S I A

Strategic Investment Advisors Group

Long Term Investment Fund

Newsletter

of August 2022

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Figure 1: **LTIF Classic EUR**
vs. MSCI Daily TR Net World Index EUR

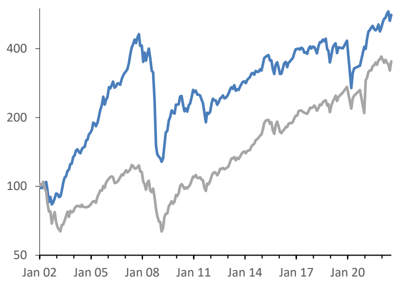
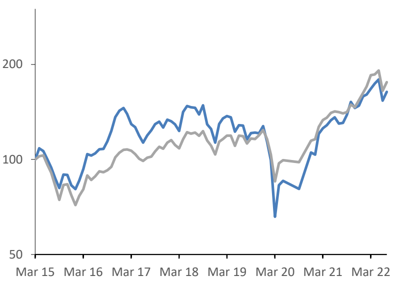


Figure 2: **LTIF Natural Resources EUR**
vs. S&P Global Nat. Res. Net TR Index EUR



"The path to long term success is rarely linear"

Michael Phelps
Most decorated Olympian of all time with a total of 28 medals

Overview of our funds

Table 1: **Net Asset Value - Net assets under management of our funds**

July 31, 2022	NAV	Δ 3m	Δ 12m	Annualized return (s.i.)	AUM *(in mio)*
LTIF Classic [EUR]	562.46	-1.3%	15.3%	8.5%	82
LTIF Natural Resources [EUR]	135.62	-5.8%	26.1%	1.4%	72

Source: SIA Group

Chronicle of a recession foretold

The LTIF Classic (+15% ytd.to mid-August) and LTIF Natural Resources (+14% ytd.) continued to perform relatively well in a year in which recession is possibly the most repeated word in financial circles. Samuelson's famous phrase "economists have predicted 9 out of the last 5 recessions" is once again relevant at a time of strong geopolitical tensions at a global level.

At SIA, we study, analyze, and even dare to predict the behavior of the world's largest economies' main economic magnitudes. Although we consider ourselves stock-pickers, we do this work to better understand the economy's macro and micro contexts, to avoid risks, and to take advantage of opportunities, although these are not the basis of our investments.

Our macro estimates (this time aligned with consensus) suggest that we are heading toward an economic slowdown that we should start feeling from the third quarter of 2022 onward, but whether this will end in a recession we do not yet know.

Whatever the case, **this is of little concern to us, as our investments are of excellent quality and our two funds, LTIF Classic and Natural Resources, will bridge any recession without suffering permanent losses.** In the meantime, the markets have corrected quite a bit and we have started reinforcing some positions at interesting prices… should they keep falling, we will continue to buy at then bargain prices. **Let us repeat the famous Warren Buffett quote that he "looks forward to recessions, because that is when Berkshire usually makes its best investments."** We will try keep up.

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In a nutshell, there are 3 main problems in the global economy: 1) high **inflation**, which is diminishing many households' purchasing power and therefore harming consumption and private investment. 2) The **Chinese economy**, which is only recovering slowly due to the government's zero Covid policy and the real estate cycle. 3) The **energy, oil, and gas prices… and generally, all fossil fuel prices**, which are the result of a decade of under-investment (aggravated by the Russian invasion of Ukraine) which are also damaging the purchasing power of households, and the costs/spending of most corporates, spreading through the whole economy**.**

Inflation and interest rates to normalize within a few quarters

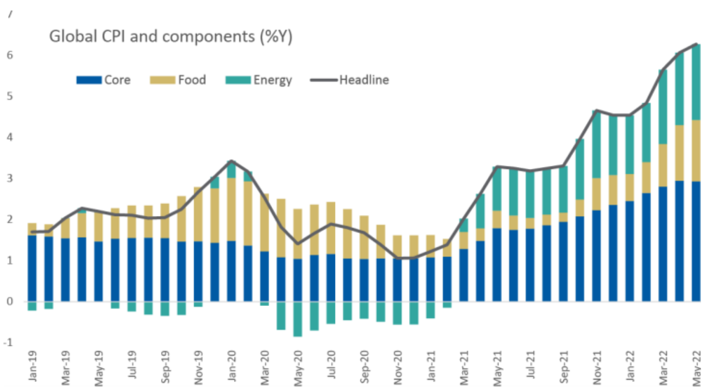
We are approaching the expected inflation peak, which, due to energy prices' comparative effect and their impact on many other products, will probably occur in 2H2022.

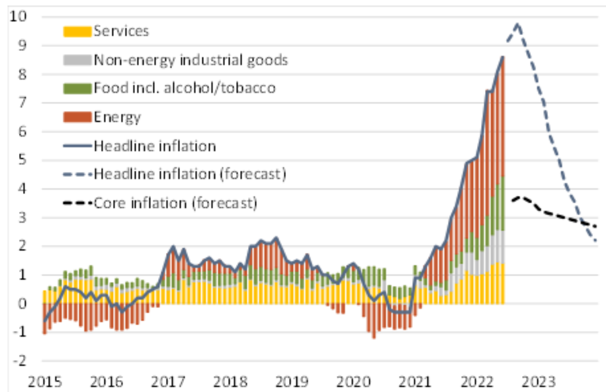
The U.S. inflationary problem is more on the demand side, which will gradually soften after rate hikes and automatic stabilizers (e.g., the dollar and energy). On the European side, the problem is more on the supply side, due to the Russian gas cuts, energy prices in general, and supply chain/logistic bottlenecks.
The market has a very clear view on what is coming: it expects high inflation for longer and an economic recession, although the two are mutually exclusive. If there is a recession, there cannot be high inflation. We suspect that the current animal spirits are biased toward pessimism.

We believe that inflation will moderate in the next few quarters to normalize by the end of 2023 due to:

1) the stabilization of energy prices (at high levels);
2) the ongoing improvement of supply chains, which has started by mid-year
3) high food prices will encourage more planting and harvesting in 2023 (i.e., a short agricultural cycle)
4) more stable fertilizer prices (at high levels also)
5) Europe not having a labor inflation problem like the US; and
6) the impact of interest rates and lower growth on demand.

To sum up, we think inflation will soon start moderating and that it will stabilize at 2-4% globally, which will probably occur in 2023-2024.





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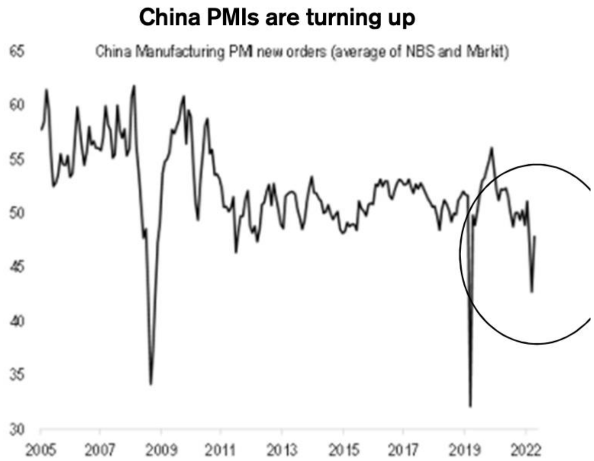
China starts to take off

The Chinese economic cycle is getting closer to an upturn, although the Covid-19 lockdowns have delayed this. M1 is growing at double digits (+10-11% in June) and a multitude of economic policies are in place to engineer a recovery. It is true that Covid-derived lockdowns still occur, and that the real estate cycle will require time and public support to recover, all of which mean that the Chinese recovery will require patience.

It is hard to truly understand the Chinese real estate cycle due to the country's vastness, the difficulty of calculating real affordability, and the authorities' multiple interventions to help accelerate or cool the cycle down. **However, over the last decades we have learned that the government has been able to control the cycle almost perfectly**, the only exception perhaps being the too high prices in TIER1 cities.

The **low inventory of homes for sale in China** is most reassuring since this is conducive to the sector's faster recovery. Although there are developers with debt issues and completion/delivery delays, all that is needed for the sector to stabilize in the absence of inventories (and the entire chain of financing and suppliers/funding linked to them) is public support and a certain recovery of demand.

We tend to think that China could have a crisis like that of the US or Spain in 2008 (GFC), but these crises are not comparable. There is no bubble in volumes, nor in inventories, or in conditions and/or financial institutions... prices are high (as they are also in Switzerland) and demand is weak while waiting for better times. **We believe China can manage its problems, with the risk being a delayed recovery rather than a 2008-style collapse.**



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Energy and commodity prices to remain high

Regarding energy prices, we maintain our view that they will remain high in the coming years, and possibly in the medium/long term due to 4 main factors:

> 1) The **lack of investments since 2013** in a sector where it takes a decade to bring new capacity.
> 2) The **energy transition,** which implies a strong increase in the demand for some commodities, mainly metals for the electrification of the world economy, while deterring investments in fossil fuels.
> 3) The increasingly dominant **ESG criteria**, which are preventing the required investments in fossil fuels and hindering many mining projects.
> 4) The **invasion of Ukraine** and its impact on fossil fuels and feedstocks.

In summary, our estimates place us in an economic slowdown in the coming months, say 2022 and 2023, from which China will emerge first, followed by the U.S. As always, this is a static forecast in a very dynamic world where things change rapidly.

That said, nothing changes for our SIA Funds: our two funds have quality and value, and we will take advantage of low prices to increase our future returns. We are convinced we will get through any recession without significant permanent losses.

At 6/30/2022, the Classic stood at EUR 530 p.a. +7% ytd. Mid-August we are at EUR 565 +15% ytd.

The LTIF Classic posted a positive performance in the first half of 2022, at +7%, well ahead of most indices. The MSCI World Index (EUR) as of June was -14%, the US SPX ($) index -21%, the European SXXP (EUR) index -17% and the Emerging Markets ($) index -19%. Although it is not fair to look at the indices in different currencies, doing so provides insight into how the market is performing for the local investor (the most representative). The conclusion is that we are satisfied with the Classic's performance in a very difficult period for most markets.

Industrials has been the Classic's best sector due to a strong exposure to defense and aerospace, followed by *salmon*, which has had a positive performance following salmon prices at record highs, and *energy* (oil and gas). All three sectors were above +20% in the first half of the year. The best stocks were Thales, Raytheon, Coca-Cola, Grieg Seafood, and the oil companies (mainly Suncor, Hess, Cenovus, EOG, and ConocoPhillips).

On the negative side, the Classic's worst sectors were *technology*, *infrastructure/cement*, and *mining*, with an average fall of 20%. In respect of stocks, we would highlight the sharp falls of Pandora, ASML, and Hudbay Minerals.

At the close of this Newsletter, the Classic has risen to EUR565 p.s., +15% for the year, ahead of most indices, and in line with our target of closing 2022 at around EUR575 per share.

If one day we get the targeted level exactly right, we may have to move to the trading business, because, as Graham said, **the short term is a voting machine… and only the long term is a weighting machine.**

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Classic's current IRR is 15%. Intrinsic value (IV): EUR852 p.a., 60% upside potential.
We are surprised about how strongly the Classic's intrinsic value has risen over the past few years. The updated IV stands at EUR852 per share, with an IRR very close to 15%, well above the levels reached back in 2020. How can the IV rise so much if the Classic does not really rotate its positions too much? The answer is simple, or perhaps not.

In sharp corrections, such as in 2020 and 2022, we tend to sell what is more expensive and buy what has fallen a lot (usually cyclical versus defensive, in general terms), which has a positive impact on the fund's IV. Our strategy of dividing the Fund into risk categories is paying off in these uncertain times.

The math is obviously clear, but with an important caveat: you cannot make mistakes (or minimize them, of course). *Average-down* only works as long as you have the right companies… *a small operational detail as we like to say.*

Historically, the LTIF Classic has traded with an IRR of between 12% and 17%, and at 15% it is therefore starting to be on the "cheap" side of its track record (20 years). If we do not make any major mistakes, the expected IRR after fees will be 13-14% going forward, equivalent to doubling the investment in slightly more than 5 years. Will we be at a NAV above EUR1000 p.s. in 2027/28? Based on the magical combination of compounding and long term, we are convinced that yes, we will be there.

The LTIF Classic. Capital preservation and decent return
As in most of our *Newsletters* we list the top 10 companies of the Classic, which account for about 50% of the investments. All of them are quality companies with good managers, strong balance sheets, and all trade with a large discount. This time, however, we want to highlight an unforeseen feature that lies hidden in some of these companies: problems (and the subsequent restructuring stories).

It is not something we have proactively looked for but, out of these 10 companies, 5 have or seem to have issues: Grifols, ISS, Sodexo, Unilever, and Reckitt are dealing with different challenges, and undertaking restructuring processes. Obviously, our opinion is that these problems are rather short term and not structural, and that these companies will be in a relatively short period out of the woods.

The Classic exposure to problems is not new and it highlights how value investors like us end up investing in troubled companies that the market hates, regardless of a sensible strategic analysis. **Market hate/fear, volatility, and perhaps a dose of extra risk are a price to pay to beat the market.**

As always, **the top 10 companies are evidence of the fund's strong business diversification**: in these 10 companies we have energy, aerospace, defense, blood plasma, cleaning, consumer products, pharmaceuticals, cement, banking, and catering. Note that the only concentration factor in the Classic is not visible here: energy/oil remains the fund's largest exposure, with 15-20% of the fund.

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LTIF Classic Top10 Holdings	
Thales SA	5,9%
Cenovus Energy Inc.	5,6%
Compass Group plc.	4,9%
Grifols SA	4,7%
ISS A/S	4,7%
ING Groep NV	4,6%
Sodexo	4,5%
Unilever	4,4%
Heidelberg Cement AG	4,2%
Reckitt Beckinser	4,1%
TOTAL	**47,7%**

Investment Case 2Q22: Cenovus

Cenovus is one of the largest companies in our two funds, Classic and Natural Resources. It is a Canadian oil company, the leader in oil sands, and quite large, with an invested capital of $34 billion. We believe the company is an excellent investment for the following reasons:

Quality Assets

Cenovus has premium (TIER1) assets and reserves, mainly in Canada, with over 50 years of proven and probable (2P) reserves (8.4 billion barrels), a production capacity of 800,000 b/d divided into 600,000 b/d of oil sands, 125,000 b/d of conventional oil, and 70,000 b/d in offshore oil.

Proven reserves amount to 6.1 billion barrels and are about 5% of Canada's reserves, and although officially the 2P reserve life is 30 years, it is actually in excess of 50 years, which is in contrast to most oil companies, which have about 10-15 years of 2P reserves.

Cenovus's assets are also in a low decline, less than 10% versus, for example, 30% for shale oil, which is important in terms of maintenance costs and spending. Cenovus also has strong know-how of in-situ technology (steam injection and chemicals), which has a positive impact in costs, capex and environment. Finally, Cenovus's assets can be developed in modular phases, which allow flexibility, process standardization, and efficiency improvements.

Low costs and reduced capex

Cenovus has worked hard to contain its costs and the latest figures put its operating costs at a low level of around $11-12 per barrel. The quality of the assets and the know-how developed over the years result in an average SOR (Steam Oil Ratio) below 3x, which is industry leading.

In addition, due to the company's huge reserves, it does not need to invest in exploration and development (F&D) as much as more traditional oil companies need to; consequently, Cenovus's future investment needs are somewhat lower. They do not need to find oil and investments will be smaller, modular, and somewhat front loaded. Keep in mind that F&D costs are around 10-15$ per barrel.

Finally, it should be noted that Cenovus has less than $2 per barrel of corporate expenses, which compares favorably with the industry and demonstrates that the group's management team is very focused on costs, profitability and thus minority shareholders.

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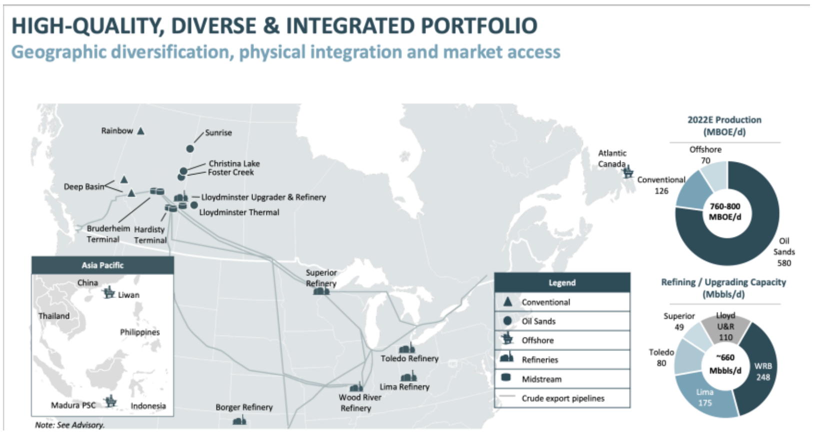
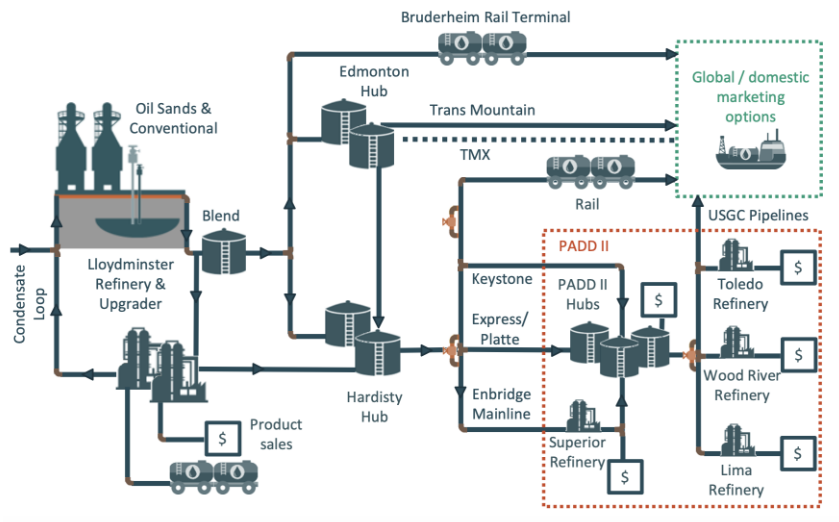
Integration and distribution as added value
Since Alex Pourbaix took the helm of Cenovus, the company has made an enormous effort to solidify the business via **vertical integration with major investments in upgrading and refining** (Husky and Toledo). Today, Cenovus has achieved its goal of becoming an integrated oil company with 660,000 b/d of upgrading and refining capacity.



The company has also made a major distribution effort, with refineries, pipelines, and warehouses in different markets, including rail transportation from Canada, as well as to the U.S. As a result, Cenovus has access to the east and west coasts of Canada and the U.S. Consequently, in the event of oversupply situations or bottlenecks in any part of the supply chain, it has sufficient flexibility to change markets and even absorb differentials.



Hope for the best and prepare for the worst.
We really like the way Cenovus' management team are preparing the company for tough times. Starting with their planning based on low oil prices ($45 WTI), almost at the marginal cash cost of the curve, followed by an ambitious cost savings and optimization plan executed in 2020-22, and finally, the corporate culture focused on strengthening the business and its profitability rather than looking for growth ventures.

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Oil is a long-cycle cyclical business, where it is easy to make mistakes due to the huge capital employed in any project. The barriers to entry are not enormous, although it is difficult to create scale, but the barriers to exit are very high, which means that adjusting supply when there is overcapacity takes many years. **In long cycles, it is key to having quality assets, low costs, integration, and a healthy balance sheet or the next crisis might take the company by surprise**. Cenovus has been working hard in this regard and is a much more resilient company than it was a few years ago.

Cenovus has also made some acquisitions at the bottom of the cycle (mainly stakes in Cristina Lake and Foster Creek, the Husky oil company, and part of the Toledo refinery, among others), which shows a management team focused on generating value, given that it is normal for the sector to buy when things are going well and not the opposite, which is when value is generated.

Good balance sheet and capital allocation

As we have already mentioned, an oil company's balance sheet must be healthy to cope with the cyclicality of the sector, which is long term on the supply side. In recent years, Cenovus has made a significant effort to do so, and the net debt forecast for 2022E is around $4 billion against an expected EBITDA of $22 billion, with a very comfortable and well-structured average debt maturity over time.

In line with the industry, Cenovus has been moving toward a far more shareholder-aligned allocation of resources and has committed to paying 100% of FCF, using both dividends and share buybacks, when the net debt falls to normalized levels. Financial discipline and shareholder-friendly capital allocation are two themes that again reveal the quality of the company's management team.

Why is Cenovus a good business?

- Good assets and long-lived reserves in a sector where exploration is becoming increasingly difficult and costly.
- Good management focused on profitability and aligned with its shareholders.
- Culture: its financial objectives are focused on costs/returns and the maximizing of its shareholder value.
- Resilience: the company's integrated low-cost model, flexibility, and strong balance sheet mean it can withstand crises.
- Growth potential: due to higher oil prices, CVE can easily accelerate its growth to mid-single-digit levels.
- Good margins and returns: at an oil price of $80 per barrel, the company generates an ROIC of 10-12%. It currently does not need to explore for oil.
- Strong balance sheet, which is a necessity in this industry with its cyclicality and sharp downturns.
- Clear plan for sustainability and zero emissions by 2050.

Why is Cenovus a good investment?

- CVE stock is still well below the CAD35-40 levels of 2011-2013. It trades at CAD22-23.
- CVE trades at 1.0x Enterprise Value over Invested Capital, below the historical median of 1.4x (historical range: 0.5x-2.5x). Trades at 1.25x book value versus the historical median of 1.5x (range is 0.5x-2.5x).
- Free Cash Flow of $6.5 billion in 2022E vs. market cap of $42 billion. 15% Free Cash Flow Yield
- IRR of 14-15% and IV of CAD35-40 per share

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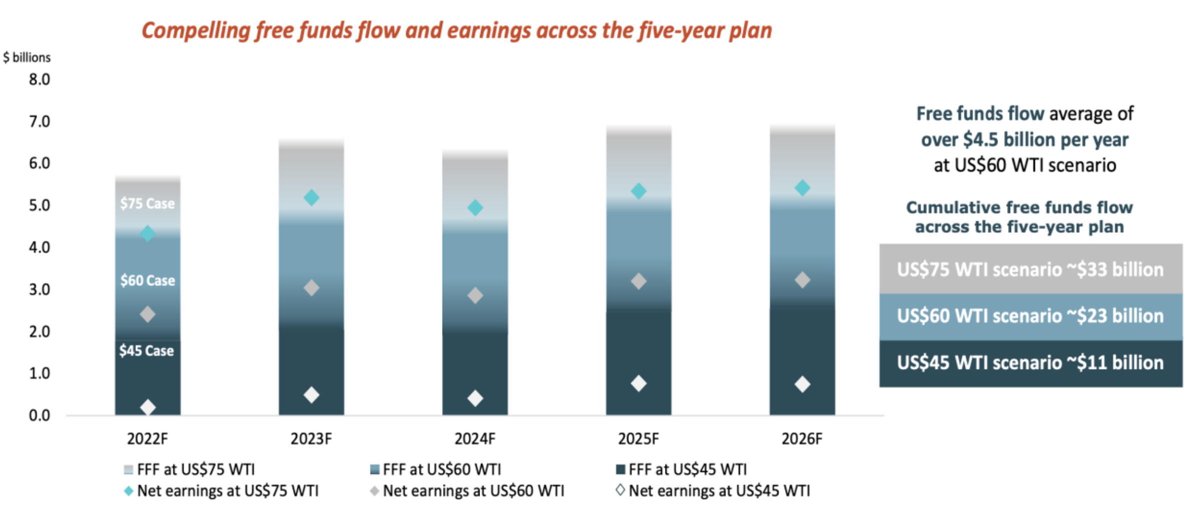
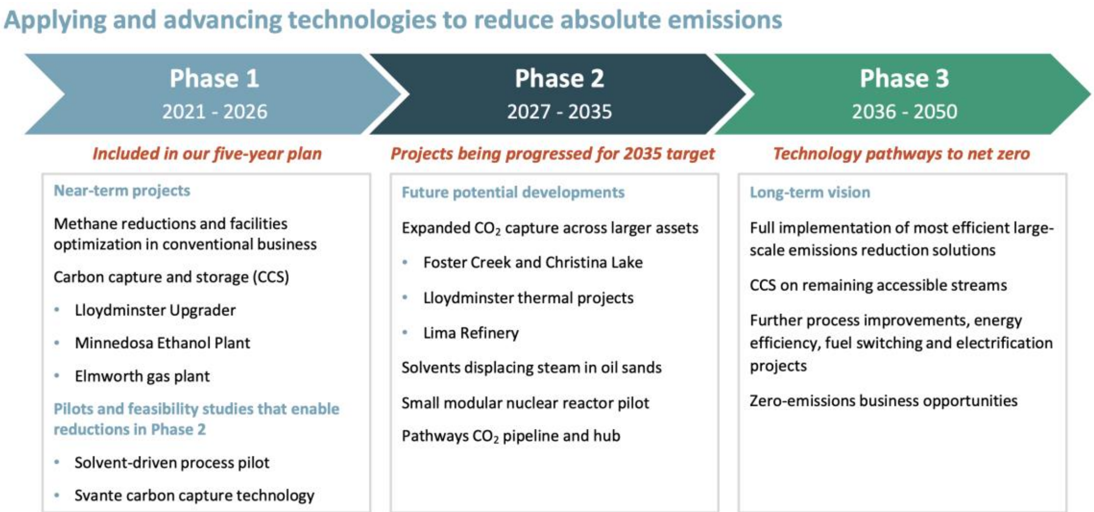
- In our oil price scenario, CVE should be an excellent investment to the end of the decade.



Last but not least, Cenovus (and the entire Alberta oil sands industry) is working hard to accelerate its goal of zero emissions by 2050. The investments required will be significant, but not very different from the rest of the sector, so that the costs and capex necessary for this transition will be passed on to the final oil price in the long term (all projects must already include these costs and pass them on to the required oil price for the project to be carried out).

The most important in terms of amount is perhaps the CCS systems, which could reach $100 billion for the Canadian oil sands, and that Cenovus has joined the working group, which, together with the Government, will design these systems.



LTIF Natural Resources. Good start to 2022 and a very long cycle ahead.

The LTIF NR fund closed 2021 up +41% and has ended the first half of 2022 up +4% to €125 per share, (valuing our investments in Russia at zero**).** As a summary of the first half of the year, we would highlight the **good performance of oil & gas** (and fossil fuels in general) **and agri-food companies**, versus the **disappointing performance of mining companies and infrastructure**, which are more concerned with the recession and cost inflation than with medium and long-term prospects.

The energy portion of LTIF NR, which has oscillated around 45-50% of the fund's weight has had a stellar half year with a +45% increase on average, followed by agri-food with +15%. On the negative side, as mentioned above, mining companies (30% of the fund) fell by 8% (-11% if we include Russia), while infrastructure (12% of the fund) fell by 20%.

The following companies are highlighted for their outperformance: Suncor, Occidental, Hess, Cenovus, TGS, Grieg Seafood, Norway Royal Salmon. On the negative side we would highlight the disappointing performance of Kazatomprom, Hudbay Minerals, Metso Outotec, Heidelberg Cement, and Vidrala, plus the three Russian companies that we have valued at zero (Gazprom, Surgutneftegas, and Norilsk Nickel).

By mid-August, the fund has recovered significantly and stands at EUR139 per share with an appreciation of 14% (+22% adjusted for Russia, where we are confident in recovering at least part of the investment).

The LTIF Natural Resources trades with an IRR of 14.5% and an average cycle IV of EUR210 p.s.

Thanks to the increased volatility in the past few months (we tend to sell what goes up and buy what goes down), **the fund's Intrinsic Value has made an interesting jump to EUR210 p.s. with an IRR of 14-15% at current prices.**

The strong volatility seen in 2022, combined with the low correlation among sectors/stocks have allowed us to buy copper companies cheaply, for example, whilst selling other investments at much higher prices. It is true that our trading is slow and very gradual, but the mining sector has corrected a great deal and there are excellent buying opportunities.

The updated Intrinsic Value does not include our 3 Russian holdings which should give us back some extra points in the future once the dust settles. Remember that the valuations of the companies in the fund are based on medium-cycle assumptions, which are extremely conservative. **If we were to use peak valuations (versus mid-cycle) of commodities, it would be easy for us to trade at EUR300 p.s., which we believe we will reach within a few years, as we are convinced that we just entered in a long-term up-cycle, which has barely begun.**

Brent has fallen below $100 per barrel (45% of the LTIF NR invested in energy, oil and gas).

Brent reached levels of between $130 and $140 in March, following the Russian invasion of Ukraine, and then started a downwards trend to levels below $100. Two factors have bolstered oil supply in the short term, 1) following Biden's visit, Saudi Arabia has raised its exports by 1 m b/d; 2) sales from the strategic reserves of several countries (especially the U.S.) are equivalent to >1 m b/d. These 2 m b/d have allowed the supply-demand balance to normalize a bit, which is good news for everyone.

Great! All sorted, yes? Well, maybe not so much. The sale of strategic reserves runs out in October, and these will have to be refilled at some point, while Saudi Arabia is producing at very close to full capacity levels with the IEA saying that the global spare capacity is down to 2 m b/d. Historic low vs. a volume of about 100 m b/d of demand (2%).

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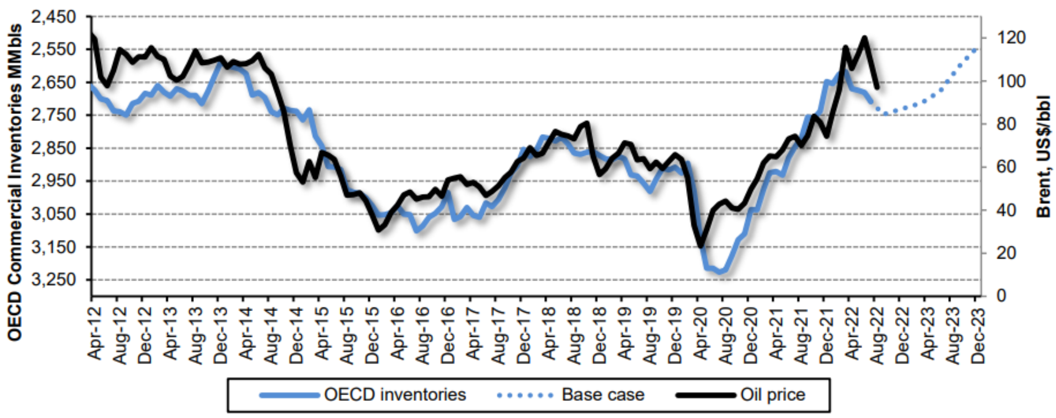
The truly important even of 2022 is the Russian invasion, which is going to have long-term effects on the Russian oil production capacity, as most other variables are running as expected. Declines, lack of spare capacity, lack of investment, the energy transition, and the impact of ESG on new investments mean that the sector is inexorably heading for a long cycle of high prices.

$100 per bbl. should be enough to do business in the sector, but who dares propose an oil project to a board of directors? Given that most oil projects are long term (15 years+), they cost billions, oil demand will peak within a decade or so, sustainability is a big challenge etc... $100 is perhaps no longer enough to incentivize them. We possibly need higher prices, stability, and time to develop new ESG-friendly oil projects and since there is no room to maneuver (the industry is at full capacity), we are entering in scenario of sustained high prices with large spikes if problems arise in oil producing countries, which are prone to many many challenges.

The following graph reflects what we should expect in 2022 and 2023. Inventories have increased somewhat, allowing prices to fall thanks to the US (strategic reserves) and Saudi Arabia (extra effort), but neither is sustainable in the long term. Supply remains constrained (decline, lack of investment since 2013, no spare capacity, Russia, under-investment due to a fear of peak demand and ESG) and demand will continue to recover even during an economic slowdown (jet fuel is still 2 m b/d below 2019). This implies an undersupplied market and, therefore, lower inventories.

We foresee high prices, and if the world continues to underinvest, we could reach a much more dramatic situation in the future. Let's hope this does not happen.

EXHIBIT 5 : **Current spot prices reflect current inventory levels. We expect oil prices will stay within the $90 range in 2022 based on current oil inventory projections**



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Copper: lessons from Atalaya Mining (and most mining companies)

Atalaya Mining published very weak 2Q22 results due to two main issues: the strong cost inflation (electricity, diesel, explosives, materials, etc.) and the drop in copper prices from $4.5/Lb. to $3.5/Lb.

We asked CEO Alberto Lavandeira what copper prices should be to start a new copper project today. He replied that at $3.5/Lb (current spot price and incentive for consensus) almost no project is profitable worldwide, except for the Congo and some existing TIER1 deposits. And he did not stop there: **he also said that according to his calculations, at least $5/Lb is the incentive price for new mines.**

There are two very relevant problems in our opinion. The first is the regulatory/tax instability and licensing issues in many countries (like Peru, Chile, Indonesia, Zambia, Congo, etc., but also in the USA, Canada, Spain, UK, etc.). The second problem is the strong inflation in capex and opex, with the ever-rising environmental constraints.

The reality is that there are identified copper brownfield and greenfield projects only until 2024/2025, but thereafter there is a significant gap in new projects. Even Atalaya is having problems obtaining the Touro project permit in Spain. How are we going to make the energy transition without the main metal needed for electrification? Copper prices need to increase a lot and stay up for many years to incentivize supply, the only solution for the problem.

Salmon prices have corrected somewhat but remain high at 75 NOK/kg (10% of LTIF NR).

We were in Bergen for the most important salmon conference in Norway and reviewed our estimates. The picture does not change much: **good product, growing demand (7-8% per year at flat prices), and limited supply.** Theoretically, high prices incentivize new supply, but there is no way to bring new supply in scale.

Aside from new licenses and post-smolt strategies (2-4% supply growth), there only 2 ways to increase supply: off-shore farms (long term, very little volume in the next 5 years) and on-shore farms, which, in our humble opinion, are not profitable at current costs and will neither produce significant volumes in the coming years.

The sector thus looks very attractive in the medium term, and thus we will remain invested in it, depending on the valuations. There is nothing very new to report, which is good news.

Infrastructure (15% of LTIF NR) has started a long-term upcycle, and we will continue to seek exposure.

At the moment, we have 3 themes within infrastructures: cables, cement, and mining equipment-services. The first half performance was negative for cement (recession and costs), mining services (recession), but positive for cables (Prysmian and Nexans raising guidance).

Nothing very new here either, Buzzi and Heidelberg are trading at deep discounts due to recession fears, so we continue to buy patiently. Cable companies have extraordinary int-takes and backlogs, and will grow significantly in the next few years.

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It is not inflation and/or recession…. It is energy!

Investors have been worrying over the spring and summer about the twin problems of inflation and recession. It's a reasonable worry inasmuch as these economic phenomena tend to have a negative impact on investments.

But worrying about these phenomena may not be a particularly productive exercise. If we don't know how severe the recession will be, how long it will last, and how it and the inflation will be resolved, there is not much we should do in respect of our investment portfolio (let alone the fact that recessions and inflation affect different investments in very different ways, not all of which are easy to predict).

It was J. M. Keynes who famously said that "***economics is a difficult and technical subject, but nobody believes it***." Since Covid turned many people into expert virologists overnight, the current economic situation similarly allows many people to make strong assertions with regard to recessions or inflation. Nevertheless, inflation is an extremely complex subject, arising from many different (even contradictory) sources, which even the best minds in economics cannot adequately comprehended. It does, however, lend itself well to simplified narratives, with the narrator usually projecting his/her prejudices.

Consequently, many people who dislike our market-based economic system argue that inflation is due to greedy corporations' increase in profits margins. This may fit a pre-conception of corporations as evil entities, but it does not really explain why such evil doers waited for 40 years to do their bad deeds. Conversely, people who tend to be owners of capital decry central banks' policies of "easy money" as the obvious source of inflation, although they do not care to explain why this causality did not work during the last 14 years. Paraphrasing Milton Friedman, we could say that "*inflation is always and everywhere a very complex phenomenon."*

Energy: fossil fuels are needed to support the energy transition

We do not want to increase the amount of hot air spent on the subject, thus contributing (if marginally) to mitigating climate warming. But there is a field that we know well and which we believe has a very important role to play in the coming realities of inflation and economic growth - energy.

We realize that in every newsletter we write about this subject, but it is not only extremely important, but its critical situation is also going to last for a while. Its importance for the world and, therefore, for investors cannot be exaggerated.

Energy companies may well represent less than 10% of the stock market, but **without abundant, affordable energy, all other economic activity slows**. Start with the most basic: food production. **A full third of the world's population exists, because fossil fuels provide fertilizers**. Without them, even if we were to till the whole world, fewer than 5 bn. people would survive. Some ecologists seem to believe that that figure is more than enough, but they probably don't count themselves and their families among the 3 bn. surplus people.

However, not only fertilization is important: the fields must be worked and harvested using machines, and without efficient transportation, food cannot be taken from where it grows to the cities where we live. 100% of the food we consume is transported in vehicles running on fossil fuels. There is currently no alternative, nor will there be one for many decades to come.

We should also consider the "clean" parts of the economy. How many tech companies can operate without data centers that consume enormous amounts of energy? And how much electricity can be produced and distributed without copper? Yes, copper mining's largest cost is energy. And so on... **The only reason, from a physical point of view, we are richer today than 300 years ago (and live almost twice as long, by the way) is that we have abundant and affordable energy**. Without it, there is no economic activity as we know it. Our wonderful technological world works on (and only on) the basis of plentiful, affordable energy.

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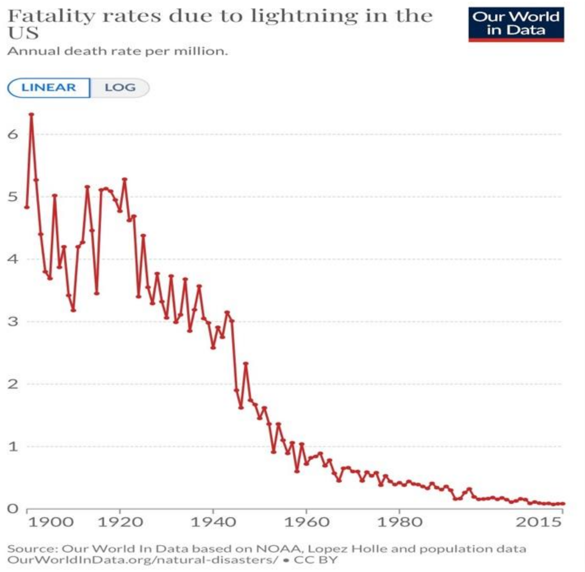
It has, of course, been pointed out that the burning of fossil fuels, which forms the basis of our energy system, releases CO_2. In turn this increases our atmosphere's "greenhouse effect," which increases the planet's temperature. We are not going to enter the debate on how much the temperature is actually increasing, how much of that increase is due to the increase in atmospheric CO_2, and how much of that increase in CO_2 is due to human activity. The answer to the above questions is probably something, but less than you read in the newspapers. We are simply going to describe what is happening, what's going to happen over the next few years, and its impact on investing.

[Below, a bit of humor on this very serious subject, but shows how the press often represents these facts:



Unfortunately, this misinformation is rather common.]

Today, the world is on the verge of not having enough production capacity for the energy it requires to continue normal economic growth. The energy system needs constant reinvestment (oil fields deplete, hydroelectric dams become silted, nuclear plants have a limited useful life) to continue to provide us with the means to produce the goods and services we need. **And the world has been underinvesting for the last 10 years**. Since these are long-term investments, nothing happens in the first few years of underinvestment, as we can coast along on the strength of the previous investments. However, after a while, reality catches up. And this is where we are now.

In past cycles, the underinvestment has been motivated by the mediocre profitability of previous investment booms, and this is usually fixed in a few years later, as soon as the situation is recognized (i.e., as soon as energy prices rise). All this process takes time because investments take many years/decades to build. That's why the energy industry has been subject to boom and busts cycles for the last 100 years, but has always delivered in the end.

Today, we are in this typical situation, but with a twist. The typical boom/bust came from the overabundance of shale oil investments during the 2012-2016 period, which created an excess production of oil. This excess crashed the prices, eventually stopping new investment. So far, this is typical of the industry. **The current twist comes from what has been dubbed "ESG." The perceived need to work on a replace-**

ment for fossil fuels has been translated into a decision to boycott conventional energy, although replacements are not yet ready. Further, “alternative” investments are creating more problems than they are solving.

Renewables need a back-up

To take a glaring example, Germany has in ten years invested the incredible amount of €550 bn in renewable energy (reminder, a large nuclear plant costs less than €20 bn). Nevertheless, it’s totally dependent on imported natural gas and coal. Why? Because the wind stops blowing and the sun does not shine in the winter. No matter how much wind and solar you install in Europe, you still need a full energy production capacity when these two stop producing.

In reality, Germany currently has two energy systems: the renewables-based one, and the traditional one, which is used when the former doesn’t work. The problem does not arise from this system: Yes, it’s a lot of money, but Germany is rich and can afford to bury hundreds of billions in a system that emits less CO_2 emissions when it’s working. The problem is that it has not invested in the traditional system (in fact, it de-invested in nuclear), which means that when the renewables are not sufficient, there is too little energy. Something similar has happened in most of the other European countries, especially in the U.K. and Spain.

Politicians are lost in translation (and in transition), but we are seeing improvements

The Ukrainian war, its associated sanctions, and countersanctions have all aggravated the situation. But the dearth of investment is a reality that is not being fixed, which is worse. In many cases politicians are doing exactly the opposite of what’s needed: energy is expensive, because there is too little of it. The solution is therefore to produce more and consume less. Politicians, however, find it easier to demonize producers (windfall taxes!) and to subsidize consumers, discouraging supply and encouraging demand.

It’s hard to see how this is going to improve the situation before it deteriorates quite a bit more. Nevertheless, mentalities are changing slowly: California, the absolute leader in “ESG consciousness” is now considering not closing its Diablo Canyon nuclear plant in 2025, and even Germany is thinking about doing something similar. The UK has announced plans to reduce reliance on oil and gas, and wants to build 8 new reactors by 2050… (We are living in the year 2022 ...) Similar news can be heard and read all over the world. The IEA even said that nuclear capacity needs to be doubled worldwide. Everybody with a bit of knowledge knew that without nuclear plants there would not be sufficient energy, but it is still good to see that politicians are finally becoming a bit more sensible. However, a total mentality change takes a long time...

All this has a great deal to do with recessions and inflation. As we said before, we don’t want to participate in macroeconomic arguments, but one thing is clear: A recession is a decrease in economic activity; economic activity is directly dependent on energy’s availability, and energy’s availability is going to be poor for the medium term. Conclusions are not difficult to draw, whatever macroeconomic theories one may want to support.

Consequently, we should expect muted economic activity in Europe, which is very short of energy, a somewhat better situation in the US & Canada, and energy-related investments outperforming everything else. This extends, by the way, to many other natural resources, which are subject to a similar cyclical period of underinvestment that are, in some cases (mining), also aggravated by increased ESG barriers.

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