Pangolin Aviation Recovery Fund May 2022 NAV

As at 31st May 2022, the NAV of Class A shares of the Pangolin Aviation Recovery Fund was US$97.14 net of all fees and expenses, down 6.42% from US$103.80 in April 2022.

The fund is 84% invested, with the split being approximately as follows:

Figure 1: Portfolio by sector exposure

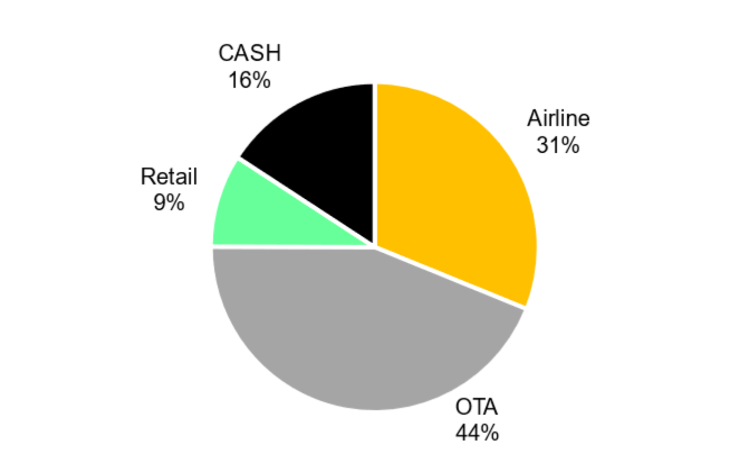
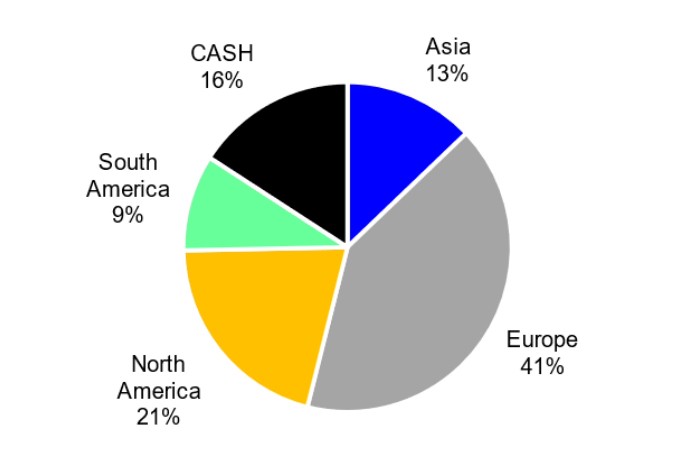


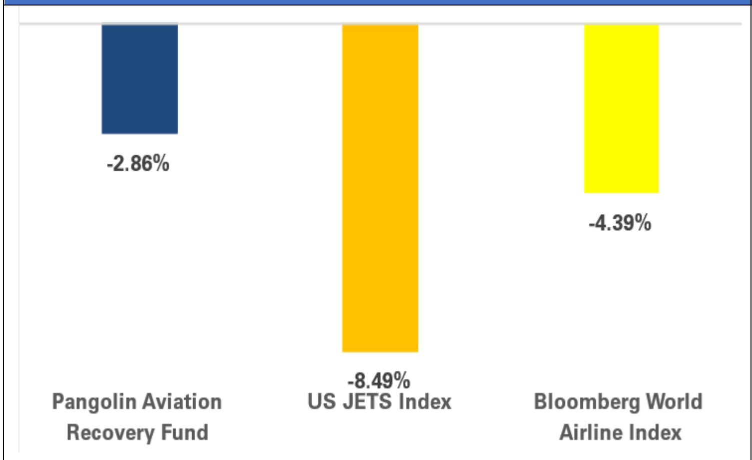
Figure 2: Portfolio by geographical exposure



Overview

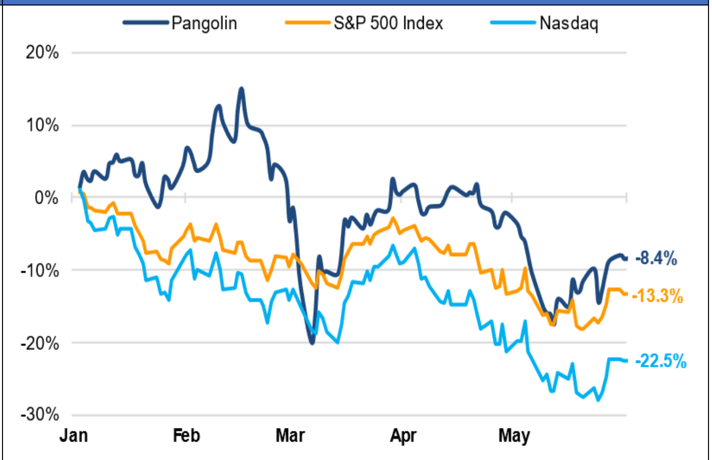
To put things into some perspective, please see the graphs below.

Figure 3: Performance since inception



Source: Bloomberg

Figure 4: Performance in the 2022 year to date



Source: Bloomberg

May 2022 marked the changing of the season, whereby everyone turned bearish, and everything declined all at once. Our fund's NAV was negatively affected, but it performed relatively better than our benchmark and the major U.S. indices. We had some inflows into the fund as seen by the high composition of cash.

Many high-quality companies' share prices have plunged despite reporting strong 1Q22 results with a positive outlook. We believe this was partly due to ETF redemptions and liquidations, which exacerbated the share price reaction. Some of our investments are victims of this wanton dumping, namely Sabre, Booking.com, and Dufry. Whilst this can be annoying, we are excited because we can add to our existing positions cheaply. Think long-term.

Traffic recovery is happening

According to the International Air Travel Association, global air passenger traffic grew by 89% YoY in the first quarter of 2022. When compared to 2019's numbers, it is 46% lower. More importantly, the traffic growth momentum will continue to accelerate as travel restrictions ease and more borders open.

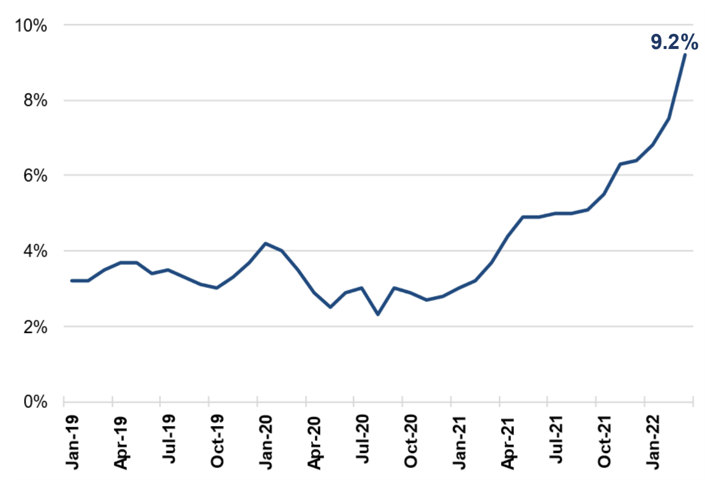
The second quarter of 2022 should see greater traffic growth in Asia as Singapore, Malaysia, Thailand, Cambodia, India, Australia, and Japan have liberated their skies. Furthermore, the Russia-Ukraine war has had no noticeable impact on air passenger traffic in Europe. By our estimate, global air passenger traffic should grow by 100% YoY in the second quarter of 2022, which translates to a 37% decline versus the second quarter of 2019 traffic numbers.

The speed of recovery to pre-pandemic levels depends on accessibility and manpower availability. The aviation world is currently 'semi-open' as China and Hong Kong borders remain closed due to their steadfast Covid-zero policy. Russia is effectively isolated due to the sanctions imposed by the Western nations and West allied countries. Without these countries, there is a huge void in the international airspace network. Manpower shortages have also become a big issue in Europe and North America, and it will take time to resolve.

Assessing inflation impact

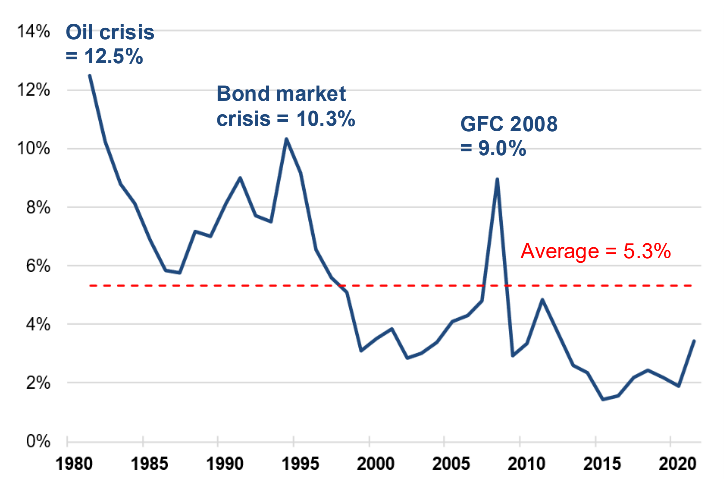
The annual rate of inflation worldwide, as measured by the consumer price index (CPI), accelerated to 9.2% in March 2022 (see Figure 5), which is well above the historical average of 5.3%. The cost of debt has also risen with benchmark interest rates spiking across the globe (see Figure 6).

Figure 5: Global CPI, short-term graph



Source: International Labour Organisation

Figure 6: Global CPI, long-term graph



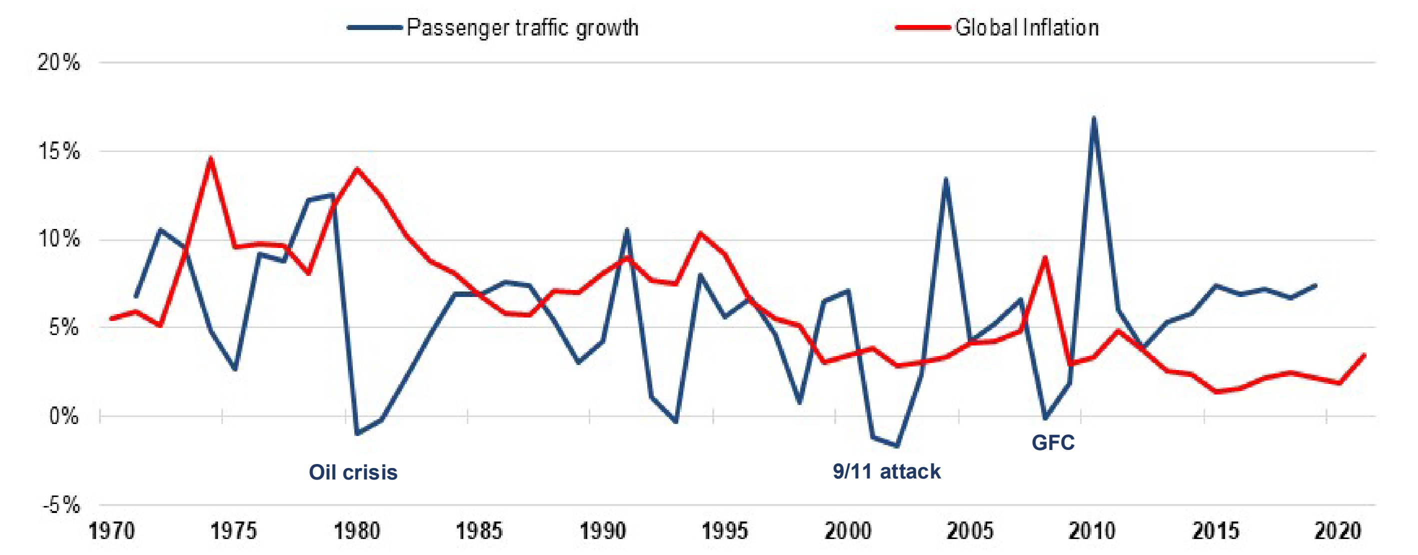
Source: World Bank

The reasons for the elevated inflation numbers are clear; strong demand versus short supply. The rapid opening of the global economy is fuelling strong demand. But manpower shortages, underinvestment for the past two years, regulatory backlog, and the Russia-Ukraine war have caused massive supply disruptions. I have never seen a situation whereby the stars are 'misaligned' so perfectly.

At what level will inflation destroy demand for the aviation sector? We mapped the global air passenger traffic growth and global inflation (see Figure 7) and discovered two periods of strong inverse relationship. The first was in 1980 in the aftermath of the 1979 Oil Crisis (a drop in global oil production due to the Iranian Revolution). Inflation was hovering at 12.5% and the air passenger traffic declined by 1% YoY. The second period was in 2008, during the height of GFC, and air passenger traffic was flat YoY.

Apart from these two events, there is no discernible correlation between inflation and air passenger traffic. 1994 was particularly interesting; global CPI was very high at 10.3% but air passenger traffic was equally strong at 8%. Therefore, these historical observations suggest we should not be overly concerned about high inflation destroying air passenger demand.

Figure 7: Global air passenger carried and Global CPI

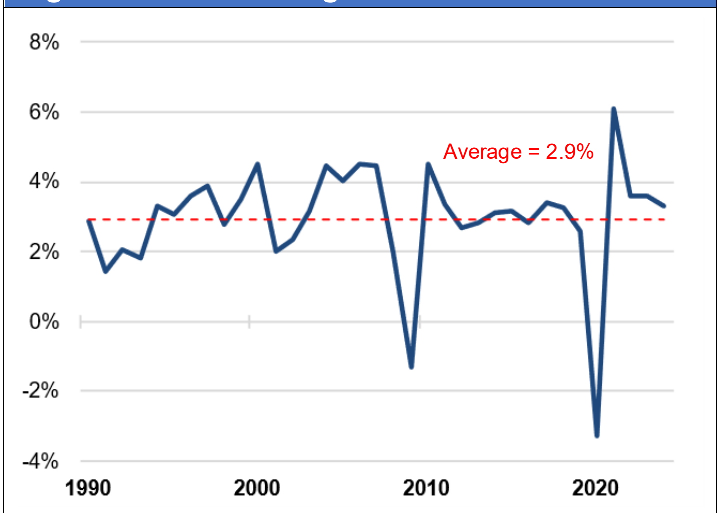


** passenger traffic for 2020-21 is left blank due to Covid-19 related disruptions*
Sources: International Civil Aviation Organisation, World Bank

The two most important macroeconomic indicators for the aviation sector are GDP growth and employment rate. The International Monetary Fund's (IMF) latest forecasts for global GDP growth for the period 2022-23 are 3.6% (see Figure 8), which is above the average historical growth of 2.9%. The global unemployment rate is expected to show some improvement from 6.2% in 2021 to 5.9% in 2022, inching closer to the historical average of 5.7%. (see Figure 9).

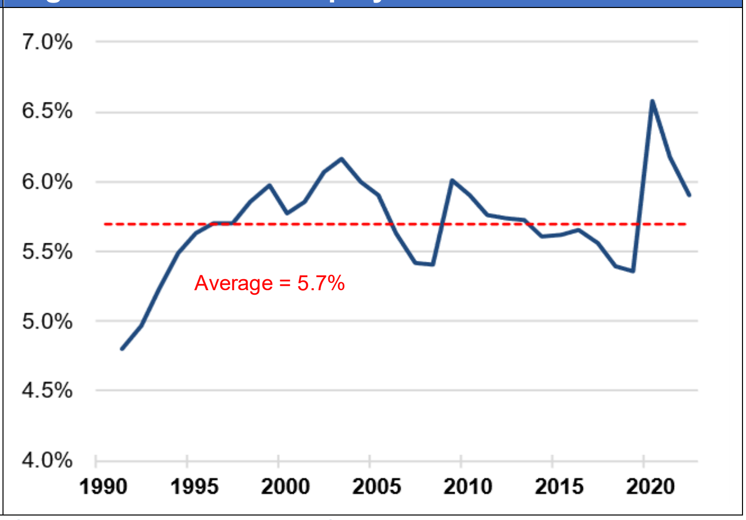
As both variables are in positive territory, the aviation sector is in a good place, and that traffic growth is expected to continue.

Figure 8: Global GDP growth



Sources: World Bank, IMF

Figure 9: Global unemployment rate



Source: International Labour Organisation

What can go wrong?

There are always downside risks. High commodity prices could drive demand destruction. Covid is not entirely behind us, and now Monkeypox is added to our virology vocabulary. Supply disruptions could deteriorate further. The Russia-Ukraine conflict could escalate further and become a European war.

More telling, the IMF's 3.6% global GDP forecasts for 2022-2023 is a healthy number and is in no way redolent of an impending global recession. The whole world is determined to open their economies and be back to "normal" as soon as possible. This gives me the confidence and resolve that the aviation sector will get out of this stronger.

Outlook

Using history as a guide, the current global economic challenges should be a mere 'speed bump' to the structural growth of the aviation industry. Think about it. What are high inflation and a recession compared to the height of the pandemic when >90% of scheduled flights were cancelled, aircraft grounded for months, and airports seemed like the setting of a post-apocalyptic movie. I believe everyone in the aviation sector will happily take on inflation and recession rather than the hell they had to go through in the past two years.

As for us investors, risk abound but so do the opportunities. We look to invest in sub-sectors that are not directly impacted by rising commodity prices and interest rates. Companies that have a cost-push mechanism in pricing their products and fixed-interest loan terms are at an advantage. Applying these filters, we found a handful of companies in the online travel agencies, cargo and logistics, and component manufacturers that fit the criteria.

Strangely enough, these sub-sectors' values have declined the most this year. The online travel agency is often viewed as a tech stock and fell in the wake of the tech sector derating. The cargo and logistics sectors are seen as proxies for global GDP and global trade which were unduly derated on recessionary fears. Component manufacturers' share prices plunged on fears that rising raw material prices will eat into their margins.

It is a clear case of investor perceptions superseding the actual fundamentals. Whenever there is a mismatch like this, it is when the best values can be found.

Mohshin Aziz
1 June 2022

Year	Details	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2022	***NAV***	110.60	108.72	106.42	103.80	97.14								**-8.41%**
	MoM %Δ	*4.28%*	*-1.70%*	*-2.11%*	*-2.46%*	*-6.42%*								
2021	***NAV***	93.38	112.20	116.33	116.30	119.97	113.86	109.74	108.43	115.97	109.28	93.87	106.06	**6.06%**
	MoM %Δ	-6.62%	20.15%	3.68%	-0.49%	3.16%	-5.09%	-3.62%	-1.19%	6.95%	-5.77%	-14.1%	12.98%	