FAWKES CAPITAL MANAGEMENT

28 September 2024

August Monthly Report

Dear Investors

We are pleased to provide you with the August 2024 Monthly Report for the Fawkes Capital Fund ("Fund"). In this monthly report, we:

(1) Update our performance for August 2024.
(2) Update our views on the current macroeconomic environment

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Performance Update

While we remain confident in the overall strength of the economy (as detailed further below), the possibility of a recession cannot be entirely dismissed. In light of this uncertainty, we have shifted towards more macro-focused positions and reduced our exposure to illiquid stock holdings. This approach enhances our flexibility should market conditions deviate from our expectations. Maintaining greater liquidity during periods of heightened uncertainty is a prudent strategy.

The Fund produced a gain of approximately 1.6% in August, primarily driven by our macro positions, including a long stance on the yen (as discussed in our previous research note) and long positions in S&P 500 index futures. We anticipate that monetary stimulation from hereon will find its way into financial assets generally. So far to-date in September, further gains have been achieved from our macro positions.

Aug-24	1 Mth	3 Mth	1 yr	2 Yrs	3 Yrs	SI (ann)	SI (cum)
Fund (Net)	1.6%	-0.8%	9.8%	2.8%	7.6%	7.1%	25.9%
Blended Index	0.4%	3.0%	9.6%	8.0%	4.8%	5.7%	19.7%
All Ords	0.4%	5.0%	14.7%	11.8%	6.3%	8.3%	30.3%
RBA Cash	0.4%	1.1%	4.4%	3.9%	2.7%	2.5%	8.4%

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 monitor the course of events closely.

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The Macroeconomic Environment

We've conducted further research into the macroeconomic situation to gain a deeper strategic insight advantage. The trajectory of the macroeconomic environment will significantly influence asset values over the next year. Given its critical importance, we present some of our findings below.

The first point to make is that, contrary to conventional wisdom, we don't believe it's likely that aggregate savings have fallen much yet. The below table outlines our findings:

	Period	Units	Value
Consumer Savings Decline from Peak	Jun 22 -> Jun 24	$b	-500
Retail Money Market Fund Inflows (Fed)	Jun 22 -> Jul 24	$b	900
Retail Money Market Fund Inflows (ICI)	Apr 24 -> Sep 24	$b	153
Bank of America CD Balance Change	Jul 22 -> Jul 24	%	100%

Source: Largest US Bank Company Reports, Federal Reserve, Investment Company Institute and Bank of America

By analysing the consumer deposits of the largest US banks, we estimate that total consumer savings have fallen around $500 billion since their peak in June 2022. Between the start of Covid and this peak, however, we estimate that US consumer savings increased by around $1.85 trillion. So, the total amount of savings held at banks declined by about one-quarter from its peak.

Were these savings spent? From the data we've analysed, we believe that it's much more likely that these savings were invested rather than spent. If money is moved from a customer's savings or current account into a money market fund product, the bank recognises a decline in the customer's deposit balance. According to Federal Reserve data, around $900 billion has moved into retail money market fund products in the last 2 years. According to the Investment Company Institute, around $150 billion of customer money has moved into retail money market funds in the last 6 months. And according to the Bank of America, they've seen certificate of deposit balances double in the last 2 years. All of this is to say that while savings balances have declined by approximately $500 billion, it's very likely that retail money market fund balances increased by more over the same period. When investment into money market funds is included as part of a consumer's savings and investments, then it's likely that consumer savings have actually continued to increase over the last 2 years, not decline.

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This finding has important implications. While the total amount of savings grew astronomically immediately following Covid (during the period March 2020 to June 2022), the total amount of savings, inclusive of investments, has grown much slower since (perhaps by around $250 billion or so between June 2022 and June 2024). But importantly, the balance has grown. Why is this important?

The reason is because it shows that the economy is rebalancing well. In June 2022, inflation in the US was 9.1%, wages were growing around 6%, new and used vehicle costs had risen around 35% and interest rates were set to rise 5% from their nadir. Two years later inflation would fall to approximately 2.5%, wages would fall to around 4%, the cost of home and motor insurance rose around 16%, rents rose around 10% per annum, and the Fed rate would stabilise around 5.25% before being cut. Despite these major changes, consumer spending has stabilised around 4% and savings has continued to increase. There is no sign that the consumer, in aggregate, is under pressure to cut back.

We have used the word in aggregate deliberately. There are pockets of weakness. In particular, lower-income households have curtailed their spending at fast food restaurants and other discretionary products. But the aggregates are still strong. In recent investor conferences, we provide some commentary of companies that see more than 75% of total US discretionary spending and that helps to illustrate this point:

- Visa commented that *"[a]nd so, quarter to date, things are looking generally stable with Q3. Sort of to give you some numbers, US payment volumes quarter to date through August up 5%, which is consistent with Q2…And then finally, process transactions growth through the end of August, also up 10%, consistent with Q2…At the end of the day, we have access to an incredible breadth of data and we are data-driven. And so, when we look at our data, the thing that I just said and the thing that we've really said through the course of this year is that underlying trends have been stable…And so we feel pretty good about where we see consumer health in general."*
- Mastercard: *"this view that we believe that consumer spending remains healthy continues. We now have the benefit of first four weeks of August that we looked at. And if you compare the trends of what we saw in July and the trends, what we see in August, they are very consistent. So overall, our outlook remains positive on that."*

- American Express: *"really over the last 6, 7 weeks, nothing has really changed much. So we're still in that same situation of stability. You mentioned a little bit of a decline. So Q1 was a little bit inflated by the extra day. It was a leap year. But so if you control for that and look at over the last few quarters, we're kind of like in the same range and nothing has really changed there."*
- Booking.com: *"we've seen actually the market relatively stable from April through to July, and that's a positive. So we're not on a gliding path where every month we see something that is slightly coming down. It actually was relatively stable from April through July. So that was another positive indicator that overall we are quite constructive about the outlook for the industry. So my main message is don't worry about it. There's not anything negative here. It's actually really positive and constructive."*
- United Airlines: "*We talked very confidently about how we expected a positive inflection in revenue per available seat mile (RASM) and domestic and Atlantic in August. We saw that. We talked very proactively and positively about what was going to happen in September, a continuation of that trend. We're seeing that…So strong corporate results, domestic results are inflecting very nicely…we expected maybe a little bit of softening at the Atlantic but the Atlantic's been actually very strong as well. So, if anything, if I wanted to differentiate, there's a little bit more weakness for the lower end consumer and a little bit more strength for the premium consumer."*
- Restoration Hardware, an upmarket retailer of furniture: *"we are pleased to report that demand was up 7% in the second quarter and has continued to inflect positive, gaining momentum each month with July finishing up 10%. Demand accelerated into the third quarter with August up 12% and product margins inflecting positive despite operating in the most challenging housing market in 3 decades."*

The consistent messaging has been that the consumer is healthy and stabilised. The decline in spending power of lower income consumers hasn't yet had an impact at the macro level.

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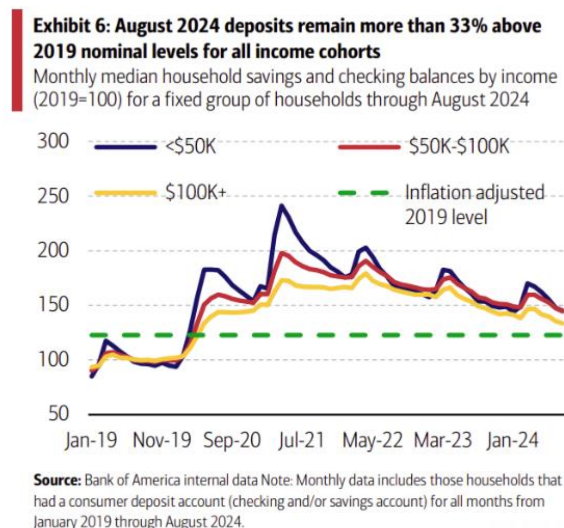
How do we evaluate the prospects of further stabilisation going forward? In our judgment, the prospects are very good. The reasons? First, according to Bank of America data, it's the lower income segments of the population that have the most savings relative to pre-Covid:



Source: Bank of America Institute

Excess savings and investments (not captured in the graph above) allows the consumer to smooth out their consumption profile. Consumers also still have untapped credit card debt available to them if they so choose to use it.

Secondly, the situation can be stable because we appear to have met an equilibrium. 3.5% wage growth plus 0.5% employment growth can produce around 4.5% nominal spending growth plus some savings. At least in the short-

term, this is producing around 2.5% inflation. Nominal wages and employment growth can continue to be the engine of the economy.

Third, as the economy rebalances, it should free up further spending power. Rents and insurance make up around 16% or one-sixth of total consumer spending across the economy. Over the last couple of years, these have grown around 16% per annum, reducing spending power by around $500 billion, or the equivalent of 2.5% of GDP. These cost increases are now stabilising below income growth. In addition, the Fed has begun to cut interest rates, which will reduce the monthly lease cost of car ownership, especially as car prices are now falling. Car loan repayments and purchases make up about 6% of total consumer spending. Around one-fifth of total consumer spending will fall to growth rates much lower than the preceding couple of years, freeing up more take-home pay.

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Is this too good to be true? Has the world reverted to pre-Covid conditions? There are many similarities. Back in 2019, nominal spending stabilised around 4.5%. The economy grew slowly, and the Fed held interest rates around 2.5%. Credit growth was sluggish. Inflation hovered around 1.5% to 2.5%.

But there is an important difference. Wages growth today runs around 4% and is picking up once more, but back pre-Covid ran around 2.5-3.0%. Once things rebalance, a full percentage of wage growth will likely add around 0.3-0.5% more to inflation in the next couple of years. At the moment, inflation is being held down by a century low in goods deflation, similar in magnitude to what transpired during the Asian Financial Crisis. Significant excess production capacity in China and the rebalancing of car prices is allowing inflation to run lower than otherwise. Once cleared up, however, inflation is more likely to settle above its 2019 averages due to heightened wage inflation.

In each of the 1970s cycles, inflation fell much faster and further than wage inflation. But premature interest rate cuts, combined with commodity shocks, eventually caused inflation to revert back towards the level of wages. In the shorter-term, our judgment is that the consumer spending can stabilise and inflation can print around 2%. But in the medium-term there is too much spending power to achieve 2% inflation, unless consumers begin to save excessively.

The other major difference is that the US federal government runs a budget deficit of around 6% of GDP. This is unprecedented during periods of strong economic growth, and compares to around 3% of GDP pre-Covid. The government continues to support economic growth and consume resources to implement Biden's Inflation Reduction Act goals.

Kind Regards,
Fawkes Capital Management

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