KTS
CAPITAL
MANAGEMENT

KTS weekly update Nr. 36

The 9th of September 2022

Macro Europe and ECB

- The ECB also start to show strong determination to move monetary policy to a more normal stance and also started addressing high inflation is the main reason for the central bank's hawkish shift.
- The ECB is expecting inflation to remain uncomfortable high in 2023 and therefore increased 75 bps at today's meeting and is planning additional 50 to 75 bps for October or December, followed by 25 bps in February 2023 and therefore interest rates going to be positive again, in nominal value, not in real value.
- The ECB has increased its 2023 inflation forecast to 5.5% from 3.5% and 2.3% for 2024. In addition, a significant growth slowdown to 0.9% in 2023. Market participants like the Swiss Bank Julius Bär are expecting only 0.7% economic growth in Europe and many others actually a recession, therefore the ECB is quite optimistic.
- On the 5th of October's meeting the ECB is also expecting to discuss the start of a QT.
- In fact, Mr. Peccatiello is rightly asking, the ECB is increasing interest rates, but there is still the **TLTRO programs ongoing** (from 2020/2021), where **European banks** can get borrowing conditions at extremely advantageous rates of -1% for the June 2020 to June 2022 and with increasing rates, banks are not going to repay these loans and **make good money on the excess reserves parked (possible profit 150bps).** Also with European governments announcing guarantees and outright help to the private sector during the energy crisis, means in other words, that the public sector will be absorbing losses through its balance sheet, which **means printing more EUR via deficits, but at least, is positive for the private sector through less defaults and a smaller decline in earnings.** Perhaps it is worth to analyze an investment into European banks.

Macro Europe and ECB

- What is KTS' opinion? We are asking ourselves, how the ECB can possibly start a QT, with all peripheral countries in "deep financial trouble" due to the energy crisis? Without to mention, who is really responsible for keeping such energy crisis ongoing. In addition we still believe, hiking interest rates is not the right strategy, but this is a political question.
- Therefore, what to do?
- Equity markets reacted quite contained to the news. European equity indexes initially fell in deep red, but rebounded. It seems, most of investors are positioned for such negative news, which were well expected.
- We have to keep some liquidity for trading, in case equity markets correct further in the next 2 months, but we still believe in a sideway trading range for the moment, as per slide nr. 11. We do not believe, equity markets are going to collapse.

Energy crisis Europe

- The drama on the natural gas crisis in Europe is not finished. On the positive side, we are pleased to read, that European governments are finally helping citizens on reducing energy costs. **In fact, Germany will support with a EUR 65 billion relief package and is still in the range of the budgets for 2022 and 2023, as the high inflation has resulted in higher tax revenues. Sweden will inject EUR 23 billion to help energy companies until March and Finland EUR 10 bn. Also France has begun its biggest energy price containment effort since the 1970s oil crisis and Switzerland is also starting to support.** Such supports are needed, because as we have seen in Prague, people has started going on the streets to protest. The European Commission is also seeking emergency power to intervene in the production of certain goods in critical situations.
- We are reading that **European utility companies experienced a USD 1.5 trillion in margin calls** and for this reason, governments have to step in and support financially companies like the Swiss Axpo and Finnish Fortum. KTS has not invested in such companies, because we are invested via experts, which would foresee such development. Market participants are arguing, that the magnitude of the bailout in the energy sector is comparable to the GFC 2008 for banks. Utility companies are facing margin calls on the hedging of long term commitments on the futures market and because of the high volatility, they face huge margin calls. Such situation was basically caused by West sanctions, causing substantial issued in the West actually.
- We agree with Mr. Steno Larsen, that the verbal **EU commission intervention started a massive melt-up in electricity prices and not only helped to stop the squeeze on the upside, but Germany electricity future base load December 2022 fell from 1’100 EUR/Mwh to basically 600 EUR, therefore -45% and help to calm down the huge margin calls, which would have also substantially affected the bank system and would have started a much bigger structural dilemma.**

Energy crisis Europe

- **For the moment it appears, we could avoid the worst** and European governments stepped in just right on time and according to the scenarios calculated by Mr. Steno, Germany and Europe should have enough natural gas for the coming winter, which would be at least a small consolation, sanctions, high inflation and financial armageddon were not for nothing! **Especially if an investor listen to the speech of Mr. Putin and how the era of cheap energy ended,** which also re-connect to our last weekly report (nr. 35 on the 6.9.2022: economic war research of Credit Suisse, Mr. Zoltan Pozsar) and also Mr. Peccatiello is talking in this direction in his latest blog.
- On the other side, Gazprom closed down the flows from the Nord stream 1 pipeline, but fortunately natural gas prices did not increase to new highs, because market participants start feeling more relaxed, having **EU gas storage at 81% leve**l in addition to the fact, that **US LNG overtook the Russian piped gas to Europe.** Nevertheless, on the news, the DAX index fell 3%, therefore we are going to **experience volatile equity markets at least for the next 2 months**, especially because news on fundamentals are quite negative. Though we do not believe, equity markets are going to collapse.
- In fact we are reading that **July factory orders in Germany fell 13.6% y/y and are at the 6th consecutive month of decline**, so the European economy is really suffering. Chemical orders in Germany were down 10.8%, followed by engineering -4.1% . Autos actually only -0.3%. On the contrary, computers and electronics were up 9.2%, showing how Europe is trying to be independent from Asia on technology infrastructure.
- Mr. Monier of Lombard Odier shows an interesting chart (not attached), with all the gas pipelines in Europe and rightly asserts, that the Nord Stream 1 flow is 0%, but via **Ukraine the flow is still at 30% and via Turkey (Turkstream & Blue Stream) the flow is still at 95% capacity. However, these deliveries account for only 20% of the pre-war total supplies.**

Energy crisis Europe

- On the other side, we can notice on the chart (not attached) of Mr. Kleintop (CIO Charles Schwab), that the **US LNG over took Russian piped gas in EU**.
- Those are very positive news for Europe and it should be the confirmation that Europe could avoid the worst the coming winter, but is also on the right direction to be independent from Russian gas over a longer term. The right question is, at which price? Having Europe paying 10 to 20 times highest than the natural gas price of 2021 and how long are such prices sustainable. We have seen in Prague, the patience of European citizens has reached the limit.
- The positive side is, more investments into energy and LNG are needed in Europe and this means, higher economic growth in the future. **In Britain, experts warned, that more investment into offshore oil, gas and wind energy has to be made. And in Germany, RWE needs to invest more into onshore LNG import terminals in order to secure long term gas supplies. KTS believes to be invested with the right partner in the right companies, in order to profit from such increase of investments in Europe.** Crisis give also opportunities. KTS does not have the know how to select the right companies, but believe to be working with the right partners.
- Some market participants are rightly asserting that, even if historically, from the **6th September to the 25th October is the weakest seasonal period for equity markets,** on the **13th of September the CPI for August is going to be released and should be a positive catalyst for equity markets, being most probably lower than expectations**. KTS also believes that inflation fell further and therefore we are expecting on the 13.9.2022 good news and a positive response from investors, though, the **upside potential is limited for the moment.**

Energy crisis Europe

- We are also pleased to read, that **European governments are also finally optimizing the consumption of electricity on public infrastructures** (lowering temperature and turning off unnecessary lighting), which should help reducing substantially the global consumption and should also be a reason to think over longer term, which lighting are necessary.
- KTS is pleased to read, that European governments are **launching stimulus packages to support European citizens** and to read all the efforts aiming at reducing substantially electricity consumption by public infrastructures. **Such news give us comfort, that the recession in Europe could be manageable** and perhaps we can avoid the worst case scenario. As mentioned, many market participants are expecting a longer recession, but ECB expect a growth of 0.9% .
- The research company Gavekal shows a chart (not attached), where we can analyze, which country could already reduce gas consumption in Q2 2022: **Finland and Latvia reduced by 55% and 40% respectively,** meanwhile Netherlands, Denmark, Estonia and Germany by 15%. Countries like Italy, Spain and France did not reduce at all! And according to **Goldman Sachs, the Italian household energy bills could rise from EUR 150 to 600 per month in 2023, asserting that this would be the nightmare scenario, because the energy bill would constitute over 20% of EU household gross disposable income!** As seen 2 weeks ago (weekly nr. 34 on the 26.8.2022), in Germany from the 1st of October 2022, a German household going to pay from EUR 80 to EUR 424 monthly, that means a increase of 5.25x, therefore the Italian citizen is “lucky” with 4x
- According to the blog of Mr. Anton B, **Italy is going to receive EUR 248 bn from the EU’s 750 bn recovery & resilience plan** and the **ECB is still doing its best to support Italian government bonds.** For the moment, EU is still supporting Italy, which is very positive.

Energy crisis Europe

- Mr. Evangelista argues in his blog, that he does not understand, why the Italian government was not supporting Mr. Draghi, having the Italian export exploding after the conflict Ukraine-Russia. We believe, this is exactly the **key of the discord,** because we have recently analyzed, that Italy is exporting to Turkey, which is exporting to Russia, therefore market participants are arguing that Italy is indirectly profiting from the Ukraine-Russia conflict and having Mr. Draghi totally aligned with the EU, it would have been a significant issue for the Italian economy. But these are only guessing from our side. In addition, market participants are speculating, that Ms. Meloni, if elected, will fly to Moscow to agree on delivery of natural gas (understandable if we look at the numbers of GS), but if that happens, the real question would be, what is going to happen with the support of the ECB? For the moment we can assert that Italy is enjoying higher exports, which is extremely important for the country, without going into politics.
- But after Italian elections, we have to closely monitor the decisions taken from the possible Meloni's administration.
- The Swiss National Bank balance sheet has just experienced the largest decrease in the last 12 months. **Switzerland is keeping a stronger currency in order to keep inflation low.** Switzerland has the lowest inflation rate on the European continent. In addition, **2/3 of electricity production in Switzerland is hydroelectric,** therefore, we can assert that Switzerland is nearly self-sufficient in electricity production. Nevertheless, also in Switzerland electricity prices are going to increase 27% next year, which is still acceptable, compared to our neighbors.
- Many market participants are advising to **invest into quality, especially Swiss companies and CHF** during those uncertain times. KTS have some exposure in the various investment vehicles, but we are not going to increase our exposure.

G7 cap on Russian oil

- Analyzing the re-route of Russian oil, and gas?, since the Ukraine-Russia conflict, we do not believe, the G7 plan to cap Russian oil prices is going to reach the wished results, on the contrary, the first reaction from the Russian side is to totally close the natural gas flow to Europe and start shipping LNG gas to Asia. Even if according to Mr. Steno's blog, the path for Russia to shift from the pipeline into LNG is going to be very long, not possessing enough LNG terminals. Mr Steno also argues, that it is not true, China is re-routing gas to Europe.
- What is clear, is the fact, that Russia's top banks have started lending out yuan and transferring China's currency outside the Swift system and therefore is clear, we have one country less buying USD in the future and not being depend anymore from the Swift system, but from the Chinese system called CIPS. The investor, Ms. Ebadian, is arguing that Russia commodity reserves will be traded and supplied via Asia through USD 80 trillion Chinese financial ecosystem and **therefore going forward, the demand of US T-Bill and USD going to fall. This is again a long term trend, but is clear against the USD.**
- Mr. Steno Larsen is even asserting that the **cap is a pretty theoretical discussion since there are no flows to put a price cap on** and Mr. Fullarton is rightly asserting that all the eyes should be on those nations that have been buying the discounted Russian oil, if the West would like to reach some efficient result on sanctions.

G7 cap on Russian oil

- Of course we understand the strategy of the G7, to **put indirectly China, and India, into the risk of possible new sanctions and if both would pay a much less price for Russian commodities, financially Russia should be weaker. Meanwhile India and China would "enjoy" even cheaper commodity prices,** and therefore are also interested in introduce such cap. The global "political mess is getting even more messier" and at the moment we can not see any diplomatic solution, in the contrary, the "ego" is risking in an further escalation. For this reason, we have to closely monitor on a daily basis, the real risk of escalation and be ready to react.
- Meanwhile, the OPEC+ agreed a **100k bpd production cut to bolster prices**. **UBS is saying, the cut suggests that there is a desire to defend the oil price to stay above the level of USD 90 per barrel. We also believe so and for this reason, we keep our investments in the sector as a hedge to global geopolitic tensions.** Market participants believe that the the cut is the Saudi message to the U.S. revival of the Iranian nuclear agreement. For the moment, the oil price is stabilizing at 85 USD.

Macro data U.S.

- Market participants reacted positively on the U.S. employment report last week, because of the **significant increase of the labour force participation rate,** which should finally help, **reducing the tightness in the labour marke**t and therefore help the FED to hike only 50 bps instead of 75 on the 21st September. In addition, **labor wage increased less than expected**. Otherwise the U.S. Labour market is still very robust, with over 300k new position added only in the month of August.
- But Zero Hedge highlights that the number of people with multiple jobs hit an all-time high, suggesting that fewer people are working, but they are working more than one job. This matter of fact is actually confirming, that US citizens need to work more jobs because struggling with the high inflation and therefore this is not a good news for US consumption. **But at the moment, negative news are actually positive news for equity markets, whereby investors hope in a dovish FED sooner than later.**
- Reading the last commentaries in Bloomberg of **Mr. Powell, he is still believing in the "hard line" and is talking about "a jumbo rate hike later this month" !**
- Meanwhile the ISM non-manufacturing / services came stronger than expected, surprising the whole market and for this reason, equity markets reacted negatively, but the move was quite contained, in the contrary, one day later market rebound over 2% .

Macro data U.S.

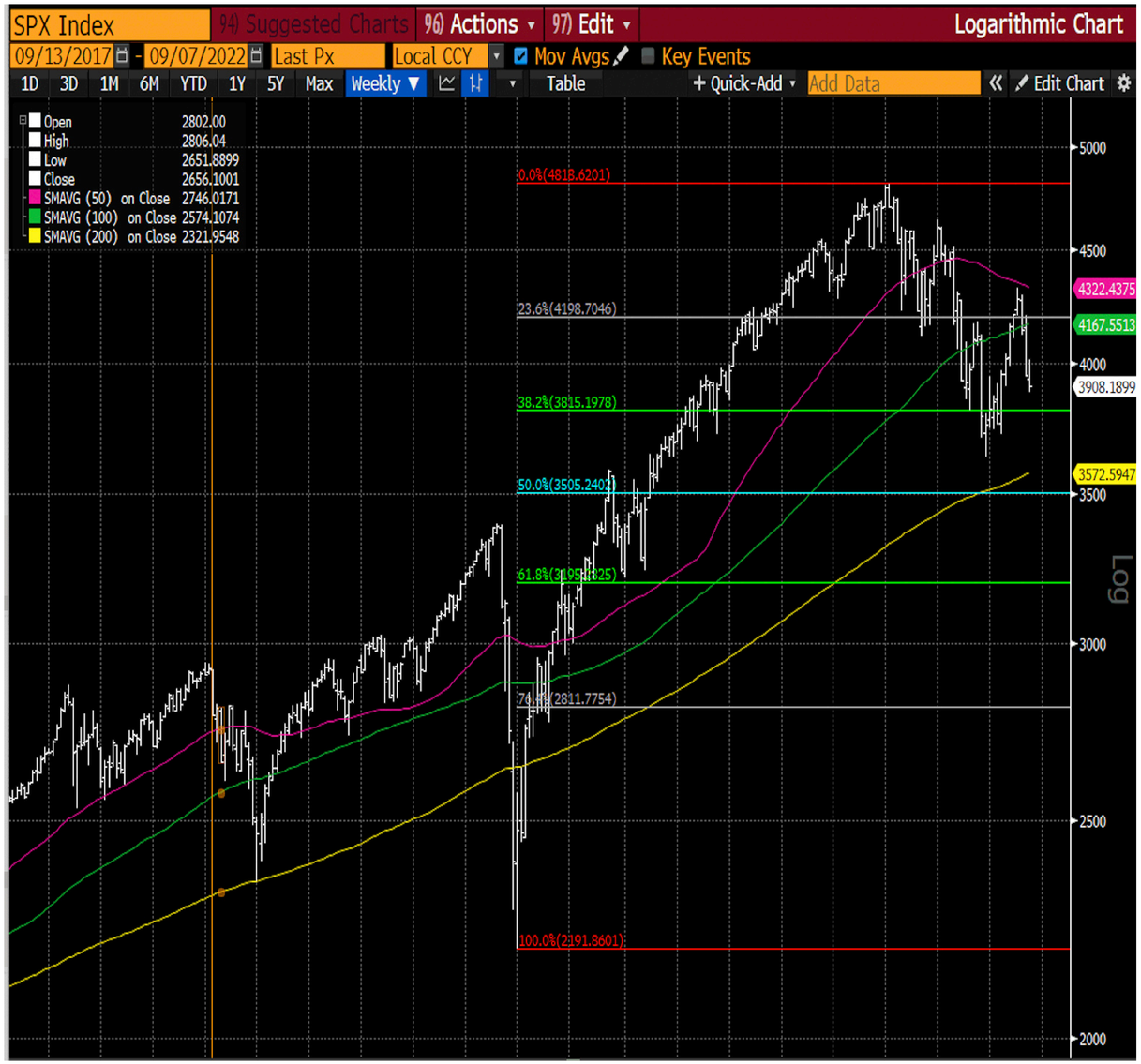
- According to the ISM manufacturing in August, many **commodities reported as being in short supply have collapsed and should help to have much lower inflation in the future**.
- In addition, more than the half of the world's manufacturing PMI are contracting now and apparently will be in recession up to year 2023. On the blog of Mr. Steno Larsen, we are analyzing a chart (not attached), which shows, the **actual level of the ISM price index are pointing out a 2-3% lower inflation in the next 3-4 months**. THIS WOULD BE THE PERFECT SCENARIO TO TURN BULLISH ON EQUITY MARKETS AND COULD REALLY BE AROUND NOVEMBER THIS YEAR, but being the chart from 42macroDDale, it is difficult to prove the credibility.
- **More credible are the commentaries of Mr. Zhao, Alpine Macro, arguing that most probably the FED is going to be behind the curve, but not because of the high inflation, rather because is still very hawkish, even if most of PCE inflation are significantly falling and inflation expectations implied by the bond market have melted and therefore the FED should be more dovish.**
- Meanwhile in U.S., the price of natural gas are doing 24% from the all-time high in the mid-June and the lowest levels in 6 months.

U.K. elections

- According to Julius Bär, the leadership change to a Truss government promises to spur foreign direct investment through a cancellation of the 2023 corporate tax hikes.
- The CIO of the Swiss Bank believes, this is not enough to support UK economy and more short-term measures against rising energy prices and the cost-of-living crisis are needed and therefore maintain a bearish outlook, at least short-term.
- KTS is invested in our best-in-class global fund Lindsell for our GBP discretionary mandates. The global diversification should help reaching a better performance vs only the UK exposure.
- Meanwhile the new PM Truss started in fact **launching a GBP 130 bn plan to help on the energy crisis**. Of course investors like Mr. Peccatiello are arguing, that on the short term this is going to help, but on the longer term is going to worsen the situation, because such **stimulus package is nothing else than a new injection of liquidity** in the market and a further increase of government debt and therefore propose that, UK needs to **find structural and long-term solutions to fix the energy crisis**. We partially agree on the long term repercussions, but on the short term, the blow due to the Ukraine-Russia conflict is just too high for European an UK citizens, that such stimulus packages are needed in order to have citizen willing to keep such endurance and acceptance on the ongoing conflict. As previously argued, Europe needs to invest more into offshore gas, oil and wind energy and those are actually new and good opportunities for Europe.
- **Longer term, the ballooning of the debt will mean a major devaluation of the GBP and investors need to own real assets, because such situation is not only for UK, but the whole West and as always argued, the high indebtedness is going to be monetized via high inflation, which means also a significant devaluation of the USD and EUR.**

Technical analysis on the S&P 500 index

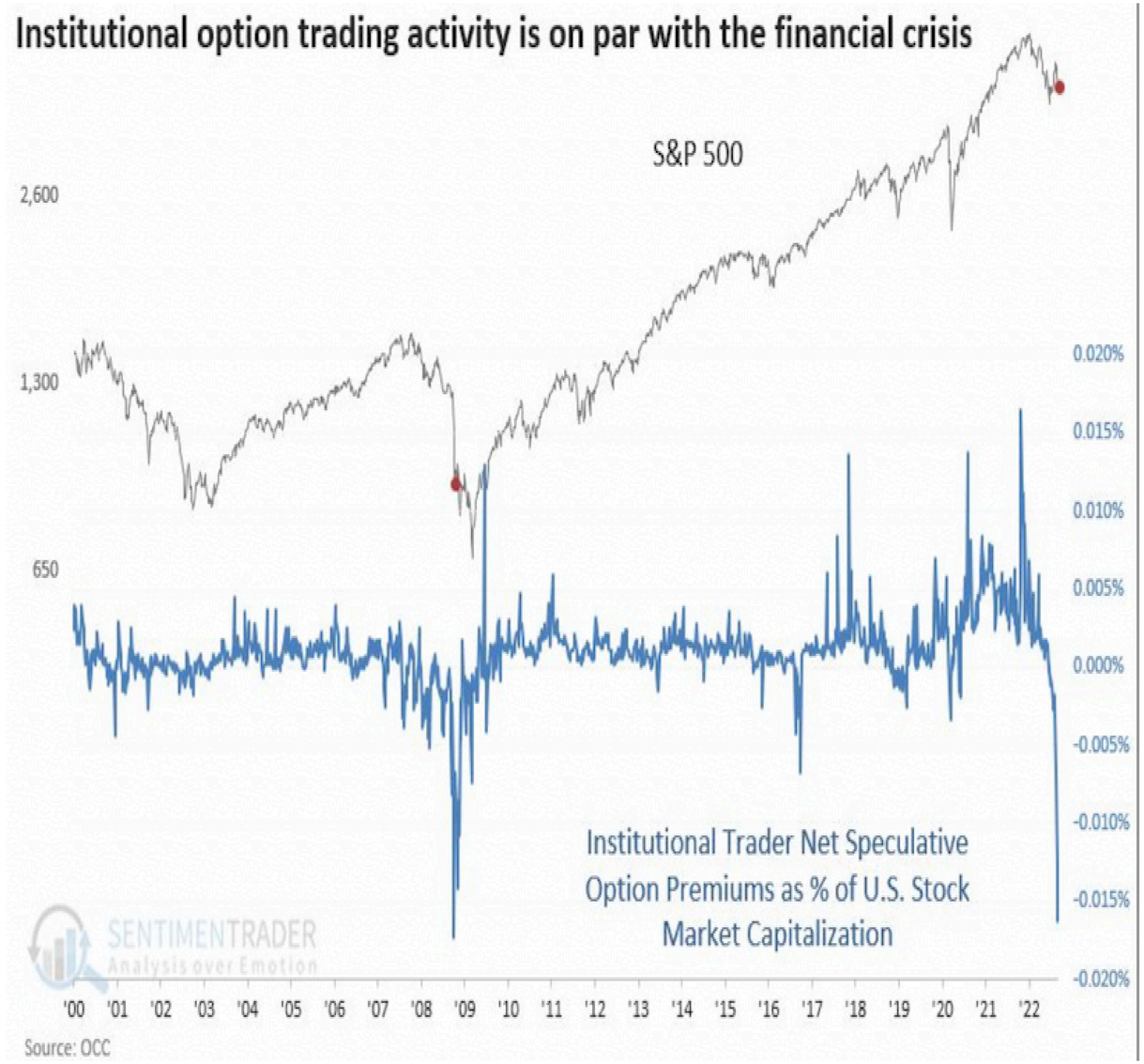
- KTS is trying to figure out on a fundamental basis, where we should feel comfortable to be fully invested.
- **But at the end of the day, we believe, the clear signals are going to be pure technicals.**
- We believe, that taking into consideration, that equity markets anticipate fundamentals by 6 to 8 months and most of investors, especially the professional ones, are still strongly underweighted equity or even short, **when the index S&P 500 is going to break out the resistance of 4'330 points, we have to turn bullish and invest our liquidity.**
- Otherwise, we believe, the **S&P 500 index is going to find a floor at 3'500 to 3'600 points**, which coincides with the 200d moving average and the 50% fibonacci from the rebound since March 2020. Other market participants, like EFG, have the similar opinions.
- Equity markets are finding also support from valuation, as we can analyze in the next slide.



Resistance: 4'330 points / support 200d mov av at 3'572

Highest put option positions

- On the right-hand chart, courtesy Mr. Ansidei, we can notice, how the net position of institutions in the options market, relative to the capitalization of the stock market, **has never been so exposed to put options since the 2008 financial crisis.**
- As we can analyze in the chart (the red point), such signal is showing a kind of capitulation, **however, it was not the absolute lowest level.**
- KTS is surprised, that nowadays' volumes are also higher than 2020, but is explainable with that fact, that having the volatility at relatively low levels compared to the amount of uncertainties around the world, economical and geopolitical, it makes today perfectly sense to buy put options as hedge. In the contrary, by the pandemic in 2020, it was more of a shock and market participants were not ready for such event and reacted too late, when volatility was already too high, therefore not many investors could buy put options.



Source: Sentimenttrader via Mr. Ansidei

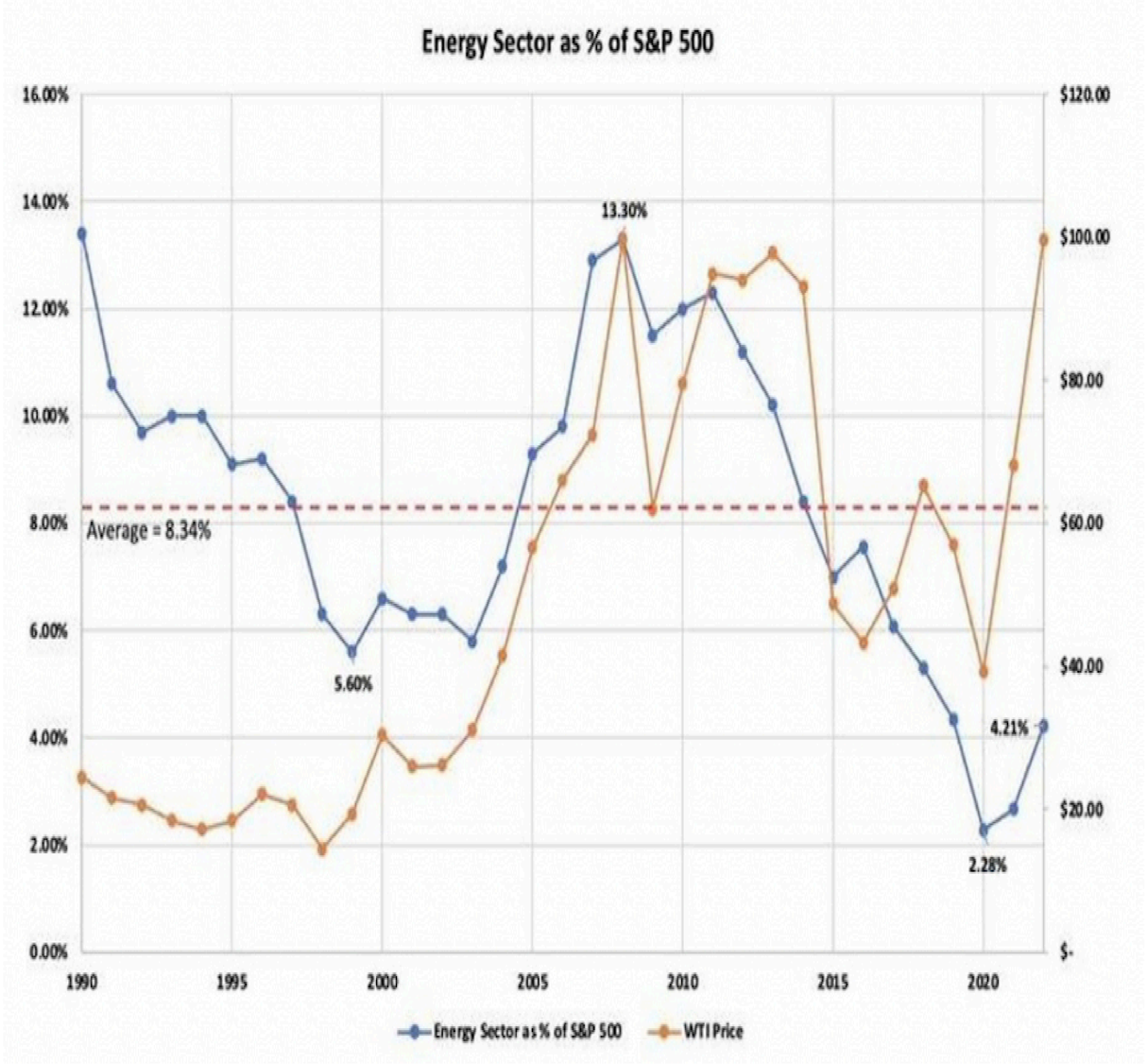
S&P 500 valuations

- On the right-hand chart, courtesy Callum Thomas research / Mike Zaccardi, we can notice how the **S&P 500 ex top 10 valuations are cheap compared to historical average from 1996, at P/E 16.6x vs an average of 16.4x**
- The top 10 are valued at 24.7x vs 20x, but KTS would argue, that having blue chips with the highest level of cash ever, **valuations should be analyzed ex-cash** and we believe, would be also cheap vs historical average.
- Meanwhile after Q2 results', operating profit margins fell 10.9%, as sales growth has slowed and with a -12% in GAAP earnings y-o-y in Q2, we have just experience the largest YoY decline since Q2 2020 (pandemic), but equity markets fell more than 12%.
- On the list of the cheapest US stocks, with a market cap over 10 bn USD, courtesy Mr. Karymba, most of the companies are all in the energy sector. But also other interesting names are on the list, like Moderna, Micron, Dell and HP, Bunge and Goldman Sachs.

SP& 500 Index ex top 10 is cheap (source: MikeZaccardi)

Upside potential of energy equities

- On the right-hand chart, courtesy Mr. Young via Syz Group, we can analyze the historical correlation between the oil price and the energy sector in percentage of the S&P 500 Index.
- According to the chart, the energy sector still has a substantial upside potential, even if the oil price would not increase.
- This is also our opinion and for this reason, we stay long our investments into the sector.
- As explained on the slide 7, on the **list of the cheapest US stocks, most of the names are in the energy sector,** as for example Lyondellbasell, Apa corp, Phillips 66, Valero, Occidental Petroleum and Marathon Petroleum to mention a fews. All such companies have P/E 4 or lower.
- Also the **Uranium sector is very attractive,** having the whole world debating, if nuclear energy is “green” and ESG. There is **67million lb shortfall between supply & demand**. Our energy expert is invested in some names.



Source: Josh Young, via Syz Group

General news

- Not only Chinese are buying less US T-Bill, but also the Japanese central bank is forced to sell bond overseas in order to buy YEN.
- According to our Vietnam's expert, Mr. Martinelli, **Vietnam's upbeat growth outlook is bucking the slowing trend elsewhere in Asia, with relatively subdued inflation that's also an exception to the general rule in the region**. Accordingly, IMF, recently raised **Vietnam growth forecast to 7% this year,** lifting it by 1% from 3 months earlier and the only significant upward revision among major Asian economies. This confirm our positive stance to the region/country and therefore we keep our investment.
- On the weekly research of Mr. Fugnoli (Il Rosso ed il Nero), he is arguing, that in the past, basically only countries from the south where issuing high debt and monetizing with high inflation and we know the final result. Instead of abandoning such strategy, now also countries from the Nord started to apply such strategy. **As always argued, the only solution is to own real assets.** It is clear, that the British government just announcing to "freeze" on household utility bills at GBP 2'500 a year for the next 2 years, is definitely helping British citizens and consumption, but ballooning the already high indebtedness and the ECB / FED would like to start the QT?

Sustainability of the credit card business model

- As recently explained, Visa and Mastercard are tremendously profiting from higher inflation, because higher prices are translated into higher revenues, having the business model of credit cards based on a percentage on revenues.
- **Visa and Mastercard combined have a market share up to 75-80%** (Visa 50% and Mastercard 25%) and basically as Mr. Kriaris is explaining in his blog, 8 out of 10 purchases are either with Visa or Mastercard.
- The model of credit cards is actually very simple: is connecting banks with customers and this middleman role allows them not only to define their access fees, but also the interchange fees that merchants pay to the card issuers.
- Apparently, US and Canada have the highest interchange fees in the world, ranging from 1.5% of the purchase price all the way up to even 3.5%.
- Europe with its strong antitrust policies has since 2015 a cap for card-based payments (0.2% for debit cards and 0.3% for credit cards).
- **Margins are at 51.99% for Visa and 46.49% for Mastercard.** Mr. Kriaris compares to **Apple, the most successful company worldwide, which has a net margin of 25.71%.**
- **But Mr. Kriaris asserts that Visa and Mastercard seem to be on the peak of their game and KTS agrees**. For this reason, KTS is trying to diversify into **Fintech and buy now pay later businesses (BNPL)**, via our Venture capital investments. KTS was too late to invest into Revolut and even we had the opportunities in the last 2 years, we did not want to invest into a valuation of 30 bn or more for the company, which is still burning cash and need also to update pricing during the weekend, but still not reaching any annual profits.

Sustainability of the credit card business model

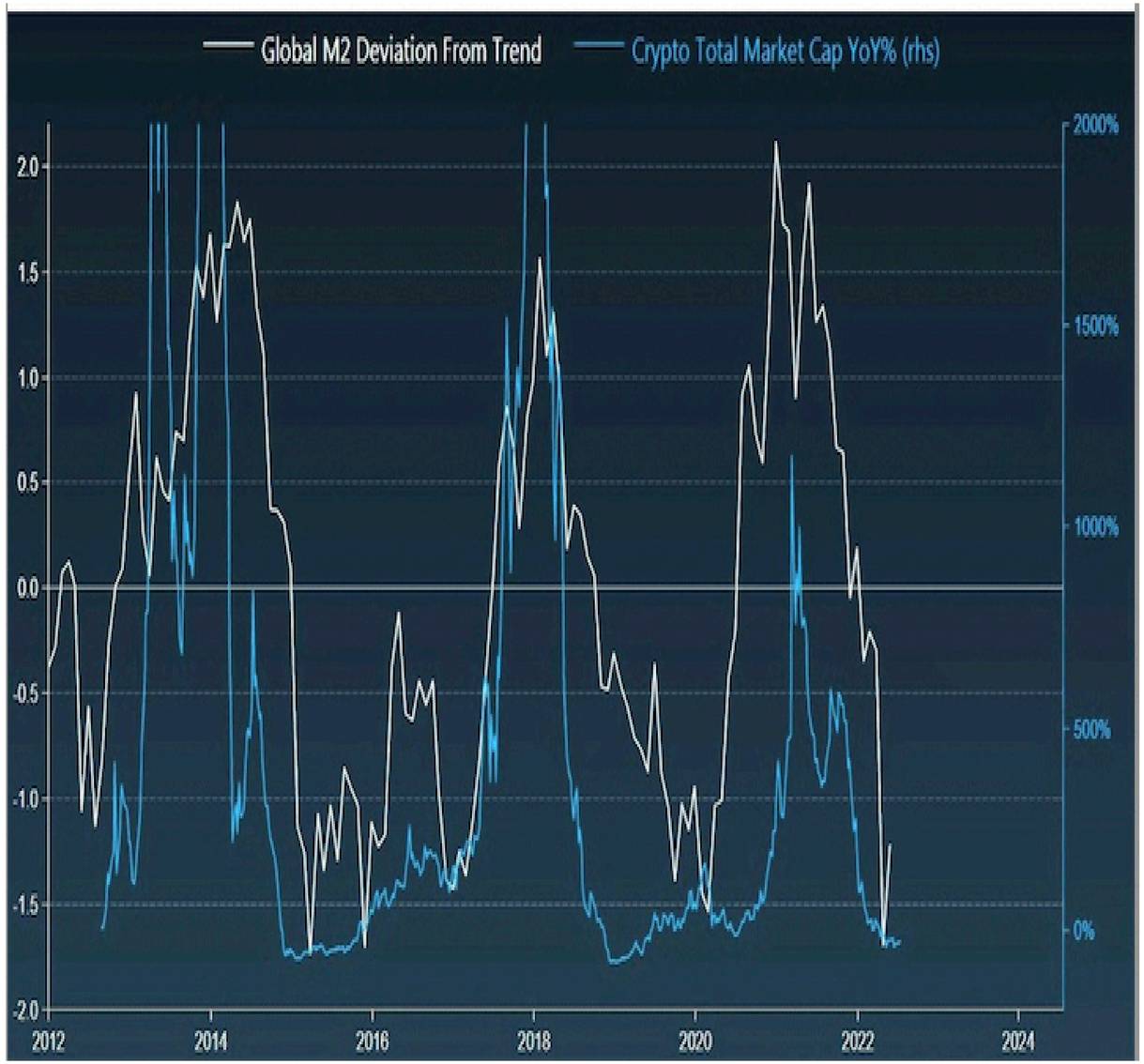
- We fully agree with the blog of Mr. Kriaris, that **open banking is in fact changing the name of the game** in that it not only **connects merchants with consumers in a direct way, but it can also initiate payments directly from bank account at a fraction of the cost of credit cards.**
- A part the fact, that regulators are globally taking a harder stance on credit cards and even in the US the recently introduced Credit Card Competition Act wants to spur competition to the market and lower acceptance costs for merchants and consumers, via forcing banks to allow merchants to choose from at least 2 different card networks, the **increase in popularity of alternative payment methods from BNPL to digital wallets and to superapps, gives back to merchants negotiating power over credit cards amidst fierce e-commerce competitions.**
- KTS recognized this trend early enough, to be able to invest in some **BNPL app like Grover, Scalapay and Twig** and also investing via **Swisscom VC fund**, which is also participating to the whole digitalization. More can be actually done and KTS is constantly monitoring investment opportunities in the field, feeling especially comfortable to work with reliable and highly professional connections like Swisscom, Fasanara and other counter parties.
- For KTS was very important to diversify, because we realized, that our best-in-class funds are invested into such major companies. Even if our best-in-class managers are active and therefore not linked to a Benchmark, they need to keep quality stocks in order to avoid deviating too much from the Benchmark and we realized, that most of the funds are invested into Visa and Mastercard, which up to today, was not a mistake, in the contrary. Therefore, investments into the new mega trends like Fintechs and digitalization allows KTS to participate into innovation and future.

General news on bitcoin

- We are reading, that according to the platform TipRanks, **62% of wallets did not sell Bitcoin for a year**. This is actually quite a bullish sign. KTS is still not long crypto currencies, is only invested in the crypto arbitrage, which is not reaching the tremendous performance of 2021 (+65%), but is flat YTD vs a disastrous crypto currency market and the default of some stable coins and platforms.

Bitcoin correlation to M2

- We are reading on more blogs that investors are questioning the increase of correlation between the Bitcoin and traditional asset classes, especially equity.
- As explained many times in our weekly reports, **we believe the right correlation to be analyzed is to the M2**. Also crypto currencies are suffering from the fact, that there is less liquidity from central banks to be invested and therefore the hypes are suffering, even more than traditional asset classes.



Source: Aries V.

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