January 2024

Monthly Report

Dear Investors, Family and Friends,

In this monthly report, we:
(1) Review our investment theses and positioning;
(2) Consider potential consequences of a Trump presidency; and
(3) Update our performance for January.

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As at the time of writing, portfolio positioning consists of the following:

(1) AI and Renewable Energy Infrastructure

We continue to believe that the rollout of AI will benefit companies like Fabrinet. As supply chain bottlenecks have started to loosen, we've seen an acceleration in the manufacture of AI infrastructure. For instance, SuperMicro reported a stunning 100% quarterly increase in revenues after being able to access more GPUs. The roll-out of AMD's GPU series ramps up during the first half of 2024, providing further access to GPU supply.

We've added two new companies to our portfolio, namely Powell Industries and Hammond Power Solutions. These companies sit at the centre of the AI infrastructure rollout and renewable energy build. Manufacturing electrical transformers and switchgear, the demand for these companies' products is growing rapidly. Transformers and switchgear are required for the datacentres that are needed to power AI as well as in almost every renewable energy project. Datacentres require significant amounts of energy and, increasingly, renewable projects are being used to power them. Indeed, datacentres price their services to their tenants on power usage, which is the major operating cost. These companies trade around 12-15 times their net earnings but are growing earnings by 50-100%. In our judgment, the key fact we've identified is that these companies will sell more electrical products at higher prices for years to come. We will write a detailed research note explaining our thesis in greater detail in the forthcoming weeks.

(2) Shipping

We continue to believe that the disruptions to the Suez and Panama Canals will be long-lasting. In relation to the Panama Canal, the water level issue continues to deteriorate as expected. As outlined in our previous monthly report, we believe Israel will remain in occupation of Gaza for a long time. So long as the disruptions are in force, the increase in ton-mile demand for dry and wet bulk shipping, along with LPG shipping, is significant. We are invested in BDRY, BWET and StealthGas (GASS) as exposure to these trends.

We've closed out our position in ZIM at a profit. The reason is because that while in the short-run container shipping is most severely impacted, recent forecasts by Maersk suggest that the ability to fast-steam around the Cape of Good Hope and continued, significant increases in newbuilds will eradicate the deficit of net supply by around the third quarter of 2024. If Maersk's forecasts come to pass, then the supply deficit won't last long enough for ZIM to generate a significant amount of free cash relative to its current market capitalisation.

(3) China – US – Europe Trade War

We continue to monitor the trade war and technology race. Recently, Chinese export data suggested that they were limiting exports of graphite to the West, but continued to grant some licenses to South Korea and Japan. The licenses to South Korea and Japan are necessary because companies in these countries have the technology to purify graphite to the concentration necessary for batteries. Thereafter, the purified graphite is sent back to China for incorporation into batteries. We also continue to hear from companies like Syrah Resources and Novonix that, increasingly, Western EV car manufacturers have begun to enquire about supply from non-Chinese sources. We believe that, as the US Treasury eliminates subsidies for EVs built with critical minerals from foreign entities of concern, the graphite market will become increasingly bifurcated.

(4) US Immigration Reform

Although the recent bipartisan Senate agreement was knocked back by Trump and House Republicans for political reasons, we continue to believe that US immigration reform is on its way regardless of the election outcome. Given that no party will garner 60 seats in the Senate, the likely outcome of the change will be a compromise between the two parties in the Senate. It's likely that the recent bipartisan deal will form the backbone of any future changes. As a result, we believe that GEO Group's prospects are far brighter than the 12-13x earnings that is currently priced.

(5) Macro

We have two unrelated macro positions. The first position relates to the unfolding economic divergence between Europe and Switzerland. We believe this sort of currency opportunity comes around only once every decade or so. While we'll detail our thesis in a forthcoming research note, we summarise the main points here. Our thesis resolves around the idea that the Swiss National Bank will no longer need to strengthen its currency through active purchases in the market. With a rising unemployment rate, some of the smallest excess savings of developed nations (since the government stimulated far less over Covid), and with headline, core and wage inflation well below target, Switzerland is very likely to be one of the first countries to ease monetary policy. Switzerland has well and truly conquered the inflation battle, and we forecast that Switzerland will have lower inflation than even Japan for some time. The strength of the currency is beginning to impact the economy, particularly its export base. Recognising the need for a shift, the Swiss National Bank President, Thomas Jordan, said that the Swiss National Bank was "no longer focusing on foreign currency sales" and that "the franc has appreciated in real terms in 2023. And that hurts, companies feel that."

The second macro position we have is based on the prediction that inflation will take longer than expected to slay than the markets expect. We outlined this view in our previous note on our macroeconomic outlook. As interest rates have risen, we've begun to reduce our position that benefitted from an expectation of later and less Federal Reserve rate hikes.

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In this section, we also consider what we believe will do well in a Trump presidency:

(1) 60% import tariff on Chinese goods and services

Trump has promised to impose a blanket 60% import tariff on Chinese goods and services, going further than the tariffs he introduced in his previous term. This will have wide-reaching consequences. Such a policy wouldn't require Congressional approval, which makes it very likely to be enforced if Trump were to win. We summarise what we believe will be the obvious ones.

The first is that such a policy would be inflationary. Goods inflation accounts for about one-fifth of total inflation and Chinese imports account for around one-fifth of total US goods imports. While we wouldn't be comfortable providing a precise estimate of how much inflation would rise by (we'd rather be imprecisely right than precisely wrong), we believe it would be meaningful enough to require the Federal Reserve to restart rate hikes after the election. At the moment, the market is expecting 75 basis points of cuts in 2025.

The second impact is that we believe companies that are currently competing heavily with Chinese imports will benefit. In particular, we believe that US steel manufacturers will benefit. When combined with upcoming changes to remove forever chemicals from water supply, a major tariff will also shield activated carbon manufacturers.

(2) Drill Baby Drill

Trump has promised to "drill, baby, drill" for oil and gas across the country. For the most part, he's able to incentivise drilling by using his executive power in selling off federal government land. For instance, Biden has only allowed 2 auctions of offshore land for oil exploration during his term, whereas Trump allowed 47 in his previous term. Possibly being approved within a Department of Energy Appropriations Bill, Trump may also be able to provide tax breaks and subsidies to incentivise more exploration. We believe that US shale oil and gas service providers will benefit if Trump was elected.

(3) US Immigration Reform

Regardless of whichever party wins the White House in November, we believe that detention centre and monitoring service providers will benefit significantly from a tightening in US immigration policy.

The chances that Trump gets re-elected appear to be somewhere around 50%. Despite polls favouring him at the moment, Nate Silver's historical studies strongly suggest that they are unreliable so far out from the election. However, at some point this year, we expect the market to start to price in a 50-50 outcome. At the moment, markets are far from pricing in a potential Trump victory. If Trump ends up winning the election, we will likely invest into each of the aforementioned themes.

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The Fund generated a 3.6% return for January 2024. The main drivers of this return came from gains in ZIM, GEO Group, Fabrinet and GigaCloud. The Fund's equity theses appear to have begun to be recognised by other market participants. We'd tend to expect that the new theses constructed around power products to support the AI and renewable transitions will continue to be recognised for some time yet. Some gains were also made from positioning around our expectation of higher interest rates in the US. Similar to December, it was a fairly clean month.

Jan-24	1 Mth	3 Mth	1 yr	2 Yrs	SI (ann)	SI (cum)
Fund	3.6%	7.0%	9.4%	4.2%	8.8%	26.0%
Blended	0.7%	7.6%	5.8%	6.1%	5.0%	14.0%
All Ords	1.1%	14.2%	7.3%	8.9%	7.2%	21.2%
RBA Cash	0.4%	1.1%	4.1%	2.8%	2.0%	5.7%

Returns are calculated gross of fees and represent the combined income and capital returns over the specified period.
All returns provided are in AUD. Blended Index returns are composed of 50% All Ords / 50% RBA Cash.

Kind Regards,
Fawkes Capital Management

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