# JEMEKK HEDGE FUND

Inception date: August 1999
Q2 2022 Commentary

| | Q2 2022 | YTD 2022 | Since Inception |
|---|---|---|---|
| Jemekk Hedge Fund | -9.84% | -8.73% | 530.94% |
| S&P TSX Composite | -13.19% | -9.87% | 378.96% |
| S&P 500 Composite | -16.10% | -19.96% | 339.64% |

**Benchmarks quoted in Total Returns*

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The second quarter of 2022 capped a historic sell-off in market indices with the S&P 500 having the worst start to a first half of the year since 1970, down 20%. The quarter saw a confluence of factors starting with inflation, leading to rising interest rates, continuing with quantitative tightening, added risks with Russia's invasion of Ukraine, and then culminating into widespread fears of a looming recession. Late in the quarter even the energy sector, the sole bright spot with strong year-to-date gains to end of May, succumbed to the unrelentless investor selling pressures. We start the third quarter clearly at a crossroad as to whether the economic indicators point to upcoming weakness or relative strength. Unemployment remains low and available job openings remain at historic highs. New passenger vehicle demand remains far above supply with dealer inventories down to working capital minimums. Economic data may show the U.S. having negative GDP growth in the first half of 2022, but never have we seen negative real GDP with full employment and demand for many things being greater than supply. The evidence points to weakness in economic data being supply driven as opposed to being demand driven. As a result, we are more constructive about the economic activity outlook for North America and Asia in the medium-term then what is discounted currently in the market. That said, we have concerns about the outlook for Europe due to the uncertainty of its energy supply – though note that extraordinarily high energy prices in Europe results in an improved competitive advantage and profit outlook for the North American businesses we focus on.

From a Fund performance standpoint, we are disappointed in the drawdown, almost all of which was experienced in June. Although we managed to navigate the choppy markets in the first 5 months of the year, June hit the Fund particularly hard. Our exposure to Energy, which had helped significantly for most of the year, suffered a material pullback, and although we remain committed to the group (discussed further below) we had not lightened up enough to offset that drawdown. In addition, our exposure to the US and cyclicals also led to the disappointing June, which disrupted the momentum we had begun to build in the preceding months.

The Jemekk Hedge Fund entered with 70% net exposure but exited Q2 at a lower figure of 62% due to increased concerns regarding a possible recession. The Fund had managed to generate gains in energy (before the late June selloff) and coal related names, as well as stock index hedges. However, as commensurate with the general market sell-off these gains were more than offset by losses in the rest of the portfolio. While energy and other commodity stocks experienced an abrupt and substantial drawdown in the second half of June, we remain positive on their outlooks. Oil and North American gas prices remain very high. Refinery crack spreads are at historic highs. Metallurgical coal prices remain well above pre-Covid levels and thermal coal prices are at new all-time highs. The enormous profit levels and free cash flow from these companies can directly impact shareholder returns in the short to medium-term via dividends and share buybacks.

We feel it relevant to point out that after having dramatically reduced exposure to technology earlier in the year, the Fund has begun to discriminately add weight to this area given much improved valuation levels and what we view as signs of a break in their downward momentum. Although weighted materially lower than in 2021, we have begun to see a bottoming for high quality growth-tech names and would expect this nominal weighting to grow in Q3.

Despite rising inflation, our gold sector exposures generated a negative return during the quarter, which we attribute to a strongly rising U.S. dollar and an investor base that was selling "almost everything." Notwithstanding, gold prices held-up far better than market indices and we feel some validation on our long-standing belief that crypto-currency is not a strong substitute for gold when investors are looking for hedges against inflation and economic turmoil. Although we have been beating our head against the wall, with respect to precious metals, we believe the group will become increasingly attractive as we enter the second half, and the pressure on the Fed to tighten, begins to wane. A lower dollar, and a leveling in rates should provide a boost to the group from extremely oversold conditions.

As per usual, we would like to highlight a new holding to the Fund to highlight the opportunities we are seeing in these dislocated markets, Arch Resources:

**ARCH Resources (ARCH) –** ARCH is a major U.S. producer of both metallurgical and thermal coal with production rates of 10mm tpy of metallurgical, 5 mm tpy of standard thermal coal and 72 mm tpy of low-btu PRB thermal coal.

Most of the world, including the U.S., is running into supply issues for all forms of the main electricity generation inputs (coal, natural gas, renewables, nuclear, hydroelectric). Even prior to sanctions against Russia, the sudden much greater reliance on thermal coal to satisfy total electricity demand was taking place. The recent reactivation of coal-fired power plants in Europe due to reductions in natural gas flows from Russia have only further added to the tight market conditions. Thermal coal prices are hovering around record high price levels.

As for metallurgical coal prices, despite a major recent pullback from lofty highs they remain well above historical averages. Importantly, we attribute some of the recent weakness in metallurgical coal prices to be the result of a build-up of steel inventories during the recent lockdowns in Shanghai. There are now definitive signs of China steel consumption returning towards pre-lockdown levels with the reopening of factories, with further support in the coming months from a new infrastructure stimulus plan.

In the case of both thermal and metallurgical coal a key factor supporting high prices is the constraint of their supply growth given ESG challenges.

Based on historical coal prices most of ARCH's profits would be generated by its metallurgical coal unit despite representing only 12% of total volumes. However, over the past year the outlook for thermal coal has improved by a far greater magnitude than metallurgical coal. ARCH's thermal assets should provide a very large tailwind to 2023/2024 earnings given 100% of its PRB coal and 50% of its standard thermal coal to be sold in 2022 are at contract prices established pre-2022 when prices were far below current market values. As such ARCH is poised to generate an enormous amount of free cash flow in 2022. Furthermore, as the company has reached net debt free status, ARCH intends to pay a variable dividend equal to 50% of free cash flow as well as likely use most of the other 50% for share buybacks, returning cash to the owners, a theme we see across several our holdings in 2022/2023.

As we reflect on the economic data and stock indices performance in the second quarter our views on the global economic outlook have become more cautious, but still favorable as we see the economic constraints to be more weighted towards supply issues as opposed to demand issues. Years of underinvestment, supply chain issues and the conflict in the Ukraine support this supply driven recession belief. This contrasts with what appears to be a consensus view for an upcoming recession that would result in high unemployment and depressed commodity prices. While there have been recent signs for incrementally weaker economic and consumer conditions, we also believe contrasting positive indicators have been somewhat overlooked. Our portfolio positioning entering the third quarter reflects our cautious optimism, but we remain nimble and apt to change as the data causes our views to.

We thank you for your continued support and look forward to communicating with you at the end of Q3. As always, reach out to us below with any questions.

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