KTS CAPITAL MANAGEMENT

KTS weekly update Nr. 27

The 8th of July 2022

Can Europe keep the lights on this winter?

- The magazine The Economist titled its article as above, arguing that the energy crunch intensifies. Unfortunately we are reading the same message from multiple sources and we start worrying too.
- The journalist argues that US LNG exports to Europe increased from 6% in September 2021 to 15% in May 2022, meanwhile Russia slumped from 40% to 24%. Needless to mention again, that US is exporting LNG to Europe and we should be thankful, but at a price over 27 USD, when it used to be 3 USD, in addition to the fact that the US natural gas price is falling, meanwhile in Europe is still increasing, for the obvious reason we mentioned.
- The supply's side is very stretched and few accidents on the gas pipeline already caused price' spikes in addition to the fact, that LNG terminals are running at full, because Europe does not have enough LNG terminals and absolutely needs to build new ones, as experts always mentioned in the past.
- Therefore market participants are raising the question about Europe's ability to stay warm this winter, and especially, if there is the risk of an industrial crisis and therefore production is in danger. We are reading with pleasure, that German real estate companies like Vonovia (more than 550k flat in Germany, Sweden and Austria) are taking significant measures in order to start reducing the consumption of gas, for example reducing the temperature in the room from 11pm to 6 am at 17 degree. It is a big step actually and perhaps Vonovia set up the right trend and more companies will follow. We need leaders in such change, because unfortunately the population is not preventive, yet is only reacting, and it would be already too late.
- Not helping is the situation with the drought in Europe, which is causing issues to the nuclear reactors in France, which are running at less than half their capacity, and France, once the region's largest exporter of power, is compensating by buying electricity from its neighbors. Electricity prices in France spiked.

Can Europe keep the lights on this winter?

- Germany is compensating the reduction of Nord Stream 1 gas's supply from Britain and Spain, but if UK would have an undersupply, it would cut off gas to Europe. Therefore, Germany has reversed plans to retire more than 1/5 of its coal-fired power stations this year. **Austria, Britain, France and the Netherlands also have said, they may either delay closures of, or reopen, coal plants. Some of the 7 European nuclear plants that are due to be shut by the end of winter, may also be kept operating a bit longer. In Germany, nuclear energy is still 13% of supply, gas 10.5% and coal 30% (wind 23% , solar 10% biomass 8.8% and water 4%).**
- As always argued from energy' experts, the plan of policy makers to shut down coal and nuclear stations too early, was not realistic and we are having the proof. We like to read on media, that governments are at least taking emergency measures and accept the reality to keep coal and nuclear energy sources for a longer period of time. Having the population suffering from the tremendous increase of energy prices, we do not see particular risk of demonstrations. It would be also very helpful, an increasing sensitivity from the side of citizen in reducing the electricity consumption. There are actually many ways to increase efficiency and perhaps governments should increase substantially the effort in communication, as the Italian journalist Gasbarro is rightly arguing.
- The article of the magazine The Economist concludes by asserting that a persistent supply shortfall means that the demand will have to adjust. High prices might do part of the job. But rationing may also have to be imposed on gas and power-hungry companies, such as producers of fertilizers, glass and steel. How drastic those curbs are, and whether they end up being extended to households, will in turn depend on 2 wild cards: winter temperatures on the continent, and the extent to which China bounces back from covid-19 lockdowns and soaks up more LNG.

Can Europe keep the lights on this winter?

- Finally the journalist says, Europe has so far been unlucky in its energy war with Russia. Many market participants believe that on the long run, Europe is going to win, but it is to be seen.
- We are reading that in Italy the army and civil protection are already preparing for emergency plans to guarantee electricity to hospitals and other vital structures.
- Some journalists' opinion is that governments need to inform better the population and plan measures to increase the sensibility for a more efficient energy consumption. Mr. Gasbarro mentions an extreme example of an 87 year old citizen, which experienced WWII and knows how to reduce drastically the energy's consumption and survive, on the contrary of Millennials, which have as priority in life, the highest quality and do not want to be aware of the real danger which is coming this winter.
- What it means for our investment process and investment strategy? First of all, the situation is still very fragile and therefore we have to be very disciplined with at least our trading part of the portfolio. Secondly, we keep our exposure with our energy expert, which is also invested since a while into LNG companies. Our expert is still very negative on the global economy, but thinks, especially after the substantial correction from the highs, that the energy sector is extremely attractive.
- We would like to mention that **Mr. Warren Buffett has just concluded and additional substantial transaction in the energy space with its biggest acquisition in more than 4 years, buying for USD 9.7 bn Dominion Energy, a natural gas pipeline and storage assets. During Q1, Berkshire added to its Chevron and Occidental Petroleum bets significantly.**
- Mr. Yardeni argues that industry analysts consensus forward earnings continues to increase and therefore should support the sector, even if the oil price is not increasing, which is the best for everyone!

Labor market, FED and inflation

- Reading that the company Meta plans to cut hiring engineers by at least 30% this year, from 10k planned and Mr. **Zuckerberg is warning employers to brace for a deep recession,** it is definitely not helping KTS's base scenario, especially when the company had big plan for the Metaverse. We believe that **experiencing at the moment a lower growth, the company is focussing more on profitability in the short term.**
- On the other side, the company **Foxconn**, which is the world's largest contract electronics maker, raised its full year business outlook on the back of strong sales of smartphones and services. Also **Samsung and Taiwan semi conductor** announced results above expectations, claiming robust demand from high performance computing and automotive chips should prevail, while negative impact from a weaker smartphone-chip demand outlook may not kick in until Q4 2022. This are positive surprising news and is also showing how the global economy is more resilient as expected!? KTS feels comfortable with its exposure in the tech segment and the announcement of Samsung and TSMC are a proof that mega trends are still supporting the sector.
- The positive side of such news is that the FED's plan is starting to work better than expected. As recently argued, the next months are going to be a "fight" between such negative news from the side of companies or global economy, but at the end of the day we will have also lower inflation rates, which **should help the FED to get more dovish** and therefore it should help market participants, and also the management of companies, to relax.
- We do not expect much from next FOMC meetings in June/July, even if we are reading that the two of the FED's most vocal hawks said they would support another 75 bpt rate increase at the end of the month, but a downshift to a slower pace afterward and downplayed the risk of recession. Most probably on the **2nd of November before the US election on the 8th November, we could expect the FED to change to a dovish tone in order to support the Biden's administration on the election?!**

Inflation and valuations

- In addition, we **would expect by November this year much lower inflation' numbers,** which should support the FED to change to a dovish tone. Therefore during the month of October it will be very important to understand, if we would like to take the risk and go "all in" and hopefully by then, we had signs of technical strength of equity markets or a capitulation day in order to have the perfect entry point for our trading position.
- We are not adding too many charts or information, but from multiple sources we are reading, that **Chinese ports are normalizing quickly and combined with the high level of inventories and tepid new orders, as the global economy is cooling down, we are already in a disinflationary environment,** which would support the FED's plan. Analyzing the US consumer (source FRED, real personal consumption expenditures in goods), the index collapsed, even if charts show, US households still aren't drawing on their savings and we still have saving excesses (more in the next slides). The "only" worry is a new lockdown in China, also more in the next slides.
- **Rents in US are slowing down in addition to industrial and agricultural commodity prices**, as seen already last week (aluminum and grain prices dropping 38% and respectively 25%). **As recently analyzed, global inflation expectations are starting to fall and the 10y US t-Bill yields peaked at 3.5% and is also falling,** therefore the bond market is telling us, we are going to experience a recession and the FED needs to change the tone to dovish sooner than we expect.
- JPM commodities team is forecasting an oil price at USD 380, if Russia retaliates to G7 oil price cap: historically, KTS's experience on such extreme predictions, is actually the time, when the price is turning on the opposite direction! Meanwhile Citigroup argues, that historically, the oil price falls in a recession period and sees the oil price at USD 65!

Inflation and valuations

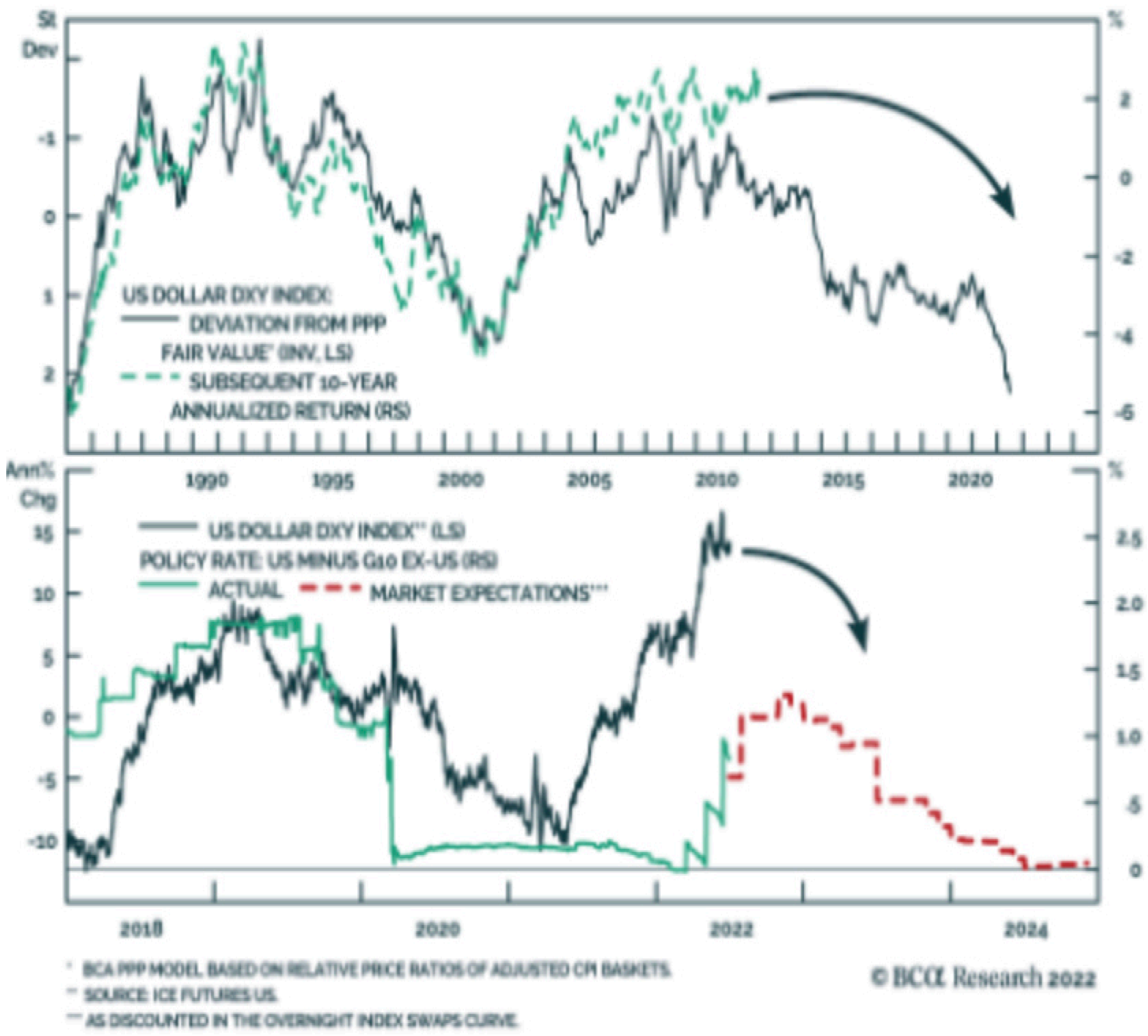
- McClellan is pointing out a curious **backwardation behavior in oil futures**, which means, the near month contracts have a much higher price of those contracts with maturity further out into the future (the analysis is on the contract 11 months out). This means, that **there is not a supply squeeze** and such **large condition of backwardation is a sign of a price top,** especially having the economy falling into recession. These are good news for the economy, contradicting the JPM's scenario. Needless to mention, a weakening oil's price is going to ease tensions on the high inflation. KTS is not expecting the price of oil to collapse and therefore we keep our exposure in the energy sector, because **oil companies are generating tremendous FCF and KTS is anyway invested in energy companies, which are improving their ESG rating, which means multiple expansion in the future.**
- We have indications, that we are actually moving on the right direction, but we **have a lot of professional investors, which are still waiting for one further "wash out" and a final capitulation**. The company AlpineMacro (CIO Mr. Zhao), for example, is still expecting EPS to fall dramatically, and therefore are still keeping the pair trade Long DOW index / Short Nasdaq, but also long US 10y / short 2y and even proposing short copper / long gold. Quite aggressive bets in our eyes.
- As recently analyzed, valuations are already discounting a lot of negativity and partially a recession, but we are still at fair value **forward P/E ratio at 15.94x**, which is below the long-term average of 16.85x but the **-1 standard deviation is at 13.5x to assert, equity markets are really cheap.**
- Having a seasonal weak period for equity markets ahead in addition to low volumes, the swing of emotions from investors can create higher volatility as expected, not only on the downside!
- **KTS is focused on long term theme with the core asset allocation and with the satellite components is trying to build up step by step positions in attractive single stocks (some names are mentioned in the next slides).**

Sector rotation

- During this week we are starting to experience, that the **energy and commodity sectors are suffering, meanwhile the Nasdaq Index, but especially "meme stocks" or non profitable/innovation tech stocks (benchmark the ETF ARKK US) are showing signs of significant rebound and slowly breaking out the long consolidation base.**
- **The correction of the energy sector has been so fast and dramatic, that is now down 27.8% from the highs vs technology down 27%**! Unfortunately we did not sell or reduce our energy exposure, because it was a kind of hedge on possible worsening of the Ukraine-Russia situation or further inflation's pressure.
- But we have to admit, that analyzing company' earnings of the sector, is the **most attractive one in the equity universe, followed by mining and precious metals, having the industry with FCF yields over 10%, dividend yield over 5.5%, billion in profits and slowly increasing capex.**
- Finally, we are not expecting the oil price to "explode", as JPM predicts, but we expect a trading range between 90-100 USD, which should make everyone happy: oil producers, consumers, but especially central banks, having less inflation's pressure. KTS stays invested in the energy sector, though if we would have taken profit a month ago, we could buy again 28% lower. Meanwhile we are also invested in the tech sector with various funds, which substantially suffered YTD (Alkeon, 2xidea to mention a fews).
- KTS is also suffering with the exposure in the gold sector. The sector used to be around +30% a few months ago and now we are basically down 30%. We were not expecting such extreme volatility, especially because the sector has the most attractive valuation in the equity universe along the energy sector, therefore we were not trading our positions. Expecting a weaker USD and strong seasonal period from September, mostly due to the Indian Monsoon wedding season, we stay invested. On the long run, we have already argued multiple times, gold is the only real safe haven in the new split world.

USD, Gold and oil

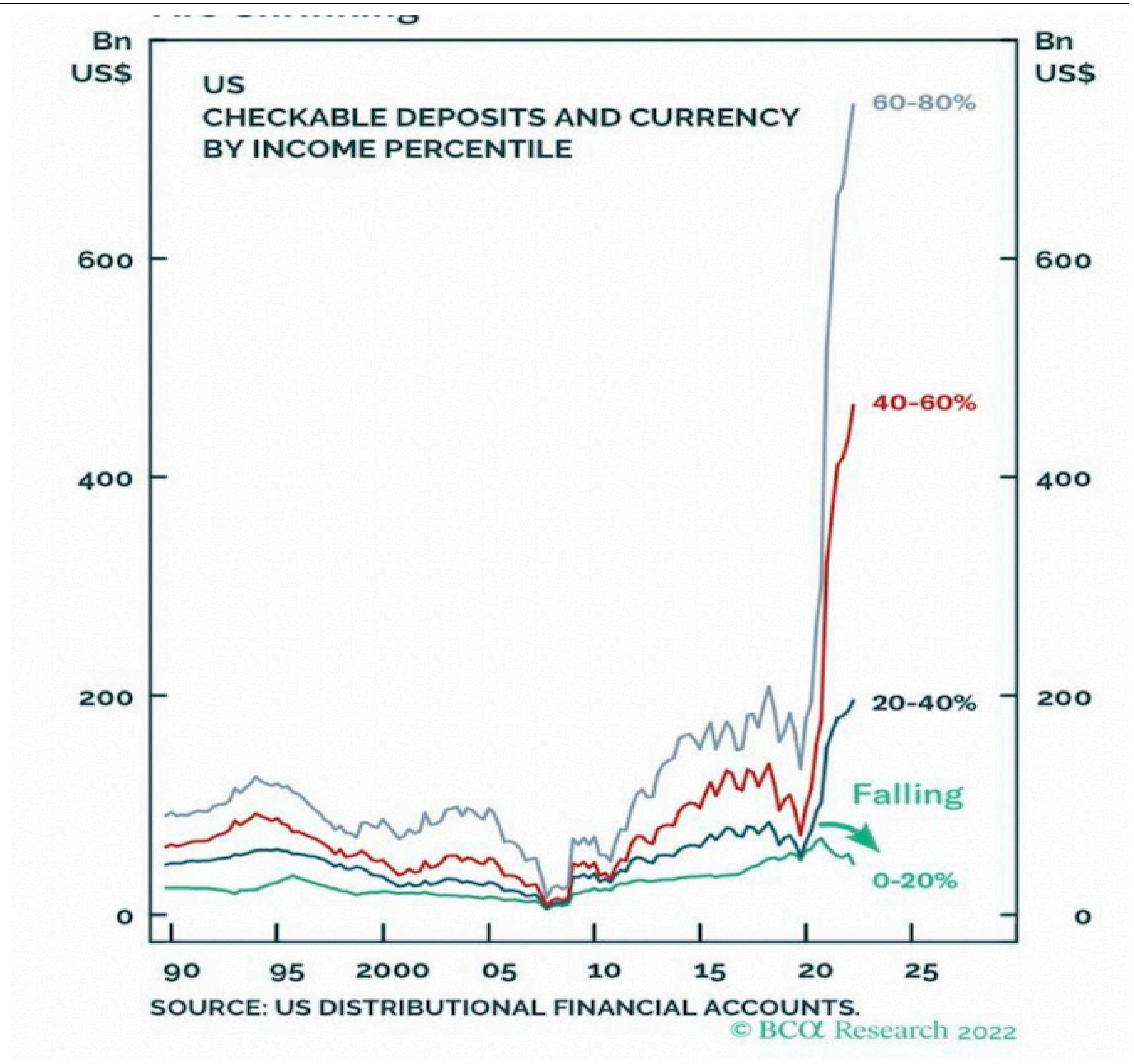
- According to the BCA research, the USD continues to post positive abnormal return in June, powered by expectations of a relatively more hawkish FED as well as safe haven portfolio flows. The EUR/USD has collapsed to a 20-year low.
- Having hedged the USD in our mandates, we are experiencing a negative performance contribution, except for CHF mandates, and we are at stop loss levels, where we have to take an important decision, to close the hedge or let it run.
- BCA Research argues, that **relative to its purchasing power parity fair value, the dollar is now nearly 30% overpriced and over the long run, valuations matter.**
- We agree with BCA research, that having the inflation peaking and therefore lower price pressures, the FED will change the tone. This is our base scenario in the next months and therefore is not an environment, which is supporting further USD strength. Therefore we keep the hedge.
- Gold and oil are also suffering from the USD strength. The oil also due to the global economy entering in recession.



Source: BCA Research

Excess in savings

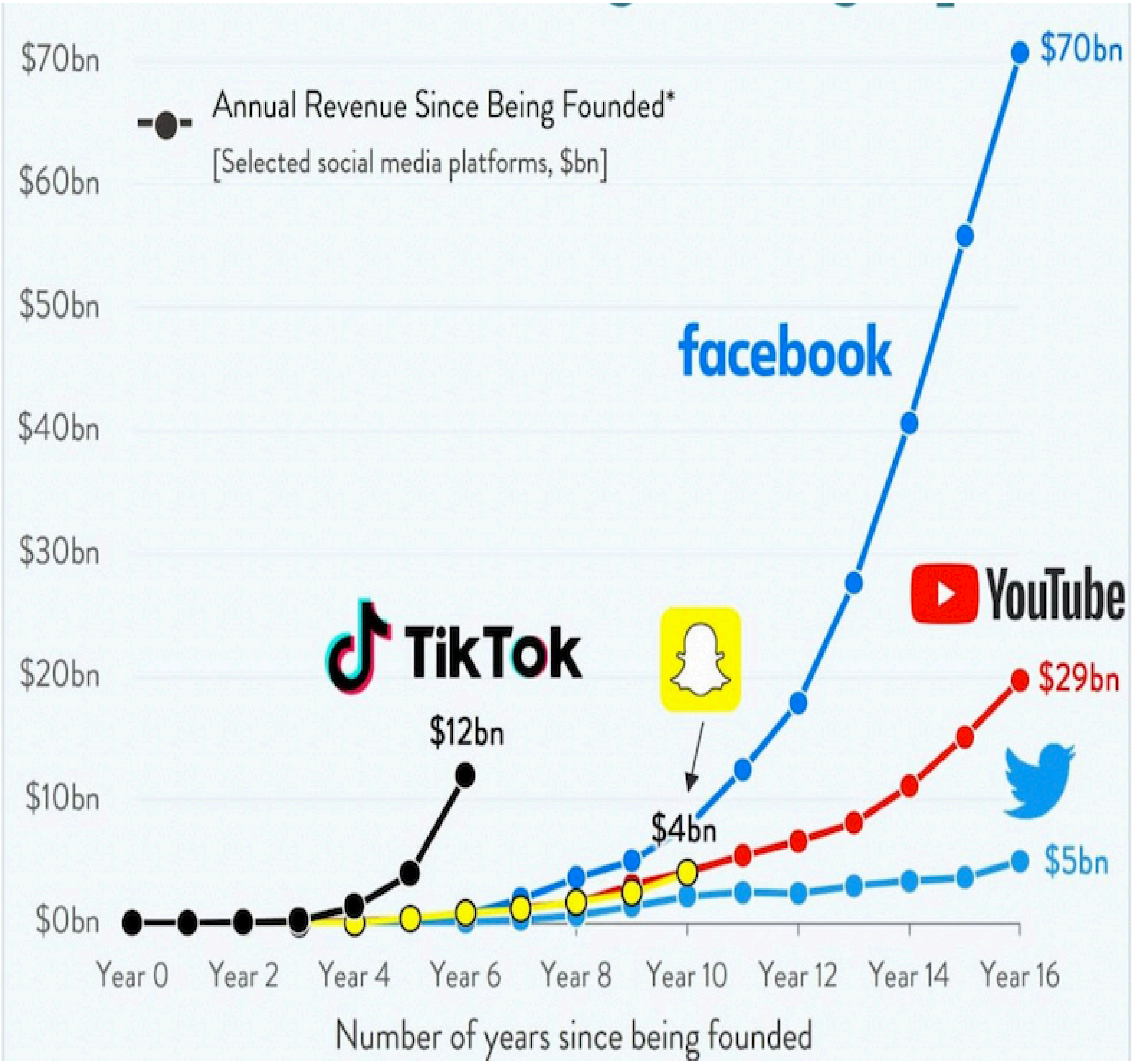
- Recently we have analyzed the dilemma of excess savings being apparently "wiped out" from the high inflation or lost with various investments into "meme" stocks or cryptos, and therefore consumption will also weaken in the near future.
- On the right-hand side chart, we can analyze, how the US **personal savings is actually falling only for the lower income,** meanwhile for the higher income percentile the saving rate is upward and is still in a strong savings excess.
- Market participants are arguing that, sad to say of course, the poorest **US households have limited impact on the total GDP**, meanwhile the **rest of the population does have ample cushion of excess savings to offset the effect of rising inflation and therefore, this should limit the impact on the US real GDP growth.**
- **We think, this is a very important chart and shows that the USD 2 to 2.5 trillion in household bank deposits are not gone yet! (which is equivalent to 10% of US GDP).**



Source: BCA research via Mr. Monchau, Syz Group

Tech growth

- As explained by the manager of our best-in-class L/S fund Alkeon, the current situation in the tech sector is not comparable with the 2000 tech bubble, **simply because growth timeline is much faster than in the past.**
- A good comparison, courtesy Mr. Cheung, is the growth of TikTok, which is on track of reaching USD 12 bn in advertising revenues for 2022.
- TikTok was founded in 2016 and have broken the USD 10 bn a year mark in just its sixth full year, a milestone that took Meta more than a decade.
- Youtube took 14 years, Snap and Twitter are both halfway to that milestone.
- Many tech stocks collapsed over 80% from their highs, but have solid businesses and there is a high probability of increasing M&A activities, having Blue Chip companies sitting on a lot of cash. **We are long DOCU US, ADBE US, TEMN SW, IDR SM, HOOD US, PYPL US, BNTX US** to mention a few names. Amazon has just bought 2% into Grubhub!



TikTok is hitting revenues milestones at lightning speed (source: Mr. Cheung)

General news

- We are worryingly reading that the U.S. is pushing the Netherlands to ban ASML from selling technology to China. If the Netherlands agrees, it would broaden significantly the range and class of chipmaking gear forbidden from heading to China. The proposed restriction would expand an existing moratorium on the sale of the most advanced systems to China. We have the opinion that Europe needs to be neutral in any decision. We are staying neutral on opinions, we do not want to get emotional, but such ban is also a dilemma in our investment process, being exposed to the semiconductor sector, and also other key sectors like specialty metals, etc. **For the moment, analysts seen a complete ban as unlikely** and the stock price is not reacting. We will have to closely monitor the development and understand, if something has to be changed in our investment process.
- The **protest in Netherlands by farmers**, triggered by a government proposal to limit nitrogen emissions by halving the country's livestock, is an example of how policy makers are not balancing the process of reducing CO2 emissions. Also in Switzerland policy makers are taking steps, whereby farmers would have to basically "pay the full price", which is of course unacceptable. At the moment, there is no real influence in our investment process, but it is clear that the costs of such reduction have to be balanced on the whole chain, which means, the profitability of companies is going to suffer and therefore it is important to foresee, who has to pay the highest price. We are going to be in constant discussion with our active managers, to better understand the development.
- Meanwhile France has just announced the nationalization of EDF, the nuclear power producer, of which the French state already owns 84%.

General news

- Market participants reacted positively with the resignation of the British Prime Minister, Mr. Boris Johnson, **expecting more political stability and the possibility of a friendlier course towards the EU, which may support business investments.** The Newspaper The Economist is even asserting that Mr. Johnson was brought down by his own dishonesty and some may conclude that a simple change of leadership will be enough to get Britain back on course! Quite an assessment.

General news China/Asia

- We are reading the the city of Xi’an, 13 million population, is starting a lockdown. This situation of 0 Covid policy starts to be a real dilemma. The market is at the moment relaxed, but such lockdowns have to be monitored, because the global economy hast just started to feel positively the improvement on the supply chain and it could be that such development is in danger again?!
- Encouraged by a weaker yen, Hong Kong investors are hunting for Japanese real estate, snapping up luxury second homes on Tokyo’s waterfront and seeking steady rental yields from studio apartments in smaller cities.

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