KTS
CAPITAL
MANAGEMENT

KTS weekly update Nr. 45

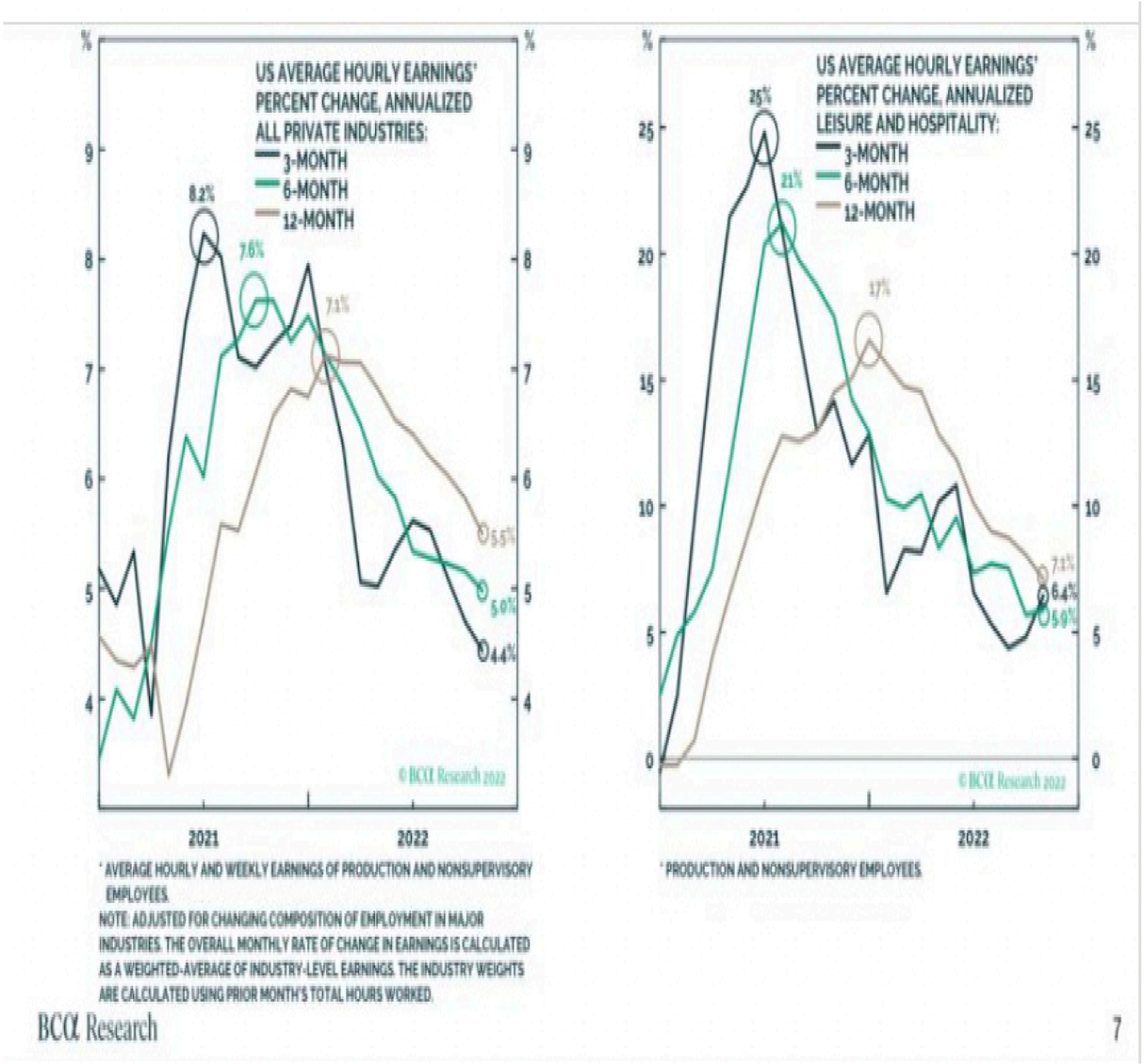
The 11th of November 2022

US CPI, annualized we are now around 3-4% (FED's target is 2%)

- **Inflation is finally coming down and for real:** in fact, we are moving at around 3-4% annualized. The target of the FED is 2%
- The equity market's reaction was as predicted since long time: **a pure short squeeze!** (See technical analysis: bullish breakaway gap).
- Of course, year to year we are still 7.7% (expected was 7.9% and in September was still at 8.2%), but the most important is the fact, that the **core inflation is also down** (6.3% vs exp 6.5%). So inflation is finally falling for goods, services and shelters.
- The big **dilemma going forward is still energy.** In fact, US oil reserves are substantially falling, and from December we will have the new sanctions on Russian oil with a cap on the oil price. The logic would call for a lower oil price; in reality, Russia will produce less and therefore a lower supply in such a fragile imbalance between supply and demand is most probably going to cause an increase of the price. For the moment the oil price is not giving any sign of a breakout on the upside.
- On the other hand, Mr. Larsen is arguing that the next step, will be when investors will understand that **inflation is coming finally down due to a recession** (as per our recent fundamental analysis)**.** The only hope for the moment is that the FED comes to the pivot point before the economy is going to collapse. But we are still depending on the strength in the job market, which is translated into wage inflation. As argued, reading the news, **most of companies are really starting to layoff staff massively** and therefore, we should have soon positive news also from this corner.
- A typical example of the reverse effect in the economy, is the latest announcement, that the global shipping industry is facing a new problem, namely, **there are too many containers as a consequence of the decline in global consumer demand** and falling economy activities.

On a 3-month annualized basis, inflation is down to 4.4%

- The right-hand chart, courtesy Mr. Berezin / BCA Research, gives an idea of where the inflation stands vs FED's target.
- On a 3-month annualized rate, inflation in core services, ex-shelter, **came down from 8% to 4.4%.**
- The comparison is based on their estimate of the composition-adjusted change in average hourly earnings for production and non supervisory workers.
- Mr. Berezin argues, that **wage growth in the highly cyclical leisure and hospitality sector has tumbled even more**, arguing that it is a sure sign, that **labor demand is shrinking**, but thanks to the elevated job openings, this has not yet translated into sharply higher unemployment.
- **They closed the short on the 10-year Treasury and went long TLT US. KTS went long 3 weeks ago high yields and European CLOs for the first time in 6 years.**



Source. BCA research

US Midterm elections

- The Republicans should win back the House of Representatives, but not the Senate. In the Senate we have 48 vs 48 seats (51 needed for the majority), meanwhile on the House the republicans hold 199 seats vs 178 for the Democrats (218 needed for a majority).
- It looks like that the **final results might not be known for weeks and in Georgia there is the possibility of run-off elections in December.**
- With such divided Congress, U.S. is going to have a **gridlock situation**, **which is a good news for equity markets**, because it will be difficult for Democrats to pass new legislations and especially increase spending. **Republicans will force more bipartisan compromise in areas such as defense, support for Ukraine and reducing supply chain dependence on China.**
- According to Lombard Odier, there is already broad agreement on the latter, and they do not expect significant changes in taxes, environmental legislation or technology firm regulation following these elections.
- A divided government could increase the risk of government shutdowns on the 16th December, but honestly speaking, we have experienced enough such situation, which at the end of the day will be solved with...increasing budget. Anyway, there is no other solution, as we always argued in the past, the repayment of the high Western indebtedness is via financial repression (in absolute number the debt is not falling, only as percentage vs GDP, thanks to higher inflation than nominal yield, translated in real negative yields and economic growth).

Macro

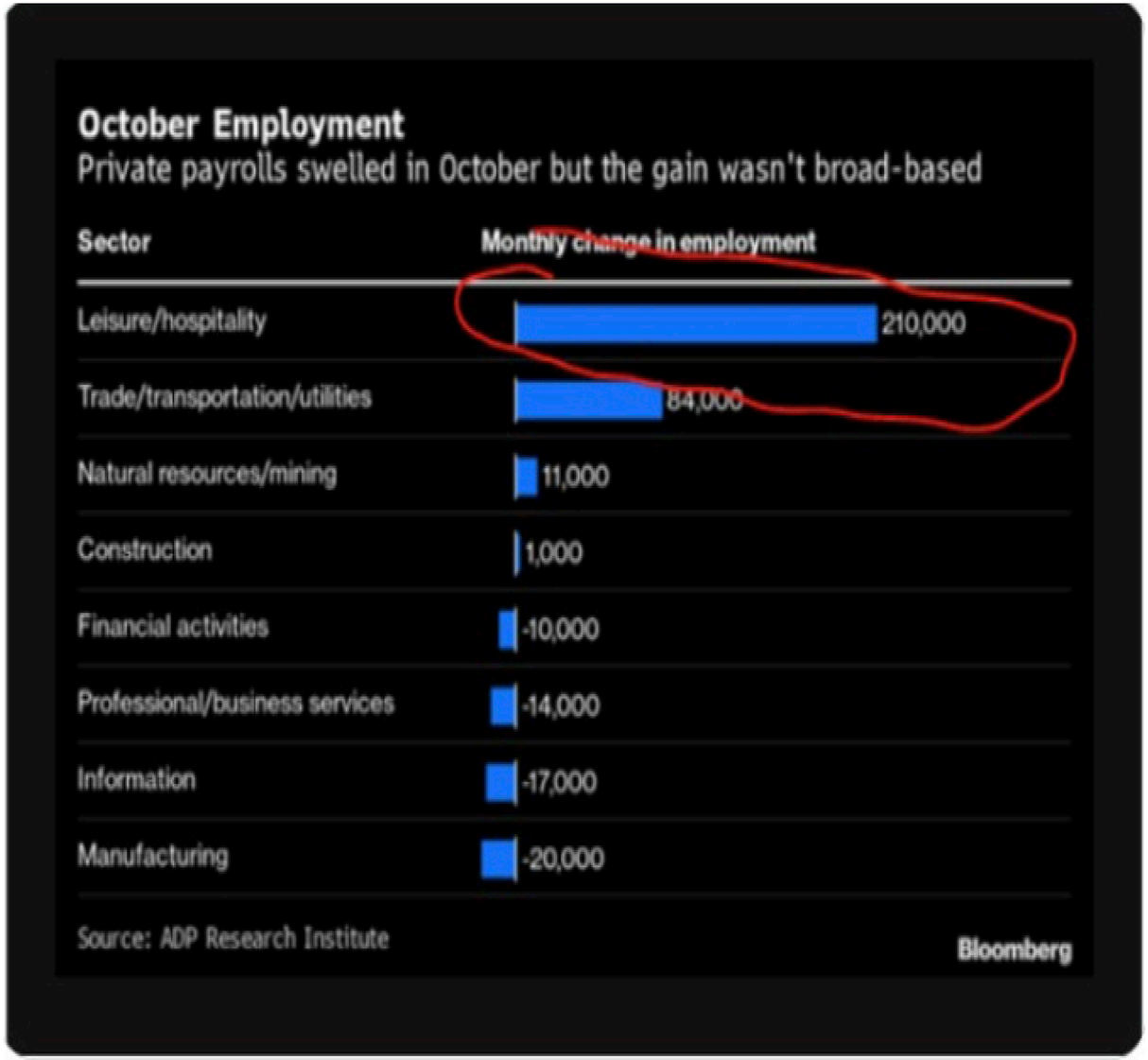
- The **Bank of Canada has started focusing on more timely measures of inflation, such as 3-month data** and, in the Q3, the **3-month annualized CPI was negative 0.4% , therefore below the central bank's 1% to 3% target.** Market participants are rightly pointing out that the fact that the central bank is now paying attention to these measures too, means there's a lower probability of over-tightening relative to what's needed to control price pressures.

Macro Europe

- During the pandemic, oil tankers were waiting on the open sea to be delivered with higher oil prices. This is what is happening right now on the Spanish coast. **30 LNG-tankers (worldwide there is a total of 700 LNG-tankers) are waiting for higher natural gas prices**. Those tankers were meant to be delivered to Asian countries, but Europe bid are higher. Apparently the value of the natural gas on the tankers equals from USD 2 to 3.4 billion.
- Meanwhile various power plants in France are scheduled to return to operations ahead of the winter peak and therefore market participants are asserting, that the energy supply situation in Europe has considerably improved.

US Job reporting

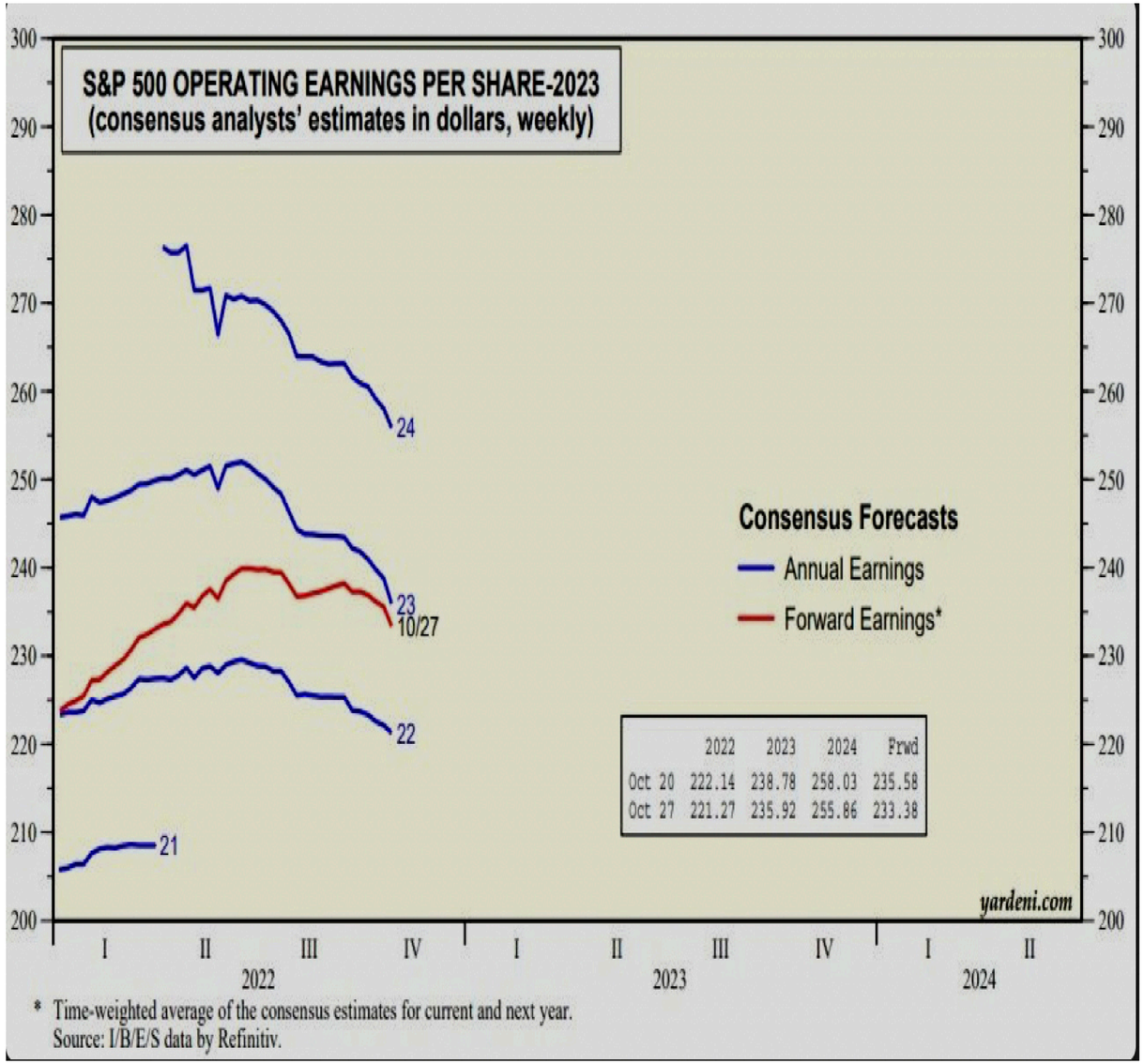
- Mr. Roberts argues that the FED is making a mistake.
- Employment has appeared to be strong, however is only the **lowest wage paying and highly temporary, such Leisure/ hospitality or transportation.**
- The **big bulk of the economy is actually shedding jobs.**
- Without mentioning the big wave of layoffs performed by tech companies, startups or venture capital firms.
- Examples are: Uber, airbnb, Booking.com, Zillow, Bolt, Snap, Lyft, etc.
- Also Meta got the message of the market and starts laying off thousands of employees this week (11’000), lowering costs in order to increase profitability. Meta stock rallied +6.5% on the news.



Source: Mr. Lnace Roberts

Hard landing? Earnings and valuation

- Last week, we have analyzed, how earnings forecasts from analysts are falling.
- S&P 500 Index ex energy reported a -5.1% EPS growth rate and now expectations fell to USD 228 from highs USD 240 in June 2022.
- Mr. Yardeni is showing that the general consensus for 2022 at USD 221 S&P 500 EPS, **2023 USD 236 and 2024 USD 256** as per right-hand chart.
- More bearish forecasts, based on a hard landing, are for USD 200 (or even lower) over the next 6-12 months.
- **Based on a P/E of 15x, the target for the S&P 500 Index would be at 3'000 (or lower).**
- **Mr. Yardeni assign a 60% probability to a soft landing and a 40% probability to a hard landing.**
- KTS believes in a relief year end's rally, but analyzing fundamental data, we are still not safe and therefore we will reduce positions into market's strengths.



S&P 500 Index for 2023 a USD 236 , at 15x P/E = 3'540 points

Hard landing? Earnings and valuation, still no bottom yet?

- We would like to mention another very reliable source of research, which argues that they also expect **USD 235 for 2023, but they calculate the target for the S&P 500 Index with a P/E of 18x to 20x and therefore expect new highs for the index mid 2023 with 4'700 points.**
- **Bridgewater** is arguing in its latest research, that **we still do not have the conditions for a market bottom yet.** Comparing the current bear market to past inflation-driven equity market bottoms, following positive conditions are still missing:
  - Inflation is still high, **especially wage growth**, and the economy remains relatively strong, such that a FED easing does not seem likely. Currently the FED has only indicated that it will slow its tightening. Analyzing past similar periods, equity bottoms are typically accompanied by a significant period of easing.
  - Despite the drop in equity prices, long-term equity expected returns still look poor compared to bond and cash, which means, for investors it is still too early to have the right incentive to jump back in.
  - **Therefore, the FED will likely need to see more weakness, and investors lower prices, before equities find a floor and begin a sustainable climb.**

  - On wage inflation, also Mr. Yardeni is arguing, analyzing the data out of the National Federation of Independent Business (NFIB), which is the **survey of small business owners, that companies in general are still struggling to find workers and to keep them**. In any case, their labor costs are rising rapidly and forcing them to raise their prices. Basically they have been sucked into the economy's wage-price spiral.

Hard landing? Earnings and valuation, still high wage inflation

- During October 2022, **32% of small business owners said, that they are planning to raise worker compensation**. This is up from 23% during September. Also in the October NFIB survey, 34% said that they are planning on raising their average selling prices (we are not including the charts). 46% of small business owners have still job openings and therefore very highly correlated to the JOLTS job openings series and the supply of jobs exceeds the demand for jobs by 4.6 million, therefore 1.8 job openings for each unemployed worker. Of course those are bad news for the FED, which would like to see the JOLTS job openings to drop and according to the NFIB survey is not going to happen very soon.
- **This is the reason why Mr. Yardeni gives a 60/40 probability on soft vs hard landing.**
- KTS does not have internal tools to calculate any trend and we can only rely on official news from different reliable sources. We would like to point out, that by reading the news of the **recent multiple layoffs, it sounds to us in contradiction to the NFIB survey.**
- In addition, we would like to mention again the blog of Mr. Larsen (weekly nr. 42 on the 21st October 2022 slide nr. 20), whereby according to his research, the number of job openings is in reality much lower than headline number, due to the work-from-home trend seen through the pandemic, companies have to post a job opening for the same job in various locations to ensure that the talent pool is exploited, therefore a **lot of job openings currently posted, are double-counting.**

Hard landing? Earnings and valuation, hard stop loss at lows of 12th October

- We have now **many companies halting recruitment and starting massive layoffs (see META)** and therefore, we will see a sharp increase in unemployment, which going to brake wage inflation and most probably, if there would have been a double counting, in 2023 would turn out double on the opposite side!
- The major dilemma is whether **higher unemployment and lower wage inflation would also mean lower consumption, which is 2/3 of US GDP and is already using full credit card limits.**
- **Not nice; therefore, we have a hard stop loss, now new on the lows of 10th November (bullish breakaway gap) from the lows of the 12th October 2022.** We believe in a year's end rally, equity market are extremely depressed, but reality is still telling us that the economy is going to fall into recession and stay invested only in the hope of the FED reacting, is not enough for being "all in", at least not with a "hard stop loss".

Deteriorating corporate cash flows points to job losses in 2023

- The below chart of Mr. Jeffrey Kleintop, CIO Charles Schwab, is pointing out, how companies are going to layoff staff very soon.
- The cash flow measured by overnight bank deposits of non-financial corporations turned negative in Europe on a year-on-year basis in September. Basically, for now, companies are cutting costs by reducing the volume of inputs.
- Soon, they may also begin to cut jobs.

Source: Mr. Kleintop

Past inflation-driven equity market bottoms

- Historical comparisons show that inflation is typically a lagging indicator, and equities rallies have typically begun when inflation is still high.
- Instead, **rallies begin when central banks see meaningful economic weakness and shift into gear to ease to stop the downturn and when equity markets have gone through a meaningful repricing.**

Inflation is usually a lagging indicator (still high when equities turn); other factors matter more

Typically, there are sufficient signs the economy is slowing; today, the economy remains strong

Fed easing is underway across cases (but alone isn't sufficient to cause a turn); today, Fed is only slowing

Long-term equity expected returns are usually elevated; today, weakness is not priced in

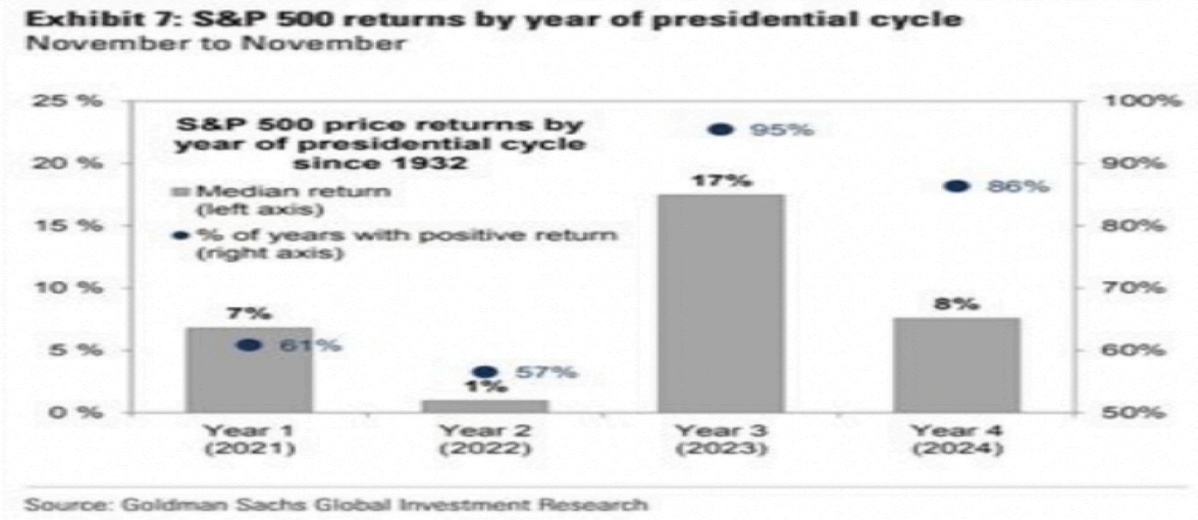
Inflationary US Equity Bear Markets

US Equity Trough	Inflation High?	Economic Weakness?	Fed Easing Underway?	Long-Term Equity Expected Excess Returns?
Sep-66	Around Target	Weak Growth	Easing	Low
Jun-70	Very High	Weak Growth/ High Unemployment	Easing	Moderate
Sep-74	Very High	Weak Growth/ High Unemployment	Easing	High
Jul-82	Very High	Weak Growth/ High Unemployment	Easing	High
Jul-84	High	High Unemployment	Easing	High
Sep-90	Very High	Weak Growth/ High Unemployment	Easing	Moderate
Sep-02	Around Target	Weak Growth/ High Unemployment	Easing	High
Today	Very High	Moderating/ Tight Levels	Slowing Tightening	Low

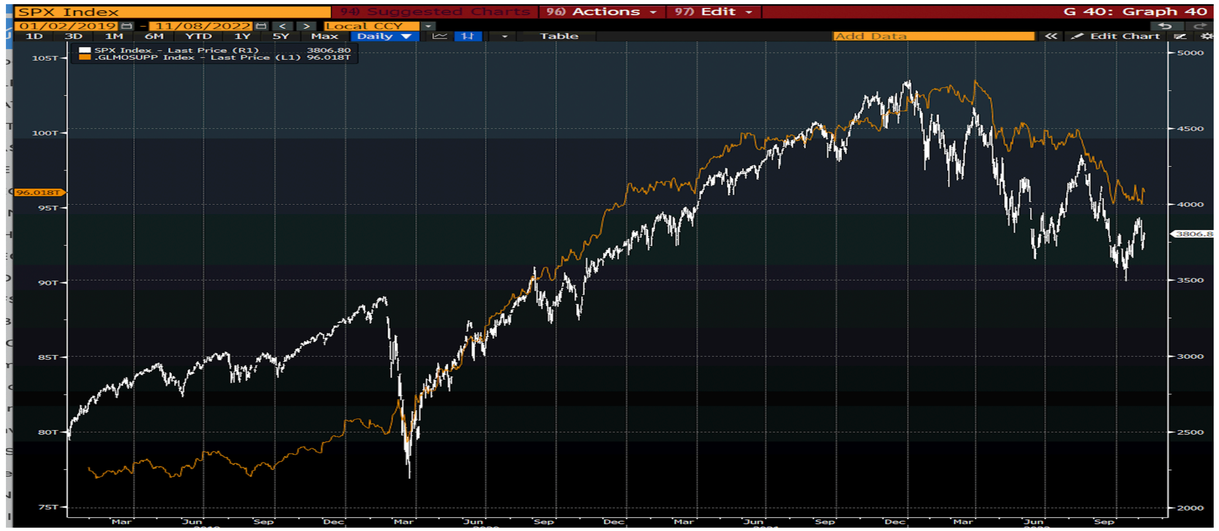
Source: Bridgewater

3rd year of the term good for equity, BUT money supply is the driver

- Goldman Sachs historical data shows that the **3rd year of the term has been the most promising for equity investors, generating a median return of 17% with 95% of the periods showing a positive return.**
- But the **real driver is money supply**. The FED started a QT with USD 90 billion per month, but US Treasury pumped USD 165 billion into the economy since the start of October (see chart below). The third chart shows the long term high correlation between equity markets and money supply.



3rd year of the presidential term most promising for equity (source GS)



FED: hawkish but not withdrawing liquidity! Therefore equity resilient

Money supply is the real driver of equity and bond markets

Green transition

- With the opening in Egypt of the 27th annual U.N. Climate talks, also so-called COP27, and most probably with all the governments reaffirming their commitments to the global fight against climate change, we give a refresh on our investments in the space of the “green transition”.
- KTS is invested into the private equity **Rimac-Bugatti automobili**, in our best-in-class fund **Bakersteel Electrum**, via our **energy expert Renaud into 2 baskets:** oil&gas focused also in companies, which are improving their ESG rating and into the Long/short green energy.
- In addition, KTS is still invested in special situations like **Gevo, Nevada copper, ZincX and others.**
- We would like to remind a few weekly reports on the subject:
  - Weekly nr 8 on the 25 Feb 2022: Geopolitical tensions: long term repercussions: green transition very important for Europe
  - Weekly nr. 9 on the 3rd March 22: Lithium worldwide production by country
  - Weekly nr. 10 on the 11 March 22: medium and longer term repercussions on the global economy: increase independency from traditional energy sources and therefore the alternative energy sector is gaining momentum.
  - Weekly nr. 26 on the 1st July 22: mega trend E-mobility.
  - Weekly nr. 34 on the 26th August 22: European gas and energy crisis
  - Weekly nr. 35 on the 6th Sept 22: Economic war + The world needs a super grid
  - Weekly nr. 38 on the 23th Sept 22: the green transition dependency: the most important commodities for the green transition are processed in China. Weekly 40 (7.10.2022): geopolitics - European energy vulnerability=mega trend alternative energy

Specialty metals

- We are invested into our best-in-class fund **Bakersteel Electrum** in order to participate to the tremendous upside potential in the space of specialty metals, but with 1/3 also into precious metal, in order to reduce volatility. We do not have to forget, that **silver** is also a pillar for the green transition (solar panels, the best chart on silver is slide 4 on weekly nr 3 21 Jan 2022).
- As we all know, Electric vehicles will drive the demand for metals. According to Bloomberg, Nickel and Aluminum are going to experience the highest increases in demand, followed by Phosphorus, Iron, Copper, Graphite, Lithium, Cobalt and Manganese.
- According to Benchmark Mineral Intelligence, the world will need 300 more mines of lithium, nickel, cobalt, and other metals to keep up with the volumes of demand expected by 2035. **The main problem is not reserves, but production.**
- Our best-in-class fund Bakersteel argues, that efforts to reduce emissions and achieve net zero will be the core driver of many commodity prices over years ahead. The historic levels of spending which must be undertaken will have a particularly transformative impact on the markets for “future facing” speciality metals needed for electrification, renewable energy and broader green technologies.
- Mining is a chronically under invested sector, which now requires a super cycle of capital over the coming decades to facilitate the green energy transition.
- An example is Congo, which is one of the few places in the world, where mining is booming due to copper and cobalt, which are essential to our electrified future. But trucks are in the queues on the border Congo/Zambia over 30 miles, due to corruption, and given that driving a truck with precious minerals is so dangerous in South Africa, companies will only allow their drivers to do it in a convoy with armed security forces. Therefore, for our green transition, there is still a lot of work to do.

Put/Call premium is getting out of hand

- We mentioned last week, how the put premium is getting well too expensive.
- On the right-hand chart we can notice the magnitude of the move and how at the moment is **2.5 standard deviations.**
- Normally at 2.5 standard deviations the move should be so stretched, then eventually it will normalize.
- Market participants were arguing before the 10th November, US CPI could be finally a reason of a short squeeze. This is what has exactly happened.

Source: Game of Trades via Mr. Larsen

Technical analysis - Nasdaq 100 Index (QQQ US)

- Due to lower US CPI numbers, the Index experienced a significant **bullish breakaways gap.**
- **Next target is the 200d moving average,** which coincides also with the downtrend channel's line. At this level, traders can take some profit. **Only a breakout of USD 336 would mean the start of a new bull market.**
- Meanwhile, we **move up our stop loss at the lows of the 10th November 2022: USD 273.85**

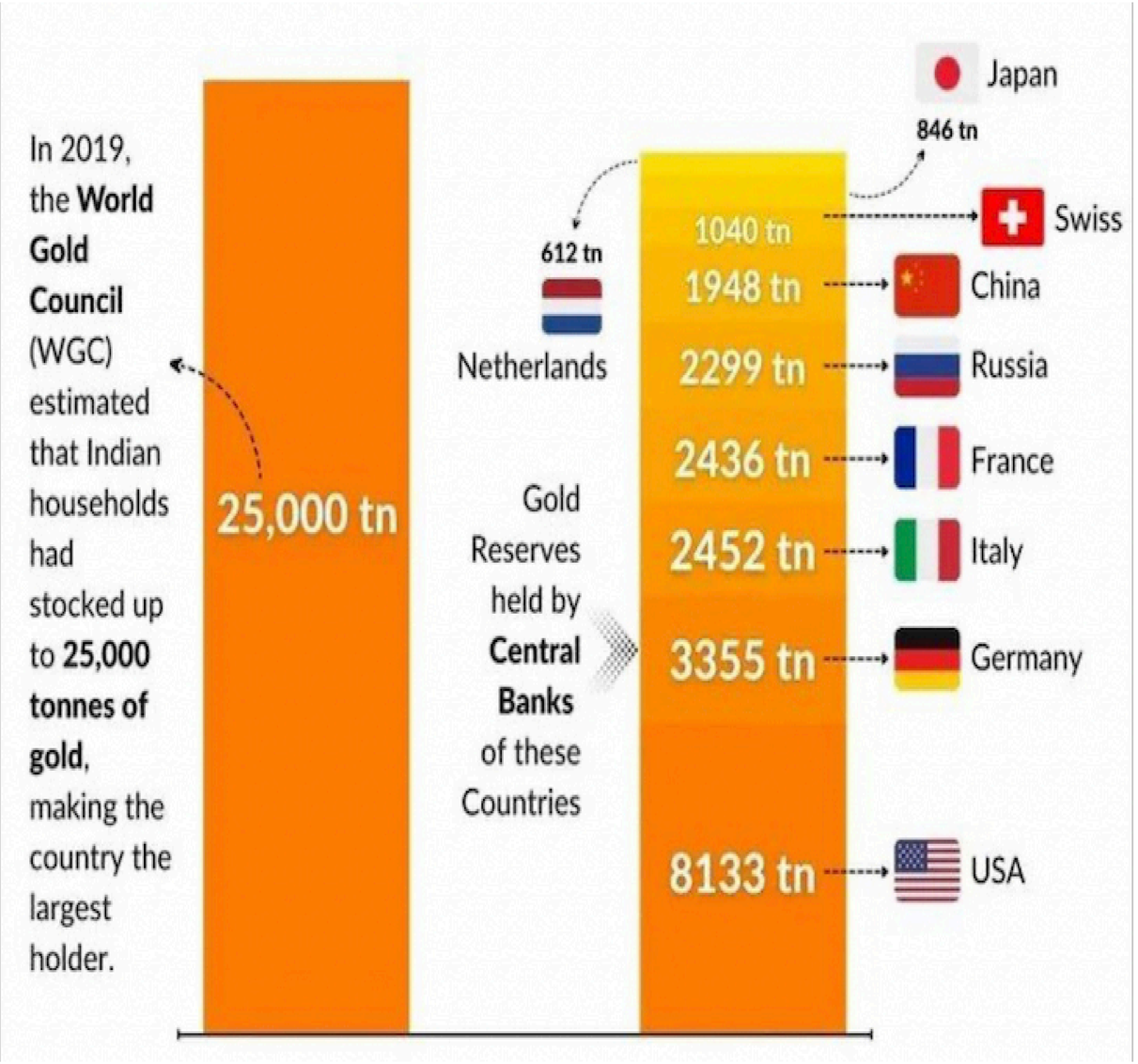
Breakaway gap = new stop loss the lows of the 10th November 2022. New bull market: only over USD 336

Gold miners are extremely attractive

- It is finally happening; **Newmont is now paying more dividends than any other time in 42 years. In fact, 6%** is the highest and during the 80' Newmont was paying 5.8% and in the boom of 2011 5.2%, thereafter we all know, gold mines started to "through out" money from the window with insane acquisition of Junior miners at insane valuations. It should not be the same this time and therefore miners are really cheap and attractive.
- **Barrick Gold is trading at 10% free-cash-flow yield.** According to statistic of Mr. Costa, such valuations happened only in March 2020 and December 2015 and both times proved to be a great buying opportunity.
- We feel comfortable with our investments in the space, via our best-in-class funds AMG Gold - Mines & Metals and Bakersteel Electrum.
- **Gold is breaking out the resistance of USD 1'737** due to lower CPI numbers and is ready to rally further.

Indian holds gold more than anyone together

- A picture is worth a thousand words.
- **The right-hand chart shows how Indian households are holding 25k tonnes of gold, making the country the largest holder than the top 10 central banks worldwide.**



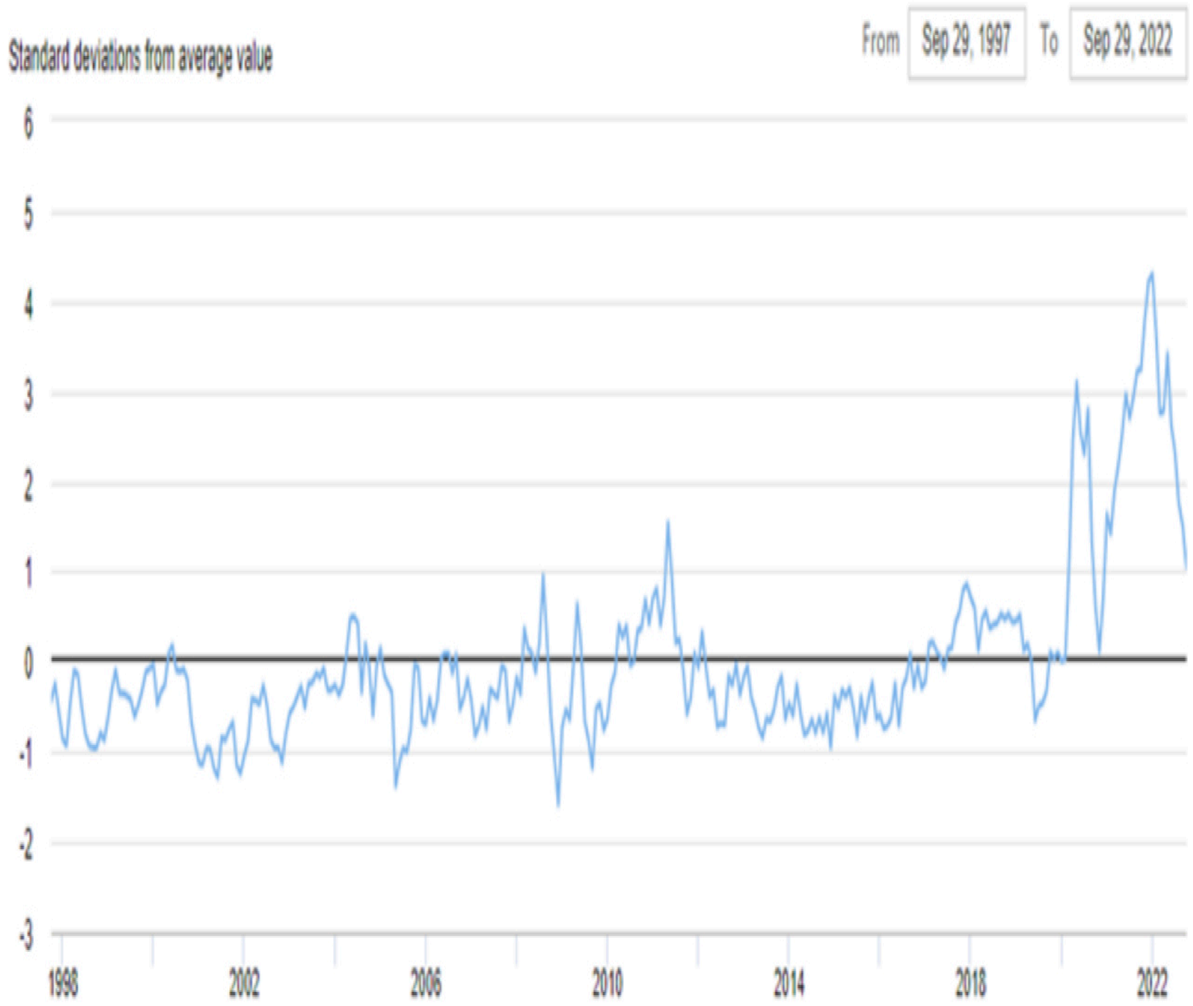
Source: Ronnie Stoeferle via Mr. Monachau

General news on Asia / China

- On one side, Chinese officials signaled no change to Zero-covid policy and did not give any indications on the exit plan or strategy and a timing. But at the end of the day, they are making fundamental changes, which are indicating, the direction is an exit to the Zero-covid policy.
- For example, authorities eases Covid measures and trims quarantine time by 2 days. Instead of making travelers stay at a centralized quarantine facility for 7 days upon arrival in the country, the new rules stipulate a 5 day quarantine, followed by 3 days of home observation.

Supply side issues abating, which means lower inflation going forward

- On the right-hand chart we can notice, how the global supply chain pressure decreased in September, making the fifth consecutive month of easing.
- The GSCPI index integrates transportation cost data and manufacturing indicators.
- The GSCPI's y/y movements suggest that global supply chain pressures are beginning to fall back in line with historical levels. In September the biggest contributor of the downward pressure was the HARPEX (container ship charter rates) was also previously seen in our weekly reports.
- This is happening, even if China is holding on the zero Covid policy.
- We are reading that new coronavirus cases are surging in Guangzhou and other Chinese cities. The rumors on Foxconn 2 weeks ago were right and Apple has just reduced forecasts due to production's reduction by his main supplier Foxconn.
- **Inflation will fall, but lockdown in China is still a big risk.**



Source: Federal Reserve Bank of New York

Source: FED NY via Canaccord

General news on crypto - Binance buying FTX

- This time it went very fast. On the 7th November Bitcoin and Ethereum were breaking out from a solid consolidation base, but fell again on news, that Alameda Research (a crypto -focused hedge fund founded by FTX exchange's Sam Bankman-Fried) was facing insolvency allegations and the CEO of the crypto exchange Binance, in order to avoid a second Terra/Luna, said his company would liquidate its entire FTX holdings in the coming months.
- Then, one day later, it happened, the crypto exchange Binance reached an agreement to buy rival FTX.com with undisclosed terms. The CEO of Binance, Mr. Changpeng Zhao, stated, in order to protect users, the two companies signed a non-binding LOI, intending to fully acquire FTX.com and to help covering the liquidity crunch.
- Funny enough, the initial rumors were spread by Binance's founder, who is now set to benefit from the bailout!?
- On the Friday 11th November 2022 we are reading, the crypto exchange FTX filed for bankruptcy in the U.S. and therefore we suppose, no deal could be reached with Binance.
- KTS must admit, we were shocked on the news, especially because Mr. Bankman-Fried was supposed to know, what he was doing. Instead, the co-founder of FTX lost 94% of his net worth in 1 day (from USD 15.6 billion to USD 0.992 bn) and is no longer a billionaire.
- We also believe that the confidence in the crypto space is still shattered and suggesting that the wounds of the crypto crisis will need more time to heal.

General news on crypto - Binance buying FTX

- But apparently is turning even out, that Mr. Bankman is not even a victim, but the cause of fraud and now is even fugitive? According to research, there is a hole of USD 8 to 10 billion in the FTX balance sheet and apparently Mr. Bankman was using FTX trading arm “Alameda” to run a Ponzi Scheme in its FTT Token. The most incredible part of the story is, Mr. Bankman was explaining to policy makers, how to make cryptos more transparent. Sound a bit like Madoff did at his times.
- Mr. Soldati was mentioning 1 day earlier the fact, that Binance and FTX, basically the 2 largest crypto exchanges in the world were in competition war and back in 2019, Mr. CZ (Changpeng Zhao), founder of Binance, made the strategic decision to have Binance invests into FTX.
- Mr. Sam Bankman-Fried (SBF), the CEO and co-founder of FTX, understands that to beat Binance, he needs to leverage US politics, and he rapidly became one of the biggest donors in US politics overall.
- Recently, SBF published proposals on crypto regulation, that were met with sever backlash from the crypto industry.
- At the point, CZ went on the offensive, announcing the sale of their USD 584 million worth of FTT tokens and later comparing FTSX to LUNA.

General news on crypto - Binance buying FTX

- These fears and rumors triggered a bank run, that is having a severe impact both on the price of FTT and FTX itself. Mr. Soldati was concluding, “there’s a good chance that FTX can weather this storm, but the will be strongly impacted by this attack, and Binance will gain considerable market share. What an impressive chess game” .
- A day after came the announcement, Binance buying FTX.
- Meanwhile Lebanon’s banking system is fundamentally broken after decades of mismanagement and now some are turning to crypto to make ends meet.

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