Hosking Partners®

Quarterly Commentary Q3 2022

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In the recent quarter investors have been spooked by a combination of renewed hawkishness of central banks in respect of inflation, inevitability of interest rate hikes, certainty that a recession is imminent and, of course, uncertainties regarding outcomes of the ill-judged Russian invasion of Ukraine. Here, paradoxically, Ukrainian successes on the battlefield greatly increase the range of possible outcomes which now include both nuclear escalation and outright Russian defeat as its military appears exhausted and ill-equipped. Neither of these “tail consequences” seemed remotely plausible earlier in the year.

The apparent inevitability of interest rate hikes, led by the US Federal Reserve, encouraged the US dollar to strengthen and the portfolio, underweight as it is to dollar assets, suffered accordingly. The US weighting in global stock markets now stands at 62%, and dollar strength generally is not associated with pro-cyclical stock market animal spirits. As clients are aware, the portfolio is skewed towards value sectors and companies and this may be of benefit at a time when interest rate expectations are reducing, in investors’ minds at least, the present value of future earnings. Unfortunately for self-styled value investors, the businesses of such underlying investee firms are often cyclical, hence many share prices within the value spheres of the market fell pari-passu with growth peers. Banks are a good example: notwithstanding valuations as low as 50% of tangible book, and growing evidence that higher interest rates will benefit/are benefiting net interest margins, investors pivoted from fretting about these things to the consequences that a recession might have on credit quality. Financials, broadly defined, represent near 22% of the portfolio. The portfolio’s double-weight toward materials similarly suffered from the change in expectations about the future, although this was more than offset by energy, a value sector which is clearly benefiting from contemporary trends.

Drilling down into the portfolio at sector and company level reveals, unsurprisingly, that the leading contributors to the relative outperformance over the quarter came disproportionally from the energy sector. As at the end of the quarter, the portfolio has c. 9.4% of assets in this sector compared with a benchmark weight of around 5%. The success of ESG awareness in developed economies has been so prevalent that it has led to supply-side tension as firms have cut back on fossil fuel developments, which creates favourable capital cycle conditions for investors in two ways. Firstly, the commodity price is well supported. Second, at the firm level, free cash flow benefits from reduced capex in conventional resource replenishment. Much of this investment shortfall may be diverted into renewables spending but long lead times and renewable unreliability often improve further the supply demand conditions in the sector. Prices for oil and gas which are higher than would otherwise have been expected are likely to be with us for some time. Elsewhere, negative contributions to relative returns continued to come from zero holdings to large benchmark stocks as well as the portfolio's holdings in companies exposed to investor fears of a business downturn. With some notable exceptions the Travel, Leisure and Hospitality sectors continue to provide disappointing news. In these areas although there is significant post-Covid business recovery in evidence this is often dwarfed by concerns around cost of living issues and consequent consumer spending shortfalls.

Against this background, or this assessment of the background, Hosking Partners' portfolio managers have held their nerve, and turnover has remained low. Approximately seven positions were eliminated (from the tail of smaller holdings) and ten new positions added. In the latter camp most of these are Japanese firms expected to benefit from rising shareholder-oriented capital returns, as well as consideration of the fact that when cash and non-core assets are accounted for many firms have enterprise values that are close to zero or even negative. The decline in the value of the Japanese yen this year suggests substantial cost competitiveness and a bullish outlook for Japanese corporate profits.

It is worth re-capping where we are, both in terms of the long-term big picture, and the more tactical shorter-term approaches the portfolio takes toward (for the time being) a hostile equity investment environment. The big picture in the last decade has increasingly come to be dominated by (at the least) a fully valued stock market, dominated by mega-capitalisation firms often associated with the technology sector and the digital transformation in the way we live now. It is now 17 years since it was possible for investors to buy Apple shares on an enterprise value of zero, the consequence of the market capitalisation being matched by the firm's cash balances. These perspectives are valuable especially when combined with the Wall Street investment adage that "trees don't grow to the sky". Reinforcing this primary trend toward overvalued stock markets has been the ever-lower interest rate trend and in the last three years the Covid-lockdown era which accelerated and brought forward the digital tendency. There appear to have been two valid contrarian responses to the new era: either a portfolio skew toward cash together with a mixture of alternative investments, or a skew toward the unloved value areas of the market (such as banking, energy, materials and transportation (particularly shipping). The Hosking Partners portfolio chose the latter course and, as logic and consistency would suggest, increased this bias further during the Covid period. The historic trends have been so strong and in force for so long that the counter trends, as they emerge (e.g. higher interest rates), are having a staggering effect on mark-to market prices (as with the UK pension funds gilt-shock late in the quarter).

In the shorter term, and as observed above, a switch to value-investing has been slow to show itself in the markets. This is due to high expectations around the probability of recession, which adversely affects sentiment around many such sectors. The good news today is the prevalence of the recession forecast, notwithstanding the clear offsets in the economy that could mitigate this, notably well-funded banks and other financial institutions, the presence in most major markets of negative real interest rates and, finally, the recovery in economic activity that is bound to follow the global pandemic (sometimes known as revenge spending!). Confined at present to the developed countries this is likely to swell to the emerging world in 2023, hopefully led by relaxation in China. This is a development which will, should it occur, have significant supply chain benefits. We are surprised in company meetings with firms in the travel and hospitality sectors how strong demand appears to be, as well as management's confidence in the likely length of the business runway. Thus, as we peer through the murk into 2023 we find it relatively easy to imagine a "glass half full" scenario just visible through the fog of current circumstances. Growth could easily surpass expectations, such is the low height of the bar, and inflation pressures should ease as normalisation returns and supply chains improve. Both would presumably be exacerbated by an end to the pointless and heart-breaking Ukraine war.

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