Katana Capital Limited
30 June 2023 Investment Report

Overview

Katana Asset Management Ltd ('The Manager') has completed a report on the performance of Katana Capital Limited's (Katana) portfolio for the 12 months to 30 June 2023. The Manager is pleased to announce the fund generated a gross investment return of 19.42% versus 9.71% for the All Ordinaries index. This represented a gross investment out-performance of **+9.71%** (before expenses).

Year Ending	Katana Gross Investment Return	All Ords Index
2006	9.20%	6.91%
2007	49.05%	25.36%
2008	-6.41%	-15.49%
2009	-23.57%	-25.97%
2010	24.54%	9.55%
2011	19.10%	7.75%
2012	-11.19%	-11.25%
2013	8.84%	15.47%
2014	26.78%	12.70%
2015	-1.57%	1.28%
2016	4.98%	-2.58%
2017	6.23%	8.54%
2018	26.27%	9.12%
2019	-0.43%	6.51%
2020	9.30%	-10.42%
2021	32.82%	26.39%
2022	1.13%	-11.06%
2023	19.42%	9.71%
Average	**10.81%**	**3.47%**

2023 Financial Year Review

The narrative throughout the 2023 financial year was largely shaped by the concerted efforts of central banks in combatting inflation. Every Consumer Price Index (CPI) print was center focus. Good news became bad news and vice versa. As it became clear that rates will likely stay higher for longer, investors en masse positioned for what's been termed 'the most anticipated recession in history'. Yet as the year progressed, the recession failed to materialize.

The fund started the 2023 financial year positioned defensively, following a violent 10% sell-off in June. As a recap, in the June half, the S&P500 had its worst period since 1970 and the NASDAQ the worst in its entire history.

Our assessment of the landscape at the time identified that the list of things to avoid far outweighed the opportunities we deemed investible. The fund moved to underweight *Financials* and reduced exposure in *Energy* and *Materials* as we saw a subtle yet swift shift in the rhetoric from inflation to recession. The fund was positioned overweight to the *EV/Decarbonization* thematic, as well as *LNG* and *Metcoal* based on strong underlying commodity prices at the time.

Putting pressure on our defensive stance, the market staged a solid recovery in July/August. In our view, investors were overly discounting headwinds of a recession, widespread earnings downgrades, escalating issues with Chinese housing and the ongoing Covid crises. In fact in August we wrote that the structural outlook is more challenging than at any time in recent memory. For this reason we became more defensive, adding to our cash balance despite a near 10% rally in two months.

Investors faced a challenging conundrum. On the one hand, the likelihood of a recession seemed to grow more certain as central banks persisted in raising interest rates, despite signs of economic weakness. On the other hand, virtually every investor, had foreseen and prepared for a market crash, or at the very least, a significant correction. Consequently, a considerable portion of selling had already occurred, leaving a substantial amount of cash on the sidelines waiting for opportunities.

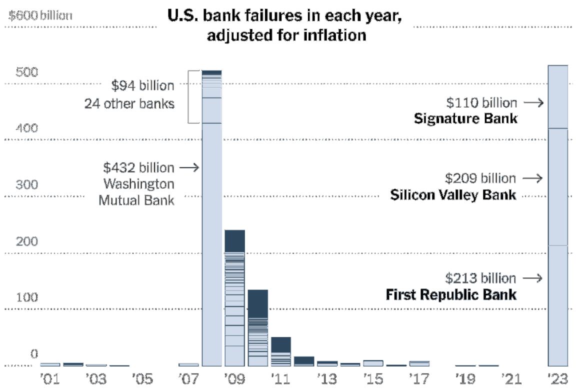
In September we saw the first of three distinct sell-offs for the year as the Index fell over 10%. The driver was US 10 year bond yields soaring nearly 60 basis points from 3.12% to 3.71%. Interest rate sensitive sectors were hit the hardest including Utilities (-13.8%) and A-REITs (-13.6%). This was short-lived as the market rallied +5% and +6% over the next two months. Perhaps this was an early indication of the magnitude of cash sitting on the sidelines anticipating opportunities to deploy.

Source: Tradingview, Katana Capital research

Around November we started seeing a change in sentiment driven by the belief that rate rises have largely run their course and that the market was past the 'worst of it'. Dovish comments by the Chair of the US Federal Reserve provided a sizeable sugar hit. This was not our base case. From our research we saw evidence that the fight against inflation had some time to run. But even more importantly, the impact on consumer spending and corporate profitability had not even registered. This viewpoint was vindicated as the market dropped near 6% in December after the US Fed re-affirmed that rates will be 'higher for longer' despite weakening economic data.

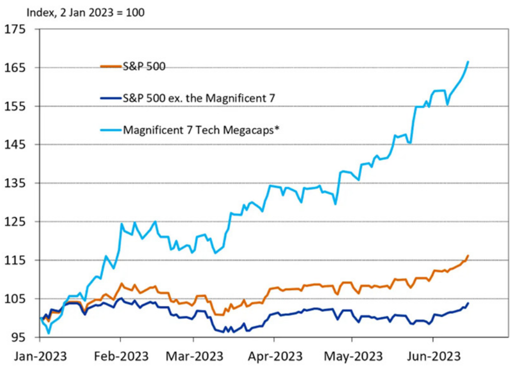
Counter to our expectations, the *Consumer Discretionary* sector staged a 9.8% rally in January despite the sector being most exposed to the inevitable decline in consumer spending. A series of strong but rear looking results from the large retailers buoyed the sector, and once again challenged the consensus viewpoint. The dilemma was once again 2-part. Firstly – the easier aspect; consumer spending could not defy gravity indefinitely: at some point it would have to rebase lower and impact corporate earnings. The more difficult aspect however, was gauging a) how much of this had been factored in and b) how much the 'market' may be prepared to look through this earnings valley to the other side. Accordingly, we were not prepared to chase the market.

In March, news broke of the Silicon Valley Bank collapse followed quickly by First Republic Bank and Signature Bank. Markets began to capitulate, quickly plunging 6% as investors started to assess how wide this could spread. However, regulators responded quickly, and remarkably the index finished the month almost square. Extraordinary when one considers that in just one month we witnessed three of the four biggest bank failures in US history, which combined were bigger than the 25 banks that collapsed in 2008.



Source: The New Year Times

Towards the last few months of the financial year, some of the most experienced and well-regarded US hedge fund managers turned bullish. And open interest in retail put options – which has proven to be a contrarian indicator more often than not - remained near record levels. At the same time the market staged an impressive but narrow rally in technology stocks fueled by momentum in *Artificial Intelligence* (AI). In fact for the half year ended June, almost 80% of the YTD return for the S&P500 was generated by just seven stocks – the "*Magnificent 7*".



Source: Factset, Russell Investments

Surprisingly given the difficult outlook at the start of the year, the index closed the year up 9.71%. The most anticipated recession has failed to materialize (to date) and the 'stale bears' are increasingly rolling over – they can 'bear' no more. Despite our average cash weighting for the year of 35% detracting from our performance, the investment team drew on every ounce of their 90+ years experience to generate enough bottom up alpha to not just match, but indeed double the index return. Not an easy task when over a third of the fund was defensively positioned in cash.

Outlook

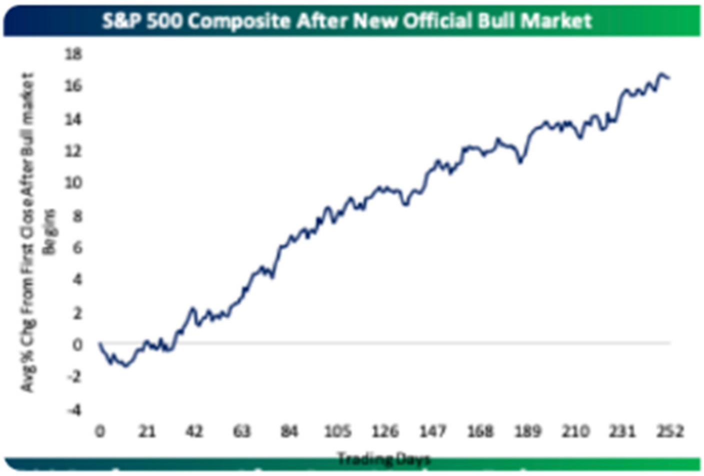
The outlook for global equities remains uncertain. In fact, there is a 50% spread between the most bullish and most bearish year-end estimate for the S&P 500, which is the widest in over two decades. That highlights just how confused the professional community is about the market direction.

In the short term, markets are driven by the marginal buyer. The marginal buyer more often than not is the aggregation of investors that change their view. This premise has given rise to the popular idiom '*markets don't peak until the last bear capitulates*'. In recent months, we have certainly witnessed some high-profile bears capitulate. But did they get it wrong, or have the pressures of short-term performance forced their hand? Our focus is not to be lured into false viewpoints, but to filter out the noise and assess the drivers.

Positive Drivers	Uncertainties
Fund manager equity exposure is low and cash balances high	Recession / Inverted yield curve highly indicative of recession
Record US buy-backs driven by under-geared corporate balance sheets	Inflation (impact on company margins)
Inflation moderating	Lack of guidance/outlook/EPS downgrade cycle underway
China commencing stimulus	Cost of servicing debt – spending capacity
Market behavior broadening and displaying overall strong price action – indices have recovered over 20%, cross above 200 day moving averages	North American regional banks under pressure / International credit squeeze
	Question mark on refi's for commercial property – look through for valuations
	Consumer spending under pressure
	REITS starting to gate funds

Positive Drivers

Market sentiment has noticeably shifted over recent months as the bears capitulate, and the viewpoint of a soft-landing gains momentum. Indeed, the technicals point to the probability that what we are experiencing is more than a bear market rally. That bullish sentiment has returned. In the US for example, the indices have recovered more than 20% (the threshold for a new bull market) and have crossed above their respective 200 day moving averages. This historically has led to strong performance in the months ahead.



Source: Bespoke Investment Group, Katana Capital research

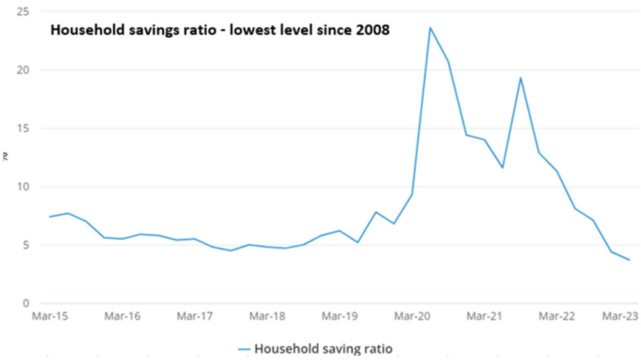
There are notable fundamental reasonings for this bullish turn point. It appears that central banks have gained control over their fight against inflation. Recent CPI prints in Australia and the US suggest inflation has peaked and is rapidly moderating. This of course reduces the need to continue raising rates and provides valuation tailwinds to equities.

The magnitude of any downside also seems limited as evidenced by the three pullbacks during 2023. The vast majority of fund managers are still underweight equities, which creates a base level of support as they look for opportunities to deploy capital. The latest rally, and sentiment shift, has made it increasingly uncomfortable for managers to be underweight and it is likely their hands will be forced to deploy into any weakness.

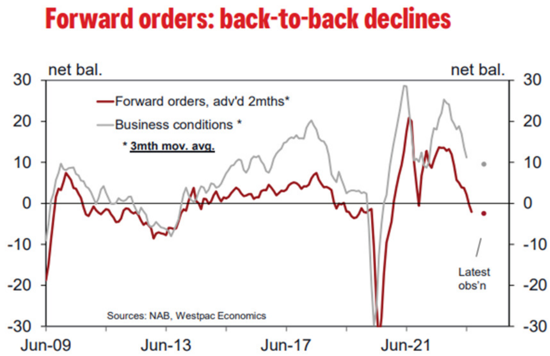
Uncertainties for the Year Ahead

In the US, the median time to recession post the inversion of the 10 year and 6 month yield curves, has historically been 11 months. We are currently sitting at around 13 months. It is important to remember that this is an average, as this lag has been as high as 21 months.

We are still in the infancy stages of seeing the full impact of the current rate rise cycle. During COVID, just under half of Australian mortgages were fixed at an average rate of 2.25%. As these expire they are resetting to rates between 6 and 7%. Consumers have been resilient to date but cracks are beginning to emerge. In June, Australian households had the biggest draw down on saving on record. A clear indication that rate increases and higher costs are starting to pinch. Further, retail forward orders a key leading indicator of economic activity, has seen its worst decline in history outside the pandemic and GFC. When you see historic records like these broken, it is difficult to conclude anything other than the view that trouble is brewing below the surface.



Source: ABS, Katana Capital research



Source: Westpaciq, Katana Capital research

Corporates are also getting hit by a perfect storm. On the input side, companies are experiencing cost inflation and higher debt servicing charges. On the output side, lower consumer spending equates to lower revenue and tighter margins as corporates fight for the sales dollar.

However, the fact that earnings have declined materially and will decline further from here is (now) not in dispute. The issue is how investors respond to this decline in earnings. Market sentiment has overtaken market fundamentals. The fundamentals continue to point to a slow down. But as 2023 has demonstrated, the markets can climb a mountain of uncertainty, especially if it is already priced in.

Strategic Positioning

There remains a limited number of sectors that we consider to have a favorable outlook. Top of the list continues to be:

- Copper – supply/demand deficit supportive of medium to longer term price appreciation
- EV / Renewables – global initiatives supporting shift towards electric vehicles and renewables
- Value laggards – bottom up fundamentally driven ideas

The Manager remains committed to maintaining a low risk diversified portfolio, with a strong focus on capital preservation and long-term compounding.

It’s difficult not to be cautious given the factors discussed above. In our view, certain parts of the market remain un-investible given the headwinds. Particularly retail and other consumer dependent sectors.

We understand an elevated cash level, particularly following a meaningful pivot in sentiment, isn’t sustainable. If technical indicators continue to strengthen, the fund will cautiously deploy capital. Of course this is a snapshot, if the facts change as we adjudge them, then we will change accordingly.

Corporate

Katana Capital Ltd finished FY23 with 33,460,417 shares on issue. During the period from 1 July 2022 to 30 June 2023, 567,510 shares were bought back on market and were subsequently cancelled. The shares were acquired at an average price of $1.08 with the price ranging from $1.05 to $1.11 per share. The buyback also provided liquidity and increased the underlying net asset backing for all existing shareholders.

Katana paid four quarterly dividends, totaling two cents during FY23. Once again, the dividends were all fully franked.

The Manager remains committed to outperforming its benchmark and rewarding shareholders with solid dividends. The Fund has declared and paid a 0.5 cents fully franked dividend subsequent to the year end.

On behalf of all of the staff at Katana Asset Management, we take this opportunity to once again thank Katana Capital's valued shareholders for your support.

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Katana Asset Management Limited

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