

Insight into Recent Market Volatility

WS Amati Strategic Metals Fund - 16th August 2024

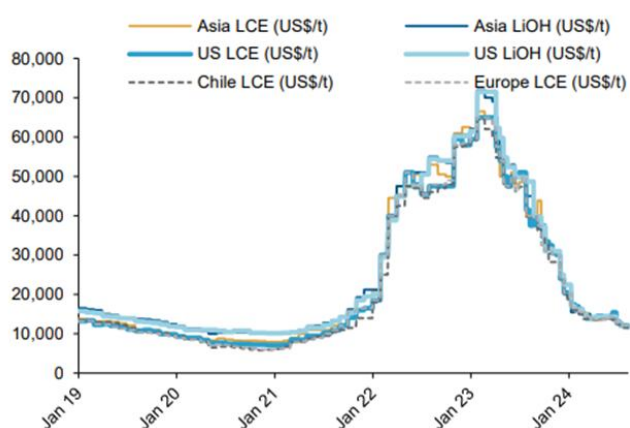


By
Georges Lequime, Fund Manager

Disappointingly, the past few months have proved very volatile for the Amati Strategic Metals Fund as its two bookends – the battery metals sector and the precious metals sector – both threatened to recover from deeply oversold levels, only to pull back again.

But there are some very encouraging recent developments to suggest that we are very close to cyclical bottoms for equities in both sectors.

Figure 1: Global lithium prices have declined 83% from their highs in late 2022



Source: Macquarie Research

Battery Metals Sector

There is little doubt that the lithium market is in a tough position right now as continued supply additions are paired with weaker demand growth. On the demand side, EV sales growth in China remains robust (21% 1H'24 over 1H'23), but this is being offset by slower western market adoption which faces increasing headwinds (i.e. removal of purchase incentives, tariffs on Chinese exports, and tougher economic conditions in general for consumers). The latest figures for Europe showed that EV sales have plateaued around 14.4% of total vehicle sales in June. This compares to a market share of 15.1% the previous year. Sales for the full year are being revised downwards to a growth of only 1.6% in 2024 compared to 2023. In 2023, sales boomed 13.9%.

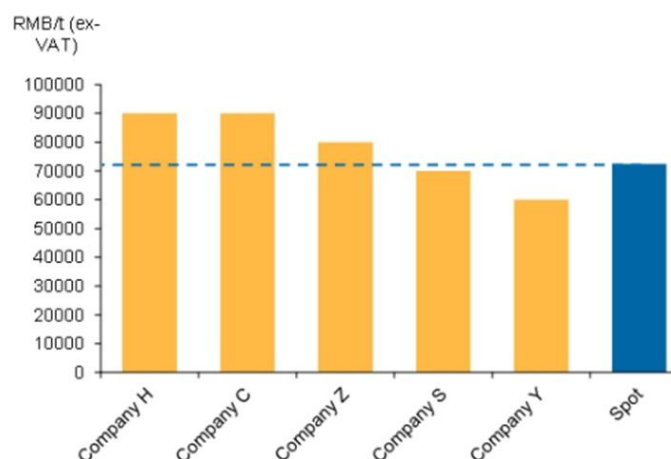
EU CO2 emission rules are set to tighten in the coming years with plug in hybrids set to be reclassified as high co2 emitting cars in 2027 so the next few years will be very interesting for Europe in trying to achieve the aggressive targets set by the EU.

The key point in the battery metals sector is that China is 100% committed to EVs and can now produce EV vehicles cheaper than internal combustion engines. Policy makers in Europe and the US are also committed to reducing CO2 emissions across their fleets. So, the industry is clearly not going away even if demand grow slows over the coming years.

This leads me on to the first key development that took place over the past couple of weeks. A statement by the CEO of Rio Tinto that they want to expand their exposure to lithium, one of the few sectors that they don't hold a dominant position. Mr Stausholm said he was very confident in long-term demand for lithium, despite prices slumping by more than 80 per cent over the past 18 months amid surging supply. "Short term it is unpredictable, but longer term it is quite predictable" Two years ago when equities were peaking, he stated that the market was overheated, and he could not find value in the sector whereas today he is talking about strengthening Rio Tinto's lithium business.

In our mind, this is perfectly understandable where companies with high quality lithium projects are trading 80-90% lower than levels reached in 2022. As the saying goes, producers are feeling the pressure, but the developers are suffering the pain!

Figure 2: Implied AISC* versus spot prices – Chinese producers



Source: Macquarie Research

*The all-in sustaining cost (AISC) is a metric used by mining companies to calculate the cost of their mining operations

But for us, the key development is that we are seeing production curtailments and scaling back of expansions across the board as spot prices have again fallen below the cost of production for many producers. Current market prices are hitting lower grade spodumene concentrate and lepidolite producers the hardest. A recent report from Macquarie bank following their trip to China showed three of the five large lithium producers in China operating at all in costs well above spot.

We expect the production curtailments announced to date to form some form of a cyclical bottom for lithium prices over the next couple of months as the inventory draw downs have largely come to an end. It will probably be at this stage that the market will start to look at lithium equities again, or even before that period if M&A activity livens up.

Right now, lithium equities are mostly trading at 0.1 – 0.4x NAV assuming a subdued lithium price outlook. While lithium prices are only down 10-15% year to date, lithium equities are down significantly and are one of the most shorted sectors in the market. Interestingly, producers are down 53% year to date while developers are down 43% - a function of the developers falling more in 2023 than the producers.

The Fund's exposure to lithium equities is currently around 13%. Our strategy has been to hold stakes in what we deemed to be the best projects in Canada, the US, Brazil and Australia with their projected costs in the lowest quartile of the cost curve. In this way we could be shielded by short-term commodity price movements. However, in reality the market has not been discerning between poor quality projects and good quality projects in this downturn.

A similar situation exists in the nickel and graphite market where prices have fallen to levels that are clearly not sustainable and significant production curtailments have been announced and are starting to flow through with nickel and graphite pricing seemingly having found a floor. Again, the Fund has an exposure to four of arguably the best development projects in the sector with two of the companies having Rio Tinto and BHP as partners.

Precious Metals Sector

Over the weekend, one of the world's largest gold companies, Gold Fields, made a cash offer for

Osisko Mining, a junior who partnered their Windfall development project in Canada.

A 67% premium was paid to last Friday's closing price. The cash offer of C\$2.2bn marks one of the largest mining deals in the country's history.

The Fund held a 2.3% exposure to Osisko Mining as well as warrants that suddenly were in the money. We have written for a while about the disparity in valuations between the smaller cap precious metals equities and some of the favoured large caps. Suddenly, with the transaction, the Fund was able to realise a 50% return on investment in one day.

We believe that this deal is significant, not only for the precious metals sector where we feel M&A is only going to get more aggressive but also for the battery metals sector where share prices have come under severe pressure.

Figure 3: Gold miners' premium/discount to the gold price



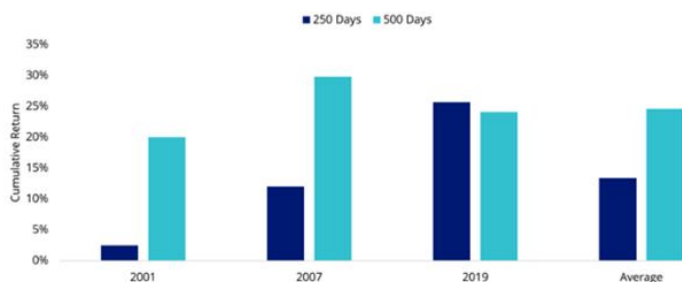
Source: Scotiabank

The Fund has a very high exposure to the sector at the moment which is motivated by a whole host of factors. Firstly, the valuations are very appealing as you can see in the chart from Scotiabank where the sector as a whole is being valued assuming a gold price 20% below, around \$1,900/oz. This is the average, and we see in our models many companies discounting \$1,500/oz gold prices or lower.

Historically, the sector used to trade at a premium of 40-240% to the gold price of the day before the breakdown happened around the time of the great financial crisis in 2008.

While this discount has been around for a while – the entire period that the Fund has been in existence – there has to be a reversion to the mean at some point.

Figure 4: Gold's cumulative return following first Fed rate cut (over last three rate-cutting cycles)



Source: Scotiabank

While most investors remain sceptical about the current level of the gold price, the gold price is nearing all time highs and getting a tailwind from growing geopolitical tensions in the middle east and elsewhere, as well as the pending cuts in interest rates in the US. Historically, the gold price has appreciated on average 12-25% over 250 to 500 days following the first rate in interest rates. Right now, the market has factored in the first cut in interest rates in September.

The metals sector is very interestingly poised right now. As frustrating as it has been seeing all these companies being oversold in a very thin trading environment, the sector is cyclical by nature, and we are seeing green shoots in the form of M&A activity and commodity price support.

Investors in the sector have tended to hide in the copper and uranium sectors where there has been some momentum. However, copper prices are starting to face headwinds as concern of Chinese economy weakness and thereby demand weakness for the red metal continues to persist. Prices dropped below US\$4.00/lb last week, with inventory levels near all-time highs. Although we believe that the long-term fundamentals for copper remain as strong as ever, we expect prices to remain depressed in the short term until things pick up again in the Chinese economy.

Uranium is another sector that has done extremely well.

The spot price has pulled back from its high, taking the equities with it but it looks like we will see some consolidation around the current price.

As in copper, the long-term fundamentals look very good, but the inventory held by financial players and companies could keep the price in check in the medium term.

We are frustrated but equally excited by the companies that we have been able to build up positions in in the Amati Strategic Metals Fund. Being an election year and a year where we will in all likelihood see the start of easing monetary policy in the US and Europe. Although we expect the volatility to continue in the short-term, we expect sentiment to improve towards the mining sector over the coming months. Rate cuts and production cuts are usually two great signs that commodity prices are going to move upwards again.



Sales Team Contacts

Rachel Le Derf

Head of Sales & Marketing
rachel.lederf@amatiglobal.com
07979601223

Colin Thomson

Head of Intermediary Distribution
Northern England, Scotland & NI
colin.thomson@amatiglobal.com
07884026517

Jonathan Woolley

Sales Director
London, Midlands, SW England & Wales
jonathan.woolley@amatiglobal.com
07818203013

Thomas Whitfield

Sales Director
London & SE England
thomas.whitfield@amatiglobal.com
07714839155

Samantha Dalby

Sales Manager
samantha.dalby@amatiglobal.com
+44 (0) 131 503 9116

Olivia Pattison

Senior Sales Support Executive
olivia.pattison@amatiglobal.com
+44 (0) 131 503 9126

Risk Warning

Past performance is not a reliable guide to future performance. The value of investments and the income from them may go down as well as up and you may not get back the amount originally invested. Tax rates, as well as the treatment of OEICs, could change at any time. The investments associated with this fund are concentrated in natural resources companies, which means that the fund is subject to greater risk and volatility than other funds with investments across a range of industry sectors. The fund invests in companies that have operations in developing markets and which therefore may be subject to higher volatility due to political, economic and currency instability. Shares in some of the underlying companies in the fund may be difficult to sell at a desired time and price. A dilution levy may be applied to the share price when the fund is expanding or contracting. Should you buy or sell in these circumstances it may have an adverse impact on the return from your investment.

This review does not provide you with all the facts you need to make an informed decision about investing in the fund. Before investing you should read the Prospectus, the Key Investor Document (KIID) and Supplementary Information Document (SID). The Prospectus sets out the main risks associated with the fund, the KIID shows you how costs and charges might effect your investment, and the SID details your cancellation rights. If you are in any doubt as to how to proceed you should consult an authorised financial intermediary. Fund documentation can be requested from Waystone or Amati and is available to download from our website.

Issued by Amati Global Investors Limited, which is authorised and regulated by the Financial Conduct Authority.