

Gleneagle Asset Management Limited Gleneagle Investment Trust (Equity Fund)

August 2022 Review

Market Summary

Despite a good start to the month, markets ended down in August with the US SP500 down -4.24% and tech heavy Nasdaq down -5.22%. Our local ASX200 fared slightly better, down only -1.46% (although the Australian dollar lost over 2% against the USD.)

The main catalyst for the selloff was the rather blunt message delivered by the Fed Chair Jerome Powell at the Jackson Hole conference in Wyoming. In his brief 8-minute speech, he came with a very clear and unambiguous message that tighter monetary conditions will continue until the Fed's core PCE 2% inflation objective is met.

"Restoring price stability will likely require maintaining a restrictive policy stance for some time. The historical record cautions strongly against prematurely loosening policy"

As you might recall from last month's letter, this was not really a surprise to us as it was in-line with our views. We laid out the case that the July/August rise was a classic 'bear market rally', and that markets were likely to roll over given that the fed would be forced to continue to tighten monetary conditions to combat persistent inflation. There had also been multiple Fed officials giving the same message over the course of the month.... it was just that the equity markets were not paying attention. We were able to use the opportunity to add some short exposure to the book and, at the time of writing, we still hold this short position as a portfolio hedge, as there are still plenty of headwinds for markets.

Market Headwinds

When investing, it normally pays to be optimistic as bull markets tend to emerge and climb a 'wall of worry'. However, there are also times when it pays to batten down the hatches and protect capital.

The rise of inflation has forced one of the greatest fiscal tightenings in history, right at the time when governments has ceased COVID stimulus payments. The Fed is now embarking on quantitative tightening to break the back of inflation and history shows a strong relationship between fiscal tightening and subsequent declines in margins. The US markets still remain expensive on almost every valuation metric, and a decline in margins will put further downward pressure on equity prices.

The war in Ukraine has been a catalyst to drive food, energy, and fertilizer (a large proportion of fertilizer is made from natural gas) to record levels. Electricity prices in Europe hit 15x their pre-war levels last month and are forcing many businesses to cease operation. If you don't make stuff, you can't sell stuff. Europe is thus hurtling into a deep recession and the ECB is learning the hard way that while it can print money, it is unable to print energy. In an almost comical move, the leaders of the G7 industrialized nations announced Friday that they had reached an agreement **amongst themselves** that will impose a price cap on Russian energy, aiming to undercut the Kremlin's finances while keeping energy flowing to the West. Russia responded by turning off the taps. Energy prices spiked higher. It turns out you can't control prices on things you don't own.

China has been the global engine of growth for the last three decades and is now facing some serious problems. We have a saying "the west prints money, the Chinese print apartments". Right now, there are many signs that the Chinese property market is faltering as many developers are starting to fail or

are on the brink. The Chinese response to the Covid pandemic is also massively slowing their economy as when you lockdown your population, they stop producing things.

Falling real-estate values are also becoming a problem in other regions, as Australia, Canada and New Zealand are starting to see large falls in property prices. Australia just had it's biggest one month decline in house prices since 1983, and the RBA is still raising rates. Yesterday we saw another 50bps raise and there are more in the pipeline. With the risk of repeating myself from previous letters, we have a combination of a negative wealth effect (asset prices are going down making people feel poorer) along with higher repayment costs, so people feel less wealth and have less money to spend. One person's spending is another person's income, so, as conditions worsen, it drives a negative spiral.

Finally, the US dollar has been rising and is at risk of becoming a global wrecking ball. As the US raise rates to combat inflation, the yield differential is sucking in money from around the world, raising the value of the currency. A stronger USD impacts all asset prices as most things are priced in USD. The real problem comes from emerging markets that borrow in USD. When the USD rises, they see their debt go up in terms of their local currency, but their repayments go up also. Right now the US is also effectively exporting their inflation problem to the rest of the world as all commodities are priced in USD. If the USD keeps appreciating, we could see things start to break as this is how debt crises emerge.

In a nutshell, the US markets are facing tightening monetary conditions while China, Europe and most emerging markets are struggling, and other western nations face slowdowns due to housing market corrections. It doesn't look great for equity markets in general right now. Long only portfolios are likely to suffer. Cash is being eaten away by inflation. Bond holders are getting hurt by higher rates. Precious metals have not been working as an inflation hedge. Real estate is coming off the boil. There are, however, still good opportunities in commodities, and we still see a positive outlook for energy and renewable plays.

Helios

I've said before that I normally don't like to talk about individual positions, but I thought I should end with some upbeat news about the Texan oil play. I know most people have seen this stock crater over the 18 months, but we should finally see this investment play out over the coming months and with a little luck I'm hoping everyone will be rewarded for their patience.

This month Helios should start the frack of their 4th well. They were due to start at the end of August but ran into some operational delays. We understand that after consultation multiple expert fracking firms they have been advised to have 4-5x more water than they had planned. This extra water must be trucked in from regional wells which our understanding of the main cause of the delay.

A successful vertical frack is considered a 'conventional well' by the industry and is both cheaper, lower risk and takes less time than a horizontal frack. This would likely attract attention from the bigger players. We are also overdue on news about well 3 being on pump. With strong oil prices and natural gas prices hitting record highs, the backdrop is good. The years of covid induced delays are finally behind them and if they can successfully execute, we could see a meaningful re-rating.

If you have any questions or comments, please drop me a line at tim.muirhead@gleneagle.com.au



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