

“Our focus, trust”

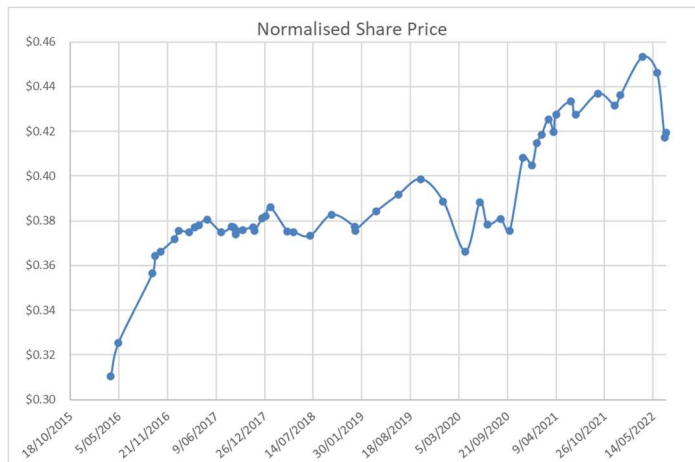
“Accounting for every trade”

Investment Performance of Deployed Capital

16-Jul-2022. Auduco Pty Ltd’s current investment position and normalised share price are summarised in the table and figure below.

30-Jun-22 Snapshot		
Top 5 Equity Holdings	Ave Entry Price	Market Price
ANZ	\$23.43	\$22.03 (Q1 perf: -\$5.57)
BOQ	\$7.96	\$6.67 (Q3 perf: -\$2.01)
NAB	\$19.01	\$27.39 (Q4 perf: -\$4.96)
WBC	\$19.88	\$19.50 (Q4 perf: -\$4.74)
WPL	\$23.28	\$31.84 (Q4 perf: -\$0.26)
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.

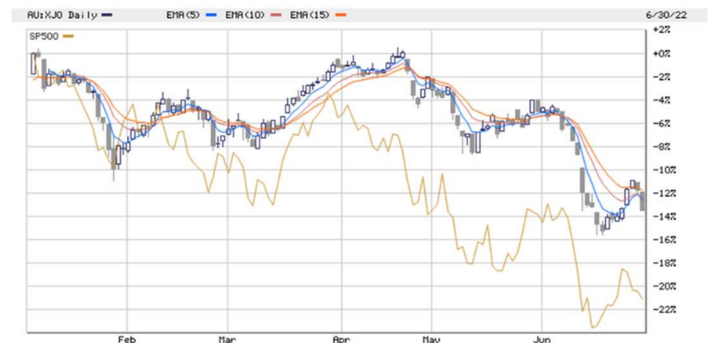


Banks buckled and our solid run went with it. The local market held up well for most of the past half a year in the face of the global downtrend. It took until early June for the S&P ASX 200 (XJO) to experience a sharp drop, which occurred in concert with the global barometer index, the USA’s S&P 500 (see figure below). The half year plunge was 21%, the worst performance since 1970. Tesla experienced its worst quarter ever and Amazon just experienced its deepest drop since 2001. The XJO, contrary

to form, outperformed foreign counterparts, like the SPX, by not falling as much.

Our stocks held up very well until June. It was banks, though, that lead the June fall. This was on the sentiment resulting from reserve bank rate rises (from their ultra-low setting) and pertains to an expected slow-down in the housing market and the fear of drastically higher expenses to due from runaway inflation. With the series of higher-than-expected inflation readings across the globe these past months, came larger than normal central bank rate rises, and that caused problems for markets. We foresaw this, despite the RBA, for example, indicating no rate rises until 2023/2024.¹

Australian banks did not have a great year in general with our favourite, NAB, being the only one the big four gaining – its net rise for FY2022 was 4.46%.



ANZ ultimately dropped over 21% and it showed its price weakness ahead of its peers. WBC was the worst of the big four with a drop of 24.5% - its June drop was 18%, but it experienced falls from greater heights in the first half of FY22, much of it before we started accumulating. It is currently at a price level where we are inclined to take more. It is still considered a buy by some brokers, with Citi having a 12-month price target of \$29.²

We have held most of our larger positions, but with the view expressed by Goldman Sachs on excess supply in the Lithium market, liquidated our holdings in that space.

Net result is our normalised share price is slightly lower than one year ago, predominantly because we hold a greater share of available capital in equities. Dividend income is at its highest level in our history due to this, even though pay-out ratios are yet to match pre-Covid levels.

¹ See Auduco Q1 FY22 update, for example.

² Here’s a look at the Westpac share price’s dismal 2022 financial year, The Motley Fool, <https://www.fool.com.au/2022/07/06/heres-a-look-at-the-westpac-share-prices-dismal-2022-financial-year/>

Synopsis

Whilst the markets have essentially been correcting for 6 months, the pullback is not steep relative to the post-Covid ascent. The analogue to this would be the correction during the first half of 2008. This does not mean we will have another 2008.

The news flow continues to be negative with a lot of focus on the supply chain disruptions and food and fuel inflation caused by the Ukraine war, the underlying inflation that preceded it and the resulting large rate increases by central banks. We flagged in our last update that “Central Banks may need to raise rates higher and faster than their [then] adjusted telegraphed trajectories to combat the inflation gradient being experienced, particularly if the Ukraine war and Chinese Covid lockdowns become prolonged.” This is what has been occurring (e.g. 75 basis point increase in the USA, the most since 1994 last month compared with a typical 25 – 100 basis points expected by some next), even the impact of Covid abating in China.

As a result, counter-intuitive as it may seem, the USD is surging to multi-decade highs on fears that the USA is already in a recession.³ It currently sits at its highest level against the Euro since 2002 (now below parity) and the Yen since 1998. The AUD (AUDUSD) is anecdotally supporting the notion of a recession given that it is at ~ 68 cents. It is usually at these kind of low levels during such periods, having been there in 2008 and 2020. And, of course, this means there is a flight to safe havens, which is precisely what the USD is. And this means that commodities, denominated in USD, generally get thumped, which is occurring. Price charts, such as those for gold and silver, did provide clues. Silver, in particular, had a very bullish chart that appeared on the verge of breakout through major resistance at \$28. It popped through that level a few times and promptly fell back below, with subsequent rallies not approaching these levels and then being followed by bouts of rapid, cascading, drops. This was difficult to read, as it occurred over 18 months, but serves as a reminder that target based exits and stop losses should always be utilised in trading. Inflation themed “buy and holders” are currently sitting on a silver commodity that is at ~\$18.5USD with the only positive being that it looks to be at major support.

Fund managers advise that it is too soon to consider taking positions at this stage in the correction. Input cost inflation only

just commenced in March and should take until the end of the year to see the full effect of this on company margins, which should therefore continue to compress and result in broker downgrades.⁴ It would be difficult for stocks to rally in that backdrop.

Nonetheless, one sector that tends to perform better when interest rates rise is financials.⁵ The caveat to this is it needs to occur under signs of an improving economy. Bank profit margins actually increase with rising rates. Right now, however, the overriding concern in markets is that economies will deteriorate in the face of uncontained inflation and the supply shocks that are amplifying food and fuel costs. It leads to the expectation that banks will experience bad loans in the face of an ‘over-priced’ property market.

Financial commentary has related that inflation is expected to abate in the medium term but repeated higher than forecast inflation prints do not help with that notion – 9.1% in June in the USA versus an expected 8.8% and 8.6% the previous month (which also beat expectations).⁶ Consumption is clearly being impacted.⁷

So far we have seen no sign that the Fed will backflip on its tightening trajectory soon. It is strongly hawkish with its messaging that it will constrain high inflation as a primary priority. Though it has expressed expectation that it will not be a long term problem. Supporting this notion is the fact that crude prices have declined sharply (by >10%) in early July with commentators suggesting that the current inflation print could be the peak.⁸

This environment will send some weak, low income, economies to the brink. Having to purchase goods in USD, with the higher commodity input costs compounded by the surging dollar (and diminishing local currency) will cause a continual loop of drastically higher input costs, reduced resulting income, fewer buyers, layoffs, inability of many to pay bills and debt, and so on. It has already happened in Sri Lanka, which is experiencing its worst financial crisis since independence.⁹ Many African countries are experiencing this too, but compounded, by their reliance on the World Food Program and the fact that 40% of their wheat supply comes from Ukraine.¹⁰ Ukraine also supplies

³ Atlanta Fed GDP tracker shows the U.S. economy is likely in a recession, CNBC, <https://www.cnbc.com/2022/07/01/atlanta-fed-gdp-tracker-shows-the-us-economy-is-likely-in-a-recession.html>

⁴ Has the market bottomed and are there buying opportunities or should investors continue to wait?, Proactive Investors, <https://www.proactiveinvestors.com.au/companies/news/987062/has-the-market-bottomed-and-are-there-buying-opportunities-or-should-investors-continue-to-wait-987062.html>

⁵ These Sectors Benefit from Rising Interest Rates, Investopedia, <https://www.investopedia.com/articles/investing/052814/these-sectors-benefit-rising-interest-rates.asp>

⁶ Inflation rose 9.1% in June, even more than expected, as price pressures intensify, CNBC, <https://www.cnbc.com/2022/07/13/inflation-rose->

[9point1percent-in-june-even-more-than-expected-as-price-pressures-intensify.html](https://www.cnbc.com/2022/07/13/inflation-rose-9-point-1-percent-in-june-even-more-than-expected-as-price-pressures-intensify.html)

⁷ See Auduco Q3 FY22 update and commentary on consumption trends within.

⁸ Consumer inflation is expected to have been even hotter in June, but it could be peaking, CNBC, <https://www.cnbc.com/2022/07/12/consumer-inflation-is-expected-to-have-been-even-hotter-in-june-but-it-could-be-peaking.html>

⁹ EXPLAINER: Why Sri Lanka's economy collapsed and what's next, ABC News, <https://abcnews.go.com/International/wireStory/explainer-sri-lankas-economy-collapsed-86538096>

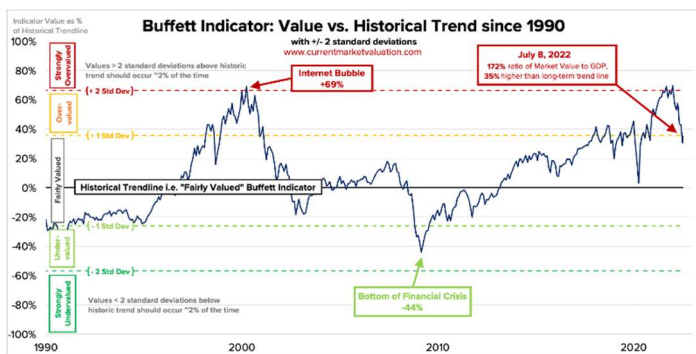
¹⁰ Forty Percent of the World Food Program's Wheat Supplies Come from Ukraine, Wilson Center, <https://www.wilsoncenter.org/blog-post/forty-percent-world-food-programs-wheat-supplies-come-ukraine#:~:text=and%20AgricultureUkraine->

up to 16% of the world's corn exports and over 40% of the world's sunflower oil.

So what can we expect locally and in stronger western countries? Speculative stocks that don't yield income will underperform. It would take some savvy stock picking to identify the clear winners in this group and most who play that game will lose more times than they win. Commodities and commodity stocks will underperform, if not already, due to the flight to safety in the USD while the markets continue with the recessionary view – this has not been to our liking as it kyboshed some of our focus trades. We expect the rotation to value to continue and banks to be among the strongest performers as their increased profit margins will start to be understood by the market. What leads us to think this is the job market, which remains strong, the oil price has appeared to have peaked (it experienced a technical breakdown and is now in a down-channel), and rates are rising, yes, but from a historically unprecedented low base.

Also, recall our comment above regarding bank profit margins increasing as interest rates rise. The first major contemporary empirical data point that supports that axiom came in the form of Citigroup's earnings report – an earnings beat attributed to higher interest rates.¹¹

In the meantime, below is presented an update of the Buffet indicator:



And...Buffet himself just took a larger position in an oil company,¹² and Australian solar projects.¹³ Interesting.

[Forty%20percent%20of%20the%20World%20Food%20Program's%20wheat%20supplies%20come, stranded%20in%20Ukraine%20waiting%20export](#)

¹¹ Citigroup tops profit estimates as bank benefits from rising interest rates, shares surge 13%, CNBC, <https://www.cnbc.com/2022/07/15/citigroup-c-2q-2022-earnings.html>

¹² Warren Buffett's Berkshire Hathaway piles another \$44 million into Occidental Petroleum, adding to its \$9 billion stake in the energy giant, Markets Insider, <https://markets.businessinsider.com/news/stocks/warren-buffett-berkshire-hathaway-energy-oil-stocks-occidental-petroleum-stake-2022-6>

¹³ Warren Buffett snaps up two Australian solar farms, and big PV and storage pipeline, Renewable Energy, <https://reneweconomy.com.au/warren-buffett-snaps-up-two-australian-solar-farms-and-big-pv-and-storage-pipeline/>

¹⁴ The Big Crypto Carnage: What Does It Mean for the Future of Industry?, NASDAQ, <https://www.nasdaq.com/articles/the-big-crypto-carnage%3A-what-does-it-mean-for-the-future-of-industry>

True Carnage in Crypto

There have been a number of events over the past few years that have chewed up a lot of investors and the crypto space is centre stage at the moment. We have touched on the extent that smaller crypto corrections wiped people out in previous updates. But now, 99.8% of cryptocurrencies have fallen past 70% below their peaks.¹⁴ Bitcoin has lost all of its 2021 gains, Ethereum 79%. The current poster-child for this carnage is Three Arrows Capital, a crypto hedge fund that had \$10 billion USD under management as recently as March and is now worthless owing not being able to meet margin calls.¹⁵ The founders have gone missing, with 'bags of cash' no doubt. Celsius, a major crypto lender, has filed for bankruptcy overnight.¹⁶ As always, it is all down to excessive leverage and, as crypto, is a 'rage against the machine' woke-centric phenomenon, there are a swathe of young amateurs who dived in with gusto without understanding risk management or leverage. Media pieces describing the extent of losses, the personal accounts, mislabelling wiped out traders as 'victims', and the support groups are starting to proliferate.^{17,18} We like the Guardian piece [ref 16] based on its relating personal stories on how some people allowed their trading to spiral out of control and the "chances to live a better life fade away". Worth a read.

System & Trading

On trading, there has not been much to do. From a long perspective it is a "do nothing" tape. The system alerts are doing their thing in that we have rarely been getting any over the past 4 months.

Not much to add on the system development front, except that discussions with the e-commerce providers that were briefly mentioned in the last update were promising. They were keen, on the idea of entering a partnership, but their timeline to commencing on our project, given their "bird in hand" pipeline, is in Q4 this year. We have proceeded to develop customer portal ourselves in the meantime.

¹⁵ Founders of bankrupt crypto hedge fund 3AC go missing, as investors try to recoup assets, CNBC Crypto World, <https://www.cnbc.com/2022/07/12/founders-of-bankrupt-crypto-hedge-fund-three-arrows-go-missing.html>

¹⁶ Embattled crypto lender Celsius files for bankruptcy protection, CNBC, <https://www.cnbc.com/2022/07/13/embattled-crypto-lender-celsius-informs-state-regulators-that-its-filing-for-bankruptcy-imminently-source-says.html>

¹⁷ This 'crypto winter' is unlike any downturn in the history of digital currencies. Here's why, CNBC, <https://www.cnbc.com/2022/07/14/why-the-2022-crypto-winter-is-unlike-previous-bear-markets.html>

¹⁸ 'They couldn't even scream any more. They were just sobbing': the amateur investors ruined by the crypto crash, The Guardian, <https://www.theguardian.com/technology/2022/jul/12/they-couldnt-even-scream-any-more-they-were-just-sobbing-the-amateur-investors-ruined-by-the-crypto-crash>