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%	-1.9%	1.0%					17.6%

- **The Cypress Fund returned -1.9% in July and +1.0% in August; YTD the fund is up 17.6%.**
- **Markets have been very volatile, primarily driven by macro. We intend to manage the fund's volatility for the foreseeable future via high levels of cash and hedges.**
- **The Fed has been unambiguously hawkish in both words and action, which is a headwind for risk assets. We will stay cautious until we see moderation in hawkishness, which is unlikely until both actual inflation and inflation expectations come down to target levels.**
- **Energy is increasingly politicized in Europe, like in Argentina after the early 2000s recession. The energy sector will be hobbled for years; shareholders and creditors of utilities will suffer.**
- **We review three of our portfolio themes: shipping is performing well, nuclear energy should benefit from positive developments, while precious metals may languish for a while.**
- **We touch upon investors' shifting levels of confidence, how it influences decision-making and the likely shift from the "abstract" to the "real".**

Dear investors,

Macro continues to dominate the investing landscape this year. Since our last note in end July, equity markets (using S&P 500 as proxy) experienced a 5% rally into mid-August after a dovish-sounding Fed, followed by 10% drop, yet another 5% rally into early September, before last week's CPI numbers sent markets careening another 6%. Such price action is impossible to predict ahead of time; we acknowledge this is a high-risk environment which necessitates proper risk management. For the Cypress Fund, this means keeping high levels of cash as well as high levels of portfolio hedges. In the rest of this letter, we share our take on both the macro (Fed, energy) and micro (specific themes). We believe that investor confidence will continue to decline due to poor macro factors; this will drive more conservative decision making, which should benefit our real assets investing strategy.

Macro Factor I: The Fed is Unambiguously Hawkish in Both Words and Deeds

Earlier this month, the Cato Institute conducted a Q&A with Fed Chairman Jerome Powell at their annual monetary conference. The interview received a fair bit of media attention as Powell reiterated the Fed's resolve to get inflation under control. We watched it and encourage you too to do so as well to get a "feel" of the central bank's determination to rein in inflation. For the Cliff Notes, you can find our summary of the Q&A in the appendix.

In short, the Fed will act aggressively to lower inflation, conceding that the Fed's monetary policy played a role in causing high inflation and they accept responsibility for getting it back under control. They desperately want to avoid a repeat of the 1970s where the inflation fight ended prematurely, which necessitated the very high social and economic costs imposed by the Fed under Paul Volcker. You can read from Powell's response to some of the questions that he cannot be more clear about their intentions:

Q2 (paraphrased): *Does the Fed have the resolve to bring inflation under control given the potential economic costs and likely political pressures?*

Powell (verbatim, with editions for clarity): *…<u>what Paul Volcker did</u> and the Fed did to finally get inflation under control <u>followed several failed attempts to get inflation under control</u> and what had happened over the course of that long period of the great inflation is that the public had really come to think of higher inflation as the norm and to expect it to continue and that's what made it so hard to get inflation down in that case… it is very much our view and my view that <u>we need to act now, forthrightly, strongly, as we have been doing and we need to keep at it until the job is done</u> to avoid… the kind of very high social costs that that Paul Volcker and the Fed had to bring into play in order to get inflation back down and set us up then for a long period of price stability…*

The point (at Jackson Hole) was to deliver <u>a speech that was narrowly focused on inflation</u>, more direct and a lot shorter than a typical Jackson Hole speech and I thought that what was appropriate was <u>a very concise and focused message…</u>

The Fed has and accepts responsibility for price stability by which we mean <u>two percent inflation over time</u>… the longer inflation remains well above target the greater the risk that the public does begin to see higher inflation as the norm and that has the capacity to really raise the costs of getting inflation down… <u>history cautions strongly against prematurely loosening policy</u>… I can assure you that my colleagues and I are strongly committed to this project and we will <u>keep at it until the job is done…</u>

Q3: *How does the tight labour market affect the Fed's ability to tackle inflation?*

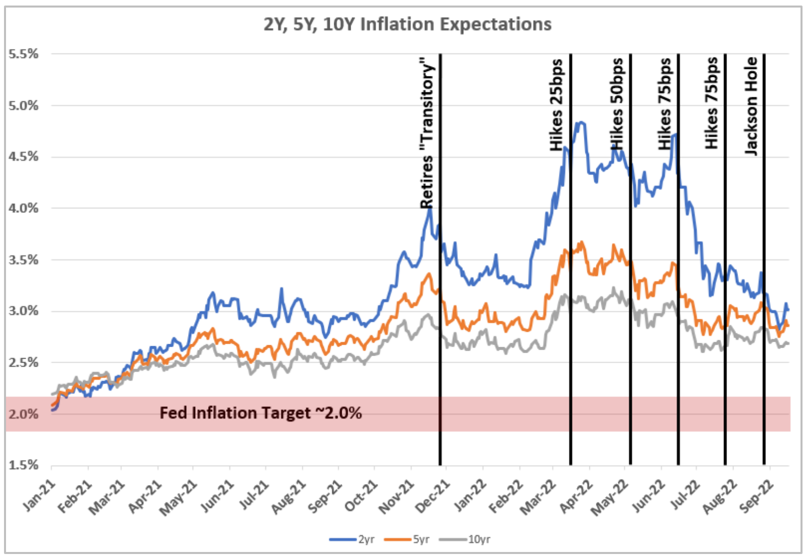
Powell: *If it does turn out that we are in a world of a persistent labour shortage over time, that will be a challenging world for companies and it will certainly create upward pressure on wages and that sort of thing. Today the labour market is, <u>demand is very very strong still in the labor market</u>. We're still printing new payroll job numbers at a high level, wages are running at elevated levels and so we think <u>by our policy interventions, what we hope to achieve is a period of growth below trend</u> which will cause the labour market to get back into better balance and then that will bring wages back down to levels that are more consistent with <u>two percent inflation over time.</u>*

Q13: *What are some of the lessons you have learnt since you became Fed Chair?*

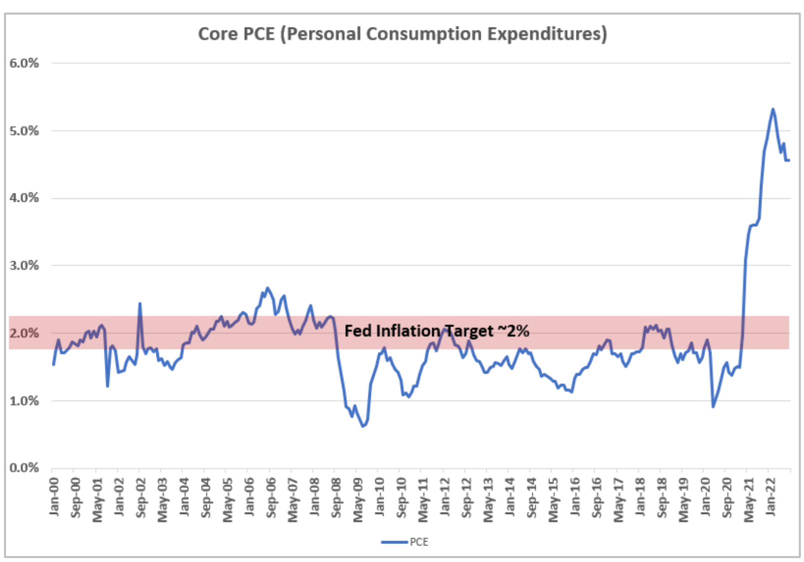
Powell: *I actually mentioned three lessons at Jackson Hole ten days ago and those were: first, that <u>the Fed does have and accepts responsibility for price stability</u>. Even now some are questioning that but that to us is settled. Secondly, that <u>inflation expectations are really important and need to be carefully monitored because if they do move up they can make the job</u>*

<u>of getting back to price stability so much harder</u>. And third, is that you know <u>there is a record of failed attempts to get inflation under control which only raises the ultimate cost to society of getting it under control, hence the need to do this job now and keep at it.</u>

We first highlighted [last November](#) the Fed's pivot from their previous "transitory inflation/rates lower-for-longer" stance. Since then, in both words and action, they have showed their commitment to getting inflation under control with arguably the most aggressive policy tightening (size and speed) since 1994. The market has started pricing in the impact of their policy action, with forward inflation expectations coming down substantially from 2022 highs, although they are still a distance from the Fed's long-run target of ~2%.



Note that the above reflects what market participants are pricing via inflation swaps, ie forecasts 2, 5 and 10 years out. Just as important are the actual inflation figures which are still very high relative to the Fed's target and history (Fed's preferred PCE below over last two decades).



Unless actual inflation starts coming down, the Fed fears that *"the public will come to think of higher inflation as the norm and expect it to continue"*, ie higher inflation expectations become entrenched which will shift inflation expectations back up.

Until both long-term inflation expectations and actual inflation (PCE and CPI) come down substantially, the Fed is likely to act aggressively. In fact, as we pointed out in our May Investor Letter, historically the Fed needed to raise rates above inflation for a protracted period to win the inflation battle. We are a still a long way from that – 2.5% Fed funds vs 4.5% PCE, 8.3% CPI. Rather than forecast a specific terminal rate, watch both expectations and actual inflation. Until they trend towards 2%, don't even think about the Fed loosening policy.

At risk of sounding like a broken record, this leaves us in a very challenging investing environment. Some argue that the Fed is like an alcoholic who has promised to stay dry (fight inflation no matter what) but whose willpower will eventually break when the going gets tough (unleashing another period of easy money). This is a distinct possibility, but we will wait for them to reach for the drink before embracing risk. Until such time, caution is warranted.

Macro Factor II: European Energy Sector Will Suffer for Years to Come, Just Like in Argentina

Hawkish monetary policy is a big macro risk, crazy energy prices is another. Last year, we touched upon spiking energy prices in Europe last year in our October Investor Letter, which is worth a re-visit now given even higher prices. At that time, we wrote:

> *The proximate causes of higher natural gas prices include lack of wind in the North Sea, low European gas inventories and Russian supply bottlenecks. Lack of wind drove increased demand for gas while supply struggled to meet the higher needs. Trader margin calls likely exacerbated the spikes, causing prices to shoot up 40% in a day in the UK, before closing lower on the day.*
>
> *The structural reasons that underpinned the spikes in Europe include increasing reliance on renewables without building sufficient baseload power, depletion of gas in the Rough field as well as the liberalization of power markets which led to increased private sector participation and reduction in long-term contracting.*
>
> *...we are less concerned about the proximate causes. After all, coal-burning power plants can be turned back on, Russia may increase their gas supply above agreed quotas and even wind conditions can change. On the other hand, structural drivers cannot be easily fixed and likely portend higher energy prices. In the short-term, price spikes can correct themselves but given structural issues, we would not be surprised if such price increases become more common in future.*
>
> *…when markets are short something that is absolutely essential (eg food, energy, shelter), prices can hit hard-to-imagine levels. The energy market is not one that I would want to short.*

Natural gas prices in October last year were trading at a shocking 3x the previous highs; today they are double that at 6x and at the peak touched nearly 10x!

Gas delivered to Netherlands TTF (EUR/MWh)

This is causing a lot of pain to consumers in Europe. A quick survey of friends in Europe show that residential power prices are up 3x in the UK, 2x in Spain and 20% in Germany. Unsurprisingly, this is now a political issue. Besides blaming Putin, the European Commission recently proposed a number of emergency intervention measures to deal with this problem:

> i) Reducing Electricity Consumption
> Target 10% reduction in electricity demand; mandatory 5% reduction during peak hours
> ii) Capping Revenue of Low-Cost Power Generators
> Capping revenue of low-cost electricity producers (nuclear, coal, renewables) at €180/MWh
> iii) Taxing Fossil Fuel Companies
> Taxing "excess" profits, ie earnings more than 20% above average profits over past 3 years

The final details will obviously change but rest assured that when politicians take over energy markets, unintended consequences are inevitable. Argentina serves as a useful case study. In the aftermath of the economic crisis in the late 1990s/early 2000s, Argentina under Eduardo Duhalde instituted a number of policies to ameliorate the impact of the recession on voters. These took the form of price caps and/or subsidies on gas, electricity and water distribution companies, including removing inflation adjustments as well as the eventual re-denomination of tariffs from USD to Argentinian Peso (after the Argentine peg to USD broke). Without judging the wisdom of these measures, we observe that voters and households were "protected" at the expense of industry, demand for gas and electricity actually went up as prices were kept artificially low, with numerous utility companies eventually ending in bankruptcies or nationalizations.

Argentina (Early 2000s)	Europe (2022 -)
Price Caps/Subsidies	Being Proposed
Bankruptcies/Bailouts	Yes (France → EDF, Germany → Uniper, VNG, SEFE)
Energy Export Bans	Rumours (France → Italy)
Emergency Laws	Being Proposed

We would not be surprised if the energy sector in Europe remains hobbled for years to come, infrastructure deteriorates as companies cut back on capex and maintenance spend, and ultimately shareholders and creditors of utilities are left with massive losses. The winners will be politicians (who will cling on to their emergency powers), politically-connected industry insiders, vulture funds, consultants and lawyers.

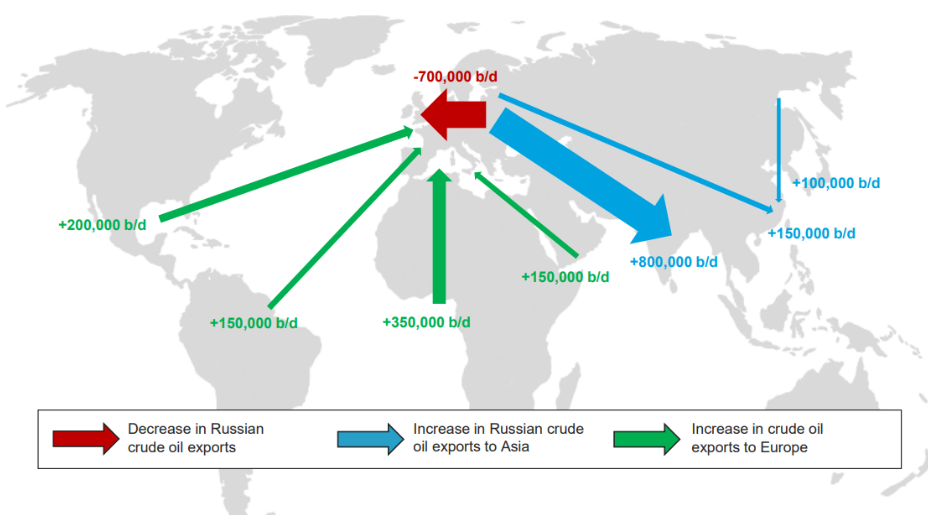
Micro: Reviewing Current Investment Themes – Shipping, Nuclear, Precious Metals

After the previous sections touching on the macro, we wanted to end with a quick review of some of our investment themes. In preview, we still like our exposure to shipping companies, the fundamentals continue to improve for the nuclear sector, while precious metals face headwinds from higher real rates and a stronger dollar.

Shipping/Oil Tankers

In our March Investor Letter, we had pointed out that sanctions on Russia would actually increase vessel demand as a result of re-routing trade routes/rising tonne-miles. This is indeed happening and has led to a surge in tanker charter rates:

Changing Crude Oil Trade Patterns Following Russia's Invasion of Ukraine



Source: Kpler – compares average seaborne crude oil flows in the 3 months prior to Russia's invasion of Ukraine vs. 3 months after

Short-haul movements of Russian crude oil into Europe have continued to fall and are expected to decline further once the EU's ban on Russian crude comes into force in late-2022. China, and *in particular, India, have increased their purchases of Russian crude, which is driving tanker tonne-mile demand higher. In turn, Europe is having to turn to alternative sources of crude from further away in order to replace Russian barrels. These changes have been positive for mid-size tanker tonne-mile demand due to longer average voyage distances – Teekay Tankers, Aug 2022*

In addition, gas-to-oil switching in Europe is also driving incremental demand for crude-related product. Previously the price differential between natural gas and crude oil made this uneconomical, this has obviously changed. Shipping (crude tankers and LPG carriers) continue to be a core holding for the fund and we look forward to continued strong charter rates into the end of the year.

Nuclear Energy

On the one hand, the war in Ukraine should be supportive of uranium prices as Russia is both a producer and enricher of uranium. On the other hand, the potential risk of a disaster at Ukraine's largest nuclear power plant due to hostilities raised fears of a potential Fukushima. The price of uranium surged in sympathy after the outbreak of war but has since traded sideways at around US$ 50/lb. The price of uranium companies that we own, such as Kazatomprom and Nexgen, have also been rangebound.

Notwithstanding the unenthusiastic price action, macro fundamentals have clearly been very bullish. Amongst other things, Biden's "Inflation Reduction Act" will be providing $30 billion towards the maintenance of the US nuclear reactor fleet, as well as put nuclear on equal footing with wind and solar for 'green' tax credits. Japan's prime minister has pledged to restart a total of 17 reactors by next summer and asked the government for the possibility of adding new advanced reactors to the grid. China has announced it will accelerate nuclear projects, while Germany, Switzerland, France, Sweden, Kazahkstan, Egypt are restarting, extending or building new nuclear reactors.

We had cut our exposure to nuclear this year as we were reducing risk across-the-board. Going forward, we expect to gradually raise our exposures to this theme given that it is among the least recession-prone sectors.

Precious Metals

We wrote in both our March and May letters this year why we are very bullish precious metals. We were already invested in the sector before that because of cheap valuations and as a protection against fiat debasement and so saw the weaponization of foreign reserves (freezing some US$ 300 billion of Russian reserves) as a clear catalyst for higher prices. China and India, to cite the two biggest examples, have enormous foreign exchange reserves which can similarly be sanctioned; it is inconceivable that they do not increase their gold purchases going forward.

This has not played out as we had expected so far. Since May, gold price is down over 10% while the gold equities we own are down 15-25%. From what we can observe, the bigger drivers of the price of gold have been the strength of the US dollar as well as rising real interest rates. A casual glance even suggests that gold should be trading closer to US$ 1200, 30% lower from current prices.

<u>Gold (white) vs Real Rates and US Dollar (yellow and green, inverted)</u>

While we still expect the official sector to provide a fundamental bid for precious metals over the medium to long term, in the short term the price action suggests that more downside is possible. Given this, we intend to hedge out some of our gold price exposure on rallies in the metal.

After Years of Abstraction, Things are Getting Real for Markets

We took the header above from a January 2022 article by Peter Atwater, a former financial services professional who now consults and lectures on social psychology. He argued then that the intense investor interest in the most abstract opportunities, such as SPACs to non-fungible tokens and the metaverse, perhaps signaled a peak in confidence, as investors fixated on the potential of concepts and ideas:

> *<u>At lows in confidence, investors crave certainty</u>. They buy shares in the safest companies, those with tangible assets, "real" earnings and cash flow, if they buy equities at all. On the other hand, <u>at peaks in confidence</u>, investors have an insatiable demand for possibility. <u>They buy dreams at the highest price.</u>*
>
> *<u>Today, what is most expensive is what is the most extremely abstract — the enterprises that have the greatest "hypotheticality",</u> the anti-real as it were. The crowd adores everything that is at the far reaches of psychological distance — in time, in place and in familiarity. We all but need binoculars to see it out there on a far horizon. Futuristic investment themes like space travel speak to our insatiable appetite for the psychologically distant opportunity.*
>
> *…the greatest risk to the financial markets isn't a decline in corporate earnings or a policymaker mis-step, but an abrupt change in investor thinking. <u>After years of devouring abstraction, does the crowd turn to more substantive investment themes — a year of getting real?</u> That process would be far from smooth. Even if more solid ground is better for the long-term direction of*

markets, those who rushed in when prices were "to the moon" will be hurt as valuations return to earth.

We are inclined to agree with Atwater. After more than a decade of investor exuberance and self-confidence, it seems as if the tide has started to turn. Whether this is due to the pandemic, the war in Europe, rising geopolitical tensions, raging inflation or restrictive monetary policy, the takeaway seems to be that confidence is on the decline. In such an environment, it is likely that investor appetites shift away from the abstract towards the real, from growth towards value, from upside maximization towards downside protection. We already see the beginnings of this shift; we think there is a long way to go.

<u>Ratio of S&P GSCI vs S&P 500</u>

Sincerely,

Yongchuan Pan
22 September 2022

Appendix

Q1: What are his views on the causes of the current high levels of inflation?
A1: The pandemic severely disrupted the economy, giving rise to the potential for very dire economic consequences that forced the policy response from the Fed. Monetary policy was obviously stimulative to demand although pandemic impact on supply-side and labour market also contributed to inflation. Ultimately, pandemic impact and policy response both contributed to inflation in a way that is not easy to untangle.
Q2: Does the Fed have the resolve to bring inflation under control given the potential economic costs and likely political pressures?
A2: The Fed will keep at this task until the job is done because the alternative, ie letting inflation expectations reset much higher, will bring unacceptable social costs further out. History (1970s) cautions against loosening monetary policy prematurely. The Fed will not be moved by political considerations.
Q3: The Fed's recently amended framework of targeting average inflation may create additional uncertainty in the market. Should this framework be changed?
A3: The framework was studied and introduced at a time when central bankers around the world were struggling to support the global economy. Ultimately, the point of the new framework is to keep inflation expectations anchored at around 2% and this seems to be the case so far.
Q4: How does the tight labour market affect the Fed's ability to tackle inflation?
A4: The labour market is very strong today. They hope policy interventions will help achieve a period of below trend growth and bring down wages to levels more in line with Fed inflection objectives.
Q5: How does he respond to people who say inflation is primarily due to expanding money supply?
A5: The relation between money supply and inflation and economic output has been much more unstable than it was in Friedman's time. Changes in monetary aggregates have not been a good predictor of the economy or inflation and does not play an important role in the Fed's formulation of policy and is not a good way to think about inflation.
Q6: What does he think of nominal GDP targeting and other formulaic ways of policy making?
A6: They have looked at nominal GDP targeting and concluded that it is not the right way to go as it is not a practical way to manage their dual mandate although it works well in models. One reason is that it is very hard to explain to general public how it works. Another reason is the difficulty in estimating trend growth when this is a changing number.
Q7: Does it make sense for employment to be part of the Fed's mandate instead of just focusing on monetary stability?
A7: Congress granted the dual mandate and it serves the public well and he does not see a case to move to a single mandate. The two goals are not in conflict, ie without price stability we would not be able to achieve a strong labour market that benefits all.
Q8: Some argue that the Fed's remit has expanded substantially in the wake of the financial crisis. Should the Fed's mandate be expanded?
A8: The current mandate is appropriate and he would not want to see it narrowed or broadened. The current mandate gives the Fed a precious grant of independence. The more they stray from their mandate, towards objectives that may be in conflict with their dual mandate and which their tools may not be suited for, the more likely their independence is challenged.
Q9: The Fed's balance sheet expanded substantially after the financial crisis and even more so after the pandemic. Is there a plan to reduce the balance sheet to levels before the financial crisis?
A9: The balance sheet is substantially larger now and so the Fed will be reducing the balance sheet substantially. However, they will not be returning to a scarce reserve regime like before financial

crisis. The world changed after the financial crisis and the pandemic and there is now high and volatile demand for safe and liquid assets, hence the current ample reserves framework.
Q10: How can concerns about financial privacy by reconciled with a central bank digital currency?
A10: No decision has been made on CBDCs and the Fed does not intend to proceed on one without clear support from executive branch and Congress. A CBDC in the US will need to be privacy protected, intermediated, widely transferable and identity verified. They will have to strike a balance between law enforcement and privacy. CBDC, if viewed as a super-safe asset, could also generate run-risks which have to be thought through.
Q11: Should crypto be regulated and will it hurt innovation?
A11: Stablecoins should be regulated. If people think something is money, then it should have the qualities of money. Money should be guaranteed to be good, not something that works sometimes but not other times. Hence we need legislation on this.
Q12: What does he think of fiscal health of the country?
A12: He worries about the country's fiscal health and does not think the path of fiscal policy is sustainable, but that is the responsibility of Congress, not the Fed. They want to focus on inflation, especially now when it is so far above the target.
Q13: What are some of the lessons you have learnt since you became Fed Chair?
A13: Three lessons he mentioned at Jackson Hole: 1) Fed has and accepts responsibility for price stability 2) Inflation expectations need to be carefully monitored because if they move up it makes the job of getting it back to price stability much harder 3) There is a record of failed attempts to get inflation under control which raises the ultimate cost to society, hence the need to do the job now and keep at it. The structure of the economy is ever changing and highly complex and many other countries are also experiencing high inflation. If we move to a world where there will be more frequent, larger and persistent supply shocks, there will be difficult implications for the conduct of economic and monetary policy.