AUDUCO

Q1 FY22 STATUS REPORT

"Our focus, trust"

"Accounting for every trade"

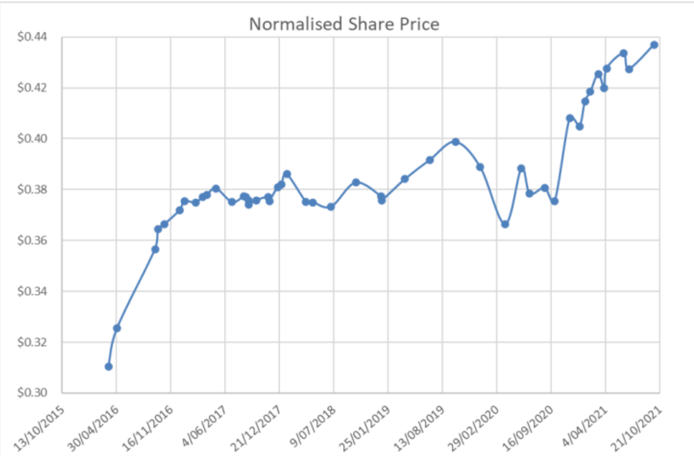
Investment Performance of Deployed Capital

Auduco Pty Ltd's current investment position and normalised share price are summarised in the table and figure below.

30-Sep-21 Snapshot		
Top 5 Equity Holdings	Ave Entry Price	Market Price
ANZ	$23.43	$28.15 (Q1 perf: $0.00)
BOQ	$7.96	$9.36 (Q3 perf: $0.25)
NAB	$19.01	$27.83 (Q4 perf: $1.61)
WBC	$16.18	$26.00 (Q4 perf: $1.59)
WPL	$23.28	$23.88 (Q4 perf: $1.67)
	Current Market Value	

FY22 Dividends to-date	
FY22 Interest to-date#	
Cash Holdings	

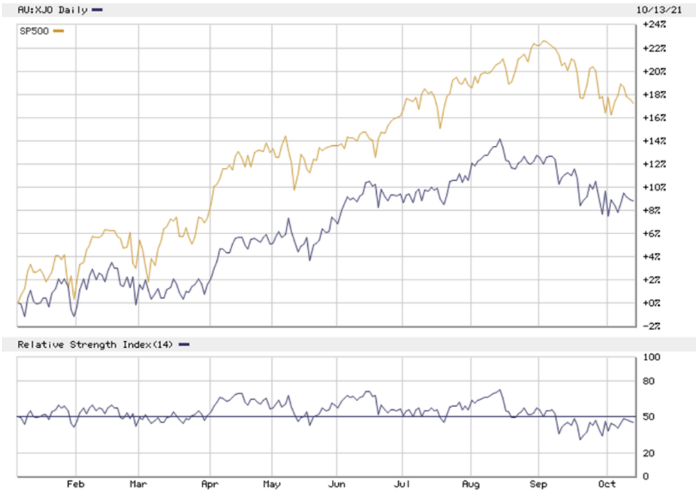
Note #: Does not include interest currently being accrued in term deposit accounts.



Interesting quarter with the Australian share market (XJO) exhibiting a shallow correction for the last second half of the quarter. Major markets were similar. The figure below shows the comparison (XJO versus S&P 500). The Auduco share price is up regardless, anecdotally suggesting rotation to value. Locally at least.

All our holdings are generally up and the trend of dividends renormalising continues.

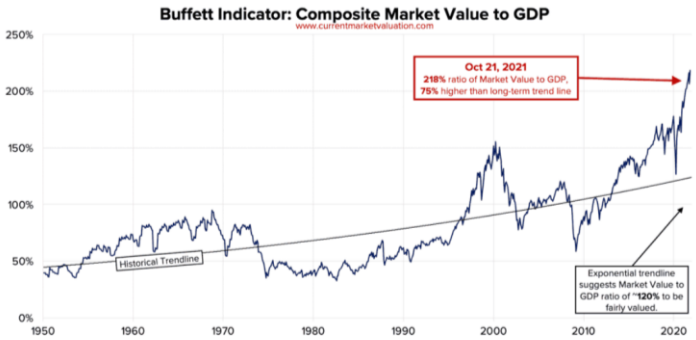
Synopsis



Two themes to discuss for the quarter:

1. Inflation.
2. Evergrande.

But before we get into them, the market capitalisation to GDP ratio is now at another all-time high. It is currently 75% (or about 2.5 standard deviations) above the historical average, suggesting that the market is strongly overvalued. Yet it keeps kicking on. The S&P 500 has again made new all-time highs since the snapshot chart above was captured. It took under two weeks.



Inflation is gearing up, with some pundits claiming central banks are longer in control, citing US Fed indications they will start to taper QE purchases is not causing any subsidence. But the 'tapering' is all just jawboning at this stage with its earliest commencement to be this December, though it is not guaranteed; July 2022 is also flagged as a possible starting point.[1] This is despite some Fed governors now seeing inflation as

[1] Clarida Lines Up With Powell on Tapering This Year: Fed Update, Bloomberg, https://www.bloomberg.com/news/articles/2021-08-27/bostic-favors-quick-taper-sees-first-hike-end-2022-fed-update

coming on stronger, yet, in keeping with the transitory theme, forecasting that it will subside at the end of this year.[1] Whilst there is talk of willingness to roll back QE bond purchases, reticence to raise rates before the end of 2023 remains.[2]

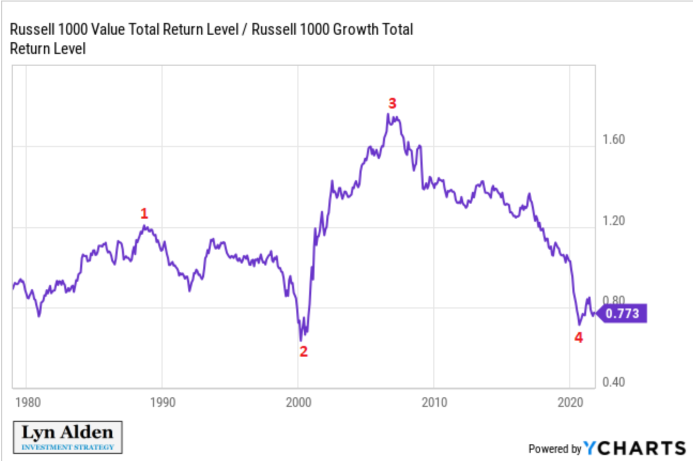
We spoke about inflation being a non-transitory issue last quarter, due to the amount of circulating debt. If that proves to be the case, central banks will be forced to raise rates sooner. Some central banks have already made the jump. Locally, some investors foresee the RBA increasing rates by August 2022, well ahead its 2024 forecast.[3]

This is not the only view. Some think that inflation will be structurally lower.[4] A key reason provided is the record investment into technology and, in particular, automation. Automation displaces labour, which retards wage growth. When wage growth is low, a large component of the pressure on consumer prices is removed, and union power nowadays is too diminished to contend against this. The argument may not consider that automation does not displace labour wholesale, rather, it fosters efficiency. Plus, a range of new job types will evolve to support the 'automation and digital economy'.

The catalyst for the recent inflationary fear was Covid-19, but the supply shocks were being viewed to be subsiding as economies were opening up. Whilst the increased cases due to the delta strain has exacerbated supply issues, it appears that China's punitive sanctions on Australia, their largest source of non-Chinese coal, are no small culprit. Coal is used for approximately 60% of the middle kingdom's energy use. When China halted Australian coal shipments last year, it resulted in a power crisis. Without sufficient power, production lines stopped in many places, causing a knock-on effect on prices.

In the face of all the differing views, it is pretty funny when US Fed Governors say things like: "*We have no economic theory on how large a central bank balance sheet should be.*" (Fed Governor Waller) It is almost like they are just making it up as they go along.

The Lynn Alden October Newsletter is worth a read.[5] She demonstrated that growth versus value equity outperformance is cyclical and showed how it has varied since 1980 using the relative measure depicted in the chart below, with 2010s being dominated by growth stocks.[6] The two factors, growth and value, went in big cycles as economic bubbles and monetary policy shifted around and ultimately ended with excesses each time.



Alden believes that the 2010s & 2020s are an analogue of the 1930s and 1940s: "The disinflationary 2010s were very similar in many ways to the [deflationary] 1930s, and the 2020s are shaping up to be similar to the inflationary 1940s." The 1940s were a highly leveraged decade with rising inflation that was kept under control while keeping rates low. So, if things develop similarly, the view is that value stocks will catch a strong bid in due course.

If inflation does pose a problem, tech stocks are expected to suffer the most. The past decade's market gains have been driven by a handful of now even more mega tech stocks. This group of stocks average P/E ratio have been sustained at exceedingly high levels (>30) for several years. It is difficult to see the hitherto levels of growth being sustained over the next 5 years (we said this 4 years ago too, citing 10 years – wrong so far, surprisingly so). Given there are a swag of stocks that are good businesses with subdued P/Es, there is room for expansion. If so, this presents a scenario where markets do not have to crash while the rotation to value occurs.

Below are some summary market and economic measures, from the Australian Financial Review,[3] for further information:

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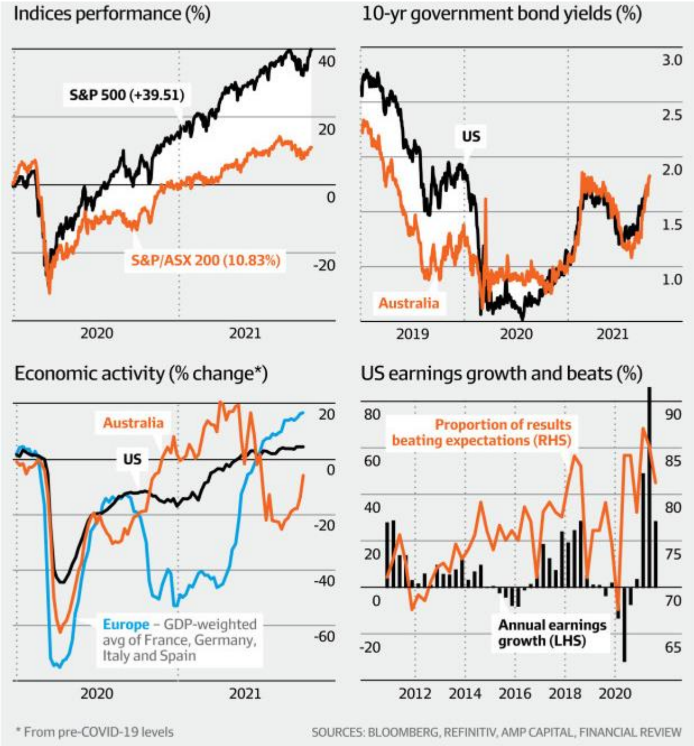
[2] Fed's Eric Rosengren backs tapering in the fall but no rate hikes until job market improves, CNBC, https://www.cnbc.com/2021/08/16/feds-eric-rosengren-backs-tapering-in-the-fall-but-no-rate-hikes-until-job-market-improves.html

[3] Markets react to powerful inflation signals, Australian Financial Review, https://www.afr.com/markets/equity-markets/markets-begin-reacting-to-powerful-inflation-signals-20211024-p592nv

[4] Two strong themes and companies that will benefit, Fistlinks, https://www.firstlinks.com.au/two-strong-themes-companies-benefit

[5] October 2021 Newsletter: A Resurgence in Value, Lynn Alden Investment Strategy, https://www.lynalden.com/october-2021-newsletter/

[6] From Alden: As the chart shows, 1) value stocks outperformed for much of the 1980s leading into the savings and loan crisis, 2) growth stocks outperformed for much of the 1990s leading into the dot-com bubble, 3) value stocks outperformed for much of the 2000s leading into the subprime mortgage crisis, and 4) growth stocks outperformed for much of the 2010s leading into the COVID-19 pandemic and subsequent fiscally-driven inflationary reversal.



Evergrande. The slow-motion collapse of China's (and the world's) largest property developer has been front and centre in main street news. Sitting on over USD $300 billion debt, they have struggled to make interest payments. The payments are being made just in time from unknown sources, but Chinese authorities had urged Evergrande's founder, Hui Ka Yan, to pay the developer's debts out of his personal wealth.

It is not the only developer struggling. Fantasia Holdings Group, Modern Land (China), Sinic Holdings and China Properties Group have all defaulted on dollar debt obligations this month.[7]

Clearly, with an estimated 90 million empty homes (up from 64 million in 2018[8]) in China, investors are running out of steam to keep purchasing. This kind of information essentially was part of the basis of our bearishness for so long. We were observing pictures of "ghost cities" the size of Perth being developed at an astonishing rate as far back as 2012 and are astonished it could continue this long. Another argument won by central bank stimulus.

Instead of continuing to bail out property developers, the Chinese authorities are taking the view that the system, their economy, needs to be restructured.[9] Shareholders and creditors will likely take a loss here while policymakers steer for an orderly debt restructuring. This may involve forcing solvent competitors to buy the distressed assets. It will be an interesting test case as 60% of Chinese wealth is held in property. We should not see a systemic collapse from the Evergrande crisis – this is not Lehman or LTCM (Long Term Capital Management). Evergrande holds land. Lehman and LTCM held highly leveraged financial assets.

However, it could mean the Chinese demand boom is over, as many insiders believe the downward trend in China is the new normal rather than a temporary blip.

System Update

Just a brief update on the trading system, which is essentially a brief extension of last quarters' feedback. Same pattern exhibited per previous quarter, reduced participation. Half the quarter saw market indices in a corrective mode, so there was not much verified activity to act on.

With respect to this context and in regard to the ongoing statistical analysis of alerts in real time, we have two new observations:

Firstly, the data indicate *potentially* better results if every alert is traded rather than to be selective on how compressed / tight and advanced price is from major consolidation zones - e.g. longer trendlines and tight compression just prior to the break. We have been favouring the latter and its not leading to an edge relative to taking any old signal, contrary to trading axioms. For stocks, for example, the win loss ratio over the past 2 months is the same for taking every signal versus those which we would greenlight for a trade. We have been unlucky in missing out on some that were under focus and have observed many run hard that were not selected. These observations are strengthening the case to automate. But before going there, it also highlights the need to identify what sectors have a greater probability of running hot.

Secondly, cryptocurrencies are exhibiting the highest win/loss ratio (followed by market indices) – 76% (and 71%) on a buy and hold basis. Stocks are currently at 58%. Note that the sample size is different – thousands of stock signals versed under 300 for each of the former. Anecdotally, we are seeing a lot of the type of setups we would greenlight advance strongly. What this tells us is that crypto is a sector that has momentum. So a filter to help discern more readily than currently available manual tools will be beneficial.

The sector analysis (ranking and filtering) dashboard, mentioned in the last update, is still a work in progress. Our coding colleague got distracted and built a portfolio simulation tool based on the real time data collected. It is a fantastic tool that will be useful as part of the web service we aim to roll out.

[7] Evergrande averts default with interest payment – reports, Guardian, https://www.theguardian.com/business/2021/oct/29/evergrande-averts-default-with-interest-payment-reports

[8] China's eerie ghost cities a 'symptom' of the country's economic troubles and housing bubble, ABC News, https://www.abc.net.au/news/2018-06-27/china-ghost-cities-show-growth-driven-by-debt/9912186

[9] Here's why the Evergrande crisis is not China's 'Lehman moment', CNBC, https://www.cnbc.com/2021/09/22/heres-why-the-evergrande-crisis-is-not-chinas-lehman-moment.html