Gleneagle Asset Management Limited
Gleneagle Investment Trust (Equity Fund)

August 2023 Review

Summary
Since the very late release of last month's newsletter, I thought I might keep this one short.

Elsight
The portfolio is already on track for a very good September month, as one of Elsight's design win partners, Airobotics, just received the first U.S. FAA 'Beyond-Line-of-Sight' (BVLOS) Type certification, which is the highest echelon of airworthiness certification for drones. This has been a 4-year long process, with reportedly over 100,000 test flights, and is both a game changer for the drone industry and a massive validation for Elsight's technology.

The CEO of Airobotics, Meir Kliner, stated "Elsight's Halo is the only communication solution that provides us with the reliability we need to perform safe and secure BVLOS operations". With over 100 design win partners and growing, we should expect to see many more of these types of announcements in the coming months, and this now opens the door for far more widespread use of drones. Elsight is well positioned to reap the benefits.

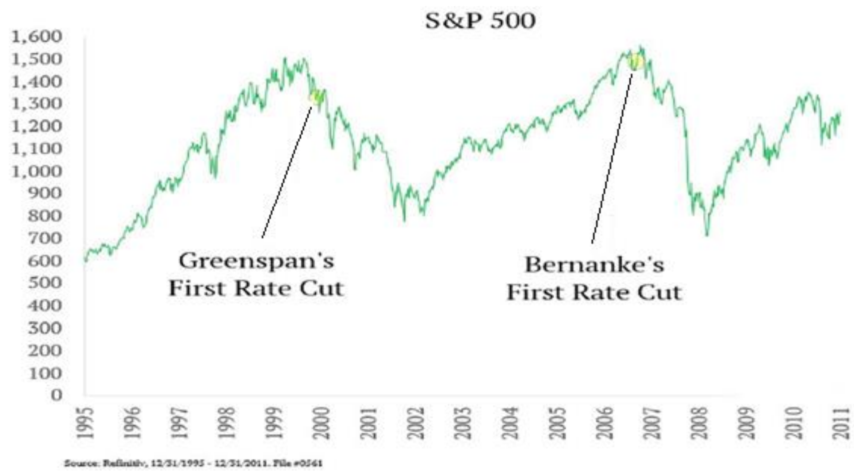
If there is one key takeaway from Elsight's design win strategy, it is that once a drone company has made the long and costly investment in getting FAA certification using Halo, if they later want to use a different system, they must start the certification process from step 1. If you've ever wondered why, when you get on a new airplane, you sit down to watch the latest OLED TV technology but your seatbelt is still the same one from 50 years ago – it's because the seatbelt is part of the safety system and is still fit for purpose. No one has wanted to start the re-certification process again.

Markets
With the huge increase in interest rates in the US and the rest of the world this year, it may come as no surprise that consumers are starting to show serious signs of stress. While US mortgage holders are largely shielded from rising rates as they are on long term fixed loans, the debt-to-income ratio for all homebuyers in the US just hit 40% for the first time in history. US Auto loan delinquency rates are now at their highest levels since 2008. The default rate on credit card loans from small banks just hit a record high of 7.5%, which is well above the 2008 high of 5.6%, and the 2001 high of 6%. What scares me about these figures is that this is happening with unemployment still at historically low levels, and the Fed is likely to keep rates high until the unemployment rate rises to its target of around 4.6%. Like individuals, many businesses are also adjusting to the rapidly rising rate environment, and many are falling short. August also marked the busiest month on record for US Bankruptcy Courts.

All these signs are pointing to a recession, likely starting late 23 or early 2024. What is surprising is that the S&P 500 is still trading at historically high ratios, with the CAPE ratio of around ~30 times when the long-term average is 15. The market is currently predicting 12% growth in earnings in 2024. It should be no surprise that in recessions, company earnings contract. Higher unemployment also leads to lower spending and lower wage growth, so company earnings contract. 12% earnings growth seems very optimistic to me.

I think part of the reason why the market is currently so complacent is that a vast proportion of market participants, essentially anyone who started investing in the last 15 years, has never seen the lead up to a real recession. In December of 2007, the economy went into recession, yet in October 2007, just 2 months earlier, the market was making a new high. At the time the economy seemed to be purring along nicely, and anyone looking at the data such as employment wasn't too concerned. The problem with the real time data releases is that they can often be misleading at the time, as they are so often revised after the fact. What is concerning is that we have just seen seven consecutive non-farm payroll revisions to the downside. Things are deteriorating faster than people think.

The equity bulls will counter that it is not all doom and gloom. Inflation has been coming down, and the Fed is likely done raising rates. If the economy gets into trouble, they now have plenty of room to start cutting rates. It's important to remember that we are also approaching a US election, so one mustn't underestimate what the government (with the Fed's help) may do to get re-elected. All true. However, if you look closely at when the first-rate cuts occurred in the 2001 and 2008 recessions, the first-rate cuts tend to lead periods of market weakness rather than strength.



Some asset classes have seen very rapid repricing to higher interest rates, but other assets such as commercial real estate and high yield bonds are yet to move. Given that we are heading into the biggest default cycle globally since the GFC, high yield bond spreads seem to be massively underpricing what is coming. This obviously presents opportunities to profit.

Despite my recessionary fears, I remain bullish on energy, even as oil has already had a strong rebound over the last few months. We also seem to be in the early stages of a major bull market in Uranium, as demand is now starting to outstrip supply with many new reactors coming online, and supply is unlikely to meet the demand for years as new mines take time to start up.

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

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