BFI INFINITY

CEO Corner

A monetary U-turn looming?

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In our last edition of our InSights report, we were focusing on the rapidly rising inflationary pressures, as well as on the expected rate hikes from central banks around the world. We would like revisit the points we raised back in spring and present an outlook for the coming months.

The big picture has changed rather dramatically since then, with inflation reaching levels between 8% and 10% in the western world, something that was unimaginable just a year ago. The rate hikes we have seen in the meantime also added to the pressure, with major markets now having dropped between 10% and 35%. The drop was especially pronounced in markets like the Nasdaq, which typically consists of growth companies. The Nasdaq is down 33% year-to-date, European markets are also down as much as U.S. markets, so we are dealing with a global bear market. This bear market is now almost 10 months old and it might persist for a while longer, so investors are certainly well advised to hold some downside protection for the time being.

Besides inflation and rate hikes, the market is also burdened by geopolitical concerns. The war in Ukraine continues without an end in sight and recently the tensions between Taiwan and China (and therefore China and the U.S.) have escalated again. While the geopolitical concerns are hard to overcome at the moment, investors are waiting for a market recovery. What could trigger such a recovery?

Our readers remember that we talked about a potential monetary U-turn in the past, as we expected and still expect the interest rate hike cycle to end sooner or later. In the morning of October 4, 2022, the Reserve bank of Australia was the first central bank to slow down the pace of its rate hikes, pointing to lower inflationary pressures. A reversal in the inflation trend and in falling yields would certainly be a very positive factor that could drive a potential recovery. Indeed, we think that the inflationary pressures will soon begin to ease. In fact, we believe that this process has already started in recent weeks. A lot of commodities have seen substantial drops in prices in recent weeks, with oil and gas down 20%+, nickel and iron ore down 30%, global shipping rates down 60%, etc. These lower input costs will only now find their way into the official statistics and with the global economy continuing to slow down, the deflationary tendencies will become even stronger.

Despite the fact that we don't expect inflation to fall to the extremely low levels we had in the past, we certainly see it dropping much lower than 8%+ levels we have now. And as lower costs begin to show up in official statistics, central banks will probably soon refocus on the support of the economy, once they are confident that rising prices have been tamed. We might see this policy shift between now and the end of Q1 2023.

The chances for a substantial market recovery should therefore not be underestimated, however, the short-term risks remain and we recommend that investors still keep a downside hedge for the time being. Should the monetary U-turn indeed materialize, we would not only expect stock markets to bounce strongly, but also the Dollar to face more resistance. We are not sure yet to what extent, but after its steep rise over the past few months, it is absolutely possible to see a substantial correction of the greenback.

As for the geopolitical factors and mainly the Ukraine war, they appear to have had a muted effect as of late. While Europe seems to be finding alternative sources for its energy needs, mostly countries in the Middle East, the sharp increase in energy costs has also caused inflation to spike and created serious financial strain for European consumers. In recent weeks, however, natural gas prices in Europe fell rather dramatically, as can be seen in the following chart.

Prices have almost been cut in half from the peak seen in late August. Gas-saving initiatives, almost full storage facilities and an increase in supply from non-Russian sources seem to be driving prices further down. While we are

Figure 1: Natural Gas Dutch TTF

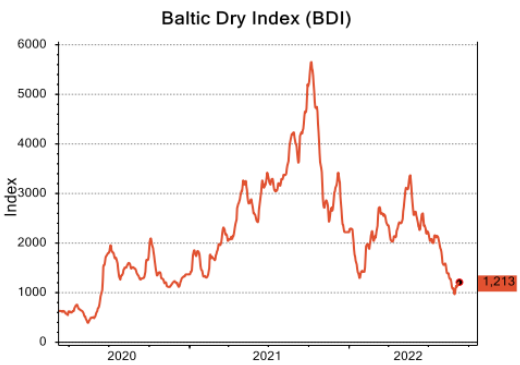
Source: Bloomberg

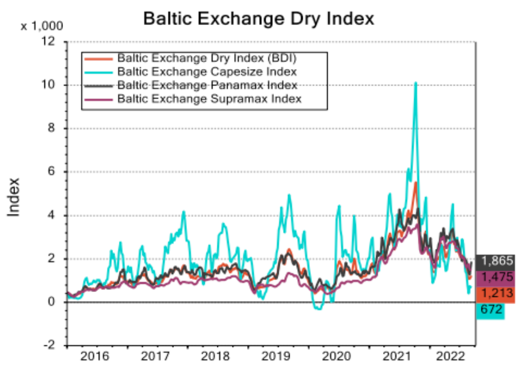
more confident on the European energy situation than we were a few weeks ago, we still remain concerned in the short run. In the long term, however, a positive effect of the energy crisis is that most European countries have embraced a more pragmatic approach and seem to have made securing ample supply a top priority.

Even with the positive market start in October, with major indices rising by almost 5%, we remain careful as long as we are still in a bear market. However, the current market environment presents us with entry opportunities and we want to take advantage of this. We will continue to phase in some of the cash we have been holding on the sidelines. While steadily increasing our equity allocation again, we are also planning to roll our equity hedges in order to have strong downside protection. While our outlook has improved somewhat, we still need to see a full monetary U-turn (combined with easing inflation).

Still, we see the current market situation as a window of opportunity to pick up long-term investments at very reasonable prices. The opportunities that we find are all connected to so-called "Supertrends" or "Megatrends", for example industries like cybersecurity that will see huge growth opportunities for years to come, because of rapidly rising digitalization. Rather than simply holding the broader market, it will be key in the future to focus on these megatrends. Of course, we will diversify, but never at the expense of conviction. In the second part of our investment update, we are providing you with an inter-

Figure 2: Shipping rates tumble from their record highs





Source: Refinitiv, ECR Research

esting summary on the cyber security industry that will explain why we are so positive on the sector long-term.

With the easing of inflation, we are also expecting sliding bond market yields. However, we are of the opinion that yields will fall temporarily, but see a risk that they will go up again in the future. In the precious metals market, prices have also seen a decline, with gold falling to a level of almost USD 1600/ounce. However, this level was holding up really well and prices have since then rallied above the USD 1700/ounce.

While we do see a silver lining on the horizon, we also want to reiterate that the current bear market is not over. Since 1928, there have been 28 bear markets, lasting around 9 months on average and with markets falling around 35%, so the current bear is pretty much average. Of course, this bear market can go on for longer, but what it seems to have in common with its predecessors is that it presents an excellent buying opportunity for the long-term minded investor. This is especially true from the point of view of an American investor that can sell some of their overvalued U.S. Dollars and buy into cheaper and more attractive currencies long-term.

Investment success is based on long-term vision and it requires the discipline to go through bear markets like this one. Investors who have these qualities will be rewarded once the markets starts to recover. Typically, the rally after a bear market delivers substantial gains within a short period of time.

We wish you a nice fall and we remain at your disposal for any questions you may have. We will also be working on our year-end 2023 outlook in the coming weeks, which we will share with you soon.

Cybersecurity: The investment case

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Have you ever wondered how much data is created each and every day? With the advent of mobile technology, like smartphones and tablets, along with innovations in mobile networks and WiFi, our digital reality has become all-encompassing and touches all parts of our economy and society.

The numbers speak for themselves and they are quite staggering. According to TechJury, in 2021, people created 2.5 quintillion bytes of data every day while 90% of all the world's data was created in the last two years alone. By the end of 2020, 44 zettabytes made up the entire digital universe. In 2022, 333.2 billion emails are sent every day… These are already confounding figures, and it is expected that the volume of data will double every two years.

These are incredible numbers and exponential growth that Investors should surely consider ways to harness. In this overview, I will focus on one theme around the edges of this digitization megatrend, namely cybersecurity, but 'pick-and-shovel' plays, such as semiconductors, semiconductor equipment vendors, semiconductor producers and data center operators, should also be included in a portfolio, as they have been part of BFI portfolios for a some time already.

The big picture

Our economies and financial markets have become reliant on ever growing flow of data. Our most sensitive information is increasingly kept digitally and our personal habits and beliefs can be identified and tracked by the 'bread crumbs" that our "cookie trail" leaves behind on our day-to-day digital journey. Today, most people have a super computer in their pocket, aka their smartphone, but when the first version of the iPhone was released back in 2007 few people could have imagined how it would transform almost everything we do. Much of the innovation has been focused on ease of use, less so on data protection and cybersecurity. So one has to stop and ask: has the march of progress towards this digital reality outpaced our ability to keep it all secure?

When asked why he robbed banks, the infamous 1930s bank robber Willie Sutton retorted, "because that's where the money is". Today, however, most of our money, assets and wealth is digital and kept in the "cloud". It is no wonder then that the Willie Suttons of today are targeting our "digital fortresses in the sky", except these "fortresses" are essentially large data centers on earth operated by humans. And demand for those is growing at a spectacular pace: storage data growth statistics show that both public and private cloud infrastructure will receive 200+ zettabytes (ZB) of data by 2025. That will be up from 2019's 4.4ZB and 2020's 44ZB.

The points of vulnerability and the "way in" to these systems are often found through individuals at the company or state level. These "gate keepers" are the weakest link and the bad actors know it. With increasingly sophisticated phishing and social engineering attacks, the cyber criminal has an asymmetric advantage: the opposition can do the right thing 99 times out of 100, but all it takes is one error for them to gain access.

Research from IBM determined that the average data breach cost businesses $4.2 million in 2021, up from $3.6 million in 2017. Estimates by Cybersecurity Ventures showed that global cybercrime costs are set to grow by 15% per year over the next 5 years, reaching $10.5 trillion annually by 2025, up from $3 trillion in 2015. Multiple sources have already recorded increases in the frequency and sophistication of cyberattacks during and since the pandemic.

Our advances in digital technology are a double-edged sword. On the one hand, digital innovation has opened up new opportunities and brought higher efficiency and productivity to our lives and businesses. But it has also rendered us more exposed and fragile, both as individuals and on a systemic level. Still, there is no "putting the genie back in the bottle" at this point, but there are ways to pay a lower price for using it.

The Rise of The Intangible

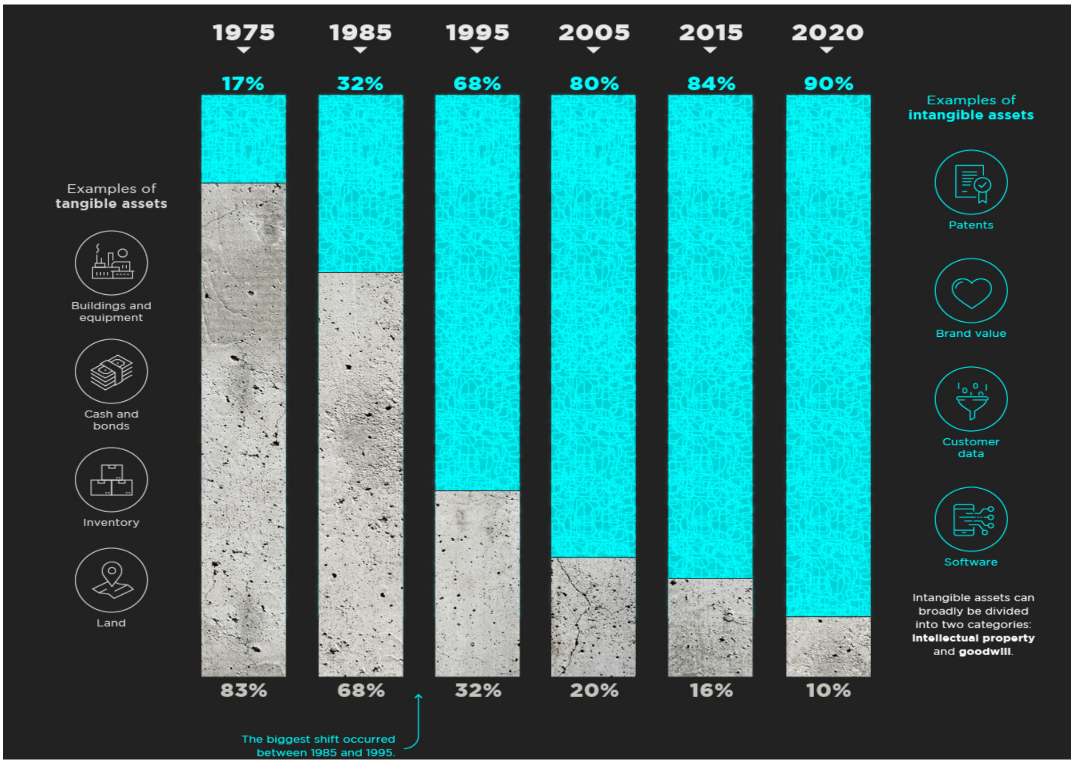
Our digital wealth goes far beyond the monetary and it encompasses so much more than the balance in our online bank account. Intangible assets that don't directly have any physical or financial embodiment, such as R&D, intellectual property and computerized information, such as data and software, have become dominant since the 1990s, when they propelled our world into the era of Information Technology.

As the infographic below highlights, in 2020, they comprised 90% of the S&P500's total assets; in 1975 that figure was just 17%. In 1985, just before the internet started its ascent and software began to "eat the world", the value of intangibles in the S&P500 was $428 billion. In 2018 it was $21.03 trillion. Entrepreneurs and investors who rode this wave successfully over the last couple of decades have done incredibly well for themselves.

As inconvenient a truth as it might be, this obviously means that most of the largest global companies' assets are vulnerable to hacking for purposes of corporate espionage, blackmail and/or destructive attacks and sabotage. We have seen examples of how the market reacts to these scenarios. When Yahoo was bought by Verizon, a data breach involving the personal information of over a billion individuals precipitated a discount of about $350 million off the acquisition price. In the 2014 hack of Sony Pictures, when internal emails and proprietary digital property was stolen and leaked, much to Sony's embarrassment, internal disruption and economic damage ended up costing the company over $100 million.

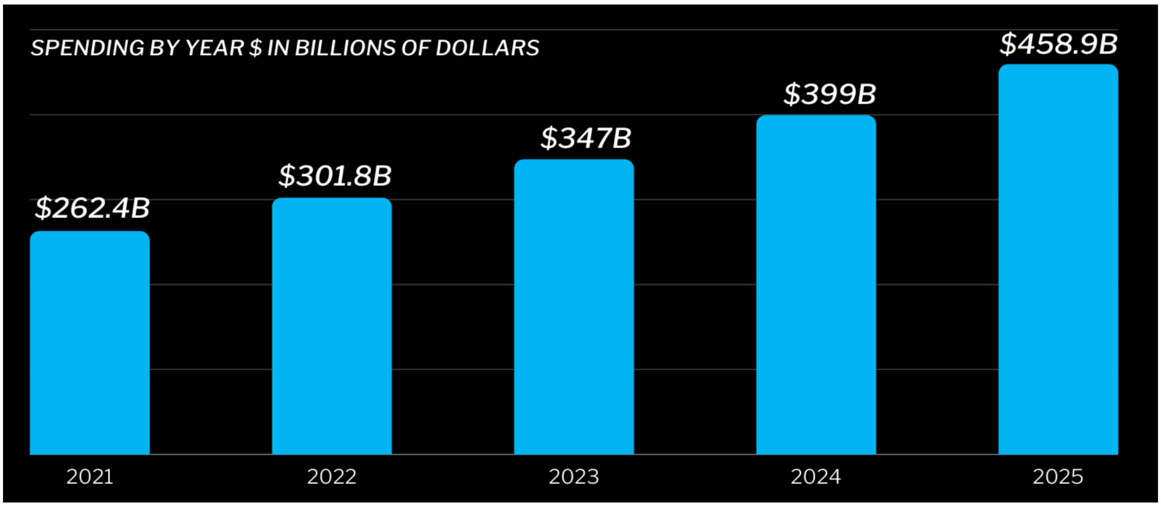
In truth, much more goes unreported or is publicly shared only once the issue is deemed to be resolved or once damage control is already underway. That was the case with the 2017 "NotPetya" attack that partly shut down the sovereign nation of Ukraine

Figure 1: Tangible vs. Intangible assets, as a percentage of the S&P 500's total assets



Source: Visual Capitalist

Figure 2: Global cybersecurity spending



Source: Cybersecurity Ventures

and went on to cripple the global operational infrastructure of Maersk, the maritime giant that on any given day is responsible for around a 5th of the entire world's shipping capacity. The attack lasted for several days causing Maersk an economic loss of around $300 million. Overall, "NotPetya" is estimated to have cost the companies affected around $10 billion. It's examples like this that begin to show us how fragile our digital world actually is and how crucial cybersecurity solutions really are.

It all gets even more worrying when one considers the increasing digitalization of the financial markets and the fact that trillions of dollars move around the global economy digitally on a daily basis. 92% of the world's currency is digital. Most of our governmental operative, administrative and even physical infrastructures, such as health records and electrical grids, are also digitized. And I would be remiss if I didn't highlight the importance and influence that digital communications and social media have on our politics and our elections.

Given how much the average person now relies on digital tools in their daily lives, be it knowingly or not, it is clear that this incredibly large and critical digital universe can only function if we continue to find solutions for keeping it all secure, yet functional.

Investment implications

From an investment perspective, it is a less obvious "pick and shovel" play. The new "gold mines" are in digital data and the optimal risk/return approach would appear to be in investing in the security space. It has endless and constantly evolving needs that require solutions from deep pocketed customers.

Globally, businesses are placing more emphasis on cybersecurity. For example, Microsoft announced in September 2021 that it would quadruple its cybersecurity investments to $20 billion over the next five years. According to a recent GlobalData's report, cybersecurity spending in the energy industry will rise to $10 billion by 2025. But it's not only corporate demand that has been on the rise.

Critical infrastructure such as governments and utilities are all potential targets. Especially over the past decade, governments have clearly recognized the need to shore up their defenses as well. There is precedent in state-sanctioned cyber warfare, like the infamous Stuxnet, the malicious computer worm that severely damaged Iran's nuclear program and there is clear evidence of the vulnerabilities that bad actors can exploit in public infrastructure, like the more recent power grid attack in 2019 in the US, that disrupted communications between controllers and a generation site for over ten hours.

Given that the digital realm is an ever more important part of the modern battlefield, the current geopolitical landscape obviously makes it even more pressing for governments to defend themselves. For instance, the Biden administration's 2023 budget included $11 billion for cybersecurity spending. The fear of digital warfare will give added impetus to cyber security spending by companies, governments and individuals. In fact, Cyber Security Ventures anticipates global cyber security spending will grow 15% year-over-year from $262 billion in 2021 to almost $460 billion in 2025.

One of our core investment tenets is that often the best opportunities are to be found around the edges of things, the more mundane and less obvious, the second or third order effects of major trends. Away from the headlines and where you have to dig a little deeper and work a little harder, real attractive risk/reward scenarios can be found.

In a digital world, digital security is the cornerstone and innovative solutions will be the catalysts that facilitate the next stages of development across all sectors of our economic, financial and social systems. As an investor, you will want to stay secure too and take part in the growth of this crucial industry.

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