KTS
CAPITAL
MANAGEMENT

KTS weekly update Nr. 47

The 25th of November 2022

FED FOMC

- **FED officials see smaller rate hikes coming "soon",** but the end target is still around 5%, which is already expected and definitely better than some FED members were arguing.
- In fact, Mr. Bullard was arguing a 7% target based on the Taylor rule, but market participants are arguing, the **FED member is working 12 months behind the curve** and having market expectations for declining inflation in 2023, we should expect the pivot of the FED sooner than later.
- Mr. Bostic FED President of Atlanta on the contrary, was arguing in the recent days that the FED is ready to "move away" from 75 bpt rate hikes at the December meeting and feels that the Fed's target policy rate needs to rise no more than another percentage point to tackle inflation.
- On the statement, the FED argues that they still see little signs of inflation abating, but at least some committee members recognizes the risks to the financial system, if the FED continues pressing forward at the same aggressive pace.
- **Meanwhile the 10y vs 2y US T-bill inversion is the deepest in 30 years with -0.75%. In 2001 and 1989 it was around -0.5% and therefore market participants are arguing that the bond market is suggesting a potential FED policy error leading to a harsh recession coupled with lingering inflation.** Others even assert that the above data points have deep implications and only get resolved when something breaks. KTS is not that negative, but we are cautiously monitoring equity market's volatility and we are going to apply strict stop losses, at least for our trading part of the portfolio.
- **The central bank decision on the next rate hike is going to be Dec 14., which is one day after the US CPI release (13th December 2022).**

Weak fundamentals

- As we have recently seen, **fundamentals are very weak and the US leading indicators (LEI) are signaling a recession risk**, the CEO confidence is at lowest level ever, US retail sales are down 0.3% in real term, but of course rising 7.5% in nominal terms due to the high inflation.
- The percentage of US yield curve inversions is now at 76% and therefore indicating a very high risk of recession. Even if, we have to be honest, such indicator is not reliable or is reacting too late, because when equity markets started correcting a few months ago, such indicator was at minimal levels and therefore not foreseeing a recession risk, but investors were already largely anticipating it. Therefore, in our opinion, such indicator is not important for market's forecasts.
- According to the CIO of Lombard Odier, the **tighter lending conditions from banks,** is also leading to a further decline in U.S. consumption, and it is an additional reason to believe that the economy is going to fall into recession in 2023. We have also already analyzed, that the level of credit card loans are at highest ever and savings are very low again; lower than pre-pandemic. So US consumers, which are making 2/3 of the US economy, are still spending, but are suffering from high inflation.
- In his latest research, Mr. Peccatiello is expecting a relatively sever recession hitting around March/April 2023. Now we know, Mr. Peccatiello has always being quite extreme negative, but his points are very valuable.

Positive indicators

- Meanwhile on the **positive side**, we have seen that the **inflation has peaked** and it is going to fall further, having US Manheim used car Index collapsing, as well shipping rates (Shanghai containerized Freight Index fell 75% from January's high).
- Next **US CPI is going to be released on the 13th December,** which is going to be crucial for any FED's decisions on the 14th of December. As recently analyzed, we expect the US CPI to be lower again, which should support equity markets on the short term and also the decision of an increase by 0.5% instead of the expected 0.75% from the FED on the 14th December.
- The oil price is also falling substantially, easing pressure on the inflation. Without mentioning that from **supply scarcity and bottlenecks we are now in a supply abundance and therefore deflation on goods.** Mr. Larsen was posting a chart (not included) showing the correlation between the **Shanghai containerized Freight Index vs PCE goods Inflation and the collapse of the Shanghai index indicates, that inflation is going to fall to 0% in May 2023.**
- Unfortunately the recent **lock downs in China** are still opening the discussion about a possible risk of supply bottlenecks.
- Mr. Peccatiello also shows the chart (source: Marine exchange of Southern California, not included) of the number of container ships in LA-Long Beach **queue, which is hitting a record low and from 100 days waiting time, we are not to 0.** Therefore the bottlenecks we had at the beginning of the year is definitely gone and the **global supply chains is not disrupted anymore due to real spending falling.**
- In addition, **significant layoffs** have recently being announced from all major IT companies, but also other sectors. Meta and Amazon are laying off respectively, 11k and 10k employees. Those are significant numbers and have repercussion on the labor market, which **should experience increasing unemployment and therefore helping the FED to ease.**

Investors in the limbo

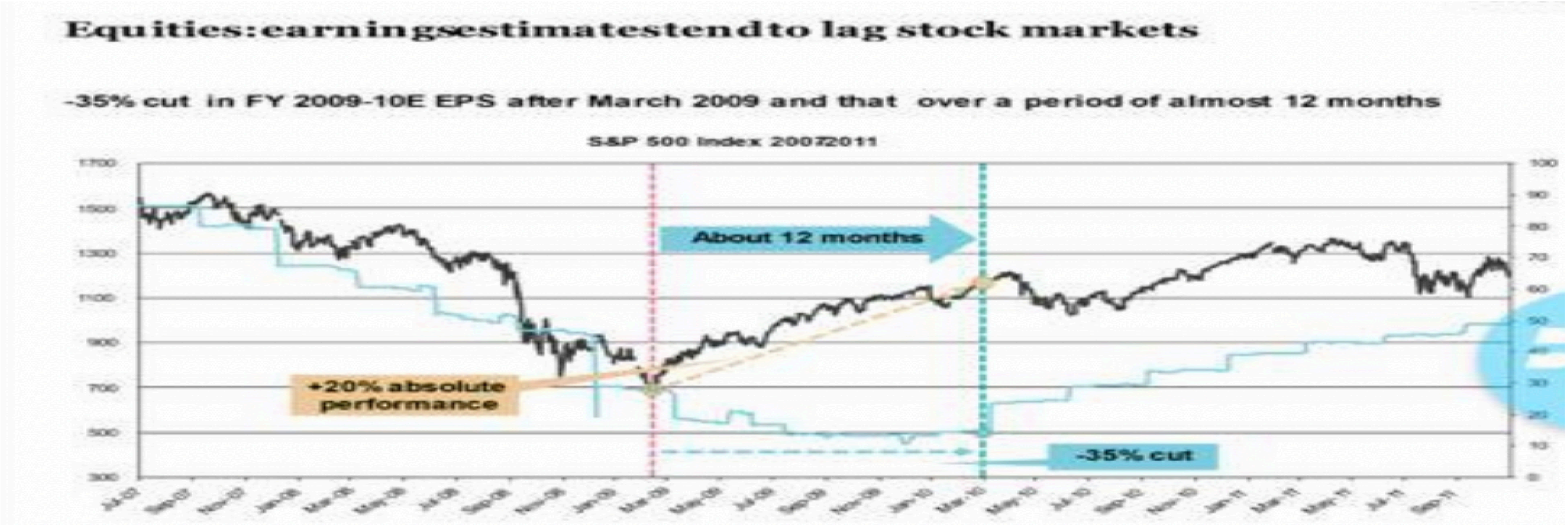
- For this reason, **FED's interest hikes are achieving the hoped result, and according to the charts of Alpine macro (not included) not only inflation peaked, but also labor wage. This should help the FED to change to a dovish monetary policy sooner than later.** And this is going to support equity markets, at least on the short term up to the end of the year.
- But, for the moment, investors are still in a limbo, between already very weak fundamentals and **still too many FED members thinking that it is not enough, and which wants to keep the hawkish path for longer,** risking to lead the global economy into a hard landing, instead the wished soft landing.
- At least, as we have seen in the first slide, the FED is reducing rate hikes to smaller steps and confirming the strategy started a few weeks ago.
- The CIO of Morgan Stanley, Mr. Mike Wilson is predicting **the end of the bear market early next year (Q1)**, **where equity markets are going to experience new lows, but where there is going to be a "terrific buying opportunity".** KTS would assert that this is general consensus, having very weak fundamentals, pointing out the global economy falling into recession in the next months, but some economists are arguing, that the economy is already in recession.
- The investor community is arguing, having the economy in recession, earnings of companies are falling further. As we have recently analyzed, equity markets are discounting a soft landing, but not a hard landing. On this subject, see slides nr 7 and 8.

Investors in the limbo, therefore strict stop loss

- Companies could should during the results in Q3, that **earnings are more resilient, than investors expected.** Outlooks have also being downgraded. But as said, analyzing fundamentals, especially the real estate in U.S. and the stretched U.S. consumption, it is still too early to totally eliminate the risk of a hard landing and therefore further compression of EPS.
- For this reason, we are investing a part of our portfolio with a trading approach, in order to profit from this possible short term rebound, but still keeping a strict stop loss, to avoid being fully invested, if equity markets are really going to correct further.

Can equity market increase, while EPS are downgraded?

- **The Bank Vontobel is showing a very interesting chart, pointing out, that during the year 2009, earnings were cut by 35% after March 2009 and over a period of 12 months, but equity markets increased by +20%**
- As we know, most of professional market participants are still very conservative positioned, expecting the economy falling in recession, which is going to be translated in further cut of earnings.



Source: Vontobel

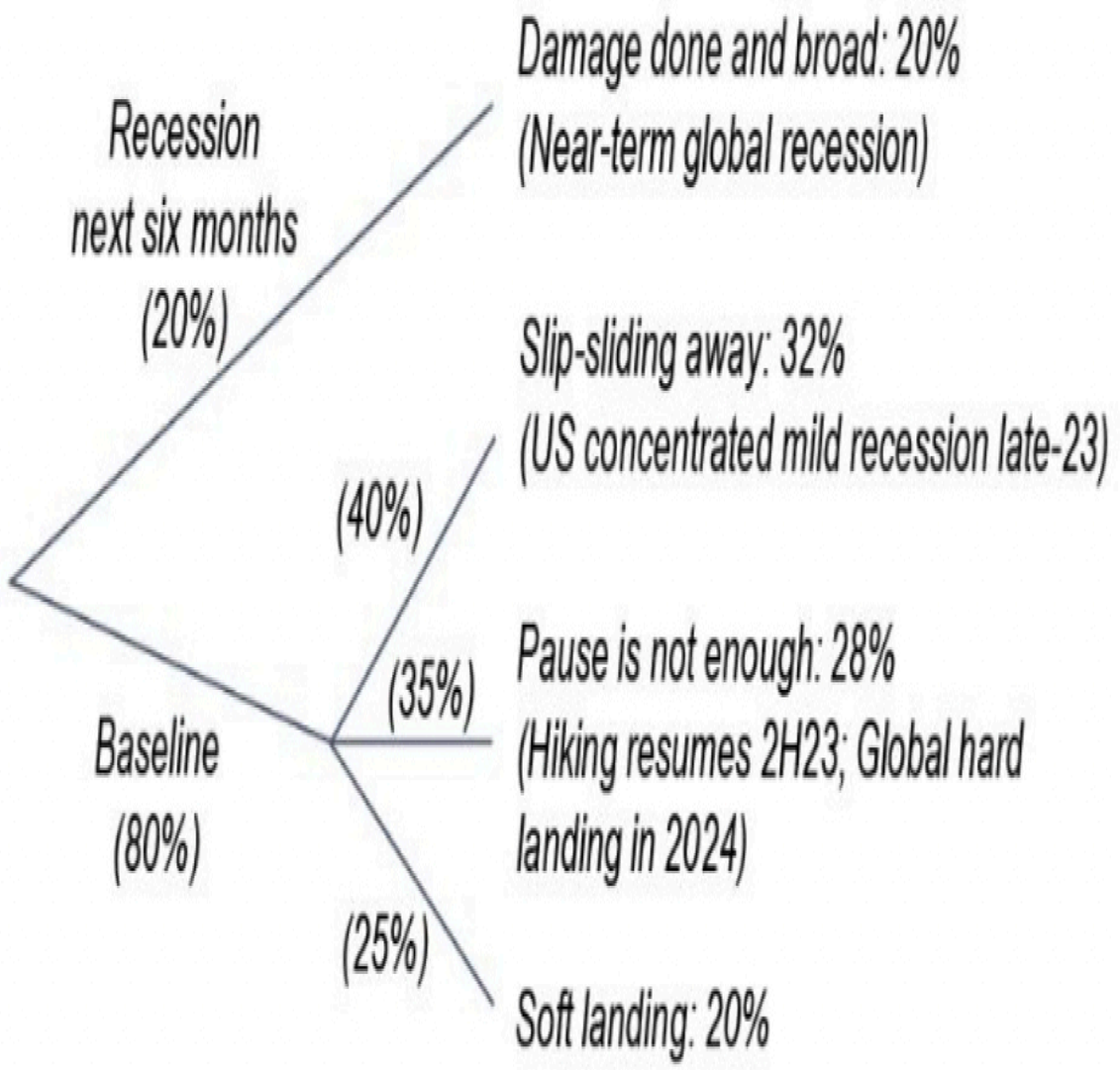
Sharp multiple contraction so far

- The Swiss bank Vontobel further argues, that central banks' tightening weighed heavily on **multiples and valuation decreased 33% from peak.**
- As we have seen recently, money supply M2 was the "fuel" of the bull market and the collapse of M2 had as consequence the correction of all risky asset classes. But, we should have find a bottom now.

Source: Bank Vontobel

JPM global outlook scenarios

- We are including the right-hand chart to give an indication of how market participants are evaluating the possible market scenarios for 2023.
- **JPM is basically positive for equity for the year 2023,** with an expected return on the balance portfolio 60/40 of around 7.2%
- JPM argues, that **stocks are 25% cheaper and this is a great entry point for equity.**
- **JPM is also positive on fixed income,** supporting our increase into fixed income last October.
- Finally, adding 10% in private equity and 10% in real estate to a 60/40 portfolio can boost sharp ratio by 10%. But this is honestly nothing new.



Source: JPM

Macro Europe

- Positive news from Europe, with the **German PPI (producer prices) falling by 4.2% MoM in October** and therefore being the biggest monthly drop in history of PPI. This should be a sign that the inflation has also peaked in Europe.
- According to the blog of Mr. Kirch, a value investor, he argues that balance sheets are currently more resilient than in the previous economic downturns. In fact, **78% of US corporate debt is currently long term compared to only 44% in 2007**. Weighted average maturity of this debt has increased from 6.7 to 10.8 year since 2007. **This support our investment into fixed income high yields**.
- Mr. Ritesh Jain argues in his blog, that **20% of all Canadian mortgages were taken on when rates were at 1.5% floor mortgage with 30 year maturity.** Therefore, 25% of mortgages on Canadian Banking system, which constitutes 50% of their overall assets, have a duration of 30+ years. This is in line with the arguments of the manager of Flossbach a few months ago, **where in the U.S. and Europe, most of the mortgages have been rolled over last year for 30+ years at very low yields and therefore, consumers are suffering less that investors think. On the contrary, with labor wage increasing, they are even profiting. Mr. Ritesh also argues in his blog, that because of the inverse yield curve, the Canadian Central bank is going to pivot with or without controlling the inflation.**

A near end of the war?

- **Last Sunday, CNN reported that speculations are growing on a possible talk to end the fighting in Ukraine and also announcing that the U.S. doesn't want to be seen as nudging Ukraine into talks.**
- This is quite an interesting rumors, especially with Democrats almost losing the majority at mid term November's election. Such a change in strategy indicates, that Democrats understood, increasing inflation and increasing spending due to the war is not accepted by U.S. citizens and hopefully there is in fact, a change in policy over the war in Ukraine.
- We are taking seriously such rumors for 3 main reasons. Firstly, CNN is a reliable source and normally it starts with rumors and end with facts. Secondly, we always have to have a scenario in our investment process, where the conflict is ending. We also believe, at the end of the day, both sides need to find an agreement. Finally, during the US mid term elections, we all understood, Republicans want to end the war in order to cut spending.
- **What this would mean for equity markets, the oil price and gold price?**
- The logic would be for an **equity market short term squeeze** and therefore we should be long equities.
- The end of the war would theoretically mean an even lower oil price, but after a long conversation with our oil's expert and oil trader, **it is not going to be the case, because:**
  - The end of the war, does not mean the simultaneous interruption of sanctions on Russian oil. Sanctions on Russian oil are going to start on the 5th of December, therefore the oil market has not seen anything yet, only the gas market. According to our expert, **diesel is going to be the real dilemma, especially in Europe, having 40% coming from Russia.**

A near end of the war?

Bloomberg is also confirming that the **diesel shortage is getting worse,** and that within the next few months, the world will potentially face a shortage. **US inventories are the lowest in 40 years.** This could be a potential risk, even a disaster, but talking to our oil trader, we believe, the West is not going to experience any bottleneck, because it is not a coincidence, that **U.S. has just granted full immunity to the Saudi Arabia's Crown Prince, Mohammed bin Salman, and therefore our oil trader believes, Saudi Arabia is going to overflow the market with diesel.**

This is most probably the reason of rumors on the possible increase in oil production from Saudi Arabia, which is not necessarily negative for the oil price, on the contrary, it is helping to avoid a disastrous situation in the next months, if the West would be with no diesel / jet fuel, basically we would have no truck on the roads and no planes in the air.

- If China would not be in lock down, the oil price would be at 200 USD and not at USD 80. Therefore, it looks like, having China partially in lock downs, what helping to have a falling inflation, especially in oil and commodities.
- Since 2014, oil companies cut capex and therefore supply has not increased. Therefore the **long term view on the oil price is still very bullish**, having only Saudi Arabia and UAE able to increase production. US oil companies have just slowly started to plan new projects or restart drillings, which were stopped, when the oil price collapsed. Therefore, before U.S. is going to increase production, it is going to pass a long time.
- U.S. needs to rebuild strategic reserves of petroleum, **around 200 mio barrels**. The Biden's administration communicated that they are going to do so, when the oil price is falling under 70 USD, which should be theoretically the floor.

A near end of the war?

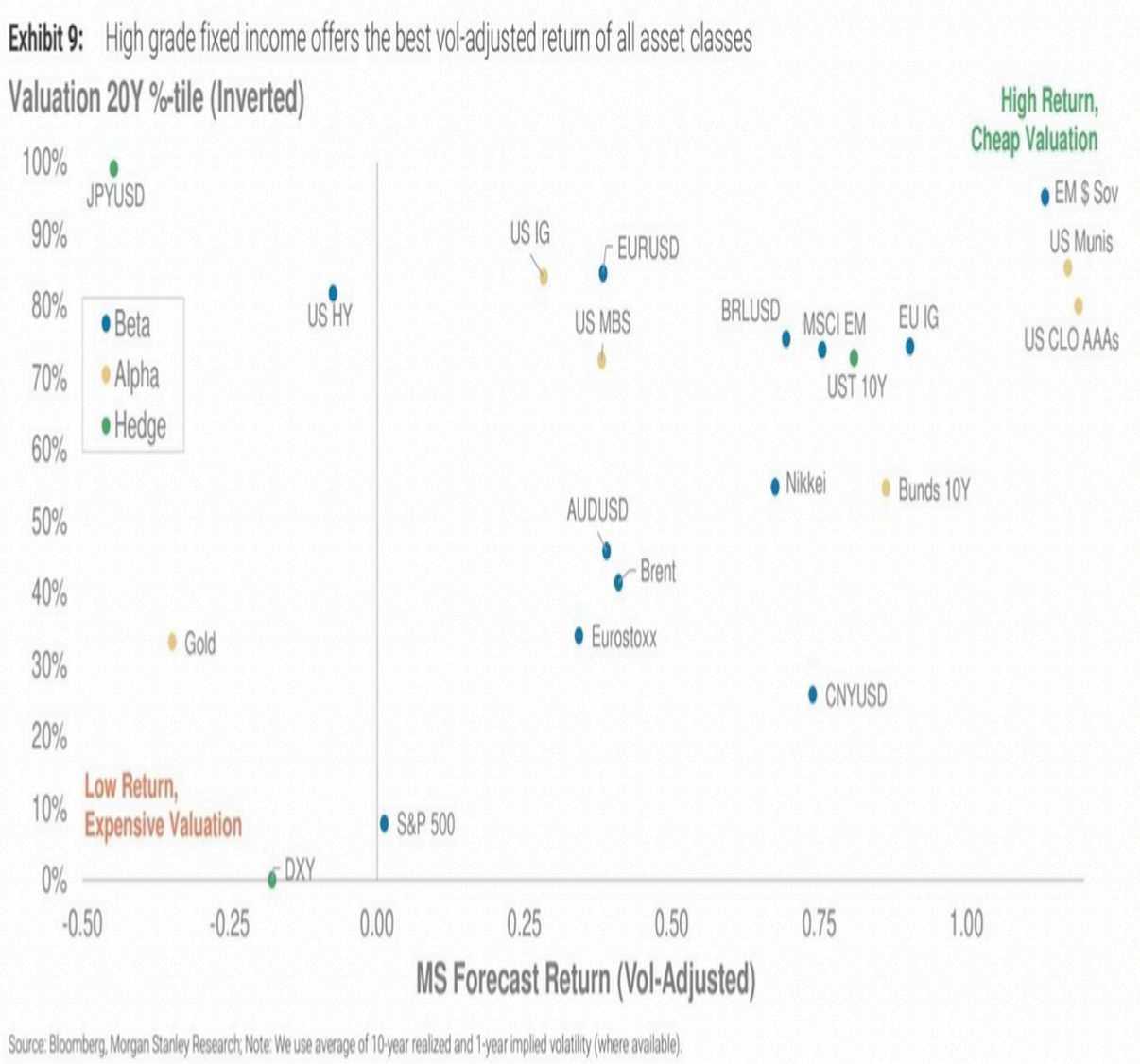
- Finally, our oil's expert does not see a combination of factors, which should lead to the collapse of the oil price. In fact, we would need simultaneously: the end of the Ukraine's conflict, with the stop of sanctions on Russian oil, or a deep recession, but with the OPEC not cutting further production and finally US oil companies overflowing the oil supply, which is not possible, because before new projects are going into production, it takes years.
- On the latest news, Saudi Arabia denied a WSJ report that OPEC+ was thinking of boosting production by 500k bpd and added, it may cut production if needed to bring the market in balance. The current cut of 2 mio barrels per day by the OPEC+ continues until the end of 2023. Saudi Arabia is not going to boost oil production, but is most probably going to compensate the gap of the missing Russian diesel, as explained previously.
- In addition, **oil companies are still very attractive**, with a lot of cash in the balance sheet and dividend yields around 7% in addition to share buyback programs. Our oil's and green expert is not only invested into oil companies, but also in other sectors, like **metals** (pillar for the green transition and with attractive valuations), **tankers** (with sanctions on Russian oil starting from the 5th December, oil shipping rates are soaring, because of the new longer route to India and China), **wind service, uranium** and also other **alternative energies,** which are profiting long term from the green transition and energy independency, especially for Europe and UK. The latest UK windfall tax on oil companies is a further support for alternative energies and the oil major Shell announced to re-evaluate its USD 30 billion investment plan and therefore increase spending into "green" projects. As always argued, the space **alternative energy is a long term investment and we are not acting, base on short term market volatility.** As previously explained, under the segment green energy, we also count the very attractive materials, precious metals (especially silver) and uranium.

A near end of the war?

- For the **gold price,** we believe, it is rather following yields and the USD, and not geopolitical tensions. Therefore it should even rise in case of the end of the war, having probably yields and the USD falling. After the FTX fiasco and the tremendous increase of volatility in the crypto space, precious metals confirmed once again, to be more stabile and have the function of safe haven and stabilizer of the portfolio.
- The USD should fall, because of less spending for U.S. on the war. In addition, less geopolitical tensions, should be translated into "**risk on" for the investor community**, and therefore buying **again emerging markets and selling USD.** This support our investment into emerging market equities and fixed income.
- According to Mr. Monier, CIO of Bank Lombard Odier, for **Japanese investors it does not make any sense anymore to buy US t-Bill,** having very expensive hedge costs for USDJPY (4.9%) and therefore a net yield of -1% compared to +0.24% for similar dated JGB. As a result, investors prefer to invest locally and US t-bills are experiencing a further reduction of demand. This fact is also confirmed by the blog of Mr. Costa, where he argues, Japan's US Treasury holdings fell the largest amount in the history by USD 81 billion. **The FED will be forced to reduce the QT and step in to buy the missing gap.**
- Inflation should fall, therefore also yields, and this is good for bonds and, as said, for gold.
- KTS is feeling comfortable with the position in gold, our long term core position in equities, the trading in equities, especially the passive ETF in the IT sector (QQQ US) and the positioning's increase into fixed income since October 2022.

Best asset classes in a period of stagflation

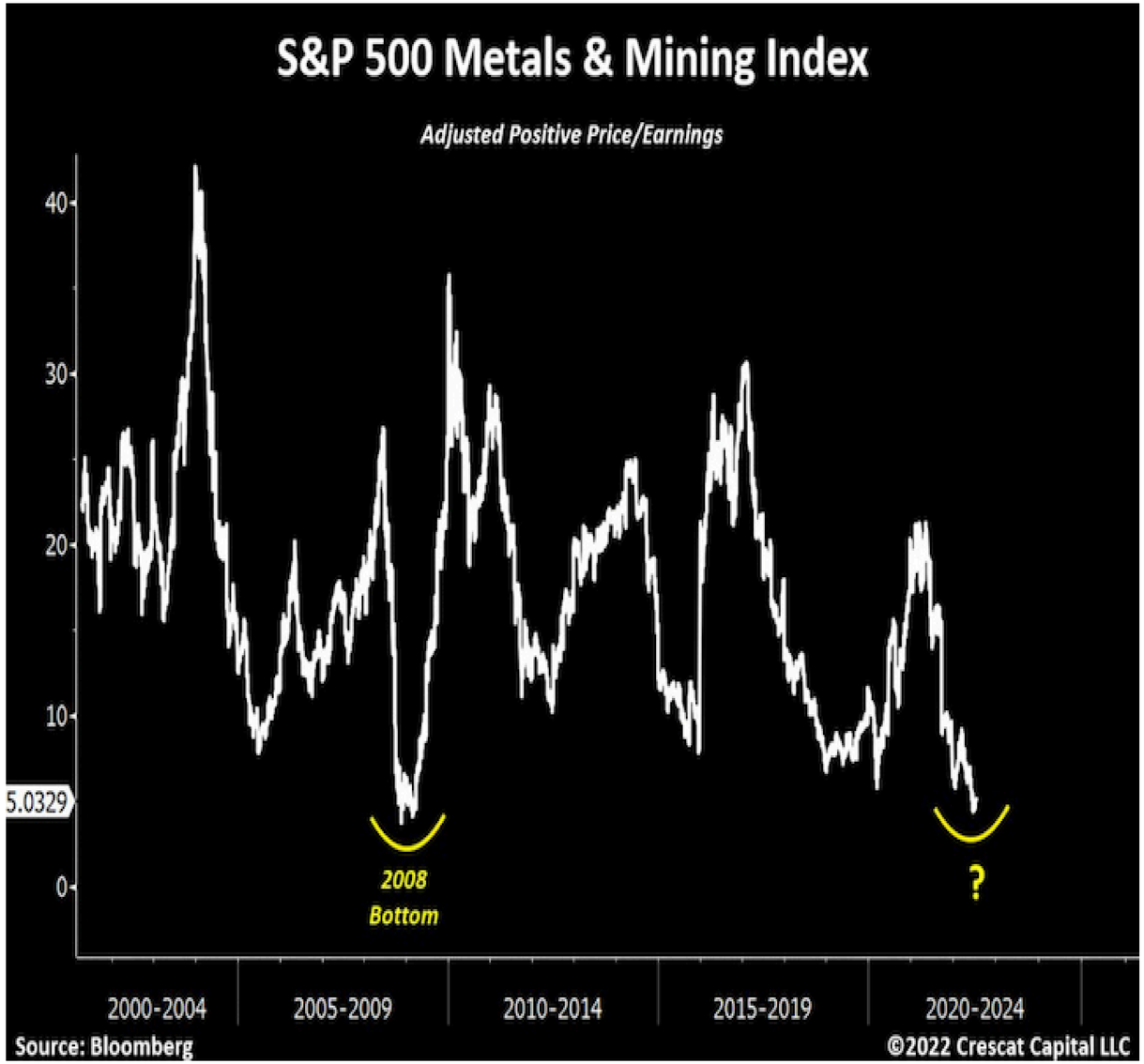
- The right-hand chart, courtesy MS via Mr. Tanase, shows the **best performing asset classes in a period of less growth, inflation, and policy tightening.**
- **MS expects the USD to have peaked and high grade bonds & EM bonds to outperform and therefore a good year for "fixed income".**
- This supports KTS's increase in the fixed income exposure, though, MS's chart showing, US stocks, High yields and metals are going to lag.
- We are not taking to seriously such statistics, because it depends on the analyzed period of time. As we have seen recently, Bridgewater had gold as best asset class, which is not the case by MS.



Source: MS via Mr. Tanase

Valuation for mining stocks

- We are including the chart of Mr. Costa, which is supporting our investments into the mining sector, and also supporting the positioning of our energy expert in the green L/S basket and of course our best-in-class fund Bakersteel Electrum.
- As always argued, mining stocks are extremely cheap, and could lead the next rebound of the equity markets.
- Energy stocks already rebounded, but are also way too cheap vs the rest of market.
- During their webinar, the manager of our best-in-class fund Bakersteel Electrum argued that **commodities have a strong outlook** relative to other asset classes, **regardless of global uncertainty.**
- In addition, competition for supplies of strategic metals and critical materials will continue increasing, while net zero will transform the metals and mining industry.
- Finally Miners remain undervalued and are in strong shape and Mining is offering value, dividends and selective growth.



Source. Otavio Costa

Share buyback programs lead to outperformance

- We are including the chart of Goldman Sachs, showing the **outperformance of companies using cash for share buyback programs, over those using it for M&A.**

Goldman Sachs via Mr. Monchau

Strong market's breadth = a bullish signal

- Mr. Budelmann posted an interesting chart, showing a strong equity market's breadth.
- 88% of S&P 500 stocks are above their short-term 50day moving averages (DMA), while 60% over the 200d. **The 200-DMA breadth reading has moved well above its August highs**. We agree with Mr. Budelmann, that strength in longer-term breadth is what bulls would prefer to see.

Source: Mr. Budelmann (Bespoke Investment Group / Bergos AG): back in June 2021, the long term breadth was actually giving a SELLING SIGNAL

Fasanara Fintech

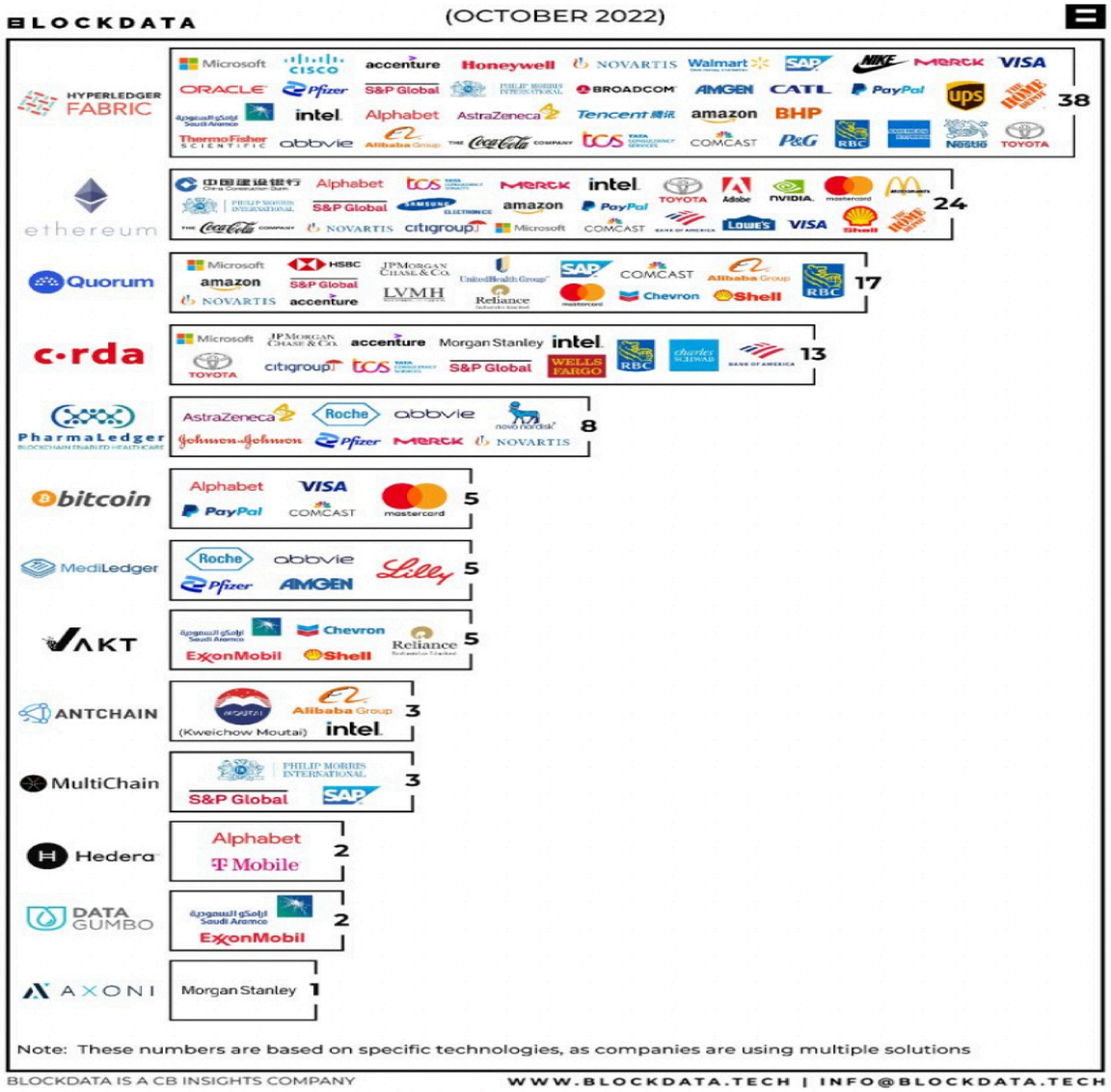
- Our partner for investments into VC Fintech has just officially announced to have received a **fintech mandate from one of Canada's largest pension funds for USD 200 million.**
- We are very pleased for the manager of Fasanara. It is well deserved and for KTS it is not as a surprise, quoting the team of Fasanara very professional with a solid long term track record.
- KTS is also very pleased, because such mandate is confirming our positive due diligence and opinion that Fasanara's management is one of the best worldwide.
- We would like to mention that the asset manager Fasanara also manage up to EUR 500 mio in special mandates into direct lending and micro economy for the EIB, after 7 years of due diligence.

General news Asia / China

- We are reading that China reveals **digital Yuan with expiry date, where people are forced to spend and are not allowed to save.** It is still and experiment, but it shows a direction which is quite scaring. Basically, if this experiment would become reality, it would mean that the government would have a total control on the population, even on the savings and citizens would be even more dependent on the government.
- Chinese authorities are increasing efforts to stabilize the real estate sector and China's financial regulators have asked banks to stabilize lending to property developers and construction firms.
- The oil price was correcting, not only on rumors on Saudi Arabia increasing production, but also on **China starting again lock downs. In fact, the city of Guangzhou begins a 5-day lockdown.** China is building again thousands of camps for Covid quarantine, but watching some videos, it looks like, Chinese citizens are starting to rebelling on the strict Covid measures.
- As argued, the latest lock downs are **again opening the dilemma of supply disruption** and therefore the global economy is again at risk. Nomura estimates that more than 1/5 of the country is under restricted movement and therefore weighing on China's economy as well as the global economy. Mr. Yardeni cited an article in the WSJ (24.11.2022), which observed, "for nationalist reasons, the Communist Party refused to accept Western vaccines that are more effective than China's homegrown shots".
- On the other hand, market participants are arguing, that **China is the key metal consumer and accounts for more than 50% of global commodities demand (Zinc, Copper, Nickel and Aluminum)**. Therefore, the reopening could lead upward pressure on inflation, given the deficit in commodities supply.
- The Chinese container company COSCO (China Ocean Shipping Company) has partnership with the top European ports: Rotterdam (15% participation), Antwerpen (12%), Hamburg (8.7%), Valencia (5.6%) and Piräus (5.3%).

Top blockchain technologies used by the top 100 institutions

- We would like to include the right-hand chart, courtesy Mr. Day, which is showing the top 100 blockchain technologies, which are used by the top 100 institutions.
- This chart is the proof that **blockchain is the pillar for future innovation and is not dead**, as many are always claiming and getting louder after the failure of FTX.
- KTS has always argued that the blockchain technology is the base for fintechs and other applications and we feel comfortable with our investments into fintech and venture capital.
- We are also reading in mainstream, that crypto can go to zero. We do not believe it, but what definitely **changed in the crypto environment, is the fact, that it needs to be regulated.**
- We expect more institutionalization in the sector and **regulated entities like the SEBA Bank in Zug being the biggest profiteer of the FTX fiasco.**
- Our crypto arbitrage fund could even reach some profit during the month of November and now is 100% cash.



Source: Mr. Antony Day

Gold as safe haven

- KTS always argued, crypto currencies can not substitute Gold and silver as safe haven.
- We were not expecting such fiasco as Luna/Terra, or more especially FTX bankruptcy, but our argument has always being, **precious metals are solid, have a long track record and are recognized by central banks.**

Source: Mr. Fuhr

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