

30th March 2020

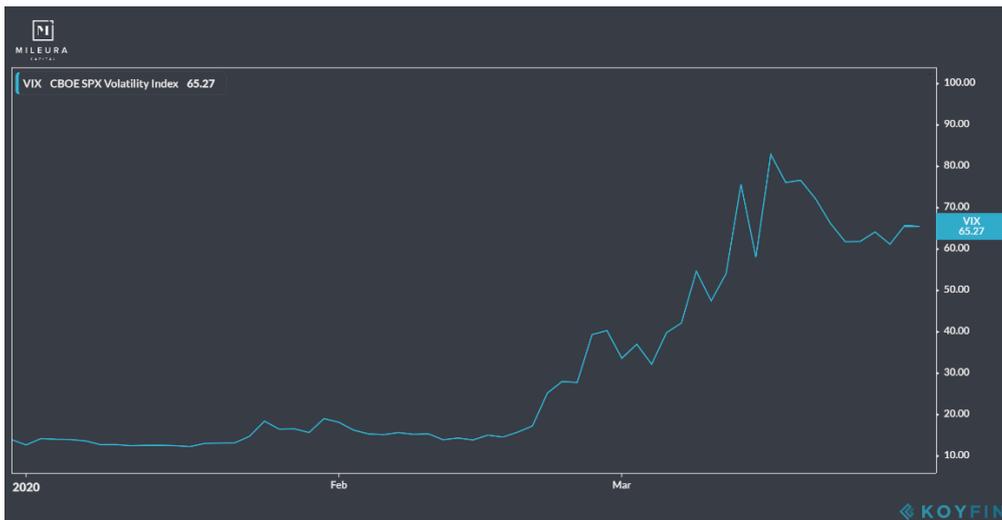
THIS IS NOT INVESTMENT ADVICE

Mileura Capital Newsletter Q1 2020

In my last market thoughts commentary, I mentioned that US equities seemed to be ignoring the risk of coronavirus and the oil market was providing the best hedge to an anticipated slowdown. Since then oil continued its effectiveness as a hedge with a massive move lower under the combined weight of collapsing demand and the rapid increase in supply from by OPEC+ post the breakdown in the Saudi & Russian alliance.

In this environment, reality finally caught up with US equities we have seen few sectors spared as main U.S. indices declined by over 30% only to rally hard last week. Not surprisingly volatility has expanded, and fortunes are being made and lost daily.

Daily chart of VIX (QTD)



Recap of previous recommendations

Our recommendations at the time were to short cotton (down 25%), long coffee (+30% at one stage, now up about 15%) and short Iron Ore in the mid to high 80s (down 5% from entry). We have exited cotton and coffee.

I would recommend squaring any short cotton and long coffee at this point if you have them open. Cotton is likely to go lower still, but momentum indicators are extremely stretched, the front spread is strong and you might get a better opportunity if you are patient.

Coffee is still bullish fundamentally but has been so volatile that to trade the long view, and maintain your capital has been a challenge for those without large balance sheets and in-depth physical analysis. If you have the pain threshold then absolutely still stay long but it is not for the apprentice.

At the time in the best place to short Iron Ore was in Q2. In early February the April SGX Iron Ore was trading in the mid-to-high 70's front, month was in the low 80s. We did see a spike up towards \$90 which was a good opportunity to initiate shorts. April is currently \$80 and May \$79 and June \$77.75. It has been a tough short to hold, with eternal optimism on Chinese stimulus, legitimate supply disruptions and a backwardated curve. We recommend staying short Iron Ore with a target of \$68-72 in Jun/Jul/Aug period

Cotton – demand destruction as retail economies freeze up. Still medium term bearish



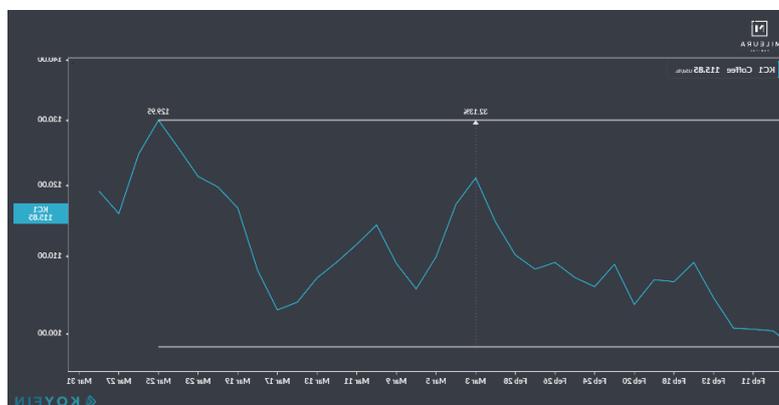
Bullish

- May/July spread is tightening
- Market very over sold
- US export sales appear to be OK

Bearish

- Retail Demand declining
- Supply chain backing up with fabric & yarn
- Market talk of defaults by textile mills
- Large contango on the Jul – Dec spread

Coffee – Very volatile market with plenty of 5-10% drawdowns daily and intra-day. Still medium term bullish.



Bullish

- May/July spread inverted
- Cash premiums are high
- Supplies trapped at origin

Bearish

- After restocking demand slows
- EM FX is incredibly weak
- Market tightness is behind us

Iron Ore – more downside as steel inventories remain high and you move past the supply disruptions



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Longer term perspectives

With so much disruption in our daily lives and the financial markets, trying to take a longer-term perspective has become more a challenge than normal. Children at home, friends distant and family members either sick or the worry of getting sick means there is plenty to distract us.

It is simple to assume that we are headed one of two extreme outcomes. Firstly, the pessimistic outlook that the current lockdown will persist for months on end and we are headed to a global depression. The opposite is that things will return to “Normal” and equity markets and life in general will have a V-shaped recovery. What is more likely, in my opinion, is something in between. On average you are likely to have a U-shaped recovery, but there will be sectors and markets that do very well and others that perform terribly.

Below I have tried to outline some of the medium to longer impacts of COVID-19 to supply chains and our daily work/life balance. As we move through time you will be better able to put probabilities around each of these. Some of the points I outline below such as changes to commercial real estate and education are far too early to tell but would be a huge change to western society and property values. They are also meant to be questioning the status quo prior to the outbreak of COVID-19. Some of these issues may never come to pass, others may only be transitory. I am not about to deal in predicting the future, at this point anyone forecasting in absolutes is naïve – there are so many different outcomes possible at this point that I think the best advice is be prepared for any outcome but hope for the best and look for opportunities.

Potential and economic and financial changes from COVID-19 to markets

1) Change in supply chains for commodities and raw materials

Assumption: Firms are prepared to pay a higher cost for security of supply and multiple sources of essential raw materials and components

- a. Bulk Commodities
 - i. Larger firms with multiple operational locations will benefit
 - ii. Single product, single geographical location companies should trade at a discount
 - iii. More focus is put on ex-China steel capacity, leading to iron ore to ship to other parts of world. Most likely Turkey, Eastern Europe
 - iv. Thermal coal could go one of two ways.
 - Remain supported as the world will need cheap, plentiful source of energy in any recovery
 - Fiscal stimulus and “Corona bonds” get thrown at ESG friendly energy investments. The end of coal in the west.
- b. Less import/export of fresh produce
 - i. Production becomes more localized to firm up supply
 - ii. Greenhouses, hothouses on tops of warehouses etc. become more popular and comparable cost to importing from far flung parts of the world. Especially relevant for large cities & surrounds
- c. Inventory Management
 - i. Does the state take on a bigger role in managing stocks of vital commodities that they cannot easily produce or source. Would create a new source of demand at a time of fractured supply chains. Already takes place for some commodities in land-locked Switzerland.

- ii. State backed buying of commodities can lead to distortions if not managed properly. In the 2010's China bought large amounts of cotton & grains leading to big price spikes followed by long term price depressions.

2) Changes in component supply chains and potential for de-globalisation

Assumption: Firms are will have to build out flexible regional hubs across demand centres with more than 1 supply chain alternative of each key component

- a. Manufacturing Industry
 - i. More regionalized hubs to provide optionality for corporates.
 - ii. Require multiple sources of raw materials, components and finished goods
 - iii. Require building out of skill sets outside of China in high-end technology
 - iv. Generally less efficient, higher cost supply chains and the corporates will have to hold more inventory on balance sheet
- b. Component manufacture
 - i. Companies begin to on-shore of component manufacturing to the demand hubs
 - ii. Should be positive for North American and EU manufacturing, allowing them to move up the technology chain
 - iii. Mexico & Canada could benefit from its proximity to the US especially if currency remains weak for an extended period
- c. Stockpiles and JIT inventory
 - i. For products that are viewed as essentials, government mandate a certain % of yearly sales. Due to Switzerland's land locked status it has mandatory reserves of essential products
 - ii. Given the current working from home (WFH) scenario you could view an internet connection as a right like electricity or gas.
 - iii. A computer, modem, wireless routers become essential for working and educating from home.
 - iv. Mobile phones, laptops and other communication devices will have to be available to all to remain employment
 - v. More bundling of products and services with subscriptions
 - vi. If the ability to work from home becomes a mandatory requirement, employers could be compelled to ensure a level of internet access (bandwidth & hardware) for key staff

3) Commercial Real Estate

Assumption: Firms find they can have a higher proportion of permanent staff operate remotely and as consequence need less staff in large centrally located offices

- a. Large corporates (banks/insurers) use their satellite real estate (offices/branches) as "spokes" to the smaller, centrally located hub.
e.g. large global banks with retail branches. Incorporate management spaces into branches and use them for high-speed, compliance approved locations for non-retail staff to work from in conjunction with head office
- b. To counter this potential impact, centrally located office space builds out leisure areas to compete with the perceived benefits of remote working from one of the spokes or from home
- c. Childcare & schooling become incorporated with commercial real estate choices to attract staff centrally

4) Bloated management in large corporates

Assumption: Most large corporates have a bloated middle & senior management (especially large banks)

- a. The disruption that Corona is causing allows more middle and junior employees to act & solve problems
- b. The staff at the coal face with the customer will be put into a position where they must solve problems in real time.
- c. Senior management can go straight to the person handling the issue rather than through hierarchies
- d. Ineffective middle management gets exposed if not effective they can't as easily take the credit
- e. Less meetings frees up time for strategic thinking from senior management
- f. Better direct feedback from customer facing roles through to senior management

5) Domestic Travel becomes more attractive

Assumption: Longer-term impact of less overseas and long-distance travel

- a. Air travel become more expensive and more of a hassle due to measures that have to be taken to prevent spread of disease.
- b. Do passenger jets have to have more space between customers?
- c. Lower fuel costs could mitigate the cost but not the hassle part. However, fuel costs are more cyclical and the cleaning and distancing measures become more structural
- d. Looking forward its likely that tourism export dollars (especially from China) will decline so tourism destinations will have to rely more heavily on domestic travel within their own countries.

6) A less consumption focused western consumer

Assumption: Less frivolous consumption and a focus on being more resilient to shocks.

- a. This type of shock might bring back a thrifty nature to the West as we have predominantly taken for granted the easy availability of food, goods, travel
- b. Food wastage reduces in a trend to more efficiency after this supply shock
- c. More home & community grown fresh vegetables means less grocery consumption
- d. Constant replacement of 2-year "old" iPhones and general electronics goes out of vogue
- e. Less mobility and less commuting leads to a different type of consumption (less takeaway coffees, more at home consumption)

Social Changes post COVID-19

1) Reduced Commuting

Assumption: More WFH means less commuting and less car pollution from travel and less congestion

- a. Less retail consumption on commute and more from home.
- b. More at home use of daily "luxuries" such as coffee, bagel, donut etc.
- c. Require better at home internet infrastructure

- d. Does the traditional Childcare industry suffer if parenting becomes permanently more flexible.

2) Local communities

Assumption: Post the initial period of isolation Local Communities will become closer

- a. Initially the isolation and social distancing causes disruption between the haves & have nots if it persists over the summer 2020
- b. Longer term, communities feel have to rely on each other building a sense of community
- c. Do the “haves” post mass wealth destruction become a little humbler and more appreciative of the essential services
- d. Does religion prosper? Between social distancing and the potential for persistent changes to the normal way of life do people look for solace elsewhere
- e. Do social networks have to cater to more local/regional user bases to cater for this need to reach out and stay connected with people physically closer to you?

3) Education

Assumption: With remote education being forced on society for a month do we both value teachers more and challenge the cost of private schooling in major cities

- a. With a large amount of remote schooling taking place how does society handle that if it persists for more than a couple of weeks
- b. Do teachers have to continue to evolve to a new dynamic where they have multiple classes, teaching some remotely and some in situ? Do they go to places of work either remotely or in person?
- c. Will this allow the in-demand teachers to be able to scale their teaching and (finally) get paid a reasonable wage?
- d. Does society finally value teaching and education as something that needs to be supported and paid for?
- e. What does it mean for private schools? Why pay large school fees if you can get high quality teaching done remotely (or part remotely)
- f. Combine childcare and schooling with the workplace. I know this happens already to an extent for younger childcare. If the facilities are built in conjunction with the improvements in remote learning, can you see an environment where the curriculum managed by schools through a government certified program

Conclusion

Whilst some (or most) of these changes may never come to pass I do hope that we as a society can come together post this crisis. Democracies need to be as strong as ever and we all need to hold our public officials accountable as they create huge liabilities for future generations to deal with.

We must support our essential services and use this as an opportunity for them to be recognized in society both financially and in social standing.

Finally, look after your family, look after each other and hopefully we can use this as an opportunity to create a less resource intensive and more balanced economy for all participants.