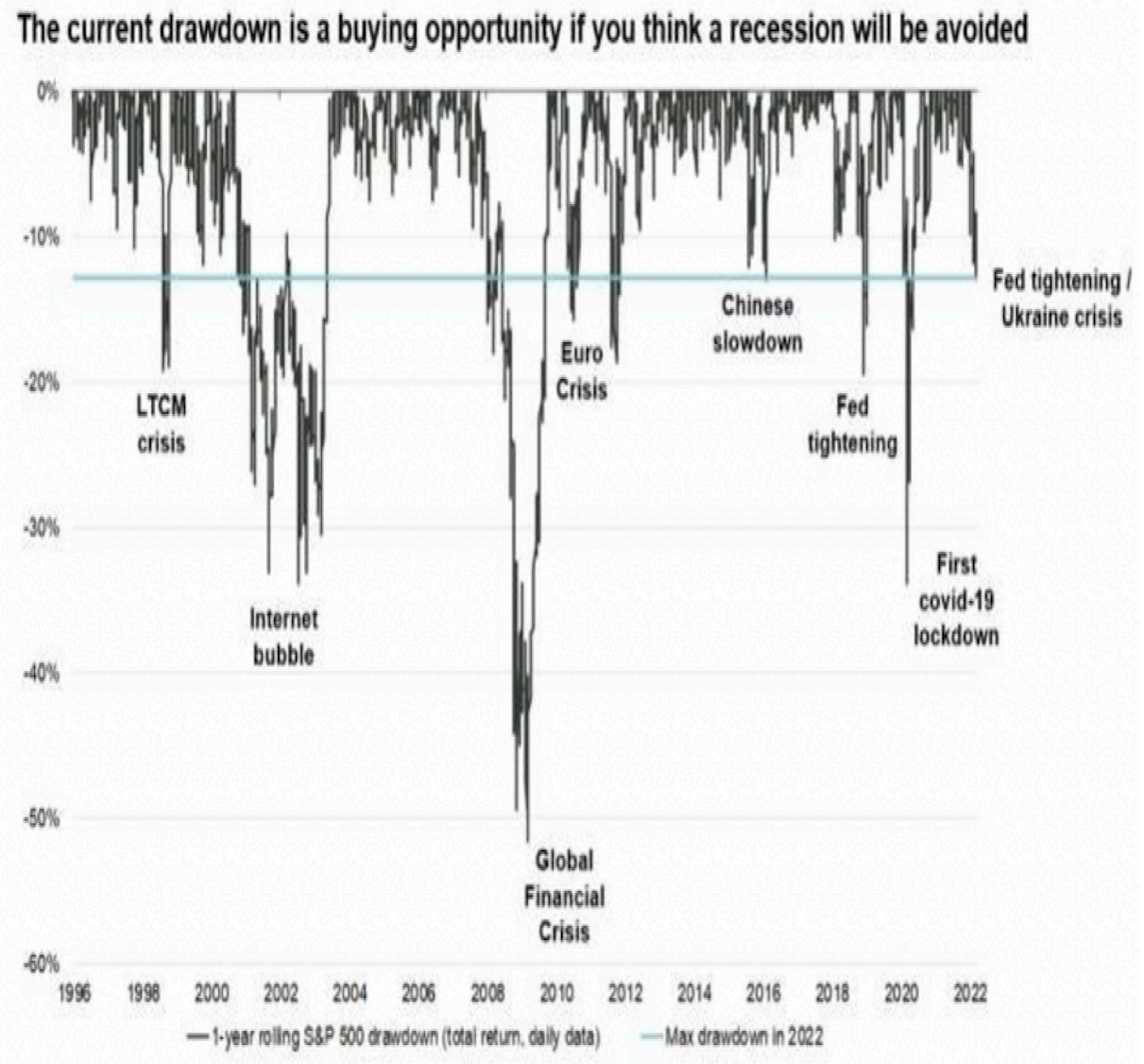
KTS
CAPITAL
MANAGEMENT

KTS weekly update Nr. 12

The 25th of March 2022

Equity markets: what is priced in?

- The real dilemma for KTS, at the moment, is understanding what equity markets are already discounting.
- As we have analyzed in the past weeks, even if Mr. Powell thinks that the US economy is not going to fall into a recession, indications, especially due to the higher oil and commodity prices, in addition to new lockdowns in China, are showing a possible different scenario.
- **According to the chart on the right hand side, courtesy Bank Vontobel, equity markets are still not discounting a recession.**
- As we have recently analyzed in some other historical statistics, **at any geopolitical event, which did not trigger a recession, equity markets performed positively over 12 months** after the event. To mention some: Cuban missile crisis, Iranian hostage crisis, USSR in Afghanistan, Iraq invades Kuwait, Gulf war, Iraq war, Crimea annexation.
- Only with 9/11, Suez crisis and Arab oil embargo events, equity markets were still negative after 12 months.



Source Vontobel

Equity markets: what is priced in?

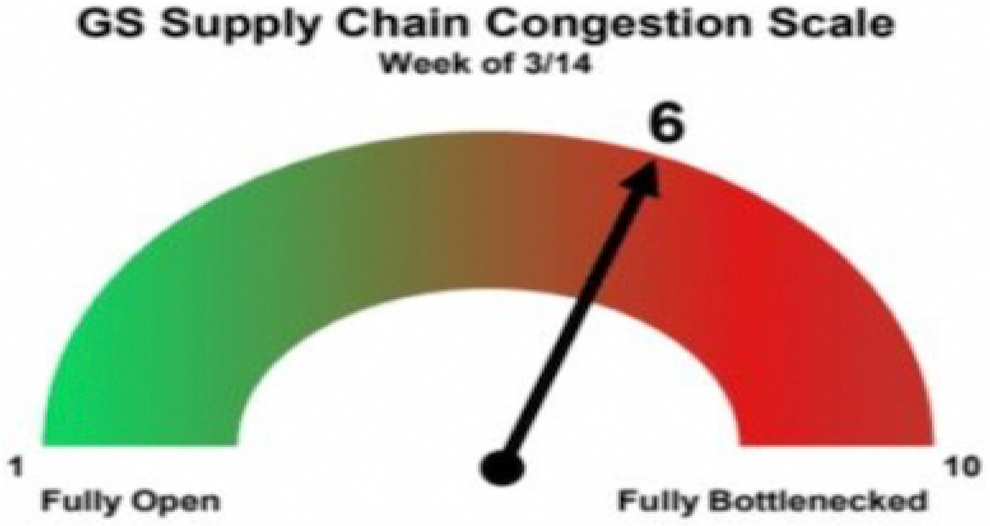
- Another historical statistic of Bank Vontobel shows that in almost **90% of S&P 500 Index corrections** over 10% and bear markets -20% since 1980, **after 1year and 2 years absolute returns post corrections** and bear markets have been positive with an average of +25% after 1 year and +37% after 2 years, **with the exception of years with sharp recessions.**
- A historical statistic, courtesy Syz group, shows that it is only the 5th time, that the S&P 500 Index gained at least 1% for 4 consecutive days. This rare occurrence has being quite bullish historically and one year later the index had on average a gain of 28%. Also strong last hours of trading are exceptional!
- Other historical statistics of Goldman Sachs are showing that since 1928, any time the S&P 500 Index was at least > 5% through 45 trading days, the average return for the rest of the year is +11.75%
- **Therefore it is of vital importance to analyze the probability of a recession for this crisis.**

High Date	S&P 500 High Price	Low Date	S&P 500 Low Price	Correction Return	1-Year Return After Lows	2-Year Return After Lows
2/13/1980	118.44	3/27/1980	98.22	-17.1%	33.0%	10.6%
11/28/1980	140.52	9/25/1981	112.77	-19.8%	9.4%	50.5%
11/30/1981	126.35	3/8/1982	107.34	-15.1%	43.2%	48.4%
5/7/1982	119.47	8/12/1982	102.42	-14.3%	57.7%	57.9%
10/10/1983	172.65	7/24/1984	147.82	-14.4%	30.3%	61.5%
8/25/1987	336.77	10/19/1987	224.84	-33.2%	22.9%	52.5%
10/21/1987	258.38	10/26/1987	227.67	-11.9%	24.0%	51.5%
11/2/1987	255.75	12/4/1987	223.92	-12.5%	21.4%	56.6%
10/9/1989	359.80	1/30/1990	322.98	-10.2%	3.7%	28.5%
7/16/1990	368.95	10/11/1990	295.46	-19.9%	28.8%	38.2%
10/7/1997	983.12	10/27/1997	876.99	-10.8%	21.5%	47.9%
7/17/1998	1186.75	8/31/1998	957.28	-19.3%	37.9%	57.7%
9/23/1998	1066.09	10/8/1998	959.44	-10.0%	39.2%	46.9%
7/16/1999	1418.78	10/15/1999	1247.41	-12.1%	10.2%	-13.9%
3/24/2000	1527.46	4/14/2000	1356.56	-11.2%	-12.1%	-18.8%
9/1/2000	1520.77	4/4/2001	1103.25	-27.5%	0.0%	-21.0%
5/21/2001	1312.83	9/21/2001	965.8	-26.4%	-13.7%	6.5%
1/4/2002	1172.51	7/23/2002	797.7	-32.0%	23.9%	36.2%
8/22/2002	962.70	10/9/2002	776.76	-19.3%	33.7%	44.8%
11/27/2002	938.87	3/11/2003	800.73	-14.7%	40.4%	51.0%
10/9/2007	1565.15	3/10/2008	1273.37	-18.6%	-43.5%	-10.0%
5/19/2008	1426.63	10/10/2008	899.22	-37.0%	19.7%	30.1%
10/13/2008	1003.35	10/27/2008	848.92	-15.4%	25.3%	39.3%
11/4/2008	1005.75	11/20/2008	752.44	-25.2%	45.0%	59.2%
1/6/2009	934.70	3/9/2009	676.53	-27.6%	68.6%	95.4%
4/23/2010	1217.28	7/2/2010	1022.58	-16.0%	31.0%	33.5%
4/29/2011	1363.61	10/3/2011	1099.23	-19.4%	31.5%	53.8%
5/21/2015	2130.82	8/25/2015	1867.61	-12.4%	16.5%	30.6%
11/3/2015	2109.79	2/11/2016	1829.08	-13.3%	26.6%	45.2%
1/26/2018	2872.87	2/8/2018	2581	-10.2%	5.0%	30.1%
9/20/2018	2930.75	12/24/2018	2351.1	-19.8%	37.1%	57.8%
2/19/2020	3386.15	3/23/2020	2237.4	-33.9%	74.8%	?
1/3/2022	4796.56	2/22/2022*	4304.76	-10.3%	?	?
		Average		-18.8%	24.8%	37.4%
		Median		-16.5%	25.9%	45.2%
		% Higher			90.3%	86.7%

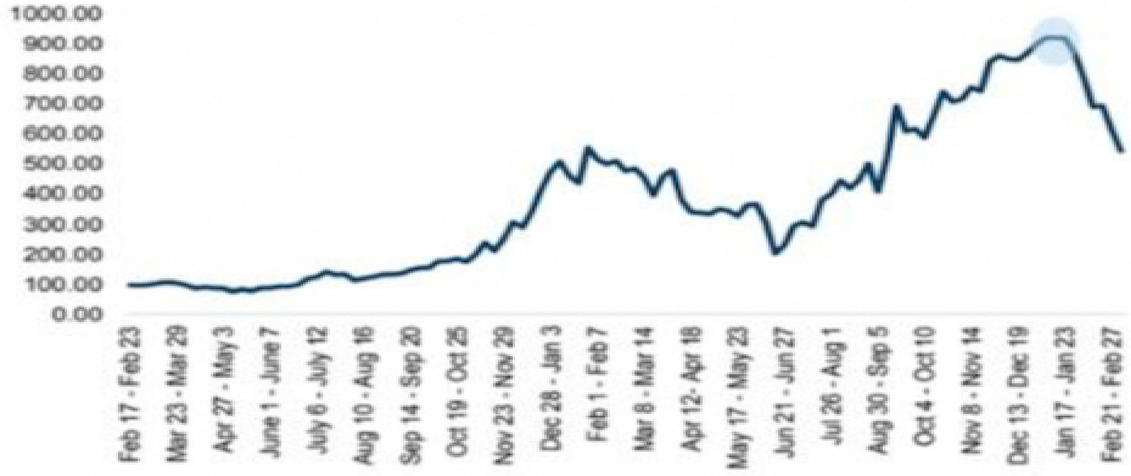
Stocks tend to do well after corrections/bear markets (Bank Vontobel)

Inflation

- According to Goldman Sachs' indicators, we should have reached the peak of supply chain constraints, and used car prices start to decline.
- On the left hand side chart, we can notice how we are still in a bottlenecked supply chain environment, whereby demand is greater than transport capacity and still hyper-elevated shipping rates, but we are falling from distressed levels.
- **Meanwhile, used car price trends are drastically slowing as supply chains crunches resolve. Used car price's spike was responsible for 40% of the recent inflation's spike!**
- The dilemma is: those numbers are for the week ending on the 14th March. Therefore we do not know the impact of China' lockdowns and the ongoing Russia-Ukraine crisis.



According to high frequency weekly supply chain data, we had the peak (GS)



The weekly index has declined 11.6% (source GS)

Probability of a global recession

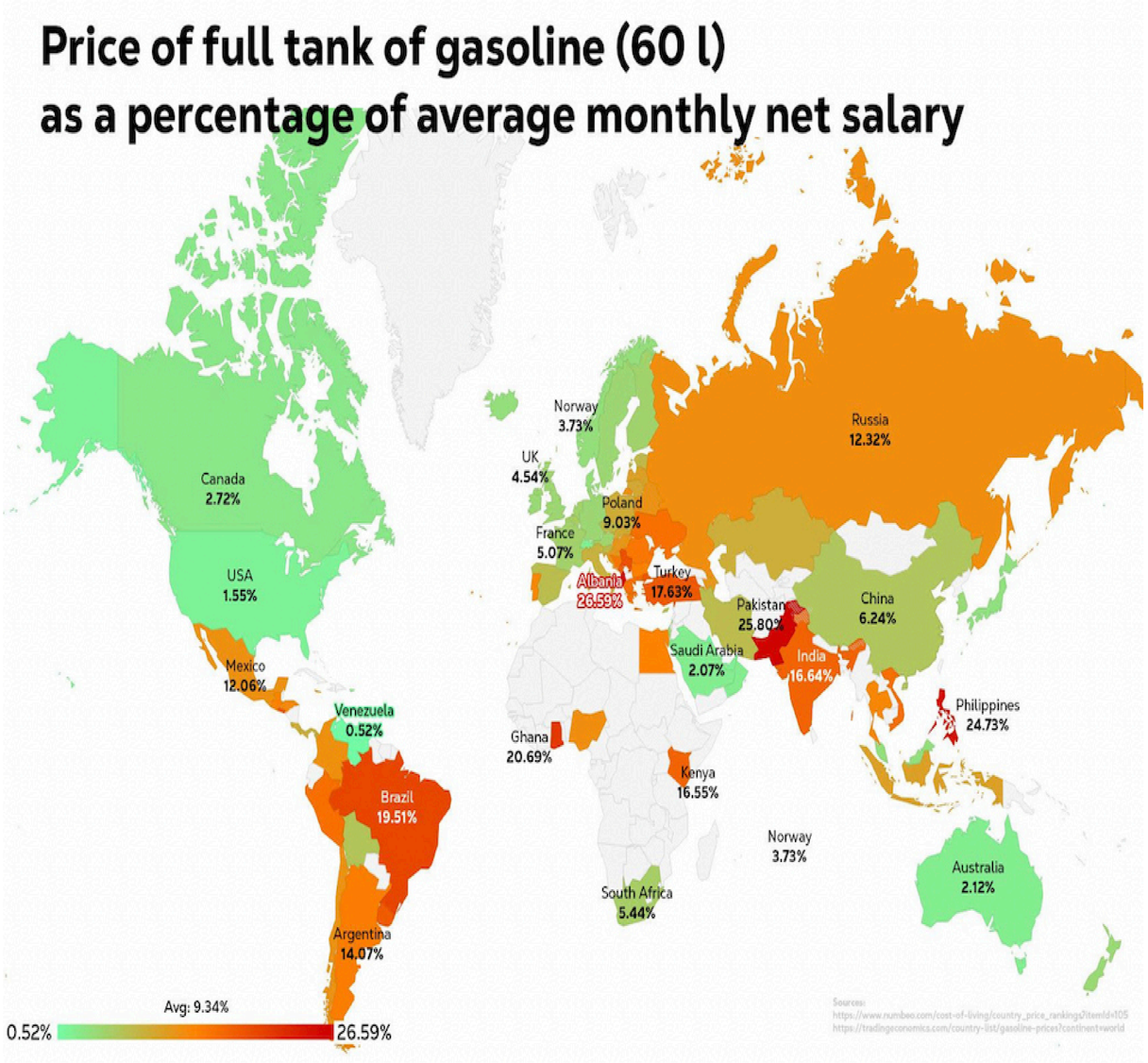
- The key assumption for the calculation of such probability is to forecast a base scenario of the war between Russia and Ukraine.
- **We still tend to believe, that a diplomatic solution could be "already on the table" with Ukraine as a neutral state, no inclusion in the Nato and the recognition of the Donbass and Crimea regions as Russians. We believe that China is going to pressure Russia for a resolution and would also stop Putin for any escalation, which would lead to WWIII.**
- We are not in the position to analyze the probability of a coup in Russia and the end of Putin's era, but **we are noticing that oligarchs are silently distancing from Putin!**
- The US economy should experience fewer repercussions of the Ukraine-Russia crisis and therefore should still grow. Most probably not at the initially forecasted 4 to 5% p.a. rate, but at 2.5% ? **China' lockdowns and a possible global disruption is the biggest uncertainty!**
- Chinese authorities are strongly supporting the economy, which should growth over 5% p.a. Also in this case, we can not predict general repercussions of the different lockdowns and we can not understand, how Chinese authorities believe to grow over 5% with such dramatic measures, even if it is already proven that the Omicron variant is not dangerous, especially for vaccinated people. Also the magazine The Economist is arguing, China must learn how to live with Covid.
- **Europe is the biggest uncertainty.** We have noticed that **European governments are reacting to the high energy costs**, planning to cut taxes or adding stimulus packages. As we can analyze in the next slides, Europe should have enough natural gas storage in order to avoid an energy crisis in the next months. Also here the escalation on payment in RUB for the Russian natural gas delivered to Europe is a big uncertainty on how Europe is going to react (see slide 12, if Russia would stop the Natural gas flow, it should not be a problem over the next months). **For the moment, Eurozone PMI are still strong at 54.5!**

Probability of a global recession

- Apparently there is a **global shortage of diesel.** Market participants are noticing that the diesel futures are moving into massive backwardation and this could add pressure to truckers and transportation, which is translated again into supply disruption.
- Central banks are aware of the recession's risk and changed the tone to dovish again, further supporting equity markets. The opinion on central banks policies is twisted, but we noticed that, for the moment, equity markets are "relaxed". We are honestly very surprised of how equity markets are positively reacting, despite China massive lockdowns, the ongoing war and the negative repercussions of the high inflation and commodity' prices on the economy.
- Mr. Yardeni actually argues that **the only way for the FED to bring down inflation is to raise the federal funds rate until it causes a credit crunch and a recession that brings inflation down**. He simply argues that it is a **lesson of history**. Inflation has always declined as a result of recessions, i.e. hard landings and he does not believe in slowly raise interest rates to gradually slow demand resulting in a soft landing.
- Goldman Sachs in the contrary downward revisions to global growth projections, **but still see 3% (**general consensus is still at 4%).
- **KTS CONCLUSION: the global economy should not fall into recession** and therefore equity markets are already discounting a good portion of a worst case scenario. We expect a consolidation phase of equity markets and we are not overly bullish in the short term due to the multiple ongoing risks.
- KTS is not adding equity exposure and we are definitely not switching fixed income alternative strategies into equity. As explained in our recent reports, **KTS stays invested in mega trends, which should be able to generate positive earnings in any market scenario.**

Price of full tank of gasoline as a percentage of average monthly net salary

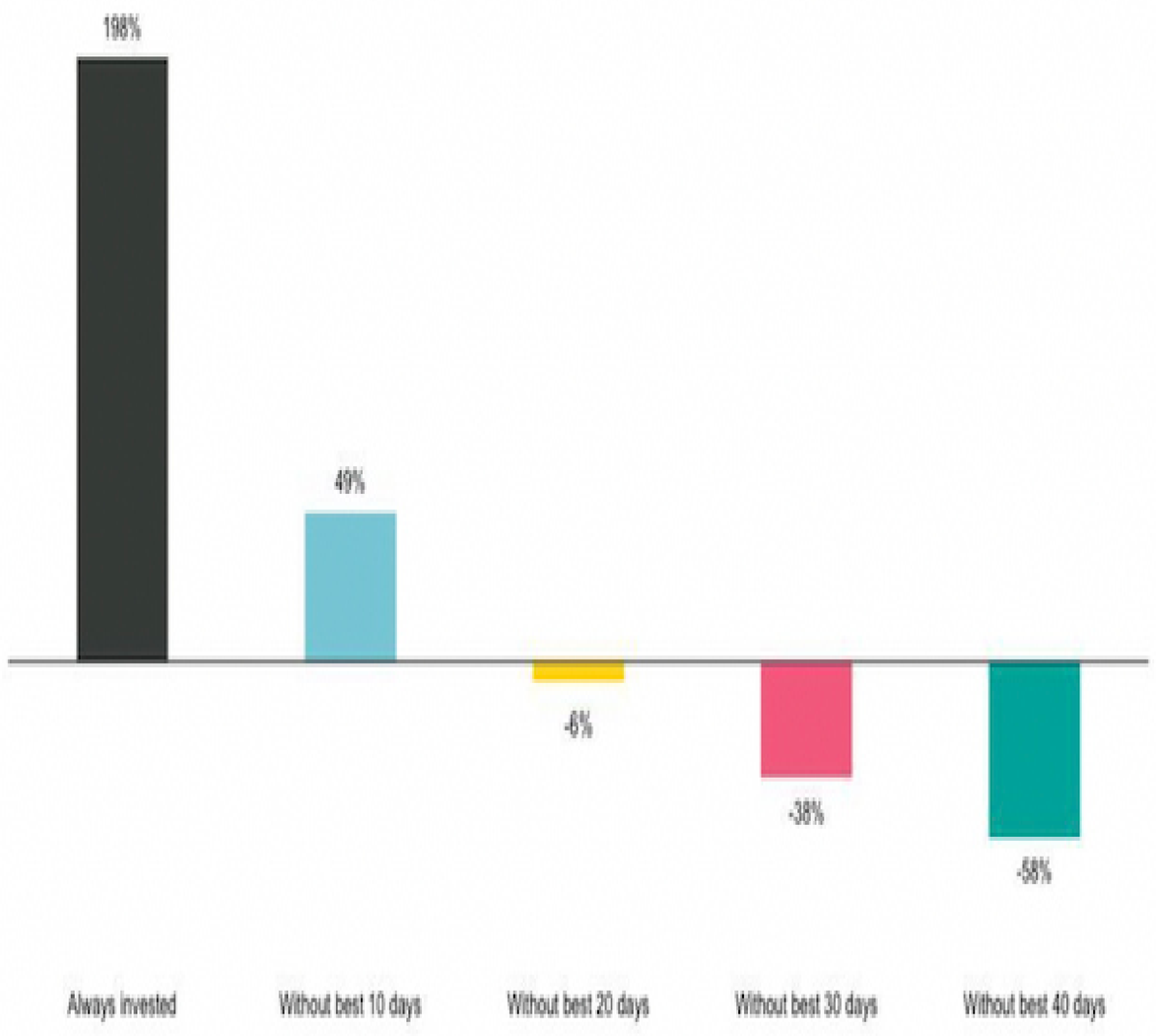
- As we have recently analyzed, the weighting of energy costs on the household budget felt substantially from the 70' and therefore the actual oil price's spike has a lower negative impact on general consumption at present time.
- Mr. Yardeni thinks that US consumers have on average USD 3k less at their disposal.
- But if we analyze the chart on our right hand side, courtesy Mr. Mukesh Jindal, the weighting in US on the household's budget should not be substantial.
- On the contrary, we have seen that the weighting is very high in India, but also Turkey, Brazil and Argentina.
- Also in Europe energy costs are relatively contained and therefore the EU consumption should "suffer" less as the majority of the investment community is expecting?
- At the moment market participants are arguing **that the only way to compensate Russian oil**, is not Iran or the OPEC increase, BUT only a **DEMAND REDUCTION.**



Source: Mr. Mukesh Jindal

A few days make all the difference

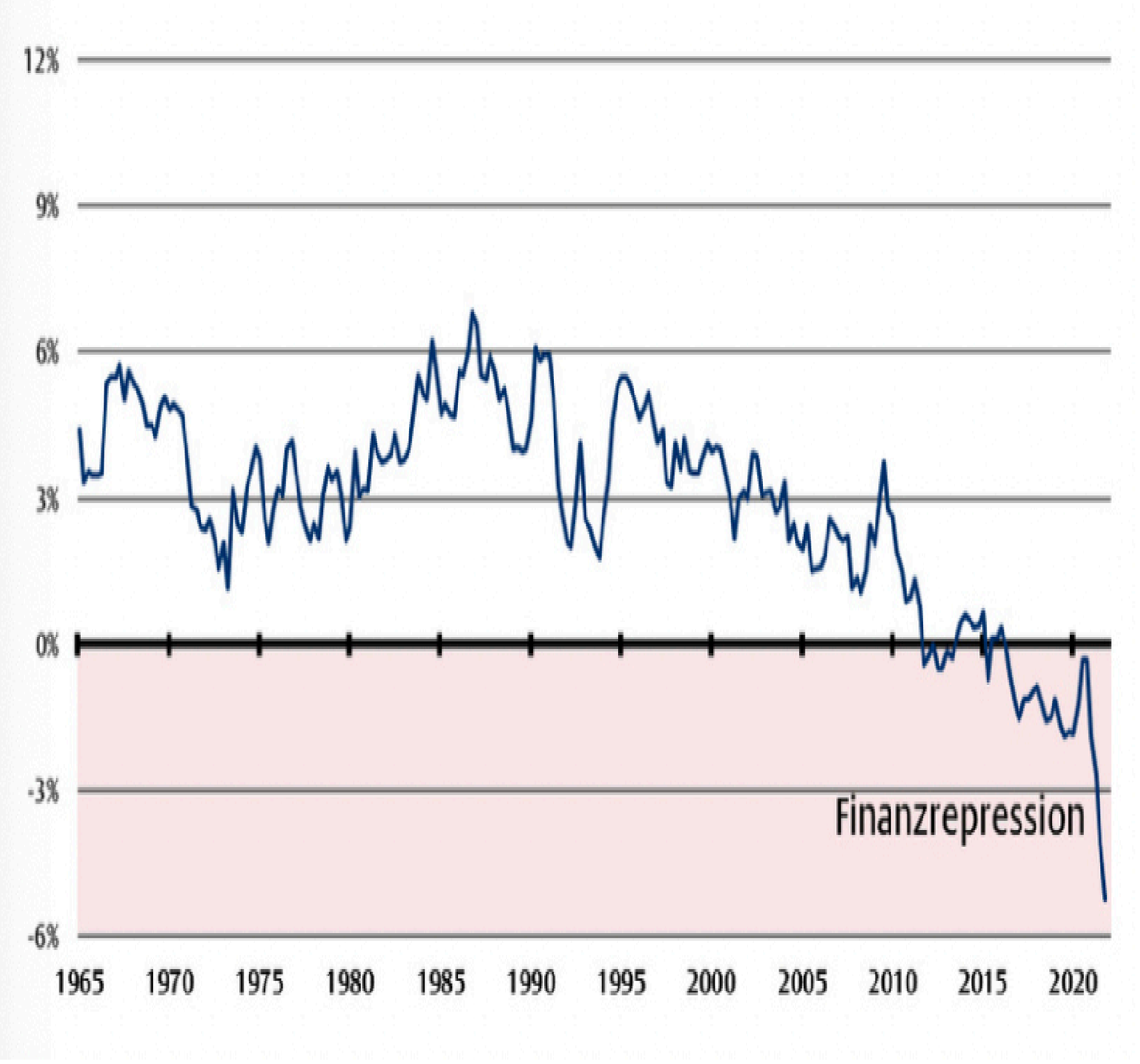
- The chart on the right hand side, courtesy Bank Vontobel, shows the impact of the best return days of the SP&P500 index on performances from 1999 to 2018.
- **Basically the performance of the investors without the best 10 days would fall dramatically from a total of 198% to 49% .**
- **If we would deduce the best 20 days, the performance result is turning even negative!**
- We would like to remind to our clients, that we already experienced recently such dramatic equity market' corrections, like Q4 2018 and March 2020, where investors, who sold positions or even worst, had to liquidate portfolios due to leverage, missed the market's rebound.



Always invested: 198% performance (Source Bank Vontobel)

Flossbach: Equity is an hedge to negative real yields

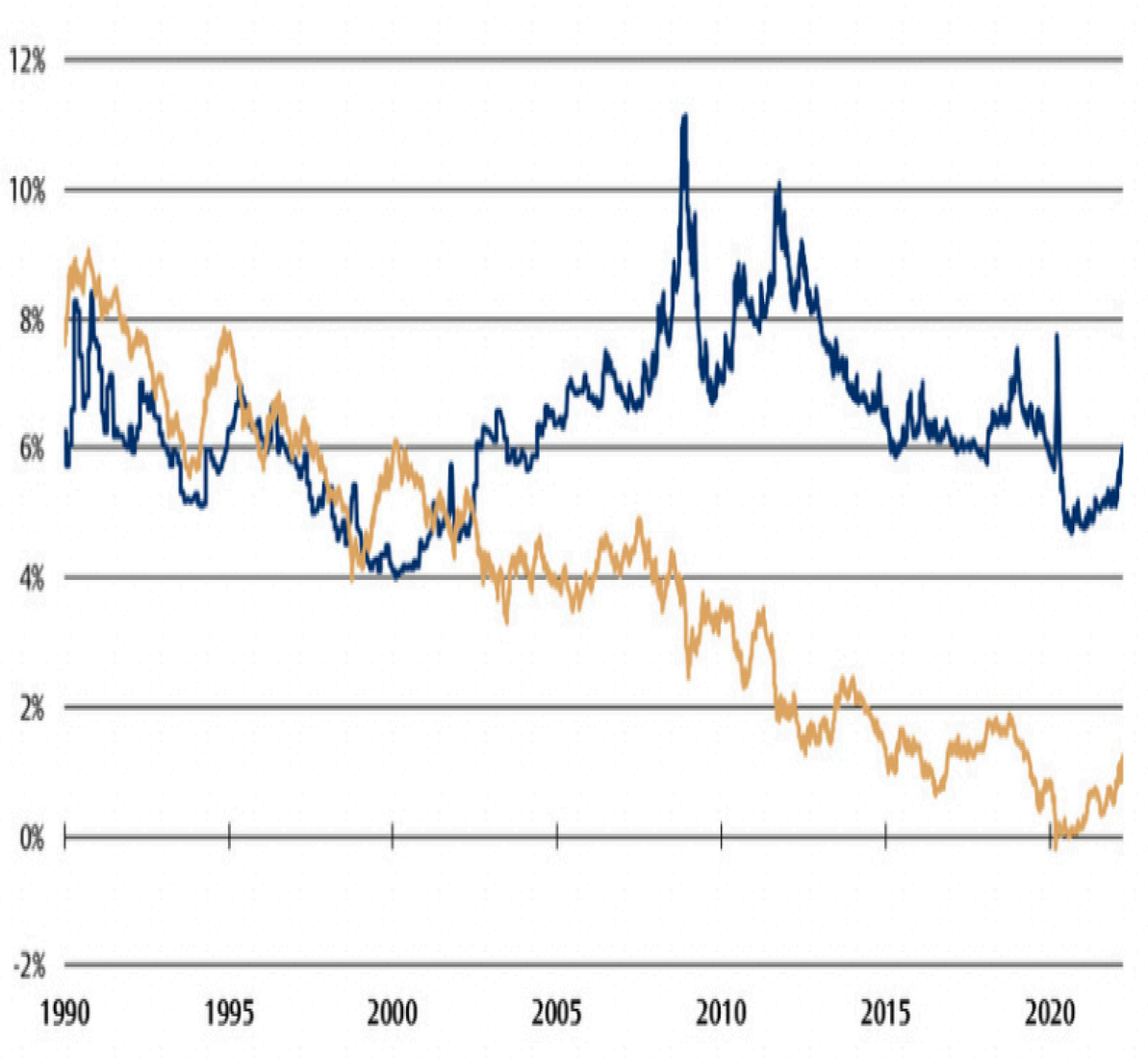
- During the webinar of our best-in-class fund Flossbach, the manager was aware of the various risks, which could cause a global recession: **China lockdowns**, which could be translated into supply disruption. Or **US labor costs increasing**, which means higher costs for companies, translated in lower margins and EPS and finally an **extended crisis in Ukraine,** which means higher commodity prices and a possible food crisis.
- But the manager explains that equity themselves are an hedge to high negative real yields, and also real estate and gold (so called real assets). **The most important thing is not the timing, but the right diversification and solidity of the portfolio, which limits the drawdown.**
- Finally the manager cited a **quote of Mr. Warren Buffett, whereby the biggest risk is not being invested.** When an investor selects solid companies with a good management, the stock price will also be positively correlated to the increasing earnings and therefore, the investor should not trade the position.



Real yields of the German bund (source: Flossbach)

Flossbach: Equity is an hedge to negative real yields

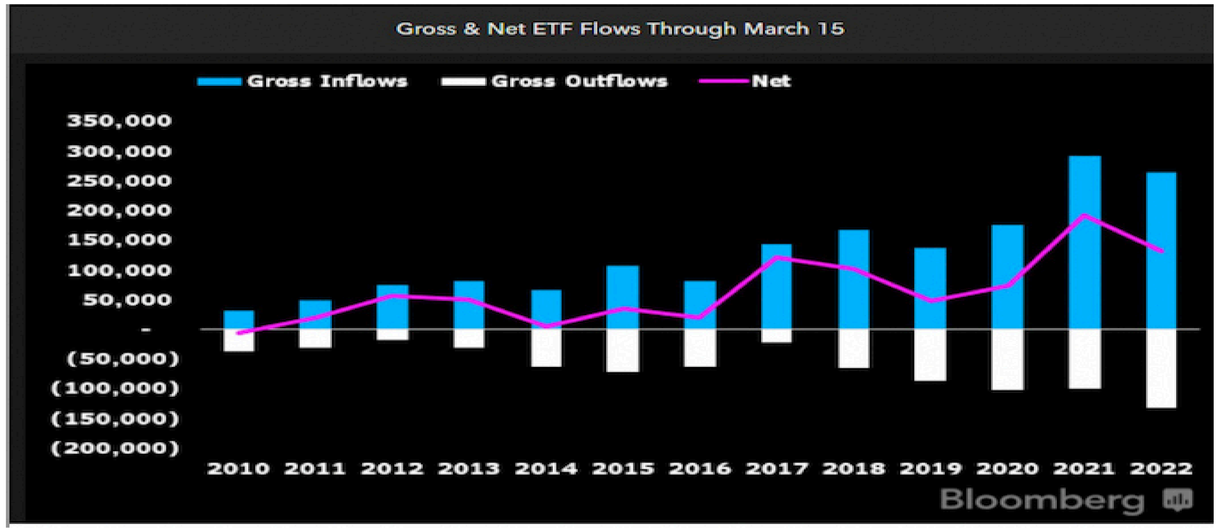
- The fund manager of Flossbach still argues that equities are more attractive than 30 years ago.
- In fact, comparing the MSCI World index yields (blue line) vs bond' yields, the asset class equity is still very attractive.



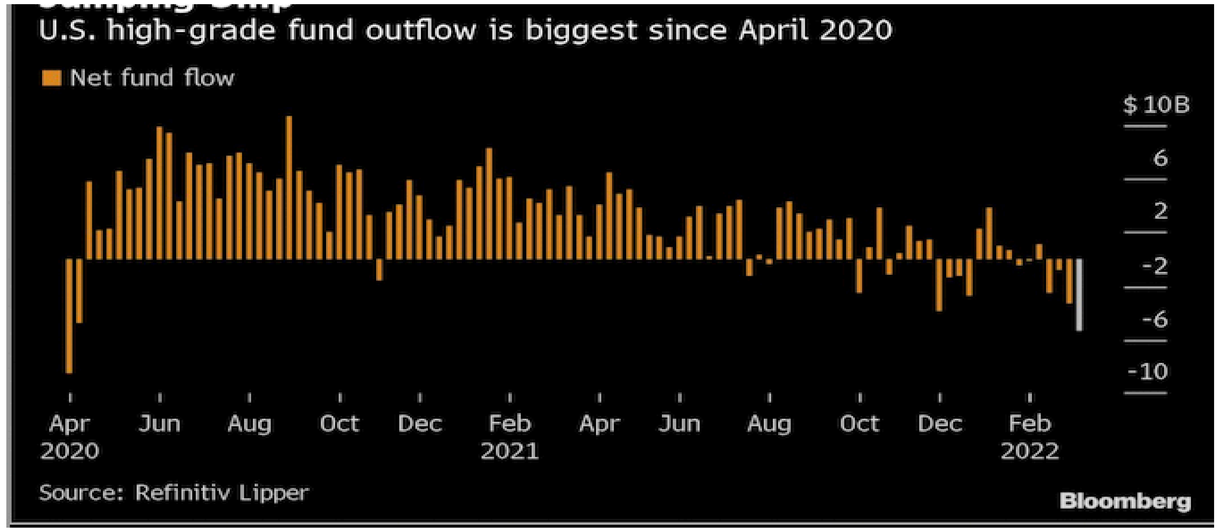
MSCI World yields (blue) vs Bonds (10y Tbill, Germ. Bund) Source: Flossbach

The “great rotation” has started?

- Market participants noticed that YTD 2022, **equity inflows experienced the second best year ever,** even with the Ukraine-Russia crisis, meanwhile **bond mutual funds had net redemptions over USD 65 billion on the year**, which is worse than any year since Bloomberg started tracking this data in 2007 and a sharp reversal after a record of USD 400 bn inflows in 2021. Also US treasuries had the worst drawdown in a century! (-8.9% vs -15.4% in 1929).
- ETFs had the 2nd best start to year ever in terms of net inflows: +USD 154 billions.
- **Important to notice that also insiders started to strongly accumulate positions during the current market’s correction, in addition to the ongoing strong share buyback programs.** Finally M&A activities should also pick up, having some “bargain” in the market and blue chips “floating in cash”.



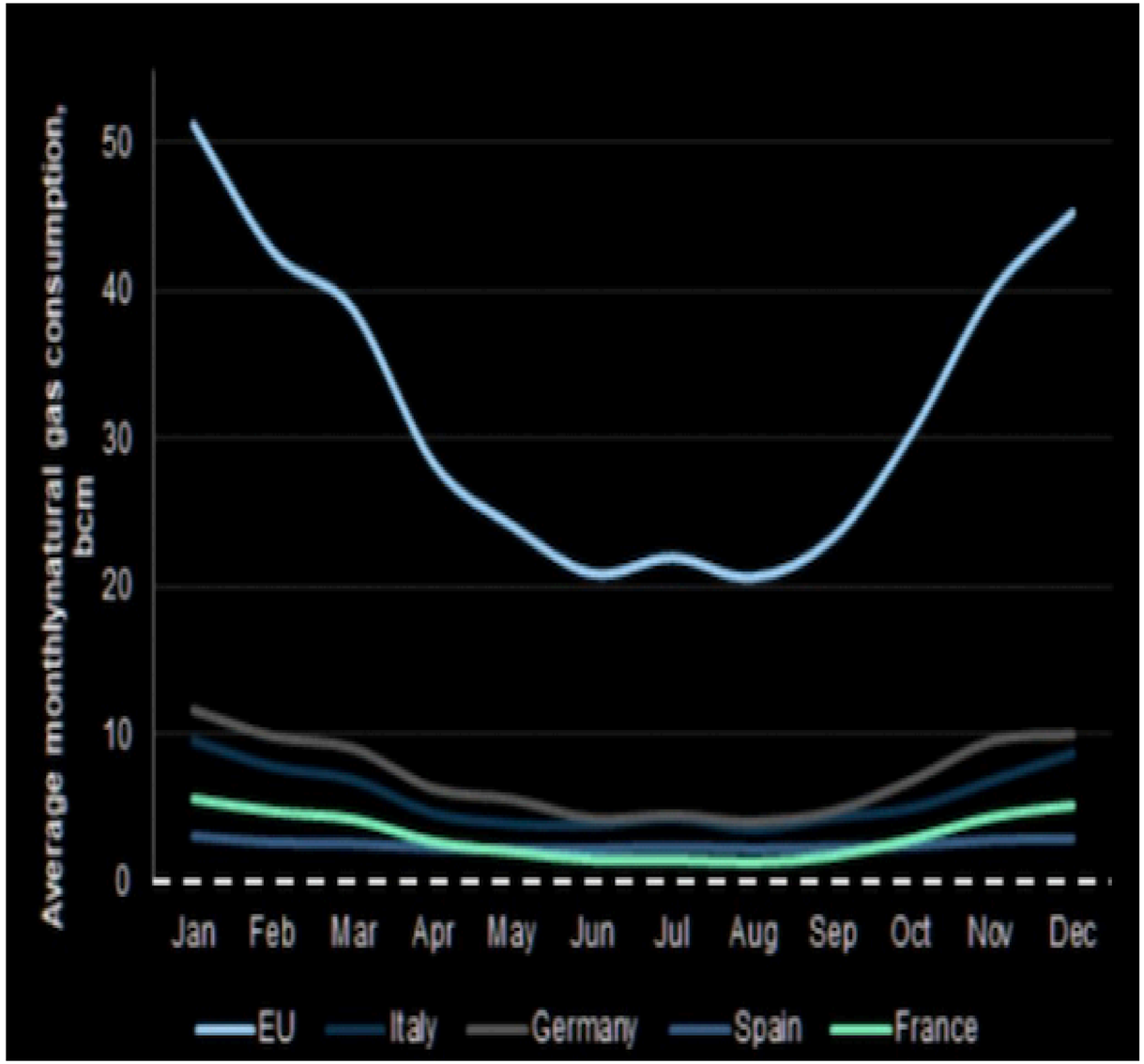
ETFs had 2nd best start to year ever in terms of net inflows (Syz group)



Strong bond outflows

Europe can survive throughout summer without Russian gas

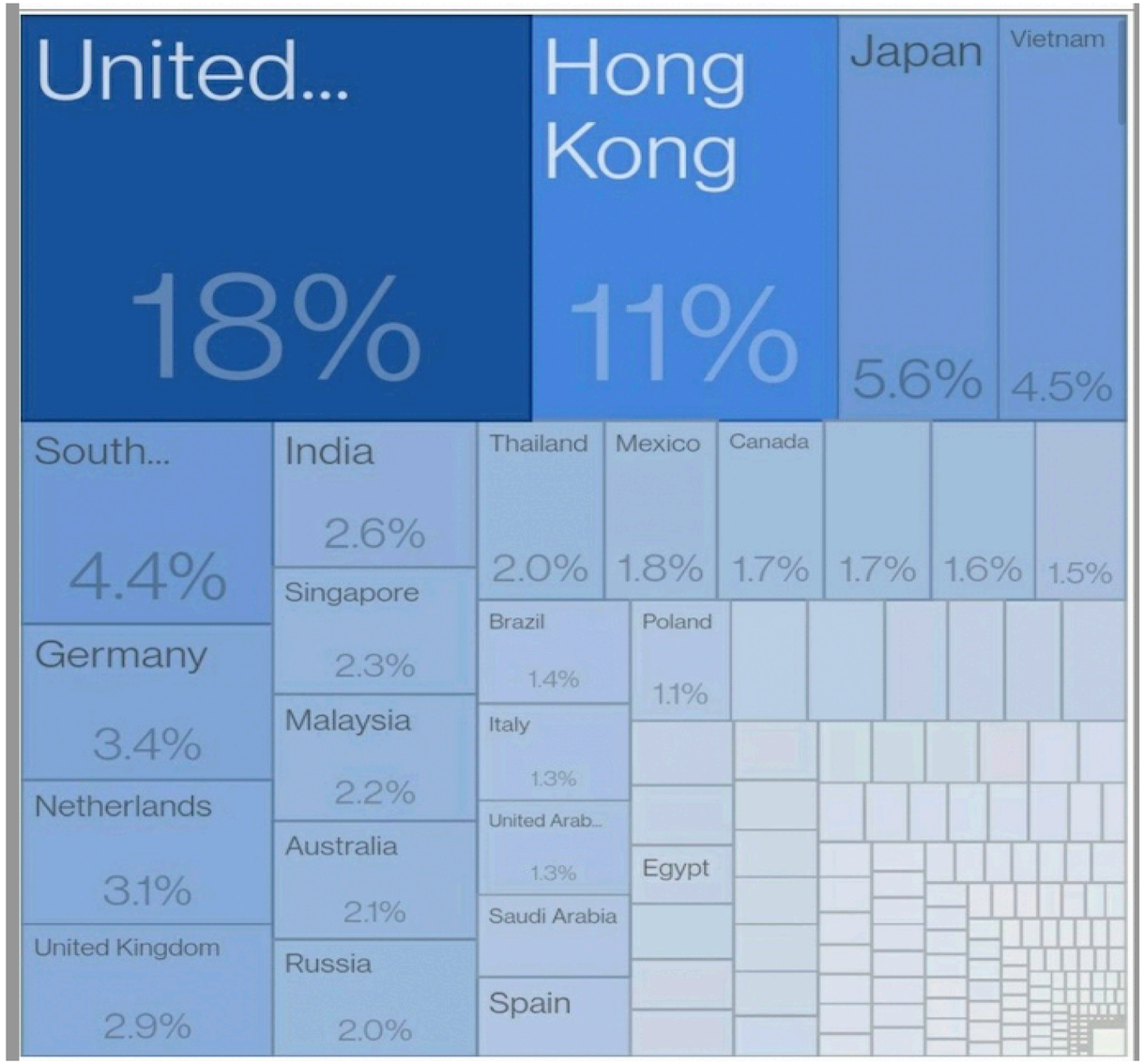
- According to the energy consultancy firm Wood Mackenzie, Europe is in a better position to cope without Russian natural gas now than it was a few months ago.
- Mild weather and sustained imports of liquefied natural gas (LNG) and Norwegian gas have improved the European storage position.
- **The final statement is, if Russian flows stop in the middle of March, gas in store would be sufficient for the rest of this winter and summer, without demand curtailment.**
- These are definitely good news and Europe should be able to avoid a short term energy crisis.



Source: Mr. Monchau, Syz group

What to expect from China?

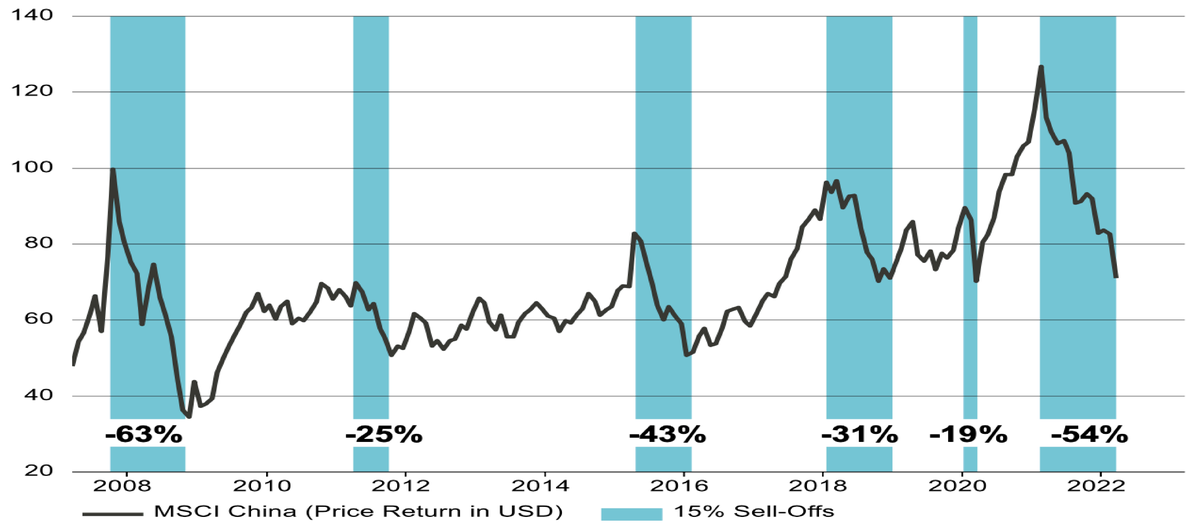
- Apparently the Chinese President, Mr. Xi Jinping told to the US President, Mr. Biden: “It is up to whoever has tied the rattle to the tiger’s neck to remove it”.
- Basically China is staying neutral on the diplomatic talks against Russia and “points the finger” to the US.
- It is clear that China has all the interest to have Russia on her side, profiting from her weaknesses due to international sanctions and buying discounted commodities and oil. Meanwhile is not in the position for more sanctions, having the Chinese economy still depending 40% from US and EU, in addition to 11% to Hong Kong and 5.6% to Japan.
- On the other hand, we would have expected China to pressure Russia for a diplomatic solution as soon as possible, in order to return to normality, given that the Chinese economy is dealing already with multiple issues: **40 mio Chinese citizens in lockdown with the risk again of a global supply disruption,** in addition to the existing real estate weakness and crackdown in the technology sector.



Chinese economy’s dependence (Source: Dario Donato)

China

- According to Bank Vontobel, from a technical perspective, the market is already pricing a very negative scenario (left hand chart) and the worst seems to be over as the credit impulse is rebounding.
- As we were arguing last week, **Alibaba is trading at a very attractive valuation. Meanwhile the company announced that is going to increase the stock buyback program from USD 15 billion to USD 25 bn.**
- Tencent reported the lowest revenue growth, but is still growing at 8% year-on-year and could increase by 60% the net profit thanks to a large one-time gain in relation to the disposal of assets. According to the company, international online games are still growing and are the largest revenue source. Xiaomi also had good results and increased the buyback program.
- Also according to the CIO of Bank Vontobel, the country has a strong economic incentive, which should help to overcome the crisis in Ukraine, adding that lockdowns have mostly had little lasting impact on Chinese equities.



Is the Chinese equity market pricing a very negative scenario? (Bank Vontobel

Top-down macro perspective: the worst seems to be over (Bank Vontobel)

News on Ukraine and Russia

- Russia's central bank will start buying government bonds in order to reach financial stability.
- Russia announced that it will accept only Rubles for gas deliveries for "unfriendly" countries. As a reaction, European natural gas prices spiked 35%, but as we explained recently, the reaction to the price is more emotional rather than due to supply disruption. The dilemma is: how Europe, UK, Japan, Canada, Norway, Singapore, South Korea, Switzerland and Ukraine are going to react?
- Meanwhile **Europe is experiencing the fastest moving refugee crisis since the end of the second world war** and apparently, already more than 5 mio Ukrainian citizens fled to Europe since the Russian invasion. Putin knows it and it is using such situation at his advantage, putting more pressure on Europe to be also willing to find a diplomatic solution sooner than later. Apparently EU is expecting 10 mio refugees by the end of April. Ukraine counts a population of 44.13 million (2020).
- **The Ukrainian President, Mr. Zelenskiy, recently announced, that "it is clear that Ukraine is not a member of Nato; we understand this" and added: "For years we heard about the apparently open door, but have already also heard that we will not enter there, and these are truths and must be acknowledged". Is this announcement a sign to a diplomatic resolution? This assertion should suffice to at least have a truce?**

The inverted yield curve

- Already last year, we were writing on the meaning of the inverted yield curve and the risk of recession.
- The inverted yield curve happens, when short term bonds (benchmark US Treasury 2y) have higher yields than long-term bonds (US T-Bill 10y). At the moment we are basically flat, at a spread of 18bps.
- Historically an inverted yield curve predicts a recession, having higher short term interest rates in order to slow the high economic growth, which eventually is going to fall into recession.
- Our main argument at the time, and still today, is the fact that long term interest rates are more and more “manipulated” by central bank’ purchases, and therefore the relationship between inverted yield curve and recession is not significant anymore.
- Mr. Yardeni is arguing, based on his study in 2019 (The yield curve: what is it really prediction?), **that are credit crunches and not an inverted yield curve, that cause recessions.**
- **Mr. Yardeni does not see a credit crunch developing and therefore is not expecting a recession** and a bear market any time soon, but of course he is also on alert, recognizing that rapidly rising energy prices have been associated with previous recessions.

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