KTS CAPITAL MANAGEMENT

KTS weekly update Nr. 5

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Valuation

- As explained in our last report, forward earnings are in general still increasing and, therefore, with falling equity markets, valuations are more attractive.
- Mr. Yardeni, with his colleague Joe Abbott, analyzed historical data from 1960 and came to the conclusion that P/E tends to fall during tightening periods and to rise during easing periods.
- Therefore the stock market action since the 5th of January, whereby forward P/E are falling in anticipation of the tightening of monetary policy over the rest of the year, would be in line with historical data. During the Tech Bubble correction in year 2000, forward P/E crashed from a peak of 25.4 during the week of March 24, 2000 to 14.5 during the week of October 4, 2002, even if the FED was easing during most of that period.
- **BUT the big difference this time is that the current earnings' outlook is much brighter than in year 2000, especially for technology stocks, where we are in the midst of a technological revolution.**
- Not surprisingly, share buyback programs "kicked in" during January's market correction, and corporate' buybacks peaked the recent highs. Again, such programs are the natural hedge of equity markets.
- Mr. Yardeni concludes his blog asserting that, while investors have been re-rating forward P/E of the S&P 500 to the downside, forward earnings continued rising to record highs during the week around the 20th of January, and that happened as forward revenues and the forward profit margin also rose to record highs. During the webinar of Credit Suisse, the CIO Mr. Varnholt asserted again that increasing labor wages are not comparable to 1970, because current company' earnings are increasing and therefore it is right to give an additional part to employees (during 2021 was +15%). Higher salaries also means future higher consumption, which is the main driver of the US economy growth.

Valuation

- The research of Mr. Yardeni is confirming that the investor community overreacted on FED guidance during the FOMC meeting and soon equity markets should rebound, as soon as inflation data would show a falling inflation going forward.
- On inflation going forward, as explained last week, also our best-in-class fund Flossbach is expecting lower figures sooner than later. During the webinar of Credit Suisse, Mr. Varnholt re-affirmed that the past high inflation was due especially to bottlenecks before Christmas, where companies were ordering 3 to 4 times more items, in order to guarantee that they would get the needed amounts. Therefore, going forward, the combination of opening up countries out of lock downs, opening ports (at Los Angeles port there are still 60 ships waiting, but down from 100 before Christmas) and increasing production, we will experience the opposite effect, and inflation is going to fall strongly and fast.
- Finally one last important point of Mr. Varnholt, the FED needed a window to increase interest rates before US election in 2024 and this year is the right timing to leave the 0% policy, which is unsustainable on the long term. But higher interest rates, especially the short term ones, are not going to stop the economy or consumption. On the contrary, during the last 2 years, most of the companies, but also private citizens, could have the opportunities to re-finance themselves long term and the US households and also US companies have never being as financially solid as now. **This is also confirmed from from S&P Global ratings, which recently wrote a research, showing that the global corporate defaults rate dropped nearly 70% in 2021 and in an additional research asserts that distressed investing sees pockets of opportunity in 2022.**

KTS best-in-class Classic global value fund

- The fund had a brilliant performance since our purchase, back in November 2020. At the time we were searching for fund managers which were focusing on distressed companies with attractive valuations due to the pandemic, but which had the financial solidity to overcome the crisis, and investors could finally profit from the equity market's overreaction. We can assert, the our mission has being accomplished and not we need to focus on the future.
- As explained in our outlook 2022, the manager, Mr. Georg von Wyss and his highly professional team, showed an interesting simulation on the performance of growth, solid consumer staple as Nestle or value stocks in an environment of increasing interest rates, whereby in the case of an increase of 1% of the 10y rate, US and EU growth would lose around 20% in value, meanwhile European value (70% of the fund's portfolio) would even increase in value. The result is due to the fact that the MSCI value index has an overweight in financial, materials, industrial and slightly in energy vs Information technology, but surely give the sense of the better hedge of the portfolio in case of increasing long term interest rates.
- The manager also ran a simulation on their model on the stock **Nestle, which, with an increase of 1% of the 10y interest rates, would lose up to 20% because of P/E re-rating from current 23.3x to 18.9x .** Basically such consumer staple, and also luxury, real estate and utility sectors are comparable to bonds. Therefore the manager rightly asserts that being long the stock Nestle, hidden risks are higher than what an investor could actually think.

KTS best-in-class Classic global value fund

- Our base scenario is more aligned with our best-in-class fund Flossbach, expecting a slow adaptation of equity market valuations to slightly higher long term interest rates and, based on the fact that central banks cemented a long term negative real rates environment, in order to reduce the government debt vs GDP, investors need to stay invested in equity, in order to reach a higher yield than inflation. Such adaptation is going to happen with higher multiple expansion, but investors will also enjoy higher dividend payments and share buyback programs. Of course, this is KTS's base scenario and, unfortunately, we do not have the guarantee that equity markets are going to react on that way. For this reason, we like the fact that being invested into the value fund Classic Global, we have kind of an additional hedge, in case of increasing interest rates.
- The fund is mostly invested in Europe (around 70%), but the geographical allocation is a consequence of the bottom up approach. We can explain such allocation with the fact that Europe is an "older" economy than US and therefore we find more value companies in Europe than US, which has more technology companies. In fact, analyzing the sector allocation of the fund, the portfolio is quite cyclical, being invested 27% into industrials and 20% into communication services / TV.
- As explained in our weekly report nr. 43 on the 26 November 2021, Flossbach issued an interesting study, where basically is explaining the wrong perception of the investment community, European equities have an attractive valuation at the present time, because they underperformed over a longer period of time the US ones. But being indirectly overweighted US equity, due to the exposure into the S&P 500 Index (both volatility based model funds are basically long the S&P500 Index, as also Fundana and Alkeon have an higher concentration into US technology), we feel comfortable to have a manager with a totally different approach and geographical exposure. The manager of the fund Classic global has a long proven track record and we are confident, that they can reach future above average performance vs peers. YTD they could also limit the downside vs equity markets.

KTS best-in-class Classic global value fund

- The manager had also had an additional interesting assertion, whereby Europe could catch up on the underperformance having more advanced technology in the green and renewable segment, which is going to be one of the drivers in the next decade. We agree and we believe to be well exposed with our energy specialist Renaud, but especially with our private equity investment Rimac automobili. In addition to the various European VC investments.
- Finally Mr. Von Wyss argued, **most of the companies are worrying about the increasing labor costs and especially in US**, after ex US President Mr. Trump stopped illegal immigration, it is very hard to find qualified and “unqualified” labor force, therefore he believes in a permanent increase of inflation and question the capability of central banks to have the inflation under control. Such structural labor force dilemma existed already before the Covid19 pandemic and it is actually not a new phenomenon.
- We are hearing the message and we take seriously the observation in our long term analysis, however we tend to be more positive on the development of the global labor force, especially, because before covid the global consent was more worried on the long term future unemployment rate of the “unqualified” labor force due to the increase of productivity via automatization and robotization. The fact, that the subject took a 180 degrees change, sounds for us too extreme, even more, we believe that the **constant increase of salaries, especially for the lower working class, is in the long term very positive, because finally we are slowly closing the gap of wealth inequality.** In addition, such financial stability in the job market, gives a general comfort and therefore people are going to consume more. Higher consumption means higher earnings for companies. **As long as we have a sound balance between increasing company’ earnings and constantly increasing labor wage**, we have the best economic scenario for a longer term stable economic growth and we dismiss the risk of a global “revolution” from lower classes, which suffered more than enough during the pandemic.

KTS best-in-class Classic global value fund

- In addition, as we have analyzed in the past, companies know the problem and are investing in the increase of productivity, which on the longer term should dismiss such cost pressure. This process is positive, having companies forced to increase capex and investments.
- We have also the confirmation of increasing labor costs from our manager of the Vietnamese market, where the lower class can profit from higher salaries, which is the consequence of the constant increase of Chinese salaries and therefore the outsourcing of production to Vietnam, but also to other frontier markets like Bangladesh, Myanmar, etc. We feel comfortable with our exposure via the best-in-class fund Emerging Market Aubrey, Stonehorn and of course the exposure into the Vietnamese equity market, which had an excellent performance but still have a very attractive upside potential.
- Finally, we would like to conclude, we came across multiple charts with the comparison Growth vs. Value stocks (Russell growth vs. Value, Russell 1000 value vs QQQE equal-weight Nasdaq ETF or MSCI growth vs value) and basically everyone is pointing out the same message, that the level of the spread between the 2 segments is at highs like back in year 2000 and after bottoming during year 2020, value investment is trending out of the downtrend from 2019. Again, we believe, this has much to do, with the fact that the energy, financial, industrial and material sectors are rebounding, but we are confident that also the Classic global fund’s portfolio has substantial upside potential. As the manager is pointing out, at the moment, inflows are more into passive investment vehicles and some stock have strange moves. But it is only a matter of time, stock pickers will also profit of the positive trend into value style and most probably M&A activities going to help into multiple expansion. One of the best example of the Classic global’s portfolio is the position Vivendi, which could finally profit from the Spin off and IPO of Universal Music group last September. Vivendi was also the top position of our best-in-class fund M&A strategy CIAM Satellite.

Market sentiment

- We came across a few more indicators, which are confirming the extreme depressed market sentiment and therefore as contrarian it is a buying opportunity:
  - The futures market shows that traders are rushing to buy the recent drop in the S&P 500 Index with net-long non-commercial positions in S&P 500 e-mini contracts increased to the highest since October 2018.
  - The Ned Davis Research trading sentiment composite fell below 20 and historical statistics show, 27 of last 30 times, the S&P 500 Index has been up 1 month later.
  - As recently mentioned, the volume of open put interest is hedging an average of USD 1 trillion worth (the nominal value) of puts per day, the highest on record.
  - A research of LPL research shows 9 of the past 10 times, stocks were down in January, on the final 11 months were higher.
  - Mr. Yardeni shows as contrarian the cover story of the 31st of January on Bloomberg Businessweek titled "The big chill: investors are bracing for more pain as a cold snap descends on the market". The points supporting the bear stance are in our eyes weak. The article argues over the weak performance of speculative investment vehicles as Ark Innovation Etf or cryptocurrencies. We agree with Mr. Yardeni, the bursting of such bubbles is actually positive for the "rest" of the market, which is solid and have still increasing earnings supported from still solid economic growth. On the contrary, the points for the bulls are interesting and were also our arguments, whereby American corporations are in great financial shape with the **S&P 500 companies sitting on a record USD 2.4 trillion in cash and other liquid assets. In addition, Mr. Yardeni argues, there is about USD 3 trillion in excess M2 liquidity** in our financial system, which corporations can use for buyback programs or finance M&A as recently Microsoft did for the acquisition of Activision Blizzard for USD 69 bn and Citrix Systems buyout of USD 13bn by private equity.

Market sentiment

- Cash levels also suggest contrarian buy signal. The cash balance of retail investors surged in the past month, suggesting some level of panic. Meanwhile, institutional investors are putting cash to work, the opposite of retail investors, which, by the way, we have seen last week, are even shorting heavily the equity market via short or inverse ETFs. In fact, last year we had a tremendous inflow in the innovative ETF Ark innovation, ARKK US and now retails are investing substantial amounts into the short ETF on Ark Innovation (ticker: SARK of Tuttle capital). The inverse ETF has a total size of USD 334 mio vs the USD 12 bn of ARK innovation ETF . We are talking only of a 3%, but it shows, how the sentiment changed.

Ukraine crisis

- Our main concern at the moment is the outcome of the harsh words exchange between the counter parties. We all are reading news on media and we all understood, US with Europe are keeping their stance. We are not discussing, if the American way to diplomacy is right or wrong, even if we have quite a clear opinion on that.
- Therefore the biggest dilemma is to understand, if Mr. President Putin is willing to ease his position, or going to escalate the situation. The general consent is at least up to the end of the winter olympic games nothing major is going to happen.
- Talking to our clients and business partners, we sense that at the moment, media are creating more tensions than the real situation in Moscow, which is apparently quite relaxed and almost everyone thinks that an escalation is not in the interest of anyone.
- According to FT, Mr. President Putin was meeting online Italian CEOs about expanding economic ties, even as Europe and the US threaten to impose punishing sanctions on Russia, if it invades Ukraine. The event was organized by the Italy-Russia chamber of commerce, of which Mr. Vincenzo Trani has the function of President. This fact of Mr. Putin looking for more allies and taking into consideration, that Russia has the support of China, is not really re-assuring. In addition we all know, historically US is always looking for confrontation, assuming they can count on sanctions (the title of The Economist this week is “America prepares the “mother of all sanctions” against Russia).

Ukraine crisis

- This is again a reason more, that the aged swift payment system is slowly but surely loosing global importance and countries already found alternatives with the blockchain technology. This fact is not helping for a better geopolitical stabilization, on the contrary, many countries now knowing to be more independent, increased the risk of unpredictable “ego” decisions. Reading the article of The Economist, whereby all the sanctions would basically target all the most important Russian figures, we are really convinced, it would not make any sense for the Russian President, to escalate the situation.
- Meanwhile US, backed by their Western allies, accused Russia at the U.N. Security Council of endangering peace and destabilizing global security by massing more than 100’000 troops on Ukraine’s borders. The Kremlin of course dismissed what they called baseless and hysterical U.S. fear-mongering aimed at weakening Russia and provoking armed conflict. We would agree that as long as it stays in Russia soil, is not destabilizing the global security.
- According to The Economist, the Ukraine’s president, Mr. Volodymyr Zelensky, is talking down the treat from Russia and dismissed leaks from American intelligence officials that Russia was transporting supplies of blood to its troops at the Ukrainian border to treat potential casualties of war. The deputy Defence minister, Mr. Hanna Maliar, posted “The purpose of such information is to spread panic and fear in our society” . US President, Mr. Joe Biden, asserted that a Russian invasion of Ukraine is certain and that Kyiv, the capital, could be “sacked”. The president of Ukraine on the contrary assert: “I am based here, and I think I know the details deeper than any other president”, asserting the steady drip of American intelligence leaks seems to them, to be serving American plans for Europe’s security, rather than helping Ukraine. This is quite of a statement and means quite a lot!

Swiss media and the analysis of the pandemic

- We are reading that the Swiss newspaper Blick, in order to help the country returning to normality, is not going to publish anymore the daily number of new Covid cases. As our clients know, KTS argued at the beginning of the year, based on the detail analysis (weekly Nr 1 of 2022) of the new cases, that there was no reason for panic and journalists should rather focus on the real situation, than to just publish a number with no real meaning. We also argued that the day governments are going to realize, that the situation is not that dramatic, the change of mood is going to be fast.
- In one way, we are extremely pleased, that almost worldwide, governments are speeding up the normalization process and automatically we sense that people have started to be more relaxed on the pandemic and rightly understand, for vaccinated people, Covid19 is nothing more than influenza.
- But, we are again disappointed, that journalists are just changing strategy, without understanding fundamentals (?), but as consequence of the policy shift of the government. Would be happier to read on mainstream the strong fundamentals of the shift.
- Nevertheless, this reality give us confidence, KTS can give a value added to its families and clients, analyzing different highly intellectual and independent sources, which can help to give the right direction ahead of mainstream. Of course, we can not be right all the time, but we feel comfortable to have a network of reliable and serious sources, helping us to at least analyze the right key points of a new event.

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