Shelter Island Capital Management Ltd.

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The Shelter Island Total Return Fund returned 2.25% in Q4 2023, bringing the total return for the year to an unsatisfactory 1.71%. However, our combined 2022-2023 return is a defensible 19%. The 2023 performance leaves the CAGR since the inception of this strategy in 2020 at 13.6%.

Our low conviction level partly explains the recent underperformance relative to most risky assets. We hesitated at jumping on the bull train because of the demanding valuations of most of the stocks on our buy list. As the market rallied from the bottom in 2022, we became forced sellers of some of our best performing positions as they reached or exceeded our most optimistic price targets.

This view is reflected in low gross and net exposures. In addition, the performance of our short book was the worst contributor to performance in our eight years' working together, or for that matter, in Luis's twenty-five-year career as a long-short manager. We find comfort that our 14-year track record of positive uncorrelated returns remains intact.

<u>Market Overview</u>

Valuation

At the start of 2022, we had some reservations about equity valuations, especially in markets that were deemed to have cyclical recovery appeal, such as China and the euro area. We were right in anticipating a mild "stagflation" for the core countries in the euro area and weaker than expected growth in China. However, neither development has been a hurdle for an extraordinary 2023 for euro area stock markets, including Germany's, where the economy is both likely to be in recession and is very geared to exports to China.

Consequently, we are even less inclined to consider European stocks today. Also, and in spite of the correction in the Chinese market, we remain underinvested there as we continue to have concerns over the financial health of the Chinese economy. We also demand a large discount because of the Chinese Government's political activism and regulatory risks.

There are of course some idiosyncratic opportunities in equities in any type of market backdrop. However, we have more confidence in "seeking alpha" with our long-short portfolio than in buying market beta. Outside equities, we find some opportunities in inflation linked US Treasury bonds but not much else that is attractive in fixed income for the time being. We are in the countdown to the Great Wall of Refinancing of 2025 and somewhat surprisingly credit spreads are at multi-year tights.

We believe that there are some risks to the downside because investors are discounting more numerous and faster rate cuts than those projected by central banks. This leads to two scenarios. One is where rates remain higher for longer than currently anticipated. Conversely, in the second scenario, central banks are forced to cut rates faster than intended because of poor employment or activity data. Whereas investors want to see lower rates in

2025 to facilitate the large upcoming refinancing needs, historically, when central banks backpedal on monetary policy, equity markets correct sharply.

This view, coupled with above average equity market multiples on earnings that continue to benefit from one-off tail winds, render the risk-reward not very attractive in our opinion. Conversely, the yield on short-term fixed income investments mitigates some of the potential foregone upside.

The S&P 500 is back at record levels for the first time in two years. However, the Wall Street Journal reports that 10 out of 11 sectors are trading at an average of 15% below their all-time highs. The equal-weighted S&P500 is down slightly for the year. Is the lack of breadth in the most recent market rally a source of concern or a source of opportunity? We are not finding many new investment candidates at attractive valuations in spite of this underperformance of the S&P493.

The Paradoxical Dearth of Activity in Equity Capital Markets and Mergers & Acquisitions

We also cannot gather great comfort in equity markets from the collapse in activity in the IPO market. Bloomberg data confirms that 2023 was the slowest year in global IPO volume since 2012 with 1,409 issues raising $133 billion. This is 32% less than 2022 and 80% less than 2021's record year. US IPO issuance volume was similar to 2022's, but 92% below 2021's record, and well below a typical year's $55 billion.

Our conversations with equity capital markets desks confirm our bottom-up research. There is a very large number of companies waiting to raise capital to repair their balance sheets ahead of large refinancings. When that window opens there will be a wall of new equity issuance. There is as well a very long waiting list of unicorns looking to go public or looking for a buyer. Finally, there is a long waiting line for financial sponsors' portfolio companies looking to go public as an exit strategy while the clock keeps ticking on the remaining lives of many vintages.

Last year was also a very slow year for mergers and acquisitions. Typically, that is not a good sign for equity markets. We suspect that some companies will wait for the outcome of the US elections in November to announce any new mergers or acquisitions because the current regulatory climate is extremely confrontational and wanton. Consider the two-year long regulatory review of Microsoft's acquisition of Activision, or worse yet, Jet Blue terminating the takeover of Spirit Airlines after a federal judge's ruling blocked their planned merger. Even if a new US administration in 2025 proves to be more friendly to business combinations, the EU regulator is likely to continue to be a significant hurdle. The Federal Trade Commission was reported to be poised to reject Amazon's acquisition of iRobot before the companies announced on Monday that they were abandoning the deal because of EU antitrust opposition.

China

The Chinese equity market is attracting the curiosity of value investors. However, while we do see some opportunities there, including some companies with a net cash position that is larger than their market capitalizations, the ongoing financial crisis is far from resolved.

China has just over 300% of GDP in total credit to the non-financial sector. This is one of the highest ratios in the world and larger than the ratio was in the US at the outset of the Great Financial Crisis.

We subscribe to the The Macro Strategy Partnership team's conclusion on the gravity of the risk that China will export deflation to the rest of the world. Macro Strategy wrote: "China's 2023 nominal GDP was up 4.2% y/y, which outside of 2020, was the lowest since 1976, the year Mao died. It only managed to get 16.4 cents of nominal GDP growth for each additional yuan of debt, highlighting just how unproductive the growth is and thereby how expensive it is in terms of future growth potential. A deflationary environment is forming amid tepid consumer demand and weak corporate earnings. With President Xi Jinping's solution of investment in more manufacturing capacity, it risks unleashing a tide of deflation on the rest of the world, or a trade war to prevent it."

Moreover, China's debt restructuring and corporate reorganization processes remain ad hoc. Some creditors complain of unfair treatment. A well-oiled and predictable corporate debt restructuring is the ultimate test of well-functioning credit markets and the rule of law. So far China is showing deficiencies in handling these challenges. Investors will watch closely how the Hong Kong court's order to liquidate China Evergrande is implemented in mainland China.

The extent and severity of potential credit losses in the Chinese banking system remain elusive as well. The obfuscation of critical financial data is not a great confidence booster. We observe a disinflationary environment which is a further hindrance to the management of the property developers' debt problems. Chinese household debt is also very high by historical standards. Research suggests that lower income households are devoting a very large percentage of household income to service consumer loans. This is one of the reasons why we believe that a devaluation of the currency may prove to be a good solution. However, Chinese authorities are adamantly defending a strong CNH policy. The Chinese stock market's poor performance may well be discounting a weaker exchange rate scenario.

AI Intelligence

Received wisdom has it that the promise of Artificial Intelligence is boundless. Investors have embraced this technology full heartedly sending the Magnificent Seven Stocks on a tear. It is difficult to see this technology develop without massive investments in new and more powerful servers using massive parallel graphic processing units (GPUs). Thus, investors have jumped on NVIDIA's stock which is up nearly sixfold since the doldrums of October 2022.

NVIDIA outsources manufacturing to Taiwan Semiconductor Manufacturing Company and Samsung Electronics. As you know we have been long term shareholders in both companies as well as other companies with dominant positions in the semiconductor equipment manufacturing industry such as BESI or Lam Research.

As we discussed at the top of this letter, we have been forced sellers of some of these stocks as they reached our most optimistic price targets and hold smaller positions today. However, Samsung Electronics continues to offer a very attractive valuation. The ratio of Samsung's Enterprise Value to Invested Capital is just under 1x while its Return on Invested Capital is above 13% on average since 2012.

A Note on Geopolitics

For many years now, political, or geopolitical developments do not appear to have a lasting impact on equity markets. However, we are seeing an escalation in a conflict between liberal democracies and illiberal authoritarian regimes. Russia's invasion of Ukraine starting a proxy war with NATO, Hamas's attack on Israel leading to an Israeli military occupation of Gaza, Hezbollah's missile attacks on Israel, Houthi attacks on commercial vessels in the Red Sea, and the most recent drone attack on a US military base in Jordan by "radical Iranian-backed militant groups" have barely had any market impact (except for Russia securities held by western investors). Is this sanguine attitude warranted? We do not have a strong opinion. However, we remain cautious when investing in some countries, such as Taiwan.

In any case, the disruption of shipping lines through Suez combined with continued sanctions on diesel imports from Russia and some refinery shutdowns in the US, result in a 15% increase in diesel prices in the EU, the world's largest importer of refined products.

The TA-35 Index of the Tel Aviv stock exchange is above its closing price of October 6, the day before the attacks. Even offshore oil and gas producer Energean's share price is not very much below its pre-conflict price. However, this company is ramping up production in its Karish facility at a very rapid pace. Revenues grew 93% in 2023 and will continue to grow strongly in 2024 in line with production which is assured thank to a solid pipeline of new fields in Israel such as Katlan. Outside the offshore gas and oil production in Israel the company has smaller production in Egypt and Italy and a significant growth opportunity in gas in Morocco underpinned by the 18 Bcm Anchois field. Needless to say, that the exposure to the conflict area of the offshore exploration assets in Israel remains a source of concern for investors and in our view an opportunity. The valuation is very compelling with the stock trading at a 2024 FCF yield of 30% and very importantly from the revenue stability the company derives form long term contracts with Israel's gas company.

Inflation and Money Illusion

We have been following inflation developments closely like everybody else. However, whereas the debate on the economy centred mostly on hard landing, soft landing, or no landing scenarios, we believe that a stagflation scenario is also possible. Budget deficits are undermining monetary policy targets while labour markets remain very tight. Moreover, while deficit spending may help sustain employment and incomes over the short term, it is not a realistic long term growth strategy. As such, it would be imprudent to put a multiple on the earnings that derive from these fiscal stimuli or to believe that the economy may not slowdown if and when household spending turns more cautious as unemployment rises. Also, importantly, we are mindful that government support programmes explain the extraordinarily low default and credit loss experience of the last two years.

We also stick to a naïve belief that central bankers should be more cautious calling victory over inflation after their disastrous "temporary phenomenon" misdiagnosis of 2021. That terrible judgment further debased most developed markets' currencies. The rally in the price of gold is the obverse of that partly self-inflicted inflation shock. Deficit spending in most developed markets only makes matters worse. For now, most economic actors seem to be adapting well to a higher inflation environment. Households have obtained wage increases that often nearly keep up with inflation, whereas some of their expenses, such as fixed rate mortgages and auto loans, remain fixed. (The opposite is true in countries, such as the UK and Spain, where the bulk of mortgages are floating rate).

Inflation also flatters the operating margins of most profitable businesses as long as these can pass on some of their cost increases. The reverse is generally true for companies that have operating losses, such as unprofitable tech businesses. Governments like inflation as it liquifies debt and boosts their coffers as the income thresholds for higher income tax rates are not indexed to inflation. In general, money illusion is working its magic for now.

In hindsight, our mistake was to believe we would face a more sanguine monetary policy stance. Given the sharp increase in inflation because of energy and shelter in 2022, a significantly lower headline inflation rate in 2023 became a very low hurdle to achieve because of the base effect. Looking at inflation prints in 2023 is somewhat backward looking. Conversely, keeping track of the announcements of multi-year pay rise packages seems more useful to gage future inflation.

While the October 2022 headline CPI print was 10.6% and the core 5%, one year later, the headline rate had declined to 2.4%. However, the core remained stubbornly above long-term targets at 3.6%. For November, the headline CPI was 3.1% while the core CPI remained at 4%. For December, the headline CPI came in at 3.1% vs 6.5% in 2022, but core CPI was 3.9% vs 5.7% a year earlier. (Admittedly, Fed officials are more likely to focus on the core Personal Consumption Expenditures (PCE) Index, the trend is similar for that series). These data points are all significant improvements but hardly definitive confirmation that inflation is a thing of the past.

We are keenly aware of the lagged effect shelter inflation has on US CPI. Unfortunately, while current CPI prints reflect a lagged decline in shelter prices, real estate prices in the US are going up again as 30-year mortgage rates have declined 100 bps to just under 7%. We also see a very hot labour market characterised by increasing union strength in collective bargaining across various sectors. The resurgence of organised labour in the US, especially the hard ball tactics used by the new leadership at the United Auto Workers union, is one of the notable events of 2023. This is the case not just in the US, it extends to the EU, where it is somewhat unexpected given the region's weaker growth. The latest such example is German construction workers demanding a 21% pay increase last week.

In our opinion, a negative headline print and a core CPI closer to the target for inflation for a few months coupled with a small rise in the unemployment rate would be better evidence that the Fed's inflation busting commitment is meeting success.

As things are, Central Banks have given up on prices retuning to near pre-Covid levels because the recession needed to engineer such disinflation would not be palatable. Bank of America's research surmises pragmatically "In other words, past inflation is mostly water under the bridge for the Fed." This wealth tax has been exacted on the fixed income allocation of savers and investors' portfolios.

Investors want their cake and it too. They usually get what they want. They wanted to believe that neither the current nor the forecast strength in US economic activity should bear much weight on Fed officials' monetary policy decisions and for the time being that consensus seems to be right. The market's unequivocal view is that central bankers have sufficient arguments to justify they have defeated inflation. Therefore, there is room for several rate cuts in 2024, as many as six in the US. However, they are ahead of Fed officials' own estimates.

From February 1994 to February 1995, Alan Greenspan's Fed shocked the financial industry with a surprise 300 bps cumulative rate hike that sent bond markets reeling, decimated the earnings and the capital of most banks, and precipitated yet another crisis in emerging markets. However, since then, rather than investors having to worry about fighting the Fed, the Fed has had to worry about fighting investors (and politicians). Surely, this election year should not be different, or should it?

The risk to the downside is that there is still a potential for the creeping indexation of wages, a phenomenon not seen in developed markets for decades. Do not be surprised if 2024 is the year when economists retrieve the concept of the **"wage-price spiral"** from the dustbins of history.

Valuation

Most of you are familiar with "End of an era: The coming long-run slowdown in corporate profit growth and stock returns," the 2023 paper by Michael Smolyansky. In this seminal study, Dr Smolyansky conforms and refines our thesis that we had lived an extraordinary period since interest rates have driven a three-decade rally up to 2022. The paper concludes that,

> *"the decline in interest rates and corporate tax rates over the past three decades accounts for the majority of the period's exceptional stock market performance. Lower interest expenses and corporate tax rates mechanically explain over 40 percent of the real growth in corporate profits from 1989 to 2019. In addition, the decline in risk-free rates alone accounts for all of the expansion in price-to-earnings multiples. I argue, however, that the boost to profits and valuations from ever declining interest and corporate tax rates is unlikely to continue, indicating significantly lower profit growth and stock returns in the future."*

We would add share buybacks as another important factor contributing to the stellar performance of US equities. We also just lived through a period when the dividend yield on the S&P500 exceeded the after-tax cost of debt for investment grade and at times even for high-yield companies. In that environment it was quite easy for management and boards of directors to justify issuing debt for stock buy backs. Even if the Return on Investment

(ROI) was not always great, the carry was positive. For companies that paid no dividends, the after cost of debt was well below the company's earnings yield. In both cases, stock buy backs were instantaneously accretive to earnings. This wondrous outcome is far more difficult to obtain in the current interest rate environment.

Jamie Dimon, JP Morgan's CEO since 2005, remarked at Davos this month, "It's a mistake to assume that everything's hunky dory. When stock markets are up, it's kind of like this little drug we all feel, like it's just great. But remember, we've had so much fiscal and monetary stimulation, so I'm a little more on the cautious side."

Regulation

It will soon be ten years since we attended a Ben Bernanke interview at the JW3 forum in London. The former Chaiman of the Federal Reserve made an interesting observation. The most perplexing issue in contemporary economics then, and still today, is how the wondrous technological advances of the Information Age appear to have contributed so little to improve productivity in our economies. He further pointed out the giant forward leaps in productivity, economic growth, and general welfare that emerged from electrification, the passenger car, the telephone, the Interstate highway system, or commercial aviation for his grandparents and parents' generations.

We would not dare claim that we are about to solve that mystery in economics. However, we would point out that the ever-growing encroachment of government regulation on private sector activity is surely a large hindrance to productivity growth as all economic activity is subjected to the supervision of costly regulation-enforcing commissars whose role is duplicated in Government. The destructive force of government activism and regulation has been unleashed on Chinese companies for three years now, shocking many investors who believed Chinese authorities would continue to nurture and protect their national champions.

For decades, the size and reach of government agencies regulating every aspect of our personal or business lives have been growing unchecked. The general premise is that these regulations are there to protect our wellbeing as citizens and as consumers. In reality, what we have seen in most industries is regulatory capture by the largest companies leading to less competition, less consumer choice, and higher prices.

The regulator-led consolidation of the banking industry in Spain is a very good recent example of these unintended consequences. Following the demise of more than half of the heavily politicised savings banks during the euro area Sovereign and Banking Crisis, both the Single Supervisory Mechanism (SSM) and the Bank of Spain encouraged mergers and takeovers. As a result, concentration in the banking industry in Spain has jumped by an order of magnitude. ECB data shows that concentration as measured by the Herfindahl-Hirschmann Index has reached a record 1,270, double that of France at 661 and over 4 times Germany's 289. Not surprisingly, Spanish banks have successfully captured most of the rate hike in the euro area in their net interest margin as they can get away with not offering interest bearing accounts. Uninformed consumers foot the bill.

Our own industry was lightly regulated until French President Nicholas Sarkozy decided in the fall of 2008 that hedge fund managers were responsible for the Great Financial Crisis and had to be more closely controlled. What ensued is less consumer choice as smaller firms were no longer economic.

We have yet to have a working AI engine and some of the largest emerging players in that nascent industry are already calling for government regulation. What is to be regulated remains elusive. We still do not know the capabilities of General AI. Our understanding today is fuzzy; however, first mover advantage may also play a role in this new industry as it has in so many others in the past.

At Davos this year, the usual unanimity shown on most issues by the world's self-appointed elites has been dented by a few speakers. Javier Milei, the neo-liberal Argentine President, has won the popularity contest on X thanks to a very courageous speech that transported some of us to the late 1970s Thatcher Revolution. Unfortunately for Argentinians, President Milei faces much higher hurdles than Mrs Thatcher did.

Mrs. Thatcher became the Prime Minister with the support of a large majority in Parliament. The United Kingdom was a G7 industrialised country with a global reserve currency. The UK was also a member of the EU and NATO while enjoying a "special relationship" with the US. A relationship that became even more special when Ronald Reagan became President.

President Milei has none of those invaluable advantages. On the contrary, he has already suffered pushback to reform in the Argentine Congress and a general strike. In addition, he is quite isolated in Mercosur and internationally. It would be another lost opportunity if Milei's reform agenda were to be undermined by his country's lack of access to funding.

Some recent developments such as the German Government's Socialist-Green-Liberal coalition openly discussing the mass deportation of some immigrants, the resignations of the Presidents of two Ivy League Universities over their handling of a Congressional testimony on campus harassment of Jewish students, or the Swedish Government announcing their support for cash payments might be signs that we are closer to the progressive extreme in the swing of the political pendulum. . A second Progressive Era, which started with the Great Financial Crisis and continues apace with Bidenomics, may run its course as public sector deficits and national debt to GDP ratios become unsustainable. Countries that choose a path to smaller government, less regulation, and more individual choice may see better productivity growth.

The EU's Growth Model Crisis

Unfortunately, such a renaissance is unlikely to flourish in the EU. On the contrary, the EU insists on becoming the regulator to the world. As we have discussed in previous letters, the EU economy has significantly underperformed both the US and the global economy since the launch of the euro in 1999. These wasted decades have not produced much progress on a political union either. If anything, the opposite is true as nationalism is the fastest rising political force. In spite of this failure, the political leadership of the EU perseveres in the same policies that have undermined the EU's competitiveness and welfare for so long.[1]

In 1998, the year before the launch of the euro, per capita GDP in the US was $34,500, 35% above France's and 28% above Germany's. In 2023, at $80,410, it is 74% higher than France's and 53% above Germany's.

This half-baked Union has developed a very powerful bureaucracy. The EU Commission is the unelected executive branch responsible "for drawing up proposals for European legislation" and implementing "the decisions of the European Parliament and the Council of the EU," the forum where government ministers from each country meet to discuss, amend and adopt laws, and coordinate policy. However, neither the EU Parliament nor the Council have the power to raise revenues through taxes on EU citizens. The multiannual financial framework for 2021-2027 is €1,216 billion, equivalent to 1.1% of annual GDP. The EU Parliament cannot appropriate expenditures beyond a small budget.

However, the Commission has been given free rein to regulate and these unelected officials have mastered the use of such powers to advance a large number of policy initiatives. The EU Commission is also the force behind a very ambitious decarbonisation agenda, the Green Deal Climate law, committing the block to reaching net zero emission by 2050. On February 6, Mr Wopke Hoekstra, the EU's Climate Commissioner, will announce a new plan to cut "greenhouse" gas emissions by 90% by 2040 compared to 1990 levels. This new target will be set in spite of significant concerns among businesspeople and farmers. The cost is estimated at a whopping €1.5 trillion annually (nearly 10% of EU GDP) which in our opinion makes the plan unworkable and a burden on long term growth and competitiveness.

Margrethe Vestager, the European Commissioner for competition, articulated the regulatory strategy "Europe must take a lead in shaping global standards, so they reflect our interests and values." Thierry Breton, European Commissioner for Internal Markets, is also intent on regulating social media even when there is not a single homegrown EU social media platform. We are concerned that the frequent large fines exacted on US platforms may further strain trade relations with the US. Mr Breton's focus is perplexing since the EU's internal markets for energy or financial services, to name just two large industries, are very far from working well. The internal market remains a complex web of national interests defending national contenders who thus easily capture their target regulators ensuring less competition or consumer choice.

Initiatives such as net zero by 2050 have an enormous cost to the EU's economy and very few benefits to the global effort to reduce green-house emissions. The reason for this is that the EU's share of global greenhouse emissions will continue to fall irrespectively of these measures as the EU's economy continues to underperform that of the rest of the world. Thus, from 1990 to 2019, the EU's share of global green-house gas emissions has fallen from 14.6% to 7.8% largely because of the growth of emission in China and India. In the

[1] The IMF has a very useful tool to compare per capita GDP at current prices at the link below.
https://www.imf.org/external/datamapper/NGDPDPC@WEO/UVK/EURO/EU

first half of 2023 construction was started on 37 gigawatts (GW) of new coal power capacity in China, 52 GW were permitted, and 8 GW of previously shelved projects were revived.

The combination of poor economic policy decisions, subpar corporate governance standards, dearth of incentives for entrepreneurship and innovation, and generally lower productivity growth and corporate profitability, are all reasons why we remain underweight euro area equities in our portfolio.

The euro area's Backstop may be in Weak Hands

Christine Lagarde has a very difficult job. Her mission is further complicated because she allegedly does not enjoy the support of the staff at the ECB. Her dilemma is to set monetary policy for an increasingly fiscally unruly and very heterogeneous monetary area. What might be too tight for some countries is too lax for others. In addition, large and small countries have largely abandoned the Maastricht Treaty (1992) fiscal rules as well as the Stability and Growth Pact commitments, which have been in the icebox since Covid.

The Pandemic allowed the unleashing of most European politicians hitherto suppressed Big Government instincts. Politicians everywhere jumped to offer state aid and spend as liberally as drunken sailors. Government debt-to-GDP ratios have risen in France, Italy, and Spain. Many investors are looking with some degree of concern at Italy's Government debt. At 135% of GDP, Italy's debt burden is much higher than that of France (98%) or Spain (95%). However, total credit to the non-financial sector is lower in Italy. Also importantly, Italy's net international investment position is far more balanced than those of either France or Spain. As the cost of refinancing goes up and governments in the euro area compete with other agents, we might see a second flare up in euro area sovereign debt markets. Mrs Lagarde has a plateful. Will she be up to the task?

Best regards,

Luis Arenzana   Juan Arias-Dávila