AozoraStep Capital LLP

UK Listed Equity Turnarounds – Macro deck April 2024

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AGENDA

INFLATION: A DOUBLE WHAMMY?

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3RD ROUND EFFECTS SHOULD BE VIEWED WITH CAUTION

After a slightly larger rise than expected in US consumer prices for March 2024, the market has aggressively repriced for first rate cuts. Most investment banks have adjusted their first rate cut to later this year and reduced the number of cuts to between 25bps and 75bps in total for 2024. The charts really tell one story, annual inflation decline has stalled and monthly inflation has stabilized at around 0.4%, which would leave inflation at near 5% annualized, if these prints were to continue. At the same time, we see once again the imbalance of services vs. manufacturing, as inflation in manufacturing (goods & energy) continues to decline, while services inflation is beginning to rise again (wages). This is just exactly the opposite of what happened around two years ago. Energy prices were first to rise, followed by a rise in prices for goods, and finally by a rise in wages – all as an initial result of higher energy prices. However, energy prices have fallen fast. Natural gas prices likely won't see a rise this year amidst record inventory levels and low gas usage for heating, leaving more for electricity. US shale also continues to produce more gas than needed as a by-product of producing more oil amidst high oil prices (although some of the largest shale gas only producers EQT and Chesapeake are cutting production). The only two things that are a threat for higher inflation in fact are higher interest rates (and as a result higher mortgage payments, higher car financing rates, higher insurance rates, which is driving higher wage demands), and higher oil prices. Let's take a look at interest rates first…

Source: https://www.bloomberg.com/news/newsletters/2024-04-11/oil-rally-is-driving-texas-gas-prices-below-zero?embedded-checkout=true

INFLATION: A DOUBLE WHAMMY?
INTEREST RATE CUT EXPECTATIONS MASSIVELY REVISED

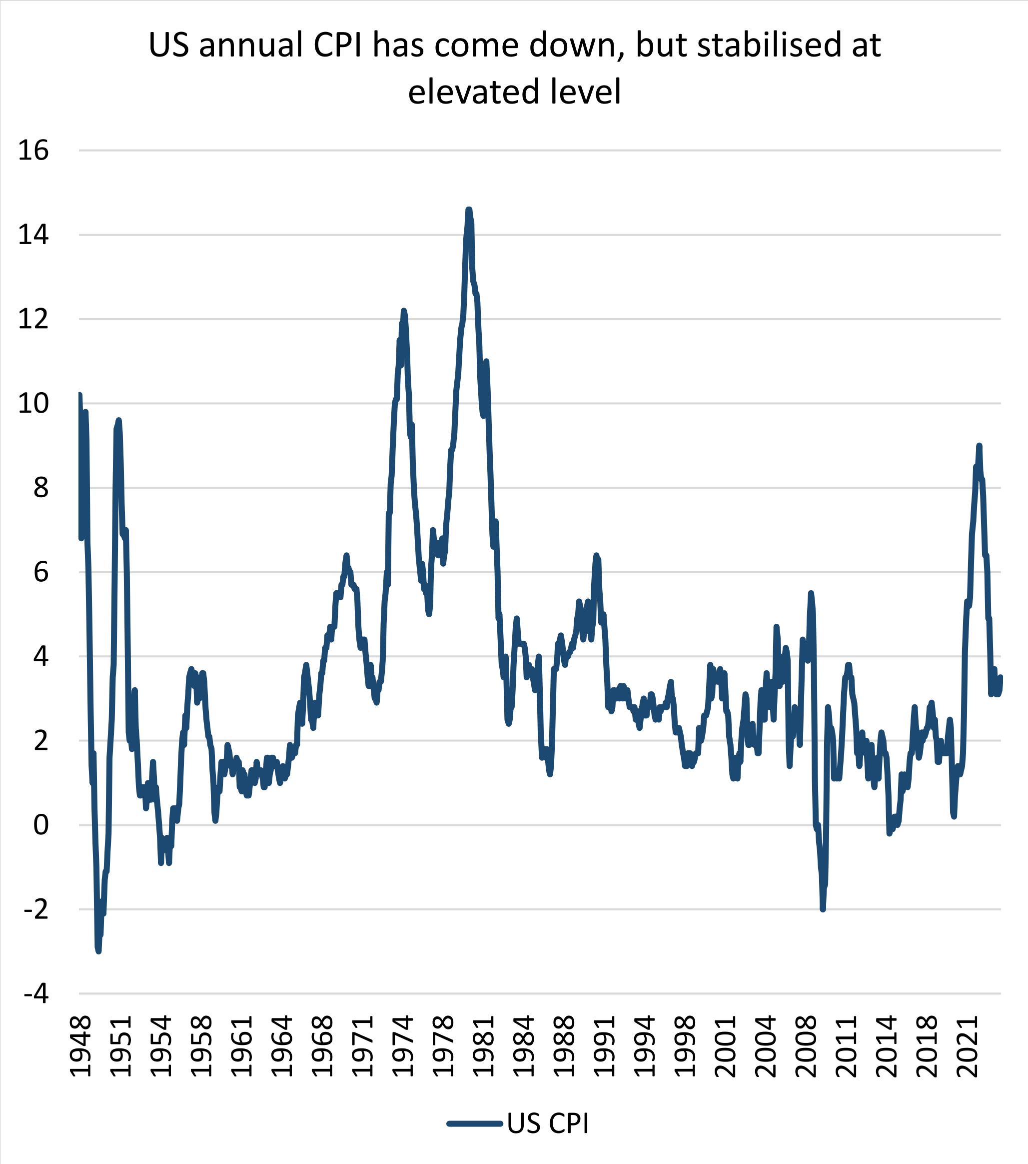
Investment banks' US rate cut forecast for 2024 as of 11th April

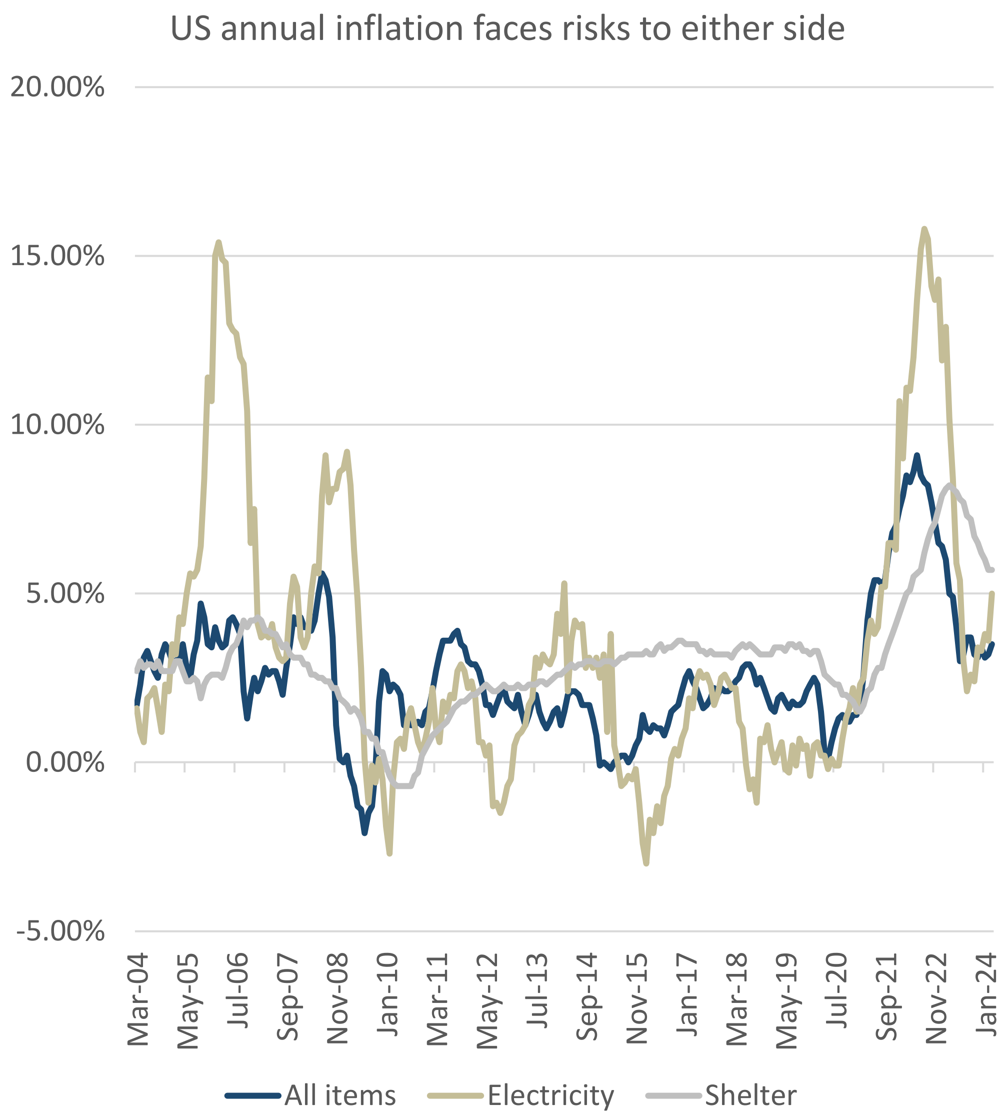
Investment Bank	First rate cut	# of 25bps cuts in 2024
HSBC	June	3
BNP	July	2
TD	September	2
UBS	September	2
Wells Fargo	September	3
Standard Chartered	Q3	2
BAML	December	1
DB	December	1
RBC	December	1

Source: Individual investment banks

INFLATION: A DOUBLE WHAMMY?

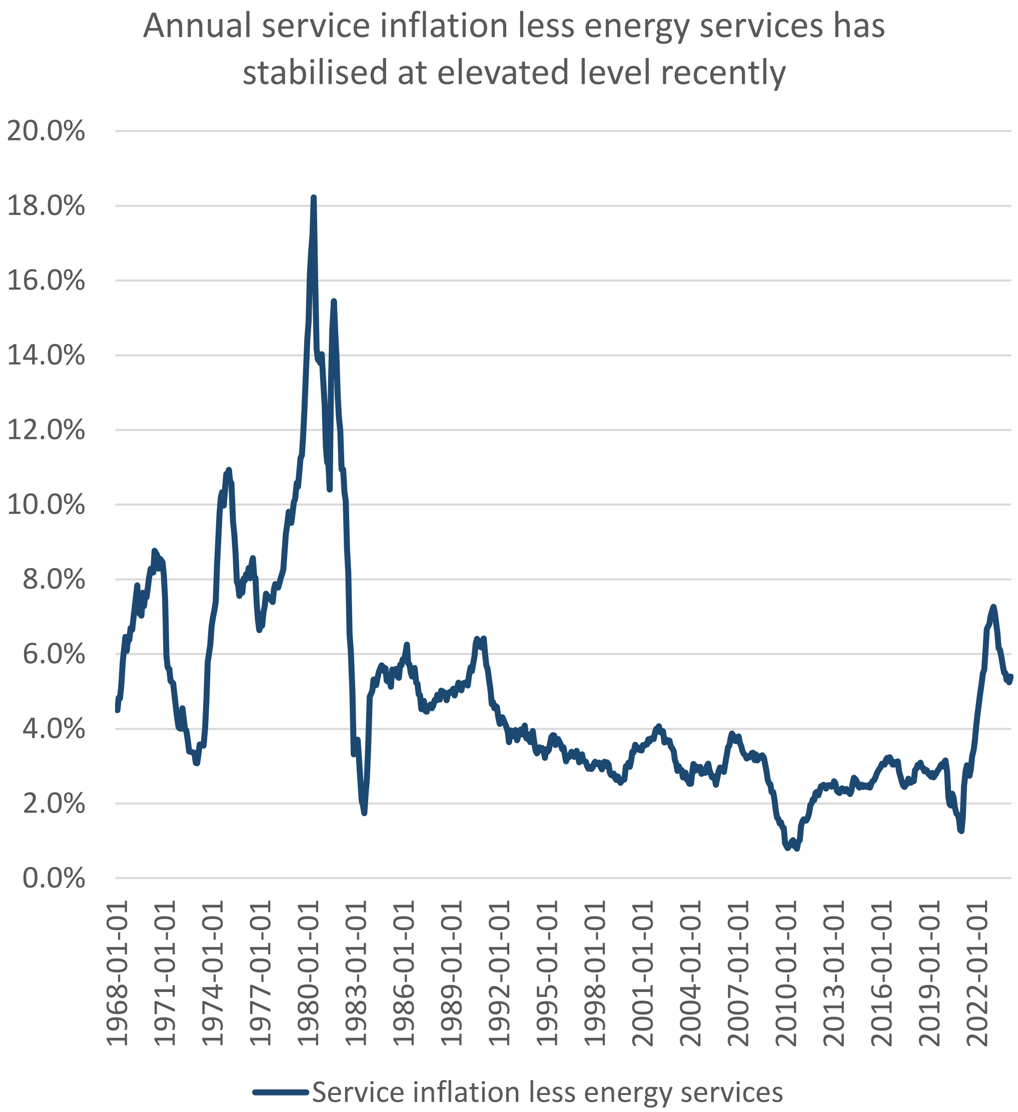
THE FED SHOULD HAVE CUT IN SUMMER/AUTUMN 2023

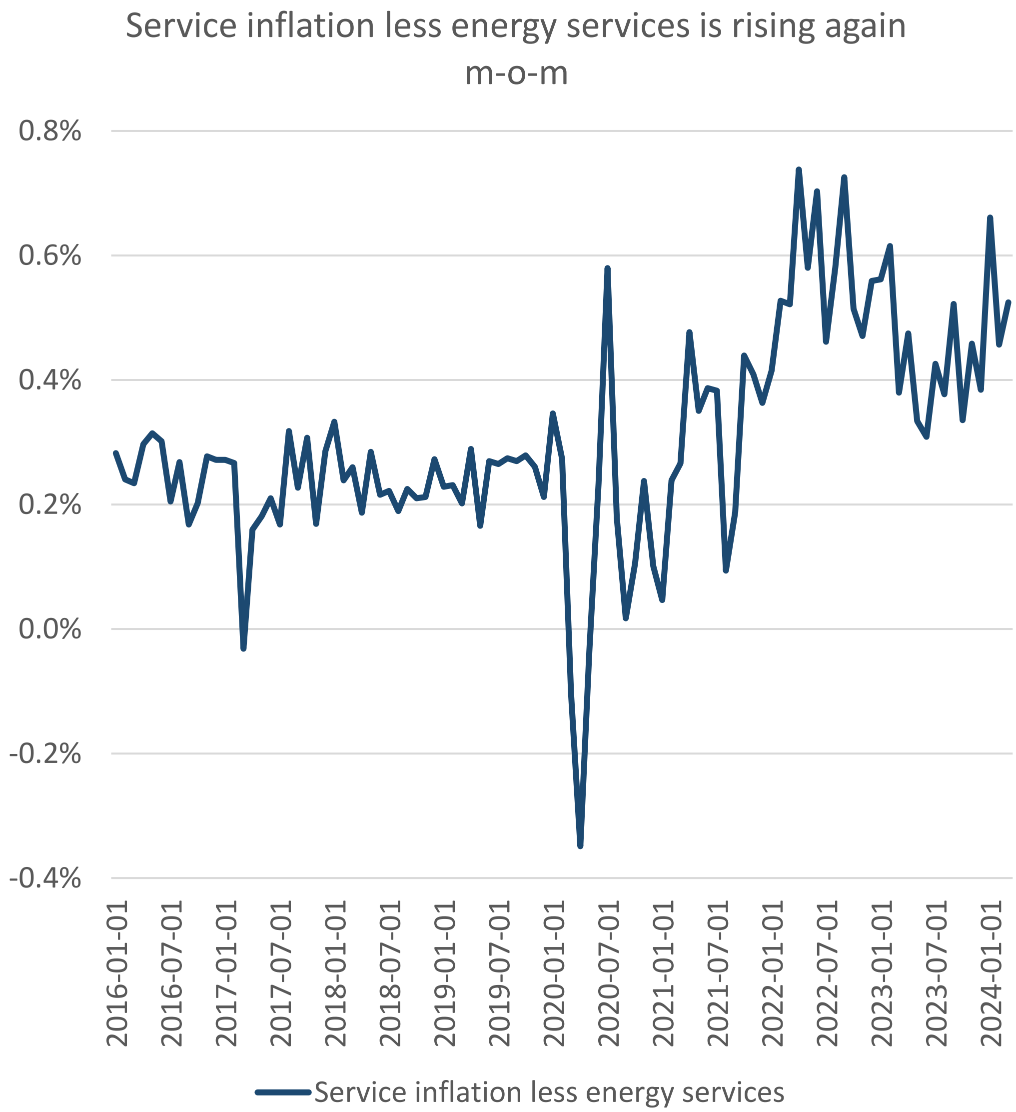




INFLATION: A DOUBLE WHAMMY?

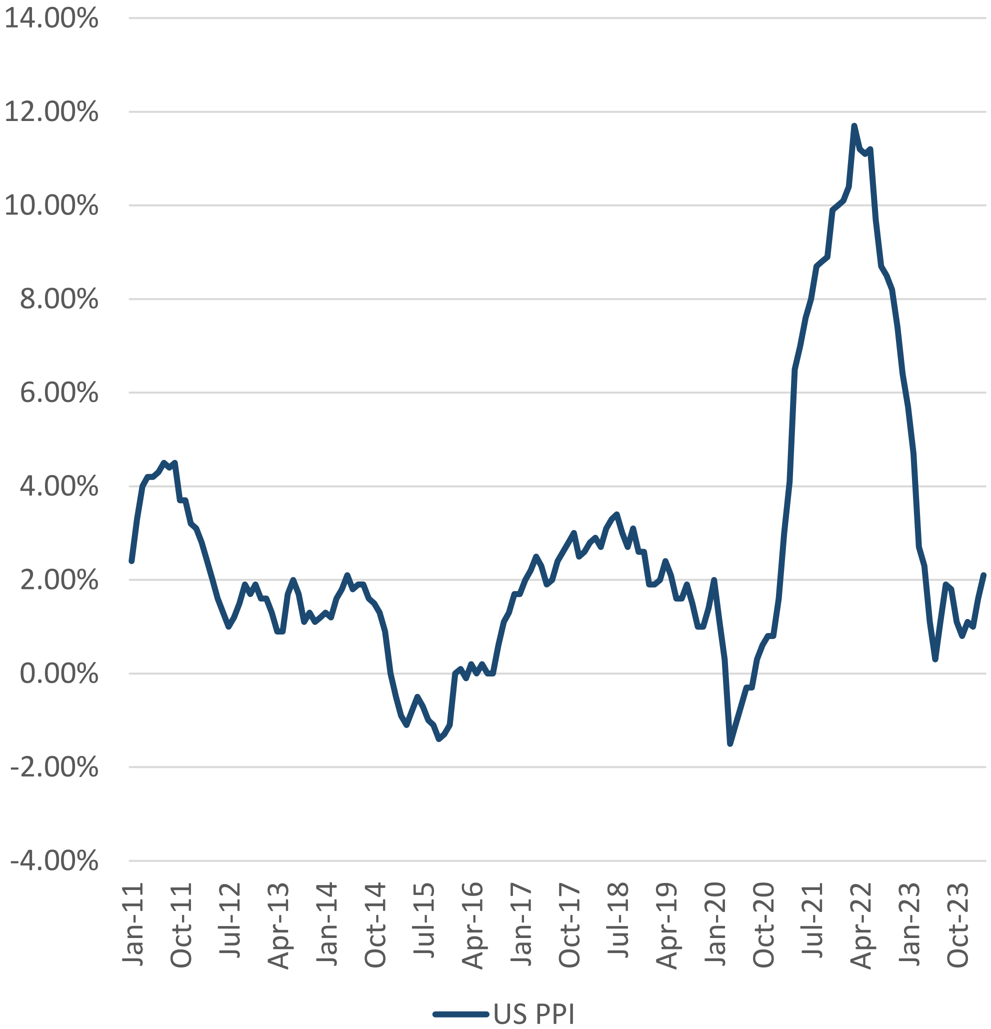
SERVICE INFLATION IS ACCELERATING AMIDST HIGHER WAGE GROWTH



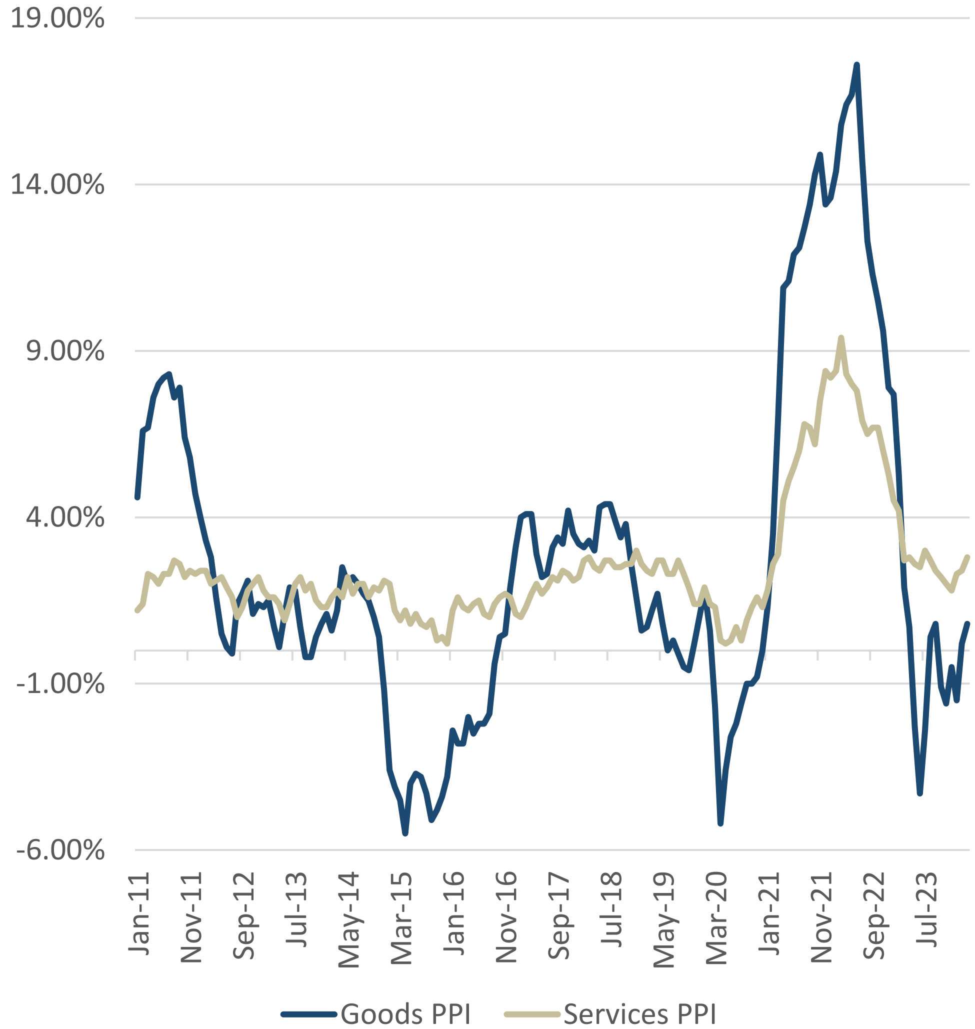


INFLATION: A DOUBLE WHAMMY?
PPI INDICATES THAT WE WON'T SEE ANOTHER SURGE IN INFLATION

US PPI has also stabilised with signs of a rise



Services PPI is rising from an elevated level



Source: US Bureau of Labor Statistics

ARE INTEREST RATES FINALLY FALLING?

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SIMILARITIES TO 2006-09 PERIOD ARE VALID

The main reason why interest rates should fall, in my opinion, is that after a rapid rise in interest rates, rates generally did not stay at the elevated level for more than a year. The longest the Fed kept rates at high levels after a rapid hiking cycle was during 2006/07 with a total of 58 weeks. Now, you might argue that the pandemic stimulus was so large that one can justify a longer period of higher rates. However, the currently high rates combined with high fiscal spending (7% deficit), is a toxic cocktail for the US government. The ratio of federal government interest expenditures over tax receipts is at 36% as of Q3 2023. The prior highs of this ratio were during the 1980s at close to 50%. But these levels were only reached after the Fed had already begun cutting rates. Once the Q4 2023 figures come out, this ratio will likely climb further. Overall, the US government fiscal spending is unsustainable, but won't change in an election year. This leaves me believing that a September rate cut would be quite late, but as mentioned in my Q1 2024 letter, could be likely due to 2007 being very similar.

ARE INTEREST RATES FINALLY FALLING?
INTEREST RATES SHOULD BE CUT SOONER RATHER THAN LATER

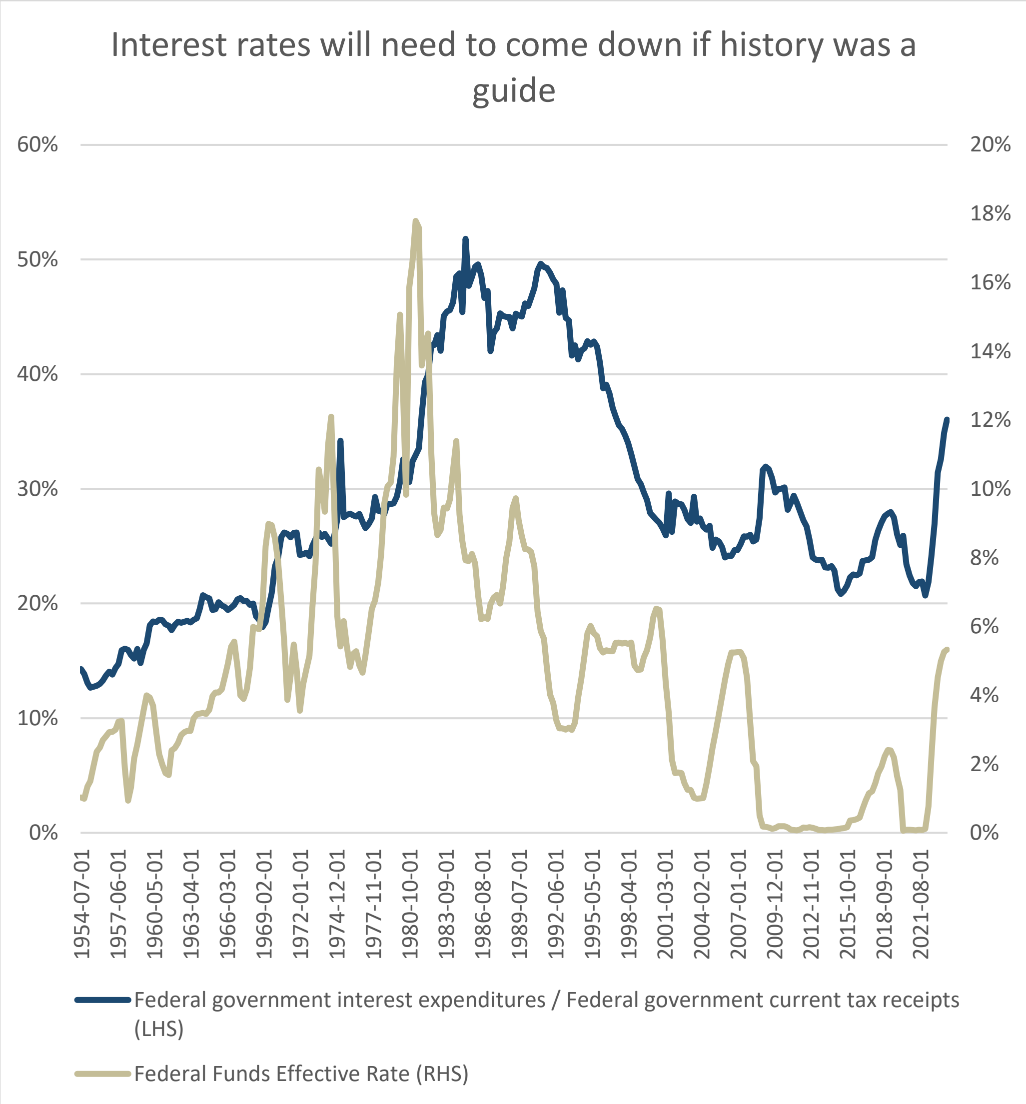
This is the longest period of high, maintained interest rates without a cut since the 2006-09 period

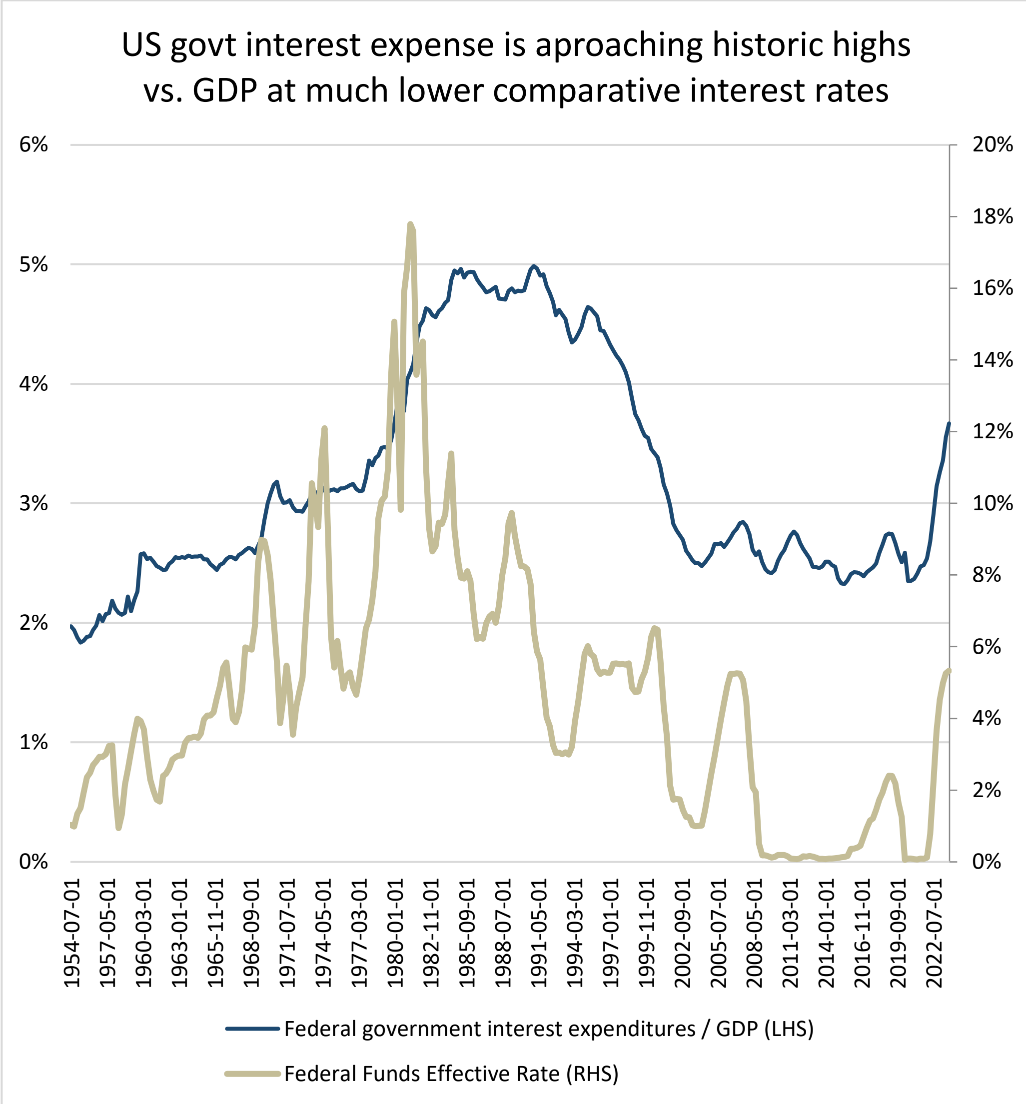
Period	# of weeks UST 10yr - Fed Funds inversion	Weeks between last hike and first cut	Weeks between last hike and end of inversion
1973-74	99	1	26
1978-80	92	1	7
1982	17	1	16
1989	52	9	39
1998	29	12	16
2000-01	46	33	46
2006-09	81	58	77
2019	23	32	44
2020 Covid	4	-	-
Now	73 (so far)	36 (so far)	36 (so far)

Source: FRED St. Louis

ARE INTEREST RATES FINALLY FALLING?

THE US GOVERNMENT CANNOT AFFORD HIGH INTEREST RATES





Source: FRED St. Louis

A BRIEF NOTE ON WAGES & STRIKES

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THE 3RD ROUND INFLATION EFFECTS ARE ACTUALLY WANING

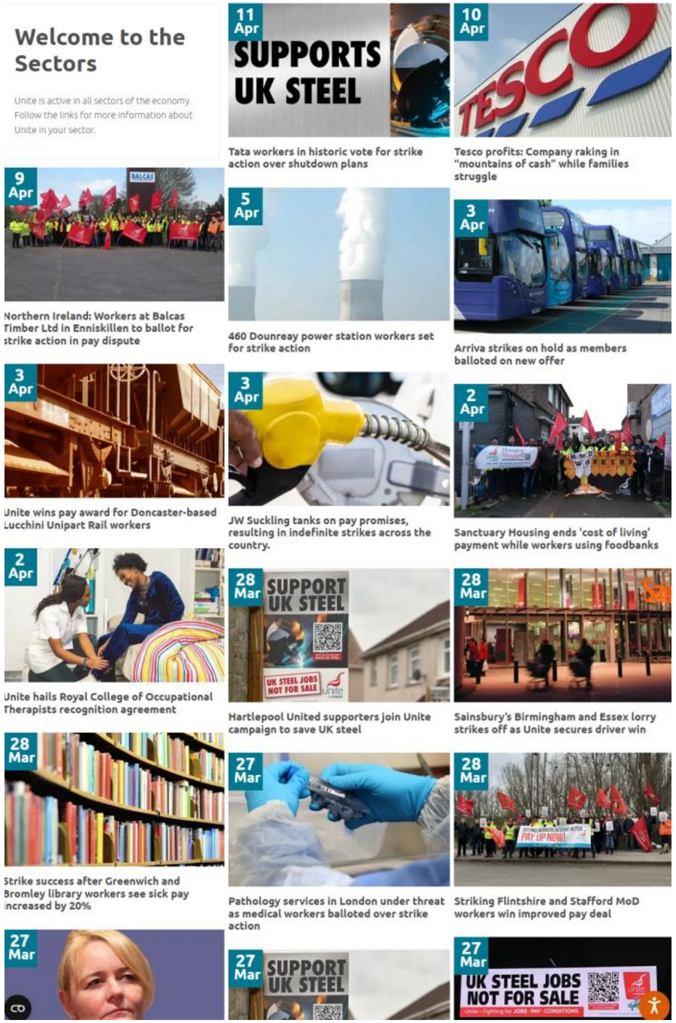
Given that inflation has come down, especially in the energy and goods space, it becomes harder to argue for a wage hike. And we are beginning to see light at the end of the tunnel. Just one week ago the NHS consultants came to an agreement with the government on pay*. In order to gauge a live view on strikes, the Unite Union's daily updates are a good barometer. The peak of daily strike news was in December/January with as many as 8 daily news. This has come down dramatically, and when compared year-on-year, there are 9 strike notices in the first two weeks of April in 2024 compared to more than 15 last year. That's progress in the right direction…

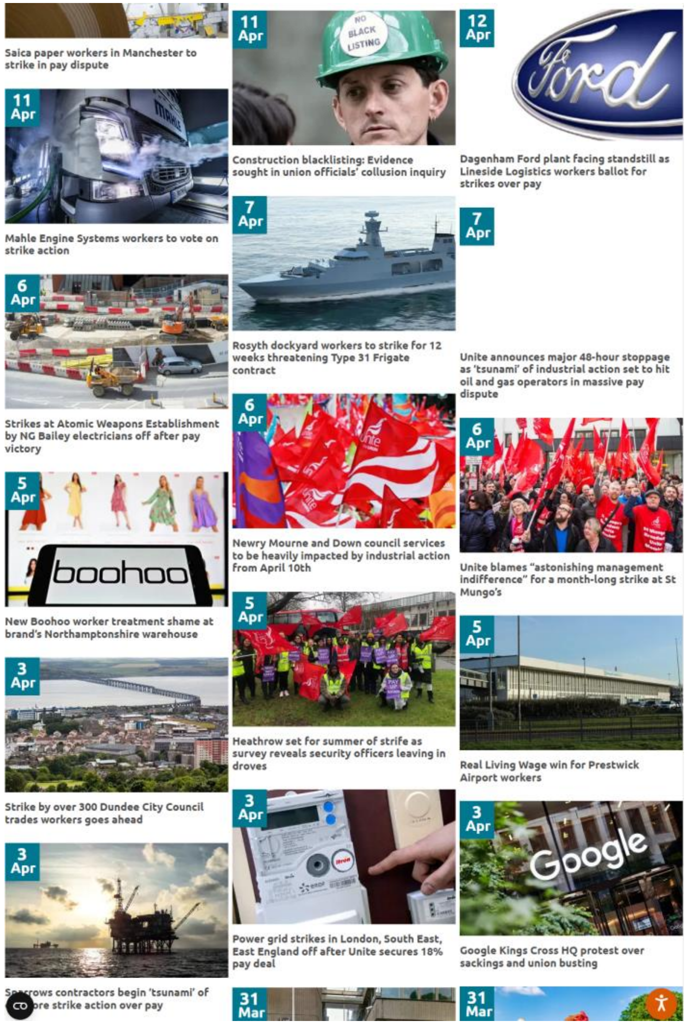
Source: https://www.gov.uk/government/news/end-of-nhs-consultant-strike-action-as-government-offer-accepted

A BRIEF NOTE ON WAGES & STRIKES

THE 3RD ROUND INFLATION EFFECTS ARE ACTUALLY WANING

Unite Union's daily strike updates 12th April 2024 vs. 12th April 2023





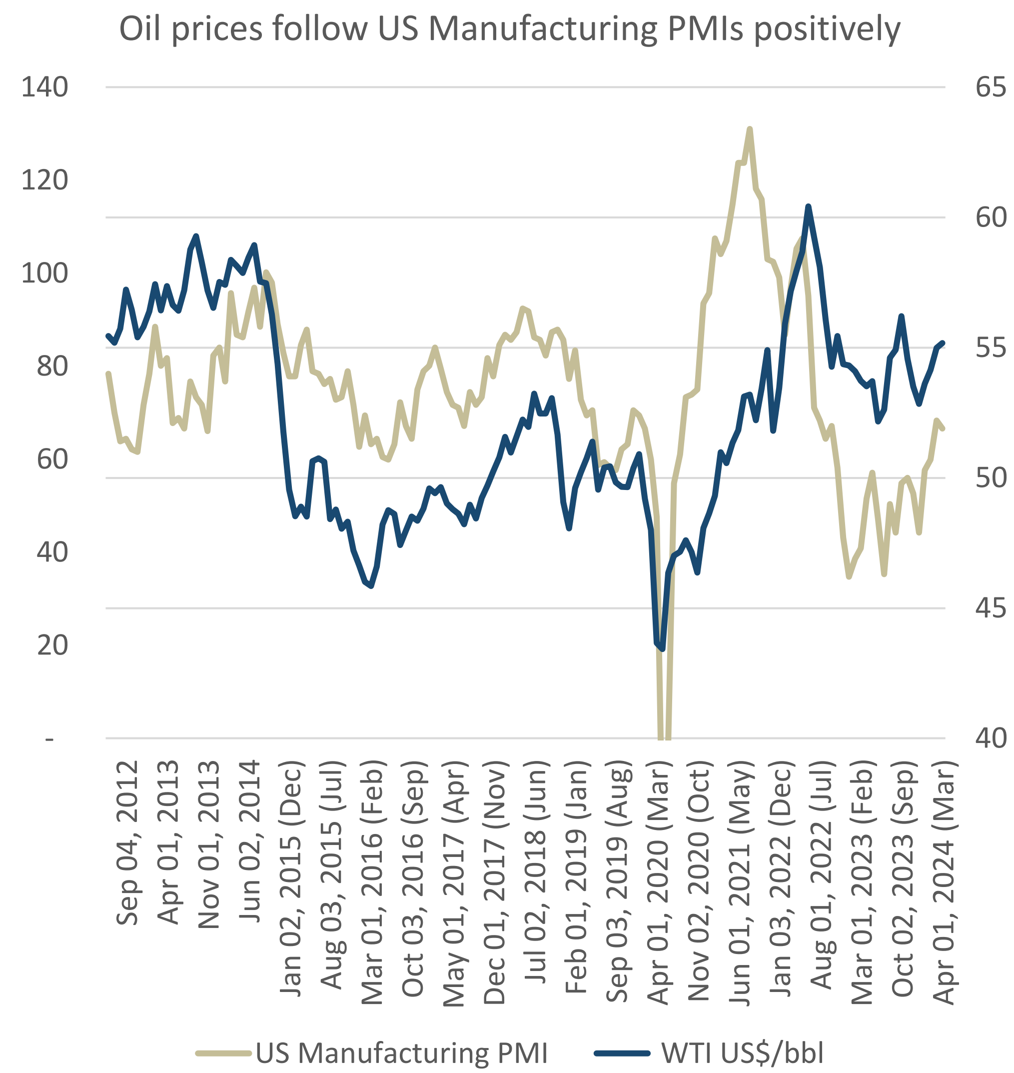
A RISE IN OIL PRICES?

A RISE IN OIL PRICES?
A COMPLEX PICTURE

Oil prices have reached levels that we saw last time during the Hamas terror attack. However, before we had the terror attack, US inventory levels began drawing down rapidly. As we move into the summer, it is quite rare to see oil inventory build ups. At the same time, the US SPR is being filled up, which historically always led to higher oil prices. However, the US DOE has now cancelled SPR purchases for July and August 2024 amidst the higher oil prices*. It is a really complex picture, as US Manufacturing PMI is now in growth mode – usually oil prices will follow up higher. Whereas on the supply side, the Kirkuk pipeline between Iraq and Turkey appears to be readying a 350k bopd restart** (although this would take Iraq way over their OPEC quota). Finally, there are geopolitical risks priced in, depending on how Iran responds to the Israel attack on their embassy in Damascus, this might be priced in/out over the weekend. Overall, this leaves risks towards the upside, yet limited risks towards the downside. How the geopolitical situation in the Middle East will evolve remains key…

Sources: *US DOE cancels SPR buyback of 3 million barrels for Bayou Choctaw site | S&P Global Commodity Insights (spglobal.com), **Exclusive: Iraq set to reopen own pipeline as Kurdish talks stall | Reuters

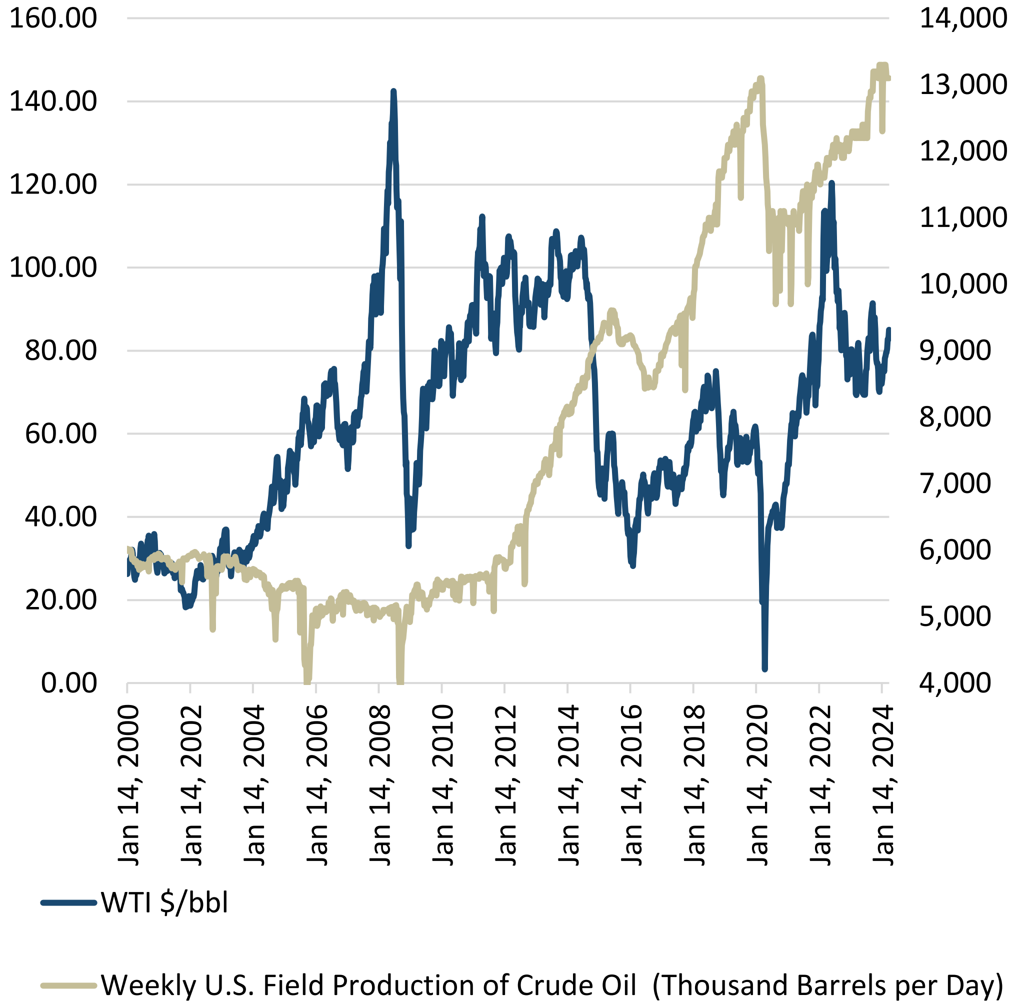
A RISE IN OIL PRICES?
MANUFACTURING REVIVAL AND LOW DISTILATES INVENTORIES



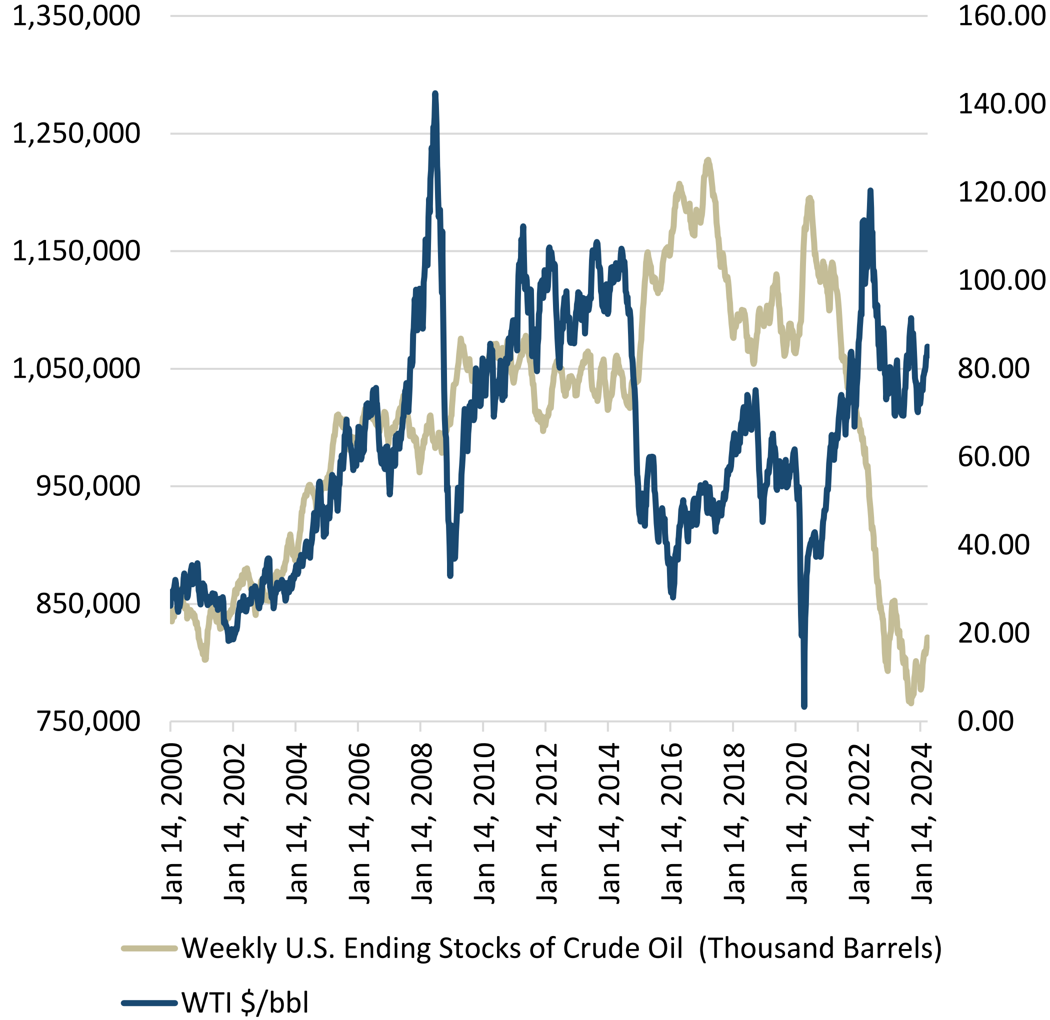
A RISE IN OIL PRICES?

RECORD PRODUCTION AND RECORD LOW INVENTORIES

Continuously climbing US oil field production evenetially leads to a crash in oil prices

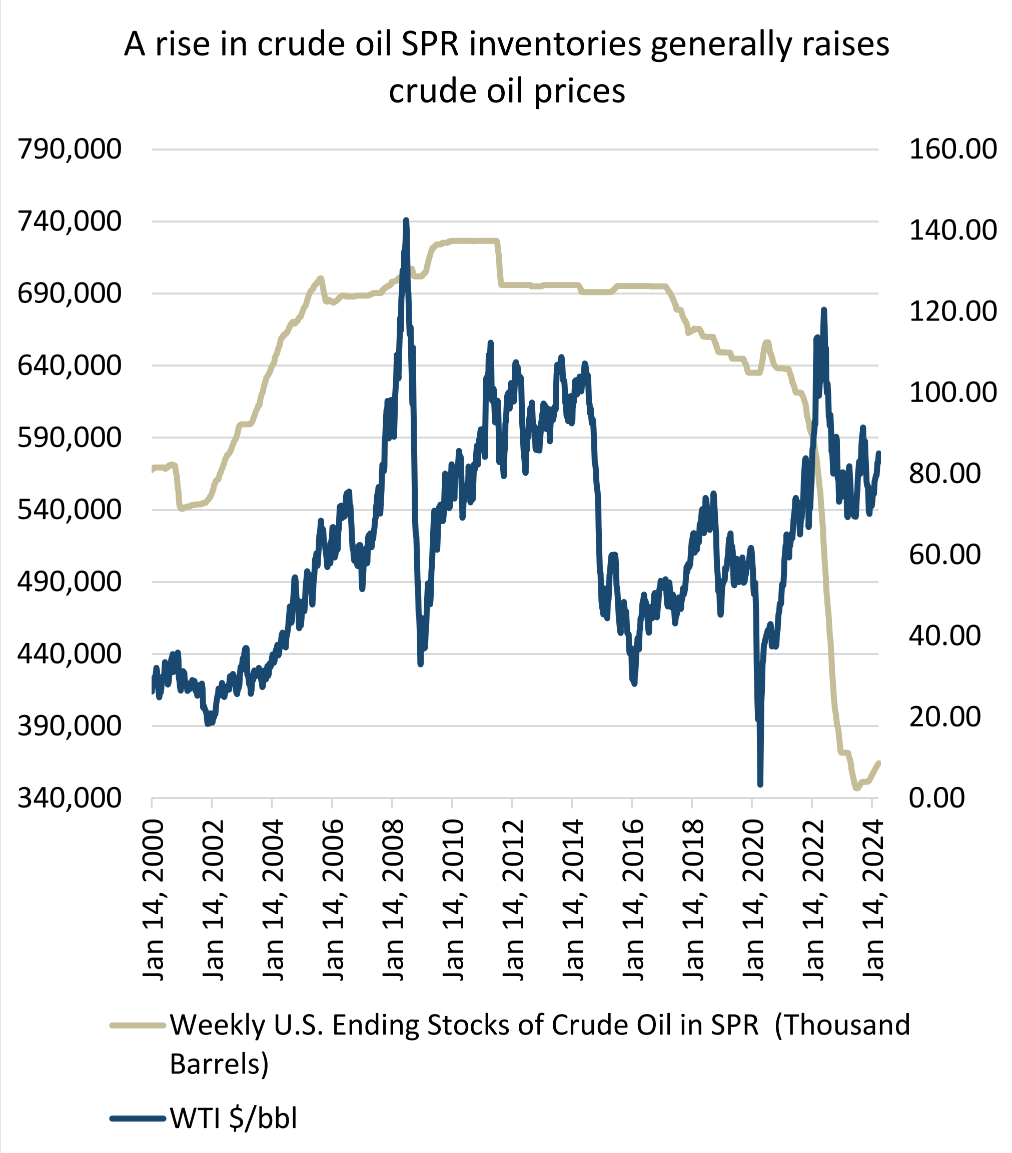


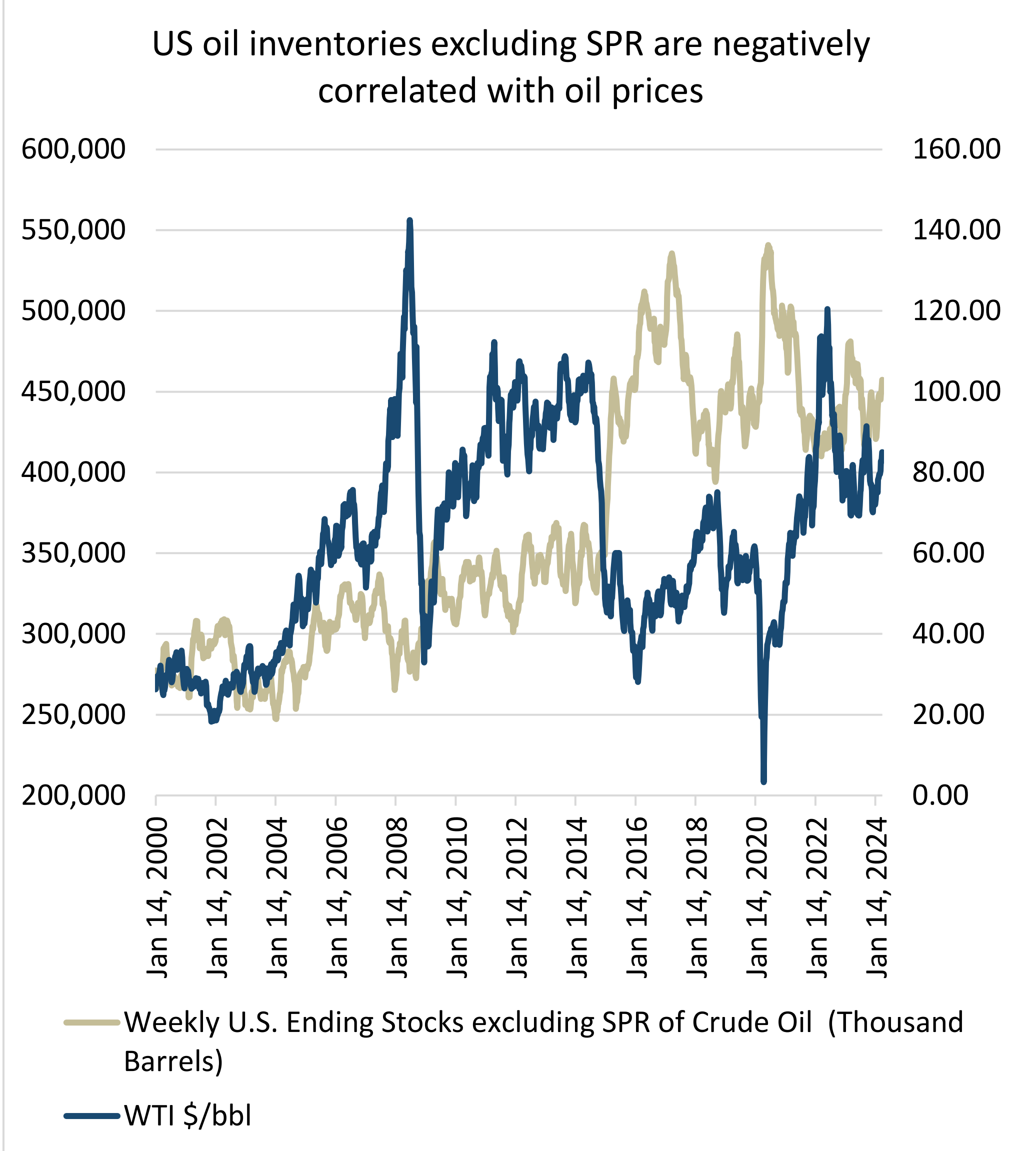
The massive draw in total US oil inventories has not led to a spike in oil prices (yet?)



A RISE IN OIL PRICES?

LOW SPR INVENTORIES, YET STABLE COMMERCIAL INVENTORIES





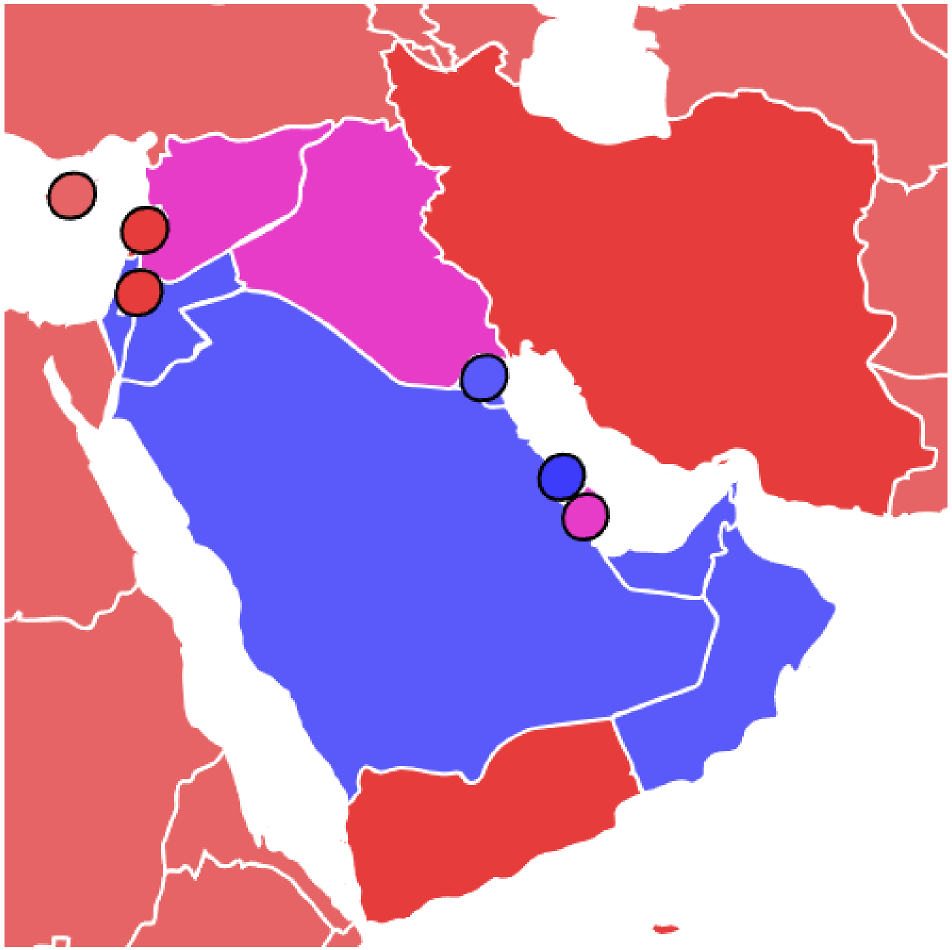
UNDER BIDEN THERE WILL BE NO PEACE

UNDER BIDEN THERE WILL BE NO PEACE
THE DANGER OF FAR LEFT (& FAR RIGHT)

Joe Biden has used very strong rhetoric to bring the US public behind him and against Trump. The 2020 election was one on principles and judgement of what is right and what is wrong. You had to take sides. With Biden winning that election, this rhetoric has spread globally and split the world into the NATO/Western camp vs. the SCO/China, Russia, Iran, North Korea camp. This makes an end to the war in Ukraine and in Gaza very difficult and could open up new conflicts very quickly. Focusing on the Gaza war, this is really a war of Iran vs. the US. Iran has influence in Iraq, Syria, Lebanon, Yemen and Palestine, while the US has military bases in Iraq, Syria, (Israel), Yemen, Saudi Arabia, Kuwait, Bahrain, Qatar, the UAE and Oman. In the map below, I have marked the countries in red where Iran has influence, the countries in blue where the US has military bases, and the countries in pink where both is true. You will note that Qatar is shaded in pink, as Qatar is a mediator between Hamas and Israel and with Al Jazeera has an ongoing campaign in favour of Palestine and against Israel even on the day of the 7th October terror attack. Iran's tactic is clear to me: Iran wants to "kick" the US out of the Middle East, and with the 7th October terror attack on Israel, it was clear that Israel would go to war in Gaza. Qatar would drum the news machine in support for Gaza, trying to bring US allied Middle Eastern countries in favour of Palestine and against Israel and the US. Iran, on the other hand, is trying everything to stay out of the war directly, as once they are in officially, the US and Israel would attack Iran and topple the regime. Therefore, I expect Iran to respond with a very measured attack on Israel that would not kill anybody, and not lead to a major retaliation. This is not about Sunni and Shia Muslims, but about major influence in the Middle East, and Iran is gaining… Oil prices, therefore, could see some downside near-term, but will likely be driven more so by US interest rates and Manufacturing PMI.

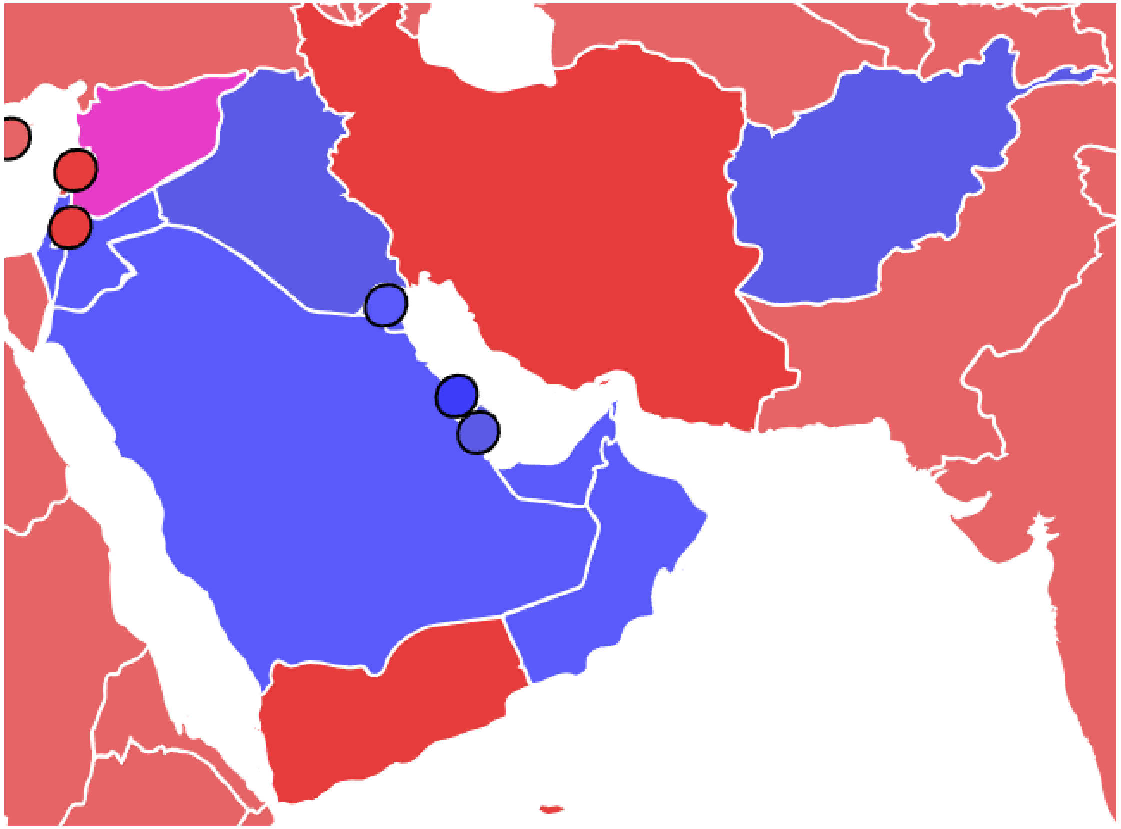
UNDER BIDEN THERE WILL BE NO PEACE
THE US VS. IRAN

Middle East map under Biden (red = Iranian, blue = US, pink = both, with Iran gaining)



UNDER BIDEN THERE WILL BE NO PEACE
THE US VS. IRAN

Middle East map under Trump (red = Iranian, blue = US, pink = both, with Iran gaining)



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