Gleneagle Asset Management Limited
Gleneagle Investment Trust (Equity Fund)

February 2023 Review

Summary

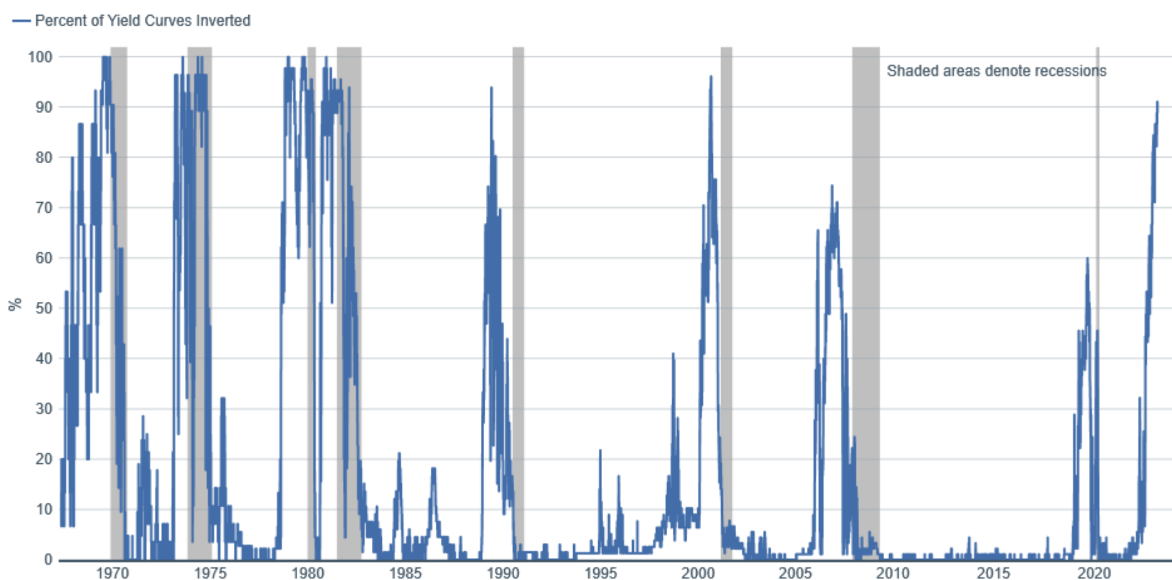
February markets were weaker, with the ASX 200 losing -4.6%, the S&P 500 down -2.6% and the Nasdaq down -0.5%. The portfolio ended down -2.75%, partly the result of one of the unlisted positions, Yumble, going into administration costing the portfolio ~4%. This was a position I inherited on taking over the fund, and, unfortunately, it can be virtually impossible to exit these unlisted holdings until they IPO or get sold privately. I have no plan to add any new unlisted positions as liquidity is a key requirement to my asset allocation model.

Market outlook

The markets went from pricing a hard landing (severe recession) in December, to a soft landing (mild recession) in January, to 'no landing' situation in February, as the US economy has remained resilient even in the face of higher rates. The US labor market remains incredibly strong, with high wages still a leading cause of inflation. To state the current dilemma simply and succinctly: The global economy is still too healthy and resilient for inflation to drop significantly, and thus interest rates will be higher for longer.

In February we saw inflation expectations rise sharply (inflation is not coming down as fast as previously thought) and interest rate expectations also had one of the sharpest rises across the curve. You can now earn a 5% yield on 3-Month Treasury Bills (contrast this to a year ago where the yield was just 0.38%) The entire US Treasury yield curve, from 1 month through 30 years, is now above 4%. We haven't seen these levels since October 2007.

Over 90% of yield curves (short dated interest rates against longer dated) are now inverted which is screaming 'recession approaching.' The only problem is that these yield inversion signals are often early, leading recessions by up to 18 months.



Source: Charles Schwab, Macrobond, US Department of Treasury data as of 2/22/2023

The Fed has clearly stated that in order to tame the inflation rate back to their target, they must increase the unemployment rate. The reason is that most US consumers who are in debt (think home loans, auto loans, car loan etc.) are on fixed interest rates, so when the Fed hikes rates, the rate rise does not directly impact them. With higher wages and full employment, they continue to earn and spend and thus continue to drive prices higher. Thus, the Fed must continue to hike until the unemployment rate increases. There will likely be a moment in the not-too-distant future when one more rate hike will be one rate hike too much. They must hike until they break something. To paraphrase Robert Solow when he was referring to Paul Volcker's actions in the 1970's ''Chair Powell and the Fed might be forced to "burn down the house to roast the pig".

We therefore continue to see challenging conditions for equities with continued volatility. There are times to be aggressively long or short in markets, but right now is not one of those. While there are opportunities, with the heightened index volatility, the risk/reward of trade setup often does not warrant pulling the trigger. Patience is probably the most underutilized tool in trading and our biggest edge. To use a baseball analogy, we don't have to swing at every ball… we wait for the fat pitch. They always come, and we will be ready for it.

Australia

In last month's newsletter I discussed how most Australian consumers are more at the mercy of variable rates (as opposed to US being on fixed rates), so when the RBA hikes rates, the effect is much more immediate on slowing the economy. With 10 consecutive hikes , the economy is already starting to show signs of strain. I believe we should see the RBA pause and perhaps even cut rates way earlier than the Fed, and possibly as early as the latter half of this year.

The great Aussie housing slide momentarily stalled in February with national prices only down 0.1% with Sydney prices posting a gain of 0.3%. Although some pundits are calling the bottom, this bounce is likely just a result of the February to April seasonality where housing prices tend to gain. As I've pointed out in previous notes, around one quarter of all fixed rate home loans are going to terminate this year, forcing these borrowers currently paying ~2% to a much higher rate of circa 6%. Australia is now facing a situation where around 15% of borrowers are in negative net cash flow, and we still have more RBA rate hikes in the pipeline. Christopher Joye of Coolabah Capital noted "Westpac sensationally revealed that $212 billion of its home loans (or 45% of the total) were advanced assuming interest rates will end up at a lower level than they will be when the RBA finishes it current hiking cycle". Interest rates are now higher than the 3% serviceability buffer that Westpac (and likely other banks) applied at the time of loan application. My view is the housing price slide will continue and won't stop until rates the RBA starts cutting.

The RBA Governor Philip Lowe has made it clear that a pause in interest rate hikes is on the table in April if unemployment, consumer spending & business survey data is disappointing, & the ABS monthly inflation figures keep showing price rises moderating.

Rental inflation remains a real problem with a backdrop of strong immigration, with very little housing vacancy rates. While immigration and lack of housing supply is providing the demand, obtaining finance to purchase a property is now out of reach of many at current

prices. Despite obvious demand for more housing, building approvals data release last month showed a massive fall of 27.6%. David Scutt of Ausbiztv quipped on twitter "Australia will soon require new arrivals to bring a hoochie and sleeping bag given how little housing supply is coming down the pipeline." This problem looks likely to worsen.

Helios

Our Texan oil and gas play is pregnant with news as we await the final flow rates for the 4th well. With the first fracking update we saw the price appreciate from the mid 7's to just under 10c, and with more news, we should see the price appreciation accelerate. I believe we could possibly see additional land leases secured around their target area. There has also been one very positive (and likely underappreciated) change regarding the gas. 2.5 years ago, they were having to design an engineering model to deal with the strong gas flows, as at that time there was excess gas in the USA. This meant they could not sell gas into the grid so they were working on pumping it back into the oil reservoir, which would have been at a cost. With the destruction of Nord stream, the US is now positioning to export gas to Europe. There is now very good demand for gas locally (and for export) from El paso and they can send gas straight into the national grid from pipelines which run through Helios land. This could potentially become a very healthy revenue stream on top of the oil.

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

Tim Muirhead
Portfolio Manager Gleneagle Securities (Aus) Pty Ltd