31 March 2025

February Monthly Report

Dear Investors

We are pleased to provide you with the February 2025 Monthly Report for the Fawkes Capital Fund ("Fund"). In this monthly report, we:

(1) Update our performance for February 2025.
(2) A macro update following recent equity market volatility

Performance Update

The Fund experienced a disappointing month in February, posting a net return of -5.1%. This has been the first major retracement for our Fund for about 18 months. The primary driver of this negative performance was the sell-off in AI-exposed stocks within the portfolio towards the end of the month.

Fortunately, despite the continued decline in Australian and US equities in March so far, the Fund has paired back some of these losses at the time of writing. The reason for this divergence and recovery can be attributed to several factors, including the rebound of some positions sold down in February, the Fund's hedging strategy through shorting stock futures, and the positive performance of macro positions in the long gold exposure, which provided additional sources of return to offset the continued March equity markets selldown.

Feb-25	1 Mth	3 Mth	1 yr	2 Yrs	3 Yrs	SI (ann)	SI (cum)
Fund (Net)	-5.1%	-6.4%	0.7%	4.8%	1.7%	5.7%	23.5%
Blended Index	-1.8%	-0.8%	7.0%	7.4%	6.4%	5.6%	22.8%
All Ords	-4.0%	-2.8%	9.3%	10.3%	8.8%	7.9%	33.9%
RBA Cash	0.3%	1.1%	4.4%	4.3%	3.4%	2.7%	10.8%

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 often write that when the facts change, we will change our investment positioning. Through the course of March we decided to tack course. We should explain why.

Macro Update

Increasingly, we have become worried about a possible recession. We had forecast a period of economic stability throughout 2024. With growth strong and inflation falling, equity market returns propelled the Fund. Significant change, however, is in motion. The Trump administration is seeking to transform American society into its mould and willing to accept short-term economic pain to do so. The policy mix is likely to produce economic conditions that are the opposite of what transpired in 2024 – falling economic growth and rising inflation. When stability reigned in 2024, a policy-induced recession has now become possible.

The key parts of Trump's agenda are the following:

- Significantly cutting the federal workforce down via the Department of Government Efficiency ("DOGE");
- A removal of illegal aliens from the country;
- Reordering trade so that it is fair rather than free; and
- Balancing the government budget over the next 4 years.

The likely net impact of these policies is slower growth and higher inflation. Throughout history, equities have nearly always fallen in periods of "stagflation." We spend the rest of this note examining what may transpire.

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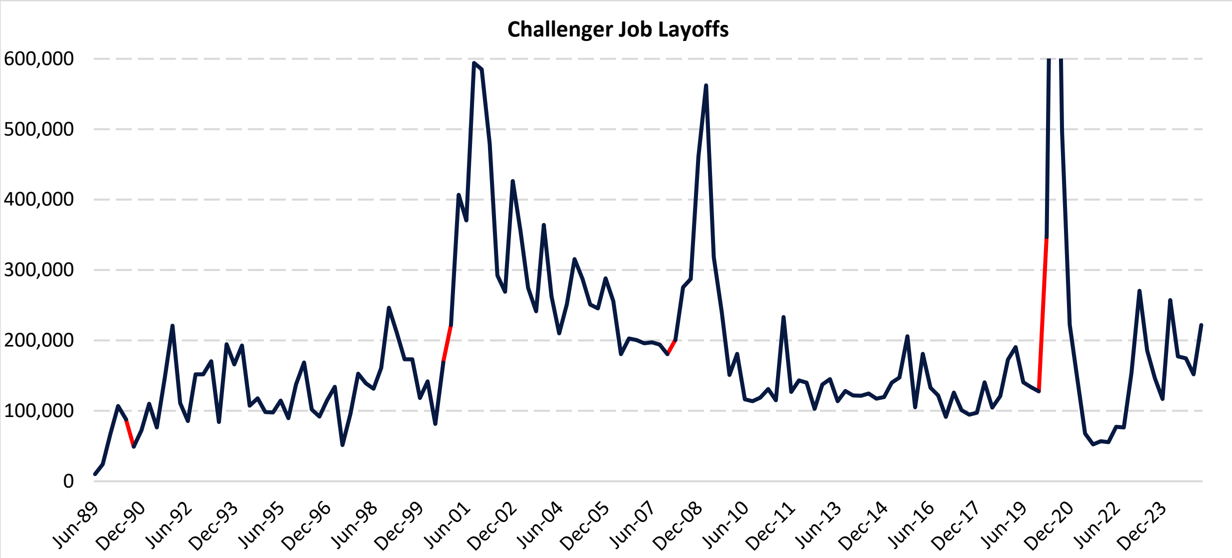
While a recession isn't guaranteed and we're monitoring the course of events, the chances of one have risen. The first major change is the speed and sheer number of jobs Trump is seeking to cut. While there is uncertainty over the final number of cuts, the New York Times has tracked around 200,000 layoffs already announced. Higher estimates from other sources that have claimed to have spoken to DOGE suggest that the overall plan is to cut around 35% of the 2,400,000 federal workforce, or around 800,000 employees.

At first glance, maximally, 800,000 layoffs as a percentage of a 159 million payrolled workforce seems fairly innocuous. After all, this would equate to about only 0.5% of the labour force. However, a study of history shows that this is far more than the number of layoffs needed to start a recession. The following chart shows the number of announced layoffs (both government and private) through time. The red highlighted sections represent the start of a recession:



Source: Challenger, Gray and Christmas

If history were to prove prescient, then we need around 250,000 layoffs in a quarter for a recession to start. Throughout history, that's been enough to catalyse significantly more job cuts. An initial round of layoffs reduces total purchasing power within the economy. As companies see the signal of reduced revenues and lower margins, further layoffs occur. As we've observed at the micro level of data, around three-quarters of the major industrial companies that have already experienced negative revenue growth have announced layoff plans. Compared to the past, 800,000 layoffs would be more than enough to catalyse a recession.

Laying off a half percent of the total workforce is significant. For instance, the following table shows how many jobs were cut *in total* during each of the recessions since the mid-1980s:

Cycle	% Workforce Laid Off
Today	DOGE 0.6%+
GFC	6.00%
Tech Recession	1.30%
1996 Soft Landing	0.00%
Early 1990s Recession	1.10%
1986 Soft Landing	0.00%

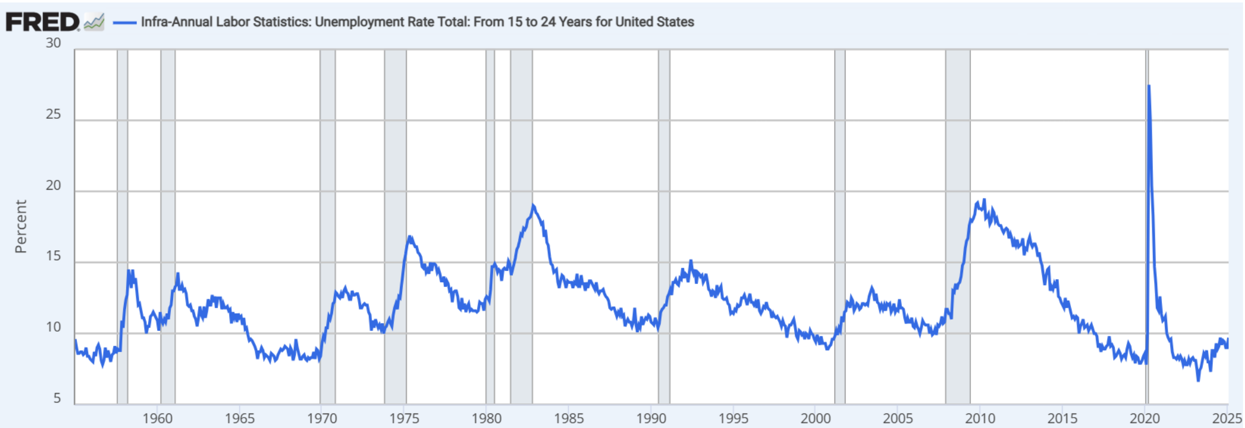
Source: Bureau of Labor Statistics

If the maximal amount of cuts end up being effected, then it would equate to about half of the *total* number of job cuts we saw throughout the dotcom and the early 1990s recessions.

The job cuts that are being proposed are likely to be nationwide. Only around 20% of the federal workforce is stationed in the Washington DC area. Many contractor jobs are also linked to the federal workforce. For instance, Deloitte and Accenture have already seen materially reduced revenues as a result of DOGE's actions. We're seeing signs that the withholding of payments for various federal programs is causing companies that relied on that funding to start to cut back. On top of this, 15% of the total American workforce is employed by state and local governments that rely on federal funding for a significant part of their budgets (averaging out to around 30%). An additional 15% of the American workforce is employed in healthcare and education that also have linkages to federal funding. The largest American employer has begun to lay off employees.

Underneath the hood of the topline unemployment rate number, we're starting to see some worrying signs that the labour market is cracking even before DOGE's actions.

Youth unemployment has begun to rise in a significant way from around 8% post-Covid recovery to 10% today:



Source: Bureau of Labor Statistics and FRED

Youth unemployment tends to rise before the total unemployment rate rises because of the expendability of young labour. It has been a precursor to nearly every recession (though it did rise temporarily in the mid-1990s soft landing).

But it's not just youth unemployment that is starting to flash red. The number of workers that could only find part-time work and need it for economic reasons has risen in a material way:

Source: Bureau of Labor Statistics and FRED

A rise in this measure has never given us a false positive for a recession. What we mean by this is that a significant rise in this measure has always coincided with a recession. In the soft landings of 1986 and 1996, there was no material rise in this statistic.

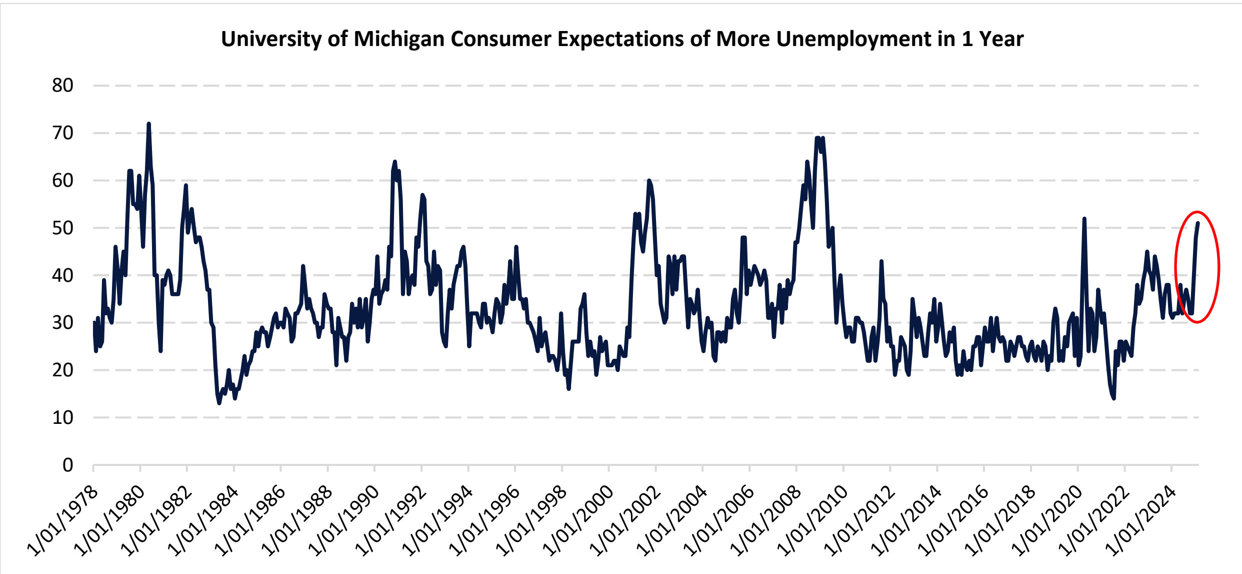
Compared to 2022, which was the last time we had around 250,000 job layoffs because of Big Tech, we're in a weaker starting point. While the situation has stabilised, we have stabilised but at a much weaker level of nominal spending growth. While nominal spending growth in 2022 was falling from very high levels (approx. 20% y/y), nominal spending growth today has stabilised around 5% y/y:

YoY Spending Growth	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24
Individual Companies ($5t)	6.7%	4.5%	5.3%	5.4%	4.3%	4.1%	4.3%	5.0%
Visa, Mastercard and Amex ($12t)	9.6%	5.4%	5.5%	4.6%	5.6%	4.9%	5.1%	5.1%
Bank Card Spending Data ($4t)	10.1%	6.9%	7.3%	6.6%	6.8%	5.1%	4.5%	5.5%
Weighted Average Consumer Spend	9.1%	5.5%	5.8%	5.2%	5.6%	4.8%	4.8%	5.2%
Core Consumer Spend Growth	3.4%	3.3%	4.4%	5.5%	3.5%	3.7%	4.3%	4.2%
Industrial Spend Growth ($2t)	5.2%	4.3%	1.3%	0.7%	1.0%	1.1%	1.5%	0.2%

Source: Company Reports

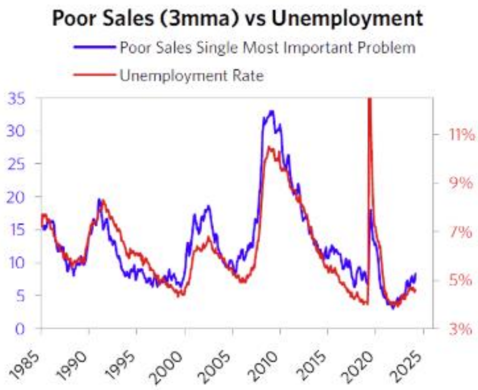
This rate of spending growth is more consistent with the starting points of a recession than the abnormally high levels immediately post-Covid. Excess savings across the system have now halved from their peak.

Whether this policy shock translates into precautionary saving by consumers remains to be seen, but the following chart on how consumers see the likelihood of more unemployment within a year isn't promising:



Source: University of Michigan

Small businesses across America, who hire about half the country's workforce are beginning to experience two problems. First, complaints of poor sales has begun to rise in a meaningful way and this tends to be correlated to the unemployment rate:



Source: National Federation of Independent Business

With these ingredients, we have the tinder box of a recession. In the first stanza, the federal government provides the initial shock. Then, in the next chapter, the lost income from this cohort is increased by the lost income from private contractors, state and local government employees and industries such as health and education that have linkages to federal spending. This lost spending power and precautionary saving from privately-employed consumers reduces nominal revenues growth throughout the economy. In the last act, private sector businesses respond to falling sales with more layoffs.

On top of this, the Trump administration is seeking to implement a broad reciprocal tariff regime. Tariffs will be placed on imports from foreign countries as well as various industrial sectors such as cars and steel. Such a policy is very likely to be inflationary. The impact from the car tariffs alone could add up to half a percentage point to annual inflation. Estimates of the inflationary impact from the holistic tariff regime centre around an additive couple of percent over time.

A tariff is effectively a tax paid to the government by the consumer for an imported good. The tariff is paid to the government at the likely cost to the consumer. It's similar to charging a value-added tax to the portion of total goods consumed in the economy that are imported. While the increase in the overall inflation level and therefore effective tax rate might be modest compared to what we saw following Covid, there will be some goods that will see major price hikes. For instance, if the price of an automobile rises by around 20%, then so will insurance premiums.

It's not clear where tariff rates will ultimately settle. In previous episodes of trade wars, initial bouts of retaliation were followed by trade deals that reduced the level of tariffs by around half of the peak. While retaliation and escalation makes sense in the short term, we can't rule out the possibility that America is looking to pursue a policy of decoupling from China in the long term. Ultimately, though, we believe that the political pressures in a democratic system will be too much for the Trump administration to bear. Taxing 100% of the population to try and benefit 1% of the population in the short-term (since it takes years for factories to be built and manufacturing to be re-shored) is a losing strategy in the end.

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Overall, in the midst of all this policy uncertainty, what are we left with? In likelihood, the outlook for the future will feature significant job cuts from the federal government and associated segments as well as some level of inflationary shock from tariffs. We will be left with much slower growth than today and higher inflation. In our judgment, that is the direction of travel due to the major, dominating forces that will exert themselves on the economy.

Whether we get a recession or not is not fully clear. We've maintained that for a recession to occur, a cracking of the labour market is a necessary condition. While we got an economic slowdown in 2022, the labour market didn't crack. We're very likely to get a further slowdown based off weaker initial conditions today. Our judgment is that there has been no greater chance of the labour market cracking since the Covid recovery than the environment we find ourselves in today.

If it was the private sector that announced 800,000 job cuts in the next few months, we'd be very certain that a recession was coming. Does it make a determinative difference if it's the government that provides the impetus. In our experience, it's times of heightened market volatility that are a feature of turning points. Significant amounts of change to the equilibrium situation bring significant amounts of risk. The prevailing equilibrium existed for a reason – because they were more profitable for business. That equilibrium is being shocked today, highlighted when the Trump administration says that their goals should be measured by Main Street and not Wall Street.

What gives us pause about unabashedly forecasting a recession this year is that excess savings still remain somewhat high in the US and the consumer has readjusted to the higher-price regime. Stabilisation in consumer spending occurred throughout the last quarter. Additionally, the pace at which consumers switched from shopping for their groceries at high-end stores compared to discount stores almost slowed to a complete halt over the last year. Combined this suggests to us that the consumer might have some spending power left over, but will they use it?

Precautionary saving is usually a necessary precondition to a recession. We're seeing some signs of it already in the first quarter of 2025. Given that nominal spending levels are much higher than income growth, we'd surmise that interest income and income generated from rising financial assets is contributing to the pace of consumption. This was a key feature of the dotcom boom, and when the music stopped in the stock market it had a sizeable impact on consumer spending. In this way, the decline in the stock market caused a decline in consumer spending, which then caused a drop in corporate earnings and the stock market.

So far, some industries have noted a sizeable drop-off in consumer spending in March. All of the major US airlines have cut their revenue forecasts. Lululemon and Nike are forecasting another decline in US sales and other major retailers like Target have warned us of a sales drop-off from tariffs. In our studies of the dotcom crash, these were the precursors of what was to eventuate.

While a recession isn't certain, what's certain is that the chance of one today are higher than they were in 2022 (because of the starting point and the size of the shock with a direct impact on employment) and back then the S&P 500 drew down -25%. It would be foolish of us not to be open-minded about such a possibility.

Most market participants have yet to adjust to the new probabilities and continue to believe that the dip should be bought. The adjustment process may take a while, especially since any garden-variety recession might take some time to play out. We continue to monitor conditions and are cautious in predicting a recession but, at the least if we don't get "recesseflation", we think the chances are beginning to favour an outcome of stagflation. Such an economic environment is the worst type for equities throughout history, but the best for commodities like gold.

Kind Regards,
Fawkes Capital Management

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