KTS
CAPITAL
MANAGEMENT

KTS weekly update Nr. 11

The 10th of March 2022

Intraday reverses during the week of the 7th to 10th of March 2022

- **European equity markets are experiencing strong intraday rebounds trying to find a bottom.**
- KTS is not trading the market on a daily basis, because we are of the opinion, that movements are too unpredictable. Too many components are depending on political dialogues.
- In addition, we listened to multiple telephone conferences on the actual crisis and repercussions on the economy, the general consent is, the global economy is going to suffer from higher persistent inflation, mainly due to the rising oil's price, but also due to strategic metals like for example Aluminum or Nickel.
- Most tragically; many emerging market countries, especially in the African continent, are sadly going to experience a food crisis, having the price of wheat and other agriculture commodities spiking.
- Therefore major banks reduced the asset class equity to neutral or even to negative. There are too many short term unpredictable uncertainties, therefore we are not adding any equity positions at the moment.

Strong intraday rebounds, sign of bottoming

Medium and longer term repercussions on the global economy

- Having too many unpredictable political developments it is advisable to do not trade the market short term, but we can in the contrary analyze, which one are medium term consequences of the crisis and act consequently. The general consent is:
  - Most of western countries realized, once again, the need to **increase independency from traditional energy sources** like oil and natural gas. Therefore the **alternative energy sector is gaining** momentum. In fact, the green energy sector was recently performing better then the rest of the market.We feels comfortable with our investments in this segment via our experts, but most especially our exposure into the private equity company **Rimac automobili**, which could recently increase its valuation, meanwhile all the quoted competitors lost more than 70% of their value (Rivian, Lucid, Nio, etc.). In addition we hold our special situation **GEVO US**, which is still basically trading at cash level, but should experience short term triggers, like the final agreement with the oil giant Chevron, which is supposed to buy 15 mio shares at 8.5 USD in addition to investments over billions in further Zero net projects with Gevo's technology, if the agreement is finalized.
  - Europe is considering to launch a joint bond sales to fund energy and defense. The EU is under pressure having launched the EUR 1.8 trillion pandemic stimulus package and now after the Russia-Ukraine crisis, the EU needs to finance energy infrastructure in order to diversify from Russian oil and gas. Again, the **renewable sector is going to profit.**
  - **Commodity prices** going to stay elevated, therefore it is important to have an exposure in the segment. KTS feels comfortable with the exposure into the best-in-class fund **Bakersteel Electrum** and the special situation **Nevada copper**.
  - A screening of countries vs profitability, courtesy Mr. Monchau of Syz group, shows **Brazil** as the most attractive country, with the highest profitability, due to commodity prices increasing, vs the most attractive valuation (P/E 6.9x vs an average of over 13x), mostly due to political instabilities in the country.

Medium and longer term repercussions on the global economy

- We do not know, if the oil price is going to spike further, but we know already, is going to stay at elevated levels, therefore oil companies are going to generate attractive free cash flows. On one side, we are reading market participants arguing, that the US and UK bans on Russian oil is not a fundamental game changer. The world is not about to run out of oil and therefore we are experiencing a price crisis rather than a supply crisis. On the other hand, we are reading that US was in contact with Saudi Arabia, but they are not increasing production, according to the OPEC agreement (Saudi also has not forgotten Mr. Trump accusing crown Prince Mohammed bin Salman of murdering the Washington Post columnist Khashoggi). In addition, apparently Iran wants Russia on the table for negotiations with US. Finally we are reading that Chinese companies are willing to buy part of distressed Russian oil companies. We feel comfortable with our exposure in the **energy sector.** In addition, oil companies are reaching enormous profits due to the crisis, have now at disposal **“fresh” capitals to be invested into renewable**.
- **Gold i**s experiencing a strong momentum and as mentioned lately in our weekly reports, hedge funds based on momentum strategies, like Man AHL Trend, are increasing positions into precious metals and the risk of breaking out the resistance of 2’078 USD is very high. Such breakout could provoke a price squeeze of 200-300 USD? If such spike would occur, we could think about rebalancing the position. But analyzing our long term view on repercussions due to the Russia-Ukraine crisis, we are of the opinion, that gold is basically the final “resort” for the “communistic bloc” as diversification out of the USD and US T-Bills. In addition, the world just experienced that via sanctions, **US could freeze Russian central bank assets.** Therefore China, India, Japan and all other countries around the world, will have to analyze their own situation and decide, how to diversify their Forex reserves. **Gold going to be the top priority in such process.**

Medium and longer term repercussions on the global economy

- **Spending in defense**. As mentioned last week, Germany decided to increase defense spending from 1.5% to 2% of GDP, which is the NATO's defense spending goal. Many other countries will most probably follow, having the majority under the 2% threshold like for example Austria, Sweden, Czechia, Spain, Canada, Netherlands, Denmark, Finland, Italy, Hungary and even China. As mentioned on slide 3, the new EU bond issue is supposed also to finance the increase spending into defense. Being mostly invested via third party funds, which are heavily focussing on ESG guidelines, and therefore not investing into the defense sector, KTS is not going to invest in this specific sector via a special investment vehicle.
- The crisis Russia-Ukraine shows once again, the high risk of supply disruption and therefore **digitalization, automatization or so called disruptive technologies (AI, robotics, space technology, metaverse, internet of things and blockchains)** are going to be the pillars of independency and de-centralization. This trend is going to gain even more momentum after the crisis. KTS believes to be invested with the right counter parties in those segments with the Swisscom VC structure for telecom 5G and health digitalization and Fasanara VC for Fintechs. Even the L/S fund Alkeon, which has clearly disappointed in the year 2021 and YTD, is in our eyes a good way to be exposed to the right selection of growth and technology stocks, which are going to profit from such megatrends. The same fundamental arguments are valid for our best-in-class global mid caps fund 2xidea and the fund Alpora innovation. Those funds are pure equity, but the selection of companies, which are leaders or most advanced innovators in their sectors, should add value to our portfolio even in such volatile equity markets.

Medium and longer term repercussions on the global economy

- The **biotech sector** dramatically corrected along global equity markets, but is actually not affected from the crisis, in the contrary. As we have seen in our last weekly report, according to the research of BCA, the sector is experiencing the deepest discount ever and pharmaceutical companies have plenty of cash for attractive and strategic acquisitions. We feel comfortable with our exposure. If we are going to rebalance our positions, the biotech sector is our first priority to add position. There is just too deep value in the sector nowadays.
- Basically analyzing the **war/oil shock/stagflation scenario 1973/1974 the sectors which could profit from such crisis were oil, commodities, copper and REITs.** This analysis is also confirmed from an historical comparisons between asset class performances in period of stagflationary environment, courtesy Mr. Steno Larsen. In the contrary growth, technology, discretionary, staples, small caps and banks were the biggest losers. Analyzing the development of the sectors growth and technology YTD, we would assert, that such segments experienced a substantial correction possibly already discounting a recession risk. If diplomatic dialogues between Ukraine and Russia could reach some kind of agreements, the risk is more on the upside, at least on the short term. In addition giant tech companies are constantly buying back shares. Such purchase programs are giving a kind of support to the equity market. We would like to remind, that 40% of the top companies included in the S&P 500 Index's performance is due to the substantial shares buyback programs.
- Major companies around the world have trillions in liquidity for investments and acquisitions. With the substantial correction of equity markets, there are nowadays multiple attractive acquisition targets. Therefore we would not be surprised of M&A activities picking up again. KTS feels comfortable with our investment into **funds based on M&A strategy.** Julius Bär issued a research with the title: **inflation is cash's enemy number one and propose also funds on M&A strategy as cash substitute.**

Medium and longer term repercussions on the global economy

- In such period of high market volatility, it makes perfectly sense to **sell put options** generating yield for the liquidity on the account as collateral.
- As we know, Europe is heavily depending on Russian natural gas and having Russia threatening to cut off Europe's natural gas, the investment community is expecting a strong recession in Europe. But some market participants are arguing, that the winter season is almost finished and therefore the risk of a major crisis is lower than a few months ago. Basically the **natural price spike is due to the emotional reaction of speculators rather than a supply crisis**. We are not in the position to have an opinion. The consideration make definitely sense and would help do avoid any dramatic developments in Europe.

Meanwhile Merrill Lynch has a new definition of FAANG

F (fuels)	• Geopolitical tensions, strong demand, constrained supplies, underinvestment—a number of factors will keep energy prices elevated over the medium term. Despite the outperformance of the Energy sector year-to-date (YTD), the sector still accounts for just 3.7% of the S&P 500 market cap, well below a 13.4% weighting in 1990.
A (aerospace)	• Defense stocks have outperformed the broader market YTD by 19%[4] amid expectations that heightened geopolitical tensions could lead to greater military spending. • Germany has pledged twice its annual defense budget; the U.K. and others made less-specific pledges. At minimum, NATO requires each member to contribute more than 2% of GDP by a 2024 deadline. Defense spending is also climbing in Asia; spending on cybersecurity will remain in a secular upswing.
A (agriculture)	• The planet will need to produce more food in the next four decades than in the past 8,000 years. The Food and Agriculture Organization's (FAO) Food Price Index hit an all-time high in January 2022. • Equipment shortages, higher input costs, climate challenges and burgeoning demand from the EM middle class all suggest more upside earnings potential for the global agricultural complex. Ditto for the expected decline in agricultural exports from Russia and Ukraine. Russia supplies about 20% of world wheat exports; Ukraine supplies about 10%, according to the FAO.
N (nuclear and renewables)	• Nuclear energy has the highest capacity factor of any energy source, producing reliable, carbon-free power more than 92% of the time—twice as reliable as coal (40%) or natural-gas (56%) plants and almost three times more than wind (35%) and solar (25%) plants.[5] • Renewable energy use increased as the pandemic induced major declines in all other fuels in 2020. Long-term contracts, ongoing installation of plants and priority access to the grid underpin renewables growth.[6]
G (gold and metals/minerals)	• Viewed as a "safe haven", gold prices are up over 6% in 2022 and posted the best February since 2016, underscoring worries over inflation and war. • The Electric Vehicle (EV) transition will be mineral-intensive. A typical EV requires six times the mineral inputs of a conventional car, according to the International Energy Agency. • The high mineral intensity required for batteries could imply 40 times the current lithium demands by 2040.[7]

Merrill Lynch

KTS's asset allocation

- According to our risk management model and analyzing the recent performance development, our beta to global market is around 0.5x
- We are invested in funds with a **dynamic asset allocation** approach or with hedge components for around 40% of our asset allocation. YTD the major performance's difference to the pandemic's correction in March 2020, lays mostly on the behavior of our volatility models ABR and Z22 as also the L/S fund Alkeon. The funds could not reach the spectacular positive result as per year 2020, having equity markets correcting over weeks with no substantial volatility's spike. In the contrary, the VIX index generated multiple false breakouts causing minor trading losses on the volatility hedge during the year 2022.
- In addition, the asset manager Flossbach is convinced of the long term solidity of their equity portfolio and are not reducing their exposure in equity, which is still at 75%. We would argue, during 2020 at the end of the day the hedge costed 7% performance to the Flossbach multiple opportunities fund and therefore the asset manager does not want to repeat the same mistake.
- Other funds like Tramondo were fortunately reducing the equity exposure before the attack to 50% , substantially limiting the drawdown.
- We are still holding our **gold, special metals, energy and renewable energy exposure**, which is around 15% . YTD those positions were the most efficient hedges in our portfolio. During the pandemic's market correction, oil & gold were also substantially correcting, this time in the contrary, were positive performance contributors.
- Our **"market neutral" part of the portfolio is around 25%** and as recently explained, we have substantial hidden performance reserves, which should materialized during the course of this year.

KTS's asset allocation

- Basically, our **pure equity exposure is around 20%** . We could unfortunately not hedge our equity positions with attractive put options during the Chinese Olympic games, as we intentionally wanted to. We are also not hedging with Futures, because the risk of a positive outcome from diplomatic talks is high.
- We believe, that the **selection of innovative companies or leaders of specific growth sectors** should give a kind of downside protection, being sectors, which are going to profit long term of the actual crisis. In addition, we believe that our best-in-class value fund **Classic global** being invested in companies with deep value, should also limit our drawdown. The YTD better performance compared the to broader equity market is the proof of the asset manager "sitting" on a solid portfolio and we are convinced in the capability of the fund manager to continue to do so. We are of the opinion that, if the market is not considering the deep value of such companies, most probably major companies, which are "sitting on a pile of cash", are going to acquire such attractive undervalued businesses.
- We are also not reducing our **emerging markets exposure**, because we are invested in countries and regions, which should actually profit from the general disruption and we are confident in the professionalism of our best-in-class asset managers. In addition emerging markets have strong fundamentals also supported by very attractive valuations, which should give a certain floor to our investments. Our major investment into the **Vietnamese equity market** was barely correcting, showing the solidity of the portfolio and the professionalism of the asset manager **Mr. Martinelli.** In addition, the fund manager of Stonehorn argues, that institutional investors had to liquidate emerging market' positions due to sanctions, but only because of the Russia's exposure, which is 2.8% of the total MSCI emerging markets. Therefore huge capitals have being basically withdraw in panic and of **Asia and China are basically well too cheap to be ignored and fully disconnected from fundamentals.**

Ukraine

- We do not want to analyze daily developments of the crisis in our weekly reports, but we are trying to outline at least the most important events. Equity markets gave much hope to the meeting in Antalya on the 10th of March and the Ukrainian President Mr. Zelensky announcing that Ukraine will not pursue the inclusion into NATO. Russia on its end is apparently ready to accept the actual Ukrainian government, if agree to accept their conditions. But at the end of the day, nothing really happened, even more Putin is admitting that sanctions have "created problems". We do not know, how to interpreter such comment, but as long dialogues are open, equity markets are still hoping in diplomatic solutions and for this reason equity market are in a process of bottoming in an already very depressed investor sentiment environment.
- CNNpolitics issued a courageous article arguing that there are increasing signs, all the heroism of Mr. Zelensky may be coming up against the West's prudent desire to avoid triggering a worst-case scenario, which could lead to a third world war. In fact the West is still not approving to secure Ukrainian skies in order to avoid a direct clash with Russian forces. The article concludes posing the question, the longer the war in Ukraine lasts, the greater the chance that political and strategic pressure also builds in Nato capitals. The fate of Ukraine may come down to a bitter question: which holds out the longest, the country's courageous people and their President, the Russian economy, or Western public opinion and leaders' tolerance for raised tension with a Russian President making nuclear treats? In our eyes the situation in Ukraine is really unsustainable and reached catastrophic humanitarian levels, therefore we are really hoping in a constructive diplomatic dialogue.
- As argued in our last weekly report, **realistic solutions would be on the table for both sides.** China, which is also supposed to be a "peace broker" of the situation, accuses NATO for pushing Russia to "breaking point" over Ukraine and warns US not to undermine its interests in handling the Ukraine war. China also added, that US sanctions will never bring peace and security.

Russia

- Western companies left Russia and there is a serious risk of a deep recession in Russia. From the comments of Mr. Putin, apparently Russia was not prepared for such magnitude of sanctions? In order to reduce domestic economic damages, also Russia is running out of time and this should increase the willingness to reach a diplomatic resolution? As mentioned in the previous slide, the alternative would be the third world war. We understand also the opinion of some market participants arguing, Mr. Putin has nothing anymore to lose and could option out for insanity. We stubbornly believe, Mr. Putin is not going to “press” the nuclear button” or China, even the Putin’s inner circle would stop him to do so.
- In order to relieve the economy from such a shock, Russian authorities decided to nationalize all property of exited western businesses. This is the latest measure seek to prevent bankruptcies and preserve jobs. **Such last move is going to make it even harder to re-start a process of reconciliation with the Western and isolated Russia even more.** The only partner left is **China.**
- At the moment in order to avert defaults, Russia companies are going to pay creditors in RUB, not USD.

Probability of a diplomatic resolution of the Russia-Ukraine crisis

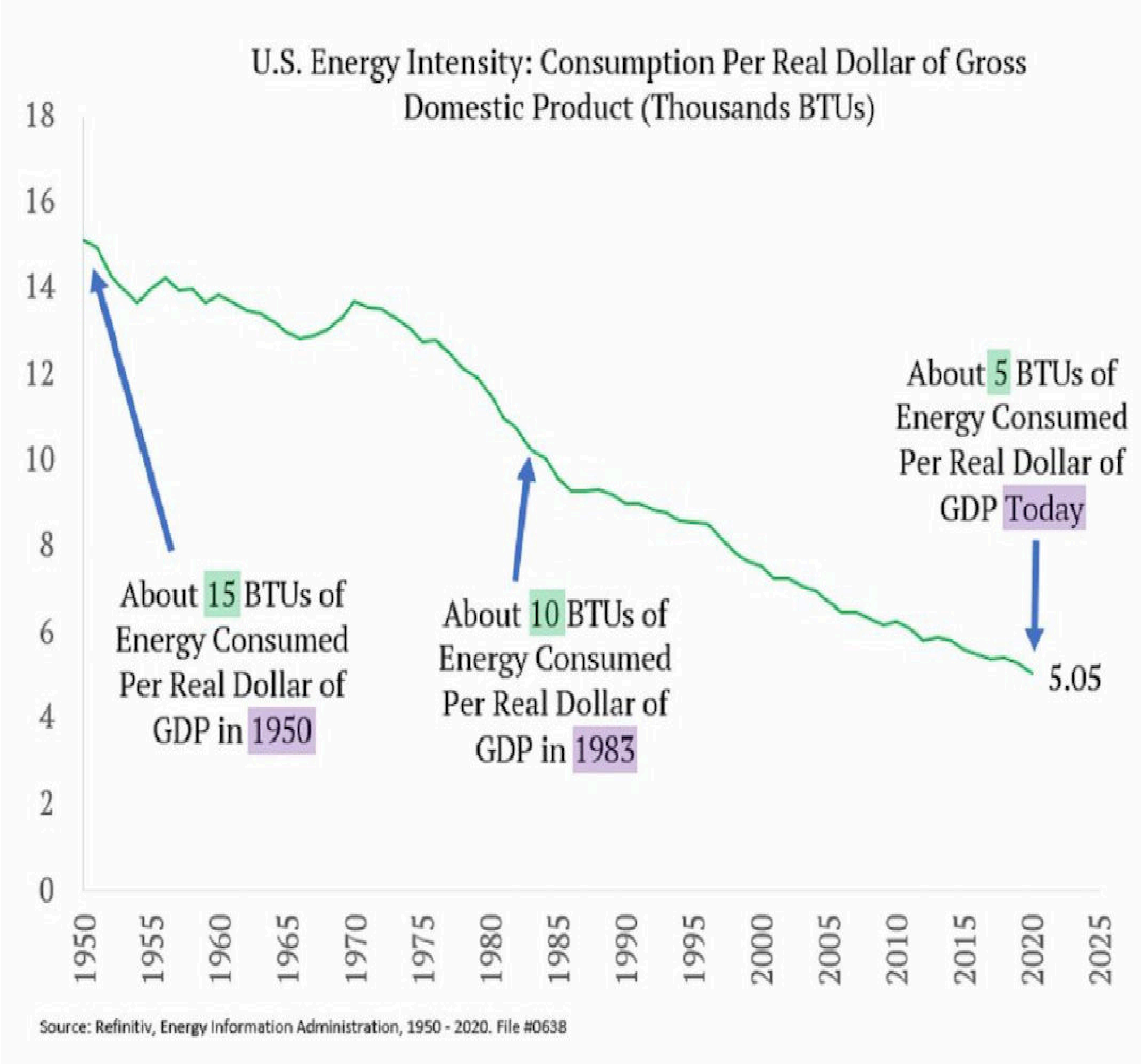
- As far as we can analyze, the **“real winner” of the crisis for the moment is China**, which is buying distressed Russian companies at 90% their value prior crisis and Russian oil at 30% discount to the spot price.
- In addition, the position of Russia is still “relatively strong” against the Western, only because Russia is backed by the Chinese, but Mr. Putin is not in the position anymore to set any conditions to China. Therefore we would argue, as the situation per today, **Mr. Putin sold out Russia at a very distressed price to China.**
- We are not sure, if this was part of the plan and according to the latest statement of Mr. Putin, he was also surprised of the magnitude of Western’ sanctions, especially on the domestic Russian economy. Most of the investment community was arguing, Mr. Putin had enough time to prepare a detailed plan from 2014, but it is slowly turning out, that not everything is running as planned. At the end of the day, Russia was just liquidating US T-bills and USD for Gold and increase Europe’s natural gas dependency.
- Reading through the lines the comments of Mr. **Putin, who sees “certain positive developments”** in talks with Ukraine, give us confidence, that he is also desperately in the need to reach some diplomatic successes, in order to “do not lose his face” and having China pressuring on “his back”, which is not interested at all in a war or further escalations.
- We had a very interesting conversation with the manager of the Emerging market fund Stonehorn, who forecasts diplomatic talks to narrow disagreements over time, but of course at a very slow pace. Finally, with China as intermediary, all the counter parties are going to agree on the main issues, which are basically a neutral Ukraine, no NATO inclusion and the recognition of the Donbass areas as Crimea, included water supply for the peninsula.
- A neutral Ukraine would be able to still have financial support from Europe, which would help to rebuild the country.

Probability of a diplomatic resolution of the Russia-Ukraine crisis

- The manager of the Emerging market fund Stonehorn, Mr. Sam LeCornu, is of the opinion that China is not in the position for more Western' sanctions or a war, having enough structural domestic problems, like the weak real estate market. The Chinese consumer is spending money, only when people sense to have increasing wealth. Even if the increasing value of the real estate is "only on paper", gives the sense of growing wealth to Chinese citizens, which spend their saving money on the bank account. But seeing their wealth value declining due to lower real estate prices, Chinese consumers are at the moment spending less.
- In addition, as we have analyzed in our last weekly report, China' exports depend too much on the Western, therefore Chinese authorities are going to avoid any direct confrontation with the Western. Finally once again, as far as we can analyze nowadays, China is the real winner and would have on board also Russia as a trading partner, adding more "power" to the already strong Chinese connections in Asia, the African continent and the Far East region (see our weekly report nr 7. of the 18th February 2022).
- **China is also the only country with could guarantee to Mr. Putin and his family a safe future,** as basically Mr. Putin promised to Mr. Yeltsin back in 1996 after the process of Russian privatization to Oligarchs. We attach a very interesting link to an interview with Ms. Julia Ioffe with Frontline on the needs and ideology of Mr. Putin. This option of the Chinese President, Mr. Xi Jinping, gives in our eyes the only hope, how to **find an exit for all the parties of this dramatic crisis and do not have Mr. Putin in the sole position to lose everything and therefore becoming too vulnerable.** It is quite clear to the investment community, that any outcome from this crisis going to be without Mr. Putin.
- https://youtube.com/watch?v=b1HWNcLDK88&feature=share
- **CONCLUSION: We are stubbornly believing, that China is going to lead Mr. Putin and Russia to a diplomatic resolution, avoiding any third world war.**

Worldwide oil dependency

- The chart on our right hand side, courtesy Mr. Monchau CIO of Syz group, shows how global energy intensity was actually 3 times higher in the 70' than nowadays.
- Therefore we can not compare the actual situation with the crisis of the 70' . The magnitude of the oil shock is lower.
- Today, the US consumes 5 BTUs of energy for every dollar of GDP. In the 70' by the oil crisis the energy intensity was much higher.
- In addition we would like to remind to our clients, that the world's largest oil reserves by country are in **Venezuela with 303.8 Gbbl (billion barrels), which coincides to 17.5% of global worldwide reserves. Saudi Arabia follows with 297.6 Gbbl (17.2%), Canada (169.7 Gbbl, 9.7%),** Iran (155.6 Gbbl, 9%), Iraq (145 Gbbl, 8.4%) and finally Russia with 107.2 Gbbl, which is 6.2% of the worldwide reserves. Kuwait has 5.9%, UAE 5.6%, USA 4% and Libya 2.8% .



Source: Jeff Wenigerneeds / Refinitiv, IEA

General news

- No big surprises from the NPC (National People's Congress) held in China.
- We would like to add a video of Mr. Ray Dalio, which is the summary of his very interesting book entitled "**The changing world order",** which should help to explain the actual situation between China and USA.
- https://www.linkedin.com/posts/raydalio_principles-for-dealing-with-the-changing-activity-6906716144317960193-8hF6
- Also the book of the writer Mr. Niall Ferguson entitled **"The ascent of money"** helps to understand from the history, the dependency of wars with the wealth of governments.

General news on cryptos

- Officials in Switzerland have announced that they will seek to freeze digital assets owned by sanctioned Russian individuals and entities. Honestly, it went much faster than what we thought.
- Also from the side of US regulators. The President of the US signed an executive order on digital assets today. Even if specific positions are not concrete yet, regulations should be in direction consumer protection, financial stability, illicit use and financial inclusion. **We all know, the real target of such regulations is to reach the same environment for sanctions as for the Swift system, but with a de-centralized system as blockchains, it will be more difficult to reach such goal.** In the contrary, the "communist bloc" set up their own digital currency based on blockchains exactly to avoid international dependency and the risk of a blockage from US sanctions.
- On one way, the new world is supporting even more de-centralization and therefore blockchain technologies. On the other hand we have recently realized, that **in this crisis environment, bitcoin and cryptos are not comparable to gold** and the negative price's reaction on the Russia-Ukraine crisis is showing, that bitcoin is not the digitalized gold. Again, it is very difficult to calculate a fair value of crypto currencies and to predict any directional movements.
- Softbank group via Paypay service is investing aggressively to expand its global presence into non-fungible tokens (NFT). After the merger of Line Cop., one of Asia's most popular messaging apps, and Yahoo Japan last year to create an e-commerce and social media giant, called Z Holding, to compete with global tech leaders; now plans to launch an NFT marketplace in 180 countries. Basically Web3 has become an umbrella term for a growing list of blockchain-based applications such as crypto currencies and exchanges, decentralized finance and the trading of NFTs.

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