PhestosCapital

July 14, 2023

Dear Partners,

I hope all is well. In this quarterly update I would like to provide a bit more color on last quarter's performance, as well as some updates on our portfolio.

Market Commentary

Market Performance Driven by Mega Caps and A.I.

There has been a lot of commentary regarding the limited breadth of the recent market performance – how just a handful (seven, to be precise)[1] of companies account for almost the entirety of the returns. I don't have much to add to this conversation, so I'll make just two quick comments (ok, two and a half): first, it is not uncommon for a relatively small number of companies to drive index returns; in fact, it is the norm. Second: that said, the recent concentration is remarkable: the top seven stocks accounted for 73% of S&P 500 gains in H1. Collectively, these seven companies now have a market cap equal to ~45%(!) of the U.S. GDP[2] and are expected to represent more than 100% of corporate earnings growth in Q2 (they are expected to increase earnings by 21% on a YoY basis in Q2, vs a ~10% *decline* for the rest of the S&P 500).

This has created a wide "valuation gap" between these mega caps and the rest of the market. An equal-weighted portfolio of the "magnificent seven" stocks currently has a forward P/E ratio of 47x; the S&P 500 as a whole has a P/E ratio of ~20x; and small cap ETFs (for example, Vanguard's VB) have P/E ratios around 12x. Another way to look at this is through the ratio of the Russell 2000 index (often used as the benchmark for small-caps performance) to the S&P 500, which last quarter hit its lowest level since 2003(!).

Bottomline is, while on aggregate the equity market seems to be fully valued (if not overvalued), there are opportunities in smaller stocks.

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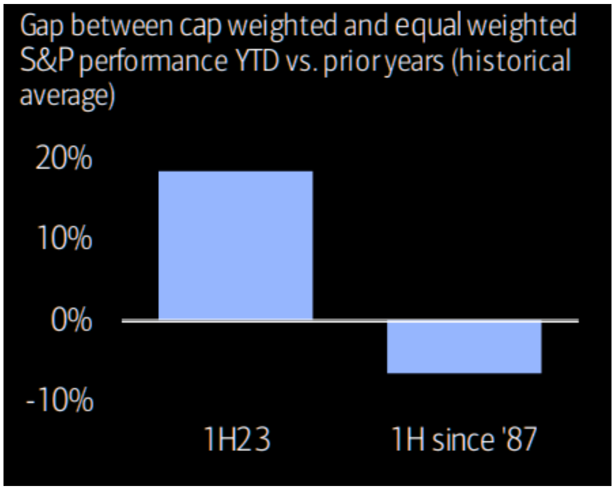
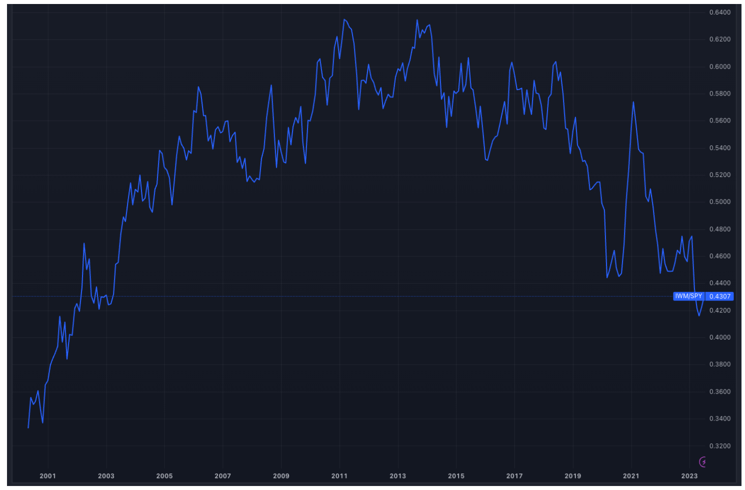
[1] These would be Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia, and Tesla – affectionately called "the magnificent seven."

[2] Their combined revenues and profits make up ~6% and <1% of the U.S. GDP, respectively.

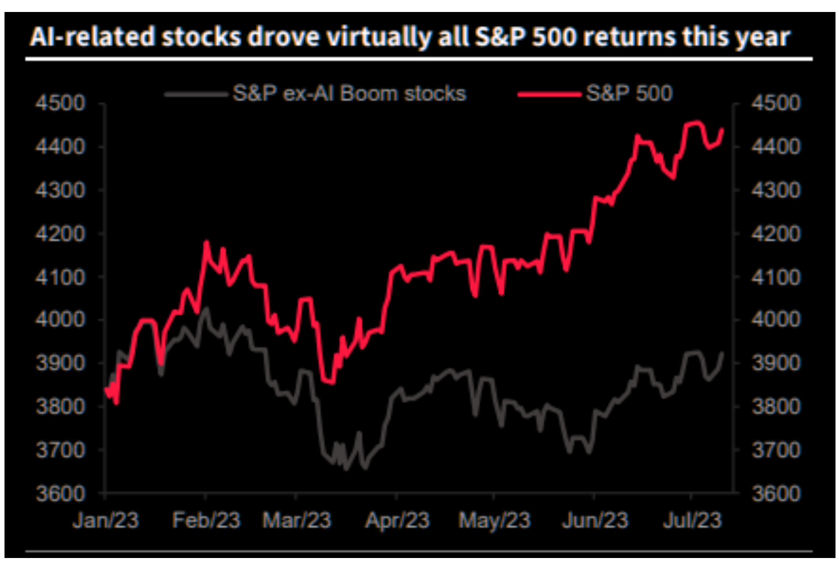


This year's performance gap between the mega-caps and the rest of the market is uncommon... Source: Bank of America



...and has led to a valuation gap between large-caps and small-caps not seen in decades, as reflected in the ratio of IWM (the Russell 2000) to SPY (monthly closing prices) Source: Tradingview

The "half" comment has to do with the "AI hype": the companies driving the S&P 500 higher all have exposure to AI; in fact AI-related stocks have driven virtually *all* of S&P 500's returns this year, as the chart below from Société Générale illustrates. I have no doubt that AI will be deeply transformative for our society, but perhaps this is getting a bit ahead of itself? Among the beneficiaries of the "AI boom" are companies with negative cash flows and low or no growth, whose only "competitive advantage" is that they include some variation of "AI" in their stock ticker. This is reminiscent of the crypto "glory days", when companies would add "blockchain" to their name and their stock price would surge, without any other reason.



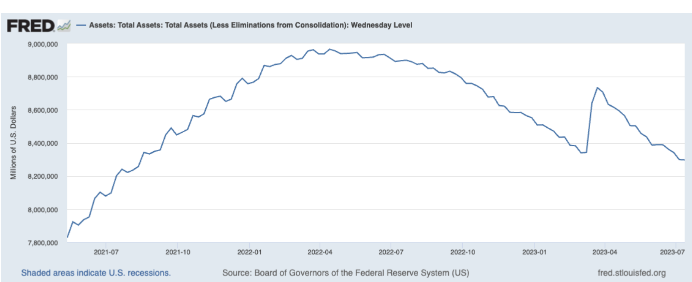
Source: Société Générale

Fundamentals Are Mixed

In terms of stock market "fundamentals," resilient economic growth and falling inflation have been major tailwinds for the market rally, but higher yields and falling liquidity are a cause for caution. Q2 GDP growth was better than expected: the official BEA data is not yet available, but the Atlanta Fed's GDPNow estimate is at 2.3%. Headline inflation in June came down to 3% on a yoy basis, but core inflation remains elevated at 4.8%. The Fed funds rate has moved higher than the market expected three months ago (back in March the market was actually pricing in rate *cuts* during the summer; it is now pricing in a ~90% probability of another *hike* this month). Treasury yields have followed the Fed funds rate higher, with the 2-yr closing the quarter at 4.9% (up from 4.0% at the end of Q1) and the 10-yr at 3.8% (up from 3.5%). Yields continued to rise into the first week of July but moved sharply lower following the CPI print. As a result of rates going up and inflation coming down, real rates (=yields minus headline CPI) are finally positive *for the first time* since the start of the Fed hiking cycle sixteen months ago. Think about that for a second: despite the much-advertised monetary tightening of the past year and a half, until very recently real rates were still negative!

There has been no meaningful increase in forecasted corporate earnings: the S&P 500 expected Earnings Per Share are currently $232, in line with expectations three months ago. The combination of no change in expected earnings, increase in yields, and higher stock prices means that the equity risk premium (=expected stock market returns over the risk-free rate) has moved lower and is now close to levels last seen right before major stock market pullbacks.

Liquidity is *not* improving, by any measure: the Fed balance sheet is contracting, as are bank reserves. I am not proclaiming that there is predictive power in liquidity moves (there are many liquidity-based models for the S&P 500 – like all models, they work for some periods, then stop working for others, and no one can really say why). But whenever stock prices seem to diverge from fundamentals, the easy explanation is that "liquidity is expanding" – this is not the case now.



The Fed balance sheet has been declining, and is now below the level last seen when SVB collapsed (triggering the increase in Fed assets in March)

Bank reserves (blue line, right axis) plotted against the S&P 500 (orange line, left axis). There has been high correlation between changes in bank reserves and changes in SPX over the past few years, but this relationship has broken down recently

Some policy support is coming from the fiscal side: the federal deficit widened in May and June, however fiscal cuts tied to the debt ceiling deal are soon kicking in, and these will narrow the deficit.

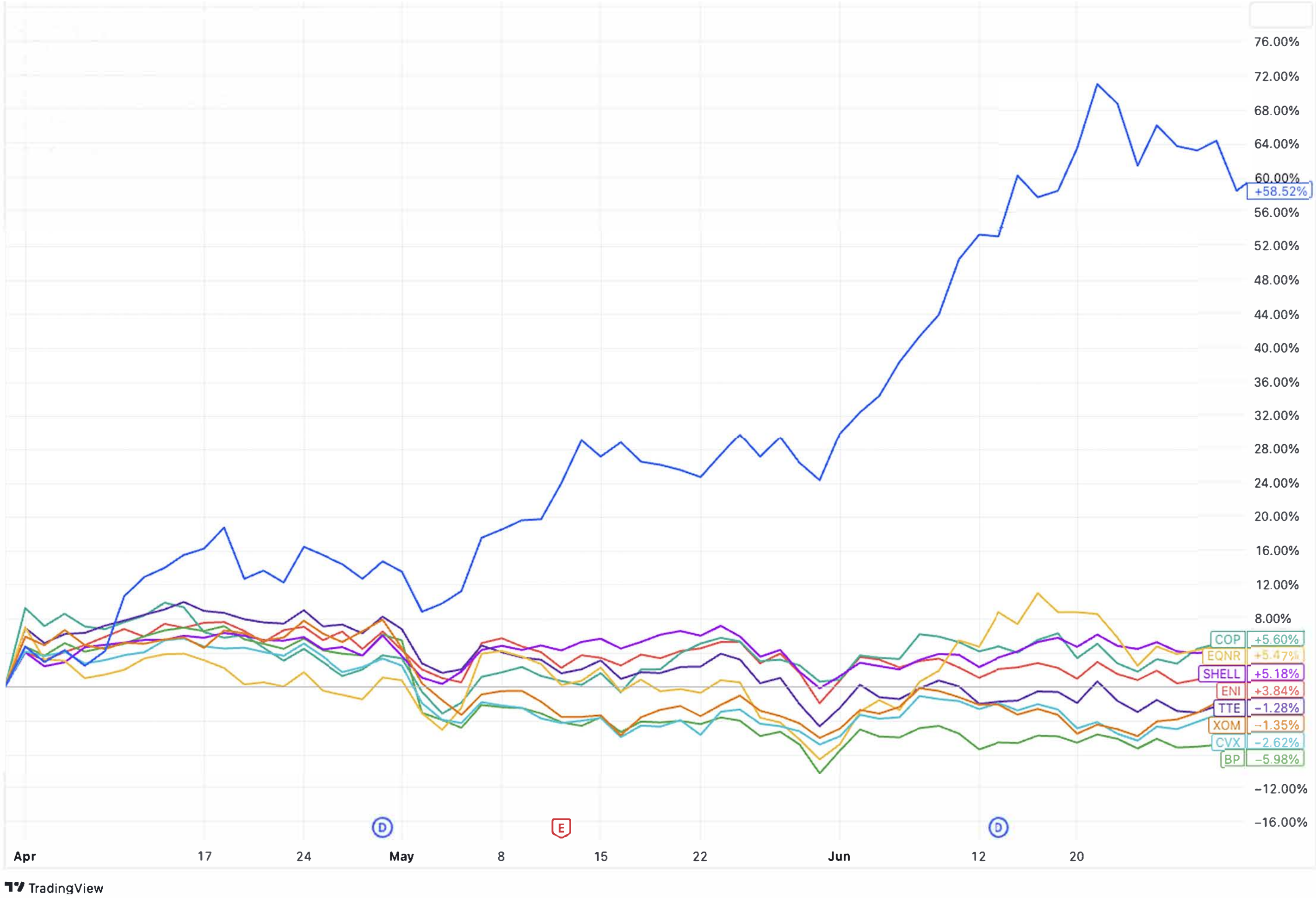
So, overall the stock market seems to overreact… perhaps it is pricing in again that now that inflation has subsided, the Fed will soon cut rates.

Portfolio Updates

Petrobras

Our largest holding, Petrobras, had a solid quarter. The combined dividend-adjusted return for our common stock (PBR) and preferred (PBR.A) holdings was 57.1%. In late March we raised our Petrobras weight to 15% of the portfolio and continued adding to it throughout April and May. Of course looking back I wish we had added more but such is the curse of investing: when it goes bad you regret investing at all, and when it goes well you wish you had invested more.
PBR is not in the S&P 500[3], but if it was, it would have been the index's fourth best performing stock for the quarter, ahead of red-hot stocks like NVDA (or any of the "magnificent seven") and trailing only the three major cruise operators (apparently this was a fantastic quarter for cruise operators). PBR's return is even more impressive if we take into account that crude oil had a bad quarter, with Brent and WTI declining by 12% and 13%, respectively. Petrobras also "crushed" other oil and gas supermajors – the chart below compares PBR.A's quarterly return (in light blue) to the returns of the comps we had used in April:

[3] It fulfills the size and profitability criteria, but of course it is not a U.S. company.

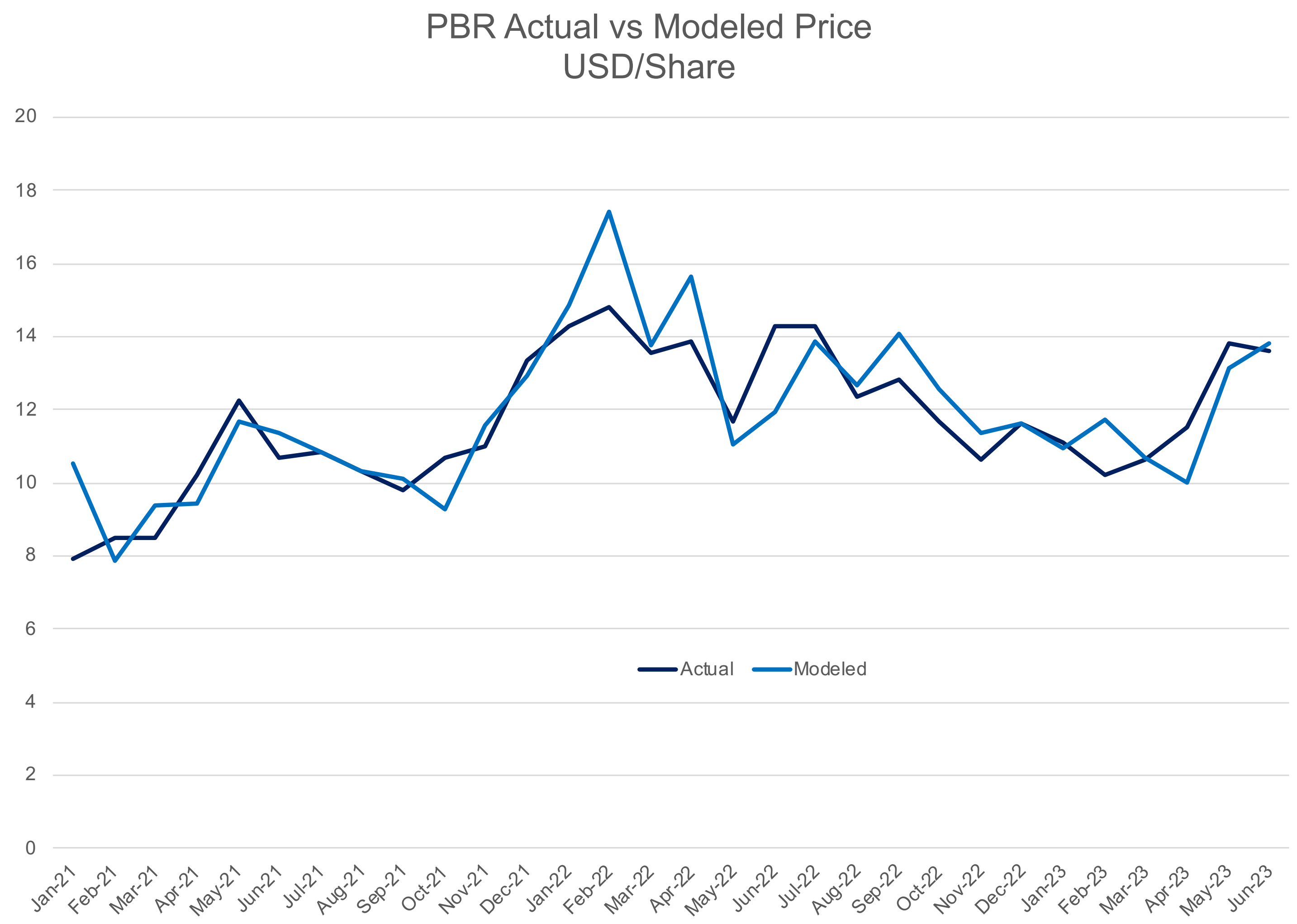


Returns are dividend adjusted and in USD

Despite the vast outperformance, Petrobras remains undervalued compared to its peers. Operationally, PBR had another solid quarter. In June, gasoline production hit the highest level in record, and pre-salt share of production continued to increase, hitting a record high of 73%.

Now, it is important to distinguish between what one believes "should" drive a stock price and what actually does. Petrobras is a good example. In a previous update I was commenting on Petrobras' operational excellence and its high-quality assets. Are these the drivers of the share price? Our analysis indicates… no.
The stock price movements correlate less with operational results and more with (primarily) the BRL/USD exchange rate and (secondarily) oil prices. These two variables combined (using Brent prices for the oil variable) explain almost all the changes in the PBR share price. As you can see in the chart below, over the past

two and a half years the actual PBR price tracks very closely with a modeled price using just the two variables mentioned above.[4]



Monthly actual PBR prices are plotted against "predicted" prices based on a model using just two variables, BRLUSD and Brent crude prices

How do I interpret this? Some correlation with the BRL/USD exchange rate is not surprising, given that Petrobras is Brazil's largest company and one of its largest exporters – as I've written before you can't be bullish on Petrobras without being bullish on Brazil. Most of PBR's production is sold domestically, so for the USD-denominated price the exchange rate is important; finally, the relationship between BRLUSD and PBR price also reflects that capital flows into Brazil are a major driver for PBR stock; Petrobras is a large constituent in every major Brazilian-themed index fund, as well as in Brazil's allocation in emerging market funds.

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[4] The model was trained with data from the period 2003-2020.

So, as a forward-looking data point, PBR price seems to reflect expectations for the Brazilian economy (primarily) and the price of oil (secondarily), rather than idiosyncratic company performance. But the latter has to count for something, right?! It does – it drives the dividend payout. As long as the market keeps treating PBR's forward-looking price as almost a proxy for BRLUSD, the company's results will keep financing the dividend. Which is why I think PBR is a better investment than just a directional bet on the BRLUSD.

PBR had a pullback (down 7.3%) in the second half of June, presumably on the news that it will lower gasoline prices for domestic distributors by 5.3% on average. The loss in market cap is not justified by the cash flow impact of the price reduction and likely reflects "political risk" fears. I don't think these fears are justified: the price reduction is in line with a simple adjustment to international prices (oil and gasoline prices have declined).

We continue to hold the stock.

Uranium Holdings

Our "uranium portfolio" returned 6.1% last quarter. It reached a peak of 13.5% on June 15 but gave back most of the gains in the last two weeks of the month. In terms of the thesis, I don't have much to add to the most recent update's thoughts. If the thesis plays out, it will likely happen fast. My only worry is that this trade may be getting a bit crowded: even Cathie Wood recently purchased Cameco through her ARKQ Autonomous Technology & Robotics ETF. That said, the fundamentals make perfect sense so we will be patient here.

With regard to specific positions, Centrus Energy (NYSE:LEU) announced in June that it successfully completed its operational readiness review and received approval from the Nuclear Regulatory Commission to introduce uranium into its centrifuges; which means it remains on track to begin HALEU production by the end of the year.

Other holdings

Rocket Companies (RKT): we added a bit to our RKT position; the most recent purchase was in the first week of July at a share price of $8.45. Nothing has changed here, this is a long term holding and we will keep adding to it over time.

<u>Guardant Health (GH)</u>: as I mentioned in the previous update, we trimmed out Guardant position when the stock traded around $33/share, the rationale being that the stock had risen too fast on no real news. We will be adding to this position over time and add more aggressively if there is a major pullback.

<u>Figs (FIGS)</u>: same here; this is a long-term holding, and we will add aggressively to our position if there is a major pullback.

<u>W&T Offshore (WTI)</u>: this was our worst performing long position last quarter, down 23.8%. The most attractive characteristic of WTI (an oil and gas exploration and production company operating in the Gulf of Mexico) is its very stable production. For most of the past two years the stock was trading at depressed levels due primarily to its heavy debt, large portion of which was maturing in 2023: the market was casting doubts over its ability to refinance and/or anticipating that refinancing would come at unattractive terms. WTI took advantage of the 2022 boom in oil prices, and the consequent excess cash flow, and significantly reduced its debt. My thinking was that once the refinancing overhang is removed, the stock would start trading at valuation multiples closer to those of its peers. WTI did indeed refinance its debt earlier this year, at relatively attractive terms. Yet, this didn't lead to a repricing of the stock. In another example of what "should" be driving price vs what is *actually* driving price, this stock trades as a levered play on the price of oil, moving almost in perfect correlation to the price of its namesake (WTI) oil benchmark. Perhaps an additional drag on the stock is the management's "ultra-long term" focus, which I commented on in the last update. The market seems to "prefer" oil and gas companies that use excess cash to immediately reward shareholders (via dividends or share buybacks) – the CEO's comments indicating that he would prefer to use excess cash for an opportunistic acquisition were not well received. Finally, the CFO, who had been with the company for more than a decade, departed last quarter (the new CFO was announced last week) and CFO departures are usually not viewed favorably by the market. Moving forward: I continue to believe that this stock is cheap in terms of its cash flow potential over the next 2-3 years. That said, in the short term this is effectively a levered bet on oil prices, and I have no view on the price of oil in the short-term. We will hold through the next earnings announcement (expected in early August) and, based on the results, forward guidance, and management commentary, decide whether we keep this position or not.

Short Positions

The bleeding from the shorts continued last quarter. As I've written before, being short is not part of the fund's "core" strategy (we don't aim to be "market neutral"); the decision to go short was based on signals that are generally rare[5] and have worked great in the past. That said, I won't keep insisting on something if it isn't working. Our quarterly "market model" is currently giving a flashing red signal for the quarter ending on September 30th – last time it produced this signal was at the end of Q1 2022, and it was followed by a 20% pullback in the SPX over the next three months. As of June 30th we have a short position on the SPY via put options spreads amounting to ~1.5% of our assets (which we may add to) and have closed all other shorts.

The stock market seems to be pricing in again that now that inflation has subsided, the Fed will soon cut rates. I have explained in previous updates why I don't think this is likely; rates indeed have stayed higher, but stock prices have *also* moved higher ("what the market "should" have done vs what it actually did" seems to be the theme of this update).

As always, I am available if anyone wants to discuss any of the above in more detail.

With warm regards,

For Phestos Fund, LP

[5] For the period 2016-2022, these signals would have indicated being short the market in just four quarters.

Nikos Angelopoulos

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