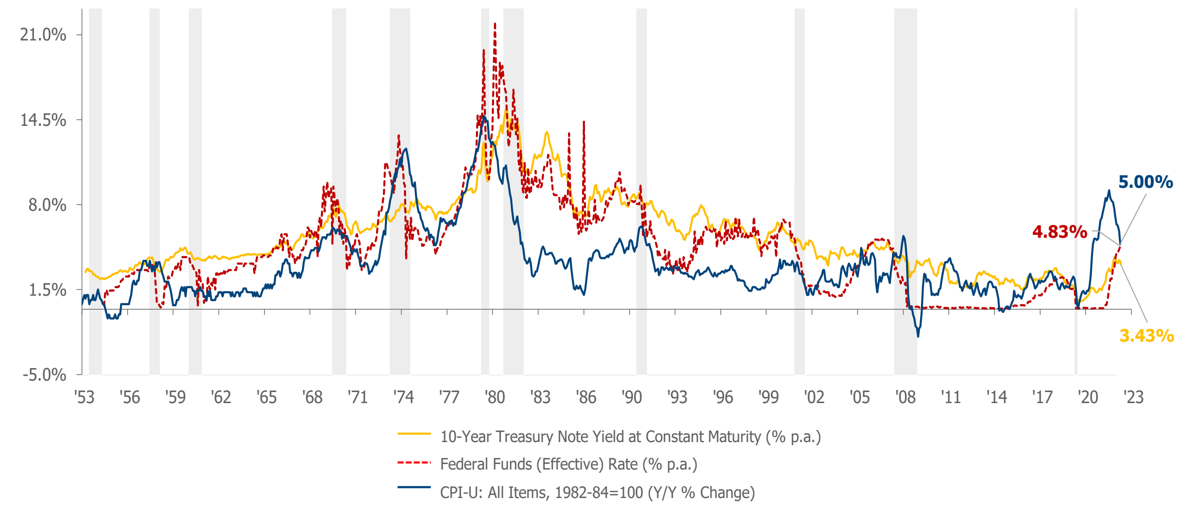
Holowesko Partners Ltd.
March 2023

Although we are stock pickers first and foremost, several themes in global markets should provide strong tailwinds to our efforts and add to our enthusiasm for our investments. Broadly speaking these are: a new era of a higher cost of capital, the large divergence in valuation for value companies globally relative to general markets, the historic relationship between higher inflation and higher returns from value, and the enormous spread in valuation between the US and non-US markets, while most of the investment public is overexposed to an expensive US equity market.

Rising Cost of Capital

Events over the recent quarter strengthen our conviction that we are firmly in a new higher cost of capital era, different than what was experienced post the Global Financial Crisis. The availability of cheap capital during the previous decade increased the price of all assets globally. A higher and less manipulated cost of capital will generally do the reverse, while also rewarding companies with high and consistent returns on invested capital. This new era is probably bolstered by higher and more consistent inflation, keeping interest rates above the almost zero cost of capital (federal funds rate) shown in the graph below after 2008.

US CPI, FED FUNDS RATE, TEN-YEAR TREASURY YIELD AND MONEY STOCK

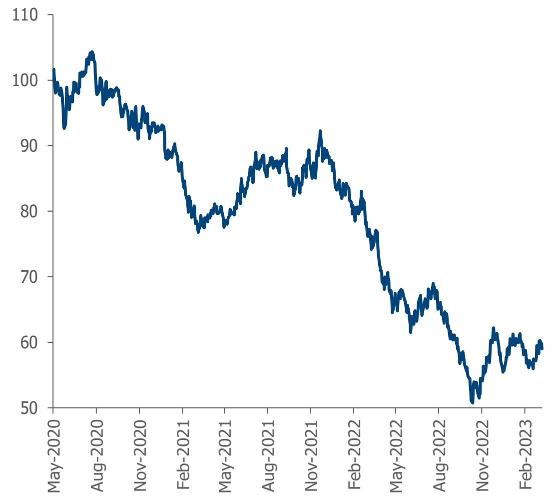


- Real 10-year US yield = -6.1% (was -5.6% when slide was prepared 1 month ago)
- Real FF [effective] rate = -7.5% (versus -8.3% 1 month ago)

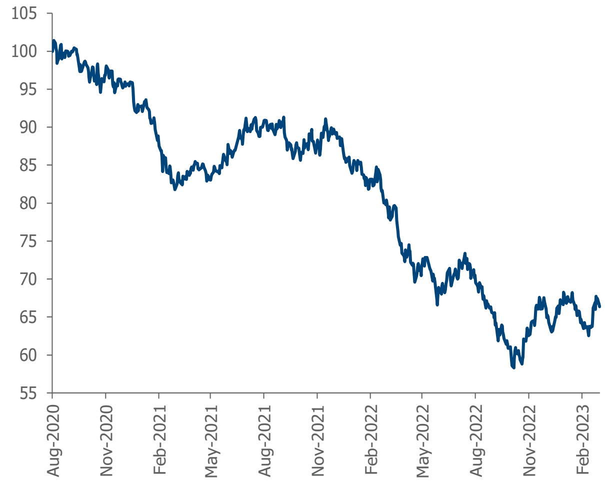
Note: Data at 3/31/2023
Source: Strategas Research Partners

With the dramatic increase in interest rates recently by the Federal Reserve and other central banks to try to rein in inflation, longer duration assets fell dramatically in price, especially longer-dated bonds. This is best illustrated by the price movement of "safe" US treasury 30 and 20 year bonds issued in 2020 prior to the rise in rates.

PRICE OF 30-YEAR US BOND ISSUED 3 YEARS AGO



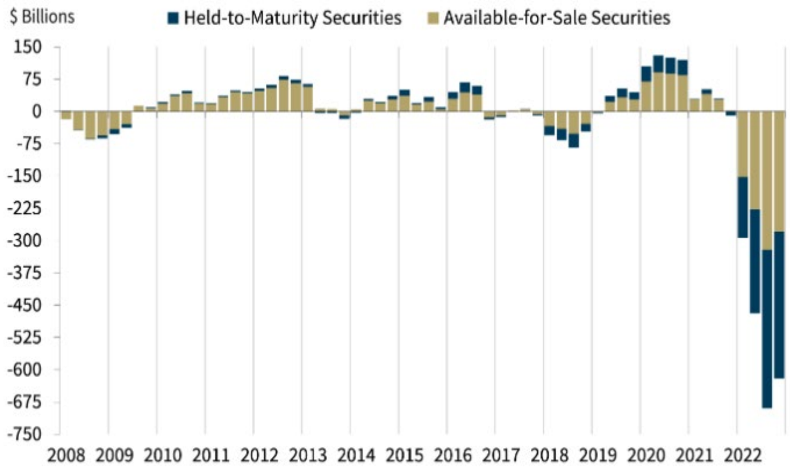
PRICE OF 20-YEAR US BOND ISSUED 3 YEARS AGO



Source: Bloomberg, HPL

These substantial declines in prices caught some by surprise and have started to cause havoc in selected parts of the economy. Quite often interest rates rise until something breaks, and in this case it included the Silicon Valley Bank in California and Credit Suisse in Switzerland. Unrealized losses in a bank's investment portfolio become realized losses when depositors suddenly want their money back and the institution is forced to sell assets to meet redemptions. The size of these unrealized losses in the US is shown below on a graph taken from the Federal Deposit Insurance Corp (FDIC) presentation to Congress.

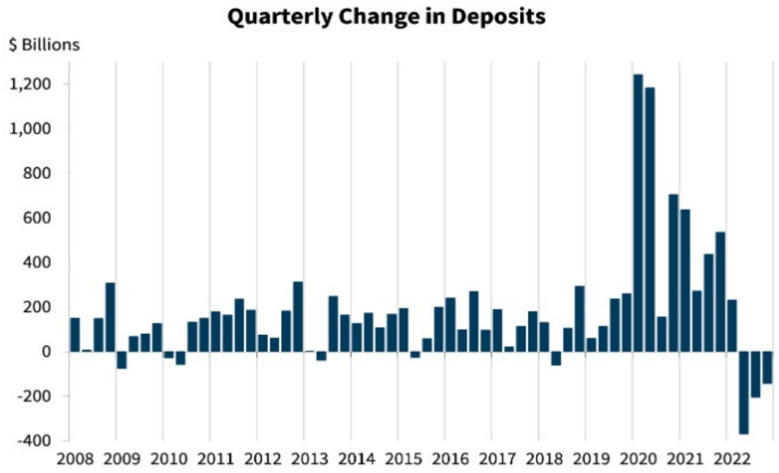
UNREALIZED GAINS (LOSSES) ON INVESTMENT SECURITIES



Note: Insured Call Report filers only.
Source: FDIC

If you add to these potential investment losses at banks the unrealized losses on mortgages when they are repriced for a higher interest rate environment, it is estimated that in March 2023 there was $1.8 trillion in unrealized losses in the US banking system supported by $2.14 trillion in equity (the difference between bank assets and liabilities). The FDIC had $130 billion to guarantee $10 trillion in insured deposits at the beginning of 2023. This is now estimated at $100 billion, post the most recent bank failures, nowhere near enough to insure the full $18 trillion of US deposits estimated in the US banking system. Although the banking failures were dramatic, the overall US banking system does not appear vulnerable to any systematic failure. The banking system is generally in much better shape than the past. Most banks will not have to realize these losses unless they experience large deposit outflows, which may occur at some smaller banks, but not systemwide. Although the last few quarters have seen the largest deposit outflows on record, bank deposits grew at an unprecedented pace in 2020 and 2021 as US consumers benefited from stimulus checks and a slow down in spending, so the recent decline in deposits should not be a huge surprise.

QUARTERLY CHANGE IN DEPOSITS



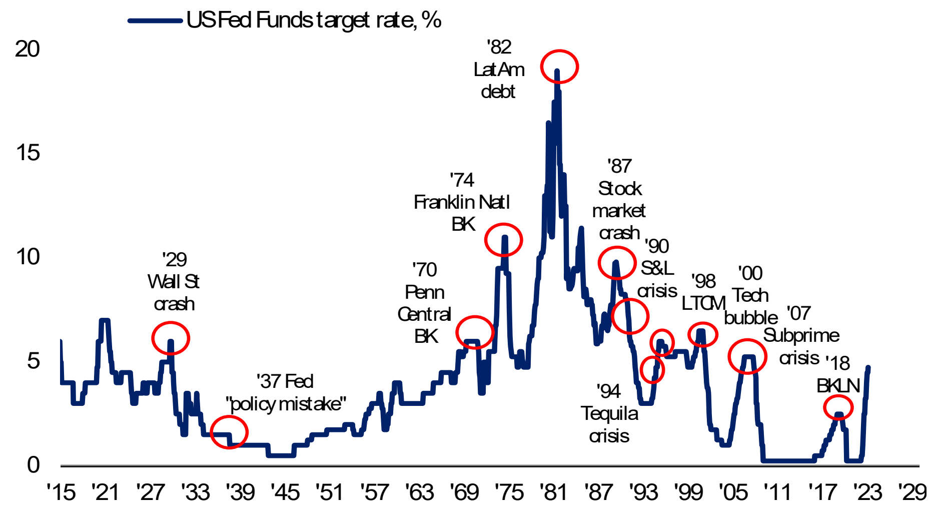
Source: FDIC

The larger US banks have benefited from an inflow of deposits leaving smaller uninsured banks. They also have more liquidity on their balance sheets than smaller banks (38% of assets versus 29%) with lower loans-to-deposits (51% versus 65% for smaller banks).

What is more interesting to us is the response by the US to stabilize the banking system, which probably means the effort to combat inflation will slow (as interest rate increases will need to slow), and the possibility of a recession in the US is probably more likely and sooner. With 80% of commercial lending in the US, 45% of consumer loans and 80% of residential lending coming from small and medium sized banks (those under the most pressure from deposit withdrawals), loan growth is likely to slow further, adding to the already apparent pressure on economic growth from higher interest rates. In fact, in the last two weeks of March, US bank lending fell by the most since records were taken in the early 1970s.

While the emphasis has been on tightening liquidity to combat inflation by raising interest rates and reducing central bank balance sheets, the banking failures in the US and Switzerland have highlighted the limited ability to raise rates much further without provoking further instability in the financial system. Failures following rate increases normally bring rate increases to a stop.

US FEDERAL FUNDS TARGET RATE

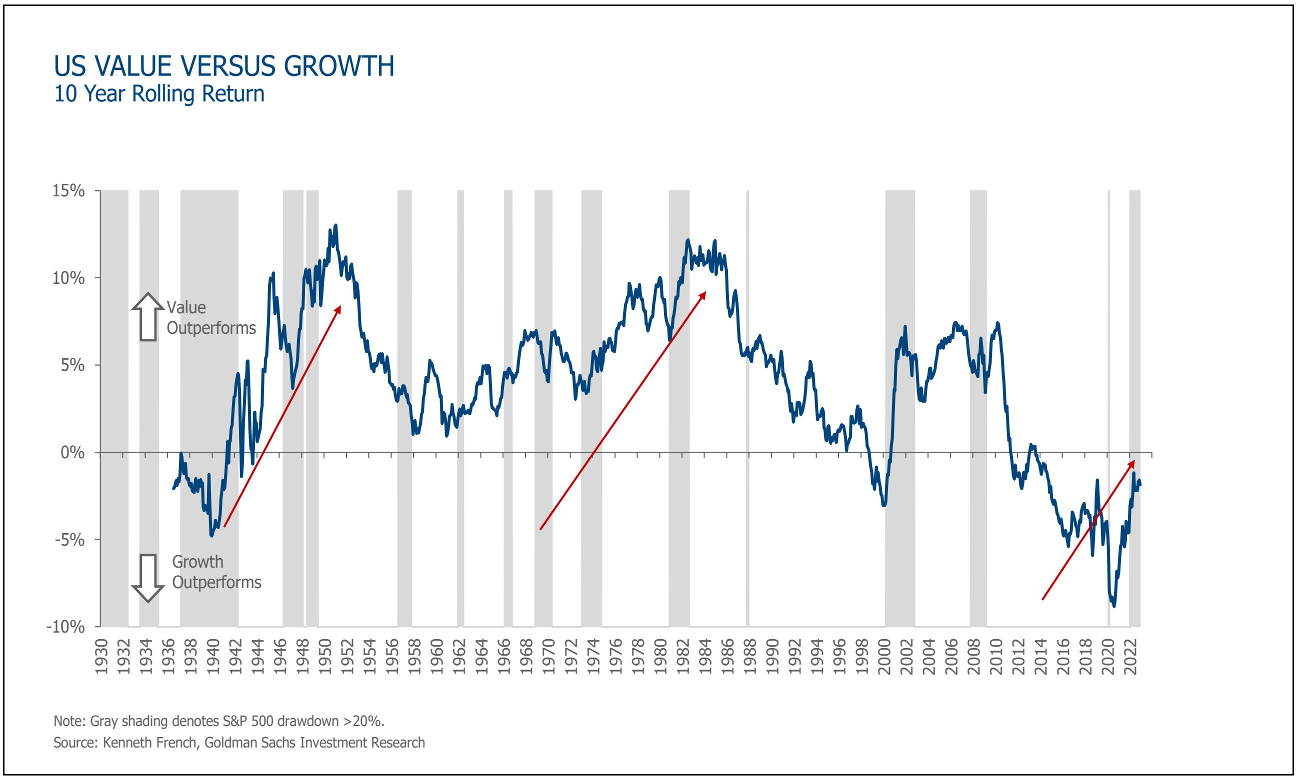


Source: BofA Global Investment Strategy, GFD Finaeon, Bloomberg

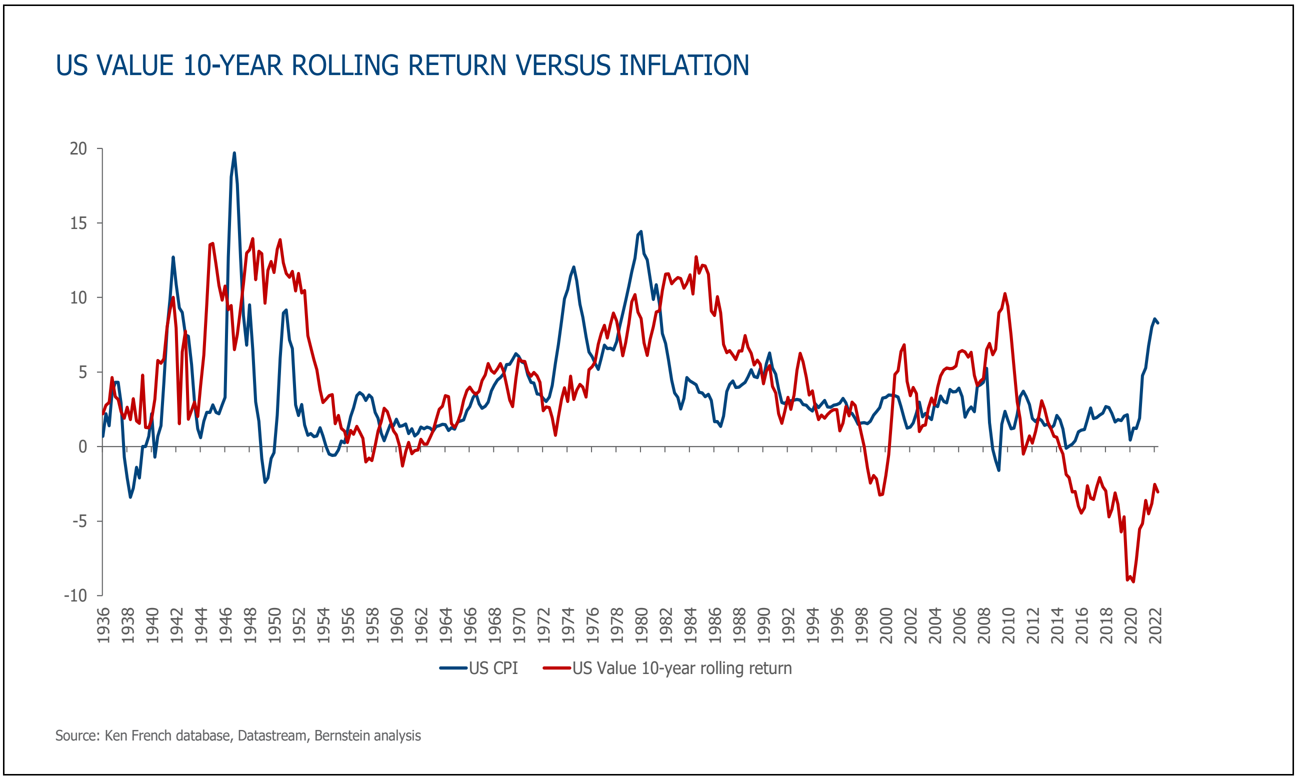
Central bankers have to weigh the possibility of further financial failures if they continue to raise rates versus letting inflation run a bit higher than anticipated. These bank failures have resulted in a temporary reversal of quantitative tightening with liquidity being pushed back into the economy, just as central banks are in the midst of their efforts to control inflation. In March, a two week increase in the US Federal Reserve's balance sheet was the third largest after the Global Financial Crisis and Covid, with the vast amount of balance sheet reduction that occurred over the last 6 months almost completely reversed. This liquidity has also been added to by actions in Japan, China and the bailing out of Credit Suisse in Switzerland. Without an ability to raise rates and with liquidity going back into the system, it is probably wise to expect higher inflation for longer. It is also likely that while rates may be unable to rise much further, they are unlikely to come down in the future to the degree some anticipate.

Value is Cheap and Benefits During Periods of Higher Inflation

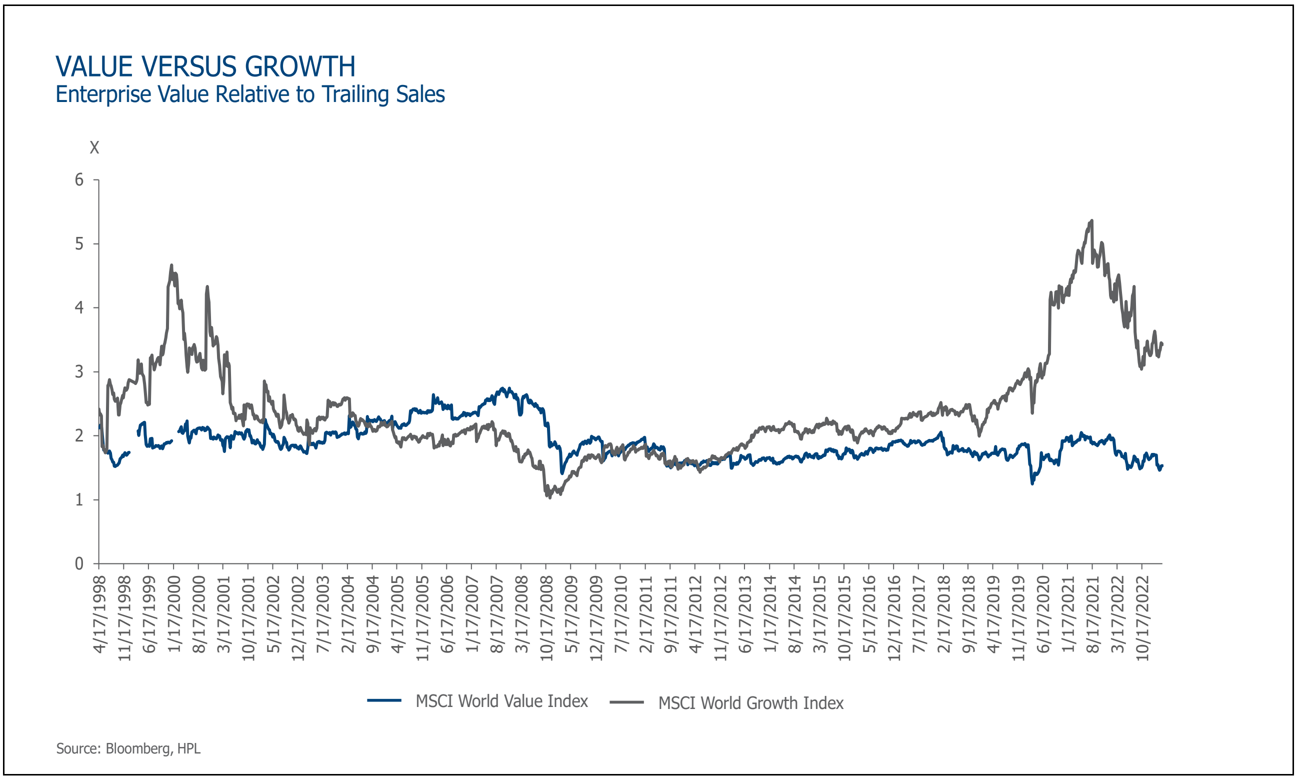
Higher inflation has usually been associated with better returns for a value style of investing. In the US, the two periods with similarities to today are the periods post WWII and during the 1970s. The graph below is a comparison of value versus growth investing going back to the 1930s. When the blue line was rising, it was a period when value outperformed growth. This was especially true in the periods mentioned above, and dramatically so after WWII when the US inflated its way out of the massive debt built up during the war.



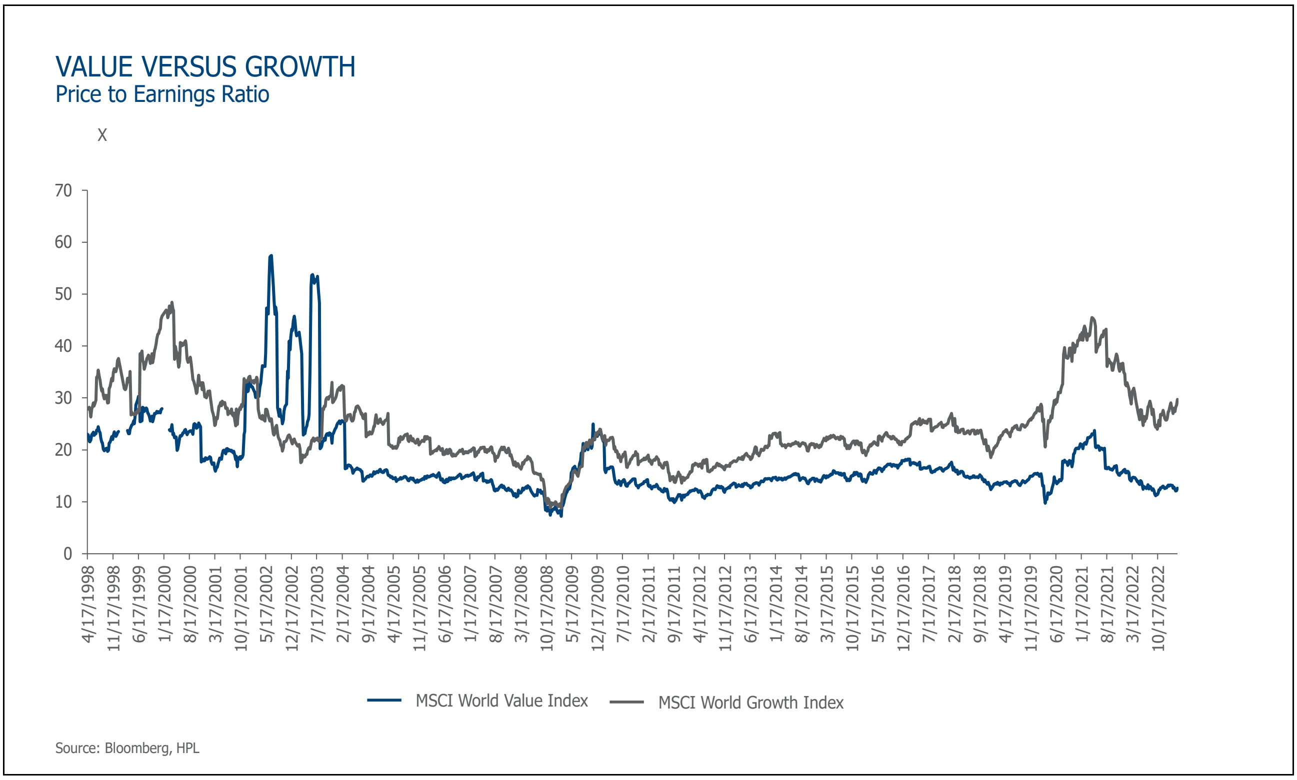
Another way to see the performance of value and inflation is in the slide below, which shows inflation (blue line - US CPI) and the 10-year rolling returns of value. During the 1940-1950 period and also in the 1970s, returns for value were well above average.



Not only does value do well during periods of higher nominal growth, which is now more likely to occur, it is also cheap. The large outperformance of growth companies, many of which were able to access cheap capital during the post GFC period, has left value at a distinct discount to growth and cheap on an absolute basis. Relative to revenues, value companies are historically cheap, and the spread in valuation to growth companies is as wide as the bubble in 2000.

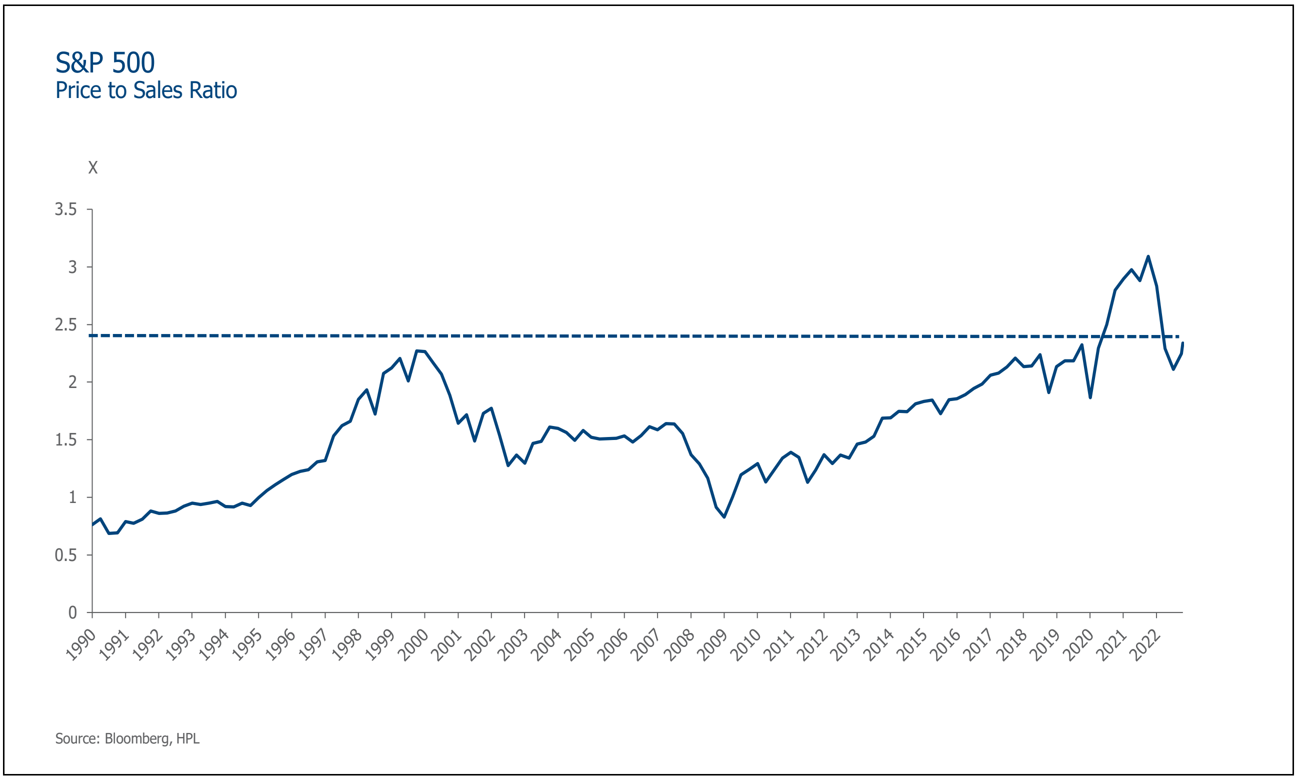


The same could be said for value when considering price-to-earnings ratios.

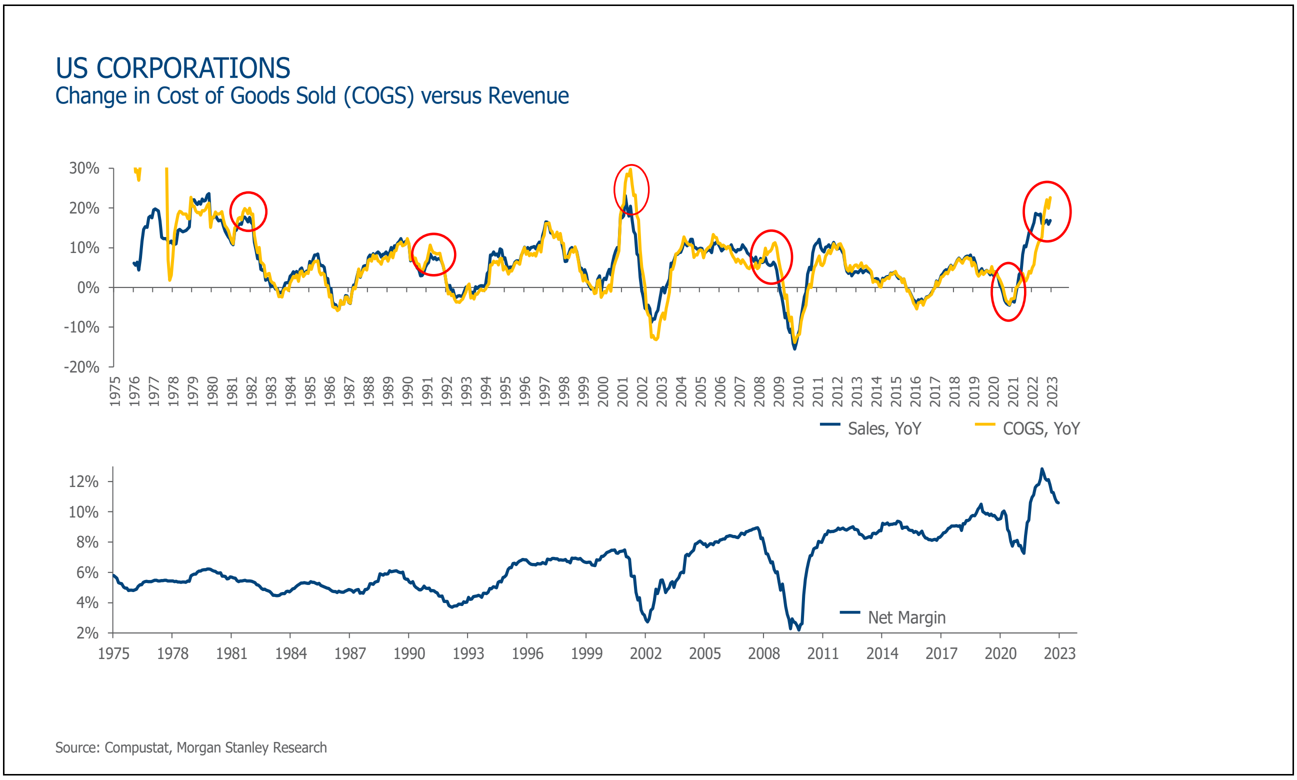


The US is an Expensive Place to Shop for Investment Bargains

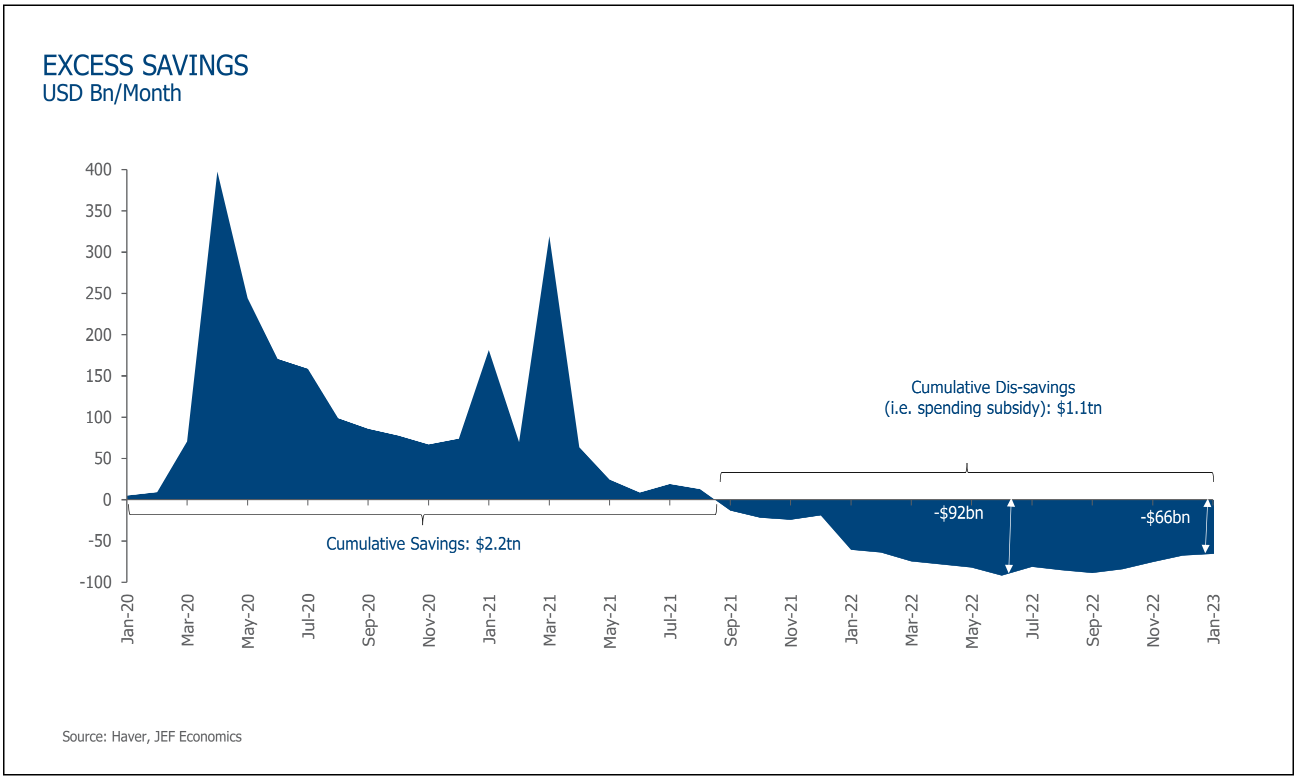
Despite the correction in equity prices last year, the overall US equity market is still overpriced versus history. The price-to-sales for the market as a whole has declined, but just back to the level of the 2000 stock market peak.



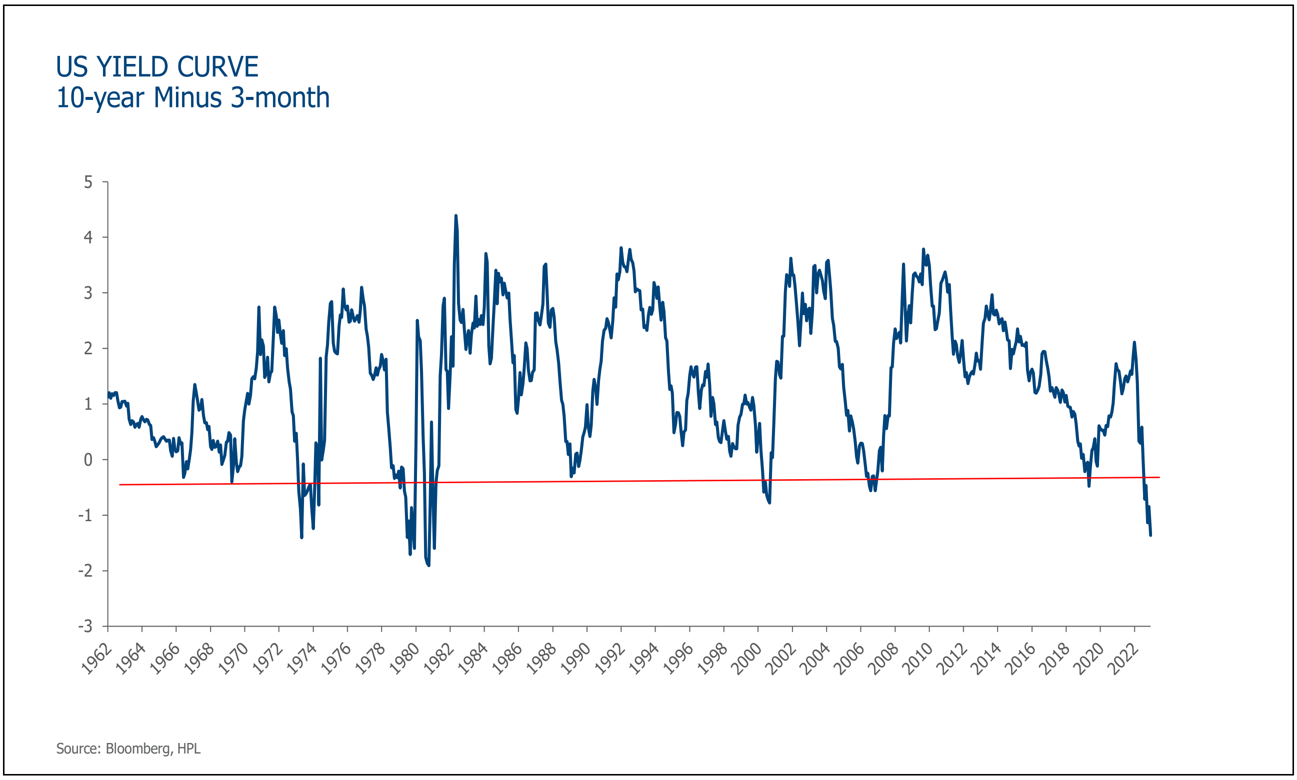
Price-to-earnings levels have also declined, but this seems more like a repricing due to higher rates, not yet taking into consideration a further rerating which may occur as earnings fall during a possible recession. In addition to the possibility of slowing economic growth, revenue growth in the US is struggling to keep pace with cost growth, which is normally associated with declining margins. As the slide below from Morgan Stanley indicates, when this occurs (red circles) there has typically been larger declines in net margins (blue line).



The US consumer, typically 2/3 of economic growth, has been spending the large amount of accumulated savings during the pandemic. Most analysis of this spending indicates it will be worked down by year-end.

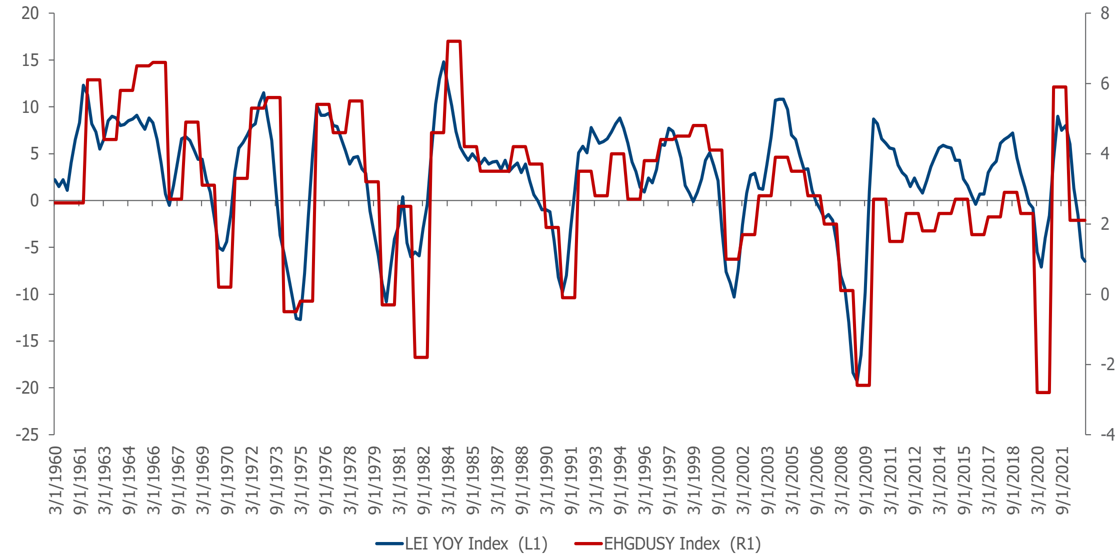


There are many reasons to suspect the US may be headed for a recession. First, the yield curve is extremely inverted. The 10-year to 3-month Treasury yield spread is the most negative in history, with all previous negative periods in the graph below preceding an economic slowdown.



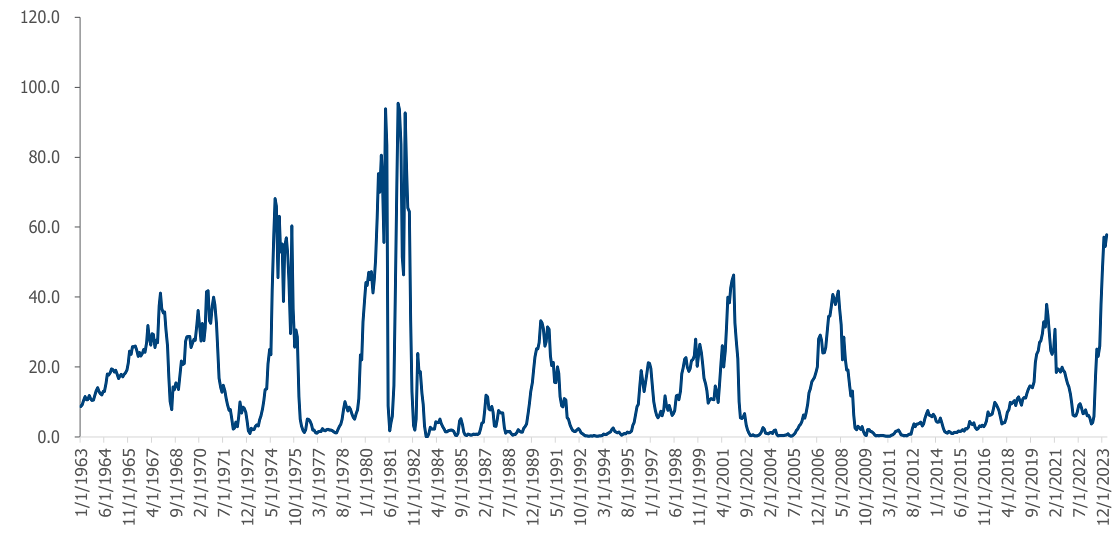
US leading economic indicators, the NY Federal Reserve recession probability model and CEO Confidence all point to a similar conclusion. America's economy is more than likely recession bound. According to CLSA, since 1960, each time the New York Fed's US Recession Probability Index has risen above 33% and the Conference Board's Leading Economic Indicator YoY change has dropped below 1%, a recession has ensued. The current prints for these metrics are now 54% and -6% respectively. We don't really know if the US is going into a recession or not, but it would be highly unusual if it did not, and it is certainly not reflected in most estimates.

CONFERENCE BOARD US LEADING ECONOMIC INDICATORS



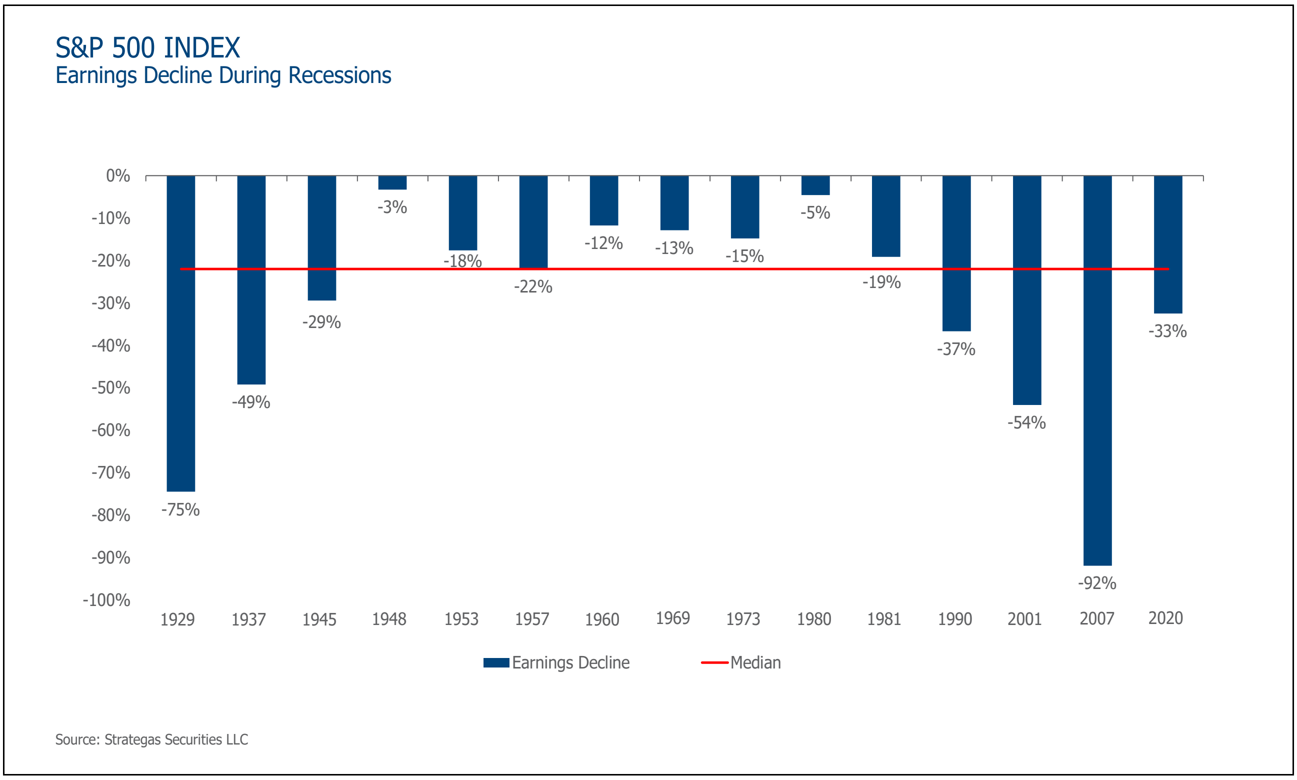
Source: Bloomberg, HPL

NY FEDERAL RESERVE PROBABILITY OF RECESSION IN US



Source: Bloomberg, HPL

If you combine cost pressure with slowing economic growth, the possibility of declining earnings in the US has increased dramatically. Earnings declines in a recession can be significant, as can the multiple used on earnings to price assets. The earnings decline in the S&P 500 during recessions going back to the 1920s is shown below. Since 1990, the declines have ranged from -19% to -92% during the GFC.



Earnings expectations in the US today seem too high given all of these factors pressuring economic growth. If you factor in a recessionary decline in earnings, and assume the market sold at a lower multiple on these adjusted earnings, the potential downside for the equity market is still substantial. The slide below shows potential EPS declines of -15% or -25% on 2022 and 2023 actual/estimated earnings and the potential market drop if the market sold at 18x or 15x these "recessionary" earnings.

S&P 500

Current Level as of March 31, 2023 = 4,108

Earnings Per Share (EPS)		Price to Earnings (P/E)
2021 Actual	= $198	P/E = 20.7x
2022 Actual	= $223	P/E = 18.4x
2023 Consensus Estimate	= $220	P/E = 18.6x

Scenarios

$223 less 15% = 189 (mild recession) x 18 = 3,402 (-17%)
$223 less 25% = 167 (regular recession) x 18 = 3,006 (-26%)

$223 less 15% = 189 (mild recession) x 15 = 2,835 (-30%)
$223 less 25% = 167 (regular recession) x 15 = 2,505 (-37%)

Source: HPL, Bloomberg

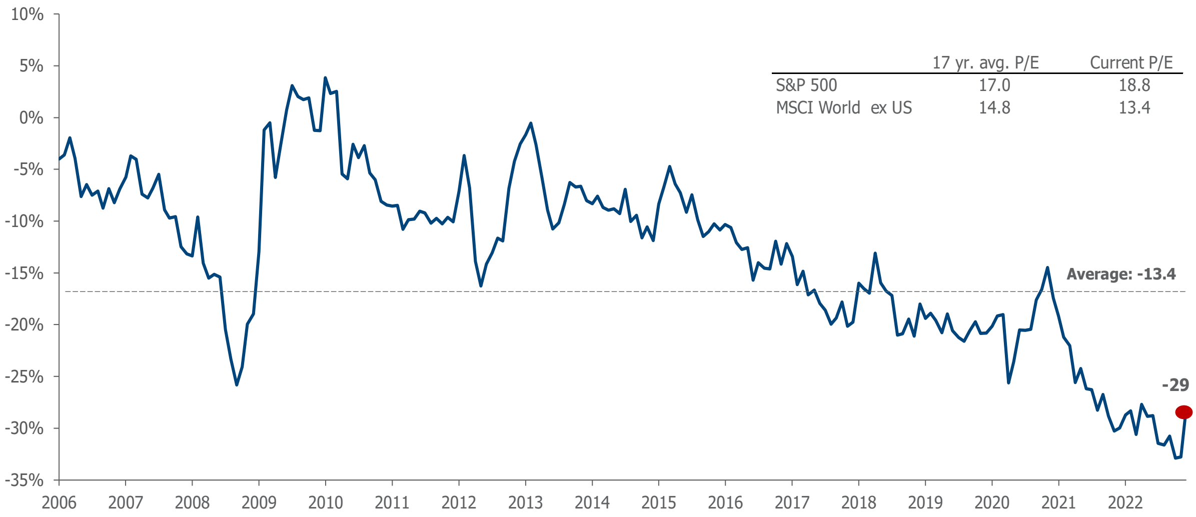
Non-US Markets are Full of Great Investment Opportunities

The good news is that non-US markets are full of cheap investments and the US market still has pockets of outstanding value. Non-US stocks are at a historic discount relative to US stocks on a price-to-earnings basis.

INTERNATIONAL PRICE TO EARNINGS DISCOUNT VERSUS US

MSCI AC World Ex-US Versus S&P 500 Indices

Next 12 Months

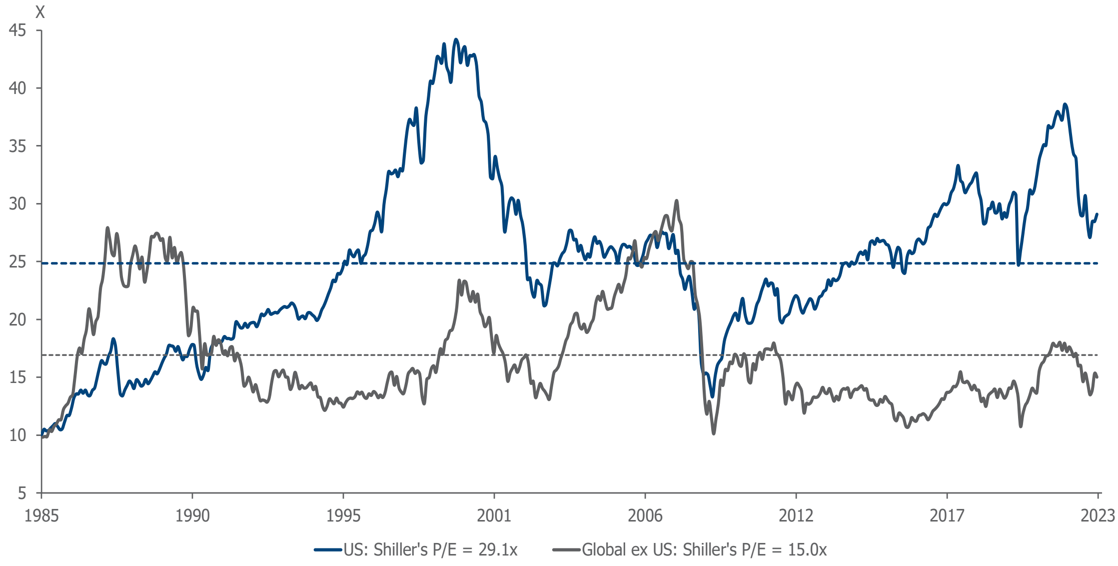


Data as of March 31, 2023.

Source: Bloomberg, HPL.

When comparing US equity prices to 10-year average earnings, long-term valuations are below 2000, but still elevated relative to history. By contrast, global ex-US valuations are well below average.

SHILLER CYCLICALLY ADJUSTED PRICE TO EARNINGS (CAPE) RATIO



Source: Refinitiv, Credit Suisse Research

Conclusion

Investing on behalf of clients is an honor and a privilege, something we don't take for granted at Holowesko Partners. This is an incredibly tough business, requiring equal amounts of humility and courage built on a foundation of careful analysis. This is also an incredibly interesting business and we are intensely passionate about our work. We are excited about our ability to find attractive investments in an environment of worry, crisis and concern. We are also consistently trying to learn and improve our analysis of return and our estimates of risk. In investing you have to assume an element of risk to generate returns. Although we have demonstrated our ability to evaluate and manage risk, we are always seeking to improve.

Thank you for your continued support.