Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2019			0.1%	0.3%	4.3%	-4.2%	0.1%	-0.1%	0.9%	-4.1%	7.5%	6.0%	10.5%
2020	-6.2%	-2.0%	2.5%	12.4%	3.6%	-6.6%	19.6%	12.1%	-3.0%	-7.1%	2.1%	11.9%	41.6%
2021	1.1%	3.5%	-0.5%	6.3%	19.5%	-3.2%	4.0%	-5.2%	6.0%	9.9%	-8.1%	-1.4%	33.0%
2022	1.5%	11.5%	5.7%	3.7%	1.6%	-5.9%							18.7%

- **The Cypress Fund returned 18.7% in the first half of 2022 with a Sharpe Ratio of 1.0.**
- **Hedges provided the lion's share (10.2%) of returns as equity markets fell in the first half. Most commodity-related names also made positive contributions.**
- **Even after the large decline in equities so far, we remain cautious heading into the second half. History suggests there is a good chance that we are already in a recession, in which case additional downside is probable.**
- **We touch upon the recent correction in commodities, reiterate our long term bullishness and share why we express our views through equities.**

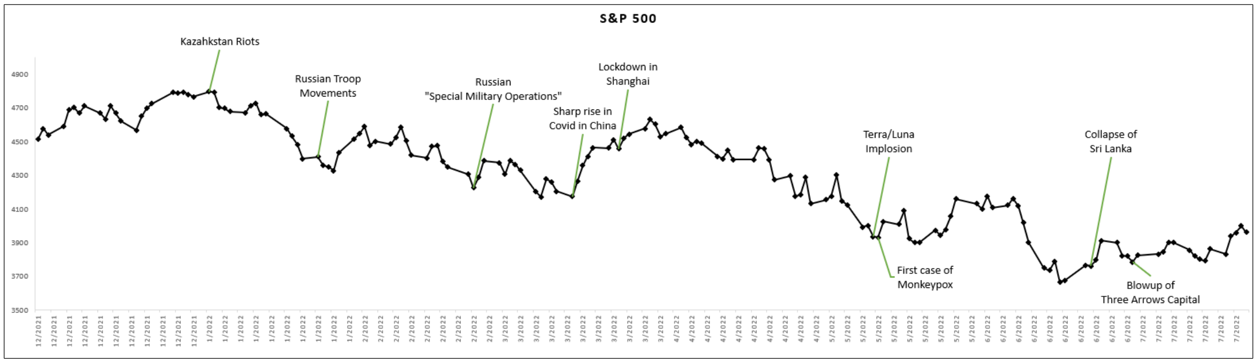
Dear investors,

2022 has so far been an incredibly difficult year for investors. Asset classes are down across the board in the first half: equities are having its worst first-half ever in four decades, interest rates rose by 150 bps (largest since 1994), emerging markets have not performed so poorly since the Asian Financial Crisis and credit is suffering its biggest first-half drawdown in 15 years. Only the US dollar and commodities bucked this negative trend.

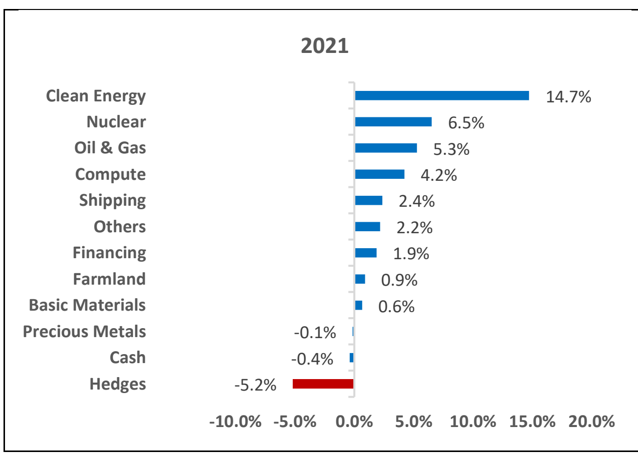
Asset Class	1H2022 Returns
Equities	-20.6%
Fixed Income	-12.7%
Credit	-15.4%
Emerging Markets	-19.8%
Crypto	-59.6%
Gold	-1.2%
US Dollar	+9.4%
Commodities	+18.0%

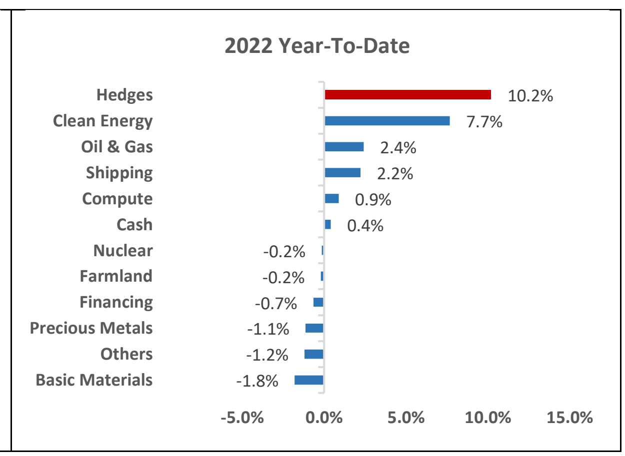
Equities – S&P 500; Fixed Income – US 10YR Treasuries; Credit – HYG ETF; Emerging Markets – MSCI EM Index; Crypto – Bitcoin; US Dollar – DXY Index; Commodities – Bloomberg Commodities Index

There was a relentless stream of bad news in 1H2022; barely had one negative headline surfaced before another rose to take its place and financial markets traded in sympathy. The bad news started with riots in Kazahkstan on 2nd January; this was soon overshadowed by Russian troop movements at the Ukrainian border and eventual invasion on 24th February. March was a constant feed of war-related headlines, compounded by the unexpected spike in Covid cases in zero-covid China that resulted in a harsh lockdown in Shanghai in April. There was no let-up in May with the crypto blow-up of Terra and Luna that incinerated at least $40 billion, as well as the first reported outbreak of monkeypox. The crypto contagion spread and in June, Three Arrows Capital blew up, kneecapping a number of counterparties in the space. As if this were not enough, recession fears rose to the forefront amidst an increasingly hawkish Fed while Sri Lanka went bankrupt.



Amidst the turmoil in markets, the Cypress Fund generated +18.7% returns in the first half, with annualized volatility of 19.8% and a Sharpe Ratio of just under 1. The biggest contributor to performance this year has been our hedges, producing more than half of our returns this year. Commodity beta has also helped our 'Clean Energy', 'Oil & Gas' and 'Compute' investment themes, although we gave back some gains in June with the sharp sell-off across the natural resources space. 'Precious Metals', our largest allocation currently, continues to languish, in part due to strength of the US dollar. Contrast this with 2021 where we had gains in nearly all of our themes. A rising tide lifts all boats; there is no doubt that we benefitted from the risk-on tone last year. 2022 is proving to be a more challenging.





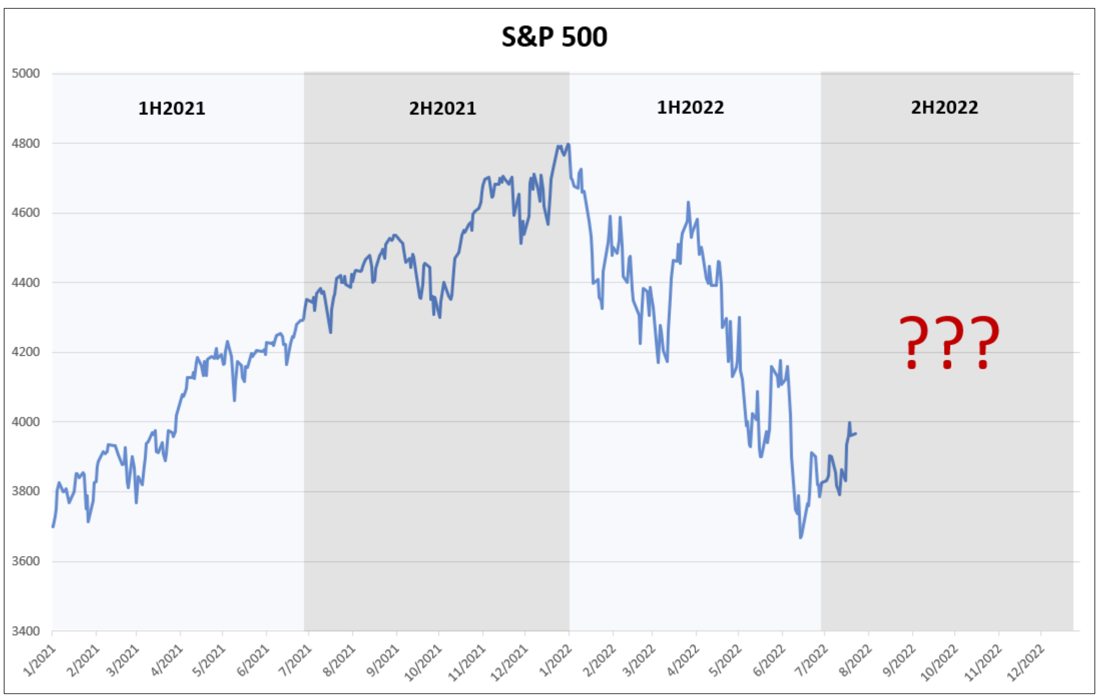
In our [2021 Year End Investor Letter](), we wrote:

> *…the macro environment changed significantly over the course of the year. Early in 2021, economic fundamentals were improving, the Fed was very accommodative, fiscal stimulus was generous and price action was strong. 12 months later, it is evident that financial markets no longer have the wind at its back as four out of five factors take a turn for the worse…*
>
> *We do not know if the market will experience a sharp correction but we see storm clouds ahead and we would rather be safe than sorry. In practical terms, we are keeping a higher level of*

hedges on, being more patient in our buys as well as trimming laggards in order to raise cash. Metaphorically, we are clearing the deck, battening the hatches and buckling ourselves in.

From a risk management perspective, we largely got the first half right, having positioned ourselves defensively by first reducing our net exposure (longs minus shorts) and then in 2Q by reducing gross exposure as well. Fast forward to July 2022, one could argue that the macro environment is actually worse than at the start of the year (see table below). Fundamental indicators such as sentiment and earnings are clearly weakening, high inflation acts as a fiscal drag and most importantly, the Fed continues to tighten monetary policy. However, unlike six months ago when markets were near all-time highs, we just experienced one of the worst first-halves for financial assets in recent history. Thus, we have to ask ourselves: *Has the bad news been priced in?*

Heading Into →	1H2021	2H2021	1H2022	2H2022
Fundamentals	Improving	Strong	Strong	Deteriorating
Fed/Monetary	Very dovish	Very dovish	Very hawkish	Very hawkish
News Flow	Positive	Neutral	Negative	Negative
Fiscal Stimulus	Positive	Positive	Neutral	Negative
Technicals	Positive	Neutral	Negative	Mixed



It turns out that the answer is, it depends. <u>If we are not in a recession, we have likely seen the lows in equities. If we are in one, we should expect more downside.</u>

Fed Officials Say Recession Unlikely; Price Action Suggests We Are Already In One

Financial markets became increasingly concerned about recession risk in the past two months with a string of headlines about extremely poor consumer sentiments, a repeat housing bubble, very negative outlook from business owners, etc (Appendix I). The sudden shift in focus from inflation to recession in June seemed strange – after all these leading indicators have been sounding warning signals for a while already and we are not sure what changed. If we ask the experts, ie Fed officials, they remain confident that a US recession is unlikely:

Recent Fed officials' position on the possibility of a recession…

Fed's Bullard Says US Recession Unlikely and Expansion is in Early Stages – *Bloomberg, 6/24/22*
Fed's Williams says a recession can be avoided – *MarketWatch, 6/28/22*
Fed's Daly Plays Down Risk of US Recession – *Bloomberg, 6/28/22*
Powell Says US Economy Is in Strong Shape, Fed Can Avert Recession – *Bloomberg, 6/29/22*
US recession fears 'overblown', says Fed's Waller – *Straits Times, 7/8/22*
Fed's Bostic thinks recession can be avoided even with further interest-rate hikes – *MarketWatch, 7/11/22*

However, these experts also assured that inflation would be transitory, that a US nationwide housing crash was unlikely and that there was no recession during the early 2000s.

April 2001…

U.S. not in recession, Fed must be vigilant – Moskow – *Reuters, 4/4/01*
Fed's McTeer Says U.S. Economy Not in Recession – *Reuters, 4/4/01*
Fed's Parry Says U.S. Economy Isn't in Recession – *Bloomberg News, 4/5/01*

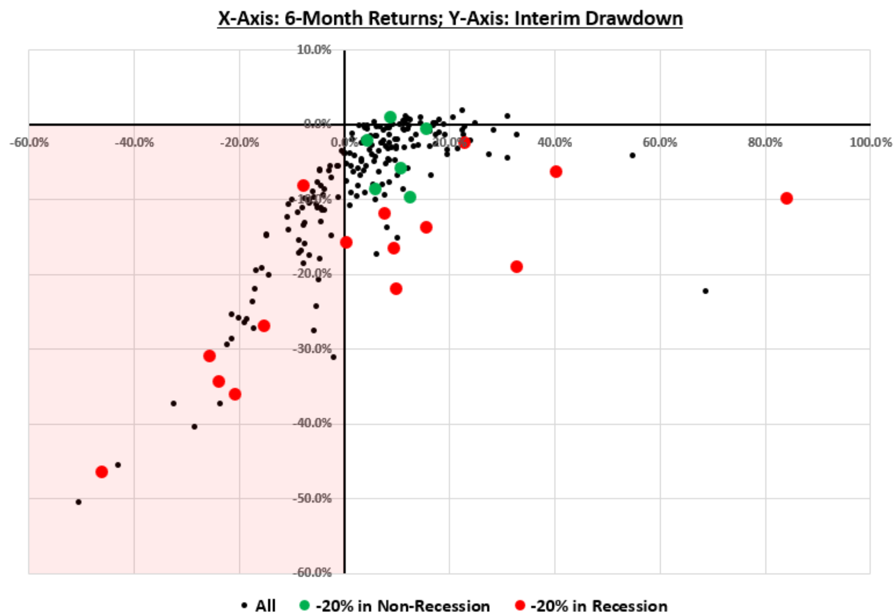
Instead, let's look at what the numbers say. Since 1926, there have been 21 non-overlapping instances where the S&P Index suffered 20% or more declines over a 6-month window, out of which 15 coincided with recessions (Appendix II). Simply put, history tells us that these rare 20% declines are *more often than not* associated with economic contractions. Of the 15 recessionary instances, 6 had markets going even lower half a year later and all of them experienced a drawdown (average of -19.9%) at some point during this 6-month window.

Index Returns and Interim Drawdown after Experiencing 20% Decline

	% Up after 6m	Avg 6m Returns	Interim Drawdown
All -20% Instances (21)	71%	3.6%	-6.4%
i) Non-recession Years (6)	*100%*	*9.4%*	*-4.2%*
ii) Recession Years (15)	*60%*	*5.4%*	*-19.9%*
All Instances (209)	67%	3.8%	-7.8%

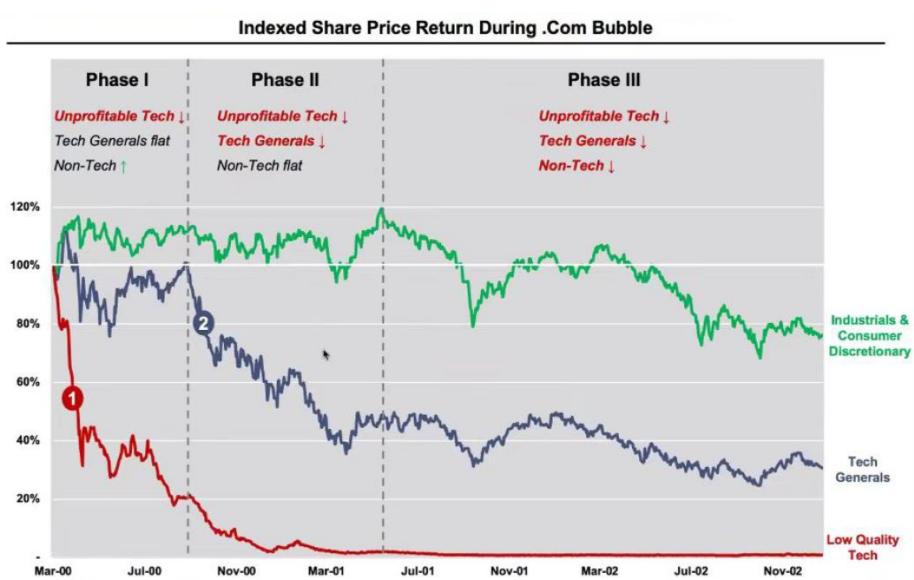
See appendix for complete table

One the other hand, the index actually ended up higher 6 months later most of the time (71%) with average returns that are positive – decent odds to be long. However, given elevated risks of an economic slowdown that may be exacerbated by Fed policy, what we need to ask ourselves is whether it *still makes sense to stay hedged after a substantial decline* like that one just experienced. The following chart shows that 20% declines during recessions are associated with substantially worse outcomes – lower returns in 6 months as well as larger drawdowns in the interim period. So while there is a good chance that markets are higher in 6 months, there is also a high chance that markets first head lower in the interim, and materially so if we are in recession. Risk management is of paramount importance, hence we think staying hedged even after the decline in prices is the right portfolio decision.

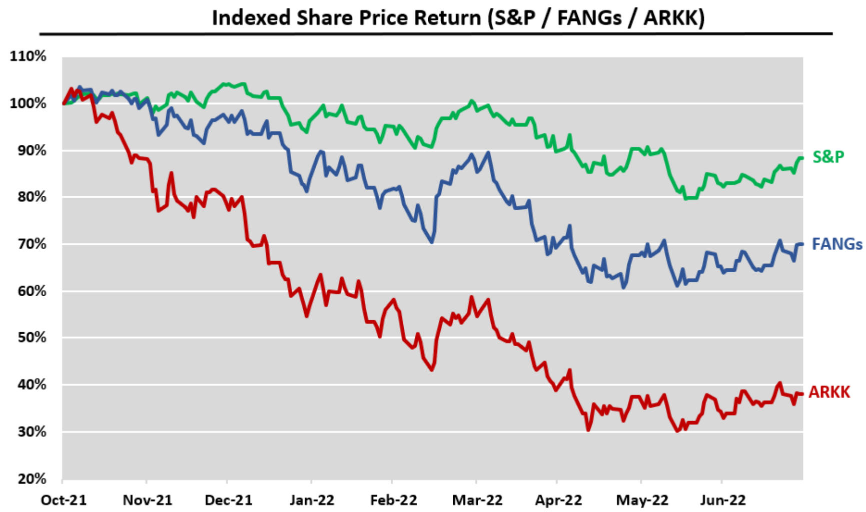


Bear Market Template: Multiple Compression -> Earnings Revision -> Capitulation

On the topic of bear markets, we found the following chart (courtesy of Coatue) to be useful. In the first phase of a bear market (using 2000 bubble as analog), valuation multiples reset lower as investor optimism and credulity were replaced by realism or outright scepticism. This resulted in collapsing prices for unprofitable tech companies that were no longer given the benefit of the doubt by investors. In the second phase, tech stalwarts, which had until then been relatively unaffected, also fell sharply as the weak economy forced them to revise earnings lower. Finally in the last phase, there was capitulation as everything traded lower in tandem (correlation goes to 1).



We cannot help but notice similarities between markets today and the early 2000s. The first phase seems to have already taken place, with the dramatic decline in the shares "disruptive tech" businesses (-70% in ARKK). The second phase appears to be starting as more and more blue chips, or "Generals", revise earnings lower (eg Walmart, Meta, Microsoft and Apple). Obviously there is no guarantee of a repeat of the 2000s, but given that the third phase is most punitive, risk management requires that we are aware of this possibility.

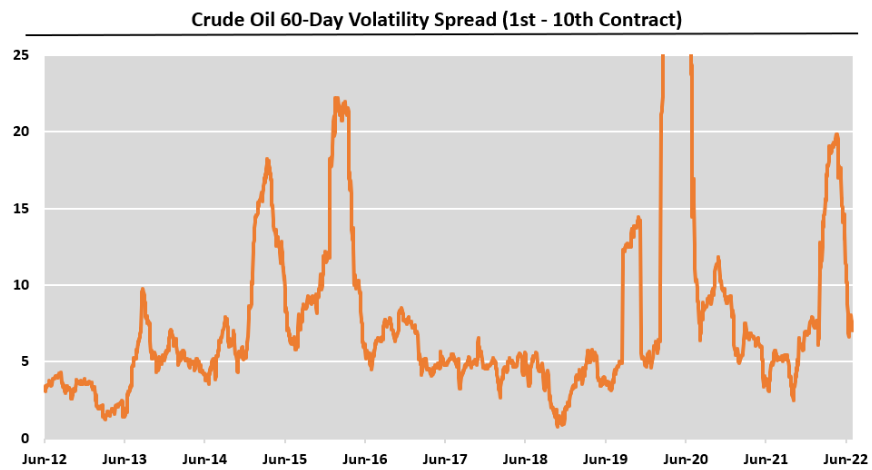


Commodities: Hard to Forecast Short Term, Easier Long Term

In the last two months, we saw commodities selling off very sharply – crude oil is down over 20%, copper is down 30% while corn is down nearly 25%. Given our indirect exposure to a number of commodity names, we also gave up some of our gains as a result. It is therefore reasonable to ask what drove the recent declines and whether they affect our investment theses.

In truth, it is very hard to know with certainty the true driver(s) of short term price action in commodities. Perhaps it was due to investor worries about recession and the potential impact on demand. Maybe it was concern about China's slowing GDP growth as well as a developing housing and mortgage crisis. It could also be something more benign – after climbing more than 40% since the beginning of the year, traders finally decided to lock in gains by taking profits. Most likely, it is some combination of all of the above plus other factors.

This may not sound intuitive but we believe it is much harder to make short term price forecasts compared to longer term projections in the commodities space. In the short term, there are a host of idiosyncratic factors that affect prices, ranging from weather (in the case of soft commodities) to geopolitics (particularly for crude oil) to technical factors (eg. recent short squeeze in nickel). These are very difficult to predict. Over a longer horizon however, price always comes down to supply and demand, both of which can be estimated within reasonable error bars. Empirically, we observe this dynamic in the volatility of futures contracts – short-dated contracts almost always display greater volatility than long dated ones (see chart below). In other words, we should pay more attention to the long term supply-demand dynamics and less on short term price action.

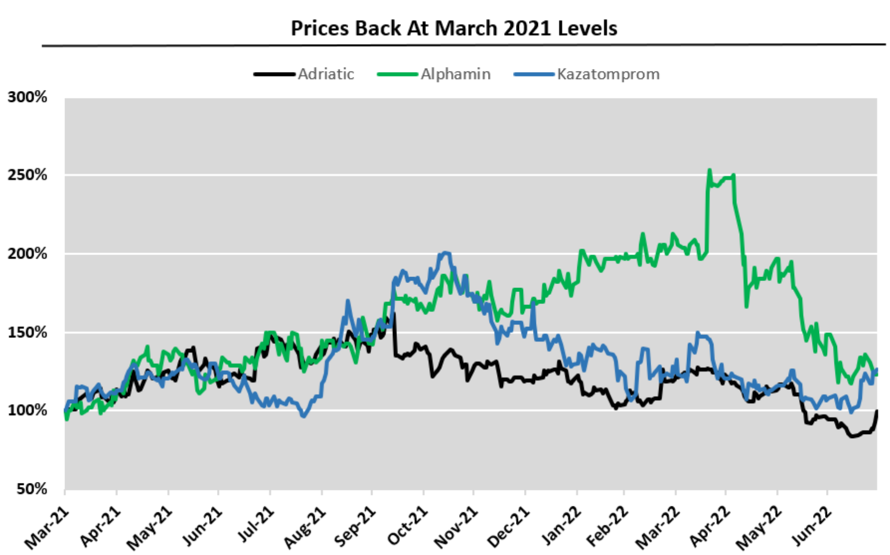


Betting on a Long Term Commodity Bull Market via Equities

In our previous letters (Mar 2021, Mar 2022), we discussed why we believe that the market is structurally short commodities so we will be brief here. In summary, underinvestment in exploration and development across almost all commodities in the past decade means that prices have to adjust in order to incentivize new supply. Unless there is a structural shift lower in demand (which we do not yet see), prices will go higher. The short term will be volatile but the long term trajectory is upwards.

We have been expressing this view via equities as they fundamentally offer exposure to longer-dated prices while also giving us:

i) the ability to buy commodities at large discounts (Adriatic Metals trades at 40-50% implied discounts to zinc, silver and gold prices)
ii) the potential for positive carry (Alphamin offers 17% dividend yield)
iii) alignment with strong management (We invest alongside the successful Lundin mining family in Filo).



And after the recent correction, some of the companies we own are now back to March 2021 prices even though the fundamentals have actually improved. Thus, amidst the market duress, we are also cautiously redeploying the cash that we have built up in recent months.

Our Job is to Know When and How to Play Defense

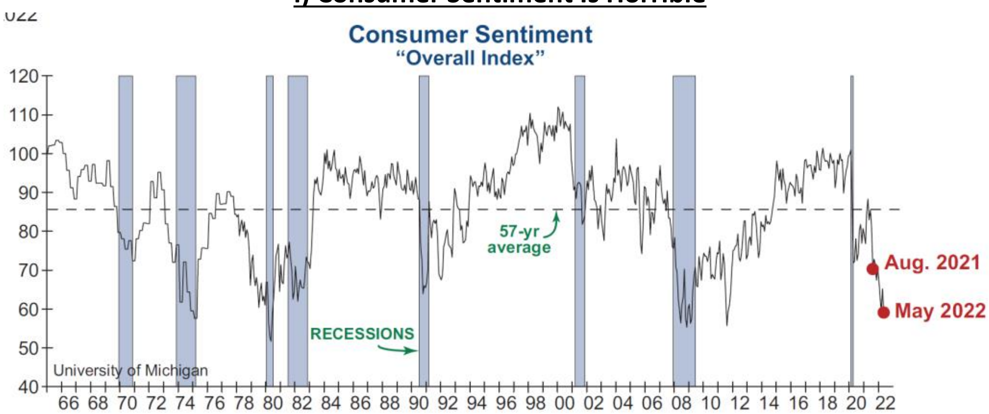
After playing defense all year, it may be worth asking if now is the time to put on our risk-on caps. This is particularly true when we look at the commodity names in our portfolio, some of which are very cheap after the recent shellacking in the natural resource space. However, the macro indicators we watch continue to flash red and there is a good chance that we are already in a recession, in which case additional drawdowns are likely. On the other hand, markets may well have bottomed, the Fed could be on the verge of pivoting dovish and risk assets in fact rallied strongly in July. When faced with such a divergence, we default to the conservative view. It is not hard to make money in a bull market and we are confident we will be able to reposition the portfolio quickly should the bulls prevail. But if we are in a bear market, history says that things can get ugly very quickly. Frustrating though it may be, we think playing defense is still the order of the day.

Sincerely,

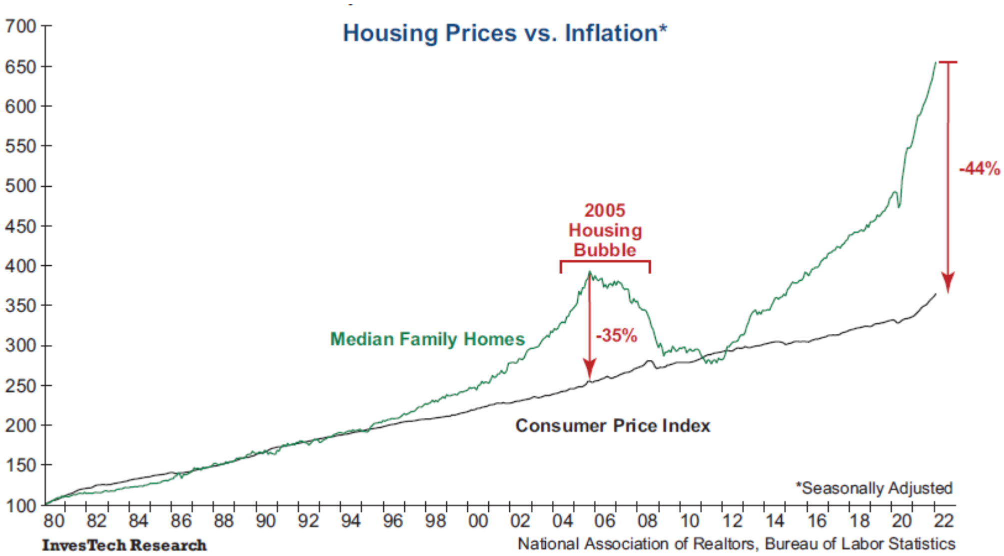
Yongchuan Pan
30 July 2022

Appendix I

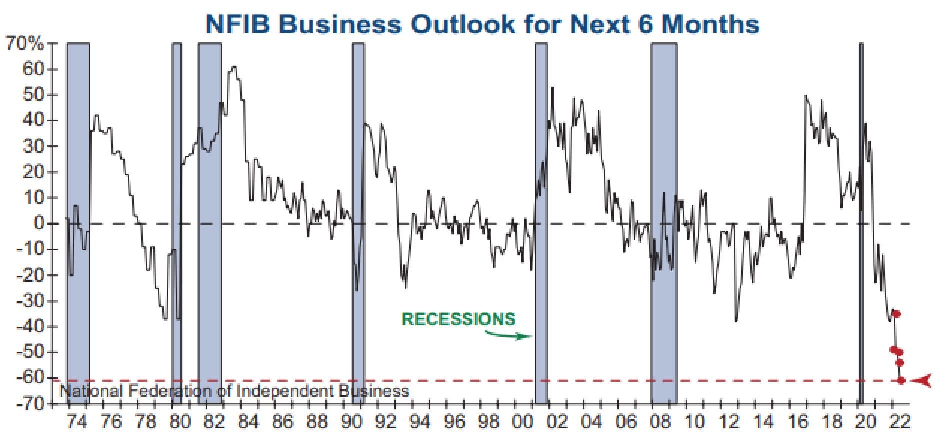
i) Consumer Sentiment Is Horrible



ii) House Prices are Bubbly



iii) Business Owners are Pessimistic



Appendix II

Prior Instances of 20% Declines in S&P Index

Date	6m Forward Returns	Interim Drawdown	Recession?
Oct-29	15.4%	-13.6%	Yes
Sep-30	-15.6%	-26.8%	Yes
May-31	-24.2%	-34.2%	Yes
Nov-31	-46.3%	-46.3%	Yes
May-32	32.6%	-19.0%	Yes
Feb-33	84.0%	-9.8%	Yes
Jul-34	8.5%	0%	No
Sep-37	-25.9%	-30.8%	Yes
Mar-38	9.6%	-21.9%	Yes
May-40	12.3%	-9.6%	No
Mar-42	5.6%	-8.5%	No
Sep-46	4.2%	-2.0%	No
May-62	10.6%	-5.7%	No
May-70	7.4%	-11.8%	Yes
Aug-74	9.3%	-16.5%	Yes
Oct-87	15.3%	-0.4%	No
Mar-01	-8.0%	-8.0%	Yes
Jul-02	0.3%	-15.6%	Yes
Oct-08	-20.9%	-36.0%	Yes
Apr-09	22.7%	-2.4%	Yes
Mar-20	40.0%	-6.2%	Yes