KTS weekly market update Nr. 24

The 2nd of October 2020

IS GOVERNMENT’S HIGH INDEBTEDNESS SUSTAINABLE?

- Our best in class Fund Flossbach held a webinar on the sustainability of global Governments’ high indebtedness and illustrated clear calculations. The conclusion is in line with Credit Suisse’s arguments from two weeks ago: after FED’s speech, **interest rates are going to stay low forever (not for longer), therefore Govs are going to reduce indebtedness via higher debts combined with higher inflation and lower annual interest costs vs GDP.**
- **INVESTMENT CONCLUSION: stay invested in EQUITY, GOLD AND REAL ASSETS and do not worry about indebtedness.**
- Of course, it is vital that Governments, like Italy for example, finalize reforms, in order to increase the efficiency of Government spending and former Italian Minister of Economy Mr. Pier Carlo Padoan tried over 45min to explain the next steps in this direction.
- Probably most of investors already accepted since long time such reality, but we have to admit that recent FED affirmations were the missing piece of the puzzle to confirm such long term structural change and now **market participants** are in fact applying new terms and are **going to accept higher Governments debts**, which is going to reduce the annual costs in percentage to GDP!
- Economic books are going to be re-written and we would almost affirm, that the 100 years Austrian Bonds basically still looks attractive?! We are definitely not going to invest in, but at the emission of the bond, we though, one day investors are going to hurt themselves; at the moment it does not look like the case, yet the contrary.
- This game changer is not **only influencing the investment environment, but also the consumer behavior.** Our ancestors experienced very difficult times and consequently had to learn, how to save wealth, not knowing what tomorrow is going to bring. Younger generations contrarily, will have to spend the money today, because of devaluation over time, without mentioning the future purchase power of pension plans. But this is exactly what policy makers would like to achieve.

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- **Germany used to pay an average of 5.3% annual interest on debt in year 2000. Today is paying 1.65% and by 2030 is going to fall to 0.65% .**
- Combined with the issue of new Government bonds at negative interest rates, the higher the volume of new issues, the lower the average interest costs vs GDP and adding higher inflation due to a massive higher money supply (European M1 increased 29% during 2020 and 13.2% just in August 2020), Governments are going to reduce the high indebtedness. The higher the efficiency of the spending, the higher the economic growth and therefore the tax incomes, which is translated to further decrease of the state deficit.
- The fact that Germany after covid-19 launched one of the highest stimulus package worldwide is the proof, that even one of the most conservative Government, accepted and want to profit from the new reality.

Germany: payable interest as a percentage of government gross debt (source: Flossbach)

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- The calculations below are the key of the future's Government indebtedness.
- Germany used to have an annual interest costs of 2.1% as a percentage of GDP which has felt to 0.6% nowadays. This is going to further **fall to 0% by 2030! Basically no costs for being indebted!**
- Italy used to have 4.1%, and nowadays is at 3.4% and going to further will fall to 1.9%. Spain is even in a better financial condition. Therefore such countries are going to be supported from higher debt in the future and investors' concerns are going to disappear. Basically no more September 2011! This is definitely a game change! And Flossbach always argued, when the investor community is going to accept such reality, the **real upside potential for equity is just going to explode** and we are going to enter in the new exuberance phase. It looks like that FED's speech was the trigger and for this reason, we believe US elections, and also political tensions like Brexit, USA-China, etc. are not really going to impact such long term sentiment.

	2010	2019	2030
Euro Area	2.5%	1.5%	0.9%
France	2.3%	1.4%	0.5%
Germany	2.1%	0.6%	0.0%
Italy	4.1%	3.4%	1.9%
Spain	1.6%	2.2%	1.0%
USA	2.0%	2.0%	1.0%

Source: International Monetary Fund, Flossbach von Storch, data as at 29 September 2020

General Government net interest payments as a percentage of GDP (source Flossbach)

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- Of course bond's demand with negative yields is going to fall, because investors are not compensated enough against inflation and risk. We are already experiencing a boom in private debt, factoring and all alternative fixed income investments. Therefore are we going to experience a collapse of the bond market? The answer is no.
- The following chart shows, analyzing the situation in Japan, that global Central Banks still have "plenty of room" to full in the gap, therefore finally Central Banks are going to finance Governments' debt.
- We would also like to point out, that after 20 years nowadays the investment community argues, that Japanese Bonds are the most attractive Fixed income investment in the Developed market! And Chinese Bonds for Emerging Markets. This fact self explains what changed...

Central Banks as last resort: enough demand for any size at lowest rate (source Flossbach)

Flossbach definition of “absolute return” investment

- When we started to invest in the best in class Fund Flossbach Multiple Opportunity back in 2010, the target performance was “absolute return”.
- **Afterwards, in the new era of negative yield around 2016, Flossbach changed the expression into “good yield at acceptable risk”**
- Nowadays Flossbach changed further the expression and is not talking anymore about absolute return or good yield at acceptable risk, but can only guarantee, that with their good diversification model, **they are not going to “screw up” ...**
- **This is a sign, that even the best Asset Managers worldwide, can not guarantee anymore an absolute return or positive real yields (higher than inflation rate).**

Negative interest rates: Debt can even pay for itself (from update 7 Sept 2020)

- Credit Suisse held an interesting telephone conference on inflation.
- In all the economic books we know, higher public debt means devaluation of the currency, which is going to cause **imported inflation** and as a consequence, higher interest rates (actual example Turkey, Venezuela, etc.).
- But this is not the case of Japan, Italy or even Switzerland (SNB ballooned the balance sheet from 120 Bio CHF to 990 Bio). This is because with **negative interest rates the higher the public debt, the lower the debt in % to GDP!**
- In addition Credit Suisse argues that equity risk premia went from -2% during years 2000 to a +4% nowadays, mainly because interest rates went from 6% to negative.
- Nasdaq used to have P/E 55 during 2000, nowadays we are still by 25-30 P/E.

Simulation of Credit Suisse on Swiss Government debt in % to Swiss GDP: because of negative interests is going to fall

Swiss National Bank

- The Swiss national Bank bought 90 billion Swiss francs worth of foreign exchange in the first 6 months of 2020. Basically during the first 6 months of 2020 SNB interventions are higher than the sum of last 3 years.
- The SNB is forced to step into the market to battle against the strong franc at an alarming pace.
- Actually the SNB still have reserves for more interventions, but the risk is actually the US ministry of finance, which put SNB on the radar of currency manipulator.
- **KTS is monitoring closely the situation and is ready to hedge currencies in CHF discretionary mandates.**

SNB currency intervention from 2010

FED: massive purchase of TIPS

- Meanwhile FED build up massive positions in the US TIPS (inflation linked bonds), which makes perfectly sense with their strategy, but an investor has the right to ask, is this an “official Ponzi system”?!
- Even more, FED is definitely manipulating the bond market, interest rates and indirectly the currency, but only SNB, Chinese Central Banks and others are manipulating their currencies. We have the feeling, we understand the wrong ethic?

FED ownership of TIPS (source Nordea)

US housing boom

- Economist Mr. Edward Yardeni thinks that the **US housing boom caused from low interest rates and de-urbanization effect because of covid-19, is offsetting the weak recoveries and stalling pandemic-challenged industries**. The recovery is going to be strong enough, even without a further coronavirus stimulus. On the contrary, too many (still) bearish economists like Taleb, Nouriel Roubini or Mohamed El-Erian, Mr Edward Yardeni were always rightly more optimistic.
- Latest existing home sales are confirming the theory of Mr. Yardeni. Home sales rose to 6 mio units during the month of August 2020, the highest pace since May 2006 (peak of the US housing bubble)! And sales numbers are likely to remain strong since the Pending Home sales Index jumped from a record low of 69 during April 2020 to a record 133 during August 2020.

Existing home sales & pneding home sales Index (source yardeni.com)

Global Real Estate Index by UBS

- According to UBS, Munich, Frankfurt, Toronto, HK, Paris, Amsterdam and Zürich at the “bubble club”, meanwhile Boston, Singapore, Madrid, Warsaw, Milan and Dubai are undervalued.
- In our opinion and related to the argumentations of Flossbach, Real estate are profiting from lower interest rates and in CHF, EUR rates on liquidity are even negative; therefore also **real estate is experiencing multiple expansion.**

GREBI score above 1.5

Bubble risk	2018	2019	2020
Munich	1.99	2.01	2.35
Frankfurt	1.43	1.71	2.26
Toronto	1.95	1.86	1.96
Hong Kong	2.03	1.84	1.79
Paris	1.44	1.54	1.68
Amsterdam*	1.65	1.84	1.52
Zurich	1.36	1.40	1.51

GREBI score 0.5 to 1.5

Overvalued	2018	2019	2020
Vancouver	1.92	1.61	1.37

GREBI score 0.5 to 1.5

Overvalued	2018	2019	2020
London	1.61	1.31	1.26
Tokyo	1.09	1.11	1.20
Los Angeles	1.15	0.99	1.16
Stockholm	1.45	1.10	1.11
Geneva	0.92	0.90	1.08
San Francisco	1.44	1.15	0.99
Tel Aviv	1.26	0.78	0.89
Sydney	1.29	0.88	0.75
Moscow	0.07	0.50	0.66
New York	0.68	0.50	0.56

GREBI score -0.5 to 0.5

Fair valued	2018	2019	2020
Boston	0.45	0.36	0.49
Singapore	0.44	0.45	0.48
Madrid	0.36	0.61	0.43
Warsaw	-0.40	-0.07	0.36
Milan	0.03	0.20	0.23
Dubai	-0.04	-0.26	-0.40

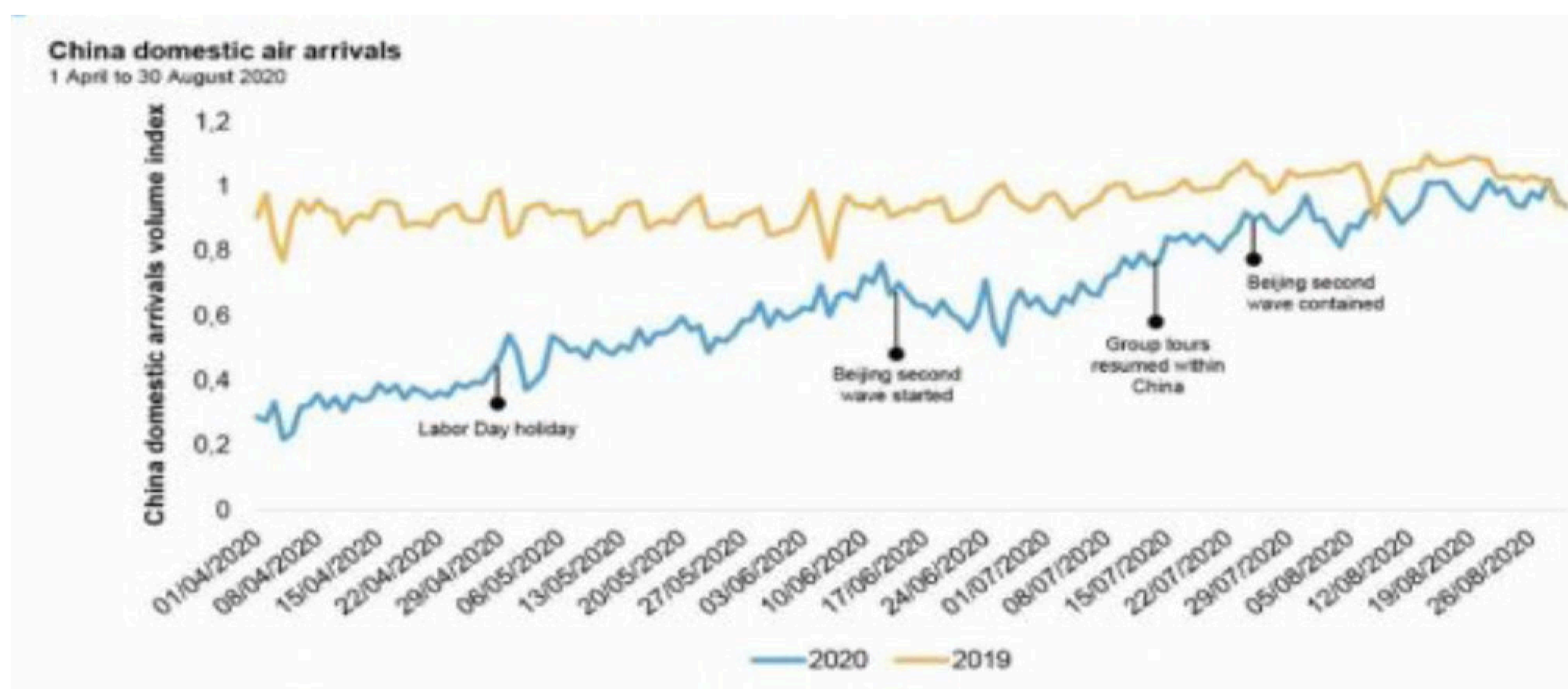
GREBI score -1.5 to -0.5

Undervalued	2018	2019	2020
Chicago	-0.62	-0.77	-0.66

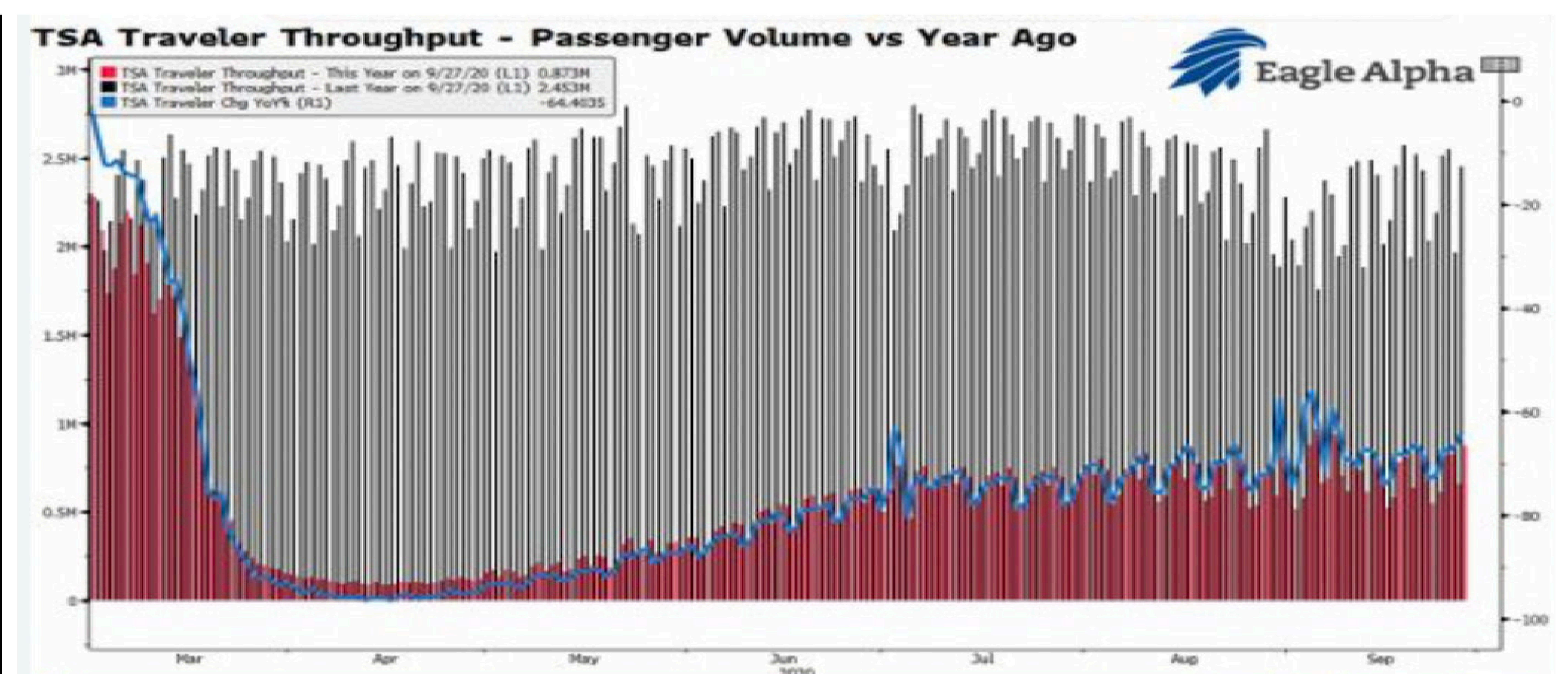
Global real Estate Index by UBS

Domestic travel within China

- **Quite impressive the recovery of the domestic travel within China**. Basically we are back at pre-covid19 levels! (Just 2% of airline operating capacity levels pre-covid19).
- Meanwhile as we already know, in the USA we are still at -65% pre covid19 levels.Consumer transaction travel spending data are down 42% YoY.
- In Europe capacity is still down 50% and with airlines cutting 4Q schedules in recent weeks with rising covid cases.



Domestic travel within China (Ian McFarlane Eagle Alpha)



TSA checkpoint travel numbers at U.S. Airports 2019-2020 (source EagleAlpha)

First US Presidential debate - keep focus on long term fundamentals

- We do not want to discuss about politic, therefore we are not going into details about the first US Presidential debate. We honestly can not understand the survey improvement of Democratic contender Biden just because proved to be more robust than many expected. It is quite impressive also that, it is proven, the son or family relative of Mr Biden received payments from Russia, Ukraine and China for an amount of around 3.5 mio USD, fact, which sound accepted?! At least Mr Biden paid 300k USD taxes! Sound more to us, people are "fed up" of Mr President Trump? After 4 years of at least discrete results, in the eyes of the US economy, it looks like the majority of US citizens can not stand the personality and behavior of Mr Trump anymore. It is a bit comparable to the situation at the time with Mr Berlusconi as Italian Prime Minister? Or are survey figures manipulated?
- In any case, **analyzing market's reaction and reconnecting to our long term fundamentals,** we have the impression, that the **US election outcome is not going to influence the market**, as many investors expect and consequently positioned with high hedges. Normally, when the majority of investors have expectations, today a possible market correction, the contrary is going to occur. According to Flossbach a research between their investors shows that the average equity exposure is at 62.9%, higher than at the end of 2019 and the total wealth of US private households is at new highs ever! In addition the U.S. Crash confidence Index is at lowest level since year 2000, therefore the investment community is expecting a correction, but not a market collapse.
- We admit, we do not have the "courage" to be fully invested yet, but **we have to closely monitor the timing for further investments**. As explained recently, even under a Democrat sweep, there are a lot of positive triggers for market (green infrastructure spending, increase minimum wage, etc.) and also the Democrat party can not influence the long term path of global central banks with the accommodative monetary policy. In addition, with a Republican Senate, Candidate Biden will not be able to increase taxes. If Mr Biden would have the Senate support, the tax increase would be effective only by 2023.

Further stimulus in U.S.

- **Renewed talks for a USD 2.2 trillion coronavirus stimulus bill**? The plan includes enhanced unemployment insurance, another direct payment, state and local aid and airline assistance. On the 30th of September Pelosi and Mnuchin fail to reach a deal, but talks continue.
- The tourism sector is in fact experiencing a second wave and stock prices are falling again, because of liquidity shortage by airlines and other companies. Therefore further aid packages to certain sectors are needed in order to avoid total collapse of some sectors.
- **The dimension of the new stimulus package would be an additional 10% of U.S. GDP** and we agree with economist like Mr Alessandro Fugnoli of Kairos Partners, that it is the best way to support the economy directly and with higher efficiency than further QE or having negative interest rates.
- SNB is forced to print more Swiss francs and buy US technology stocks in order to devaluate or at least fight the appreciation of the Swiss francs, especially to support Swiss small and mid companies and keep stable the Swiss labour market.

Global news

- Citron Research issued a report claiming **irregularities on the last 2 press releases of INO US**. INO's chemistry manufacturing and controls are unacceptable to the FDA. The price of the share is at 11 USD and Citron Research has a 2 USD target. KTS is invested only in Biontech as a "investment bet" for a Covid-19 vaccine and we always argued to our clients, that the company INO US actually never had an approved vaccine, but in the last few years, always claims to have a possible one for Ebola, Zika, etc.

- Very interesting to read that the most influential economist in Germany is the **Swiss Professor Mr Ernst Fehr** of the University of Zurich, followed by Prof Mr. Clemens Fuest (IFO-Institut). Prof Mr. Hans-Werner Sinn (IFO) is "only" at position 7, used to be the number one.

- We add a links to a very good and interesting research on Gold from Bridgewater, which is supporting our long term thesis:
- **https://www.bridgewater.com/research-and-insights/some-perspective-on-gold-in-the-new-paradigm**

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