Mercator
International
Opportunity
Fund

Mercator International Opportunity Fund
Third Quarter 2022 Report

(Class I Shares: MOPPX & Class A Shares: MOOPX)

Performance Report					
Fund / Index	**Q3 2022**	**YTD**	**1 Year**	**3 Year Annualized**	**Since Inception Annualized**
MOPPX (CL I) Inception Date: April 2, 2018	**-11.00%**	**-51.03%**	**-52.81%**	**-1.13%**	**-1.20%**
MOOPX (CL A) Inception Date: August 30, 2019	**-11.04%**	**-51.06%**	**-52.88**	**-1.23**	**-1.26**
MSCI EAFE INDEX	**-9.36%**	**-27.10%**	**-25.13%**	**-1.84%**	**-1.50%**

Expense Ratio		
Fund	**Annual Fund Expense Ratio (net)**	**Annual Fund Expense Ratio (gross)**
MOPPX (CL I) Inception Date: April 2, 2018	**1.41%**	**2.17%**
MOOPX (CL A) Inception Date: August 30, 2019	**1.55%**	**2.52%**

Performance data quoted represents past performance and does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. The Fund's current performance may be lower or higher than the performance data quoted. For up-to-date performance data please contact the Fund's transfer agent at 1-800-869-1679.

The Fund's adviser has contractually agreed to reduce its fees and to reimburse expenses, at least through April 30, 2023, to ensure that total annual Fund operating expenses after fee waiver and reimbursement (exclusive of any front-end or contingent deferred loads, 12b-1 fees, taxes, leverage interest, borrowing interest, brokerage commissions, expenses incurred in connection with any merger or reorganization, dividend expense on securities sold short, acquired (underlying) fund fees and expenses or extraordinary expenses such as litigation) will not exceed 1.40% and 1.55% of the average daily net assets attributable to the Institutional Class and Class A shares, respectively.

The Mercator International Opportunity Fund. Third Quarter 2022 Report

After an attempt to rally, the Mercator Fund quickly gave back its bounce and then some. The "everything selloff" resumed its course in the second half of last quarter. Macro headwinds were again dominating traders' Pavlovian behavior. For a full year now, stocks have sold off in anticipation of a dramatic slowdown in business activity. And yet, for a full four quarters, the fund's investments have continued for the most part to deliver better-than-expected top-line and bottom-line growth. Since many of these stocks were GARP stocks (Growth At a Reasonable Price) to begin with, they now look unreasonably cheap.

Frankfurt Am Main. The eye of the storm.

The Monetary Cycle

Old timers remember Paul Volcker's brutal remedy for the spiraling inflation of the 1970's and early 80's. His decision to hike interest rates abruptly induced a sharp but short recession. It did the trick. Inflation slowed down and the bond market began a 40-year bull market.

The years following Volcker's tenure were characterized by increasingly interventionist monetary policy. When the stock market crashed in October 1987, Alan Greenspan's Fed issued the following statement: "The Federal Reserve, consistent with its responsibilities as the nation's central bank, affirmed today its readiness to serve as a source of liquidity to support the economic and financial system." Investors got it. Greenspan had created a put option on the stock market.

Just like that, the Fed single-handedly gave itself a third mandate. Going forward, the Fed would not only control inflation and keep unemployment low, it would also protect the value of assets. Investors cheered.

The Greenspan Put was followed by the Bernanke Put when the Great Moderation, a 20-year period of relatively low macroeconomic volatility, turned into the Great Recession that followed the financial crisis of 2007/2008. Ben Bernanke sought to fix things by once again providing liquidity and thus the first Quantitative Easing (QE1) was born.

QE 1 was quickly followed by several more QEs, all with the stated goal of manufacturing a “wealth effect”. With massive purchases of Treasuries and mortgage-backed securities, the Fed modified its role yet again. No longer limited to providing liquidity in order to avoid a major crisis, it began to use its power to inflate asset prices and prop up consumption.

In the process, interest rates were kept artificially low. All major Central Banks followed suit, even to the point of pushing the yield on some sovereign debt below zero! Historians will surely have a hard time explaining the rationale for an instrument that is guaranteed to lose value. The argument that the alternative could be even worse strikes one as a strange way to build confidence in the monetary system.

Pumping things up was the easy part. Reversing course is much harder. Under Bernanke’s successor, Janet Yellen, the Fed failed to normalize monetary policy. It did not want to take the short-term pain of raising interest rates. Instead, with eyes fixed on the rear-view mirror, a “data driven” Federal Reserve carried on with low interest rates and a hugely bloated balance sheet. That’s when a pandemic brought world trade to a virtual standstill.

By that time, Jerome Powell had inherited a Federal Reserve that could inflate no more, or so one would have thought. After all, the Fed’s balance sheet had already ballooned to more than $4 trillion. But even so he doubled down. When all was said and done, the Fed’s balance sheet had exploded to touch $9 trillion, up tenfold since the financial crisis of 2008. Stock prices and real estate prices promptly resumed their uptrend.

Powell, still focusing on the rearview mirror, at first refused to acknowledge the danger. Inflation was dubbed transitory. Until it no longer was.

This short history of recent monetary policy illustrates the mistake markets are making in believing--or hoping--that inflation will soon abate. It will take sustained monetary tightening to reverse forty years of activism.

We have come full circle from Volcker's day. Fighting inflation is again the stated priority. We have barely moved into restrictive territory. In any normal cycle, 4% interest rates would be considered extremely stimulative when headline inflation is above 8%. Let’s hope peak interest rates fall somewhere between these two numbers. It is more likely, one fears, that rates will have to double from here before the Fed is done tightening.

Habits die hard. Investors have gotten used to being bailed out by central banks. However, the new financial reality is that the Fed is finally letting markets play their role of price discovery.

The Powell Put no longer exists. Once market participants are reconciled to the idea that rates are going higher and that the Fed is no longer going to bail them out, we will likely see stock prices reflect companies’ fundamentals again. The past year's indiscriminate sell-off in the stock market is happening at a time when the contrast between different companies' fundamentals is becoming more apparent.

The rising tide that lifts all boats has turned. We are either already in a global recession or about to enter one. In hard times, weak companies will suffer and the strong ones will get stronger. The indiscriminate sell-off of late does not reflect this fundamental law of nature.

Soon the art of valuing stocks will come back into vogue. Picking the winners will yield very good returns as they are very oversold.

The Strong Dollar

The US central bank's go-it-alone monetary tightening has taken other countries a bit by surprise. Dollar strengthening has accelerated in line with the widening gap in global interest rates. The greenback has risen more than 30% against the Japanese yen and 20% versus the euro and the pound sterling since January 2021.

Big moves in currencies have many implications. In the US, analysts are revising down earnings of companies with high exposure to revenues earned abroad. These earnings are substantial. Almost 40% of market-weighted sales of the S&P are generated overseas.

The reverse is true as well. Foreign companies with high dollar earnings benefit from recent currency movements. Many companies owned by the Mercator Fund have important dollar revenues. Since costs are largely denominated in local currency, the currency moves help profit margins above and beyond the translation effect. To top it all, a weaker currency makes overseas companies much more competitive against their US counterparts in the US and elsewhere.

Now Europe is also raising rates and, barring a major escalation in the war in Ukraine, we expect European currencies to stabilize, probably around today's levels against the dollar. Japan, which has been struggling to reflate its economy for more than three decades, is resisting this trend of raising interest rates. The Japanese well remember how big a role the weak yen played in their post-war economic boom.

The War In Ukraine

Germany's decision to shut down all nuclear energy plants and to import most of its natural gas from a bellicose dictator does not look too smart in retrospect. Europe is waking up to some hard realities. It needs to finally invest in its defense and stop being naïve about energy sources.

Europeans were incredibly unprepared for the energy crisis. The invasion of Crimea and parts of the Donbas in 2014 did not alarm Merkel and company. A quick look at a map should have shown them that linking the two conquered pieces of Ukraine would be Putin's next move. We wrote about this back in 2015 after driving through Ukraine. Instead, Europe stubbornly made itself even more dependent on Russian oil.

The past errors make the wake-up call harder. Europe is scrambling. Replacing the energy it used to import from Russia is not an easy task. Newspapers are full of articles predicting a very difficult winter, especially if it should turn out to be an unusually cold one. Yet this recent visitor to Frankfurt was struck by how normal things looked. There was no sense of panic. Restaurants were full. Bars were booming. Company managements were not overly worried. In short, could it be that the media and the markets are exaggerating the problem?

After all, Europe has had several months to prepare for the winter since Russian gas stopped flowing. Governments, companies and individuals have not been sitting on their hands. From revamping coal plants to buying floating LNG terminals and keeping nuclear plants running longer than planned or just storing firewood, Europe is getting ready for the short term. In the long run, more oil and gas will be imported from Norway, the Middle East, North Africa and North America. Huge wind farms are being developed in the Baltic Sea and solar energy is back en vogue.

Programs to enhance energy efficiency are also under way. In France, for example, landlords are now required to remediate houses with poor energy efficiency by better insulating them before signing new or renewal rental contracts. The Mercator Fund has invested in Saint

Gobain (SGO:FP; 1.96%), France's leading building material producer, to take advantage of this.

One last thought about this most unnecessary war. The Ukrainians have shown incredible courage and bravery. It is difficult to see how Putin comes out as a winner. However, nobody can predict how this war will end: a nuclear bang, a civil war or a coup? The sooner it ends the sooner the world economy will go back to a new normal. The stock market will rally and Europe will look more assertive and hopefully better prepared.

The Semiconductor Cycle

What happened to diplomacy? At best, we can say it is missing in action. We are now fighting a proxy war with Russia and starting a new cold war with China. The semiconductor industry is greatly disrupted by the latter. The long term demand coming from the many different applications for semiconductors—EV, cars, PC, mobile phones, AI, video games, military applications, robots, etc.—is overshadowed by strong cyclical headwinds.

Demand for PCs, mobile phones, and video games seems to have peaked for now. Demand for cars is low. The ban on exporting high-end semiconductors to China is further disrupting the industry.

Over previous quarters, we took profits in European semiconductors STM (STM:FP) and Infineon (IFX:GR) and Japanese semiconductor production equipment companies Disco Corp (6146:JP) and Advantest (6857:JP). Over the summer we also sold Taiwan Semiconductors Corporation (TSM:US) and PVA Tepla (TPE:GR). We have put the proceeds from the sale of these cyclical growth companies to work in companies with stronger pricing power.

Waiting For Recession

Unlike Godot, the recession is very likely to show up. It has taken a long time in coming. Stocks have been predicting a major recession for at least 4 quarters now. Just as governments have had time to prepare for the coming difficult winter, business people have also been busy. They have had a full year at least to get leaner. Businesses with strong buying power have already hiked their prices to reflect inflationary pressures. This is why most of the stocks owned by the Mercator Fund have consistently published better-than-expected quarterly figures. The few exceptions are eCommerce companies that have suffered from a slowdown of their growth rate after a pandemic-driven explosion of sales the year before.

These excellent results have not prevented major cuts in valuations. The day confidence comes back in the markets, we expect these stocks to be the first to rebound to valuations more in line with their prospects. At the present, great companies are being given away.

Hervé van Caloen, CIO