AozoraStep

Q4 2022:
There is no cost-of-living crisis, there only is a cost-of-lockdown cycle

Quarterly Performance	Personal Account	FTSE All Share TR
Q1 17	0%	0%
Q2 17	-8%	1%
Q3 17	-5%	2%
Q4 17	-1%	5%
Q1 18	9%	-7%
Q2 18	19%	9%
Q3 18	-16%	-1%
Q4 18	-30%	-10%
Q1 19	45%	9%
Q2 19	39%	3%
Q3 19	0%	1%
Q4 19	8%	4%
Q1 20	-43%	-25%
Q2 20	42%	10%
Q3 20	-3%	-3%
Q4 20	76%	13%
Q1 21	32%	5%
Q2 21	-3%	6%
Q3 21	5%	2%
Q4 21	1%	4%
Q1 22	37%	1%
Q2 22	-3%	-6%
Q3 22	17%	-3%
Q4 22	20%	9%

Annual Performance	Personal Account	FTSE All Share TR
2017	-9%	9%
2018	-31%	-9%
2019	113%	19%
2020	52%	-10%
2021	37%	18%
2022	99%	0%

Overall Performance	Personal Account	FTSE All Share TR
CAGR	**31.0%**	**3.9%**
2017-22 Return	**405%**	**26%**

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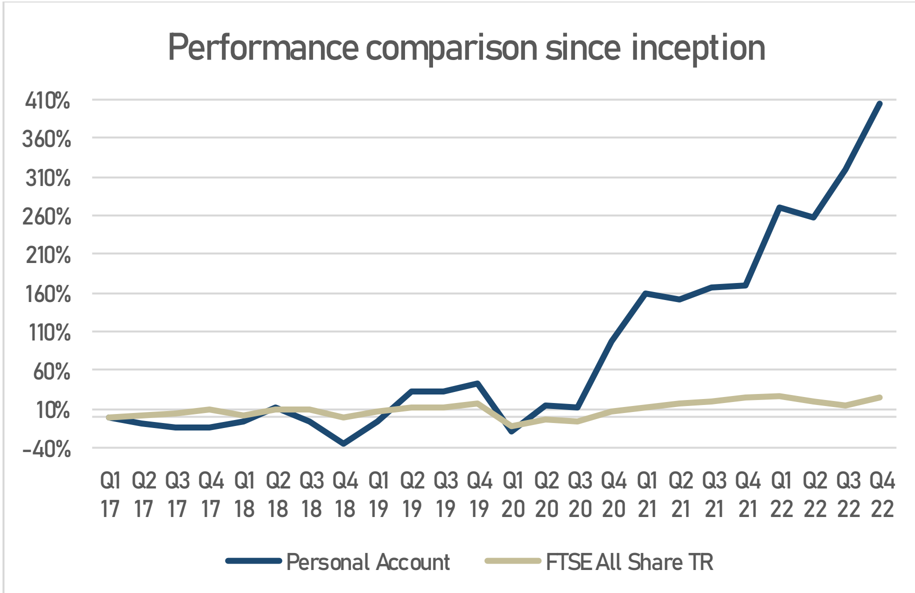

9th January 2023

Dear fellow investor,

As often happens, the new year begins with a new shift in markets. Last year it was the energy crisis that was driving markets. This year warm weather and high gas in European storage has put the energy crisis behind and the focus shifts to the consumer, who should be in a much better state than feared... Below is a brief macro-overview followed by our positions and performance of the year.

For the latest one pager, factsheet, presentation, and market views, please check:

One Pager

Factsheet

Presentation

Market views

The poor consumer (?)

British newspapers are telling you every day about the cost-of-living crisis amid escalating inflation. This has led to Unions pushing for higher wages. Over the last two months we have seen a number of pay rises, mostly in the double digit %, and on average around 14%. Most of these wage hikes were for lower income jobs, such as drivers and factory workers, and exactly those jobs that exhibit the highest labour shortage due to Brexit. Since income below £50k annually will be taxed 20%, the average post-tax income change is in many cases 11.2%, which just about beats the 11.1% CPI peak in October 2022 – although it often covers both 2022 and 2023. Nonetheless, many of the agreements formed in November/December are backdated to April 2022 and include one-off bonuses, and many of the bonuses being paid in January 2023. If this is not enough to boost the consumer, the UK government has now issued new stimulus checks for 8mio low-income households of £900 paid in three £300 tranches over 2023[1].

Pay rises agreed under Unite Union in November/December 2022

Company	Department	Employees	Agreement in %
Biffa	Wirral council trash collection	200	15%
Menzies	Heathrow Airport ground handlers	400	10.5%
Go North East	Engineers at certain depots	150	10-13.1%
Greencore	Drivers and production workers	700	20-33%
Wincanton	Tanker drivers	150	20.7-37.1%
Rolls Royce Motor Cars	Production workers	1,200	14.8-17.6%
Felixstowe port	Port workers	1,900	7% + 8.5%
NHS Scotland	NHS workers	155,800	7.5-11.24%
OCS New Covent Garden Market	Security guards	?	22%
Metroline	Bus drivers	2,000	11%
Stagecoach	Bus drivers	3,000	10-20%
West Midlands Metro	Tram crew	170	20.1%
GXO	Draymen	1,000	9.5-12.5%
Telford Heinz	Factory workers	150	11%
National Express	Bus drivers	2,400	14%
Princes Group	Food workers	700	11.5%
ASDA	Supermarket workers	?	14%
Arriva	Bus drivers	80	14%
Peel Ports Liverpool	Dockers	600	14.3-18.5%

Source: Unite Union

[1] https://www.gov.uk/government/news/millions-of-low-income-households-to-get-new-cost-of-living-payments-from-spring-2023

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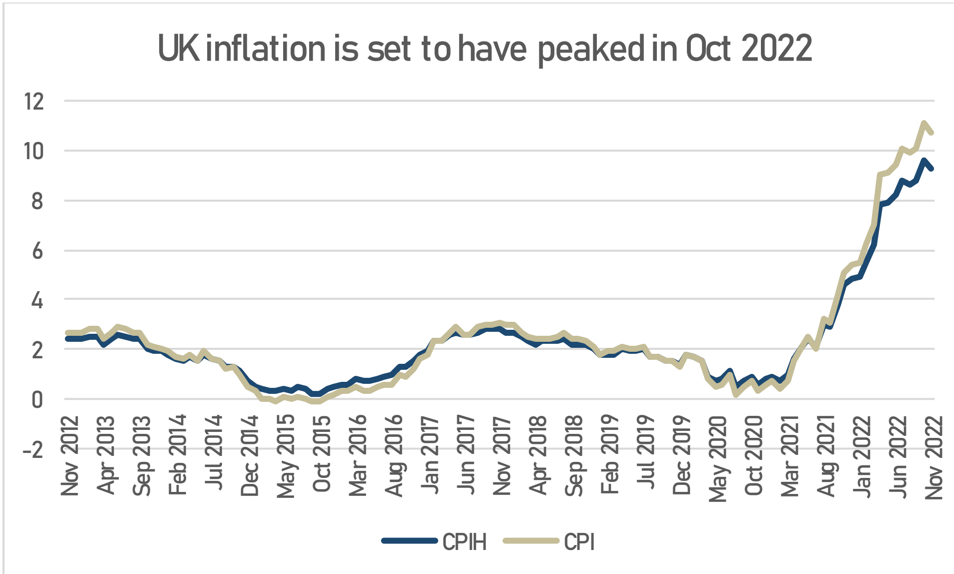

Source: Office for National Statistics

The UK governments' finances

The new stimulus checks for 8mio low-income households will cost the UK government £7.2bn. It comes at a bizarre moment when the government struggles to find an agreement with unions on pay for the NHS and train drivers. However, taking into account that the interest payable on UK government bonds, especially index-linked government bonds, has doubled and is expected to reach £120bn for FY23, once inflation comes down, the interest payable will quickly reduce as well. Pre-pandemic interest expense amounted to around £50bn a year. If interest payable returns back to pre-pandemic levels, net borrowing would quickly follow through with levels equivalent to pre-pandemic levels. The OBR forecast assumes £177bn net borrowing[2]. Once inflation subsides, which it already does, this bill could get down to £120bn net borrowing, and with energy prices down, the energy support package, which costs £60bn over the winter 22/23, would be eliminated. Voila! Public net borrowing would be back at its ~£50-60bn pre-pandemic levels. With the corporate tax hike from 19% to 25% (£12bn) and NIC contributions increase (£10bn), the UK government has room to increase pay and therefore I expect an agreement on train drivers and NHS pay in the coming weeks.

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2 https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/bulletins/publicsectorfinances/november2022

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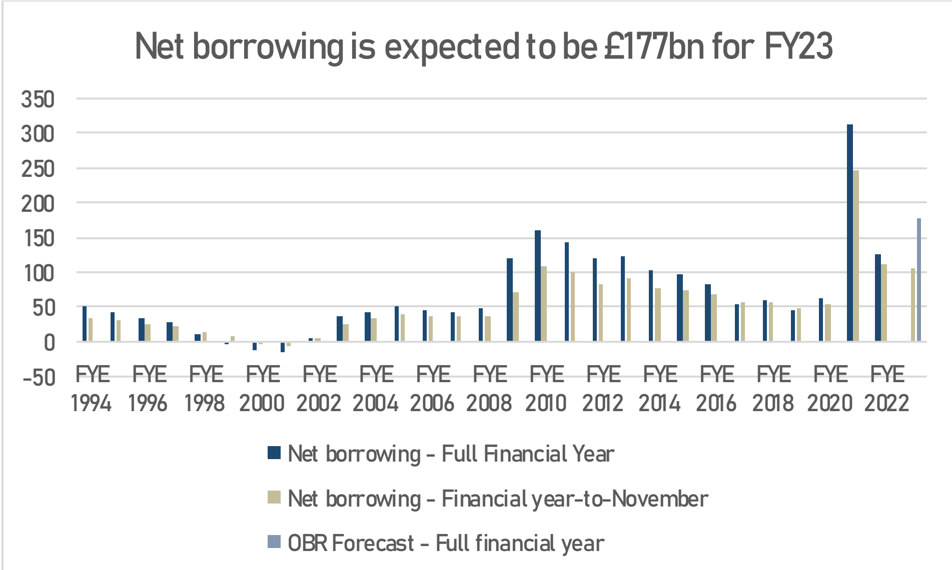
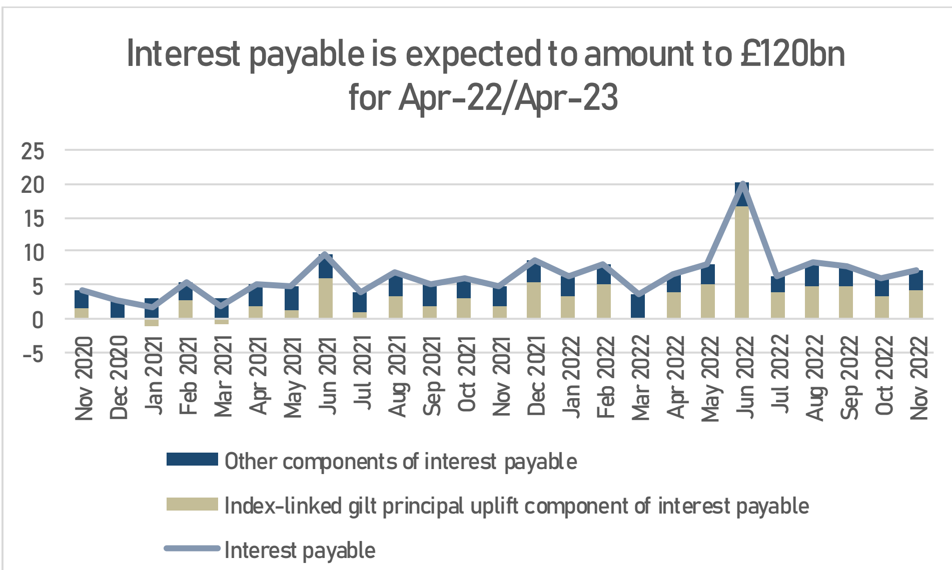


Source: Office for National Statistics



Source: Office for National Statistics

<u>Potential net borrowing relief for FY 23/24</u>

Variable	Amount in £bn
Net interest expense decline	£60bn
Energy support bill (6mo) over	£60bn
Corporate tax increase	£12bn
NIC change	£10bn
Total potential budget relief	**£142bn**

Source: Own estimates with data from Office for National Statistics

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The cost of pay hikes

The UK government employs around 5.77mio people vs. 27mio people employed in the private sector[3]. The average public sector salary is £26,854 according to checkasalary.com[4] (median salary is £42,500 according to totaljobs.com[5]). If we were to round it up to £30k and assume a 12% pay rise, it would cost the UK government £20.7bn annually for 5.77mio employees. This is a high estimate, as the higher paid employees will likely get no or a much lower pay rise. However, assuming these numbers are roughly correct, the corporate tax and NIC hikes alone (£22bn expected) pretty much pay for the hike in government employees' pay. Broadly simplified, an agreement on wages and an end to the strikes therefore would lift UK markets and especially benefit retail and consumer discretionary sectors. This could come on top of an agreement on the Northern Ireland Protocol, which could happen around the 25th anniversary of the Good Friday Agreement (7th April 2023) with a visit of President Biden.

The state of the world economy

The latest PMI survey indicates that inflation has eased further, supply bottlenecks are resolved, output and new orders continue to decline sharply (especially in manufacturing), employment begins to fall, and construction is dropping rapidly. The countries that are posting growth are mostly developing countries in oil rich nations or those surrounding China, which point to an uptick in business due to the World Cup, high oil and gas prices as well as the reopening of China, and perhaps the beginning of moving supply chains out of China. However, easing input- and output prices is helping Europe to recover with expectations improving in strong positive territory, while the US posted the lowest output figures globally. In addition, ECB's Lagarde hinted at the last meeting that the 50bps rate hike is tied to at least two or three additional 50bps hikes in the coming meetings – which could be higher than the Fed's potential 25bps hikes. Bigger picture, this could mean that the US$ continues to weaken, oil prices remain supported, but importantly gas prices remain lower than in 2022 and general inflation stays subdued. The backlogs will decline rapidly in the manufacturing sector, and this is why central banks will likely begin to turn less hawkish, as otherwise we would face a deeper real estate downturn. Importantly, however, the

[3] https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/publicsectorpersonnel/bulletins/publicsectoremployment/september2022

[4] https://www.checkasalary.co.uk/salaries/public-sector

[5] https://www.totaljobs.com/salary-checker/average-public-sector-salary

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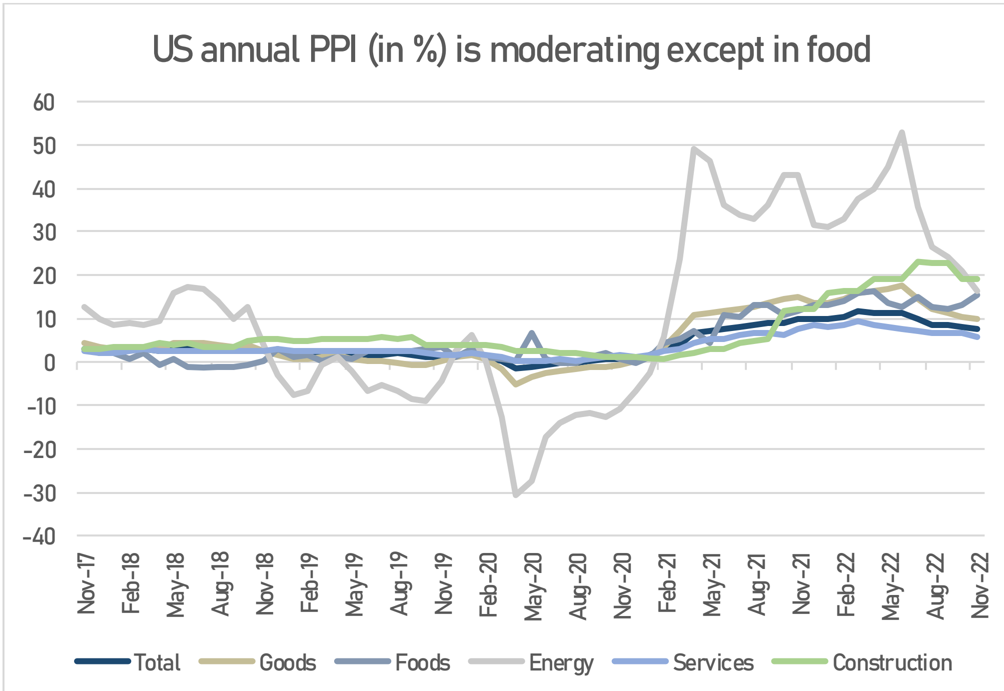
yield curve is inverting further, and depending on the mortgage market, this could help construction to some degree, but in markets like the UK with short-term mortgages, there is likely worse to come - at least in the construction sector. *All PMI data and comments can be found at the bottom in the appendix.*



Source: U.S. Bureau of Labor Statistics

Performance

The 4th quarter has shown broad gains across all major indices. Hence, the +20% performance vs. FTSE All Share TR +9% has been smaller than I was hoping to achieve given the attractive valuations. Our position in Reach Plc could be exited with a 33% return, we achieved a +23% return in Hunting, a +11% return in Smiths News and a +8% and +18% return both in IG Design Group. However, the rapid decline in gas prices made me also exit the 2nd time I held Serica Energy with a -10% loss. I then allocated towards the UK retail sector but uncertainty around Superdry's going concerns has led me to exit this position with a -17% loss. Towards the end of November, I viewed two scenarios as likely: 1. Colder weather in Europe would lead to higher gas prices while oil prices have a floor due to the SPR refill, & 2. Strike action is likely a one-off and would be kept under control while travelling would stage a strong comeback. Under these two macro scenarios, I bought Harbour Energy and Greencore based on attractive valuations. More details to be found under www.aozorastep.com/turnarounds

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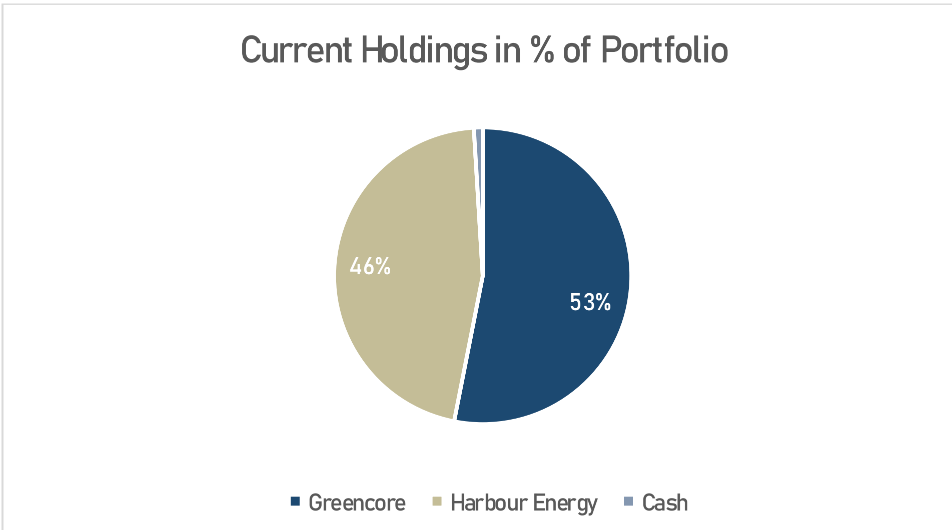
Current Holdings

Company	Average Purchase Price	Current Market Price	Currency	% change
Greencore	0.68	0.64	GBP	-6%
Harbour Energy	3.19	3.04	GBP	-5%

As of 31st December 2022



As of 31st December 2022

Review

In previous quarters I have explained the exits and entrants of positions individually. This time I have cancelled this section, as the details as of why I entered or exited positions can all be found at the turnarounds section of the AozoraStep website. However, the review section remains as it enables me to look back over mistakes made with past positions – and in Q4 22 there were a lot.

The biggest mistake I made was on exiting UK retail early, and partially with losses. Recent trading updates from high street names indicate that the warm weather initially caused subdued consumer spending, which then reverted when the weather turned colder in mid-December. I have learnt a big lesson there, as I underestimated how reactive the average consumer is and how weather plays such an important role in the consumer's short-term decision making. I, myself, won't buy a new winter jacket because it's colder

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than usual outside – since this happens every winter, I'm prepared for it. The average consumer, on the other hand, will look to delay purchases where possible.

Secondly, although my thesis on the colder weather and higher natural gas prices in Europe played out correctly, the valuation of Harbour Energy did not reprice, partly due to a short-term sell-off in oil prices, and partly due to investors looking through the short-term cold spell. Nonetheless, I initiated Harbour Energy with quite pessimistic views in terms of commodity prices for 2023, hence the company remains very attractively priced here and I expect to see better returns in coming weeks.

Thirdly, the railway strikes were not averted and despite my positive outlook on strikes, pay hikes and the strong consumer, if the railway strikes are worsening, the position in Greencore likely won't recover as quickly as expected. Although the valuation of Greencore still appears attractive, I made two mistakes when analysing the company. Firstly, I expected capex to be around £30mio, not £60mio for this year. Secondly, I have not looked in detail at their non-Executive board members. I believe the company wastes their resources in having basically almost 5 people all with an ESG background. ESG has always been a temporary trend for me and companies should spend their resources better, for example by appointing non-executive board members with complementary industry know-how and connections that could help the business. At max have one ESG specialist and then just hire someone for advice during the year – not give up so many board seats for this rather secondary function. I'm planning to attend the AGM in Dublin on 26th January to get in touch with management. The key thesis remains: People are travelling more, have less time, try to save money and therefore will more likely buy sandwiches. A recent trading update by Gregg's has confirmed exactly this, yet Greencore is trading at 3x operating cash flow.

Lastly, as set out in this report, the numbers tell me that the consumer is strong and this should also benefit airlines, which valuations traded at decade lows in recent weeks. Despite looking at it, I have not invested in easyJet or IAG or also an attractively valued retail name like Marks & Spencer. This can be seen as a mistake but given that I would need to sell Harbour Energy and Greencore to buy the other companies, I have decided against it for now – both names that indicate over 40% upside to me.

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Outlook

Opportunities in the current market remain plentiful, and for the first time in a long while I could have performed better with a more diversified portfolio – at least in the first couple days of 2023. While I might have missed the turnaround points in airlines, I could still invest in easyJet or IAG, if my current positions achieve fair valuation faster. In fact, when looking at valuations as of today, Greencore and Harbour Energy remain extremely attractively valued, and on a relative value basis are even more compelling. The current market environment sometimes reminds me of 2009, when a lot of risks remained, a few bankruptcies still occurred, but overall the initial housing/banking crisis was over, as is the high inflation today.

Sincerely,

Herrmann

David Herrmann

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Appendix: December vs. November PMI

Country	December PMI	November PMI	Comment
Asean	50.3	50.7	Softer expansion in output for 15 months with fall in new business
Australia	47.5	48	Continued slowdown with falling demand despite lower input cost inflation
Austria	47.3	46.6	Slower fall in output, new orders drop sharply, as does inflation
Brazil	49.1	49.8	Employment decline, new order stable, inflation easing, manufacturing worsens
Canada	49.2	49.6	Output and new order continue to fall
China	48.3	47	Manufacturing demand taking harder hit in December, weak overseas demand, business optimism improved
Colombia	51.1	47.3	Marginal uptick in sales underpins production growth
Czech	42.6	41.6	Further substantial contractions in production and new orders, more inflation, lower employment
Dubai	54.9	56	Output and new orders continue to rise
Egypt	47.2	45.4	Output and new business fall at sharp, but softer rates, jobs are cut
Eurozone	49.3	47.8	Construction PMI at lowest since May 2020, Activity is rebounding elsewhere with inflation easing
France	49.1	48.7	Fifth consecutive fall in new orders with backlogs unchanged
Germany	49	46.3	New orders remain below output, but broad-based upturn in business expectations
Ghana	47	44.9	Softer output and new order falls, sharp decline in inflation, higher business sentiment
Global	48.2	48	US at bottom of PMI output index, new orders contract at faster pace
Greece	47.2	48.4	Cost pressures soften, contraction in output and new orders
Hong Kong	49.6	48.7	Business activity improves despite weak demand
India	59.4	56.7	Manufacturing and service providers recording faster expansions in output, stronger sales
Indonesia	50.9	50.3	Upturn in inventory levels, output and new orders rise, prices decline
Ireland	50.5	48.8	Service business activity rises first time in 5 months, manufacturing clear backlogs
Italy	49.6	48.9	New work declined, but at slowest pace in six months, level of outstanding business falls
Japan	49.7	48.9	High service demand from overseas, expansion in new business, confidence for year ahead
Kazakhstan	49	49.8	Downturn in activities and lower growth prospects, but lower prices amid lower demand
Kenya	51.6	50.9	Strongest rise in new business since Feb 22
Lebanon	47.3	48.1	Output and new orders decline, inflation eases
Malaysia	47.8	47.9	Lower selling prices for first time since May 2020, lower output volumes
Mexico	51.3	50.6	Factory orders continue to expand
Mozambique	50	50.8	Marginal output expansion, lower purchases
Myanmar	42.1	44.6	Output reduction and new orders decline sharply
Netherlands	48.6	46	Softer falls in output, new orders, exports and backlogs, easing prices
Nigeria	54.6	54.3	Currency weakness adds to higher output prices, strong demand

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Philippines	53.1	52.7	Price pressures moderate, output increases faster
Poland	45.6	43.4	Cost inflation drops to 29-month low, slower falls in output and new orders
Qatar	49.6	48.8	Construction-driven pause in new work offset by surge in retail trade and services amid World Cup
Russia	48	50	Decrease in new business in services, manufacturing is expanding
Saudi Arabia	56.9	58.5	Further expansion and job creation
Singapore	49.1	56.2	Output and new orders decline
South Africa	50.2	50.6	Renewed downturn in new orders
South Korea	48.2	49	Fastest contraction in order books since June 2020, lower inflation, longer lead times
Spain	49.9	49.6	Growth in services, ongoing contraction in manufacturing output, prices fall
Taiwan	44.6	41.6	Softer, but still severe falls in output and new work, downbeat year ahead assessment
Thailand	52.5	51.1	Production growth picks up though demand worsens, lead times improve
Turkey	48.1	45.7	Softer moderations in output and new orders, higher job creation
UAE	54.2	54.4	Slower increases in output, new orders and employment
Uganda	52	50.9	Growth of demand fuels rise in activity, high business confidence
UK	49	48.2	Inflation down, employment stopped growing, new order declined for 5th consecutive month
USA	45	46.4	Activity and new orders fall at sharper rates, cost burdens decline
Vietnam	46.4	47.4	Sharper reductions in output and new orders, lower output prices
Zambia	48.3	49.1	Sharpest fall in output since Feb 2021
Global Sector PMI	7 sectors expand		Pharmaceuticals, financials and industrial services fastest expansion, real estate, paper and banks deepest contraction
US Sector PMI	6 sectors decline	5 sectors decline	Fast drops in financials and basic materials
Asia Sector PMI	4 sectors expand	3 sectors expand	Transportation, industrial services, pharmaceutical expand, paper, metals & mining and healthcare service contract
Europe Sector PMI	8 sectors expand	2 sectors expand	Technology, pharmaceuticals and software fastest expansion, Chemicals, paper and metals & mining deepest contraction
Global Manufacturing PMI	48.6	48.8	30-month low, output, new orders decline, but growth expected
Eurozone Construction PMI	42.6	43.6	Decline in housing activity and new order fall
French Construction PMI	41	40.7	Strong decline in activity and new orders
Italy Construction PMI	47	52	Fresh downturn in new orders
Germany Construction PMI	41.7	41.5	Sharp drop in residential activity
UK Construction PMI	48.8	50.4	Activity and new work decline at fastest rate since May 2020, job cuts
Commodity Price & Supply			Price pressures drop to 30-month low, supply shortages at lowest level since Oct 20

Source: S&P Global PMI

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