26 April 2024

March Monthly Report

Dear Investors,

In this monthly report, we:
(1) Review the investment theses we favour;
(2) Consider the macro environment;
(3) Consider the risks from geopolitics; and
(4) Update our performance for March 2024.

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Review of Investment Theses

As at the time of writing, we favour the following investment concepts:

(1) AI and Energy Infrastructure (Including Renewables)

We wrote in last month's update how AI, alone, was likely to drive a significant increase in the demand for electricity. In summary, data centre demand for electricity is likely to increase from its current 4.5% of total US power supply to around 10% in the next 3 years. As a result, AI alone is going to drive a quadrupling in the growth rate of electricity demand.

Recently, Kinder Morgan, which transports 40% of US natural gas through its pipelines reported and laid out the investment case nicely. Rich Kinder, the CEO, said:

> "Before turning the call over to Kim and the team who reported a good quarter at KMI, let me comment on another broader issue. In past quarters, I've talked a lot about the demand for natural gas resulting from this country's LNG export facilities. Today, I want to speak briefly about what I and others in the industry now see as another source of increased demand for our commodity, the tremendous expected growth in the need for electric power. This growth is being driven by a number of factors, most prominently by the increasing demand of new and expanding data centres, especially those required to support AI.
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> One recent survey showed a projected increase in electric demand to power data centres of 13% to 15% compounded annually through 2030. Put another way, data centres used about 2.5% of Us electricity in 2022 and are projected to use about 20% by 2030. AI demand alone is projected at about 15% of demand in 2030. If just 40% of that AI demand is served by natural gas, that would result in incremental demand of 7 to 10 Bcf a day.
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> Utilities throughout America are sounding alarm, one Southeast utility announced its expectation that its winter demand would increase by 37% by 2031. PJM Interconnection, which operates the wholesale power market across part of the Midwest and the Northeast, has doubled its 15-year annual forecast for demand growth and estimates that demand in the region by 2029 will increase by about 10 gigawatts. Now to put that in perspective, 10 gigawatts is about twice the power demand in New York City on a typical day.
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> The power needed for AI and the massive data centres being built today and planned for the near future require affordable electricity that is available without interruption 24 hours a day, 365 days a year. This type of need demonstrates that the emphasis on renewables as the only source of power is fatally flawed in terms of meeting the real demands of the market. This is not a knock on renewables. We all know they will play a significant role in the future of electric generation.
>
> But it's a reminder to all of us that natural gas and nuclear still have an extremely important role to play in order to provide the uninterrupted power that AI and the data centres will need. The primary use of these data centres is

Big Tech and I believe they're beginning to recognise the role that natural gas and nuclear must play. They like the rest of us, realise that the wind doesn't blow all the time, the sun doesn't shine all the time, that the use of batteries to overcome the shortfall is not practically or economically feasible.

And finally, that unfortunately, adding significant amounts of new nuclear power to the mix is not going to happen in the foreseeable future. In addition to all of these factors, the market is now understanding that building transmission lines to connect distant renewables to the grid typically takes years to complete and that's a timeframe inconsistent with the need to place these data centres into service as quickly as possible.

All that means that natural gas must play an important role in power generation for years to come. I think acceptance of this hypothesis will become even clearer as power demand increases over the coming months and years and it will be one more significant driver of growth in the demand for natural gas that will benefit all of us in the midstream sector."

If 40% of the electricity requirement to power data centres comes from natural gas, then the extra 7 to 10 Bcf per day will add another 10% or so to daily demand. This, we believe, will require a lot more natural gas power plants to be built. Argan builds natural gas power plants along in the US and Ireland, which houses around one-quarter of the EU's data centres. There are also other companies that make it possible to extract natural gas and to move it to where it's needed.

While the infrastructure needed to facilitate AI development is very well known by the market (NVIDIA, AMD, ARM, Vertiv, Arista Networks, Camtek, SuperMicro, Fabrinet all trade at high multiples on high growth rates), the follow-on impact on the demand for electrical infrastructure is less well recognised. We intend to publish a more detailed research note on this topic.

Increasingly, we are discovering new companies that stand to benefit from this theme. While we took profit on our position in Powell Industries as we discovered that the company is more leveraged to downstream LNG construction that we'd like, we remain invested in Hammond Power Solutions. We've added positions in Argan and others that we believe will stand to benefit.

(2) Shipping

After holding the position for months and the dry season in the Panama Canal coming to an end, we've taken profit on all of our shipping investments.

(3) Immigration Reform

The short-term change that's provided a positive impulse to providers of immigration services to the US government has been that the Department of Homeland Security appropriations bill has been signed into law. The new law increases the amount of funding for immigration beds in the US by around 33%. While this will provide a short-term boost to the earnings of affected companies and allow them to deleverage, the bigger change may come from the November presidential election.

(4) Limitations on PFAS within Drinking Water

The US Environmental Protection Agency (EPA) recently finalised its rule which limits the amount of PFAS that can be found within drinking water. For the main forever chemicals, the new rules reduce the traces allowed within drinking water from 70 parts per trillion to 4 parts per trillion. This change will impact a significant number of municipal water systems (around one in six water utilities will be affected based on previous testing results). However, the EPA allowed water utilities extra time to comply with the new rules. Enforcement won't begin before 2027, which may limit the speed at which the demand for granular activated carbon grows. We're mindful of this and will manage the investment position within ARQ accordingly.

(5) China – US – Europe Trade War

The trend towards greater protectionism around the world has gathered pace. The Biden administration recently moved to begin the process of tripling tariffs on Chinese steel and aluminium imports into the US. Republican presidential candidate Trump has also promised to raise tariffs on Chinese imports by up to 60%. The EU has begun new fair-trade probes into Chinese health equipment imports. Both Treasury Secretary Yellen and German Chancellor Olaf Scholz visited Beijing with the same message: that Chinese overproduction and exports were an issue. The world continues to become increasingly bifurcated.

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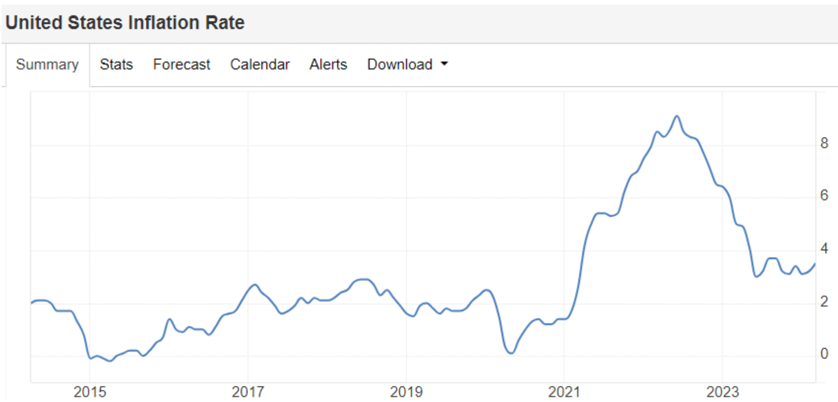
The Macro Environment

There's been a change that's been brewing for a while, but finally became recognised by market participants in early April. While we've been writing about how inflation in the US looks like it had bottomed and would settle around 3.0-3.5%, market participants finally took notice when the March inflation data was recently released.

Both year-over-year headline inflation and core inflation have started to pick back up again:



Source: US Bureau of Labor Statistics and Trading Economics

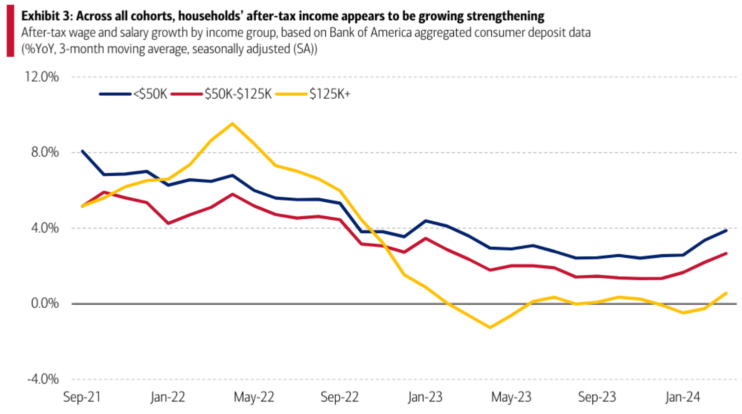
While the rise in inflation over the last few months may seem like a small blip, there are two problems:

- The first is that it's occurring well above the Fed's goal of 2%.
- The second is that the details of the inflation reports show no progress on quelling services inflation.

The services inflation is problematic because from the data we see, this problem may get worse, not better. The reason is because wage inflation also looks as if it has bottomed and is starting to rise again. If the economy begins to pick up again in the second half of 2024 as we expect and our forward indicators suggest, then it will be hard for services inflation to fall much below 6% year-over-year. Given that services inflation makes up around 1/3rd of the CPI measure, services inflation is by itself contributing 2% year-over-year to total inflation before housing and goods inflation are added in.

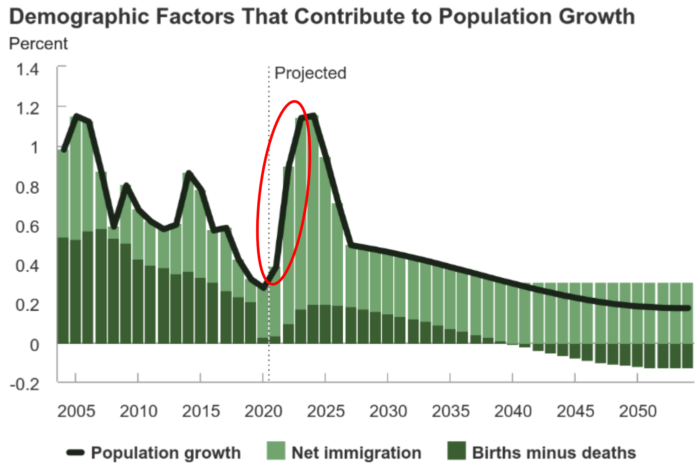
The Fed's hypothesis was that 5% interest rates, if maintained long enough above the rate of inflation, would slowly cause the labour market to slow. A labour market in better balance would produce lower rates of wage growth. Lower rates of wage growth would then bring services inflation back down. The stock and bond markets believed them.

The hypothesis isn't playing out. While most measures of wage growth appear to be moderating, more timely measures show an acceleration. For instance, the following data from Bank of America that tracks income growth being received by their customers is beginning to reaccelerate:



Source: Bank of America

The other reason the Fed's hypothesis hasn't been playing out is because of very high rates of immigration:



Source: Congressional Budget Office

Total population growth of the working age population is higher than at any time of the last few decades. This is adding to spending and employment across the economy.

Inflation is also being spurred on now by the rise in base commodity prices. Energy prices have risen a substantial amount year-over-year and, a little more speculatively, the major grain prices of the world may come close to basing. The general basing of commodity prices isn't helping the Fed's fight against inflation.

Combined with the gradual spend-down of still-large savings leftover from Covid stimulus, this is causing a significant increase in demand across the economy. When we track corporate earnings reports, many companies are foreseeing a pick-up in activity in the second half.

The market is finally catching on. When inflation topped out in October 2022, it led to a bottom in the stock market. Recently, at the time of writing, the stock market has been falling now that market participants have recognised that inflation is still an unsolved problem. More, it seems quite likely, needs to be done to get inflation back to 2%. Interest rates have risen, the US dollar has risen and stocks, particularly risky or sensitive thematic stocks to interest rates, have fallen with a thud. We have the flexibility to overlay macro exposures to our stock-specific investment concepts and we hope to use it well in this changing environment.

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A Short Word on Geopolitics

We've written about geopolitics many times before. Sometimes, geopolitics may have a durable bearing on financial outcomes but more often than not it doesn't. The situation in the Middle East is a tinderbox, but it's unclear whether any financial fires will get lit.

Israel's recent attack on Iran makes a lot of sense to us. We believed it to be in Netanyahu's political interests to strike back at Iran. Israel is massively advantaged in its missile defence technology, strike capability and it has the defence support of its Western partners. Iran learnt that the recent missile defence systems it bought from Russia aren't nearly as good as Western ones. After all, if Russian missile defence systems were as good, Ukraine may have made far less progress than they have so far.

Technology (and being partnered with countries that invented and produce that technology), not the number of soldiers, allows Israel to have control of the Middle East. Having now established its dominance, Israel may continue its campaign to dissemble Iran's footprint throughout the Arabian Peninsula.

It's unclear whether the continued attack on Iranian assets will lead to another counter-punch from Iran, or a broader shooting match in the Middle East. Israel it seems may want one, but Iran likely doesn't. It may be in Israel's interests to bait Iran into making another strategic miscalculation so that it may establish a mandate to go after Iran's deeply-protected nuclear program. It may be in Netanyahu's political interests to be seen as the leader who removed the only threat to Israel's existence. While polling on the issue is roughly evenly divided, Netanyahu might end up becoming a national hero if he could achieve this objective. Given that Iran will never have technological superiority over Israel, the only existential threat to the Jewish state is if Iran gains the know-how to build a nuclear weapon.

A middle-eastern ground war or shooting match between Israel and Iran is a scenario that we're monitoring. The chances seem low because the equilibrium remains on where Iran wants to avoid one, but much has changed in the thinking of those that are in control since the Hamas attacked on October 7th. The main implication of this scenario for Western economies is the potential for the supply of oil to be disrupted, sending the price of oil higher. As we've written before, if the Houthis can disrupt the flow of ships through the Red Sea, then Iran has the capability to disrupt the flow of oil tankers through the Strait of Hormuz. If a broader war panned out, then Iran would have a big incentive to push the price of oil higher. Like the Yom Kippur War, such a scenario would have consequences for global inflation and interest rates.

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Performance

The Fund delivered a net return of 2.92% in March. The main drivers of the Fund's returns were the macro currency positioning in EUR/CHF (which again accounted for around half of the Fund's return), as well as the rise in the stock prices of Hammond Power Solutions (which accounted for about a quarter of the return) and the rise in the price of ARQ (which accounted for about a quarter of returns).

Mar-24	1 Mth	3 Mth	1 yr	2 Yrs	SI (ann)	SI (cum)
Fund (Net)	2.9%	11.8%	14.6%	6.1%	9.2%	28.3%
Blended Index	1.8%	3.3%	9.6%	5.2%	5.6%	16.8%
All Ords	3.1%	5.5%	15.0%	6.7%	8.4%	26.4%
RBA Cash	0.4%	1.1%	4.2%	3.1%	2.2%	6.5%

Returns are calculated net 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.

We continue to try and act in an equanimous way. Given some of the points made in this note, it should not be hard for one to foresee how the macro environment is likely to get much trickier from here. Our hope is that this will throw up a number of attractive opportunities for the Fund to act on, however note that there is also a reasonable chance of heightened volatility for markets in the period ahead. We will continue to navigate the Fund with a close eye to protecting and growing investor capital through this period. We believe our ability to invest across asset classes and take advantage of a broader opportunity set positions the Fund well within this environment.

Kind Regards,
Fawkes Capital Management

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