key sector. The underweight to the Technology sector helped relative performance and partly offset negative contributions from our underweights in Healthcare, Consumer Staples and Utilities. As a reminder, these underweights are not a result of our attempt to forecast the likelihood (or not) of an economic recession, rather the outcome of our long-term and bottom-up investment process.

Early in the quarter, two portfolio managers raised cash to redeploy in shares offering more discounted valuations. At the quarter's end we retain a cash weight of around 4%, which will provide further opportunity to be 'greedy when others are fearful'. Major additions over the quarter centered on Japan, where the fund took advantage of declining share prices coupled to a dramatic weakening in the yen. All the stocks have substantial activist involvement and were purchased to gain exposure to the increasing focus on corporate governance and stakeholder capitalism. Japan now accounts for 4.3% of the portfolio (up from 3.2% at the end of March). Sales were primarily focused on stocks which have shown resilience in these challenging market conditions, freeing up capital to invest in more beaten up ideas.

As markets close a chapter in which years of under-investment – compounded by an over-simplistic approach to ESG – have reset forward-looking returns for producing assets, a new chapter begins. We are likely in the early stages of a multi-year process of capital reallocation, something that should play well to our sector-skewed portfolio and capital cycle-led approach. Whilst the portfolio is sensitive to discounting changes in expected near-term demand, the longer-term supply deficit in many areas presents an increasingly attractive setup, and stands to reap rewards for those who stay the course.

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