Katana Capital Limited
30 June 2024 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 2024. The Manager is pleased to announce the fund generated a gross investment return of 9.21% versus 8.27% for the All Ordinaries index. This represented a gross investment out-performance of **+0.94%** (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%
2024	9.21%	8.27%
Average	**10.72%**	**3.73%**

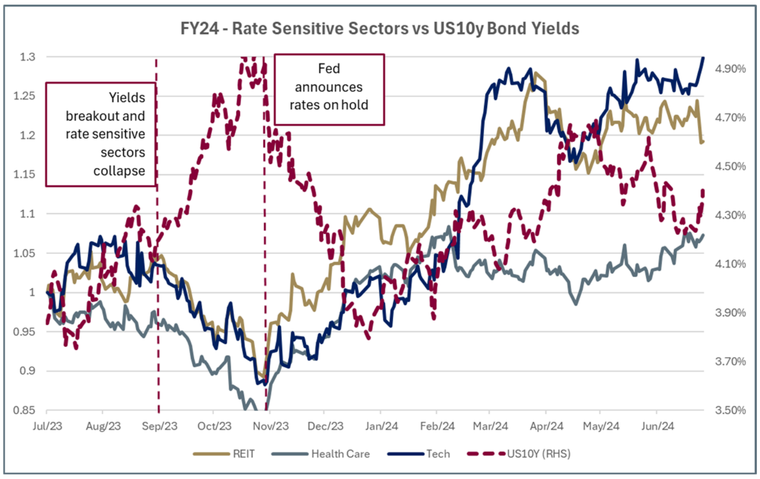
2024 Financial Year Review

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'*. As the year progressed, we certainly witnessed some high-profile bears capitulate, as the market increasingly leaned towards a soft landing and near-term rate cuts.

We found ourselves questioning whether the possibility of a recession was still an issue? The fact that earnings had declined materially and were likely to decline further was not in dispute. The issue was anticipating how investors would respond to this decline over the coming year. In July 2023, the market rallied nearly 3%. The technicals pointed to the probability that what we were experiencing was more than a bear market rally.

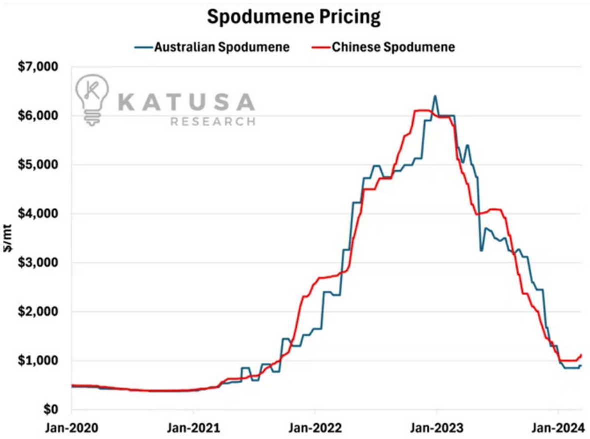
The investment team commented in last year's annual report, that if technical indicators continued to strengthen, the fund would cautiously deploy more capital. Accordingly, the fund reduced its cash holding from 27.7% at the start of the year to just 4.1% by year end. As the year progressed, it also became increasingly clear that key headwinds were likely to reverse. For example, we were at peak inflation and hence peak interest rates.

To obscure the soft-landing narrative, US 10-year bond yields rallied in September/October, taking out the highs set a year earlier. The market pivoted rapidly to the view that rates may rise further as stronger than expected economic data emerged. Good news continued to be bad news. This drove strong selling, with the index falling over 6% in two months. Rate sensitive stocks such as REIT's, Technology and Healthcare were the hardest hit with these sectors falling more than 10%. The selling was brutal - but short lived. In November the Fed signaled rates were definitely on hold, with potential cuts on the horizon. Bond yields fell as quickly as they rallied and the index climbed over 13% in two months led by these same rate sensitive sectors.



Source: Factset, Katana Capital Research

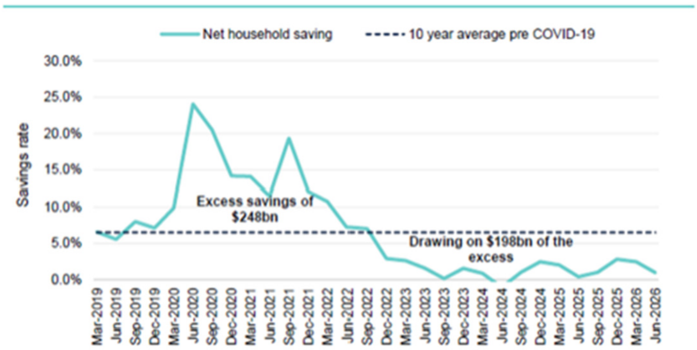
Concurrently, we witnessed a pronounced sell-down in the lithium price complex. Data emerged showing growing levels of lithium inventories particularly in Asia. Fear quickly spread that there was no longer a significant demand-supply deficit, as previously forecast. This was a startling reversal, and the spodumene, carbonate and hydroxide prices declined at an extraordinary rate. The lithium market is shallow and lacks transparency, so small fluctuations in volume or sentiment can create large price distortions. Our view at the time was that EV sales were on track and expected to accelerate, supply-demand forecasts continued to highlight notable deficits over the medium to longer-term, and with that lithium prices should rebound in due course. However, as the year progressed lithium prices continued to deteriorate and by January spodumene collapsed from a high of over US$6,000/t to below US$900. As more data points became available, we had to acknowledge that the facts had changed. Supply simply responded much faster than forecast. Accordingly, we have notably reduced our exposure in this space.



Source: Katusa Research

Financial stocks then rallied despite the prevailing sentiment, and closed out the year as the top performing sector with a 29% gain. This move was purely valuation expansion with earnings expectations actually declining by 2.2%. At year end the big four banks traded on an average price to book of 1.9x. The most expensive of these – Commonwealth Bank of Australia (CBA) – closed out the year on an historically high price to book value of 2.9x; almost double that of one of the world's largest and best performing investment banks - JP Morgan. The consumer discretionary sector was also one of the best performing categories with a gain of 22.7%. We actively monitored this segment for data which could suggest a pivot. Instead we saw Covid savings buffers eroding, household spending beginning to rebase, consumer confidence declining, and the effect of 13 rate rises over the past two years beginning to bite. Yet despite all these factors, retail sales continued to defy gravity and earnings in the sector continued to beat expectations.

Source: ABS, Barrenjoey Research



Source: ABS, MST Marquee

The fund's largest exposure for the year was resources which ended the year as the second worst performing sector; down -2.3%. This was partly driven by the rapid collapse in the lithium market. In the larger end, concerns emerged that the growth engine in China had well and truly run out of fuel. China's collapsing housing bubble coupled with an ageing population and lower capital expenditure, put pressure on commodities. There was some anticipation in the investor community about the magnitude of potential Chinese government support. However, with no meaningful stimulus eventuating, resources were particularly hit in the second half as the sector fell -13.4% vs the index gaining 2.4%. Despite the poor performance from the sector, the fund generated strong alpha from bottom-up stock selection particularly in copper, coal and gold.

In February we wrote in a monthly update that we believed a slow-motion train crash was emerging in the US Fiscal system. For example, the US deficit was growing at US$1trn every 100 days. In our simple assessment, the level of indebtedness had passed the tipping point. In our view it was and is no longer possible for the US economy to grow its way out of this position. At some point, the US Government will need to print money – permanently as opposed to Quantitative Easing (QE) – to pay down foreign and domestic debt. A permanent expansion of the money supply above the rate of GDP. This expanding US money supply would likely lead to a wholesale debasement of the US$. Accordingly, we meaningfully added exposure to gold through 6 high quality gold stocks. Gold commenced to breakout in March 2024 at a speed and quantum that surprised even us. And in April it rose above US$2,400 for the first time in history. We saw this as confirmation that central banks were increasingly nervous about holding $US reserves and instead increasingly choosing to add to gold reserves.

Source: Factset, Katana Capital Research

As the end of the financial year was nearing, persistent inflation especially in respect to wages, was front and center. The index remained in a holding pattern as investors weighed the possibility of further rate hikes by the RBA. At the time the market priced in a 45% probability of a hike in August. Fears subsequently dissipated with the June quarterly CPI print coming in softer than expected which drove a near 2% rally in the index on the day.

The past year has been amongst the most challenging in the funds 18 year history. We take comfort that despite being wrong-footed on selected macro viewpoints, the fund was able to generate alpha through our bottom-up stock selection process. Despite the challenges, the fund delivered outperformance over the index for the 5th consecutive year.

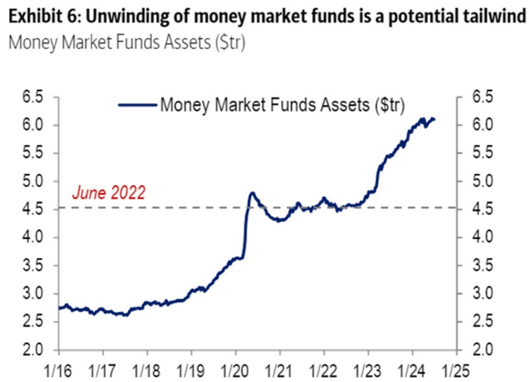
Outlook

In contrast to the past two years, there has been a recent pivot in the fact that bad news is indeed bad news! At the risk of repeating ourselves, the US is likely moments away from a recession. Economies globally are slowing, resulting in lower earnings across the board. What is considerably more difficult to ascertain, is how the market will respond in terms of how much has been factored in.

Positive Drivers	Uncertainties
Under-geared corporate balance sheets – particularly in the US	Persistent wage inflation putting pressure on operating margins
US buybacks re-commencing	Cost of servicing debt like to remain higher for longer
M&A activity picking up	Lack of guidance/outlook
Unwinding of money market funds	Possibility of US recession re-emerging
	High level of volatility in the VIX generally leads to something breaking

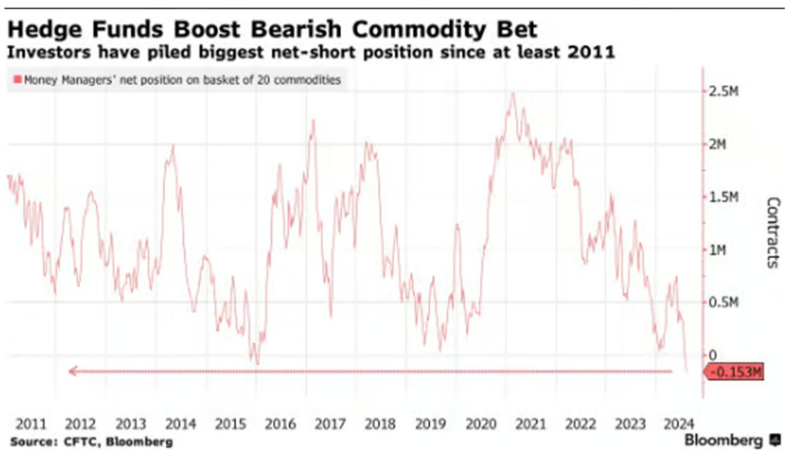
Positive Drivers
Since 2022 when the record rate hiking cycle commenced, investors have piled into money market funds. The flow has been driven by two factors. Firstly, following the rapid rise in interest rates, money market funds offered a tangible alternative to equities, especially on a risk-return basis. Secondly, investors globally began transitioning from equities into money market funds in anticipation of a weakening global economy. Following the weak US non-farm payroll print at the end of July 2024, investors poured US$98.6bn into money market funds in a single week alone.

In total, global money market funds have grown ~US$1.7trillion since 2022. When this eventually unwinds, it will provide a significant tailwind for global equities. Some of these flows should begin to reverse as interest rates begin to fall. This is a potential near-term catalyst with the market pricing in a 25bps cut by the Fed in August 2024 and 50bps cut in September. Locally, expectations are for the RBA to implement 4 rate cuts by the end of 2025. Additionally, if we do indeed see a soft-landing scenario play out, flows which poured into money market funds on recession fears should also unwind back into equites.



Source: BofA Predictive Analytics

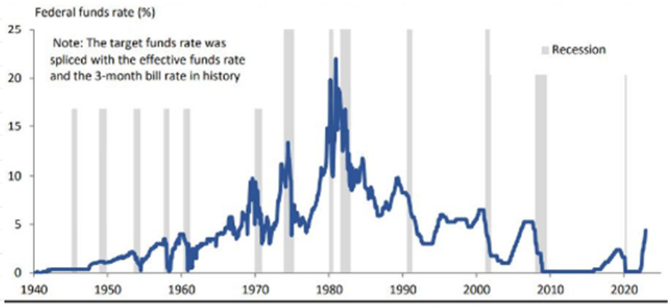
To fund the strong inflows to money markets, some sectors have witnessed disproportionately larger selling. To that point, some parts of the market experienced extreme outflows. Data compiled by Bloomberg shows that hedge fund positioning in commodities are at extreme bearish levels - the lowest in 13 years. This is positive on two fronts. Such bearish positioning often throws up buying opportunities in the near-term. Secondly, it also suggests that the market has already largely re-positioned in that sector.



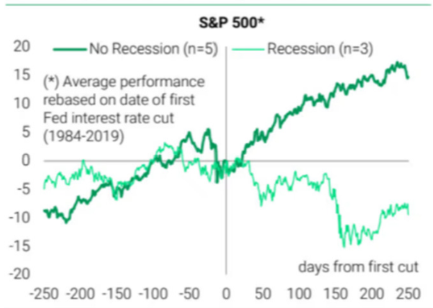
Source: CPTC, Bloomberg

Uncertainties for the Year Ahead
As discussed above we are most likely just weeks away from seeing the first rate cut by the Fed in the US. And in the not-too-distant future locally here by the RBA. At first it might seem logical that rate cuts are

positive for equity markets. Lower rates puts less pressure on consumer and corporate balance sheets. And force investors to take on more risk by moving out of money market funds into equities. However, the study of previous rate cut cycles highlight a clear distinction. Equities typically rally with rate cuts, but only if there is no recession. The study of previous cycles also show that the Fed’s first rate cut often marks the sustained rise in unemployment which typically indicates a recession.



Reserve Bank of St Louis NBER



Source: OECD, Bloomberg

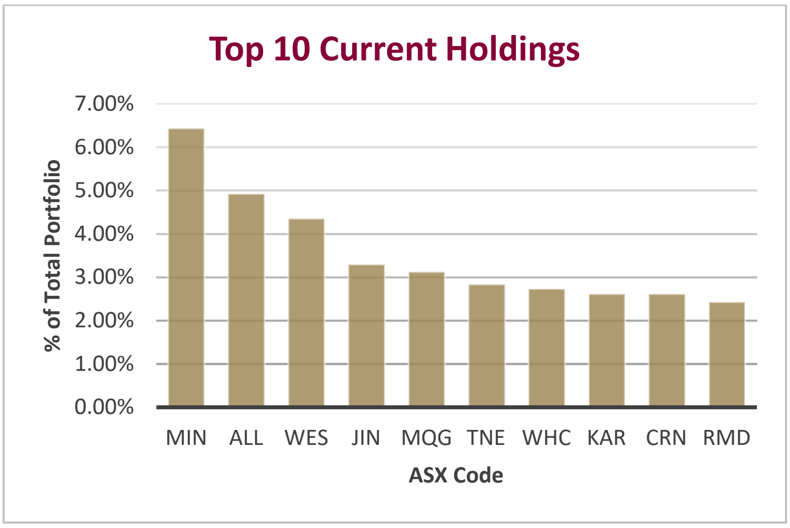
The uncertainty of course is whether the positioning for a recession has largely taken place. If we see only a mild recession, it is possible that investors simply look through the dip and commence buying. A more severe recession would of course trigger more prolonged selling. As we often quip, investing is part art and part science. The science is often the easy bit. Determining how the masses are positioned and likely to react is an art that often confounds the experts.

Strategic Positioning

We are conscious that our reluctance to enter the consumer discretionary trade has been a notable detractor over the past year. Yet we once again ask ourselves is the shoe about to drop? Has the average consumer actually remained as resilient as the headline numbers suggest? And perhaps even more pertinently at this juncture, do the elevated share prices in this sector offer further upside? We remain underweight consumer discretionary but actively monitor signals that suggest it is time to pivot.

The funds underweight posture in Financials continues to make sense - to us at least. We believe that this sector will at best provide market beta and at worst downside from the current levels. Banks are trading on above average multiples with below average growth prospects.

We continue to see upside in selected commodities namely gold, uranium, energy and coal. We are also seeing opportunities emerge across Health Care given the sector’s relative underperformance over the past two years. And we have established modest exposure to defense contractors.



Corporate

Katana Capital Ltd finished FY24 with 31,907,411 shares on issue. During the period from 1 July 2023 to 30 June 2024, 1,553,006 shares were bought back on market and were subsequently cancelled. The shares were acquired at an average price of $1.16 with the price ranging from $1.09 to $1.21 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 FY24. 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 the staff at Katana Asset Management, we take this opportunity to once again thank Katana Capital's valued shareholders for your support.

Romano Sala Tenna
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Katana Asset Management Limited

Hendrik Bothma
Analyst