

KTS
CAPITAL
MANAGEMENT

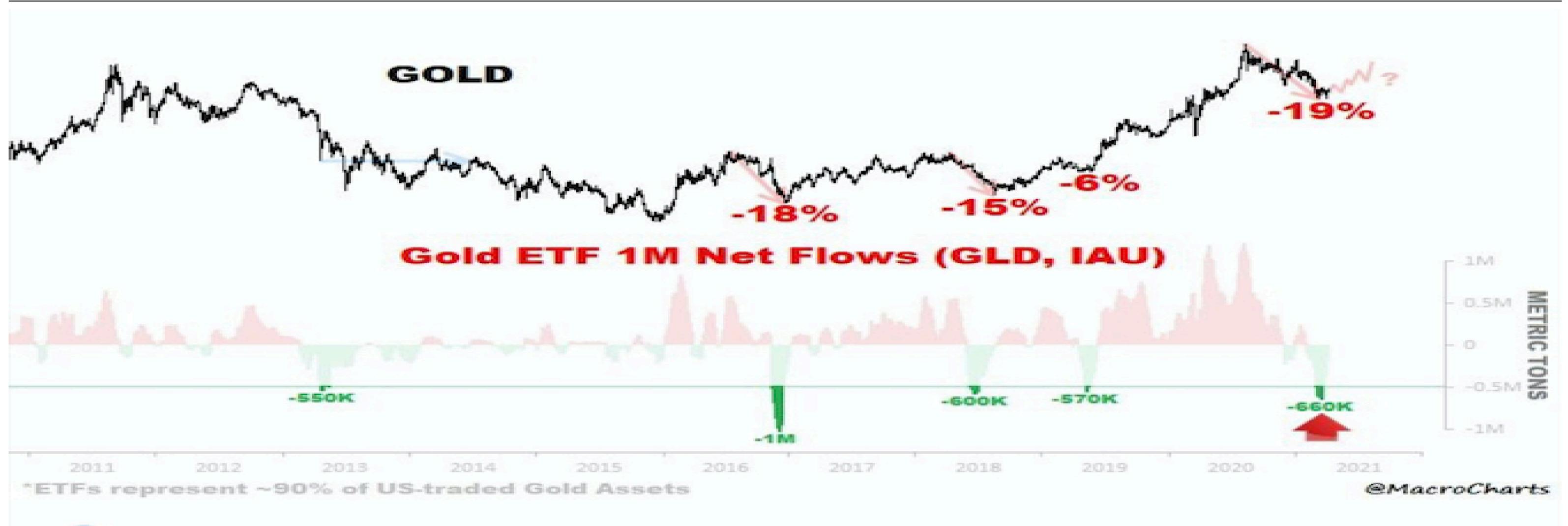


KTS weekly update Nr. 13

The 16th of April 2021

Gold

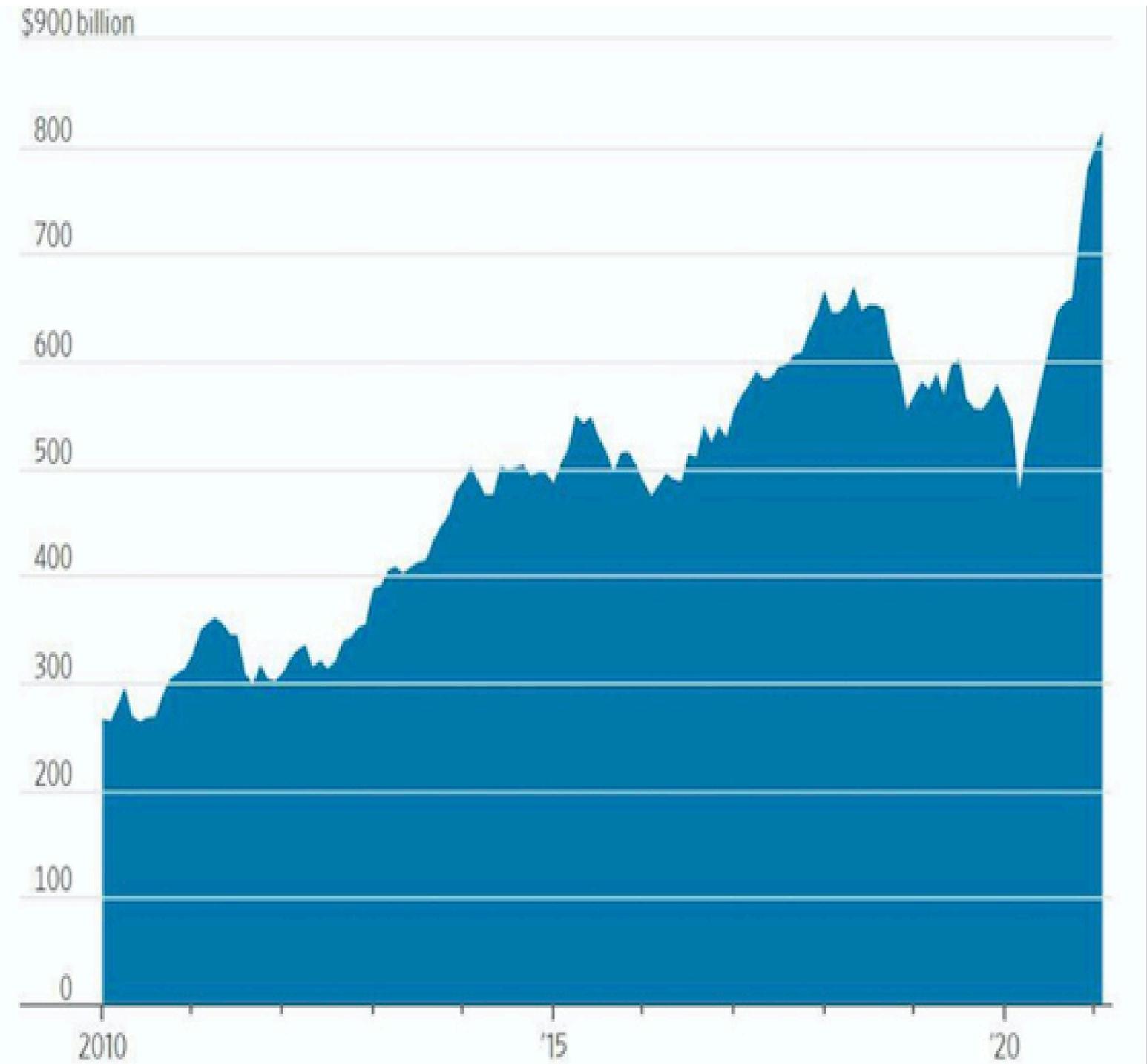
- Interesting chart from Mr. Tilo Marotz / Macrocharts: **historically, after such meaningful outflows from gold ETFs the price of gold has risen.**
- Are market participants going to finally experience a rebound of the gold price?
- As analyzed last week, inflows into bitcoin are at the expense of gold. How long is this going to last?



Source Tilo Marotz/macrocharts

Global leverage

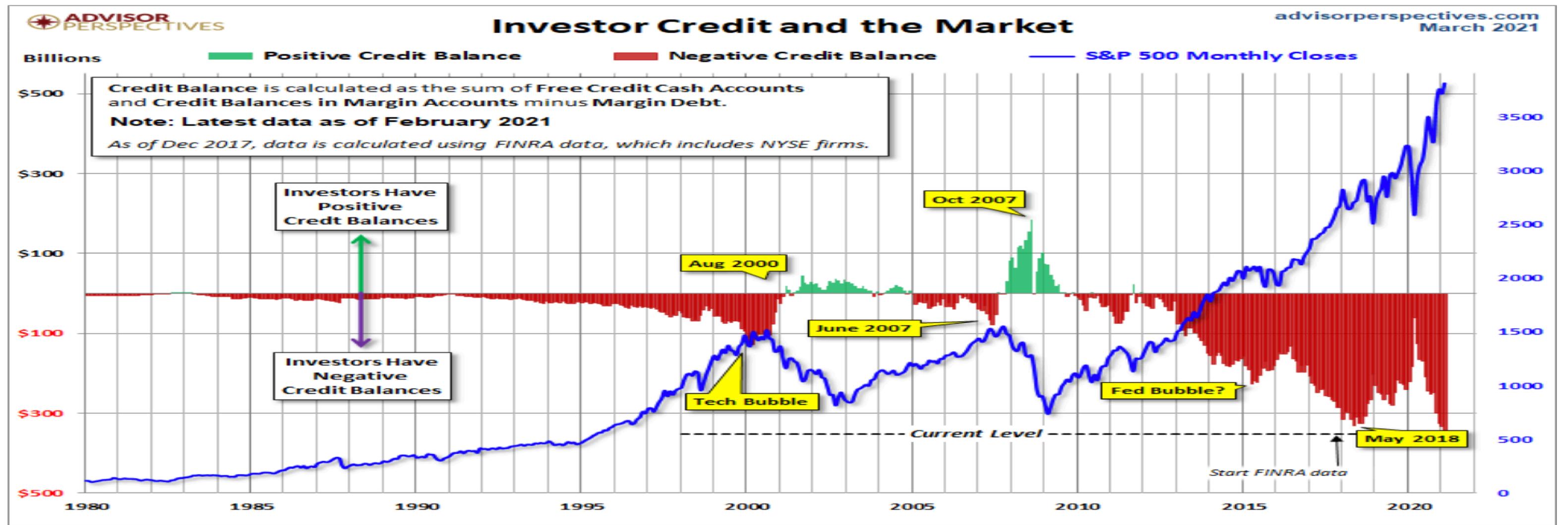
- We are aware that the huge amount of liquidity injected into the system by global central banks is synonymous with a new paradigm. Therefore, historical analysis and the comparison of current data with the past must be made taking into account this new dimension, which is definitely not easy to quantify.
- But, we believe that the **financial system's mechanism is basically going to stay the same-** as an example, markets are rallying again based on increasing leverage.
- As equity prices increase, banks allow higher margin debt. But, in the event of a severe market reversal market participants are going to experience a cascade of selling once again.
- As of late February, investors had borrowed a record USD 814 billion against their portfolios, up 49% from 1 year earlier and the fastest annual increase since 2007. Surely, it is not a coincidence that we are talking about the year before the 2008 financial crisis.
- Though we are in a new paradigm, the financial markets are using the same old dynamics and the **outcome is known.**



Total margin debt (source Flowbank/Finra)

Historical total margin debt

- On a longer term chart we can see that the current margin debt level is 3 times higher than in year 2000 and we are at new highs.
- Taking into account the fact that global central banks injected 3 times more liquidity than back in the 2008 financial crisis, we can accept the new leverage levels. But, the real dilemma is how much further the banks can increase margin debt? Following the Archegos scandal, regulators are going to scrutinise the debt margin dilemma- there must be the risk of serious consequences.



Source: advisorperspectives

Bank loans and leases to the economy

- We have discussed how investors are highly leveraged. Banks are mostly allowing such margin debt.
- On the other hand, the US bank loans-to-deposit ratio hits a new all-time low. Banks are basically NOT lending to the economy.
- The real question is: do companies not require credit lines at the moment because domestic economies are in lock down? Or, are banks just not lending, despite stimulus packages, and history is repeating itself? Is this the same situation that we experienced back in 2008 during the financial crisis?
- We believe that the stimulus packages have still not yet really “kicked in” to the economy. If this is the case, very soon companies will need credit to be able to increase capex, in order to increase capacity to satisfy stimulus package demand for infrastructure, etc.

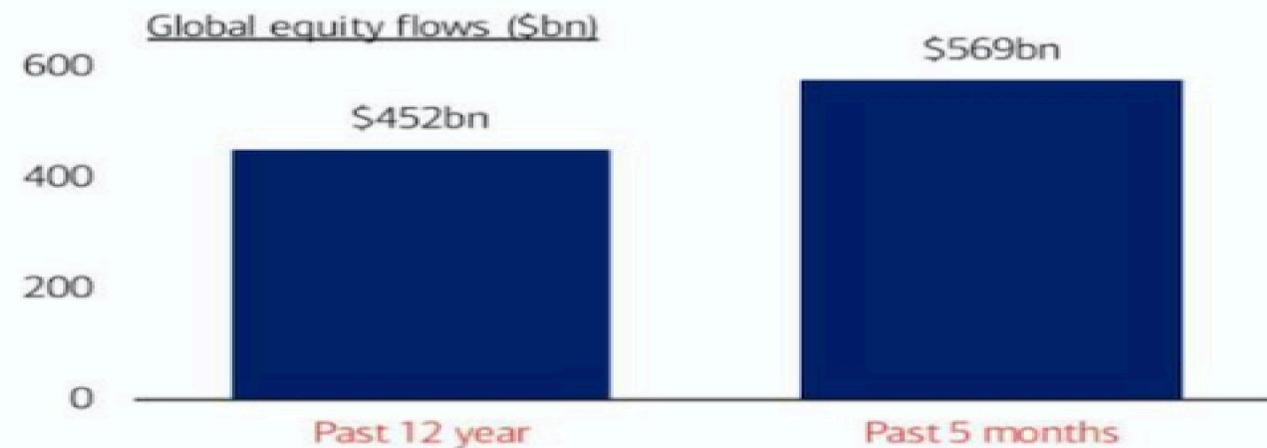


FRED: bank loans and leases

Equity and bonds inflows

- According to Bank of America, equity inflows during the last 5 months equal those of the last 12 years. This is something quite amazing and alarming. Taking into account the data on global leverage, we begin to not feel comfortable with market dynamics.
- Actually there is still a positive side. Theoretically, global equities still have some room to catch up against global bonds (around USD 1.4 trillion?). Practically, we know that most pension plans have restrictive investment regulations and most of them have to invest minimum 60% in bonds. Therefore, we are not expecting equity to get to the same levels as bonds, even if bond yields are nearly 0%. As explained, institutions are investing more in direct lending: factoring, Japanese, Chinese and EMMAS bonds.
- Once again, we believe that the fundamentals for equity are still strong. We expect more economic growth, EPS growth, share buybacks or dividend increases; but the market balance is now very fragile. Therefore, KTS is going to continue to prudently buy put options for downside protection. Investors need to be preventive, not proactive. When it happens, it will be too late to react.

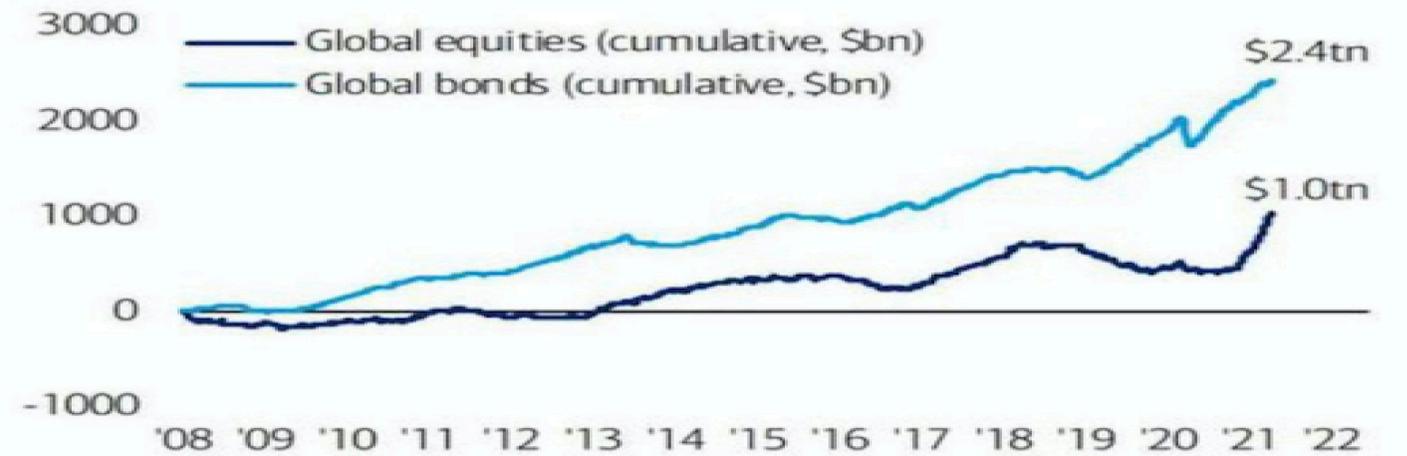
Chart 3: Inflows to stocks past 5 months > inflows prior 12 years
Inflows to global equity funds, \$bn



Source: BofA Global Investment Strategy, EPFR Global
BoFA GLOBAL RESEARCH

Equity inflow comparison: past 5 months vs past 12 years (BofA/Flowbank)

Chart 4: Bonds > Equities in past 12 years
Since 2008 inflows to bonds = \$2.4tn, inflows to stocks \$1tn

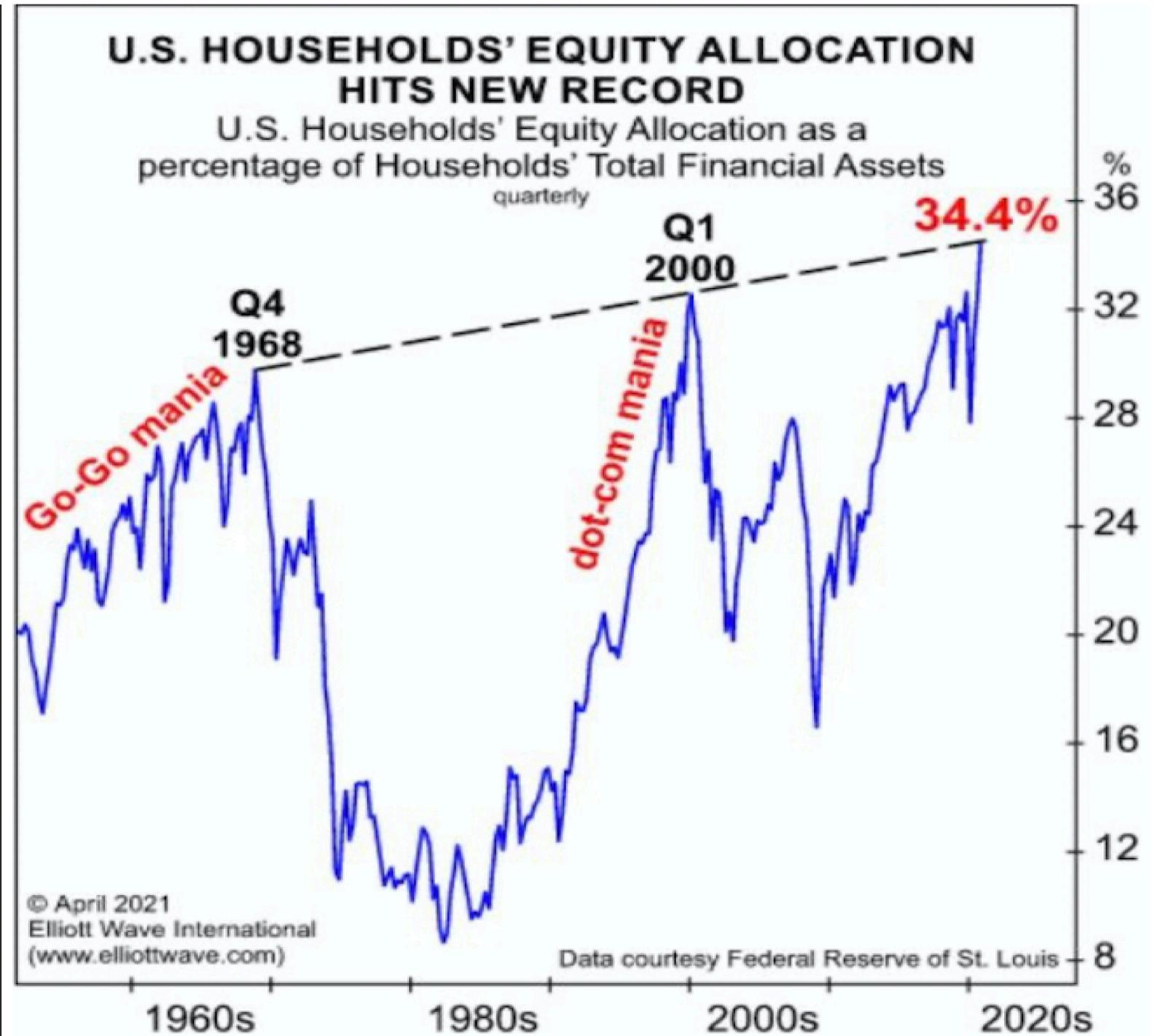


Source: BofA Global Investment Strategy, EPFR Global
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Global equity accumulation vs bonds (BofA / Flowbank)

U.S. households equity allocation

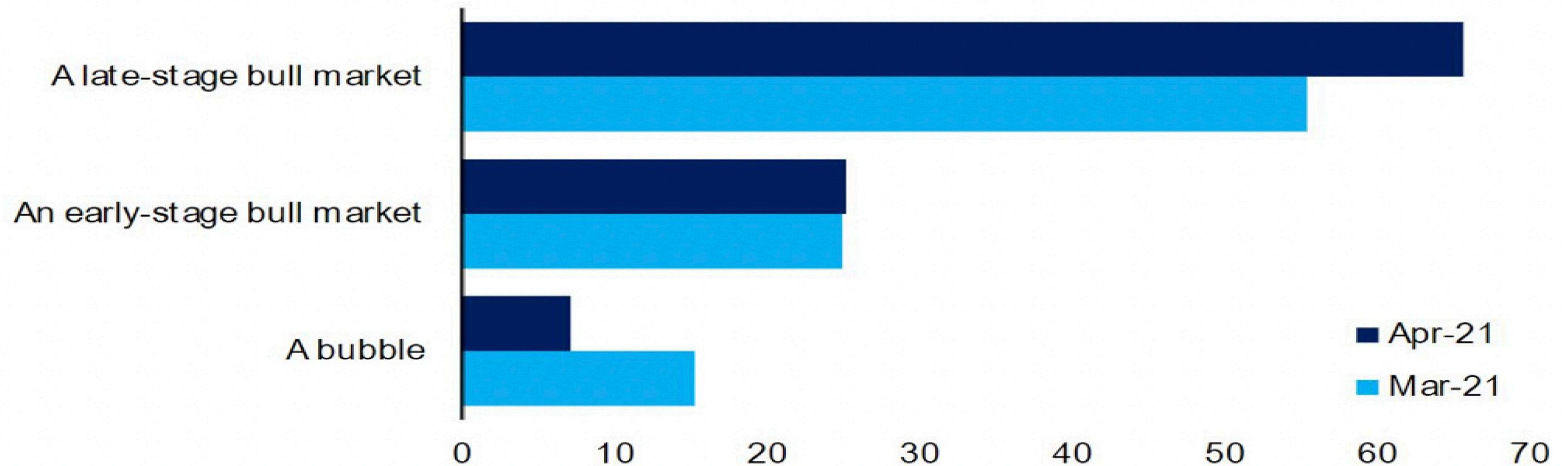
- The first answer to our question about how further and higher equity inflows could increase, is the current percentage of investments in equities on the part of retail investors/households.
- In America, **households hold now 34.4% in equity, which is a new record.** Therefore, short term upside potential should be limited?
- On the other hand, households don't have any restrictions, as do the institutions; and with bonds at 0% yields for private investors it would make sense to invest up to 100% in equity.
- The younger generation, having a longer investment horizon, could logically invest everything in equity. But, this is not so for the older generation, which cannot afford large losses of capital or be forced to panic sell at the market lows for fear of losing what is left of their precious pension.
- Nowadays, it is quite a “tricky” situation for the older generation: bond yields are at 0% and life expectation is much longer than for previous generations.



Source Federal reserve/Christof Leisinger

Opinion on the market from US investors

- According to a survey of Bank of America, only 7% of investors think that the US equity market is in a bubble.
- On one hand such a survey is supportive, because investors want to stay invested and believe that stimulus packages are going to create further support for more economic growth, which is going to be translated in higher EPS and higher share prices.
- On the other hand, the real question is- is everyone already fully invested? Analyzing the previous slide, many appear to be.



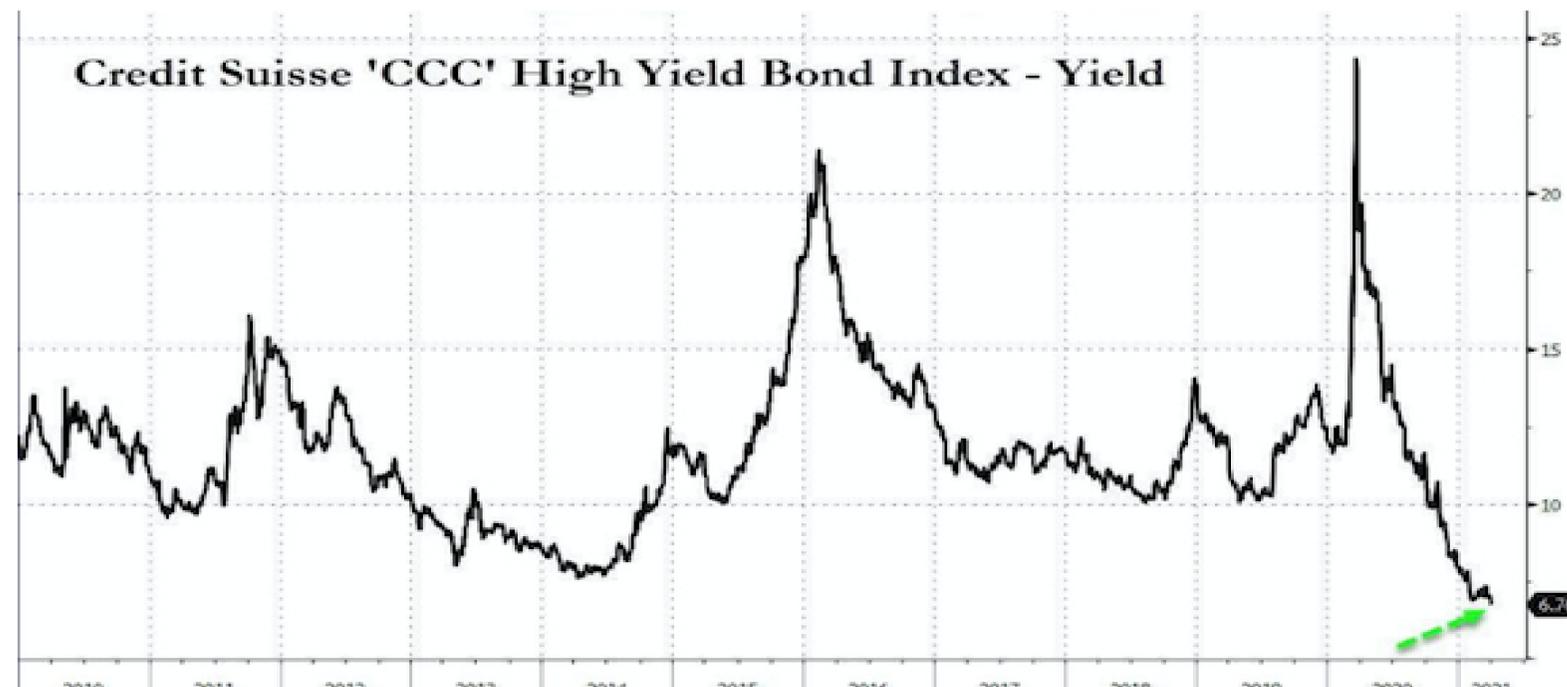
Source: BofA Global Fund Manager Survey

BofA GLOBAL RESEARCH

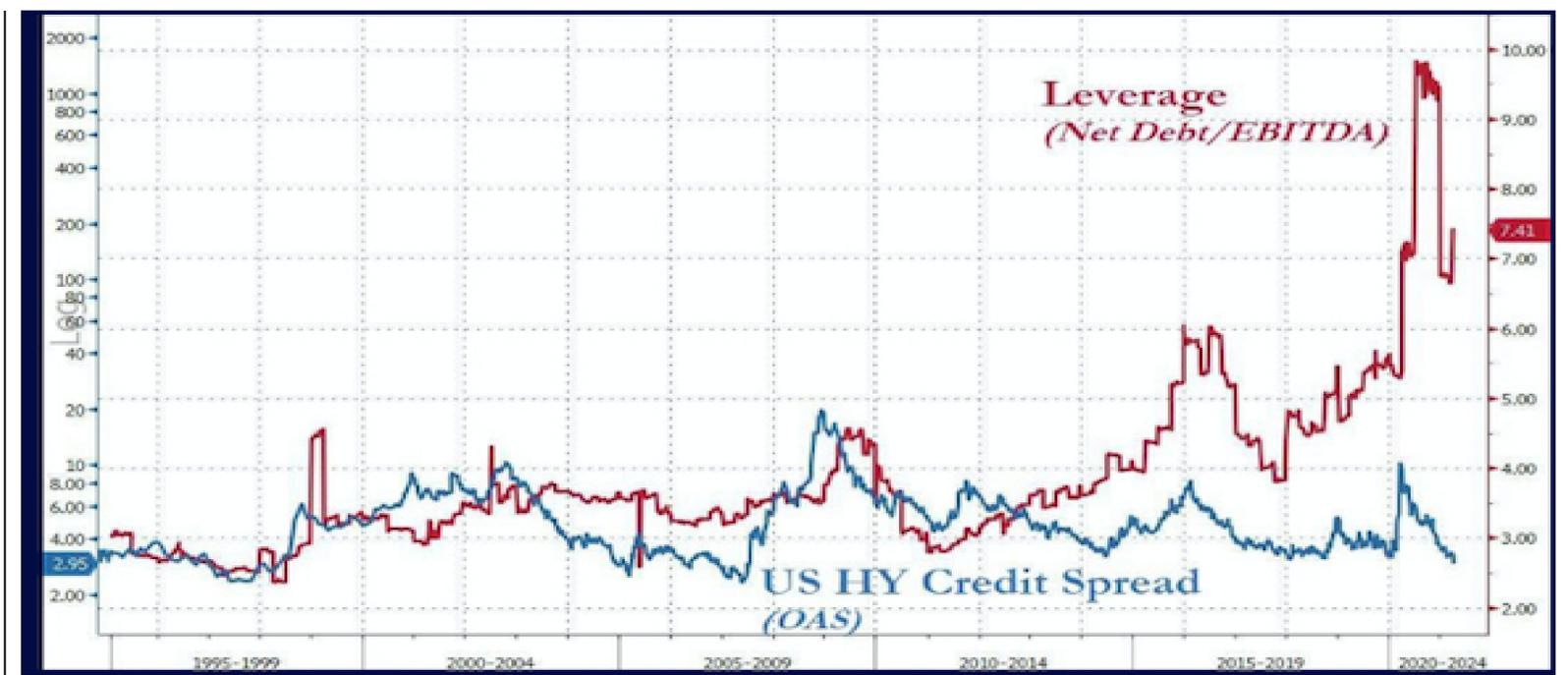
Source: BofA / Flowbank

Bond yield and quality

- Issues of CCC bonds have recently been hugely oversubscribed, even if yields are at record lows (6.7%).
- Meanwhile, fundamentals are deteriorating with companies increasing leverage. Market participants are convinced that “zombie corporations” are able to obtain cheap access to cash in order to finance their survival. The question is for how long?
- Historically, such market dynamics would be a clear sign of the market’s exuberance and bond investors would be cautious. Having central banks as the biggest buyers, it is very difficult to find attractive opportunities in the fixed income space. Market participants should be aware that the *real buyers* of these bond issues are actually our pension plans!
- KTS considers that exposure to bond market risk does not make any sense in a private investor portfolio, especially considering that bonds are already held in our pension plans. Therefore, we stay focused towards direct lending, factoring and micro credit, and also emerging market high yields.



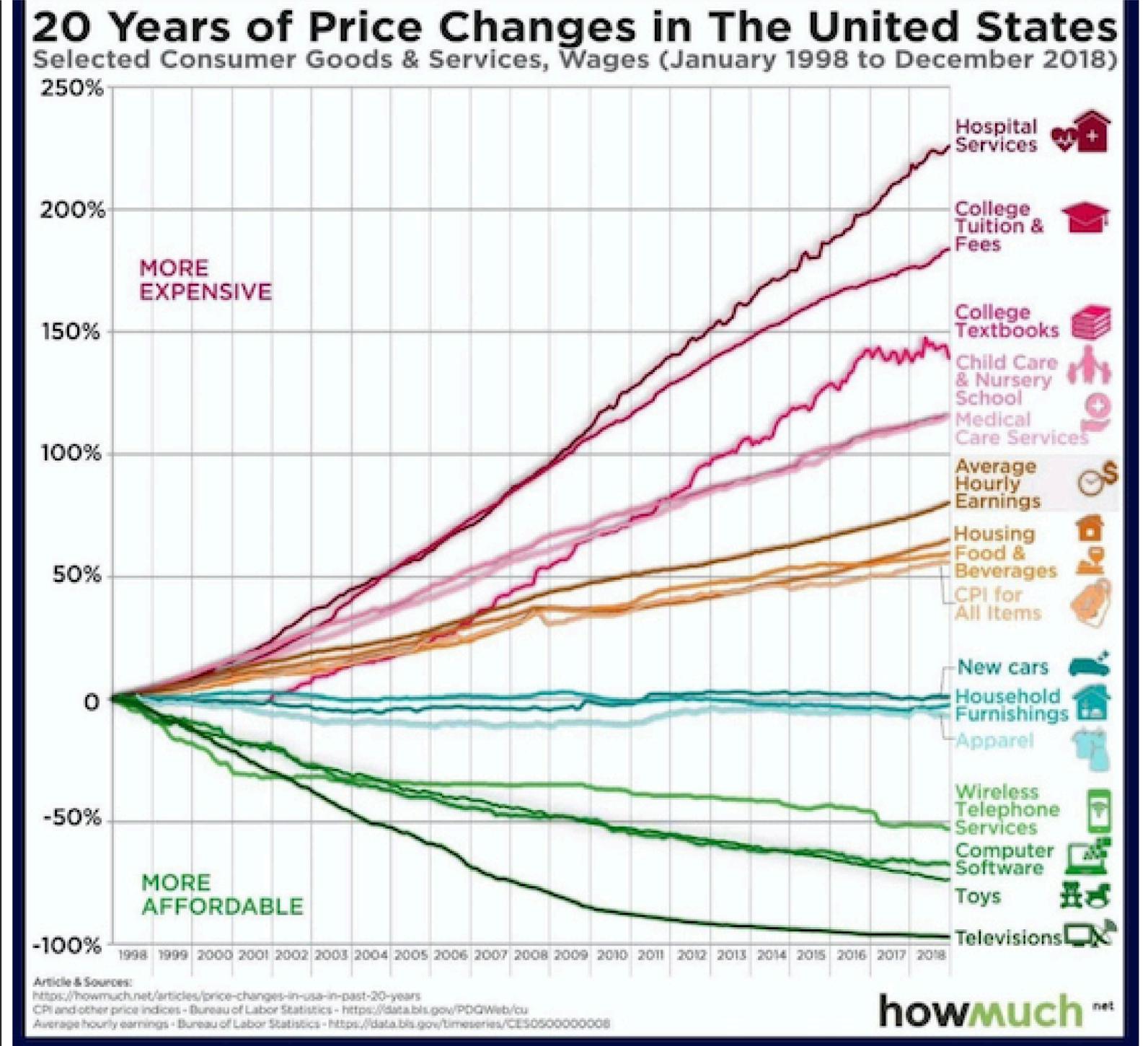
CCC yields at record lows (source Flowbank)



Leverage at highs, credit spread at lowest (source Flowbank)

The real inflation

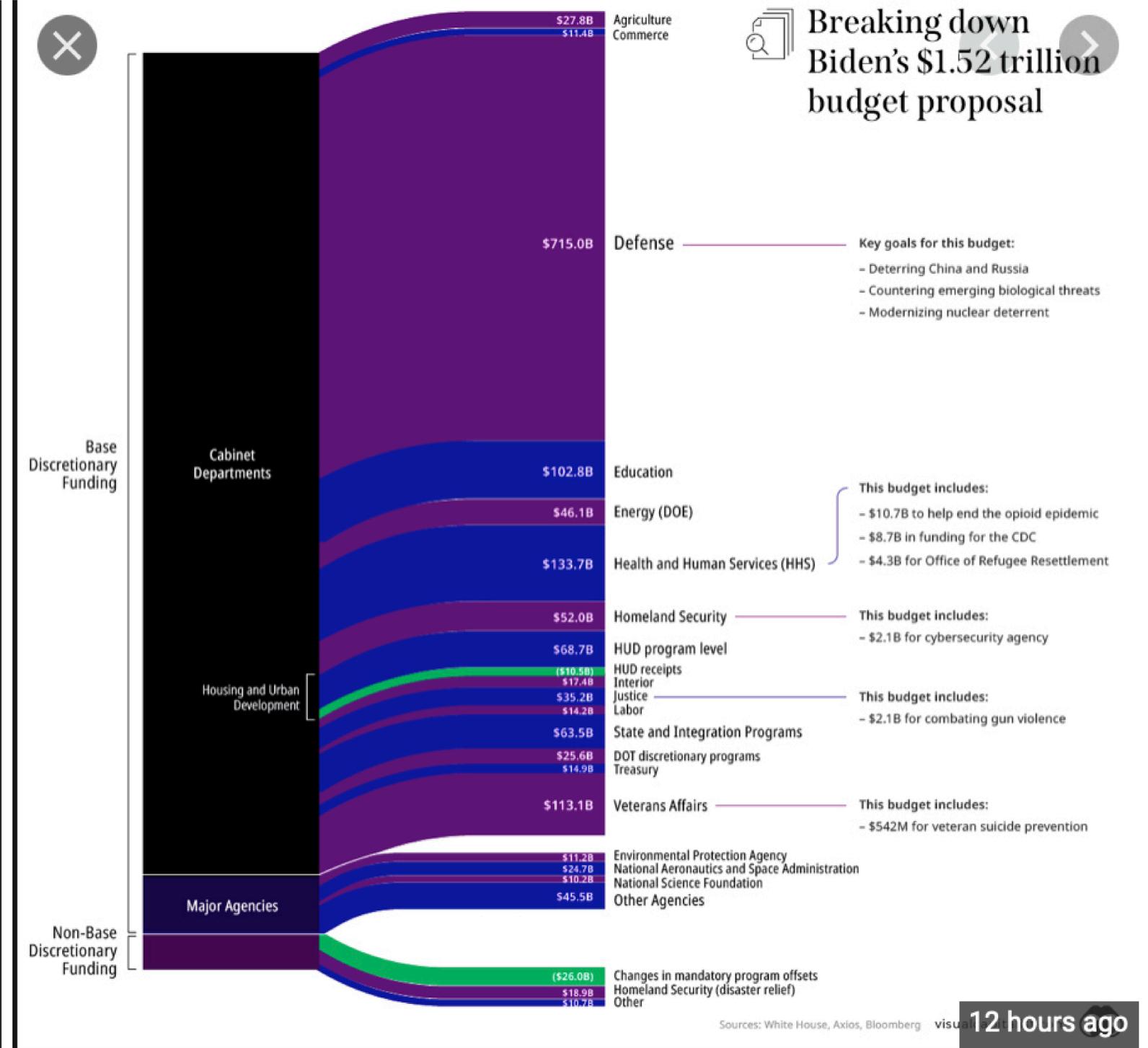
- Official numbers are low, but manipulated.
- Most citizens feel the real inflation and this chart of www.howmuch.net shows the real price increases in some goods & services over the past 20 years.
- It is not as a surprise to anyone that hospital services have increased by more than 200%, followed by education, child care and medical care.



Real increase over the last 20 years (flowbank/howmuch.com)

Biden's USD 1.52 trillion budget plan for 2022

- The Biden administration increased by 42% the budget for education (new at USD 102 bio), followed by commerce (+28%), health and human services (+24%), environmental protection agency (21%).
- Unfortunately, defense (also adding 113 bio for veterans affairs/suicide prevention) is still 55% of the budget plan, with a total budget surmounting USD 830 bio.
- The main official reasons for this are: deterring China and Russia, countering emerging biological threats and modernizing the nuclear deterrent.
- Peace is only a beautiful dream.



USD 102 bio for education vs 830 bio (defense + veteran affairs)

SEC into SPACs

- According to Bloomberg, the SEC has begun to look more into the accounting practices of SPACs, especially warrant plans, which should not be included under the equity capital, but accounted for as liabilities.
- We suspect, as many experts do, that this step is just the beginning of more regulations to oversee the sector. Historically, when the hype becomes meaningful the regulators step in.
- The main concerns of the SEC also include risks from fees, conflicts of interest, sponsor compensation (also from celebrity sponsorship) and the potential for naive retail participation, drawn by baseless hype. Also anxiety about the sheer amount of capital pouring into the SPACs, each of which is designed to hunt for a private target to be taken public.
- As mentioned in our recent weekly updates, there is clear exuberance in the space and the solidity of many projects is highly questionable. We are pleased to read that the authorities are going to analyze this space. The movie “Boiler Room” is probably the best and most amusing way to understand what is probably going on in the space nowadays.

General news

- New York raised income taxes on the super wealthy. This week, state lawmakers passed a budget that raises the personal income tax on individuals making over USD 1 mio and introduced 2 new brackets for those making more than USD 5 mio and USD 25 mio. The top 1% of New Yorkers paid USD 4.9 bio in local income taxes in 2018, accounting for 42.5% of the income tax collected by the city. We understand the noble intention of ensuring that the most wealthy pay their fair share of taxes. But, there is a real dilemma here. France also tried to increase taxes on the top most wealthy citizens (80% for income over EUR 1 mio), but then had to reverse their policy very quickly. They soon discovered that they were losing many the top wealthy French citizens, who were leaving the country, mostly to London. Wealthy citizens can be very flexible and move easily around the globe.
- Therefore the only real solution for such dilemma, is not to increase taxes to the top wealthy citizens, but spend the budget wisely.
- Merger & acquisition activities have already reached the record year seen in 2000. This is a clear consequence of the huge liquidity injection by global central banks. Our certificate investing in merger & arbitrage strategies is enjoying a strong positive performance, already from 2020, after disappointing earlier years.

Bitcoin' news

- Meanwhile, bitcoin reached new highs and is in full break out mood. In a interview with the German magazine “Der Spiegel”, Isabel Schnabel, of ECB, clearly stated that bitcoin is neither money nor a currency, because it does not fulfill the basic properties of money. Adding, `bitcoin is a speculative asset without any recognizable fundamental value, which is no stranger to wild price fluctuations`. Ms. Schnabel, in concluding, said bitcoin is a very fragile system which could result in disruption in financial markets. The euro is backed by the ECB, which is highly trusted, and is legal tender. Nobody can refuse to accept euro, bitcoin is a different matter.
- We are also reading some negative comments from insiders, like Mr. Jesse Powell (CEO of the bitcoin exchange Kraken), for example, who is concerned of a possible crackdown on crypto currencies. This is due to several warnings from central banks of the use of cryptocurrencies for illicit transactions. Therefore, Mr. Powell warns of governments stepping in with new regulations. Not only U.S. Treasury Secretary Janet Yellen but also Ms. Christine Lagarde (ECB president) have sounded the alarm about the use of bitcoin for money laundering, terrorist financing and other illegal activities. We all know that the higher cryptocurrencies go the higher the probability that the authorities will eventually step in.
- For this reason, we will stay invested in gold and silver. Not only are they accepted by central banks, but are also purchased by them as a reserve `currency`.
- From the SEC we have more comforting news. SEC has begun to review of WisdomTree`s bitcoin ETF application, starting the countdown clock to a final decision. Any positive outcome would be very positive, at least on the medium term.

Bitcoin's news

- According to Flowbank (Mr. Charles-Henry Monchau) and Glassnode, bitcoin miners are holding bitcoin in anticipation of a price rally. Blockchain data shows bitcoin miners accumulated 1.806 mio over the past 2 weeks. Again, adding to the new bitcoin millionaires. The supply of bitcoin is based on a very fragile pack of cards, if somebody starts to take profits the resulting selling cascade is going to be painful. **Therefore, bitcoin's rally has to be enjoyed with caution.**
- India has laid the groundwork for a central bank-run digital coin and has threatened to clamp down on any rivals. Reading through the lines, an outright ban would place India among the world's most draconian governments when it comes to digital currencies. Reuters reported last month that the government is considering forcing anyone holding crypto to liquidate their positions or face criminal penalties! This is very worrisome!
- After the Indian Supreme Court order last year that banks would be allowed to serve the crypto industry, the interest in the Indian market surged and, apparently, 2 mio Indian citizens are using crypto platforms. But, Indian officials have expressed concern that the growth of cryptocurrencies could prove a vehicle for illicit activities, such as terrorist financing, whilst undermining the rupee. Indian lawyers think, however, that an outright ban would prove to be unconstitutional.
- It is an open discussion and, in our opinion, it is in nobody's interest to totally ban crypto currencies, which is helping the strong growth of the IT sector. But risks are around the corner and should not be underestimated.

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