KTS
CAPITAL
MANAGEMENT

KTS weekly update Nr. 13

The 1st of April 2022

US hike on the ultra-rich and corporations taxes

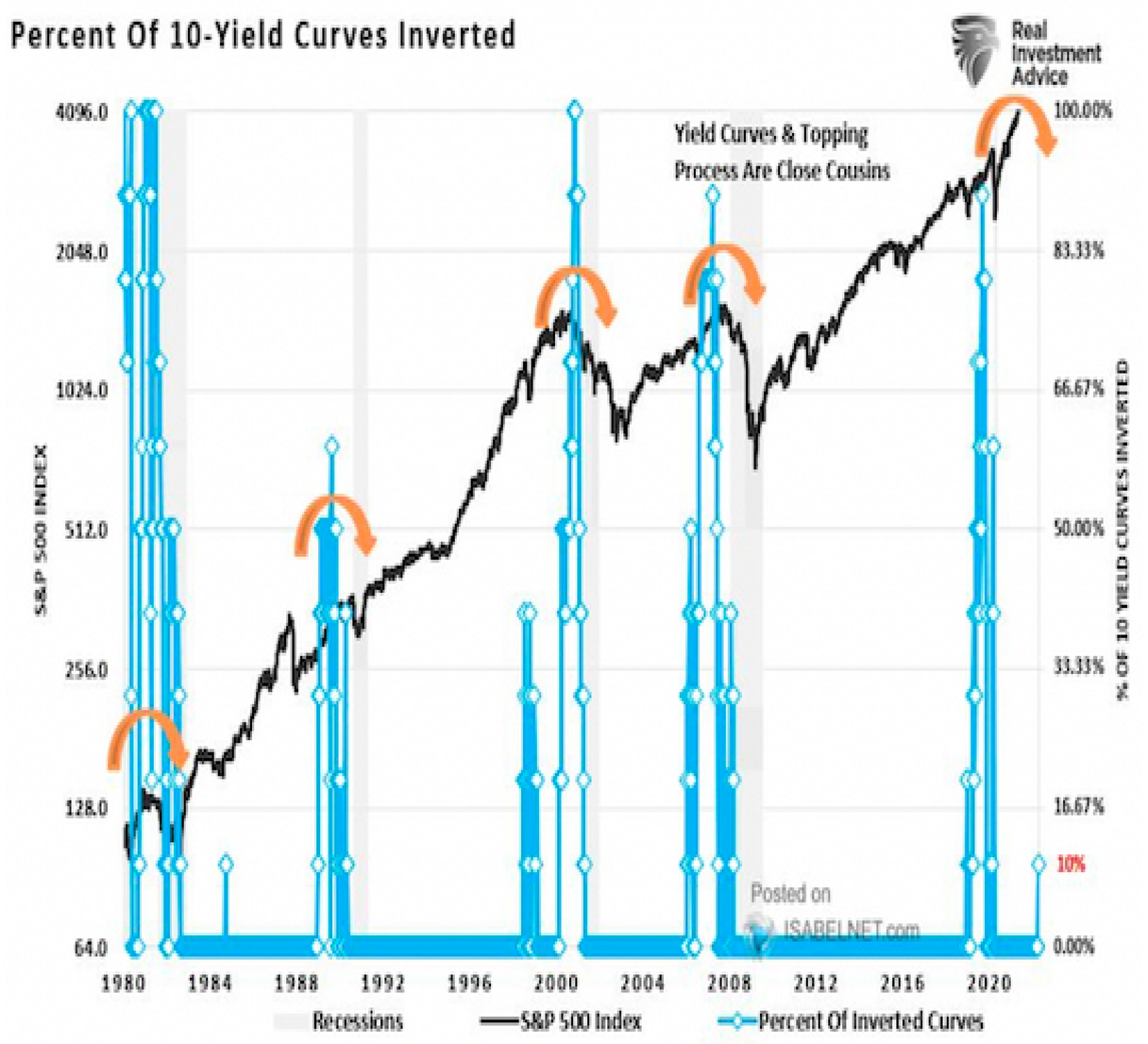
- The Biden's administration **would hike taxes on the ultra-rich and corporations for the budget of 2023 in order to boost defense** and police spending. The request to the Congress is a new "billionaire's minimum tax", a 20% income tax rate for the top 0.01% earners and households worth more than USD 100 million.
- The budget shifts focus away from Covid-19 pandemic and toward the new goals of lowering the crime rate at home and securing NATO allies abroad in the wake of Russia's invasion of Ukraine.
- **Nowadays, investments avoid taxes until they're sold for a profit. The proposal would tax income, even if the assets are not sold.**
- Under Biden's plan, billionaires paying a tax rate below 20% of their income and unrealized gains, would have to pay additional taxes to make up for the difference, while those already paying more than 20% would not owe additional taxes.
- According to the plan, the tax would raise an estimated USD 361 billion over the next decade, with more than half the revenue coming from billionaires alone.
- According to internal statistics of the Treasury, the wealthiest Americans account for the bulk of tax evasion because higher-income taxpayers have the financial resources to "top into the services of accountants and tax consultants which help shield them from bearing their true income tax liability".

US hike on the ultra-rich and corporations taxes

- In KTS' opinion, asides from the fact that talks over peace worldwide are definitely not reached by increasing defense spending, the wealthiest citizens in any country are responsible for the substantial part of tax income.
- **The top 10% of US citizens is responsible for 71% of all income taxes paid in US,** therefore, the risk of wealthy US citizens moving abroad to countries with better taxation regime is very high and already happened to many other countries.
- Of course is a long term process, but a country with **high public indebtedness** has to be very careful increasing taxation to wealthy citizens. In addition, after US sanctions to Russia and frozen Russian assets in USD, the world realized that any forex reserve in USD is not safe anymore and therefore **future currencies shifts** are the consequence, as already argued in our recent weekly reports.
- **Having China further reducing the purchase of US Treasury and USD in the possible combination of wealthy US citizens leaving the country, is an extreme long term dangerous "cocktail" with fatal consequences for the US and the currency USD. This means for investors, to avoid unnecessary exposure to the USD, even if short term the USD is still "enjoying" the traditional financial mechanism of "risk off" and "risk on" of the market.**

Inverted yield curve

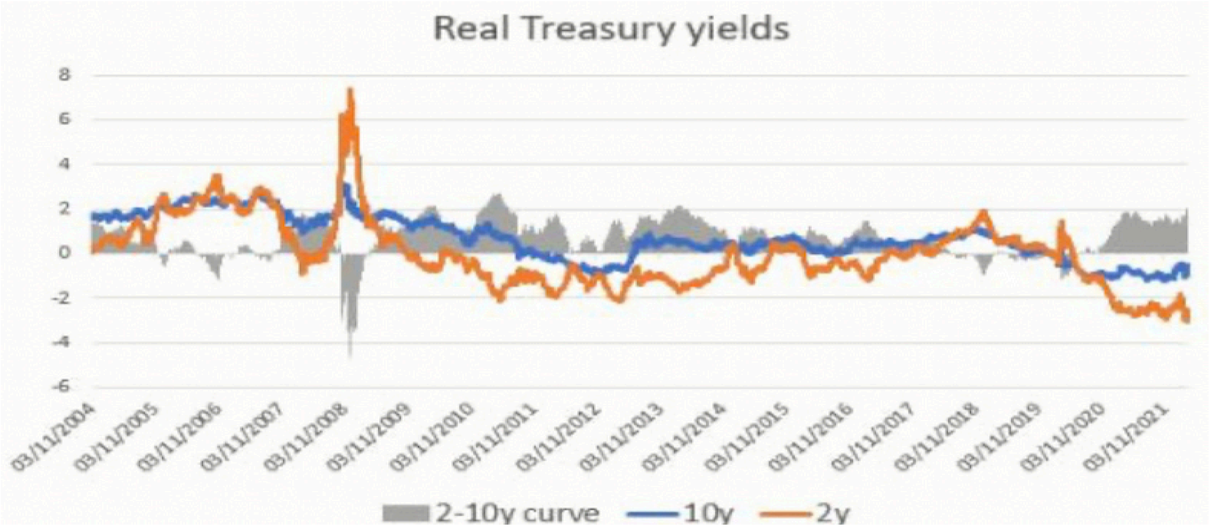
- **On the discussion of the inverted yield curve, Mr. Powell is arguing that investors should focus on the spread between the 18-month forward 3-month Treasury and the 3-month Treasury has actually steepened signaling economic growth!**
- On the right hand side chart, courtesy Mr. Ansidei, we can analyze, how the risk of a US recession increases significantly, if the number of inverted yield curve exceeds 50%. Now we are just at 10% , far from any possible risk of recession.



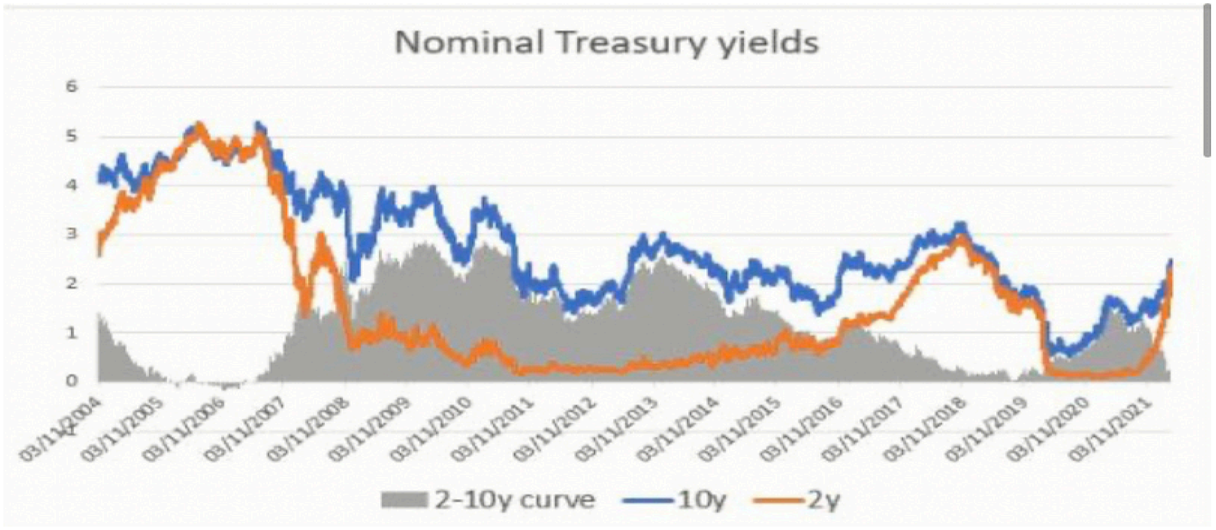
Source: Mr. Ansidei

Inverted yield curve

- Mr. Lorenzo Ippoliti is rightly arguing that market participants should not focus on the **2y interest rate, because it already incorporates a massive series of increases.** Basically he is aligned with the affirmation of the FED, whereby Mr. Powell argues, investors should focus on the 3m vs 18m.
- Mr. Ippoliti also explains that, **inflation expectations are higher on the short term, but tends to fall towards 10 years.** For this reason, the **2year real rate (nominal rate minus inflation expectations) is significantly lower than the 10year real rate.**
- On the left hand side chart we can notice, how the real rate difference is still positive, meanwhile the nominal rate difference is flat (color grey).
- We fully agree and we have already argued in the past, that short term inflation' expectations are high and should fall in the near future. But inflation' expectations on the medium and long term are around 2%, which is an healthy level for the economy.



Differential real rates (source Mr. Lorenzo Ippoliti)



Differential nominal rates (source Mr. Ippoliti)

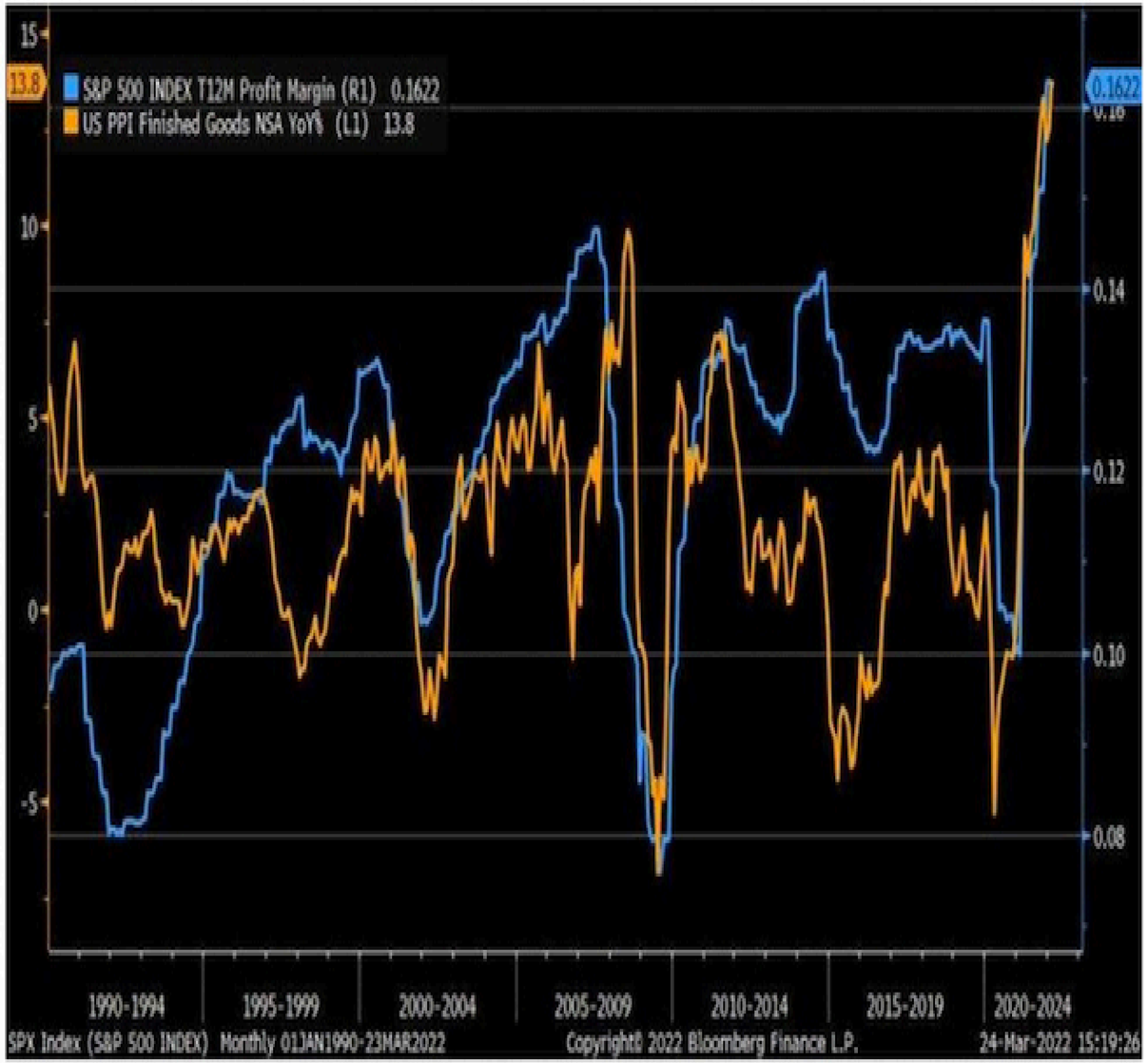
Inverted yield curve

- On the right hand chart, courtesy of Pharus Asset Management, we can analyze the FED study of 2019 on the risk of recession of an inverted yield curve.
- The **study indicates the risk of recession, the development of the US GDP and the direction of the equity market**. From the chart we can notice that nowadays the near-term-forward spread is positive, which it means, there is a low probability of an imminent recession, the US GDP is still growing and no major correction expected on equity markets.

Source: Pharus Asset Management

Pricing power

- As we have recently analyzed, many companies are able to pass the production costs' increase, due to higher inflation, to consumers and therefore keeping high margins.
- The erosion of profit margins due to higher inflation or higher labor costs is the main investors' concern, but at the moment we can notice that **companies still have a strong pricing power, which is at least giving a floor to equity markets.**



Source: Bloomberg via Syz group

Conflict Ukraine-Russia

- Mr. Zelensky says that Ukraine is ready to discuss neutrality status. The Ukrainian government would be ready for security guarantees and neutrality, and also non-nuclear status. Meanwhile Mr. Abramovich has also being spotted in Istanbul on peace talks. At the moment the Kremlin sees no breakthroughs in talks, but Germany announced to be ready to be guarantor of Ukraine's safety. **Basically Mr. Zelensky asserted that, one vital condition for Ukraine for agreeing to be a neutral country, is to have US, UK, France, China, Russia, Turkey, Germany, Canada, Italy, Poland and Israel as warrantors of peace.**
- Russia added that there is no negotiation on the Crimean Peninsula, which is considered as part of its territory.
- **Equity markets are actually reacting quite positively on ongoing peace talks, despite having China in lockdowns.** Mr. Yardeni is arguing that the **consumer sentiment index is depressed** because of higher inflation and US consumers are reducing living standards due to rising prices and soaring 30-year fixed mortgage rates and he expects higher volatility on equity markets going forward. We tend to agree that there are at the moment too many uncertainties to be overly bullish.
- The French President, Mr. Emmanuel Macron, is "steeping in" as a good mediator in the US-Russia crisis, warning against an escalation of "words or actions" , after the remarks on the speech of President Joe Biden.
- Mr. Bernie Sanders (Senator for the State of Vermont) also addresses to Biden the following statement: Mr. Putin may turn out a liar and a demagogue, but it is hypocritical of the US to insist that we as a nation do not accept the principles that characterize "spheres of influence". For over 200 years our nation has operated according to the "Monroe Doctrine", according to which the US has the right to intervene against any nation that may interfere with or threaten our legitimate interests. And under this doctrine the US has weakened or overthrown at least a dozen countries.

Conflict Ukraine-Russia

- Meanwhile China is arguing, that comparing the situation China-Taiwan to Ukraine-Russia would create again geopolitical tensions in the region.
- Apparently Russia is having again tensions with Azerbaijan and the real reason is the fact that Azerbaijan is dealing directly with Europe on sales of natural gas.
- Meanwhile the G7 rejects to pay for Russian energy in Rubles. Market participants feared Russia to stop the delivery of gas to Europe, but in our opinion, this is not going to happen, because Russia needs cash flows more than ever today. We are reading in the media, that Mr. Putin will still accept payments in EUR from European buyers. In any case, as analyzed last week, apparently Europe has enough storage of natural gas to avoid an energy crisis at least over the summer.
- KTS feels comfortable with the exposure of our energy experts, being also invested in LNG shipping's sector. We believe the oil price is going to be capped, but we are not expecting a major correction and therefore energy companies are going to generate substantial cash flows, which should be mainly invested into the green transition.

Oil, natural gas and coal price

- Apparently **Iran is preparing to ramp up oil production to 4 million bpd** (barrels per day) according to an interview of Mr. Mohsen Khojasteh Mehr, chief executive of the National Iranian Oil company (NIOC). Meanwhile, Iran's Foreign Minister Hossein Amirabdollahian said to Reuters: "We believe that today we are closer to an agreement in Vienna than ever before". This is good news and should help the cap the increase of the oil price, but analysts are warning, it will likely take months for Iran to significantly boost its oil exports. In addition, some market participants are arguing, that Iran was selling at discount on the black market oil to China (as also Venezuela) and therefore the impact on the oil supply's increase is minor than the majority of the investment community would expect.
- Meanwhile, fears triggered by the announcement of further lockdowns in China are also weighing on the oil's price and the Biden's administration is planning to release roughly a million barrels of oil a day from US reserves for the next several months to combat the rising gasoline prices and shortages.
- Russia is offering India a steep discounts of as much as USD 35 on the direct sale of oil. As we have analyzed last week, the Indian economy is the most exposed to the increase of the oil price.
- **We believe, these events should help to cap the rise of the oil price** and therefore also cap the increase of inflation.
- We were reading a very interesting article of the journalist Mr. Ambrose Evans-Pritchard, magazine Daily Telegraph, who argues that **China changed the energy policy to "orderly energy transition"** and the decision of the **People's Congress to change the priority from climate to energy security.** The new policy is being called "smart decarbonization, which is an euphemism for coal. In fact, China is increasing the production of coal and is planning to further increase next year.

Oil, natural gas and coal price

- Such increase in coal production should cause the crash in global coal prices and therefore also the halving of European gas prices by summer (also due to the increasing shipping of LNG) and the journalist argues, UK energy price will return to normal levels, consequently analysts will soon be **talking about plummeting inflation, allowing central banks to keep a dovish tone.**
- The scenario pictured by Mr. Pritchard should be **positive again for the technology sector** and equity markets in general**.**
- KTS was keeping the technology exposure, therefore we are pleased to read such analysis. At the moment KTS is trying to keep a diversified positioning in energy (especially energy transition, and also LNG shipping, being in a distressed situation due to US delivery), gold, value stocks, technology, biotech, Venture capitals into Fintech and telecom/digitalization and private equities into e-mobility.
- The journalist concludes by asserting, that China accounts for over half of the world's coal use and a third of carbon emissions; and the change of policy could put at risk the energy transition. As we argued in our KTS outlook, governments are adopting extreme measures on extreme situations, which is the only solution at the moment. **But we strongly believe that, with the conflict between Russia and Ukraine, any government fully understood that energy independency is vital and therefore the green revolution gained even more momentum.**

China put

- We had the possibility to read the latest update of the Stonehorn emerging market's manager and also Aubrey emerging market, who are arguing that **China set the same policy "whatever it takes"** like back in time Mr. Draghi still at the ECB.
- On March 15, the Financial Stability and Development Committee (FSDC) held a meeting to send key signals directly to the market. The market's reaction was impressive, with the Hang Seng Index soared more than 9% on one day, just a week later, when the investment community called China "no longer investable" (the bank Julius Bank has now 0% exposure in China).
- The 10 most important messages of the meeting were:
  - **The Chinese government will take substantial measures to support economic growth**.
  - **Accommodative monetary policy:** should be supporting the economy and new loans should maintain appropriate growth. We have seen already some rate cuts, more to come.
  - **Real estate risk mitigation**. The Chinese government will study and launch effective risk prevention and mitigation solutions for real estate enterprises. As argued in the past, KTS believes that the goal of the Chinese government introducing new regulations, was to weaken too big players like Evergrande. Having the government starting to support the sector again, is a proof that the goal has being reached.
  - **Positive progress on Chinese** ADRs. Chinese and U.S. regulatory bodies have made progress and are working together on a concrete cooperation plan to regulate US-listed Chinese firms.
  - It looks like, Mr. Biden is likely to exempt some of the Chinese tariffs, which are inflationary. Specifically, 352 products on which Washington first imposed levies in 2018. KTS is quite surprised, having still quite a strong debate on

China put

the Russia-Ukraine crisis, where China is still staying too neutral in the eyes of U.S. and the risk is quite high, further sanctions against China could be implemented.

- **Chinese tech regulations.** Relevant departments should steadily advance and complete the rectification work on large platform companies as soon as possible. The Cyber Administration of China (CAC) released draft rules regarding the online protection of minors, like teaching children how to better use the internet, strengthening control of online content for minors, enhancing personal information protection for minors and finally the prevention and control of minors' internet addiction.
- **Balance Chinese tech regulations**. Apparently the Chinese government tech giants to reduce their wage expenses and increase cost-efficiency in order to improve international competitiveness. **In addition, significant share buy-back programs are allowed (Alibaba has just increased from USD 15 billion to 25bn)**. Also IPOs are encouraged, and also M&A activities.
- The **Chinese government is encouraging investments into equities from long-term institutional investors.**
- The FSDC urged enhanced communication and coordination with Hong Kong regulators to maintain financial market stability in Hong Kong.
- Finally, relevant **authorities should actively introduce market-friendly policies** and prudently introduce policies with a contractionary effect.
- **The manager concludes, that the FSDC meeting sent a powerful message: China cares about its capital markets.**

China put

- **The major dilemmas KTS sees on the short term are: the repercussions of Chinese lockdowns on supply disruption and on the global economic growth.** As recently argued, equity markets are not discounting a recession. KTS is not expecting a global recession, but it would be unprofessional to assert that we know how long it will take to China to resolve the spread out with a 0 tolerance policy. The only solution we can see is, China must live with the virus, as the rest of the world is doing. We do not sense that the Chinese government is ready for this step any time soon?
- We have the feeling that equity markets are mainly focused on the Ukraine-Russia peace talks rather than Chinese lockdowns. The fact that a total of 831 international companies have their regional headquarters in Shanghai, which is now in lockdown, and is responsible for almost 4% of China's GDP, which is 2.5 times the amount of Wuhan, could have substantial repercussions on supply disruptions and therefore on the global economic growth.
- **Market participants are arguing that if we include also the surrounding provinces, the region even accounts for a 1/5 of China's economic output and therefore there are enough reasons to be worried.**
- After the rebound of the equity market and the volatility index falling under 20%, **KTS decided to invest 0.5%** of the Optima dynamic fund into **put options, 5% OTM, with maturity July 2022.** The position is going to hedge at least 1/4 of the equity exposure. We missed the purchase during the Chinese Olympic, but now having the volatility back at 20% and too many uncertainties over lockdowns in China and the possible repercussions of high inflation, we decided to stay long our equity positions, which should profit from long term mega trends, but we aim to limit the drawdown in case equity markets would suddenly shift the focus on negative news from China, or if companies worldwide start to reduce their outlooks.

General news

- **EU just launched a new legislation, the digital markets act**, aiming at stopping the largest tech platforms from using their interlocking services and considerable resources to box in users and squash rivals, creating room for new entrants and fostering more competition. Basically the law will limit the ability of companies like Google to collect data from different services to offer targeted ads without users' consent and may require Apple to allow alternatives to its App Store for iPhones and iPads. We think that **China started the "battle" against monopoly of giants tech, but the world is aligning.** This is the new normal, at the moment equity markets are reacting relaxed, not being in the position to analyze the real repercussions on the business.
- The **Federal Marijuana legalization bill is officially scheduled for House floor vote on the week** of the 28th of March.

DISCLAIMER

This report has been prepared by KTS Capital Management AG (“KTS”) / VICTRIX AG (“VICTRIX”) and is intended for information purposes only and does not constitute an offer or an invitation by, or on behalf of, KTS/VICTRIX to make any investments. Opinions and comments reflect the current view of The Investment Team of KTS/VICTRIX and not that one of a third party. We assumes no obligation to ensure that other such publications are brought to the attention of any recipient of this publication. Investments in the asset classes mentioned in this publication may not be suitable for all recipients. This publication has been prepared without taking into account of the objectives, financial situation or needs of any particular investor. Before entering into a transaction, the investor should consider the suitability of the transaction to his individual circumstances and objectives. This publication does not constitute investment, legal, accounting or tax advice or a representation that any investment or strategy is suitable or appropriate for individual circumstances, or otherwise constitutes a personal recommendation for any specific investor. We recommends that investors assess the specific financial risks as well as legal, regulatory, credit, tax and accounting consequences with a professional advisor. The information and data herein are obtained from sources believed to be reliable but no guarantee can be made that the information is accurate or complete.