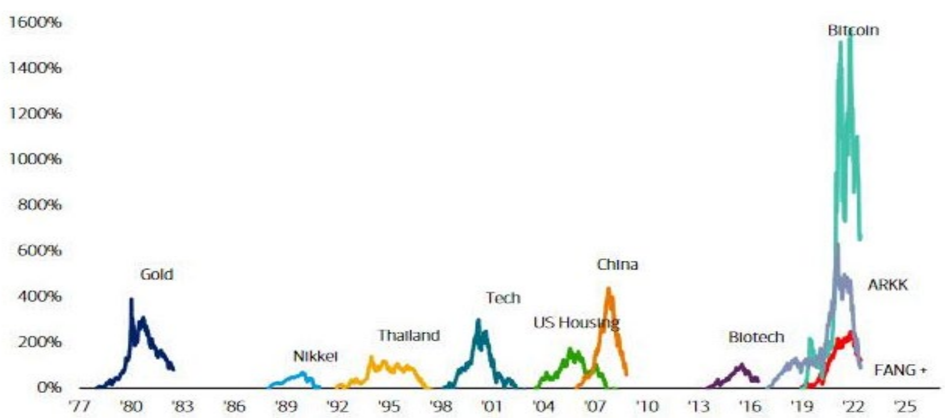
Holowesko Partners Ltd.
June 2022

Commentary

In our December 2021 commentary, I offered some advice to the abnormally large number of people asking for ideas on what to do with their savings. I wrote about a variety of topics and asset classes, and although the comments were biased towards owning value stocks for the long-term, it's worth looking back and updating these comments.

On crypto, in our December commentary, I wrote "so for now, avoid almost all crypto currencies. If you have a bank, a checking account, or the ability to wire money, I would wait for the collapse of most crypto currencies, similar to the collapse of the internet bubble in 2000, which should then eventually produce something backed at last by common sense". Using bitcoin as an example, prices of crypto currencies have started to collapse this year and many of the more questionable crypto currencies or organizations are slowly starting to disappear. I still think we have a way to go in the collapse given the magnitude of speculation and the lack of meaningful intrinsic value in this questionable asset, and I would continue to avoid this space as if it were a new strain of Covid.

CAPITULATION IN CRYPTO
History of Asset Bubbles

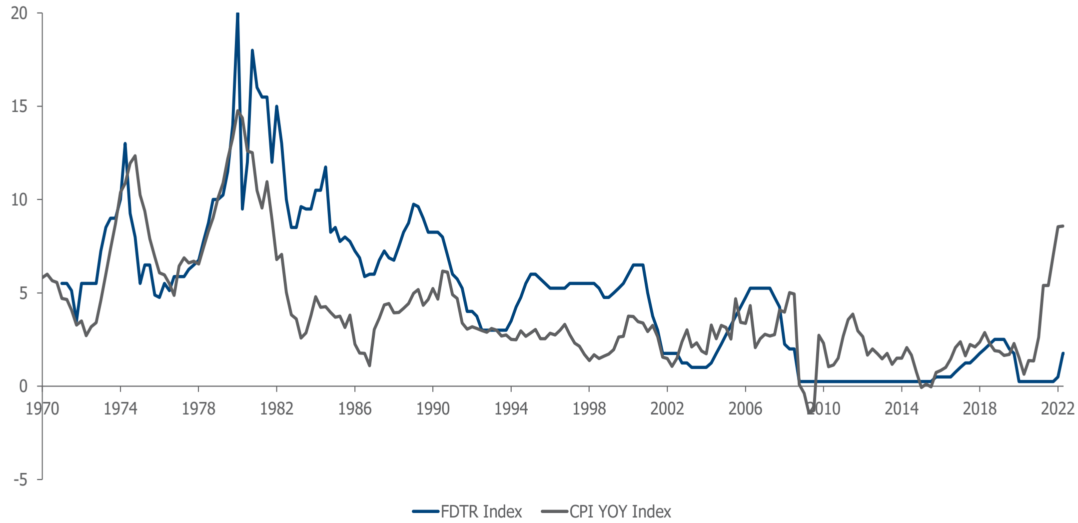


Source: BofA Global Investment Strategy, Haver

I also wrote that "inflation probably isn't transitory when you consider: the large amount of money thrown at the system by central banks; the surge in demand from consumers flush with cash; the rise in energy and labor costs worldwide making their way into the cost of producing products and services; supply chain bottlenecks; and the need for governments to inflate away their massive debts".

As we have gone through the first six months of 2022, US inflation has ticked up from 7% to slightly over the 9% recently reported. The word "transitory" has been dropped from central bank speeches, replaced instead by language about the need to raise rates quickly to control inflation.

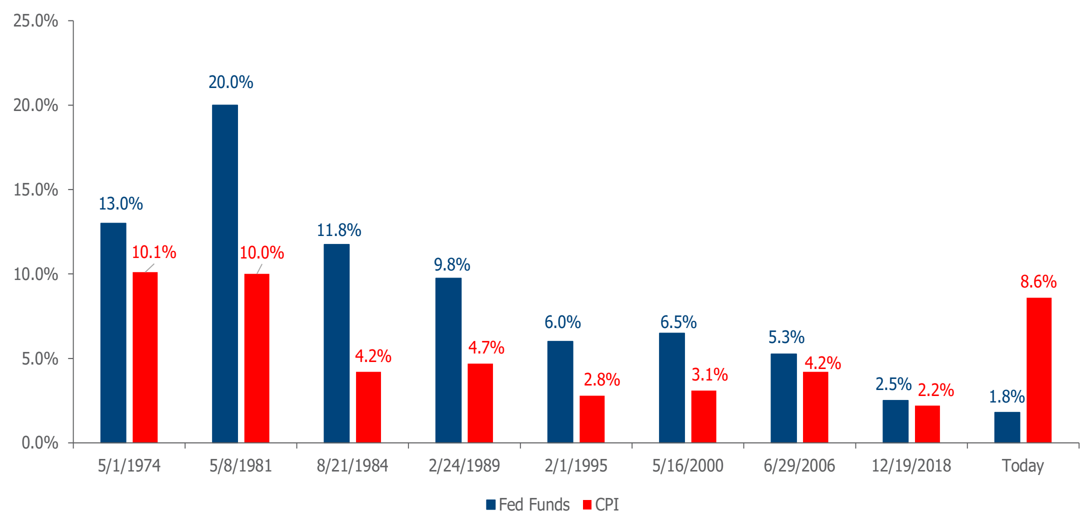
FEDERAL FUNDS TARGET RATE VERSUS CPI YOY INDEX



Source: Bloomberg, HPL

Prospects for interest rates to rise further (and bond prices to fall) are supported by how far the US Federal Reserve is behind the curve on raising rates. Previously, inflation didn't get under control until the Federal Funds rate was close to or above the rate of inflation. The slide below shows how the Federal Funds rate was above CPI at all previous periods of tightening, except today.

FEDERAL FUNDS TARGET RATE UPPER BOUND AND CPI AT THE END OF PRIOR TIGHTENING CYCLES



Source: Strategas Research Partners

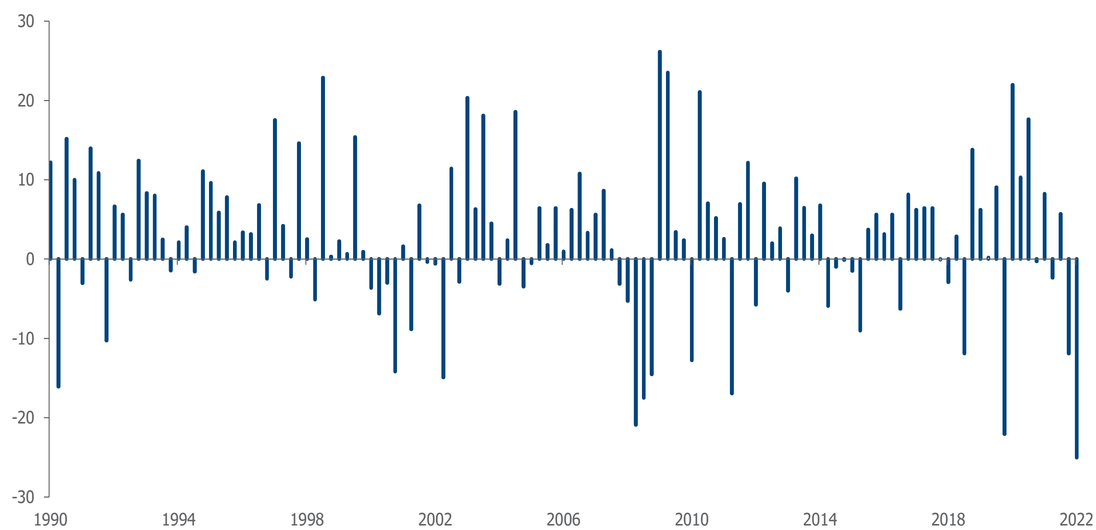
"If inflation isn't transitory, then investing in bonds will be a very poor choice" I wrote. "Bond yields do not reflect current inflation or the prospect of future high or sustained inflation and these yields are starting from abundantly depressed levels". Returns for bonds in the US in the first half of 2022 were the worst since the 1700s. Although many investors today now anticipate higher interest rates, very few expect rates to rise to even half the current rate of inflation. Prospects for returns from bond investments at his point still seem poor for the foreseeable future.

I also mentioned that "US stock indices are at historically high valuations just as the US Federal Reserve has begun to reverse course on rates and stimulus. Dramatic declines in equity prices are difficult or impossible to predict, but the risk of loss at this point on low-cost index funds must be greater than the likelihood of return".

In the US, the S&P 500 experienced its worst first half in 2022 since 1962. Combined stock and bond losses in the US for 2022 are now the worst in US history.

STOCKS AND BONDS ARE HAVING THE WORST RETURNS IN HISTORY

MSCI All-Country World Stocks Index + Bloomberg Global Bonds Index



Source: HPL, Bloomberg

The largest decline in the US has been in technology and the growth heavy Nasdaq. The 26% decline from the peak so far is below the average decline of 37% and the time frame of the decline is a bit more than half the normal average.

NASDAQ BEAR MARKETS AND ASSOCIATED S&P DECLINES

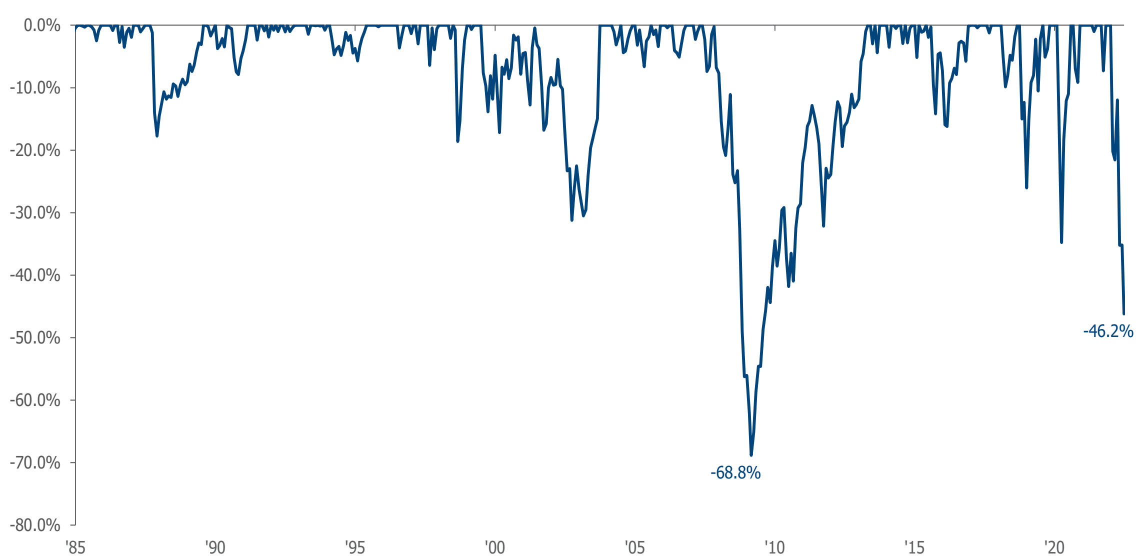
NASDAQ Bear Markets				Associated S&P Declines				
Peak	Peak to Trough (m)	Trough	Peak to Trough Performance	Peak	Peak to Trough (m)	Trough	Peak to Trough Performance	Recession
Jan-73	21.0	Oct-74	-59.9%	Jan-73	21.0	Oct-74	-48.2%	✓
Sep-78	2.1	Nov-78	-20.4%	Sep-76	17.5	Mar-78	-19.1%	
Feb-80	1.6	Mar-80	-24.9%	Nov-80	20.7	Aug-82	-27.1%	✓
May-81	14.7	Aug-82	-28.8%					✓
Jun-83	13.2	Jul-84	-31.5%	Oct-83	9.6	Jul-84	-14.4%	
Aug-87	2.1	Oct-87	-35.9%	Aug-87	3.4	Dec-87	-33.5%	
Oct-89	12.4	Oct-90	-33.0%	Jul-90	2.9	Oct-90	-19.9%	✓
Jul-98	2.7	Oct-98	-29.5%	Jul-98	2.7	Oct-98	-19.0%	
Mar-00	31.4	Oct-02	-77.9%	Mar-00	31.0	Oct-02	-49.1%	✓
Oct-07	16.5	Mar-09	-55.6%	Oct-07	17.2	Mar-09	-56.8%	✓
Aug-18	3.9	Dec-18	-23.6%	Sep-18	3.2	Dec-18	-19.8%	
Feb-20	1.1	Mar-20	-30.1%	Feb-20	1.1	Mar-20	-33.9%	✓
Average	10.2		-37.6%	Average	11.8		-31.0%	
Median	8.2		-30.8%	Median	9.6		-27.1%	
Rec. Avg.	14.1		-44.3%	Rec. Avg.	15.7		-39.2%	✓
ex-Rec. Avg.	4.8		-28.2%	ex-Rec. Avg.	7.3		-21.2%	
Nov-21	5.9		-26.5%	Jan-22	4.4		-16.1%	

Note: In shaded rows the S&P did not enter a bear market alongside NASDAQ
Source: Refinitiv, Credit Suisse research

Bond and equity markets experienced significant declines as investors started to reprice bonds for higher interest rates, and the higher "cost of capital" started to impact the pricing of assets. As we have written in the past, for too long, an almost zero cost of capital (low, zero or negative interest rates) caused all assets to be mispriced, especially companies with low returns on capital and fast-growing companies that destroyed capital as they rapidly expanded their businesses.

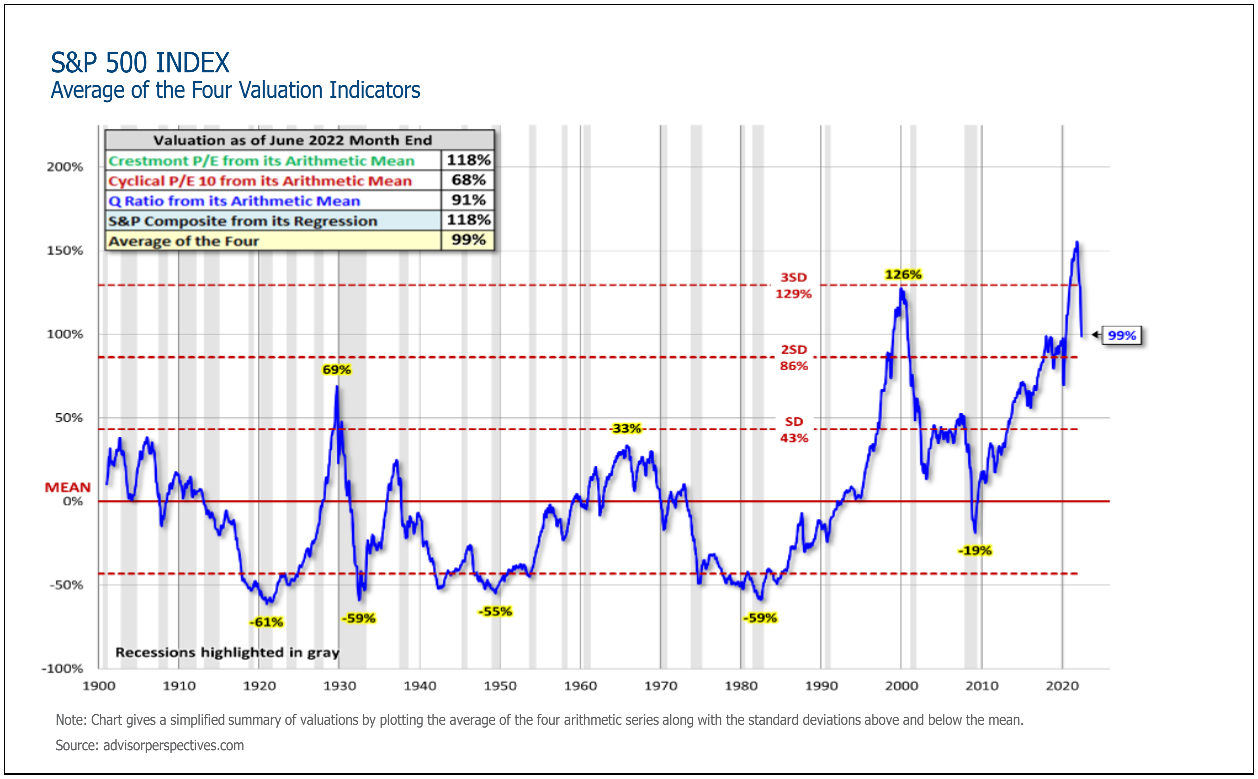
In value terms the decline in US equity valuations so far this year was over $13 trillion, compared to $12 trillion in the Covid decline of 2020 and the $11 trillion lost during the Global Financial Crisis. According to Strategas Research, relative to GDP, the decline in stock value was the second worst in over 45 years.

US EQUITY MARKET VALUE DRAWDOWN AS A PERCENT OF US GDP

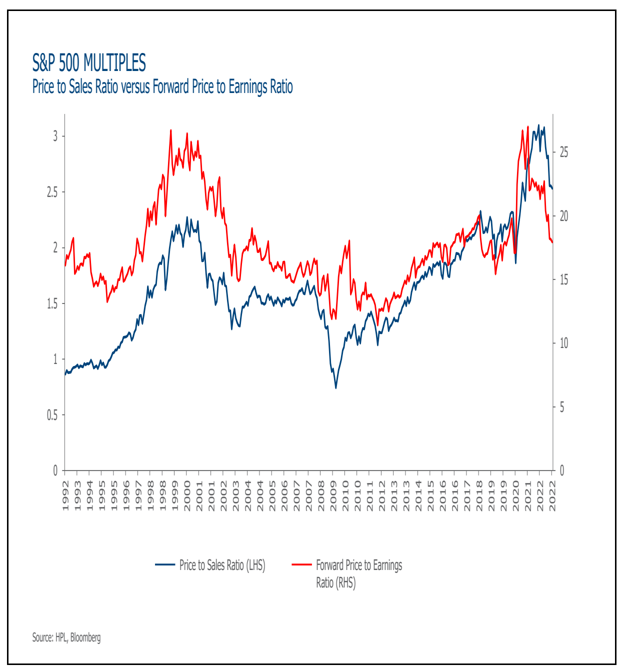


Source: Strategas Research Partners

Although price declines for equities in the US may seem excessive, valuations are still not “cheap”. The average of four valuation indicators specified in the upper left-hand side of the graph below are just below the historical peak in 2000.

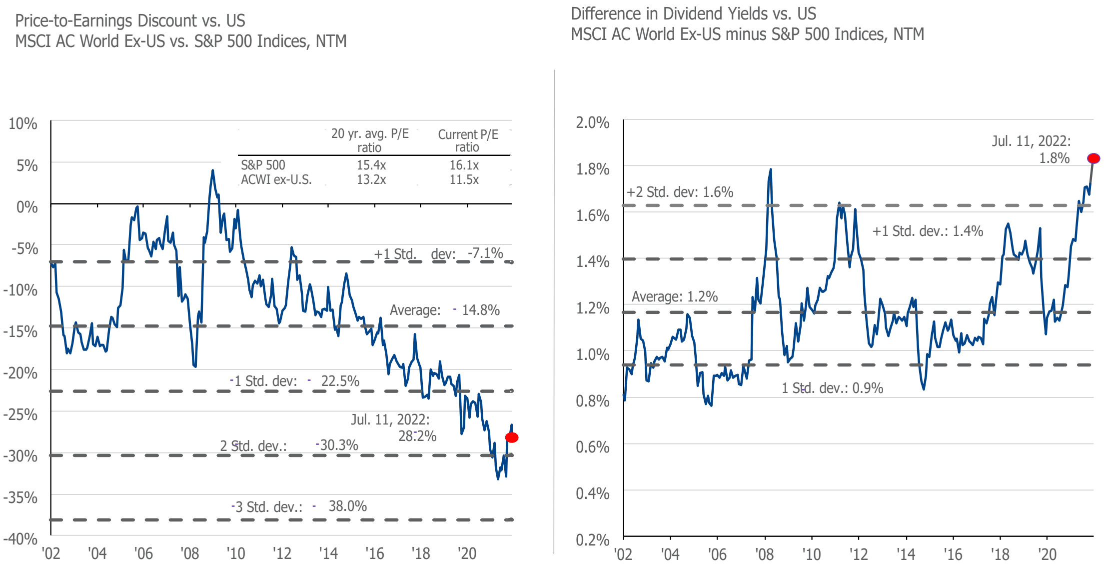


I also mentioned in the 2021 year-end note that if “the US market fell 30%, it would just be at the historic peak of 1999 relative to revenues”. The chart below shows just that, and relative to GDP we are also now back to the previous peak.



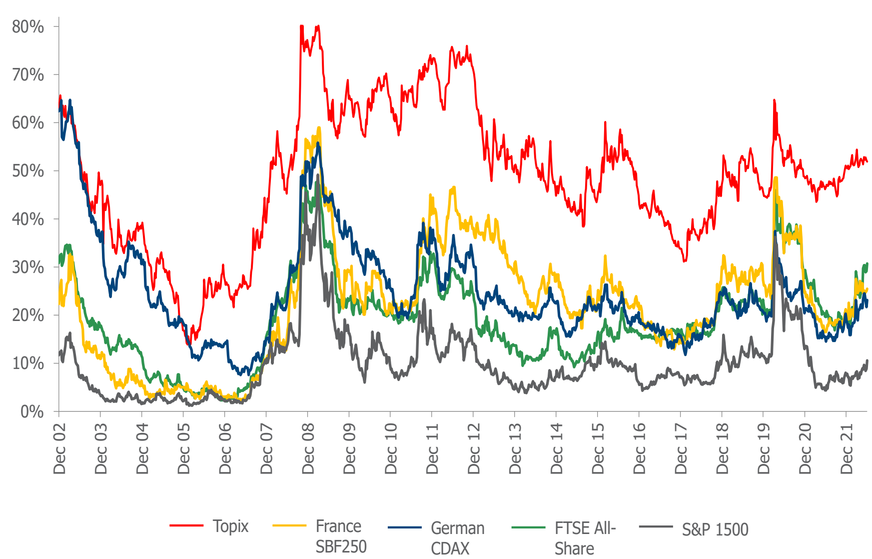
This isn’t the case for non-US markets.

INTERNATIONAL VALUATIONS AND DIVIDEND YIELDS



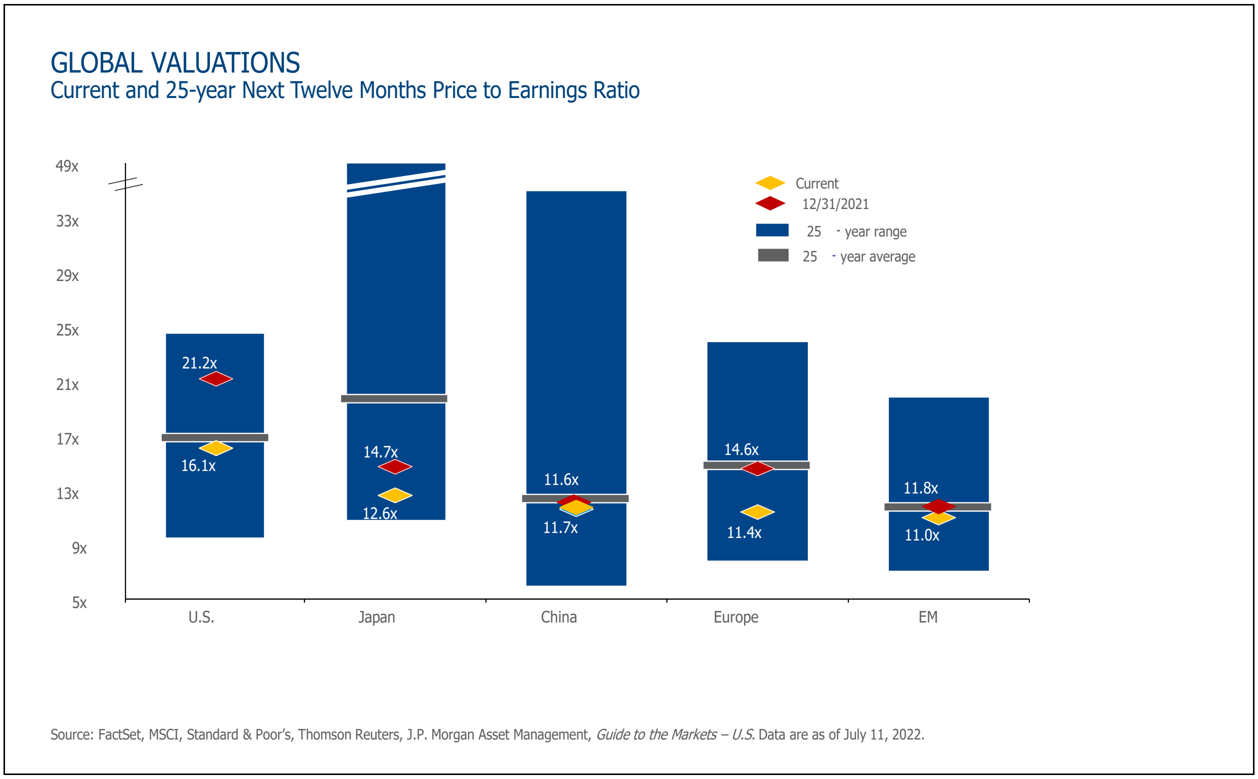
Source: Factset, MSCI, Standard & Poor’s, J.P. Morgan Asset Management, *Guide to the Markets – U.S.* Data are as of June 30, 2022

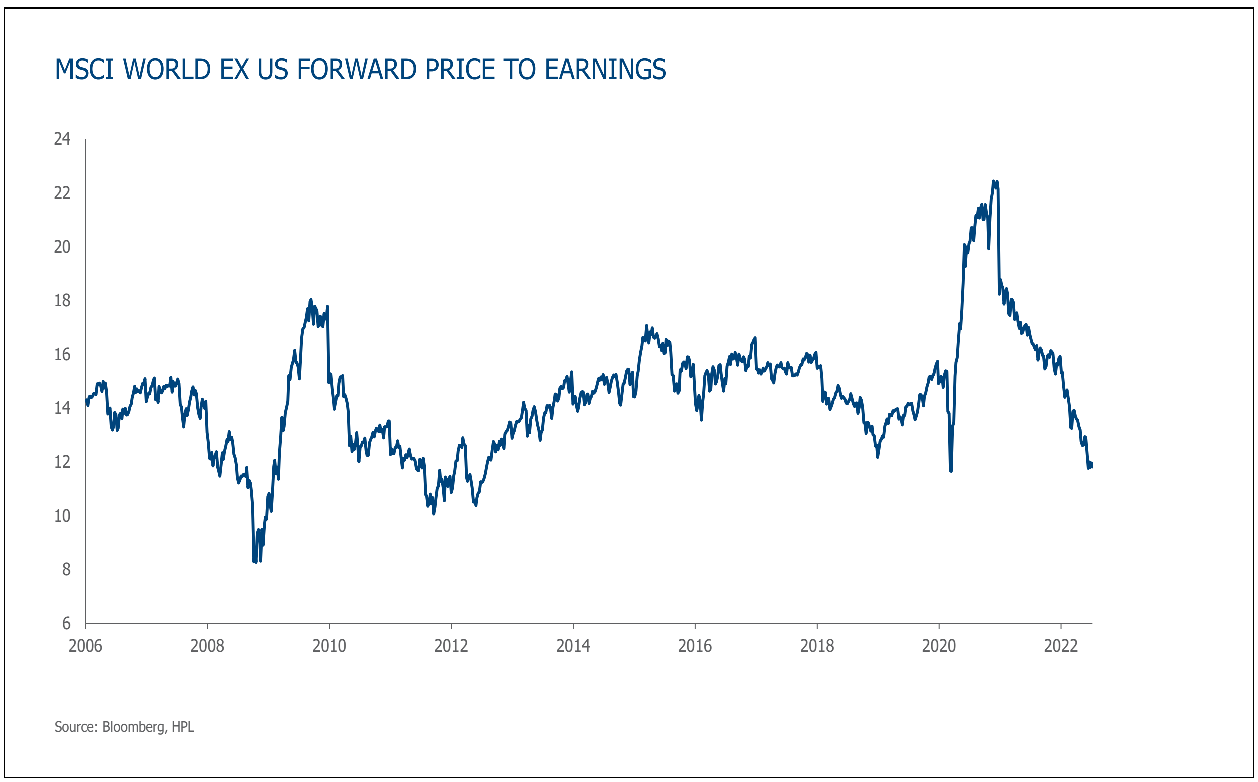
PERCENTAGE OF STOCKS TRADING BELOW BOOK VALUE



Source: CLSA, Bloomberg

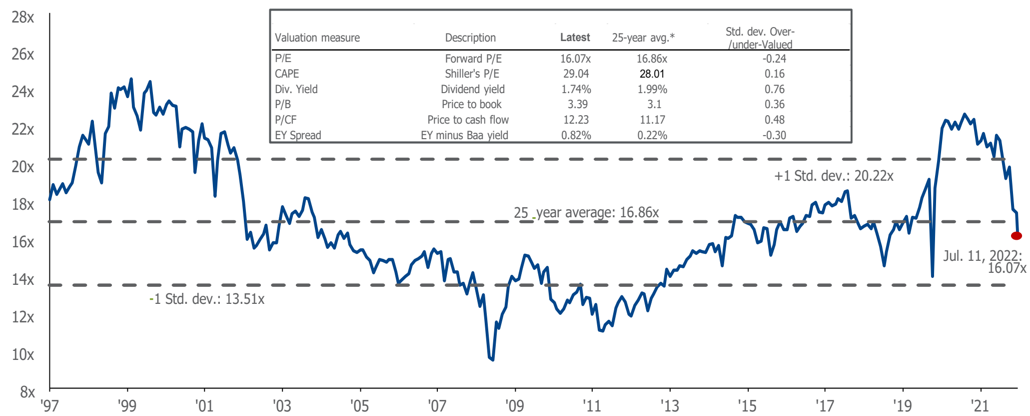
While the price-to-earnings ratio for the US market has moved back to its 25-year average, P/E ratios for Japan and Europe are substantially below their own 25-year average and lower on an absolute basis than the US.





Although forward P/E ratios in the US have declined to slightly below average, earnings estimates are still high.

S&P 500 INDEX
Forward Price to Earnings Ratio



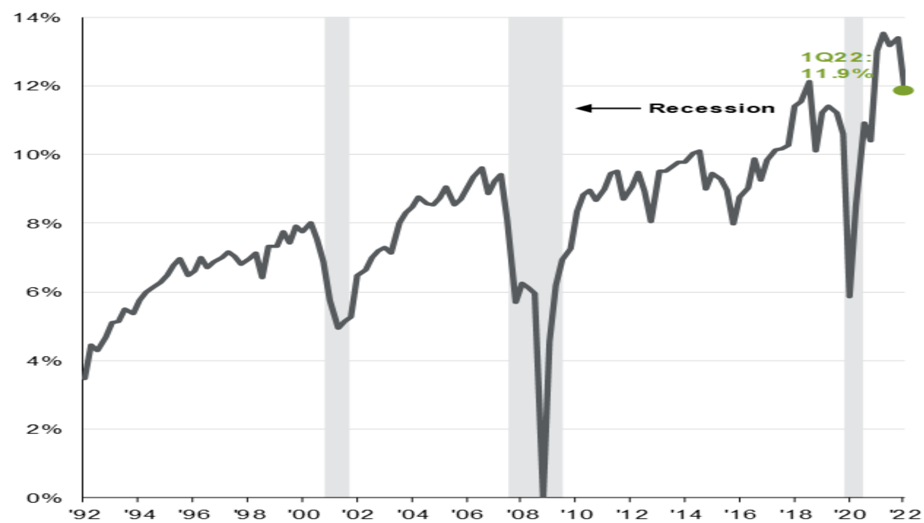
Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	16.07x	16.86x	-0.24
CAPE	Shiller's P/E	29.04	28.01	0.16
Div. Yield	Dividend yield	1.74%	1.99%	0.76
P/B	Price to book	3.39	3.1	0.36
P/CF	Price to cash flow	12.23	11.17	0.48
EY Spread	EY minus Baa yield	0.82%	0.22%	-0.30

Note: Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since July 1997 and by FactSet since January 2022. Current next 12-months consensus earnings estimates are $240. Average P/E and standard deviations are calculated using 25 years of history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure. *P/CF is a 20-year average due to cash flow availability.
Guide to the Markets – U.S. Data are as of July 11, 2022.

Source: Factset, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management, *Guide to the Markets – US.* Data are as of July 11, 2022.

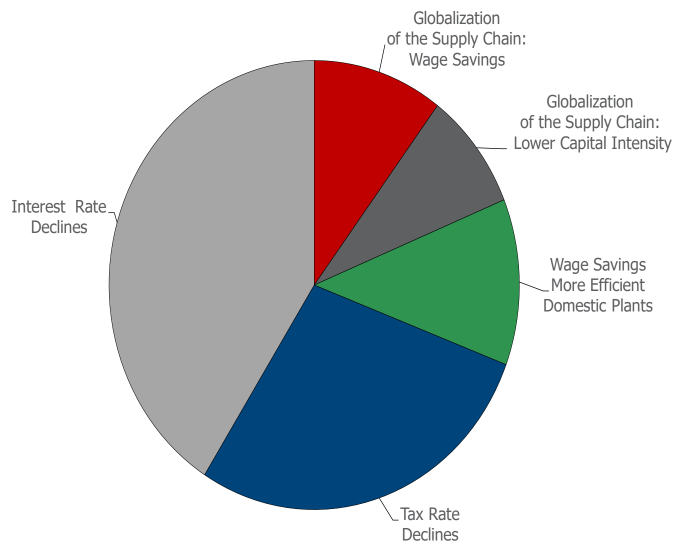
The potential impact of a slowing economy or recession has yet to be fully factored into earnings estimates. In the US, the average decline in earnings in the last four recessions has been 22%, and the average in post war recessions according to Credit Suisse has been 19%. For the S&P 500, earnings estimates for 2022 still show 4% growth versus 2021 actual earnings and estimates in 2024 are up 9%. Even if these estimates are accurate, it portends negative real growth (adjusted for inflation) in US profitability. The vulnerability of earnings is highlighted by the fact that profit margins are currently elevated, with 60% of the improvement in margins having come from lower interest rates and taxes. Both of these are now on the rise, as are wages and input costs.

S&P 500 PROFIT MARGINS
Quarterly Operating Earnings/Sales



Source: BEA, Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.

S&P 500 MANUFACTURERS
Margin Expansion Dynamics
2021 versus 2010



Source: U.S. Census Bureau, U.S. Bureau of Labor Statistics, Corporate Reports, Empirical Research Partners Analysis

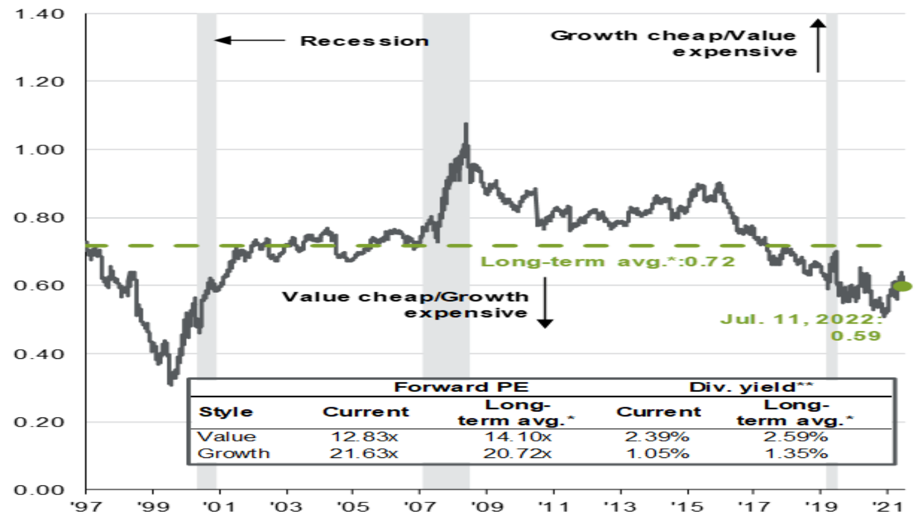
Although employment and wage growth have both been well above average, the sudden rise in commodity prices and the impact of inflation and higher interest rates make a recession a possibility.

"Absolute valuations and valuation spreads give us confidence in investing in certain equities in today's environment. Specifically, spreads are unusually wide between growth and value", I wrote in the December report, and this is still the case despite the significant decline of growth companies' share prices. There remains a sizeable difference in the valuation between value and growth, as illustrated by the P/E variation shown below.

VALUE VERSUS GROWTH RELATIVE VALUATIONS

Relative Forward Price to Earnings Ratio of Value versus Growth

1997 - Present



Growth is represented by the Russell 1000 Growth Index and Value is represented by the Russell 1000 Value Index. *Long-term averages are calculated monthly since December 1997.
**Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price.

Source: FactSet, FTSE Russell, NBER, J.P. Morgan Asset Management

It's helpful to look at the conditions in US equity markets during the 1970s when inflation averaged 9%, roughly where we are today with the US CPI. In the chart below, the first thing that should jump off the page is how much higher the Federal Funds rate was during that period. The lowest level was 6.5% and Fed Funds got up to 18% in 1980. Today the rate is 1.7%, incredibly low versus the rate of CPI.

Another thing to note is how well value stocks performed compared to the S&P 500 and Nasdaq, with stellar returns from energy and materials.

GLOBAL EQUITIES – 1970s INFLATION

	Average Annual CPI Changes	Fed Funds Rate	S&P 500 Total Return	10YR Treasury Return	High Dividend Yielding Stocks	Value Stocks	Nasdaq	Energy Index	Precious Metals Index
1973	6.2%	9.0%	-14.3%	3.7%	-14.3%	-9.7%	-31.1%	42.7%	60.7%
1974	11.1%	8.0%	-25.9%	2.0%	-16.6%	-23.4%	-35.1%	230.7%	67.7%
1975	9.1%	4.9%	37.0%	3.6%	45.6%	52.1%	29.8%	0.3%	-1.3%
1976	5.7%	5.9%	23.8%	16.0%	38.2%	49.9%	26.1%	11.0%	-16.2%
1977	6.5%	6.5%	-7.0%	1.3%	2.7%	7.4%	7.3%	10.3%	13.9%
1978	7.6%	10.0%	6.5%	-0.8%	3.5%	9.1%	12.3%	4.9%	27.3%
1979	11.3%	14.0%	18.5%	0.7%	18.5%	27.9%	28.1%	114.2%	72.2%
1980	13.5%	18.0%	31.7%	-3.0%	19.7%	18.5%	33.9%	20.8%	93.3%
1981	10.3%	12.0%	-4.7%	8.2%	10.2%	12.9%	-3.2%	-0.2%	-32.8%
CAGR	**9.0%**		**5.3%**	**3.4%**	**10.1%**	**13.6%**	**4.3%**	**35.8%**	**24.6%**

Source: Bloomberg

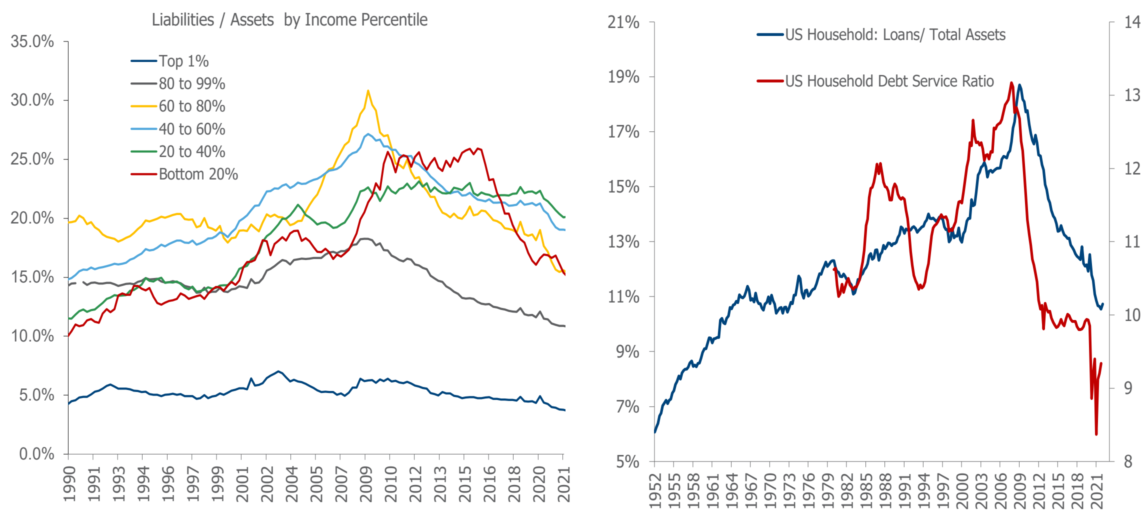
Remember, "value companies have a history of performing well while governments try to inflate their way out of too much debt. The period post World War II is a prime example. The graph below shows the US CPI in blue compared to the US value 10-year moving returns. The period after World War II is very similar to today, with high inflation but good returns on value".

Although I don't know the timing or extent of any recessions in the future, some of the following factors give me more confidence.

- Outside of the US there are many companies trading at absolutely low valuations reflecting poor news.
- Currencies outside the US are relatively low versus the dollar.
- Pessimism is high and growing.
- Investors have started to mark down private equity positions, something that happens in the second half of bear markets.
- Hedge funds have dramatically reduced long risk.
- The banking industry in the US, UK and many parts of Asia are strong and overcapitalized allowing for strong loan growth.
- Although debt is high at the government level, it is low at the corporate level, especially in the US and Japan.
- Commodity prices have fallen from peak levels easing inflationary pressure. Copper is down 33% from March 2022, lumber prices have fallen and oil prices are receding to their pre-Russia/Ukraine War level.
- China is opening back up, albeit slowly, after Covid induced shutdowns.
- Employment levels are high and wages are growing. In the US, savings and liquidity levels are substantial.

The severity of any recession should be offset in the US by healthy consumer balance sheets. US household loans to total assets and debt servicing ratios are the lowest since the 1980s.

US CONSUMER BALANCE SHEETS ARE AS HEALTHY AS IN 2008



Source: FED, Bloomberg, BNP Paribas Exane estimates.

There is no doubt that markets are facing near-term challenges including persistent inflation, central bank tightening and prospects for a recession. Although markets are beginning to anticipate and price in a more pessimistic outlook, we remain enthusiastic.