ALIUM CAPITAL MANAGEMENT

ALIUM MARKET NEUTRAL FUND

January 2022

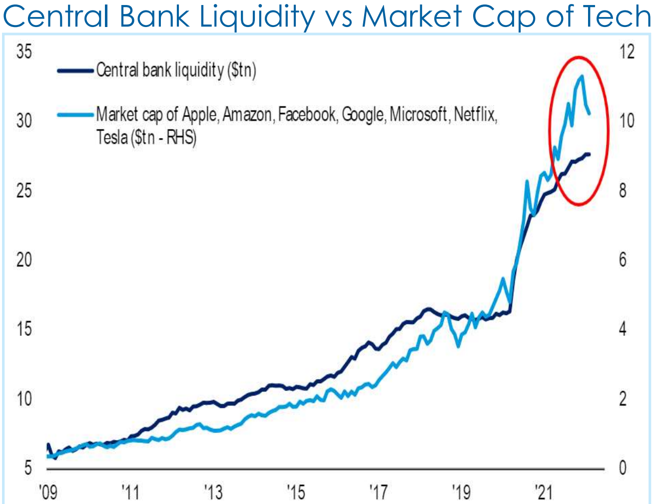
Performance (%)	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	YTD
2017					0.9	1.4	1.7	1.2	-0.3	-1.4	-0.2	-0.8	2.5%
2018	3.6	3.1	2.2	1.2	0.7	0.0	-0.3	-2.3	1.2	0.8	4.3	1.6	17.1%
2019	-1.9	1.8	1.8	-1.4	1.7	-0.5	-1.6	1.8	1.1	-1.0	0.9	0.7	1.0%
2020	1.3	1.8	7.1	-0.6	2.4	1.4	2.1	-3.1	2.8	0.4	-0.5	2.9	19.3%
2021	-0.4	1.1	2.4	1.4	0.9	-0.5	1.9	0.4	-0.2	0.4	1.8	0.2	9.9%
2022	0.3												0.3%
Inception													58.5%

Dear Investor,

Economic data is increasingly pointing to higher growth and inflation in many parts of the world. The prolonged inflationary pressure from COVID disruption, a strong consumer and tightening labour markets have convinced the US Federal Reserve to begin raising interest rates (likely next month) with the principal debate being whether the first hike is 25 or 50 basis points. Some central banks, such as the Reserve Bank of Australia (RBA), are holding onto the belief/hope that inflation will moderate, even as the cost of food, travel, petrol and construction continues to rise. If the RBA is wrong, it risks having to raise the cash rate more aggressively later this year, hurting the economy and hitting the housing market. Many of these cyclical risks have been reflected in the sell-off in equities in January, with investors selling shares of cash burning companies and replacing these with earners.

As we have previously noted, the underperformance of unprofitable technology stocks is not new. It began a year ago, in February 2021, and an index of these stocks is already down over 60% over this time. This also coincided with an increase in short alpha (the returns made from short positions) by Alium Market Neutral and some other Funds and has historically been a leading indicator of tops in the equity market as a whole.

Central Bank Liquidity vs Market Cap of Tech



Companies in the US are reporting full year earnings and we are now seeing a large degree of dispersion between winners and losers with Meta (formerly Facebook) a notable example of this. The ten biggest stocks by market capitalisation now constitute one third of the S&P500 and these are mostly technology, so when investors decide 1 or 2 of these are ex-growth, this inhibits the ability of equity indices to move higher. The time for greater selectivity across the market as a whole is here.

In line with the macro environment, winners this year have been those stocks seen as inflation beneficiaries or at least hedges. Energy and materials stocks have performed well and our long position in BHP was amongst those, up 11.7% in January. We are watching closely the rapid rise in cost inflation for producing raw materials. In Western Australia this is over 20% in many cases and the shortage of labour and materials is leading to production delays and downgrades too. This is not a concern when commodity prices are strong, but will hurt margins when they reverse.

Another sector than can benefit from interest rate rises is banking. We described our preference for Japanese and US bank stocks over Australian banks in our recent Golden Age of Banking Theme and this played out in January with Mitsubishi Bank (8306 JT) up 14%, Bank of America (BAC) up 7% in January while NAB fell 6%. Mortgages form the majority of profits for Aussie banks and competition remains intense while house prices are peaking. We also remain short fintech, particularly Buy Now / Pay Later stocks where competition and regulation is increasing and margins and growth are falling. Affirm, Block (who bought Afterpay) and Zip fell 36%, 24% and 27% respectively in January. These stocks were some of those most widely bought by retail speculators on platforms like Robinhood and Commsec over 2020 and into 2021. On the topic of retail favourites, lithium stocks are now amongst these and although lithium spot prices continue to skyrocket, the stocks are no longer rallying. Our long in Allkem, formerly Orocobre, fell 13% in January and we are reducing our exposure to lithium miners.

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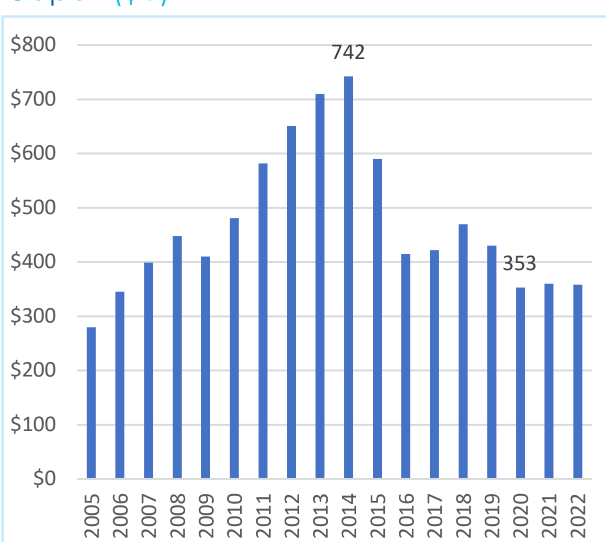
Theme: The Energy Transition

The world is moving away from fossil fuels towards renewable energy. In 2015, 196 parties signed The Paris Agreement, on climate change, agreeing to limit the word's average temperature increase to below 2 degrees Celsius. In order to achieve that, a large number of countries and corporations have pledged their 'Net Zero' ambitions – a date by which any greenhouse gas emission produced must be offset by emissions being taken out of the atmosphere. The practical reality however is that the transition won't happen in a straight line. Below we discuss a number of companies that we believe have been overlooked in their importance to that journey. Meanwhile, we have identified a number of more speculative companies that we believe have benefited from the ESG Thematic, but are likely to disappoint.

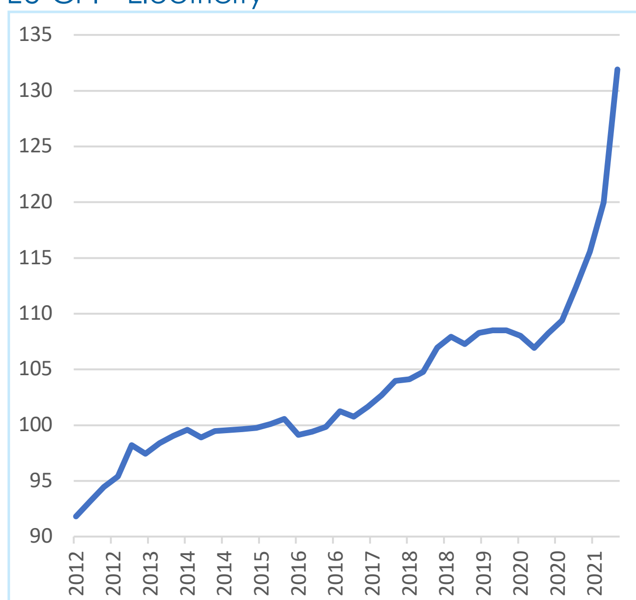
Supply Constrained. As 'Net Zero' gains momentum, the suppliers of fossil fuels are scaling back production more quickly than demand is tailing off. The International Energy Agency (IEA) has calculated that even in its 'Net Zero by 2050' scenario – in which oil demand falls by 29% by 2030 – annual investment in oil and gas fields still needs to run at $365bn a year over the remainder of the decade. However, at the same time debt and equity financing for such investment is becoming less available, and more costly. So far, close to one hundred banks, representing a third of global banking assets, have promised to decarbonise their lending and investment portfolios, in line with their net zero ambitions. When combined with the rise of shareholder activism and low energy prices over the past 5 years, there has been significant underinvestment in the traditional sources of baseload energy.

Global Oil & Gas Field Development Capex ($b)



The energy shortages and blackouts we saw in the second half of 2021 in Europe and China are partly a result of this underinvestment. For instance, in the UK wind power (mostly from the North Sea) provided 25% of the county's energy needs in 2020. However this fell to just 7% in late 2021 due to a lack of wind. This saw the country scramble for gas generation and forcing up the price of offsetting carbon credits. The National Grid even asked utility EDF to restart coal fired generation after two months of coal-free electricity generation in the country.

EU CPI - Electricity



China blinks. China's Paris Agreement commitment is to reach its carbon peak before 2030 and carbon neutrality before 2060. Subsequently, there has been a significant push to reduce its reliance on fossil fuels and in particular thermal coal. In addition, during the 14th Five-Year Plan, China committed to a 13.5% reduction in unit GDP energy intensity. In August last year, the National Development and Reform Commission (NDRC) announced that as many as 20 provinces had exceeded these energy intensity targets. The ensuing crackdown, alongside tightness in thermal coal markets, led to power blackouts in September. With the 20th Party Congress scheduled for later in the year, and continued weakness in the property sector, China can ill afford their manufacturing industry to be constrained by energy shortages. The likely infrastructure program to boost GDP growth in 1H22 will see the unit GDP energy intensity of the country increase.

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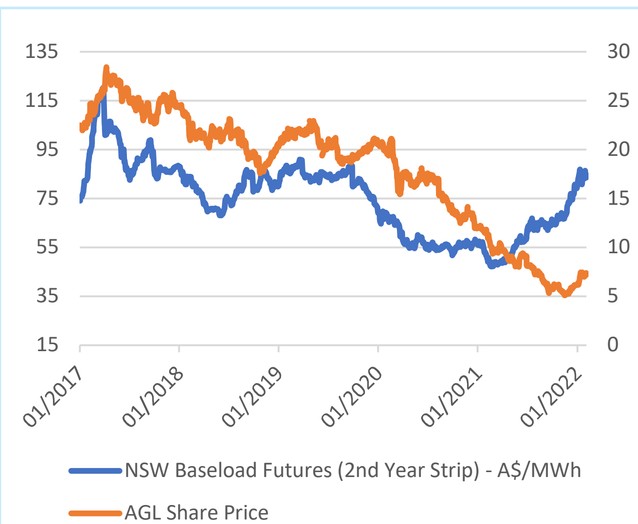
Indeed, we are starting to see signs of policy adjustment accordingly. China is no longer announcing quarterly results of their energy intensity evaluation since the September blackouts. Meanwhile, at the World Economic Forum, Xi delivered a speech that noted the need to see an orderly reduction in traditional energy sources. This followed an article in the State run People's Daily "China must seize the 'Bowl of Energy" which noted that coal should remain a major energy source. Ultimately, this should benefit providers of baseload energy. One such company is **CGN Power (1816 HK)**, China's largest nuclear power operator accounting for >50% of installation in the country. The stock currently trades below book value and offers close to a 5% dividend yield.

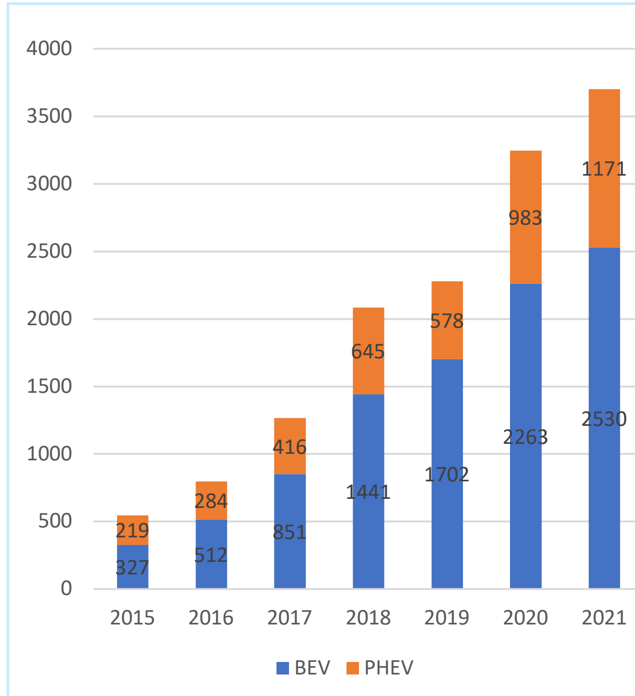
In Australia, another example of an out of favour provider of baseload energy is AGL **Energy (AGL AU).** It is the largest vertically integrated utility business in Australia and as such has the highest carbon intensity of earnings of any stock in the ASX200. However, underappreciated is that it is also the largest private owner, operator and developer of renewable generation assets. Since the company released FY22 guidance, average forward prices have increased 36%.

AGL vs Baseload Futures



Hybrids Electric Vehicles (HEV) vs Battery Electric Vehicles (BEV). Another example of where the journey matters is in the car market. We often hear pushback on **Toyota Motor (7203 JP)** that their BEV strategy lags peers in Europe, US, and China. Late last year, the company greatly increased its forecasted 2030 BEV production (2m to 3.5m units). However, it is Toyota's market leadership and expertise from over 20 years in HEVs (battery performance maintenance, vehicle heat management, optimal motor control, etc.) that will not only prove applicable to BEVs, but go a long way to reducing CO2 emissions as the EV adoption curve meets challenges such as charging infrastructure and battery material shortages.

Global BEV + HEV Unit Sales (000s)



Unintended consequences. The Net Zero Asset Managers initiative was launched in December 2020, with ~220 signatories representing roughly $57 trillion assets under management committed to align their portfolios with 'Net Zero'. While we have already discussed the potential implications of this on the supply of traditional energy sources, it has also resulted in a wall of money for companies perceived to be enabling decarbonisation. We have identified a number of companies that have promoted themselves as such in order to attract this capital, but are likely to disappoint investors.

Taking profit in Lithium stocks. In 2019 (see Future Mobility) we argued that Lithium would be the bottleneck in the EV supply chain should the projected BEV production output of the major OEMs come to fruition. While we still believe this to be the case, it has become increasingly well understood and the price has reacted accordingly. We also note with interest commentary out of the Ministry of Industry and Information Technology (MIIT) in China looking to speed up the development of domestic resources in order to secure supply and dampen prices. This policy might create an overhang for lithium/ spodumene sentiment near term.

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Finally, we note with interest that a number of the more speculative lithium producers in Australia that have seen their share prices rally strongly over the past 12 months have also seen a large portion of their trading volume dominated by online retail brokerages. An equal weighted basket of such names doubled in 2021 per the chart below. While we remain bullish on selected battery materials longer term, we see risk of crowded positioning and disappointment and hence have taken profits on the majority of our positions.

Australia – Retail favoured Lithium Stocks

Kind regards,

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