KTS
CAPITAL
MANAGEMENT

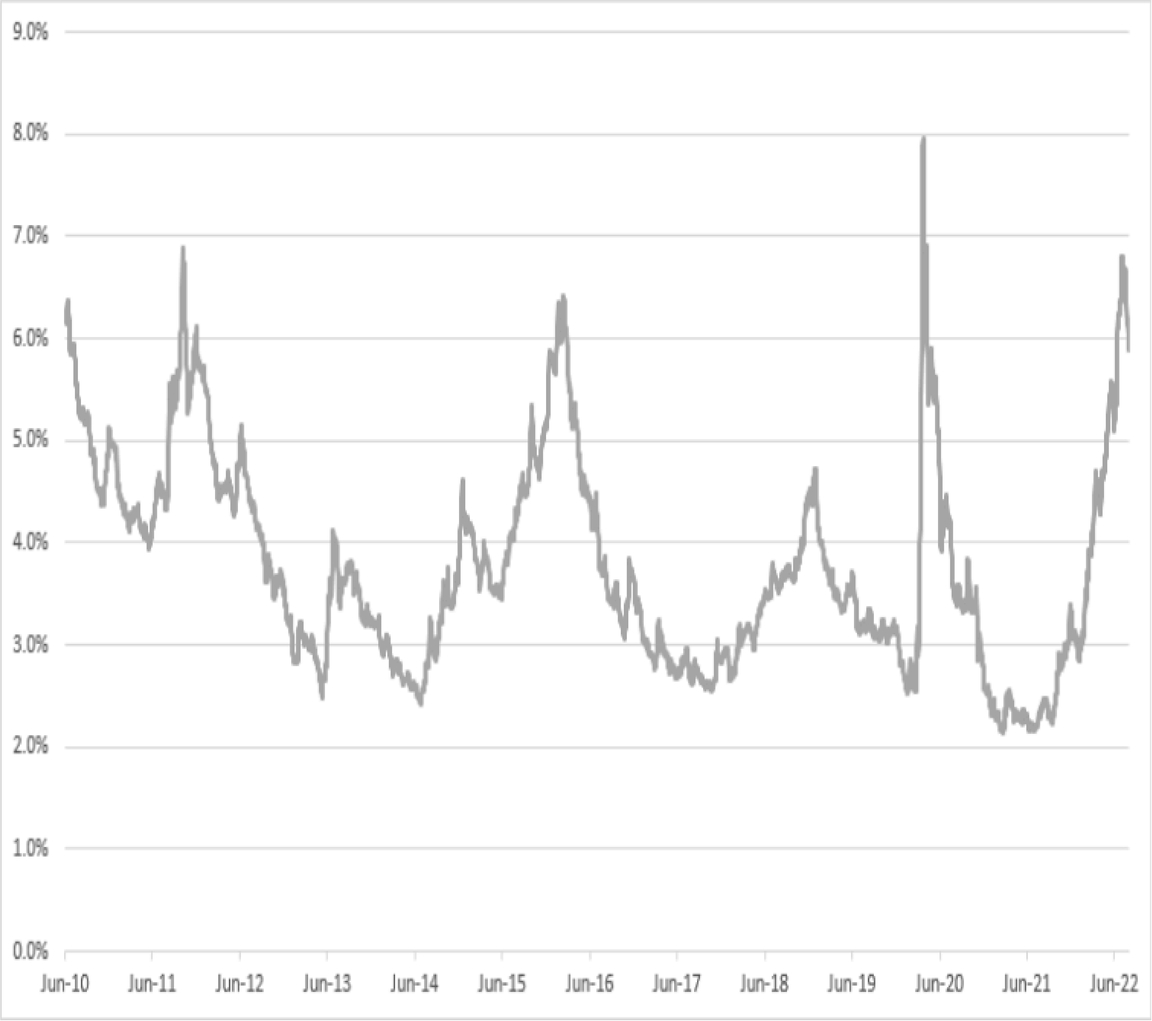
KTS weekly update Nr. 39

The 30th of September 2022

High yields - very attractive valuations and yields

- As we have seen, the real panic was in the bond market rather than equities.
- Headlines are talking about an absolute “bloodbath” and the **volatility in the bond market (MOVE Index) is at the same level as 2008.** The 10y US bonds lost from the highs over 40% (TLT US), the 30y is almost -60%. **57.8 trillion USD, equal to 3x US current GDP, has been wiped out in value this year.**
- As our clients know, we could avoid such a “bloodbath” not being invested in plain vanilla bonds for over six years now.
- But, believing that we do not have a systematic crisis and talking to experts, which are confirming that the current situation is not comparable to 2008 and 2000, but yields are extremely attractive and over 10%, we believe that it is the right time to build up positions into global high yields and CLOs. **Valuations are fair, but implied default rates provides significant compensation for the risk, which are rare events.**
- **KTS bought the best-in-class global high yield fund MAN/ GLG and the CLO fund from the manager Cartesia.**

Difference in Global HY YTW and MSCI Dividend Yield



According to Man, credit looks more attractive than equity

The USD

- Taking into consideration that KTS believe, the **FED's monetary policy and the inflation peaked**, consequently the USD's rally should run out of steam and therefore **we hedged the currency in our discretionary mandates CHF, EUR and GBP** with a strict stop loss.
- Technically, on the 28th September we had **hammer formations** in the currencies GBPUSD, EURUSD, as also in bonds (TLT US) and Gold.
- We also believe that gold will rebound from the very important support, having a weaker USD. Gold experts are already "screaming" for a strong reversal.
- In addition, the Bank of England launched emergency interventions in the markets buying government bonds, therefore giving a sign that the limit of tolerance was reached, especially, because pension funds would have faced defaults.
- Expecting a pause in the rate hikes' expectations, we started to build up positions in high yield bonds and we will increase our emerging market bond positions.

Long term chart of the USD vs basket of global currencies: DXY index

Further stimulus package and long term repercussions

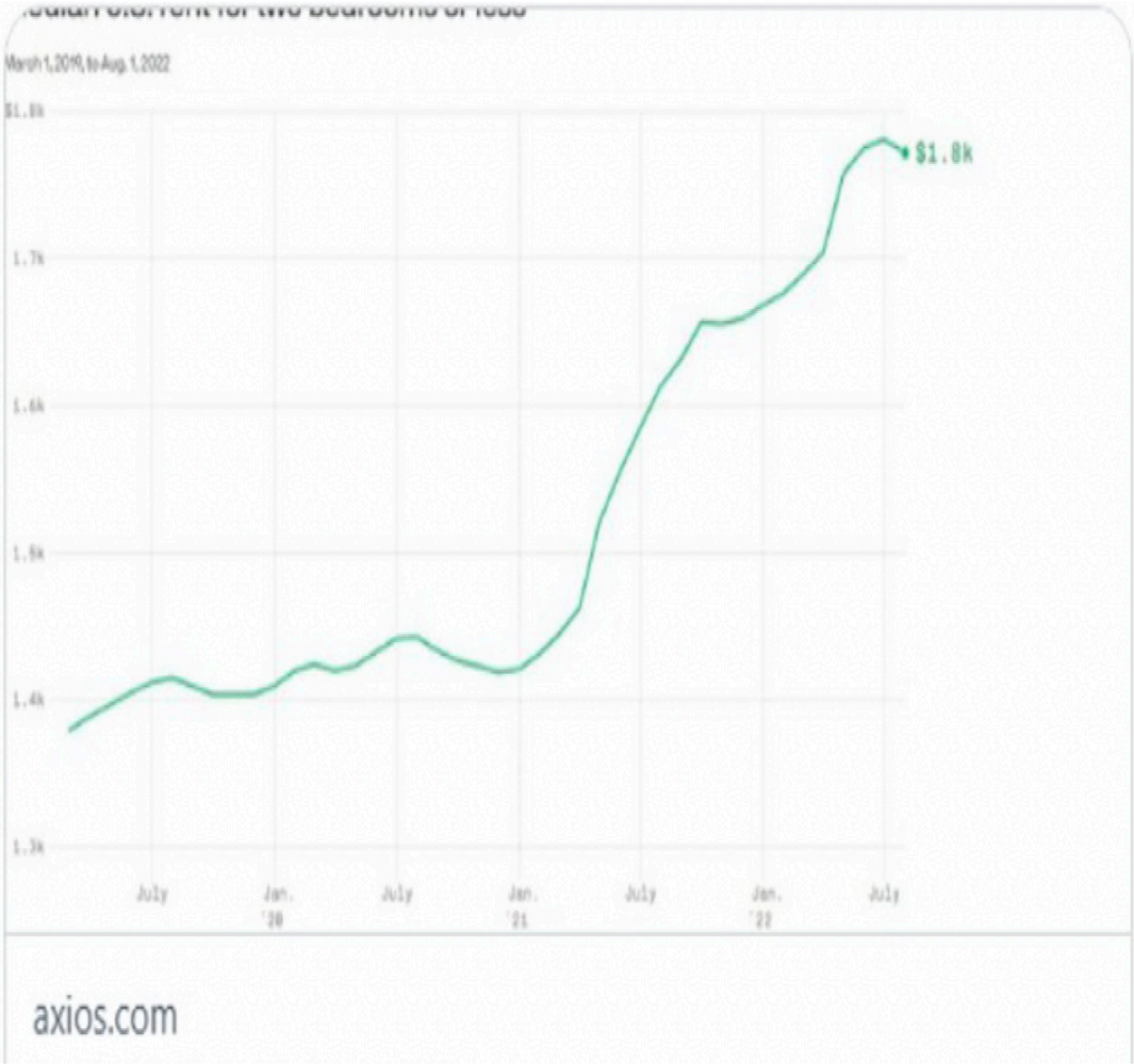
- Part of a new stimulus package of EUR 18bn in Holland is to raise the minimum wage by 10% .
- Western central banks keep increasing interest rates; meanwhile, governments are issuing stimulus packages to support citizens. We want to remind that UK and Germany have just launched similar stimulus packages lately in order to help lower incomers.
- In KTS' eyes, it does not make sense in the long run. Western governments are increasing indebtedness, which means devaluation of their own currencies for longer and weaker ratings for European government bonds. As you know, with high debt, governments, instead of analyzing how to spend the money wisely, are increasing taxes. Therefore, top wealthy citizens optimize their wealth structure internationally, creating a vicious circle for the government. Such a bad circle could be stopped only by reducing taxes, which will not happen. We want to bring two recent examples. The founder of the company Patagonia, Mr Yvon Chouinard, decided to donate the entire company, worth USD 3 billion, to fight climate change instead of normal heritage and pay USD 700 Mio heritage taxes, as Bloomberg mentioned. Or Mr Rokke, who decided to move to Switzerland from Norway.
- It looks like the only safe havens are the **CHF and gold**.
- In addition, as we will analyze on the last slide, western governments can reduce such high indebtedness only with real negative yields; therefore, it **does not make sense for an investor to buy bonds with a nominal interest under the inflation rate**. For this reason, KTS is investing in global high yields and CLOs with real positive yield expectations.
- **Finally, the bond's correction YTD has just destroyed USD 16 trillion worldwide in wealth**. As we all know, most of this wealth is lost by pension plans, which are already in deficit with their long-term liability (see KTS's outlook 2021 & 2022). Is a logical consequence, that in the future, the pension age is going to be increased everywhere

Inflation - CPE

- As recently argued, we were expecting lower CPE numbers than expectations, because as Mr. Yardeni was explaining, the weighting of rents/shelters is lower (15% instead of 30% in CPI).
- The **numbers were slightly higher with 6.2% instead of expected 6% ,** but equity markets were reacting positively, because the shock was already on the CPI and the FOMC speech.
- KTS was expecting actually a trigger for a strong rebound, but this has not materialized yet.
- Meanwhile, the last numbers on the **Mannheim used car index fell further and we are now back at pre-covid levels,** which is very positive and were not in the August's CPI number.
- In addition, **container shipping rates are now really collapsing,** which is also a very good signal. Tough, the nowadays levels are still 3x higher than pre-covid.

Rents could finally peak

- According to the blog of Mr Barraud (statistic of axios.com), it could be that rents have finally peaked.
- In fact, new data shows that average rents declined in August for the first time in nearly a year.
- Of course, this is not a sign to turn overly bullish because, as we saw last week, according to Bridgewater, housing tends to last longer than expected.
- In addition, Mr Raoul Pal published in this blog a summary of macro charts entitled **"terrifying charts"**, pointing out ALL forward-looking data have substantially deteriorated. The US **real estate has already collapsed** (US new family home sales, US pending home sales index, US new housing starts, inventories, US housing affordability, etc.), mainly because of the US 30-year mortgage rate doubling in the last 12 months. Because of such an increase, all the homebuilder sentiments collapsed. In addition to car sales collapsing, retail sales, etc.
- As mentioned lately, also KTS believe the FED is "behind the curve" on the other way now.



Source: axios.com via Blog Mr. Barraud

Inflation - bullwhip effect in the future

- We came across a chart showing how historically, it took over an average of 10 years to take down inflation above 5% to 2%.
- We believe this time is an extraordinary combination of too many temporary factors which caused such a dramatic increase (pandemic, Ukraine war, etc.). Therefore, we should also have a faster reverse of the situation.
- Though we also do not believe we will see 2% soon. The 5-year forward inflation expectation rate is at 2.32% (from 3.76%) and falling, but market participants are arguing that Powell's speech on the 21st of September was a sign that the FED did not want to declare early victory, as it happened in the late '70 with Mr Volcker and therefore will stay hawkish for longer, even if fundamentals are sharply deteriorating. However, KTS believes we had the peak of FED's hawkishness.
- KTS is trying to figure out, with external sources and conversations, **when the inflation would fall to the wished levels of the FED**. We do not have to forget the **bullwhip effect** (see also weekly report nr. 14 on the 15.4.2022), where at a certain point not too far in the future, we will have a double effect on inflation on the downside. As we have just experienced with **electronics in August, prices fell 15% on high inventories (too many orders during lockdowns) and now are sold at a discount, creating deflation.** Micron Technology announced a substantial reduction in capex for 2023 (-30%) and Meta Platforms outlined plans to cut headcount for the first time ever and to cut budgets. Those are signs of a sharply deterioration of the labor mark and economic growth going forward and we hope the FED is aware of that.
- The same bullwhip effect is going to happen with many other goods, as soon hedge on commodities, inventories with high prices, new purchases of commodities at lower prices, lower transport costs, lower oil, etc. are going to "kick in" in prices of companies and therefore in lower CPI. For example, most commodity prices already collapsed, some over -40%, but such an effect is still not in the CPI of August because companies are still selling goods produced, while prices were much higher.

Inflation - timing of bullwhip effect kicking into CPI numbers

- When such a bullwhip effect would “kick into” the CPI numbers? Some CIOs or economists say **February/March 2023;** others **still expect one year from now**. Finally, the asset manager Bridgewater explained that 60% of the CPI index (housing and labour wage) is moving slower; therefore, it will take longer to see the wished inflation targets of the FED.
- KTS tends to believe more in the analysis of Alpine Macro, whereby according to their model analyzing the PCE inflation, which is the inflation gauge that the FED cares about, inflation has peaked and will move down faster than anticipated.
- **Alpine Macro analyzed supply and demand side inflation, where the demand side inflation has already fallen to 1%, while the supply side is still high but falling.**
- The CIO of Alpine Marco, Mr Zhao adds according to their model, the PCE inflation will fall to 1% by the end of the following year, and the bond market seems to agree with our forward-looking assessment, as it is anticipating inflation to fall to around 2% one year out, supporting the conclusion of their model forecast. KTS would assert, equity markets tend to anticipate by 6-8 months (see Vontobel’s research on our weekly nr 25 on the 24th June 2022) such event.
- Finally, he says, this is why they think it’s **not the right time to be panicking about inflation.** He also adds that to have a **bad recession, you usually have to have a financial crisis, which means something in the system will have to break, which Alpine Macro does not see currently.** Mr. David Rubenstein, CEO of Carlyle Group, said in an interview with CNBC, that waiting for the market to bottom is a mistake and investors should buy now.
- KTS fully agrees with Alpine Macro, and for this reason, we keep our core asset allocation, even if we are suffering. But being investments in mega trends, we are confident to reach an above-average performance over 2-3 years. With the trading position (around 15%), we are trying to follow more technical analysis in order to generate some value added in a period of higher volatility.

Inflation - when equity market could turn?

• Analyzing the US fed funds and the CPI annualized rate, we can assert that FED rates are going direction 4%, meanwhile the CPI is falling at 4%.

• Adding that the economy is basically in recession and fundamental indicators are weak but not (yet) in a severe crisis, we would also expect, as the CIO of Alpine Macro, that we have **reached the peak of bad news from the side of the inflation and FED,** of course not from the side of company' earnings. But the **stock market is already discounting a mild recession**, and again, the sentiment is so extreme that the majority of the investment community is more speculating on a deep crisis rather than a stabilization.

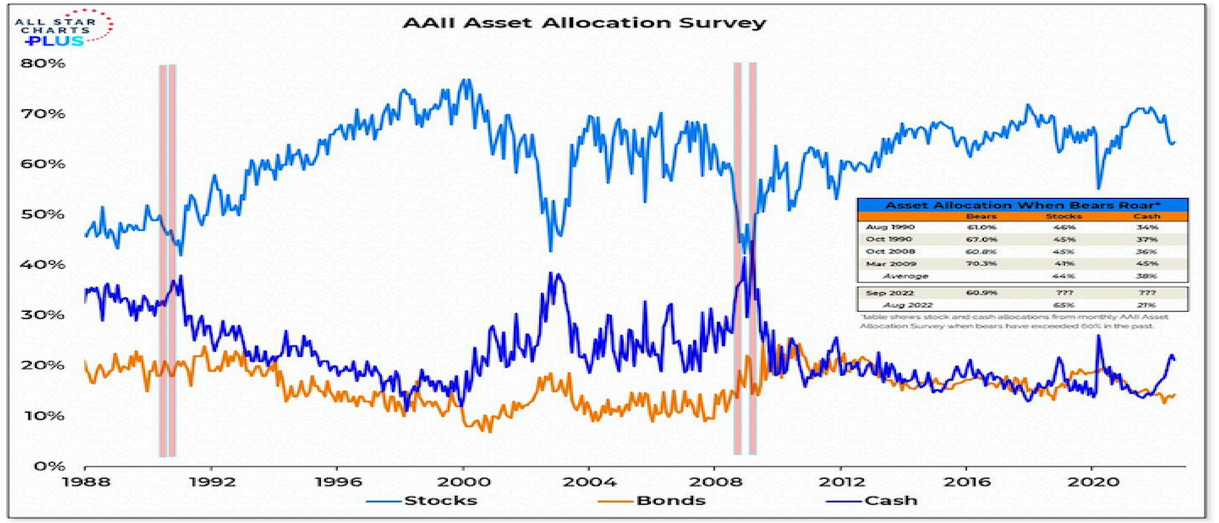
• Comparing to the year 2000, when most of the IT companies were only losing money, and corporate were highly leveraged, or the year 2008 & 2020, when the world just stopped; this time, we feel life is still normal, and we are not sensing a deep recession or crisis. As we saw last week in **Gallup's survey, "only" 14% of US citizens are seriously struggling with the high inflation,** causing a change in their life standards.

• For this reason, we do not see any reason to panic yet, so we remain patient.

• If we analyze some positions in our portfolio, trading **market cap < net cash**, we feel like the downside is limited because if such companies are sold off, major players are going to buy just "for free" smaller and attractive competitors. As we have recently seen, **not only we are not in a financial crisis having household, which lowered their indebtedness dramatically after the financial crisis, but the corporate sector and banks is in good shape and has the highest level of cash ever.** During 2000-2003 we had a corporate crisis, having all corporates in leverage. In 2008 we had a financial crisis, having banks, the heart of the economy, but also the US population, highly leveraged. **This is not the case now; therefore no reason to panic.**

Extreme depressed sentiment not in accordance with positioning

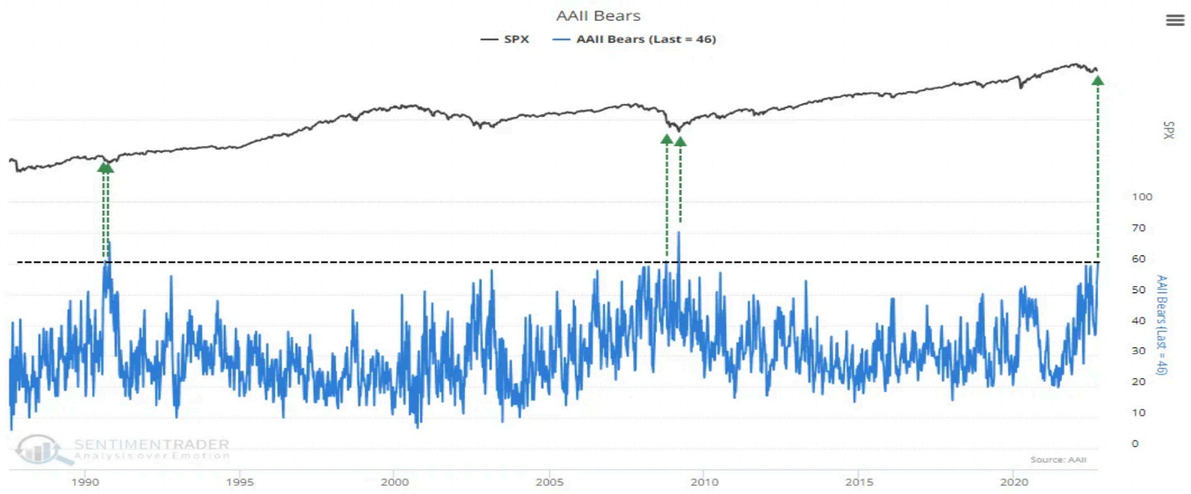
- Many market participants are still arguing that we have not seen any capitulation yet, because retailers are still strongly buying and **historically, the asset allocation in equity is too high compared to past capitulations.**
- Mr Baird argues in his blog either the sentiment gets more optimistic, or we will experience a capitulation if the market continues to correct.
- In addition, the Syz group argues that last week, we just experienced the **3rd highest equity inflow (USD 20bn +)**



Still 65% equity instead of 47% .Cash and bond allocation still too low.

	Net Flows ($, mm)	AUM ($, mm)	% of AUM
U.S. Equity	20,155.69	3,807,248.12	0.53%
International Equity	20.43	1,084,071.75	0.00%
U.S. Fixed Income	3,610.91	1,101,675.51	0.33%
International Fixed Income	70.80	137,956.24	0.05%
Commodities	-420.56	134,707.46	-0.31%
Currency	148.79	4,158.52	3.58%
Leveraged	34.15	45,354.52	0.08%
Inverse	1,260.82	26,894.10	4.69%
Asset Allocation	-22.64	16,501.73	-0.14%
Alternatives	113.59	8,456.33	1.34%
Total:	24,971.98	6,367,024.27	0.39%

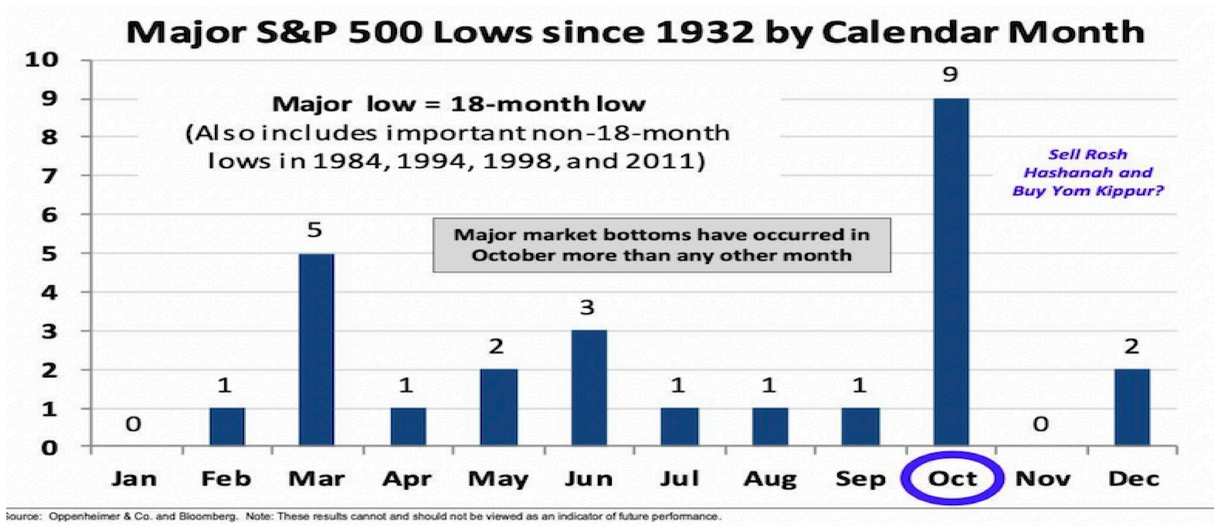
ETF weekly flows by asset class (Syz Group)



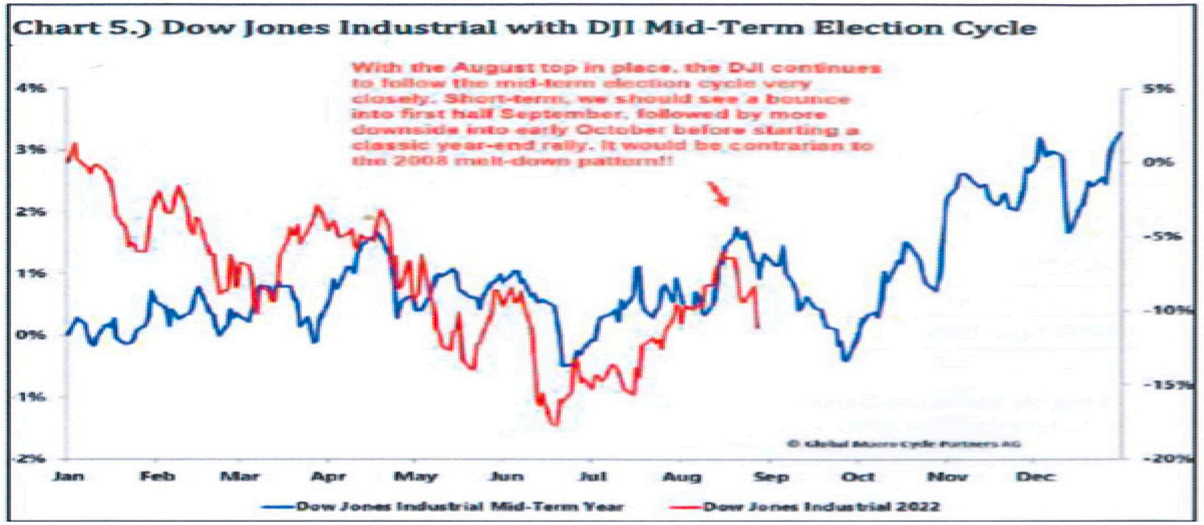
Most bearish reading since 2009 (source: Callum Thomas)

Seasonality charts

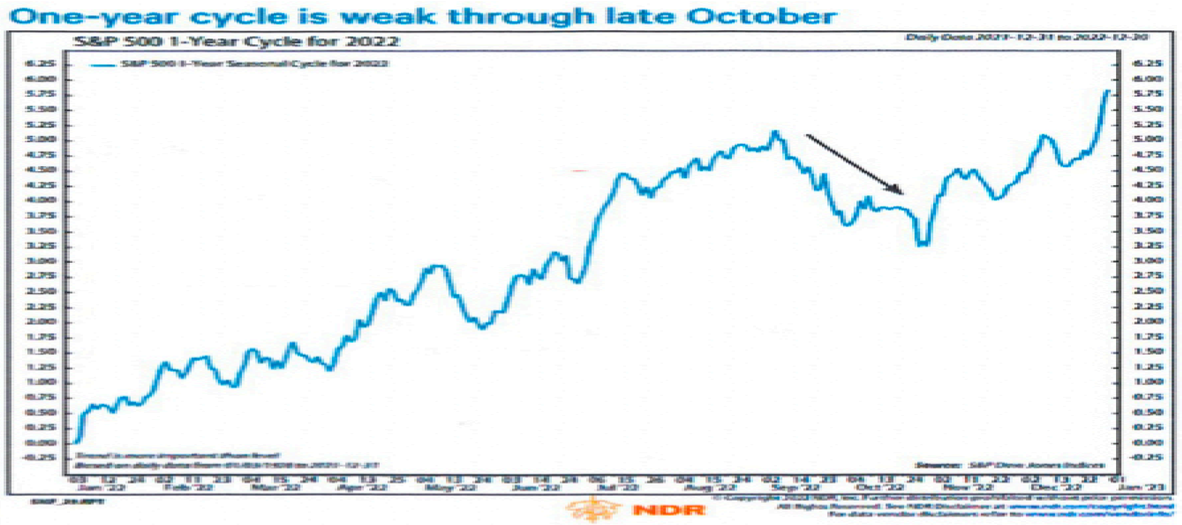
- We are including three chats, which are pointing out a possible equity market bottom could be built during October / beginning of November, which is also the high conviction of KTS, after US elections, professional investors will be under pressure to “improve” the disastrous performances YTD and therefore we could have a year end’s rally.
- Being a very important support, we could have the risk of a washout, but it would also mean for KTS, all the liquidity has to be invested.



Major market bottom in October? Source: Oppenheimer via Syz Group



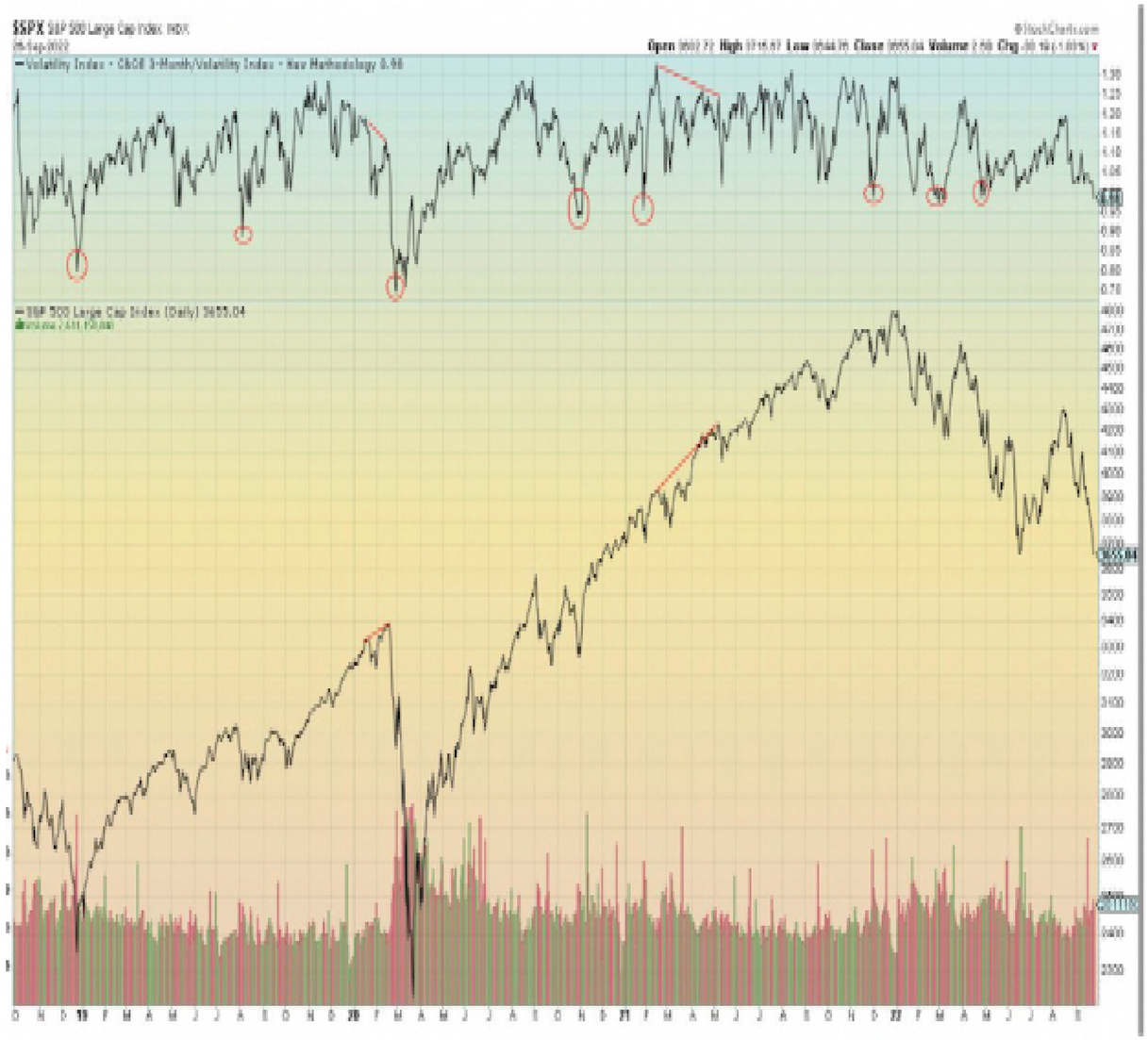
Mid term election cycle: beginning of November a year end’s rally? (Tramondo



Seasonal weakness in October (source NDR via Tramondo)

Volatility in backwardation

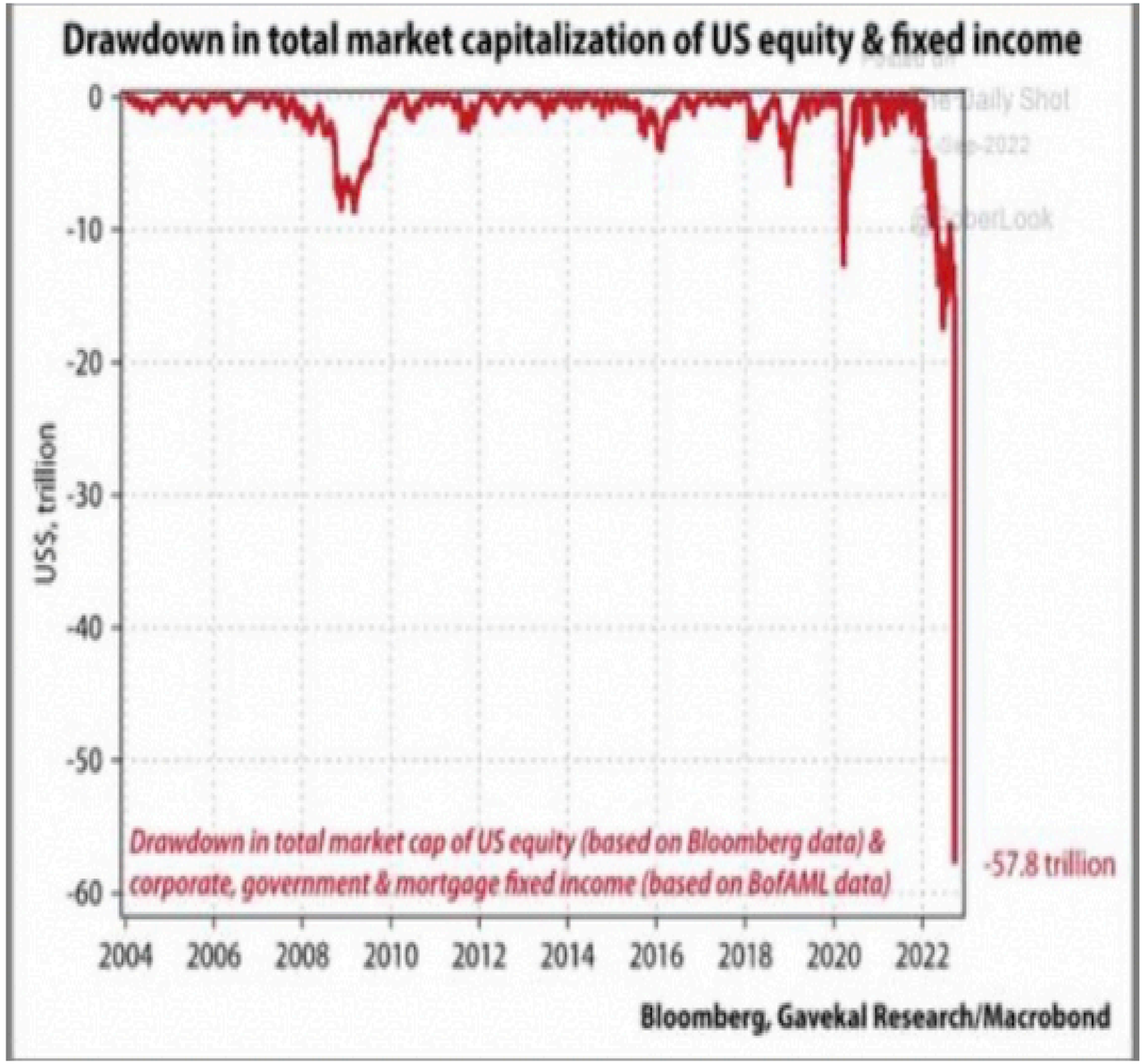
- We have two different interesting signals from the volatility, which point out the equity market is building a bottom.
- On the right-hand side chart, courtesy Mr Froio, we can analyze the **VxV/VIX ratio, which fell below one** and therefore shows the short-term volatility (VIX, one month) is priced higher than the 3-months (VxV). **Historically when the ratio falls below 1, it marks market lows.**
- On the other hand (no chart attached), our expert on the volatility model, Mr Lukof of ABR New York, said that the **1-month SPX realized volatility has flatlined at 23, in contrast to the VIX (implied volatility) at 32-33.** Therefore the volatility **risk premium (VRP)**, which is VIX - 1-month realized volatility, **has been in the top 5-10% of all historical observations since 1990.**
- Historically, in the **1-3 months following such a large VRP, S&P 500 returns have actually been positive on average.** Mr Lukof never does market forecasts, but he analyzes extreme values in statistics, and therefore such assertion is a rare event which normally comes true.



3 months VxV in backwardation (source Mr. Froio)

Lost in total market capitalization in US

- **57.8 trillion USD is the market cap of US equities and fixed income lost during 2022.** Some market participants argue that **in 70 years of treasury market, 2022 is the worst by far.**
- Other investors are arguing the **QT has already been done, and the FED has to think again about which monetary policy tone wants to use going forward.** In addition, investors argue that having any country worldwide with its own internal issues and busy supporting their own currencies, most of the world is selling US T-bills in order to buy their own currencies. Therefore only the FED can step into the bond market and buy the gap, which is QE and not QT.
- What we can analyze in the chart on our right-hand side is the magnitude of the drawdown compared to the past. We can notice that 2008 & 2020 losses were nothing in comparison.
- Being the wealth destruction mostly in bonds, this is impacting especially pension funds, as previously explained.



Picture Title

Italy

- In Italy, as we know, Giorgia Meloni should become the first female prime minister and will have the support of the majority in Parliament (lower and upper House), though a far-right coalition.
- Foreign media are questioning if this should be an alarming sign for the EU.
- Apparently, the participation in elections from Italian citizens was the lowest historically.
- Of course, everyone expects the new government to go on a confrontational path with Europe, and therefore EU's von der Leyen already warned, "if things go in a difficult direction, we have tools". We let ourselves surprise, to be honest.
- According to the blog of Peccatiello, Ms Meloni's most immediate actions could be to **cap Italian households' and corporate energy bills at pretty low levels and to proceed with further expansionary fiscal policies in a similar fashion to what is happening in the UK.** The dilemma is, Italy is not in the position to do so, having an excessive deficit imbalance and therefore, under the new ECB's program TPI purchases, Italy would not be able to launch such initiatives.
- We have a small exposure via our best-in-class value fund Classic global to the Italian companies Buzzi, Unipol and Anima.
- According to the blog of Mr Kirch, the Italian stock market is now trading at book value, and for this reason, it is not a coincidence that our value manager has at least three positions in the Italian equity market.
- An additional issue could be for such Italian companies with the **HQ in Holland** in order to optimize taxes. Amongst such companies, there are also **ENI and Enel**, where the Italian government also have a 25% participation. Some market participants are pointing out, if it makes sense, to launch stimulus packages in order to support Italian citizens in the energy crisis, but 2/3 of the profit of ENI and Enel are not taxes in Italy.

Italy - powerful shift in the European balance

- According to the magazine The Economist, Europe is experiencing a **powerful shift in balance towards the nationalist hard right,** having the population fed up with the failures of the established parties and therefore plumping for the untried and untested.
- Back on the French election, also Ms Le Pen took 41% of the vote, and in Hungary, we have the populist prime minister, Mr Orban.
- In addition, we would dare to say, in Germany, the green party definitely created a real mess, and there is the risk in the next election that the AfD (alternative for Germany) could potentially win part of the population, which wanted a change and in the hand of the green party, got the electricity bill 5 times higher. Elections in Germany are in August 2025; the green party can still rescue itself?!
- As we argued back on French elections, **nationalism is a real threat to Europe,** being the consequence of general discontent. Therefore we have to take such matter of fact into our investment process. For this reason, we still believe **gold and CHF as possible safe havens, and in any rebound of equity markets combined with falling volatility, we are willing to invest capital into put options as a hedge for any geopolitical risk, such as the increasing nationalism in Europe.**

General news

- Mr Peccatiello says “thoughts and prayers to people who took a mortgage to buy real estate in the Metaverse”. We can not believe it happened, but even if it were the case, we do not believe too many did. But, such a reality is the final proof that one year ago, the world just had too much money in its hand, and it is a sign we had a bubble in such a segment, which is definitely comparable to the IT bubble back in the year 2000.
- According to the newspaper Barron, **only 40% of active managers of nearly 3000 active funds could outperform their average passive peer over the last 12 months.** A rate which is below the 47% of last year. KTS agrees, and for this reason, we are going to trade around 15% of the Optima dynamic portfolio with the passive QQQ US ETF, and we sold the fund positions, which disappointed us during the last two years.
- Gold has just broken out in GBP, but according to Bloomberg, hedge funds have the most bearish positioning in almost four years. Most probably are trying to “put” pressure on the crucial support at around 1’650 USD.
- Market participants, especially from the “gold corner”, are arguing that the country, USA, which printed most of the money, has the stronger currency and therefore asking how sustainable it is, especially now, with the world split, and therefore many countries are not going to buy US T-bills anymore.

General news Asia

- As explained recently and as also mentioned in the blog of our expert in Vietnam, the asset manager Turicum Investment, Vietnam is emerging as a winner from the era of de globalisation. According to Turicum, in 2019, Vietnam produced nearly half of the USD 31 billion worth of American imports that moved from China to other low-cost Asian countries. Many big firms are turning to Vietnam due to geopolitical tensions between the superpowers China and America, but also China's onerous pandemic restrictions and rising labour costs.

Performance balanced portfolio

- According to market participants, the year 2022 YTD has become the **2nd worst year in the history for a balanced portfolio, after 1931, with a YTD performance of -19.3% or probably more, being the statistic already 1 week old.**
- The **balanced portfolio of KTS is around -7% in EUR**, GBP even better, and CHF and USD, of course, with higher negative performances because of FX (the USD is around 6% performance difference).
- We are very proud of the result, and it is a proof that our strategy to limit the downside works.

60/40 Portfolio: S&P 500/US 10-Year Treasury (Total Returns, 1928 - 2022)

Year	Return	Year	Return	Year	Return	Year	Return	Year	Return
1928	26.6%	1947	3.5%	1966	-4.8%	1985	29.0%	2004	8.2%
1929	-3.3%	1948	4.2%	1967	13.6%	1986	20.8%	2005	4.0%
1930	-13.3%	1949	12.8%	1968	7.8%	1987	1.5%	2006	10.2%
1931	-27.3%	1950	18.7%	1969	-7.0%	1988	13.2%	2007	7.4%
1932	-1.7%	1951	14.1%	1970	8.8%	1989	26.0%	2008	-13.9%
1933	30.7%	1952	11.8%	1971	12.4%	1990	0.7%	2009	11.1%
1934	2.5%	1953	0.9%	1972	12.4%	1991	24.1%	2010	12.3%
1935	29.8%	1954	32.9%	1973	-7.1%	1992	8.2%	2011	7.7%
1936	21.2%	1955	19.0%	1974	-14.7%	1993	11.7%	2012	10.7%
1937	-20.7%	1956	3.6%	1975	23.6%	1994	-2.4%	2013	15.6%
1938	19.3%	1957	-3.6%	1976	20.7%	1995	31.7%	2014	12.4%
1939	1.1%	1958	25.4%	1977	-3.7%	1996	14.2%	2015	1.3%
1940	-4.2%	1959	6.2%	1978	3.6%	1997	23.8%	2016	7.3%
1941	-8.5%	1960	4.9%	1979	11.4%	1998	23.0%	2017	14.1%
1942	12.4%	1961	16.8%	1980	17.8%	1999	9.2%	2018	-2.5%
1943	16.0%	1962	-3.0%	1981	0.5%	2000	1.2%	2019	22.6%
1944	12.4%	1963	14.2%	1982	25.4%	2001	-4.9%	2020	15.3%
1945	23.0%	1964	11.3%	1983	14.7%	2002	-7.1%	2021	15.3%
1946	-3.8%	1965	7.7%	1984	9.2%	2003	17.2%	2022*	-19.3%

Source: CharlieBilello, via Syz group

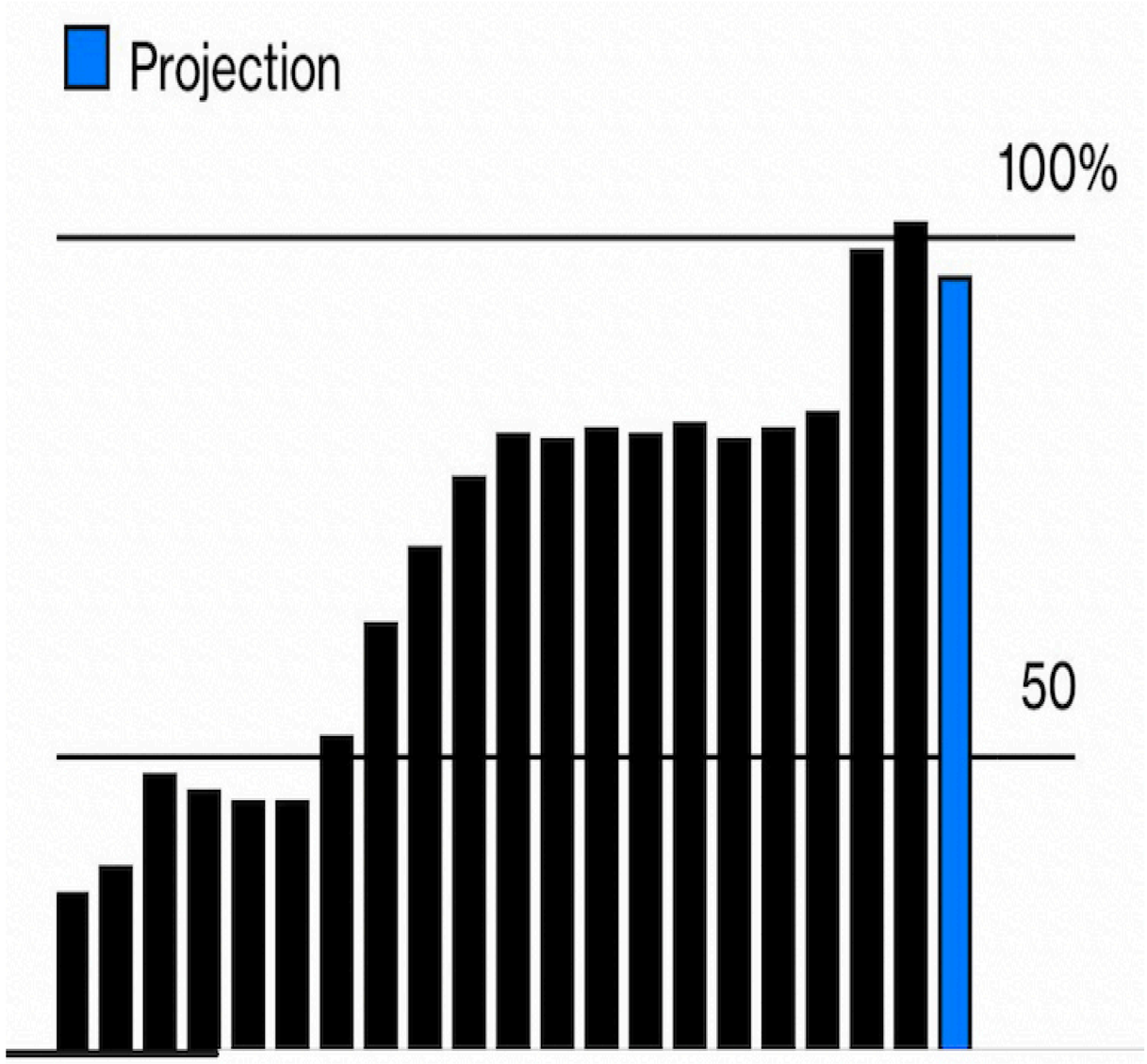
S&P 500 year-end targets

- The right-end chart shows, once again, how all S&P 500 forecasts from economists have zero credibility.
- We like the assertion of Mr Zhao in an interview with the magazine The Market, where he says, actually nobody knows what the stocks are going to do tomorrow, next week or next month.
- But if you analyze the **extreme bearishness and therefore underweighting in equities, combined with the peak of inflation and the monetary policy, the instinct would tell you should bet on the other side.**

Something went wrong (source: Syz group)

US public debt as a share of GDP is falling

- On the right-hand chart, courtesy of Mr. Rowles, we can analyze how the **U.S. debt vs GDP is falling** due to negative real interest rates, even with the ongoing substantial stimulus packages of Biden's administration.
- This is the result of **higher inflation than nominal rates** and the only way western countries can reduce the tremendous indebtedness.
- Therefore, in KTS's opinion, **it would not make any sense for the FED and the U.S. government to increase nominal rates over inflation** and have real positive yields because otherwise, it would stop the so-called **"financial repression", whereas, with high inflation and economic growth, the government is reducing in a relative value (not absolute) the high indebtedness.**
- We would like to mention again that **the U.S. already reduced the debt vs GDP substantially after WWII with high inflation and economic growth.**



Source: Mr. Rowles

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