AUDUCO

Q4 FY24 STATUS REPORT

"Our focus, trust"

"Accounting for every trade"

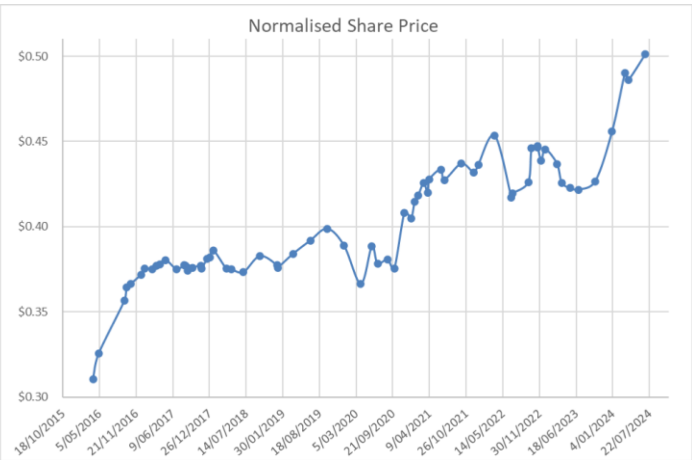
Investment Performance of Deployed Capital

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

30-Jun-24 Snapshot		
Top 4 Equity Holdings	Ave Entry Price	Market Price
ANZ	$23.43	$29.40 (Q1 perf: -$1.16)
BOQ	$7.96	$6.32 (Q3 perf: -$0.51)
NAB	$19.01	$34.64 (Q4 perf: $1.59)
WBC	$20.94	$26.10 (Q4 perf: $1.13)
	Current Market Value	

FY24 Dividends	
FY24 Interest#	
Cash Holdings	

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



Our normalised share price notched a new all time high in the quarter. The portfolio did not experience the collective rise of all positions as it did in the previous quarter. The top four equity positions table reflects this. The two that were up for the quarter are our largest holdings – with WBC itself being the latest addition to that group (recalling we focused on accumulating it for a time).

Other holdings, new ones included, were also mixed. Lynas is up, Accent Group steady, Uranium holdings mixed/consolidating, and Pilbara Minerals dropped considerably. Plus, our commodity trading yielded over 300% for the quarter.

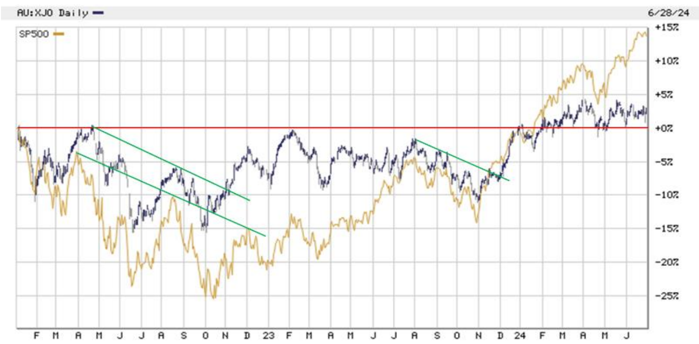
We did pick up some Fortesque metals on the dip. A small parcel. We expect this to consolidate for some time before rising. It will provide good dividend yields in the meantime. If it shows the right signs in supportive macro conditions, we will take more.

For the index comparison we show nine months instead of the usual three to show the progression since the commencement of the bull market in November. The S&P 500 charged ahead impressively, with a small correction in April, whilst the Euro Stoxx 50 has consolidated since that point. US markets do tend to outperform in election years. The XJO (ASX S&P 200) remained flat for the quarter, so our portfolio did great, all things considered.

Synopsis

Commencing with the long-term index comparisons that we have been presenting over the past year, below is the chart from the last update (Q3 FY24) showing the S&P ASX 200 and the S&P 500:

Fast forward to end of the March quarter and you see there is a clear extension of the bull run for the S&P 500, up almost 25% from the commencement of the run (~15% from the bear market finish line), with the XJO now clearly lagging:



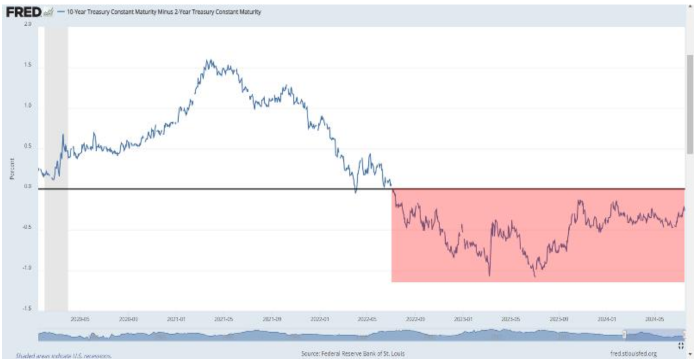
The S&P 500 is actually the second-best performing stock index in the first half of 2024 – outpaced by the Japanese Nikkei Index by ~2.5%. The median for major indices around the globe is around 10%.[1]

The cause of the divergence of the XJO relative to the S&P 500 and other performers? A look at the XJO relative to its two heaviest weighted sectors (financials, 29.3% weighting and materials, 20.9%, as of July 2024) will provide the clue:

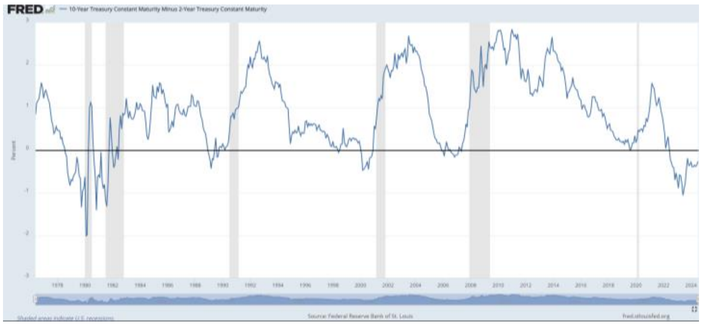
So, it is materials (i.e. mining and oil and gas) with those long-discussed China factors coming into play, weighing the XJO down. Recall, last update we relayed Goldman Sachs' prediction of the 'completions cliff' that will result in a sharp iron ore price drop, among other things. The price has held steady around $100 / tonne this past quarter, but this is one to keep watching.

Also, last quarter the buffet indicator was showing significantly overvalued at 2x standard deviation relative to fair value.[2] We are putting the updated snapshot up earlier this time because it is becoming significant. Looking through the chart's history, you can see it does not mean a crash is imminent in of itself.

This is a good point to bring up the yield curve – which is regarded the world's most reliable economic crisis indicator (e.g. a recession). We have not brought this type of data up for over a year. It has been inverted for two years now, as shown by the red shaded area of 10-year minus 2-year yield curve, below.

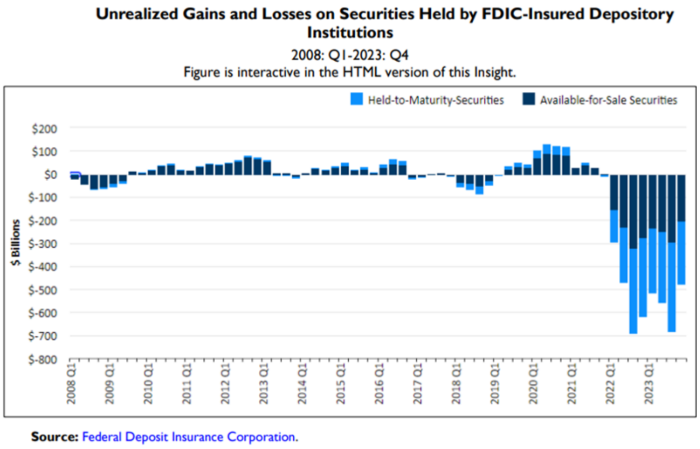


Inversion is the phenomenon that provides the prediction. But the problems do not usually occur until after the curve reverts to normal (i.e. crosses back above 0) usually as it steepens out. You can see this by examining the same 10-year minus 2-year yield curve, but over a multi-decade period, per below. The grey shaded areas demarcate recessions, and we can see the curve looks to be on its way to returning to a positive read, signalling that a recession is near.....and that this time is likely not different.



The takeaway from this is that it's time to be cautious again.

Looking into it further, the graphic below which illustrates unrealised losses on assets held by banks – covering US banks only.[3] This covers from just before the GFC through to the end 2023.



We all know what happened during the GFC, prior to which banks were carrying a peak of about $100b in unrealised losses.

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[1] World Markets Watchlist: July 15, 2024, Vetta Fi Adviser Perspectives https://www.advisorperspectives.com/dshort/updates/2024/07/15/world-markets-watchlist-july-15-2024

[2] The Buffett Indicator, Current Market Valuation, https://www.currentmarketvaluation.com/models/buffett-indicator.php

[3] FDIC Quarterly, 2024 Volume 18, Number 1, Insured Institution Performance, https://www.fdic.gov/analysis/quarterly-banking-profile/qbp/2023dec/qbp.pdf

At present we are looking at $700b. It provides a sense of the scale potential trouble if things go wrong.

Banks hold mostly U.S. Treasuries and mortgage-backed securities backed by the US Government. Unrealised losses do not matter until they become realised. Since treasuries mature at full value, only forced sale events will cause issues.

The two main causes of banks being forced to sell:

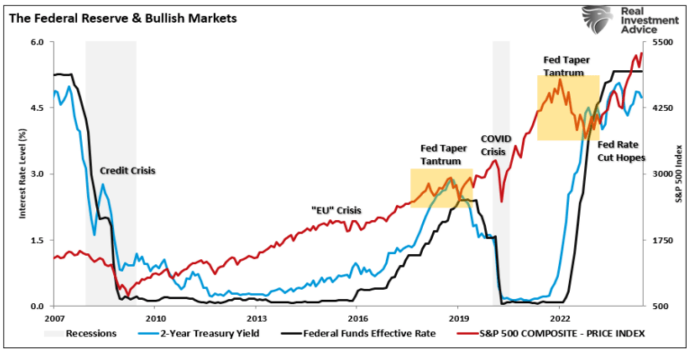
- Deposit flight. A recent example being the Silicon Valley Bank Collapse we covered in our Q3 FY23 update.[4] Recall it was the second largest in US history.
- Margin on funding costs start causing banks into a negative carry situation. That is, the rates-based funds they are paying in liabilities (e.g. deposits) exceeds the income from assets (e.g. the treasuries). This forces them to sell their treasuries at a loss and buy convertible notes that pay a higher rate of return but are riskier. This is analogous to what occurred with mortgage-backed securities during the GFC., and a recent example is the Japanese Norinchukin bank just one month ago.[5]

This adds to information that is not new to us, vis a vi the unprecedented outstanding central bank balance sheets. The big question is whether a possible upcoming recession will be a hard landing or a soft landing. We do not know. All we have to go off is the central banks have successfully buoyed the markets through every precipice since the GFC. Either way, in the high inflationary environment being experienced now, with Mainstreet increasingly under pressure, a recession couldn't come at a worse time for many.

Inflation has started to come down with June reading showing the first drop.[6] This has helped reign in the diverging views on a possible rate cut with confidence on the first move being September this year.[7] Bolstering this confidence was US Fed Chair, Jerome Powell, expressing concern at the recent Senate Committee on Banking that holding rates too high for too long would impact GDP growth.[8]

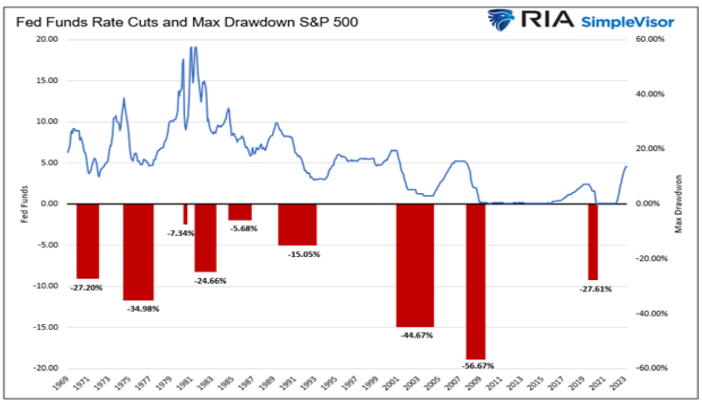
One dissenting view is Jamie Dimon citing multiple inflationary forces including large fiscal deficits, infrastructure needs, restructuring of trade and remilitarization of the world.[9] He also maintains his view that debt is becoming excessive.

This would lead to an interesting situation as, with the expectation of rate cuts, markets have usually rallied. In fact, over the pas 10 years, markets only went down significantly when the Fed undertook rate hiking cycles.[10] These were the "Taper Tantrums" where the Fed attempted to remove excess liquidity from the markets:[10]



Moreover, over the past couple of years, pullbacks have correlated to hawkish comments from the Fed, whereas all rallies have been on the back of the more dovish statements leading to a market belief that rate cuts were coming:[10]

However, rate cutting cycles are not bullish:[10]



[4] Here's how the second-biggest bank collapse in U.S. history happened in just 48 hours, CNBC, https://www.cnbc.com/2023/03/10/silicon-valley-bank-collapse-how-it-happened.html

[5] Japan's century-old Norinchukin Bank gives warning over losses from higher-for-longer rates, The Straights Times, https://www.straitstimes.com/business/century-old-japanese-bank-sends-warning-to-world-on-higher-for-longer-rates

[6] US consumer prices unexpectedly fell in June, drawing Fed closer to cutting interest rates, The Guardian, https://www.theguardian.com/us-news/article/2024/jul/11/us-inflation-fall-june

[7] Traders Pricing in 100% Chance Fed Will Cut Interest Rates in September, Investopedia, https://www.investopedia.com/traders-expect-fed-interest-rate-cut-september-8678517

[8] Fed Chair Powell says holding rates high for too long could jeopardize economic growth, CNBC, https://www.cnbc.com/2024/07/09/fed-chief-powell-says-holding-rates-high-for-too-long-could-jeopardize-economic-growth.html

[9] JPMorgan's Jamie Dimon warns inflation and interest rates may stay higher, CNBC, https://www.cnbc.com/2024/07/12/jpmorgans-jamie-dimon-warns-inflation-and-interest-rates-may-stay-higher.html

[10] Fed Rate Cuts – A Signal to Sell Stocks and Buy Bonds?, Investing, https://au.investing.com/analysis/fed-rate-cuts--a-signal-to-sell-stocks-and-buy-bonds-200601607

In other words, such rate cutting cycles occur when central banks are trying to counter a deflationary economic cycle or a financial event, and we are not going through one yet. It would coincide with a major contraction in earnings, which is contrary to consensus expectations.[10]

So, if the Fed is going to start cutting, what are they seeing that the market and equity analysts are not? And maybe the likes of Jamie Dion are right, and they will remain elevated. A cut would otherwise be welcomed by Mainstreet given the inflationary pressure we have been reporting, and drop in the numbers notwithstanding, inflation remains high.

One of the tools on the we use on the https://www.get-set-alerts.com/ website is the VIX Sustainability Threshold model. This is an additional filter that we look to in addition to examining raw trends. The chart below is a snapshot of how it is presented. Here we display both the S&P 500 (which comprises the 500 biggest US companies, right price scale) and its corresponding Volatility index (VIX, left price scale – the daily closing value is plotted).

Two daily moving averages are also plotted:

- 100 day simple moving average (SMA).
- A 40% offset of the 100 day SMA.

The VIX itself is colour coded: yellow on days when it is higher than its 100 day SMA, red when it is above the 40% offset of the 100 day SMA, grey otherwise.

This information is what provides the use of the model: When the VIX is above its 40% offset of the 100 day SMA this is a trigger to cease attempts to take long trades, if you haven't already from it having entered the yellow zone.

Taking trades in the red, and possibly yellow, zones is analogous to taking a long trade against the trend, which would experience a high probability of being a losing trade. Conversely, when the VIX is coloured grey (below the 100 day SMA level) it indicates trades can be taken, with typical risk considerations, in the direction of the prevailing trend.

At the time of writing, the VIX is showing persistently yellow. When in this state, its best to wait for it to turn grey before trading again.

As the US stock markets are the global bellwether, it has implications for other markets. So caution has become the mode for us right now. We still hold considerable quantities of cash and our major holdings are good yielding stocks with strong fundamentals. We will be assessing our smaller, non-blue-chip holdings.

We are also assessing one of our larger holdings, Bank of Queensland (BOQ). It has been a laggard in our portfolio and is part of a regional banking sector that is coming under pressure, relative to larger institutions which have lower funding costs in comparison.[11] This leaves them at a competitive disadvantage to the larger banks, one that has been forced upon them by regulators.[10] One consequence of this environment is the takeover of Suncorp Bank by ANZ. Recent media reports indicate the BOQ is now a takeover target.[12] Despite this, the company remains fundamentally sound, beating analyst expectations on net profit and margins for the first half of the financial year.[13] Albeit, its margins are under pressure and a takeover, whilst good in several respects, removes competition from the market.

In terms of share price, below is presented BOQ performance over the past four years with WBC (which was out of favour at one point, leading to our accumulation of it). You can see where WBC took off in November 2023, along with the rest of our bank holdings. BOQ has not followed suit. What it has done right is break the long-term trend line and form a shallow uptrend. These can precede a sharp uptick, catalysts for which can be market realisation that the market hasn't been efficient in its treatment of BOQ, or a takeover offer. These are just some possibilities.

As always, we will keep monitoring. Until next time.

For more information contact Dr Gianluca Paglia, 0425 388 222

[11] Regional banks dying a slow death, Australian Financial Review, https://www.afr.com/companies/financial-services/regional-banks-dying-a-slow-death-20240414-p5fjmv

[12] BOQ share price rises amid rumoured takeover interest, The Motley Fool, https://www.fool.com.au/2024/07/17/boq-share-price-rises-amid-rumoured-takeover-interest/

[13] Why Bank of Queensland is crushing doubters and short sellers on Wednesday, Market Index, https://www.marketindex.com.au/news/why-bank-of-queensland-is-crushing-doubters-and-short-sellers-on-wednesday