KTS CAPITAL MANAGEMENT

KTS Investment Horizon

17 December 2019

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EXECUTIVE SUMMARY

- Worldwide markets ended a decade of spectacular performances after a dramatic 2018.
- KTS is trying to keep focus on fundamentals, avoiding noises and misapprehensions of geopolitical tensions.
- If an investor would analyse only numerical facts, for the next decade he should **invest in fundamental sound equities** with constant dividend yield and earnings growth, rather than in a 10 years bond bearing a negative interest rate.
- KTS still feel comfortable with its **uncorrelated strategy in the fixed income** space, to generate higher returns than cash and bond with negative yields, giving stability to the portfolio.
- As for **equities**, we continue to deliver value added with the selection of the best in class strategies. Nowadays a sound diversification in the portfolio can only be reached **by combining different strategies**, given the high correlation amongst asset classes. The confirmation of our value added is the performance of the Optima dynamic fund in USD, fund for which KTS is the advisor, being at the top percentile worldwide in Bloomberg.

2019 had an impressive performance after a market crash during Q4 2018. Many investors missed the sharp rise in markets; in fact, the second half of 2019 triggered a fear of missing out (FOMO) market rally. In a nutshell, geopolitical tensions, especially between the US and China, triggered a global industrial recession, but central banks could rescue markets. Most of the investors were focused on geopolitical risks or the US inversed yield curve, rather than key fundamental factors of the economic cycle. We are going to analyze some facts for the next decade. We fully agree that the current economic cycle is the longest in history but **had a slower growth rate**: 2.3% p.a. versus an historical average of 5%. Therefore, we are also confident with the general consensus for 2020, that markets still have an upside potential, although limited for the US to around **3'200-3'300 points** for the S&P 500 Index, reflecting a 18x P/E. By analyzing fundamentals, we believe that Europe could be a bigger surprise during 2020. Also, from a technical point of view, the EURO Stoxx 600 Index could potentially have a major breakout compared to the peaks in 2000, 2007 and 2015 (see chart 1)! The uncertainty caused by the potential victory of the democratic candidate Elizabeth Warren at the next US elections, also referred as "Black swan", is going to limit the upside of the US market further. She definitely has good arguments where capitalism fails, but her strategy is going to hurt at first the financial sector, and also oil companies and tech giants. In this potential scenario, market experts foresee a correction up to 30%!

On the other hand, we see many positive catalysts for markets. We expect President Trump to reach meaningful improvements in the tariff war before US elections and we believe China is going to maintain a steady growth, having the celebration of the 100th anniversary of the CCP (Chinese Communist Party) planned for 2021. General consensus expects the Chinese economic growth in the next 5 years to be higher than the USA and Europe combined.

We believe the risks in Europe are discounted from the investors'

Chart 1: Euro Stoxx 600 – Major breakout ahead in 2020?

community and as previously mentioned, we strongly believe European markets could finally surprise positively. Brexit is not really going to impact markets. It is important to focus on the weight and influence of the UK economy in a worldwide picture, which is not meaningful. The Chinese economic growth, from the date of the Brexit referendum up to today, is as big as the whole UK GDP during the same period of time. Therefore, we keep focus on the most important factors of the actual economic cycle, mainly the Chinese and Indian GDP growth. Furthermore, China started stimulating their economy again during 2019 and we will therefore see more positive economic data during 2020. The FED was dovish during the second half of 2019 when the market was focusing on the US inversed yield curve and the ECB was claiming European Governments should stimulate economies via fiscal policies. **Germany** is technically in recession, but the German Government is not supporting its economy even **having the only positive fiscal deficit worldwide**! In Germany, infrastructure spending is only 2% of the total GDP, compared to 3% in Switzerland, 3.5% in France and an average of 3% worldwide. The US economy is still in expansion and US corporates are still experiencing earnings' growth. Recession indicators are not pointing to any distresses yet or any time soon. Moreover, the Leading Economic Index (LEI) is still growing, even if growth rates have slowed over the past months. Key fundamental factors like monetary policy, interest rates, inflation, growth and valuations are still in favor for further steady but slow economic growth and, in turn, higher equity markets. During August 2019, investors were too complacently bearish. This negative sentiment had a similar spike during October 2007 and October 2008. As a contrarian indicator, we believe the majority of investors are still underweighted in equity and will be forced to invest. US small businesses and consumer confidence, the main driver of the US economy, are still very strong and supportive. As mentioned previously, KTS is going to keep the focus on economic fundamentals, avoiding short term noises. Going forward, we are convinced that Central banks will be synchronized, and will do "everything we can" to avoid a major crisis.

We also believe there is no chance of returning to higher interest rates, and that an environment of lower interest rates will continue for some time. These means bonds will continue to be overpriced and equities will continue to offer attractive valuations. In fact, we passed the critical juncture with a range of available options; Central Banks are in a lock-in phase, there is only one path left to be followed: monetization and inflation. On the longer term, market participants are going to lose confidence in the financial system. For this reason, we believe any investor should be invested at least **5% in Gold** and precious metals as an alternative currency, and eventually Goldmines. With the further halving of new Bitcoins in May

2020, we believe the crypto currencies market could be interesting.

Bondholders are mainly pension plans: **27% of global fixed income assets trade at negative rates**, almost 17 trillion USD (82% of CHF bonds and more than 40% in EUR). We believe in a 15 to 20-year horizon, most of the retired population will not be able to afford the cost of living. This fact is not only going to affect negatively the behavior of consumers but will also challenge the affordability of real estate in developed countries. In addition, markets are going to question whether or not it makes sense to have bonds with negative yields. A recent example is the announcement of the Illinois Teachers pension Fund having a funding ratio of 40.7%, one of the worst in America. We also believe the bond market or so called "safe-haven" assets are creating the biggest bubble in history, but we do not know how long it will last. Japan could manage, and is still managing, flat to negative yields over 25 years. Therefore, we prefer to be invested in alternative fixed income investments to reduce the duration risk and improve the risk/reward of investments. Fund manager Ray Dali issued a detailed research on three big issues and 1930 analogue: 1) The end of long – term debt cycle 2) The large wealth gap and political polarity 3) A rising work power challenging an existing world power. He is less positive than KTS as he is warning markets of an imminent crisis. We believe it is too premature for such a scenario because nowadays central banks and policy makers still have some "ammunition" to avoid a crisis. The introduction of **5G is going to bring a tremendous innovation** and evolution in robotic and artificial intelligence (AI) for the next decade. Furthermore, **machine learning** is going to have an increasing impact on any investment process. The sensitivity of our millennial generation could finally trigger a profound shift in awareness and engagement in our health, social and environmental behavior. These megatrends are going to influence our economic cycle for decades. Hence, we are investing in the **Biotech sector**, digital Health, life science, specialized Tech Funds and also mid-caps. Americans spent an average amount pro capita of about $1'000 on healthcare in 1980. In 2018, that amount reached $11'000 (according to the US Centers for Medicare) and is projected to rise to $17'000 by 2030. Going forward we are going to weigh even more the aspect of ESG (Environmental, social and governance) guidelines in new investments and in our selection of best in class funds. **ESG guidelines are in an early stage phase**, therefore, we have to analyze if the positions in funds are coherent with our expectations. Once again 2019 showed to investors, how difficult is to time markets. We had an interesting level of volatility, but the tendency of investors, was to react with wrong timing. The Investor community forget the natural buyers of the markets: **$1 Tn in share buyback programs** for US companies which are financed from increasing cash flows over years, rather than via debt, as most in the investor community are arguing. Basically, half of US companies' profits, which doubled from 2009, is invested in share buyback programs. Expectations for 2020 are higher than 2019, therefore we expect further support for markets on this side. Of course, it would be better for economies, if the excess liquidity would be invested in CAPEX, but on the other hand, a massive increase in CAPEX would also mean an unsustainable increase of inflation. We would therefore prefer a smooth and stable development of the economy. Historical data show that increasing the investment horizon for equities allows investors to reduce their volatility. In fact, from a time horizon of over 10 years, equities basically have no negative yields. KTS decided to sell the strategy Long/short, which accomplished disappointing results. We will now invest more in selling options during market corrections, taking profit of the higher volatility and taking into account that markets have a strong support from share buyback programs and central banks. KTS will also build positions in long puts as a protection for the equity exposure in the Optima dynamic fund. We believe that a maximum of 1% yearly can be invested in protection, taking into account that the vast majority of the blue chips included in the funds we are invested in distribute around 3% in yearly dividends. In fact, we invested 0.5% in long puts during December 2019.

Via the Emerging Market exposure, KTS want to catch the **E-Commerce megatrend in Asia**. With 25% penetration rate growth in China, compared to 8% in Germany or 4% in LATAM, Chinese E-Commerce companies are an attractive investment opportunity at a better valuation than US Tech giants. 80% of transactions in China are digital and are processed through an app on mobile, compared to 40% of the second fastest growing E-Commerce country: Denmark.

Due to the weak Governance and transparency in Emerging Markets, KTS are investing mainly via Experts and Best in Class Funds. We also prefer Emerging Market Debt over US High yield to reduce the risk of the oil price volatility. Some of KTS best in class dynamic asset allocation Funds have a concentrated exposure in European High Yields, in line with our positive view on Europe. In 2019 KTS sold the exposure in CAT / Insurance Linked Bond Funds in which we had been invested since 2011. The strategy is not generating an attractive performance anymore, especially taking into account hidden risks like earthquakes or major hurricanes. We also avoid investments in Venture Capital as there is a bubble in valuations which can be compared to year 2000. We also struggle to invest in Private equity as we are seeing today the highest leverage levels ever. Most of our families and clients are owning real estate, therefore we do not want to add exposure to this asset class in their portfolios.

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