Harper Capital Management:

Global Markets- April 2023 Outlook:

In January we wrote the following:

The current economic data is mixed- inflation remains high, but is declining; goods inflation has declined, but services inflation remains sticky; job losses have mostly been in the technology industry; earnings expectations have been revised down; CEO confidence surveys suggest caution; economic surprise indices are turning positive again; overall employment remains strong, but part-time jobs appear to be driving this; monetary tightening in the United States and Europe is countered by greater liquidity in China and Japan. The unclear economic picture creates the likelihood that the Federal Reserve will have to keep rates higher for longer. The bond markets are suggestive of this with rates moving higher since the last Fed meeting. Investor behavior on market rallies during the downturn suggest that speculative behavior remains. According to Bloomberg, during the strong rally in late January retail trading was about 23% of market volume, higher than the previous high of 22% during the meme-stock and SPAC driven trading of 2021. The gamification of retail trading has also resulted in large-scale option (mostly naked) trading. Option trading in just one stock, Tesla has generated over $700 billion in premium income. On balance, we do not think the current market rally is the start of a new upturn. We think interest rates can remain high for longer than the more optimistic projections. The longer rates stay high and the greater the duration of the inverted yield curve, the more likely it is that we end the cycle with an economic downturn. A premature Fed pivot can result in a rally in risk assets but creates longer-term risks to economic stability. As we said in October, we would suggest that long-term investors use drawdowns like the ones in June and September to add to risk assets rather than chase short-term rallies.

Equity and bond markets have been in a trading range over the last six months. The US Equity market has not re-tested the October 2022 low and is broadly at the same level as when we published the January Letter. 2- and 10-year Treasury yields are slightly lower. European markets have been the strongest YTD performers and Asia has lagged. S&P 500 earnings show modest YOY decline, but have been about 7.2% above expectations with about 77% of companies beating expectations[1].

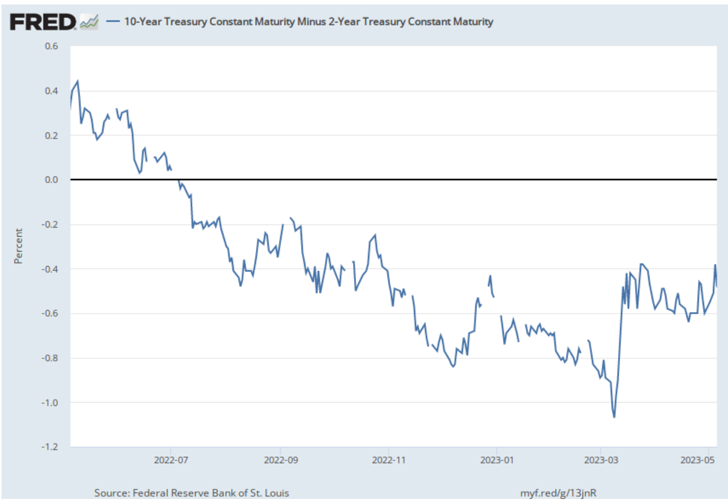
Through the end of April 2023, MSCI ACWI Index was +8.85%, EAFE Index +11.53% and the MSCI EM Index +2.78%. Among major European developed markets, economically sensitive Germany (+17.81%) and France (+19.24%) lead the way, ahead of more defensive markets Switzerland (+11.49%) and UK

[1]https://www.reuters.com/business/refinitiv-data-shows-further-improvement-q1-us-earnings-forecast-2023-05-05/

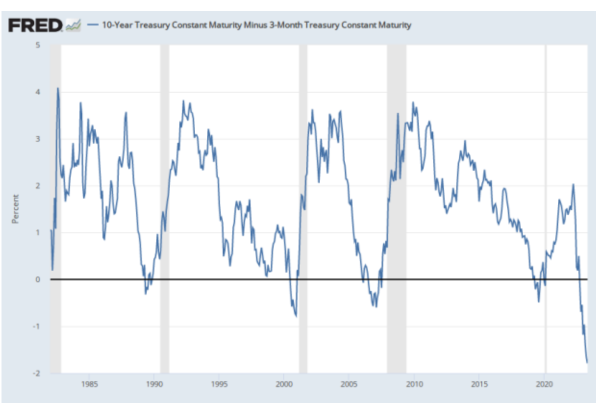
(+10.18%). US (+8.53%) and Japan (+5.49%) have lagged European equity markets so far this year. Among emerging markets, Mexico (+22.85%) and Emerging European Markets (Czech, Poland, Hungary, and Greece) were strong performers. Brazil (-2.54%), China (-0.76%) and India (-2.71%) were laggards.

Bonds which performed poorly in 2022 are faring better this year, with the longer duration ETF TLT +7.90% through the end of April and, and the aggregate bond ETF AGG +3.74%. The 10-year-2-year spread is less inverted than a quarter ago, but the 10-year-3-month yield spread is now wider at -182bps, reflecting the market view that rates stay high in the immediate term, but will decline over time.

10-year- 2-year yield spread:

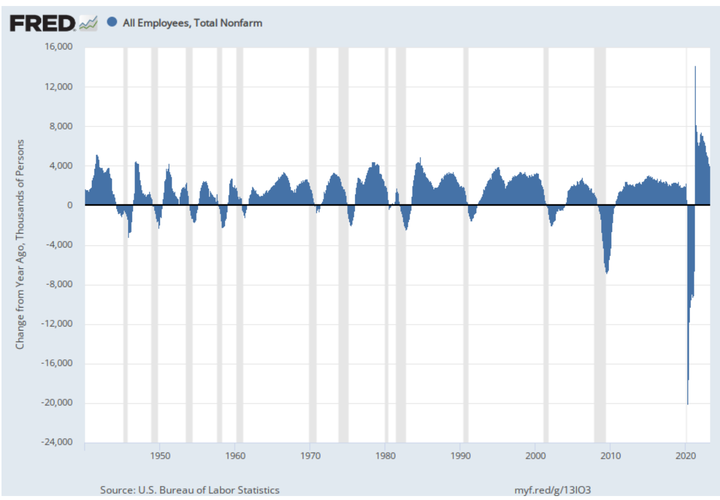


10-year- 3-month yield spread:

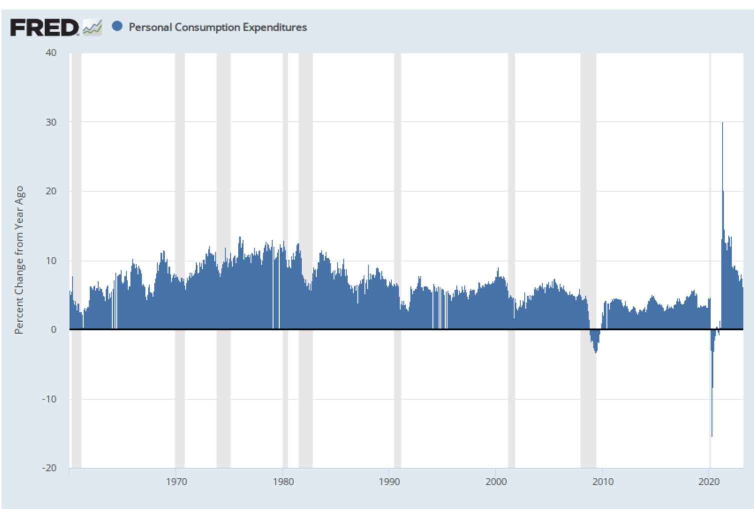


As we wrote three months ago, the overall economic picture remains unclear with employment and consumer spending suggesting a robust economy, whereas profit margins, commodity prices, money supply and bank lending standards indicative of a weakening economy. The single-family home market has stabilized and shown some improvement despite mortgage rates staying much higher than in the recent past.

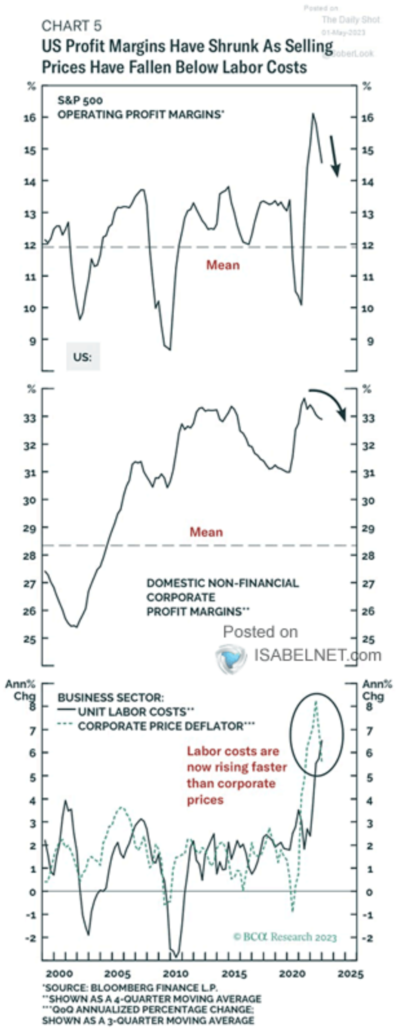
Non-Farm Payroll remains strong:



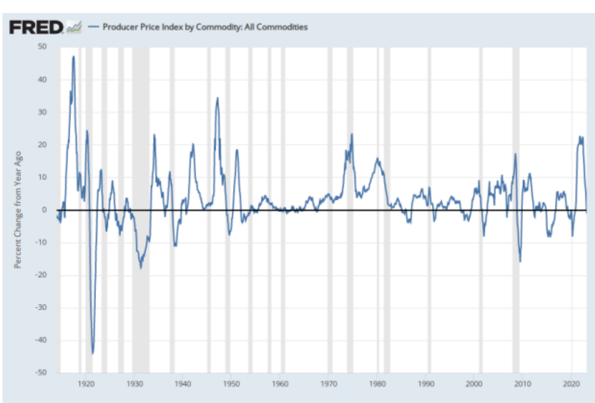
Consumer Spending remains strong:



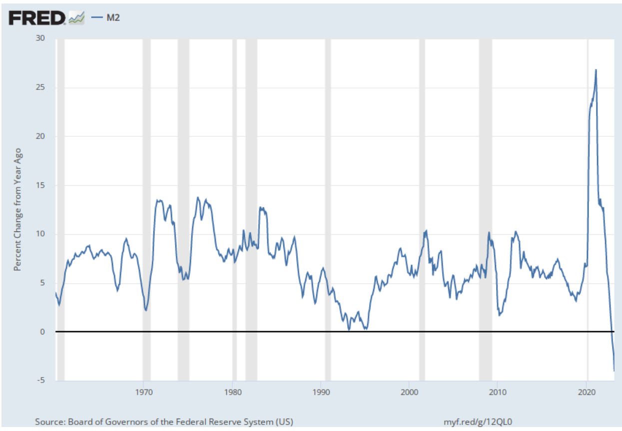
Profit Margins Weakening:



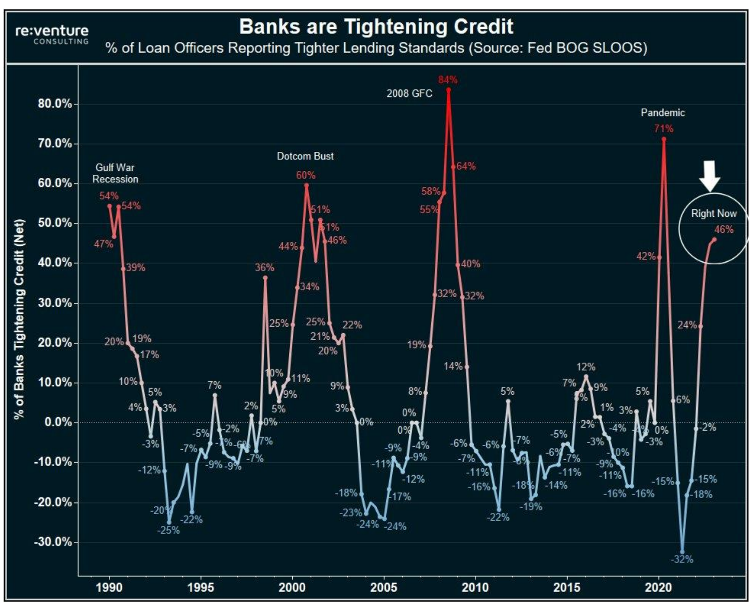
Commodity Prices Weakening:



M2 Negative YOY:



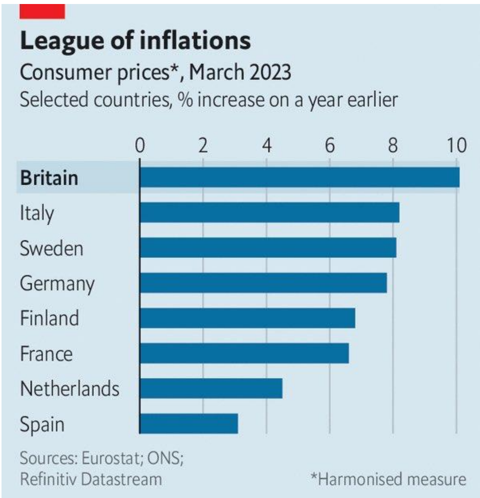
Tightening Credit:



Europe:

The rebound in European equity markets and the Euro currency continued through the end of April. Inflation in Europe remains high and further interest rate adjustments are likely.

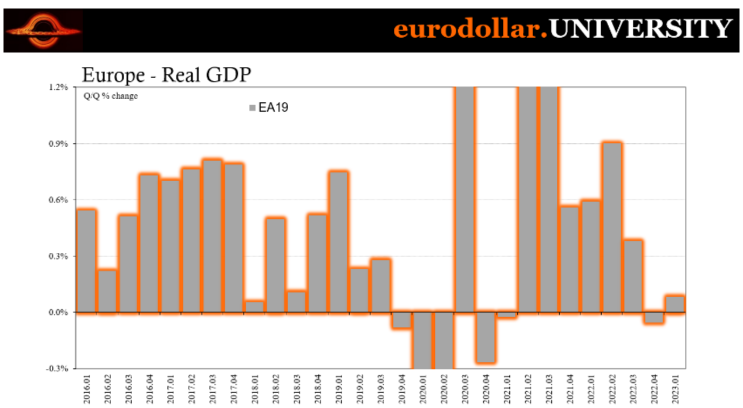
European Inflation is high:



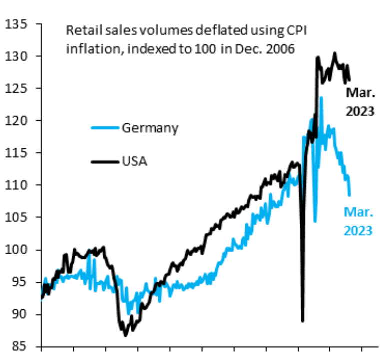
The Economist

European economic growth rebounded strongly in 2021 and early 2022 but is now back to its historic lower growth profile. GDP rose at an annualized rate of 0.3% in Q1 2023 after shrinking 0.2% in Q4 2022. A decrease in energy prices and a milder winter limited the impact of reduction in Russian gas imports.

GDP growth weak:

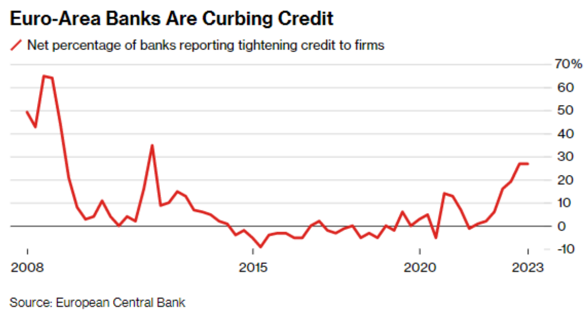


The German economy in particular looks weak.



The ECB has signaled that inflation remains too high and that interest rates will increase further. This combined with tightening credit will be headwinds for the rest of the year.

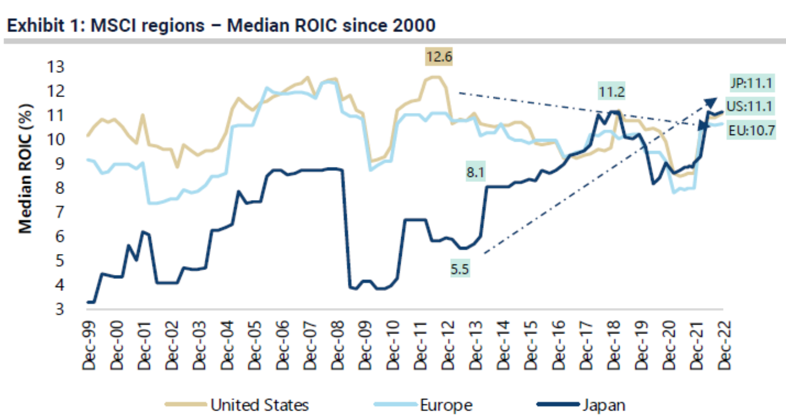
Tightening Credit:



Japan:

Warren Buffett visited Japan ahead of last weekend's Berkshire Hathaway annual shareholder meeting and disclosed that his firm had raised its stake in Japan's five largest trading companies- Mitsubishi, Itochu, Mitsui, Marubeni, and Sumitomo. Berkshire Hathaway largest investments outside of the United States are now in Japan. Buffett viewed his firm's ability to borrow at very low local rates as a key factor in investing in these trading companies which trade close to book value, have strong cash flows and dividends. The renewed interest in Japan comes as there are other shareholder friendly changes happening in the country. The Tokyo Stock Exchange made a non-mandatory request that firm's trading below book value published plans on how they expect to improve valuation multiple to greater than 1x P/B. Companies that have been successful in the past have typically focused on greater return to shareholders in the form of dividends or share buybacks. The added benefit of these measures is an improvement in Return on Equity and Return on Invested Capital.

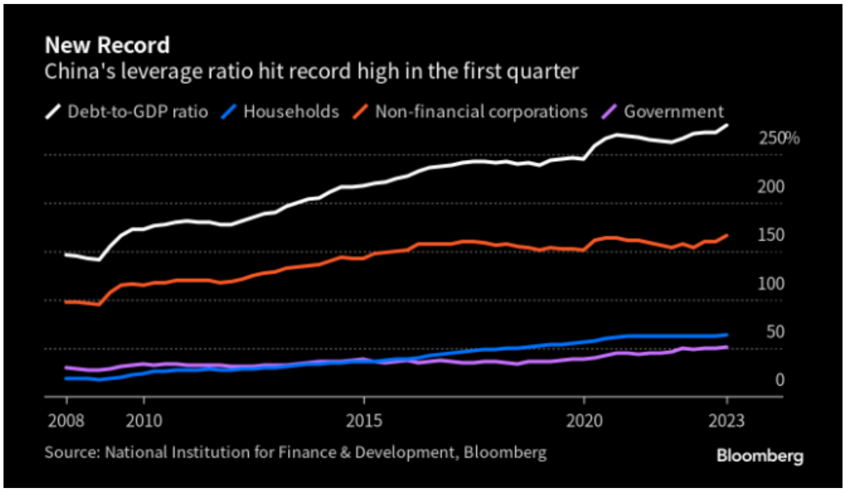
Improving Return on Capital:



China:

Recent economic data suggests that the Chinese economy is not rebounding as much was expected following the lifting of Covid restrictions. April trade data showed Exports +8.5% YOY (reflects a low base from the Shanghai lockdown in 2022) and Imports -7.9% YOY. Q1 GDP growth was 4.5% YOY and factory activity remains sluggish. China faces a debt problem on two fronts- local governments and corporates. Overall debt has risen to levels seen in many developed countries.

High Leverage:



The above chart may not capture the full extent of the problem since novel techniques that employ related-party transactions are often used to hide indebtedness[2]. In mid-April, one of China's provinces, Guizhou, publicly acknowledged its inability to deal with the high level of indebtedness (debt of $3.6 trillion at end of 2021) and asked for assistance from the central government. Subsequently the Guizhou government hired Cinda, one of China's top state-owned distressed debt funds to help resolve its problems[3]. Guizhou is one of several provinces that face a significant debt burden. China's closed and administered banking system can prevent a financial crisis, but as we discussed before[4] such methods lower future growth and while it may buy short-term political stability, they are always a poor economic trade-off. China's offshore initiative to support domestic companies, the BRI (Belt and Road Initiative) has sputtered in recent years.

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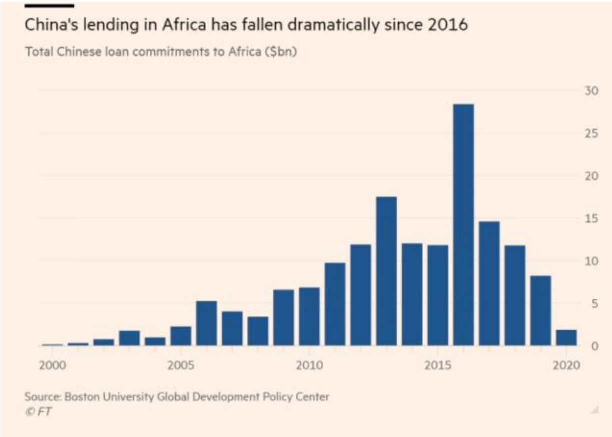
[2] https://asia.nikkei.com/Business/Finance/Bad-loan-shuffle-How-Chinese-state-companies-make-debts-disappear.

[3] https://www.cnn.com/2023/04/27/economy/china-guizhou-province-debt-crisis-bailout-intl-hnk

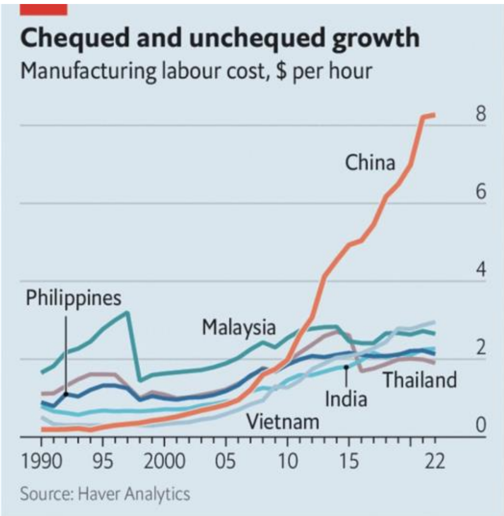
[4] https://harpercapital.net/assets/blog/GlobalMarkets_January2022_Outlook.pdf

Decline in overseas lending:



Initiatives to support export growth have helped the automobile sector as China has grown to be the global leader in the EV market. However, exports will face several challenges in the years ahead- conscious effort to limit access to advanced technology (driven by open IP theft by China) and the loss of wage competitiveness to other developing Asian countries.

Loss of wage competitiveness:

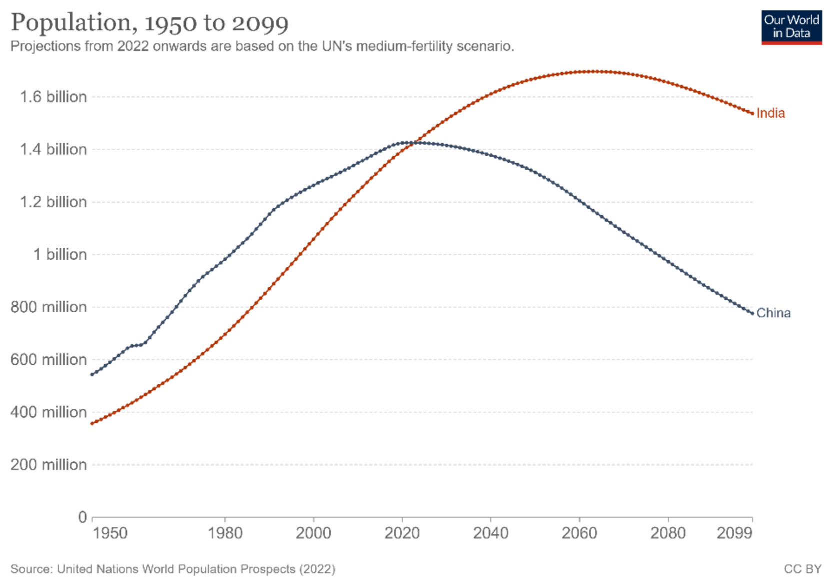


The Economist

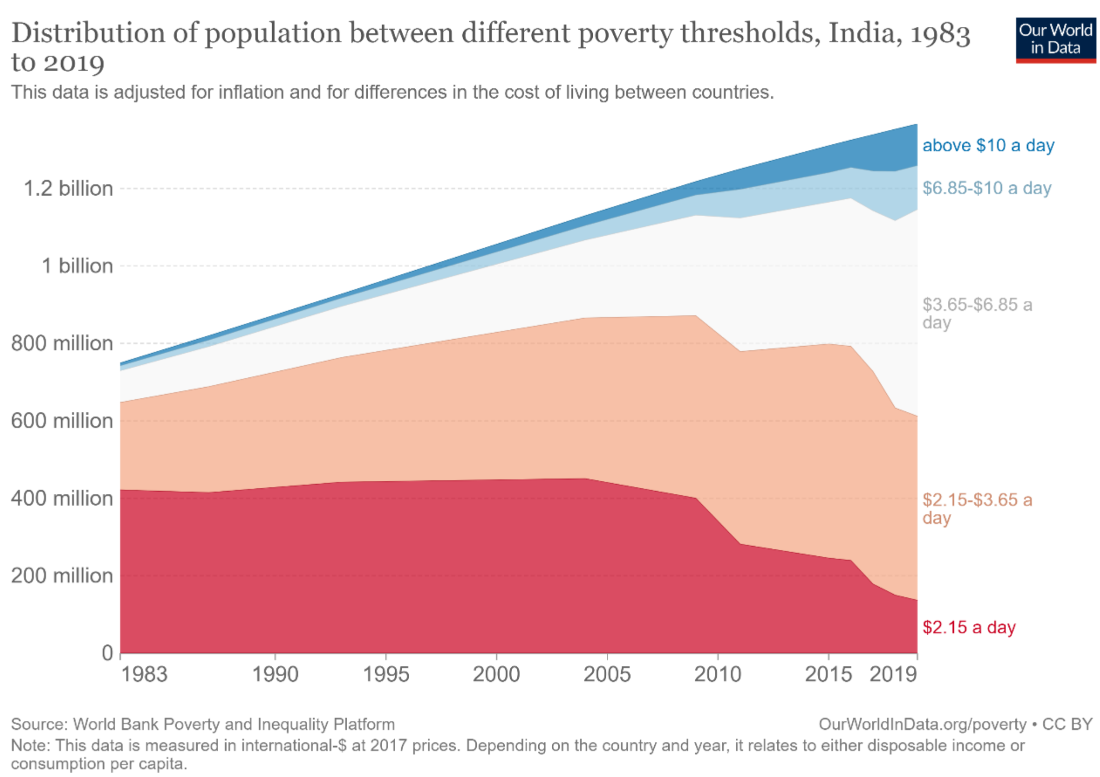
India:

It is now estimated that India is the most populous country in the world and if current trends hold, its population may be over twice as much as China's by the end of the 21st century. India's population is also much younger and its working age population is expected to be substantially higher than China's in the decades ahead. Since opening up its economy in the early 1990s, India's real GDP growth has averaged well over 7%/year. While this lags the 10+% that China averaged for a few decades, it has resulted in a substantial reduction in poverty and improved the quality of life for all segments of its population.

Comparison of populations: China Vs India:



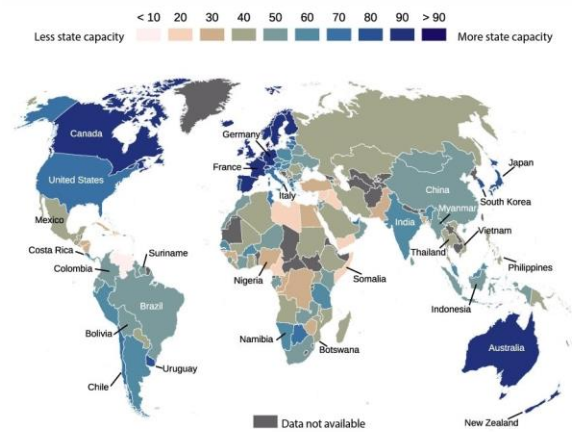
Reduction in poverty in India:



The improvement in living standards has been driven by multiple factors- rapid economic growth, higher government tax receipts supporting targeted transfer payments, improvement in state capacity (see below) and reduced corruption since the current BJP government came to power in 2014. We have written in previous Letters about the rapid improvement in infrastructure and the digital transformation underway in the country[5].

Better Governance:

FIGURE 3.5: State Capacity Index by country, 2019



Much has improved since India's economic and political awakening in the early 1990s, but much remains to be done. Quite specifically the country has to improve its:

- Primary and Secondary School Education
- Manufacturing Capacity

When asked about India replacing China as the world's populous country, China's Foreign Ministry spokesperson, Wang Wenbin said[6] it was important "to look at not just the size, but also the quality of its population". While this is in-line with the impolitic ways of China's "wolf warriors", who do not lose an opportunity to highlight to the rest of the world the risks that come with a more powerful China, it is a message that India needs to heed particularly when it comes to school education and gender equality. Scaling up manufacturing in India will benefit from the infrastructure investment in recent years and the demographic dividends discussed earlier. The decision by Apple to significantly expand iPhone production including its most advanced model in India is a sign that the government's effort to encourage "Make in India" is appreciated by global companies that seek to diversify their manufacturing beyond China. In 2021, Denmark's Vestas, a wind-turbine

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[5] https://harpercapital.net/assets/blog/January_2023_Global_update.pdf

[6] https://www.nbcnews.com/news/world/china-reacts-india-overtake-worlds-most-populous-country-economy-rcna80581

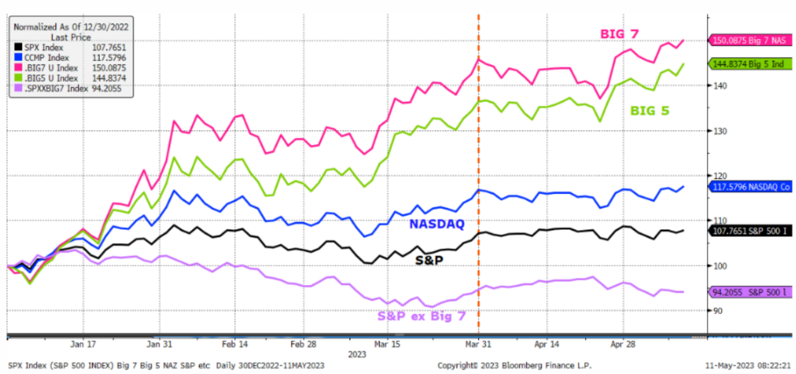
manufacturer, built two new factories in the Indian state of Tamil Nadu[7]. Vestas expects 85% of their suppliers to eventually set up Indian factories. Rivalling China's industrial capacity will be difficult and would require a better educated workforce, further improvement in infrastructure and a better business and regulatory environment. While some economists like University of Chicago professor Raghuram Rajan suggest that India focus on service-led growth[8], we think this is a folly. Sustaining economic growth and improving living standards requires significant industrialization and the higher quality jobs that come with it.

Outlook:

Equity markets have recovered this year after weak performance in 2022. In the United States, the rebound in the indices, masks underlying weakness- breadth has been poor.

Market breadth is poor:

Big 7, Big 5, NASDAQ, S&P, and S&P ex Big 7 year-to-date.



Reasons for strength in the large technology companies could be due to the view that they have solid balance sheets and could withstand the economic, budgetary, and political uncertainty. The economic picture remains mixed as we suggested earlier in this letter. The market is pricing in some risk from the debt ceiling impasse with a substantial rise in US credit default swaps (CDS). The global political environment remains uncertain as we have discussed before[9].

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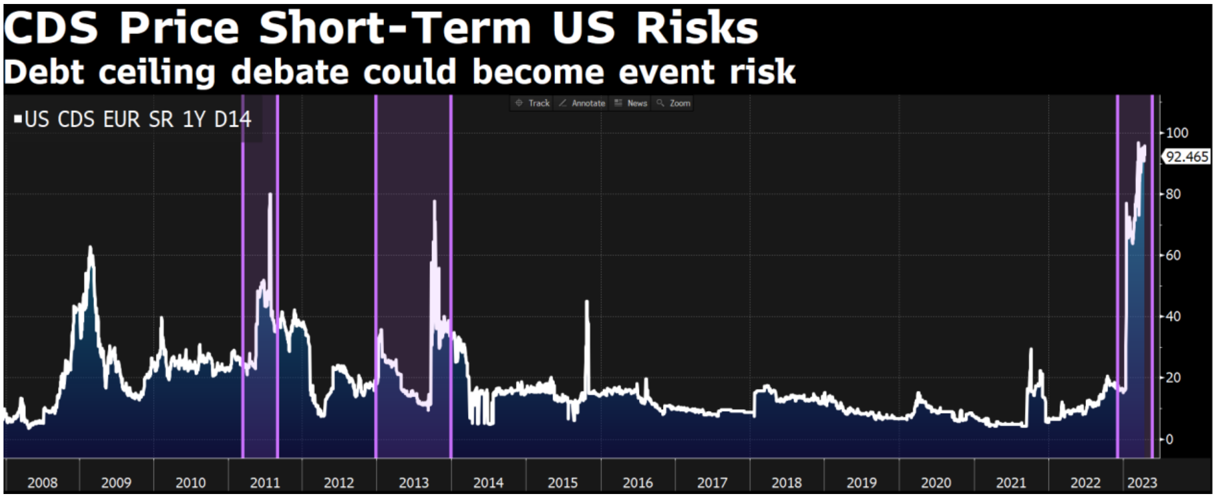
[7]https://www.wsj.com/articles/india-china-factory-manufacturing-24a4e3fe

[8]https://www.moneycontrol.com/news/business/economy/indias-growth-path-lies-in-liberal-democracy-to-earn-worlds-trust-raghuram-rajan-10578561.html?utm_campaign=fullarticle

[9]https://harpercapital.net/assets/blog/January_2023_Global_update.pdf

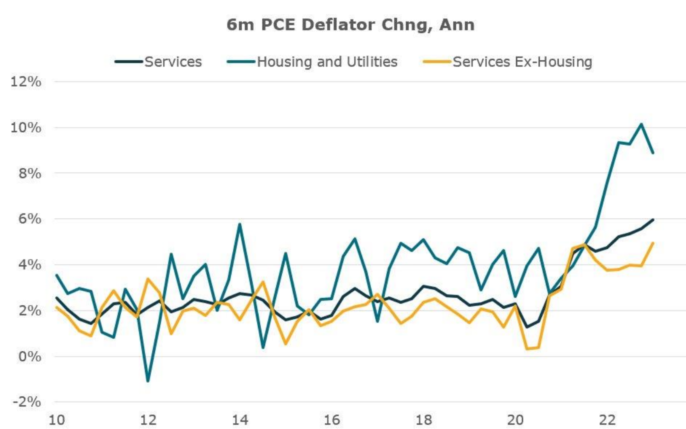
Impact of debt ceiling impasse:



The excitement around generative artificial intelligence (AI) where the leading tech companies appear to have an edge could be another reason for their relative outperformance. For example, our portfolio holding, Alphabet, had lagged following Microsoft's ChatGPT announcement, but has performed well following their recent announcements on AI integration into their suite of products.

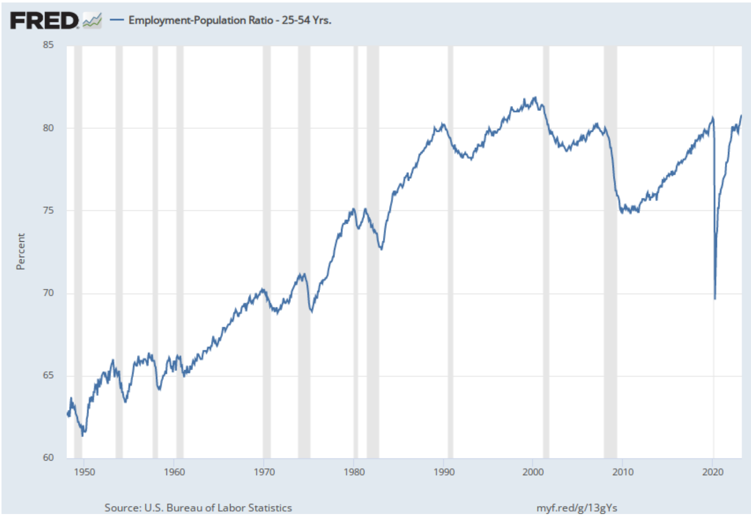
How the stock market progresses during the rest of the year depends on the resolution of conflicting data. Overall inflation is coming down, but some components may remain elevated for longer.

Super-core inflation remains high:



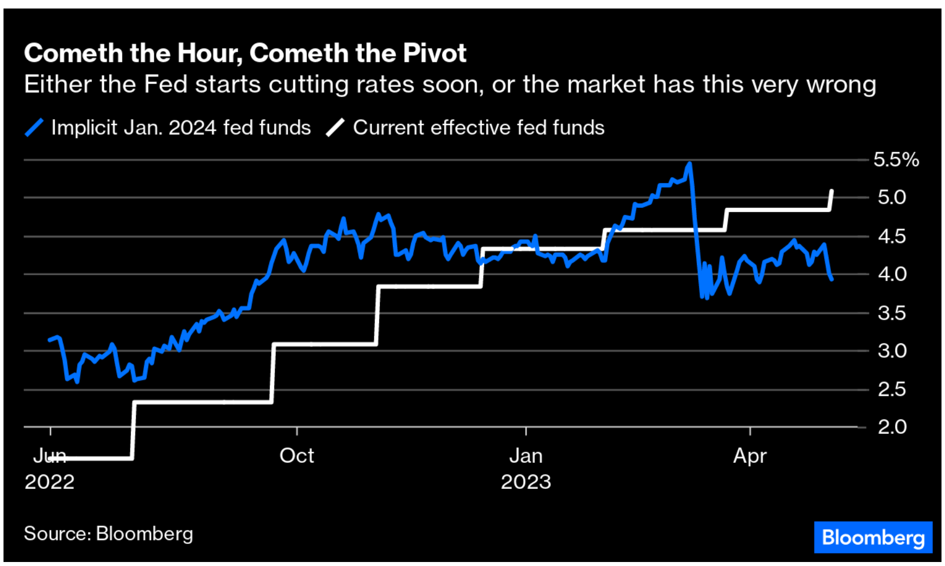
Current data is indicative of full employment.

Employment remains strong:



Fed Fund futures are suggesting a substantial cut in rates by January 2024- 125 bps over the next six meetings.

Markets expect rate cuts:



Barring a financial crisis, we think risk assets are pricing in an optimistic scenario in terms of interest rates. We expect that the impact of rate increases globally, and the tightening of credit following the failure of multiple mid-sized banks will result in an economic slowdown and possibly a recession. The Federal Reserve will be challenged to both bring down inflationary expectations to their long-term target of 2% and avoid economic slowdown. With the equity markets trading at the higher end of their recent range, we think that there will be better opportunities to add risk to portfolios later in the year.

Updates on Portfolios (detailed performances since inception can be seen in Appendix I):

2023 YTD PERFORMANCE (04/30/2023)	Portfolio	Benchmark	Morningstar Category Median
INTERNATIONAL VALUE	7.21%	9.35%	10.14%
GLOBAL	7.72%	8.37%	7.86%
EMERGING MARKETS	4.31%	2.78%	4.27%

Portfolio changes (12/31/2022 through 04/30/2023):

International Value: We exited small positions in Haleon (GSK spin-off), Accelleron (ABB spin-off) and SAP. We trimmed positions in BASF and Schlumberger, and added to positions in Roche, Newmont Mining and Diageo.

Global Equity: No Trades.

Emerging Markets: No Trades.

Additional Thoughts:

For 2023, the International Value (-214bps) and Global (-65bps) strategies are slightly behind their respective benchmarks, and the Emerging Markets (+153bps) is slightly ahead. Our strategies have added significant value relative to the respective benchmarks and peer groups over time. Longer-term performance metrics:

International Value: +468bps annualized (5 years)

Global Equity: +516bps annualized (ITD, ~3 years)

Emerging Markets: +392bps annualized (5 years)

We do not manage with the goal of short-term performance, but believe that a robust and disciplined process can compound investor returns at superior rates.

Readers of this Letter may be aware that we have been positive on the prospects for Indian Equity since the inception of our firm. For investors seeking to invest directly in just India, we recommend our partner firm Sameeksha Capital which has a seven-year track record which is one of the best among Indian Managers. Sameeksha Capital was founded by Bhavin Shah who I have known since our time at the University of Chicago, Booth School of Business. For more on Sameeksha Capital, Bhavin and the team, please use the link below:

https://sameeksha.capital/march-2023-sameeksha-completes-magnificent-seven-years-fy23-becomes-hat-trick-year-of-outperformance-top-rankings-for-three-and-five-year-periods-retained/

HARPER CAPITAL MANAGEMENT Performance Update April 2023

INTERNATIONAL VALUE	Portfolio	MSCI EAFE Value	Morningstar FV Category	Comment
2016	(3.20%)	6.90%	n/a	***Start date 8/1/2016***
2017	24.27%	21.43%	22.08%	
2018	(14.28%)	(14.78%)	(15.50%)	
2019	22.84%	16.09%	17.83%	
2020	7.62%	(2.63%)	0.93%	
2021	14.45%	10.89%	11.40%	
2022	(4.42%)	(5.58%)	(9.12%)	
2023	7.21%	9.35%	10.14%	***YTD 4/30/2023***
ITD	59.79%	43.15%	n/a	***Cumulative (8/1/2016 to 4/30/2023)***
ITD	7.19%	5.46%	n/a	***Annualized (8/1/2016 to 4/30/2023)***
1-year	7.33%	8.38%	7.56%	***Annualized***
3-year	14.06%	13.80%	13.14%	***Annualized***
5-year	6.46%	1.78%	2.59%	***Annualized***
5- year Analytics (as of 3/31/2023)				
Annualized Alpha	4.05			
Information Ratio	0.47			
Upside Capture	82.38%			
Downside Capture	74.51%			
Portfolio Turnover	10.23%			***Annualized***

GLOBAL	Portfolio	MSCI ACWI	Morningstar WLS Blend Category	Comment
2020	31.80%	23.10%	n/a	***Start date 7/1/2020***
2021	24.03%	18.54%	18.04%	
2022	(16.46%)	(18.36%)	(16.71%)	
2023	7.72%	8.37%	7.86%	***YTD 4/30/2023***
ITD	47.10%	29.10%	n/a	***Cumulative (7/1/2020 to 4/30/2023)***
ITD	14.59%	9.43%	n/a	***Annualized (7/1/2020 to 4/30/2023)***
1-year	3.78%	2.06%	3.06%	***Annualized***
ITD Analytics (as of 03/31/2023)				
Annualized Alpha	4.97			
Information Ratio	0.77			
Upside Capture	107.31%			
Downside Capture	89.97%			
Portfolio Turnover	20.00%			***Annualized***

EMERGING MARKETS	Portfolio	MSCI EM	Morningstar EM Category	Comment
2016	2.71%	8.67%	5.42%	***Start date 6/1/2016***
2017	41.92%	37.06%	34.17%	
2018	(11.93%)	(14.58%)	(16.07%)	
2019	19.63%	18.42%	19.26%	
2020	6.70%	18.31%	17.91%	
2021	4.94%	(2.54%)	0.08%	
2022	(7.73%)	(20.09%)	(20.84%)	
2023	4.31%	2.78%	4.27%	***YTD 4/30/2023***
ITD	65.65%	42.90%	37.90%	***Cumulative (6/1/2016 to 4/30/2023)***
ITD	7.57%	5.30%	4.76%	***Annualized (6/1/2016 to 4/30/2023)***
1-year	10.10%	(6.51%)	(3.74%)	***Annualized***
3-year	12.95%	4.33%	5.82%	***Annualized***
5-year	2.87%	(1.05%)	(0.52%)	***Annualized***
5- year Analytics (as of 03/31/2023)				
Annualized Alpha	3.36			
Information Ratio	0.28			
Upside Capture	92.35%			
Downside Capture	85.56%			
Portfolio Turnover	15.46%			***Annualized***