Frame Funds.

Investment Themes worth backing in 2022

A consolidating economy

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First words

2021 was a year of great challenge and opportunity. Challenges were seen at every turn, as world leaders attempted to navigate an environment where new strains of the virus were discovered often, and had an immediate impact on supply chains, travel routes and monetary and fiscal policy decisions. This was all while determining how all these decisions may impact inflation and the cost of human life if a poor decision was made.

Investment Themes 2022 breaks down our key themes for 2022 and beyond. These themes may be a continuation, an acceleration, or a change of a current trend. From page 6, we have included a number of tactical themes which we are monitoring to see if they provide us with a skewed reward to risk entry opportunity.

In response to the COVID crash of 2020, global central banks launched a synchronised response which resulted in a reduction of interest rates across the globe. Governments also launched aggressive stimulus packages which attempted to allow businesses to keep people in jobs, and support businesses as they emerged from COVID-19. These supportive measures were generally effective for each country, however the impact of COVID-19 on global supply chains was underestimated.

Due to some of the largest exporters in the world going in and out of lockdowns (China, emerging market economies, the United States and Europe), supply chain bottle necks were seen everywhere. These bottle necks resulted in domestic demand outstripping available supply.

This imbalance resulted in substantial increases in the price of goods. Inflation in the US is currently running at a hot 6.8% y/y.

With supply chains still bottlenecked, these price distortions are expected to linger a lot longer than forecasted. The focus will be if these input prices decline in 2022, and if businesses will pass these price declines on to consumers.

In our minds, the biggest winners for the year have been renewable energy & battery material companies. As mentioned in our Investment Themes 2019, this space offered huge opportunities then, and still does three years later. Year to date, PLS, SYR, VUL, LTR, ORE, GXY, TSLA and a basket of other smaller businesses, have experienced huge gains.

The focus for investors is now on the path of interest rates and asset purchases. Most central banks have stated that interest rates will increase from 2022, and asset purchases will reduce at the tail end of 2021, however how quickly that happens is important.

Looking ahead, our three core investment themes are: 1. Battery market consolidation, 2. Mid-cycle bull market, and 3. Inflation. Tactical themes are: 1. Alternative energies, 2. Blockchain technology, 3. Underinvestment in Oil & Gas.

Like we saw with our “2021 Investment Themes”, some themes play out quickly, some may never happen, while others may take years to play out. The timing of entry and exit is crucial to ensure we maximize the reward to risk of these opportunities.

We hope you enjoy reading these Investment Themes 2022.

Hue Frame
Managing Director

Theme 1

Battery market consolidation

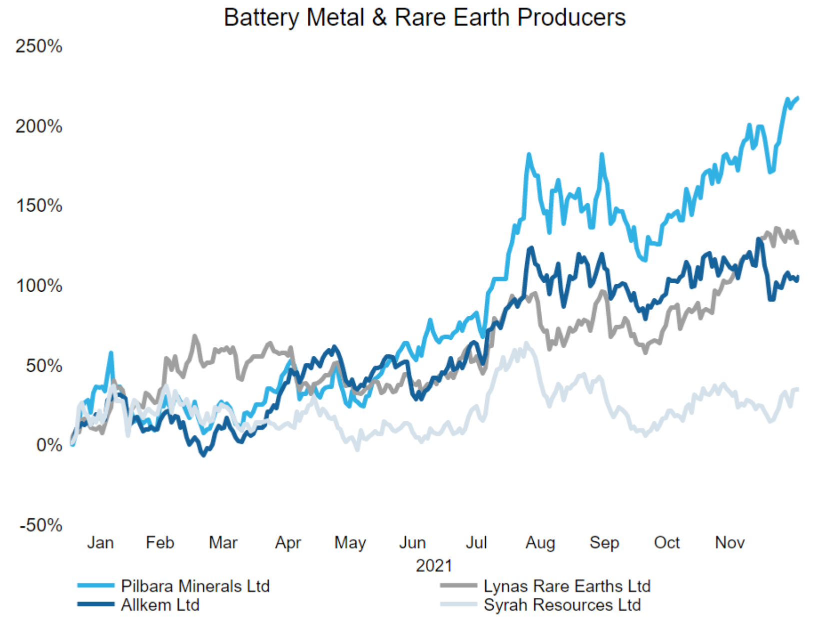
Looking back at 2019, we initiated coverage on the battery metals sector, and mentioned at the time the market had reached an inflection point. We noted that 'Recently, an inflection point has been reached on the demand side. Investors have become extremely bullish on Tesla's electric vehicle and battery market demand forecast'. We saw a market that went from being over-supplied with key battery components, to a market which was expected to be undersupplied over the next 5 years.

Two years later, we have seen the demand for these key components continue to accelerate, even as additional supply is brought to market. This is benefiting the companies that are producing these raw materials, Syrah Resources, Pilbara Minerals, Lynas Rare Earths and Allkem, have risen by 246%, 1038%, 322% and 230% respectively, from the 1st of January 2020 to the 24th of December 2021.

In our view, the next stage of this secular theme is the consolidation and integration, both vertically and/or horizontally across the supply chain. We have already seen this with a merger between Galaxy Resources and Orecobre (now named Allkem). This merger improves their production capacity, allows them to gain market share and at the same time, ideally improves their profit margins.

This theme can be further demonstrated by the recent agreement between Syrah Resources and Tesla Inc. They announced an offtake agreement with Tesla Inc to supply natural graphite from its vertically integrated production facility in the USA. This agreement locks in a price and the materials for Tesla Inc, and production capacity for Syrah Resources.

We expect that there will be further consolidation within the battery material producer & explorer space. In our view, it is prudent for the larger and more established companies, to acquire junior explorers with significant deposits. Also, a focus on acquiring other businesses that may operate within different parts of the supply chain, battery production facilities for example can be good business.



Source: Refinitiv Datastream/Frame Funds

Theme 2

Mid-cycle bull market

As economies recovered from the initial shock of COVID-19 in February 2020, global central banks and governments attempted to reflate their economies, which we believe they have managed to do. Now that economies have moved passed the initial reflation phase of the current market cycle, we now focus on the next stage of the bull market. In our view, this stage can be defined as mid-cycle.

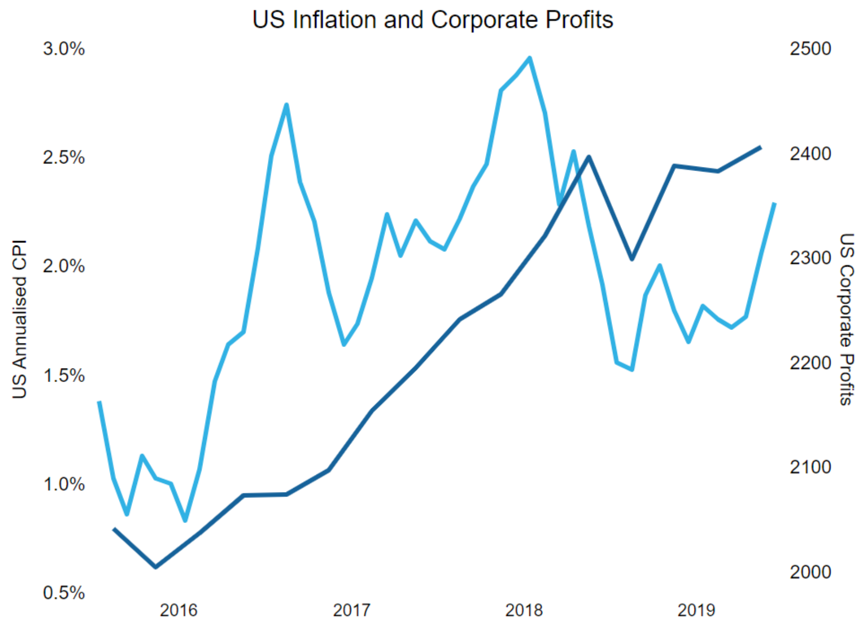
This is essentially where policy makers are restraining stimulus, the earnings cycle has picked up, demand is slowly rising (independent of policy), and economies are growing at above trend.

Historically, when equity markets are within the mid-cycle, we see mid to high single digit growth for equity markets (in 2016, the S&P 500 rose ~12%).

Currently the US Federal Reserve is restraining stimulus, by reducing their asset purchases by $30bn a month, with an expected end date early-to-mid 2022. After the wind down of their monthly asset purchases, they have communicated to the market that they may look at lifting interest rates after that time, however it is data dependent.

This phase of the market cycle can be challenging to manoeuvre, as on the horizon is the late-cycle stage. Generally, this is when policy makers surprise on the tighter side to restrain demand significantly. Equity markets generally underperform during that period.

Investors should focus on a pivot in policy from central banks which may be ahead of current market expectations. This pivot may indicate we are entering the final stage.



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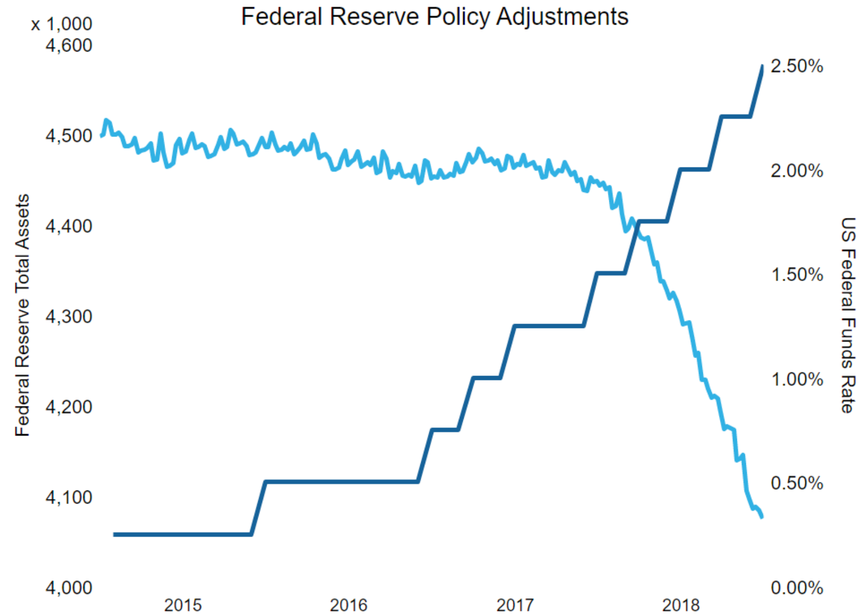

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Theme 3

Inflation

In our '2021 Themes' document, one of our 'tactical' themes was an inflation spike. We continued to cover its development over the course of the year in issues 2 and 10 of 'In the Frame' and it is now back as a main theme for 2022.

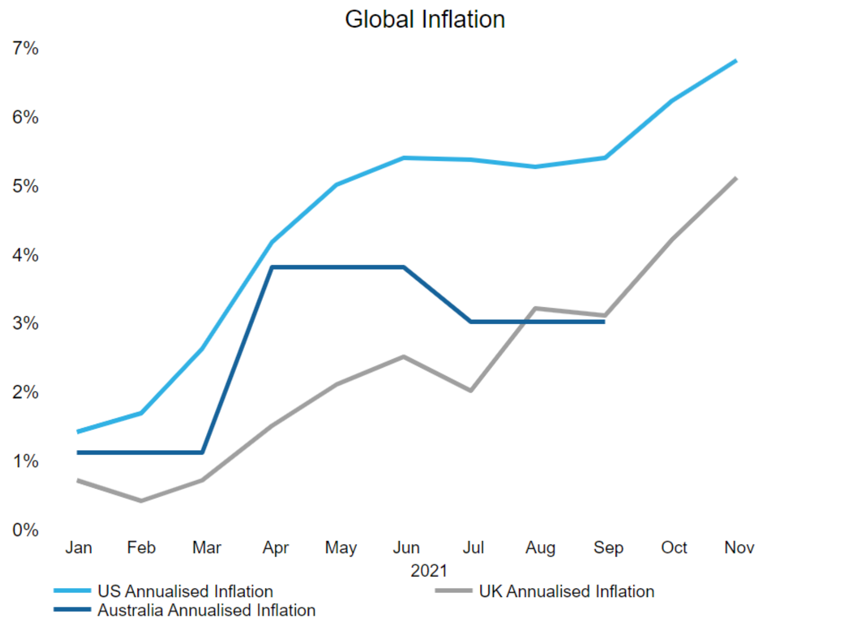
2021 saw sustained supply chain bottlenecks combine with elevated consumer demand and wage growth to fuel inflation to levels not seen since the 1980s. The CPI in the United States is now running at 6.8%, with the United Kingdom at 5.1% and Australia trailing at 3%. As gas shortages hit Europe, UK CPI numbers are expected to continue to rise. Australia on the other hand is comparatively behind, however the most recent CPI figures hail from a quarter Sydney and Melbourne spent in lockdown.

The battle for 2022 will be how global central banks decide to deal with inflation. Most seem content to push the inflationary envelope to ensure the economy is strong enough to withstand an increase in interest rates. The Federal Reserve have begun tapering, however, continues to reinforce that interest rate increases are disconnected from their tapering timeline. The Reserve Bank of Australia will re-evaluate their bond purchase program in the February meeting, however, have indicated they do not see the economic conditions necessary for a rate hike materialising until 2023/2024.

With this in mind, we believe we will see inflation remain at elevated levels in the United States and continue to increase in Australia and the United Kingdom. If this occurs and central banks sit on their hands, inflation will pose a real threat to the continued economic recovery in 2022. Consumer purchasing power will deteriorate, which would result in money being withdrawn from markets as the cost of living rises and wages lag. We will continue to closely monitor consumer and producer prices, as well as central bank rhetoric over the next 12 months.

There are a variety of options when positioning a portfolio for a high inflation environment. Real estate assets generally hold their value as rental income typically keeps pace with inflation. Investing in REITs (Real Estate Investment Trusts) can be a good way to get exposure to the property market without needing excessive amounts of capital.

Commodity markets also tend to outperform in an inflationary environment. This is because increased demand for goods flows down the supply chain and causes price rises in base production materials like copper and oil. Investments in listed copper and energy companies may be a good way to get exposure to this trade.



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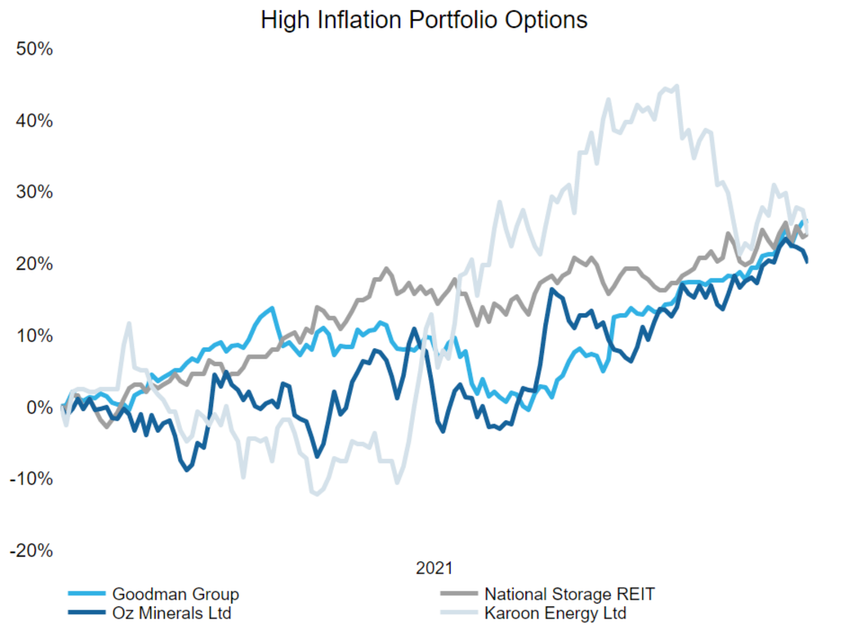

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Tactical Theme 1

Alternative energies

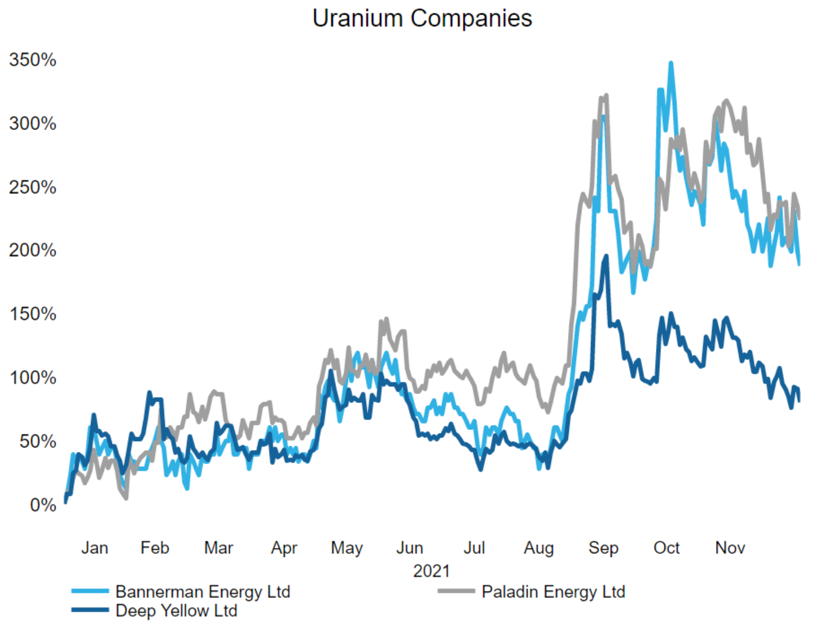
Alternative energy sources have been gaining increasing attention in markets, as governments around the world continue to demonstrate a strong strategic investment in these solutions.

The rising importance of environmental factors has built mounting pressure for large-scale reform in the energy space. As such, alternatives such as hydrogen, uranium, wind, and solar power are all seemingly being favoured into the future. This remains true, particularly as the cost of implementing the infrastructure for alternatives is somewhat high but is falling materially over time.

This is in contrast to existing energy sources such as oil and gas, where prices are expected to remain sticky throughout 2022 and potentially beyond due to a reduction in supply.

Many governments have responded to climate change pressures by introducing decarbonisation or carbon-neutral directives, typically paired with a target date. For example, Germany has pledged to have 65% of its power to be sustainable by 2030. Similarly in Australia, the Renewable Energy Target (RET), in conjunction with other policies have seen yearly alternatives growth of 11%. Each year, governments are committing to meet annual energy goals in order to satisfy global agreements and alike. As the pace of this theme quickens, governments are likely to intensify investment in these areas.

Looking forward, we can explore opportunities within the alternative energy space (uranium, wind, solar, hydrogen to name a few). Businesses that are focussing on these areas, are poised to reap the rewards of government infrastructure spending in their respective industries and the global energy transition.



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Tactical Theme 2

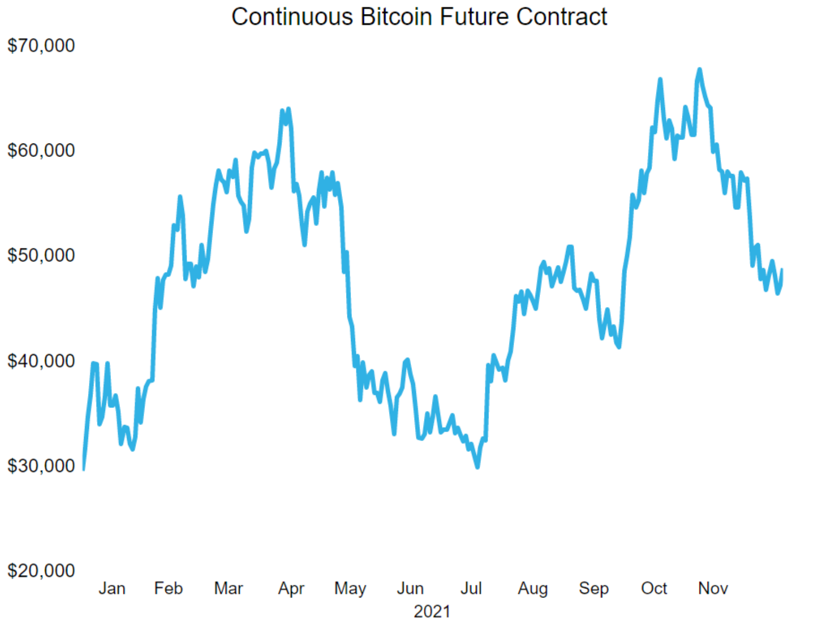
Blockchain technology

2021 saw continued normalisation of the cryptocurrency and blockchain space. Ethereum joined Bitcoin in having a standardised futures contract on the CME. Central banks stepped up their pursuit of digital currencies – China has already rolled out an e-renminbi (a digital version of the renminbi that can be accessed without internet, credit or bank accounts).

The US is conducting a review into the possibility of an e-dollar, while Australia, Malaysia, Singapore and South Africa are looking to implement a cross border central bank digital currency exchange program. Some countries like El Salvador have gone even further, making Bitcoin legal tender.

These adoptions are the first of many uses for Blockchain technology. Although Bitcoin, Ethereum, speculative coins and tokens receive a huge amount of media coverage, our focus is on the wider use cases for blockchain technology. Whether that be for the ownership of digital and tangible assets, tracking of share market trading approvals, music royalty tracking, anti-money laundering, personal identity or cross-border payments to name a few.

At this stage the breadth of use for blockchain technology is unknown, there are currently enough use cases, that it warrants being a tactical investment theme in focus for 2022 and beyond.



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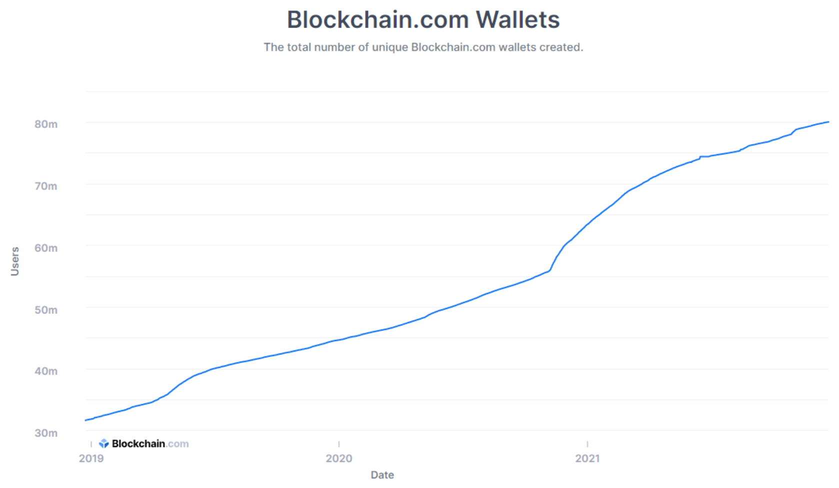


Tactical Theme 3

Underinvestment in oil & gas

The burgeoning importance of environmental, social and governance (ESG) factors in recent years has grasped global markets firmly, initiating a major structural shift towards 'greener' practices in several industries. This is typified by the global energy industry, with calls and commitments to transition to renewable and sustainable energy sources in the future. This has seen major reductions to upstream oil and gas activity (exploration and production).

As major energy firms realign their focus toward alternatives such as hydrogen and renewable electricity, strategic investment in oil and gas has weakened. Key energy firms around the world have decreased upstream capital expenditure in the face of these decarbonisation themes coupled with dividend pressures.

Over the course of the next decade, there is an expected US$600 billion shortfall in upstream capital expenditure for oil and gas. This notion is already materialising, where in 2021 total upstream investment in oil and gas fell 23% against pre-pandemic (2019) levels. Despite this, demand remained somewhat intransigent, which saw oil prices rise ~55% over the year.

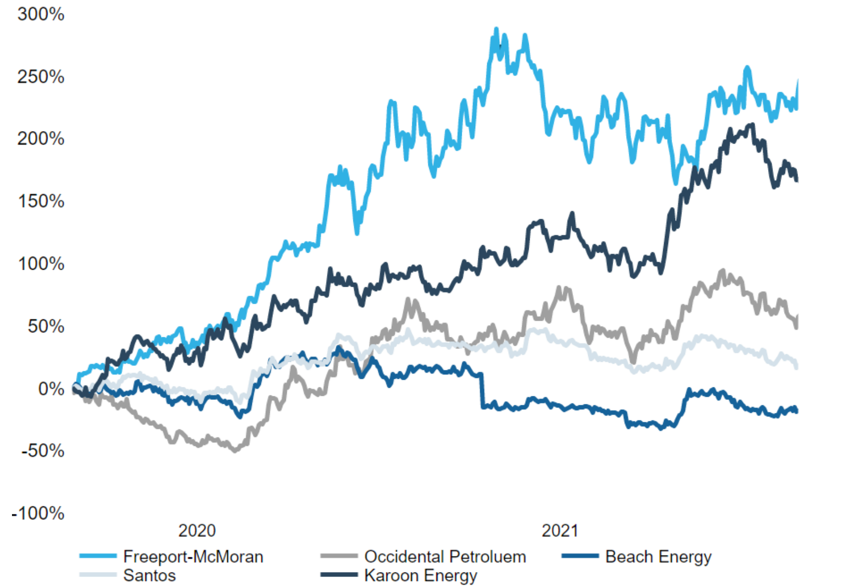
With major players such as BP expecting to reduce total production of oil and gas by 40% over the coming decade, and demand likely to remain relatively inelastic, energy prices are expected to remain notably high.

In our view, this reduction in capital expenditure will result in a reduction in the number of new oil discoveries, and additional supply being brought to market. In turn, this may provide continued support to oil and gas prices, which may make major oil and gas companies and junior explorers attractive investments through-out 2022 and beyond.

US Oil Price and Inventories

Source: Refinitiv Datastream/Frame Funds

Energy Companies



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