KTS
CAPITAL
MANAGEMENT

KTS weekly update Nr. 49

The 9th of December 2022

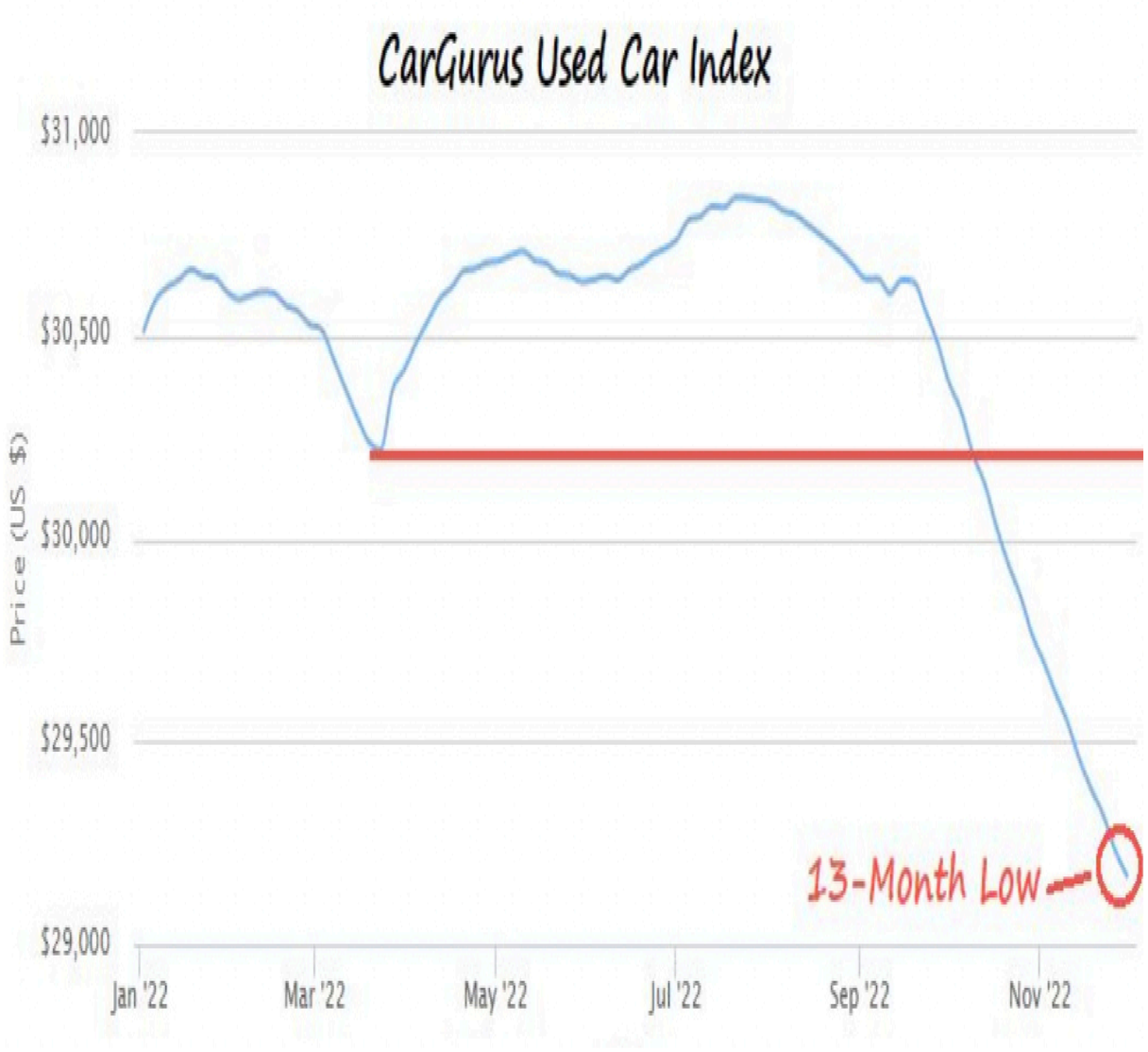
Performance asset classes year on year - 2022 a disaster year

- We include the right-hand chart, courtesy Mr. Lysiuk, which gives the perfect idea, during 2022 basically no asset class could reach a positive performance and basically any asset class is negative double digits.
- US MLPs (listed Master Limited Partnerships are not really an asset class for global investors) and commodities is basically the energy sector, in which KTS proudly invested since November 2020.
- Therefore, the only safe heaven would have been liquidity.

Source: Canaccord, Mr. Lysiuk - Topdown Charts

Used cars index

- It is clear to everyone now, that the used car's mania is gone and prices literally collapsed in less than two months.
- The reason for which we are including again such chart and subject is to remind to our clients that we were arguing since the beginning of this hype, post pandemic, that this phenomenon would end soon, comparing a similar behavior of people after the **9/11 event, where for a few months, no one wanted to fly,** but people soon realized, that to drive cars is much more dangerous than to fly.
- KTS was stubbornly waiting for lower used car prices, which was one of the main inflation contributors in 2022, and it happened 6 months later. Now we start being in a deflation in certain segments, having the **bullwhip effect "kicking in".**
- The next inflation' contributors which are going to collapse are OER (owner rent) and labor wages and soon the FED pivot, which is going to be **bullish for equity markets and for the global economy.**
- Energy prices are the only open question mark.



CharlieBilello

U.S. labor market - open jobs in U.S. need to be solved via immigration

- Last week, KTS was arguing that there are still over 10 mio open jobs, but after the pandemic, **USA has 3.5 mio citizens, which are newly invalid** and are not able anymore to work, in combination too many **elderly people retiring earlier after the pandemic.**
- According to CEOs of smaller companies, over **50% of open jobs are high end or jobs where special education** is needed. In the U.S. there are not enough specialists and therefore a **targeted immigration is needed.**
- Now we are reading that with Tech layoffs, over 50k only in November, **visa holders are literally scrambling to find work in order to stay in the U.S.** The phenomenon is accentuating even more the dilemma of missing specialists in the country.
- This is the result of the Trump administration's hostile posture toward immigration and the **Biden's administration needs to solve the dilemma as soon as possible, because there is the high risk that the FED is focusing on the wrong issue and risks to cause a severe recession for a problem which can not be solved with further rate hikes, but rather with solutions on the immigration side.** Many well known entrepreneurs are pointing out the same solution and normally, they know, what they are talking about.
- In addition, Mr. Peccatiello was mentioning the possible **double counting in official statistics,** fact already mentioned by Mr. Larsen weeks ago.
- Mr. Peccatiello is also rightly pointing out, that **Linkedin data** shows the pace of hiring in the US is quickly deteriorating, confirming that official statistics are not correct, or at least, much weaker official data should follow soon.

U.S. labor market - the situation is worse than statistics are showing

- Mr. Peccatiello was posting that following his labor market thread, Washington DC literally reached out to see if he can help to fix the data quality and statistical issues with the NFP data. Most probably is a PR action of Mr. Peccatiello, but for us it is important to notice that **US authorities and the FED are in fact working on wrong data.** We have to admit, expert like Mr. Peccatiello or Mr. Larsen are a very reliable source of serirous fundamental data.
- Mr. Ishihara is also observing that on the latest 5% yearly growth in average hourly earnings, comparing the average hourly earnings **(weekly earnings - weekly ours worked) it turns out that there was a -1% slowdown in weekly hours worked, having retail sector, especially leisure & hospitality, marking the major slowdown in worked hours.**
- This actually means that the labor wage is lower than statistics are showing. The chart of Macrobond is not included in the report, but we have to hope that the FED is analyzing such details. Bottom line is, **fundamentals data are weaker than statistical data and analyzing the FED's change of tone, it looks like, also the FED members realized this fact.** We would expect a rate hike of only 0.5 in the FED's meeting on the 14.12 and lower US CPI number on the 13.12, which should be positive for equities.
- Economists, respected entrepreneurs and well known experts are indicating that equity markets reactions are based on wrong statistical data and therefore it is very important to have a double check in our investment process, in order to understand, which data are reliable and which one are not. In addition, it is very important to look forward, as we tried to do with several index in the past, as for example as mentioned, used car prices index, shipping index, commodity prices, etc.
- The equity market's reaction, closing almost flat last Friday, indicates that the investment community understood that the labor market is weaker than statistics are showing and KTS is confident that going forward, labor market data are going to worsen and therefore easing pressure on the FED, which should be **bullish for stock markets.**

U.S. Labor market - the positive trigger for 2023

- What it means for our investment process?
- The professional investor community is still invested in an extremely conservative way, because the strength in the labor market is pressuring the FED. In the meantime, it is clear for the majority of the investor community, that inflation has peaked.
- It is beyond doubt for KTS, that the **labor market is much weaker then statistics are showing**, in addition to the fact, that the Biden's administration needs to find solutions with immigration and therefore, the most feared challenge for 2023 in order to have the FED at inflection point, is already weaker than most investors think, which gives us confidence, that **equity markets are going to perform much better in 2023 than most of investors expect.**
- The big question mark is the **re-opening of China,** where we have to agree with many market participants, it could be the biggest risk for equity market, if the **normalization process in China would create inflation**, especially for oil and commodities. On the other side, we should not have any supply disruption anymore, which is an advantage for equity markets.
- KTS also believes that the re-opening process is going to be a slow process over months and, therefore, we should not have unnecessary inflation pressure, or at least not in the magnitude to put the FED in an uncomfortable situation. In addition, we do not have to forget that in the coming months, the shelter inflation, especially **OER, is going to dismiss significantly.** As we have recently seen, with real estate prices collapsing, also rents collapsed during October-November period.
- **Labor wage inflation should also slowdown** and therefore, as we have seen recently, **60% of the US CPI contributors are going to fall in the coming months.**

M2: the next major trigger for risky assets

- As argued in the past, the growth of money supply M2, via Central banks' huge liquidity injections due to the pandemic, was the major trigger for increasing valuations of risky assets. **Having the M2 collapsing, all risky assets also collapsed.**
- Mr. Raoul Pal is comparing the actual situation with WWII. Back then, equities rocketed with the announcement of war (same as the pandemic), the economy subsequently fell into recession shortly after the end of the war, with the market correcting around 20% and thereafter was up 5x over decades.
- The driving forces of the bull market after WWII were negative real rates, yield curve control, massive fiscal stimulus and a rapid increase in GDP growth, which helped to **take down government high debt to GDP from 125% to 30% .**
- Mr. Pal argues that currently we are in the same situation. Having the FED pausing monetary policy and governments pausing fiscal stimulus, the **M2 YoY is right back were it was in 2018,** when the FED last reversed course on rates and QE.
- The situation is similar globally, having the global M2 falling around the world.
- Charts in the blog of Mr. Pal are showing that, once the **ISM crosses 50, liquidity comes in to try and buffer it. A possible changes in banks' regulations or Operation Twist will kick off the liquidity boom.**
- **The growth in Chinese credit and the rise in Chinese M2 is also kicking in and has already started. In fact, Chinese Credit impulse leads global M2 by 5 months and therefore the return of liquidity is imminent,** having already M2 in China rebounded since months (KTS also mentioned in recent weekly reports).
- Therefore, **the bottom of the business cycle is coming in Q1 2023.**

M2: the next major trigger for risky assets - BULLISH for risky assets

- **Finally, first M2 turns, then the business cycle bottoms and turns.**
- **As we have seen, the correlation between risky assets and M2 is very strong, therefore equity markets are going to turn when M2 turns.**
- **Of course, the IT sector is going to profit exponentially, and probably also Bitcoin**

Open FX swaps for USD 80 trillion

- The Bank for International Settlements (BIS, a Switzerland-based institution) announced that worldwide, pension funds and other "non-bank" financial firms (which are suppose to be mainly hedge funds and private equity structures in our opinion) **have more than USD 80 trillion of hidden, off-balance sheet dollar debt in FX swaps.**
- Market participants are arguing that in the past, **the Dutch pension fund or Japanese insurers borrows dollars and lends euro or yen before later repaying them, have a history of problem.**
- In addition, during the global financial crisis in 2008 and the pandemic in March 2020, the global financial market saw funding squeezes, which required central banks to intervene with dollar swap lines.
- To be noticed, that the USD 80 trillion-plus "hidden" debt estimate exceeds the stocks of dollar Treasury bills, repo and commercial paper combined, the BIS said. It has grown from just over USD 55 trillion a decade ago, while the churn of FX swap deals was almost USD 5 trillion a day in April, 2/3 of daily global FX turnover.
- Finally, for both non-U.S. Banks and non-U.S. "non-banks" such as pension funds, dollar obligations from FX swaps are now double their on-balance sheet dollar debt, the BIS estimated.
- After the UK gilt market's crisis it appeared clear to all market participants, that pension funds globally are in leverage on the fixed income part of the portfolio and it is not a coincidence, that the **FED needed to change the tone to a more dovish monetary policy,** because of the **illiquidity in the U.S. T-Bill market,** which is due to the global margin calls of such FX swaps, which is the nature of the leverage, having probably European pension funds short EUR at negative interests and buy US T-Bill. The same with the JPY.

Open FX swaps for USD 80 trillion

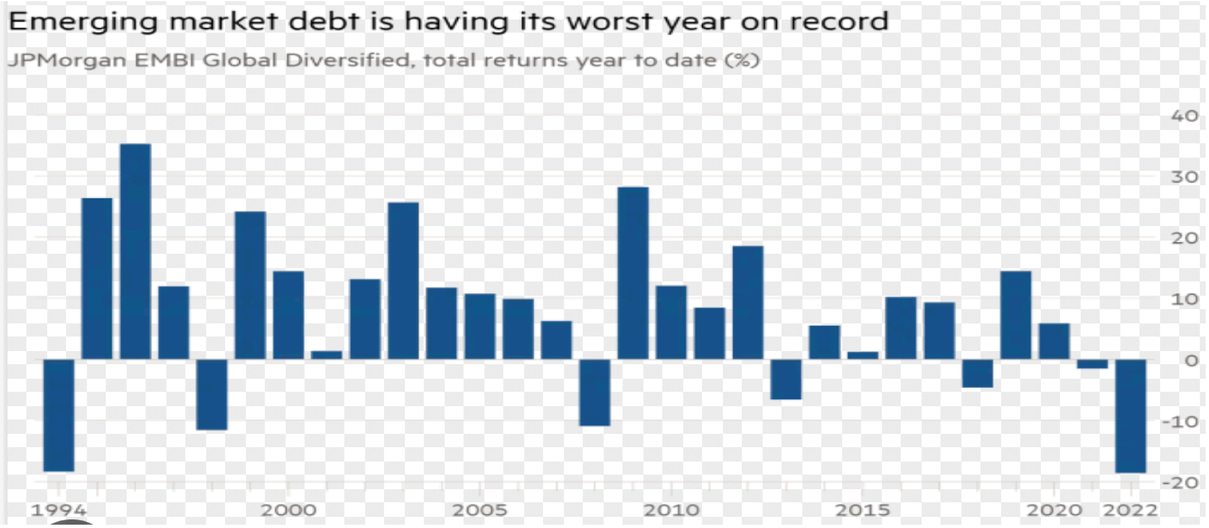
- Now, having USD interest rates too high, the trade is not profitable anymore, in addition to margin calls, and pension funds need to slowly close down positions.
- The **headline is painting of course a dramatic situation, but we would like to emphasize, that such FX swaps are also part of the macro strategies of hedge funds (non-bank structures) and therefore always existed, as we have seen in the previous slide, 10 years ago the off-balance amount was USD 55 trillions.**
- Mr. Peccatiello also rightly explains in his latest blog, that FX and cross-currency swaps require variation margin for 5-10% of the notional amount (private clients need to have 15% as collateral) but the notional amount in derivatives generally are used to offset existing positions, which are mostly centrally cleared and the Clearing House takes care that the continuous market-to-market and margin posting exercise. Mr. Peccatiello is also arguing, that the headline is “too dramatic”, but also warns about maturity **mismatch between USD funding and assets and of course, during stressed times there is a rollover risk.**
- KTS also believes that with increasing USD interest rates, but especially with a changing environment, where it is clear that interest rates are not staying at 0% forever as market participants believed up to last year, portfolio managers need to change some leverage strategies applied in the past on the fixed income part of the portfolio.
- That said, portfolio managers need to re-calibrate portfolio, but we are also of the opinion, that it is wrong to call such positions “hidden debt”, because the nature of the transaction is neutralizing existing position in the portfolio.
- In addition, we sense, that central banks understood, they need to give time to portfolio manager in rebalancing the portfolio and for this reason, are getting more dovish.

Open FX swaps for USD 80 trillion

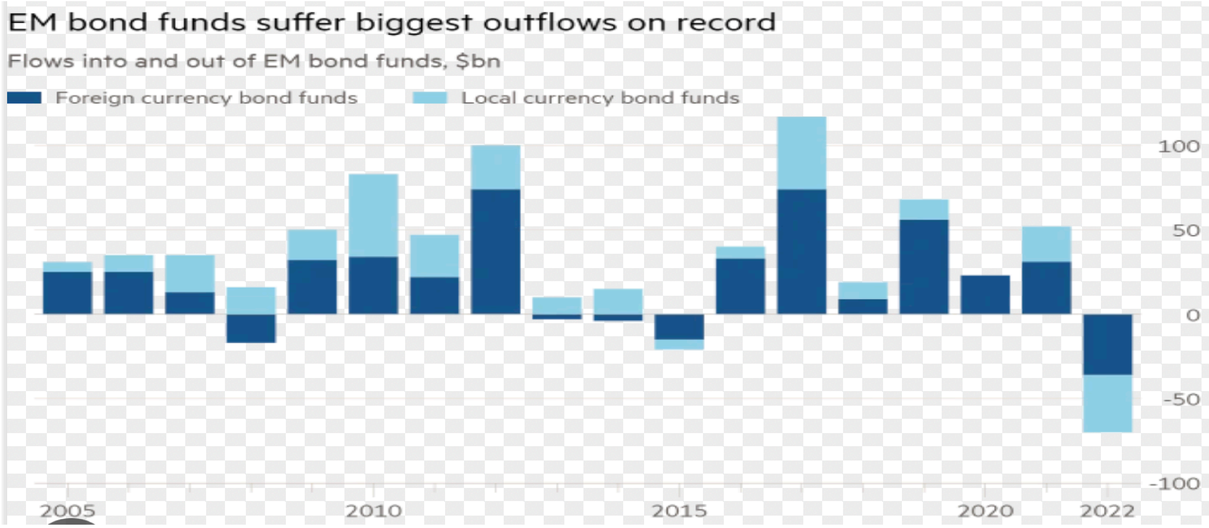
- For this reason, KTS is convinced, that the FED cannot further aggressively increase interest rates and needs to make investors comfortable again that interest rates are not going to spike. An additional confirmation, that yields have peaked.
- We also believe that central banks will not be able to implement any QT program, because as the newspaper Financial Times is pointing out this week, who is going to buy UK gilt after the crisis of October 2022 and with pension plans reducing leverage? The answer is very simple: **central banks need to step in and fill the gap, which means QE.**

Emerging market debt - 2023 should be a positive year

- After the meeting with one of the managers of emerging market debt, we can assert that the emerging market debt and equity experienced during 2022 their **capitulation** and most probably is linked to the margin calls of the previously discussed FX swaps.
- **EM bonds suffered the biggest outflow on record with USD 85 billion vs USD 65 bn in 2015.**
- **Yields are again over 10.5%** and companies should be more solid, having oil price, as also commodities prices, increasing.
- We feel comfortable with our investments and it is the only asset class, and also MAN high yield and CLOs, where it is going to profit in any scenario during 2023, as previously explained in other weekly reports.
- In addition, historically, bonds have a recovery period of 9 months, therefore much shorter than equities, fact, which is additionally supporting our investment case.



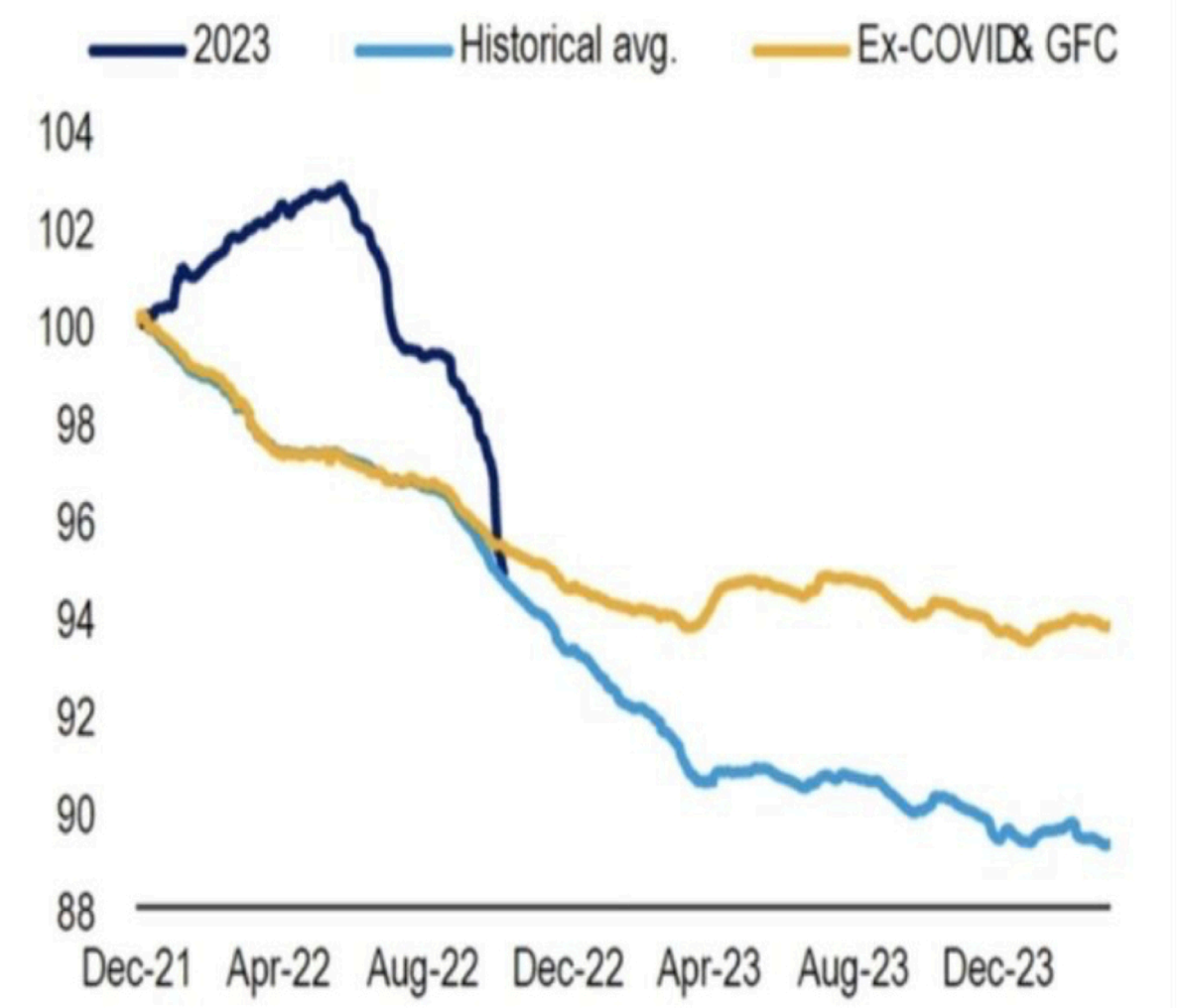
Worst performance year on record (source FT, JPM)



Combined with biggest outflows on record (source FT, JPM)

Earnings revisions for 2023

- The analysts of Bank of America are giving an indication, **based on the historical average from 2001-2021, of the magnitude of EPS downgrades ahead in 2023.**
- EPS could basically fall an **additional 6%** according to the historical average, and this could probably happen, if the economy would experience a soft landing in Q1-Q2 2023.
- We believe that equity markets already discounted such EPS downgrade and if such lower than expected revision would happen, it would be quite bullish for equity markets.



Source: BofA US Equity & Quant Strategy, FactSet; Note: historical average based on 2001-2021

Source: BofA via Syz Group

S&P 500 Index price sensitivity to EPS and P/E valuation: target 4’700 points

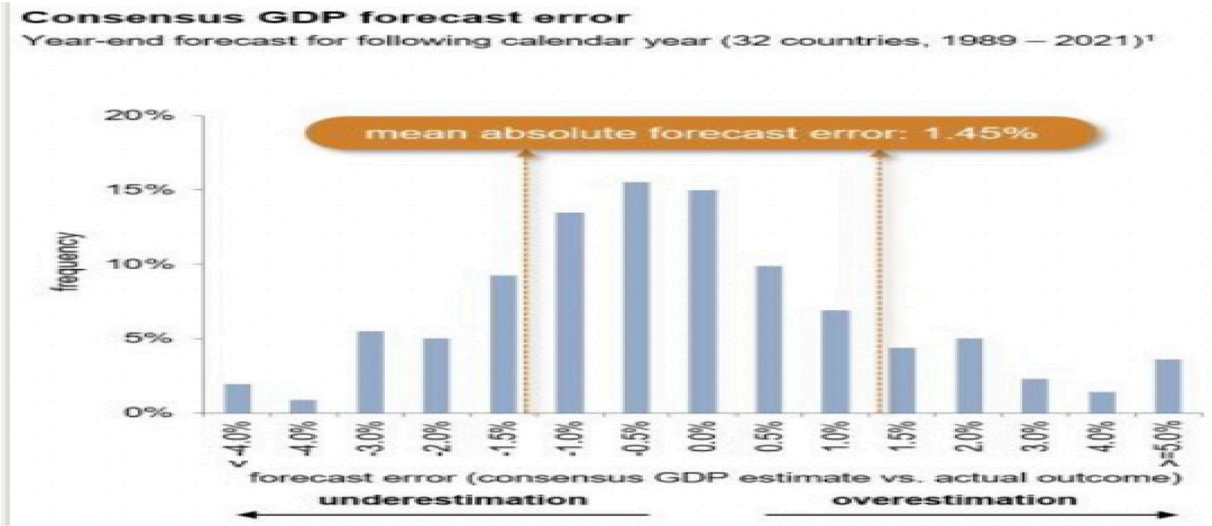
- We would like to re-post the scenarios of P/E valuations based on the S&P 500 Index, because the right-hand chart, courtesy GS via Syz Group, gives a simple idea of the potential of equity markets going forward.
- Currently the **S&P 500 Index is trading at 17x P/E**, which is not cheap. As we have recently seen, consensus for 2023e is above 231 (around 235-236) USD, which is 4% over 2022 and for many market participants too optimistic, because expecting a recession.
- With no growth, therefore EPS at USD 224, the fair value of the S&P 500 Index a 17x P/E would be around 3’800-4’050 points (3’941 as per today).
- In case of a recession and EPS falling to 200 USD (-11%), the fair value could be around 3’000-3’400 points.
- **KTS base scenario is USD 236 with also multiple expansion, due to yields falling and therefore with 18-20x P/E and USD 236 the S&P 500 Index target could be around 4’700 points.**

		2023 EPS scenarios		
		Consensus	GS baseline	GS recession
		$231	**$224**	**$200**
	Growth vs. 2022	(+4%)	(+0%)	(-11%)
Forward P/E	19x	4400	4250	3800
Current	18x	4150	4050	3600
	17x	3950	3800	3400
	16x	3700	3600	3200
	15x	3450	3350	3000
	14x	3250	3150	2800
Mar. '20	13x	3000	2900	2600
	12x	2800	2700	2400

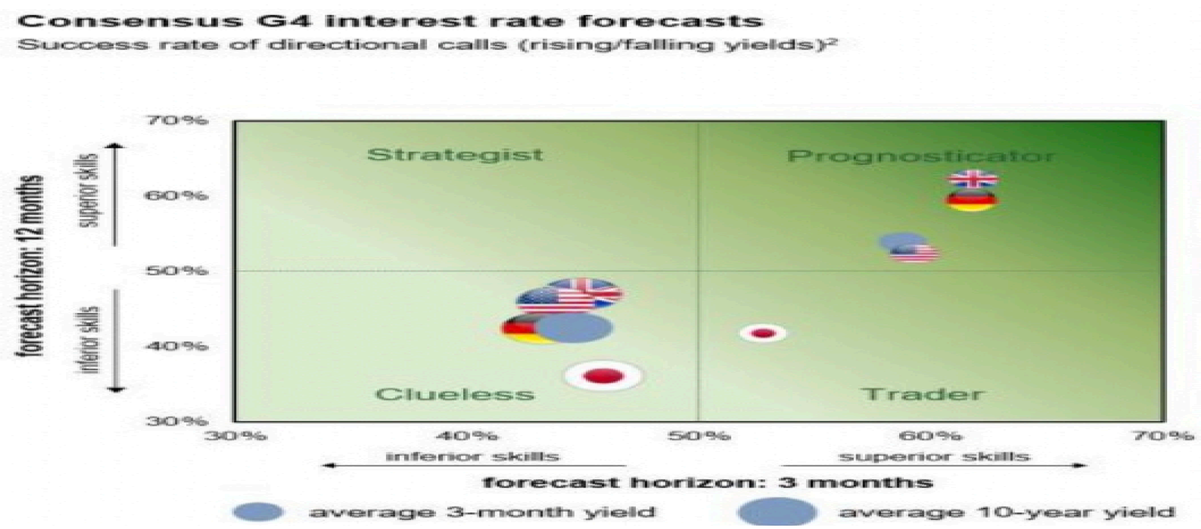
Picture Title

Consensus forecasts are not a reliable source, in the contrary

- We include 2 charts of the blog of Mr. Hochstein, which are showing, that even **flipping a coin has been more successful in some instance than consensus forecasts.**
- This assertion is in line with the arguments of the manager of MAN TrendRisk, which has always demonstrated that **general consensus is mostly wrong,** especially from all economists on macro. In fact the chart on the left side shows, over the past 30+ years, the average of economists has demonstrated no particular skill in predicting important economic variables.
- This is also valid for stock analysts in general, which are mostly reacting and not forecasting. Therefore we should not focus our investment process on earnings or economy forecasts, otherwise **we would always be a step behind.** Stock markets are always trying to discount the future, especially after the pandemic, where in 2020 equity markets had a tremendous rebound discounting a global economy boom and during 2022 equity markets fell in a bear market discounting the recession ahead us.



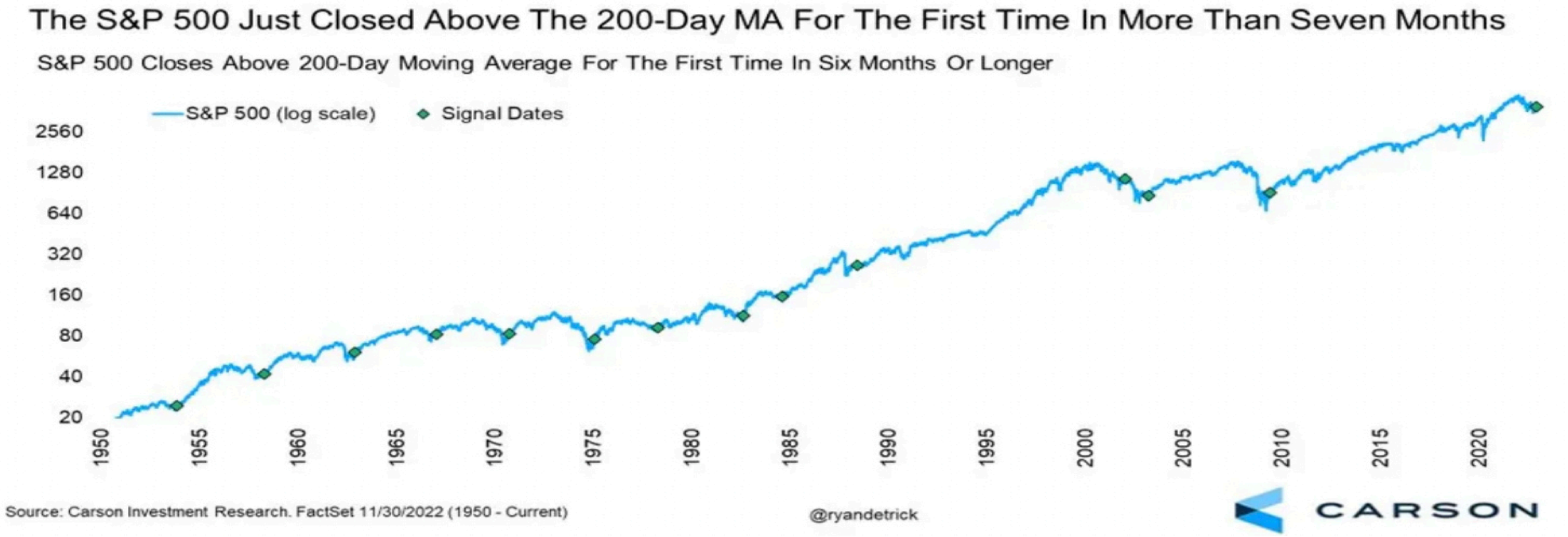
The average economist has demonstrated no particular skill in predicting



Flipping a coin (clueless) had a better success rate than forecasts

Technical - strong bullish signal

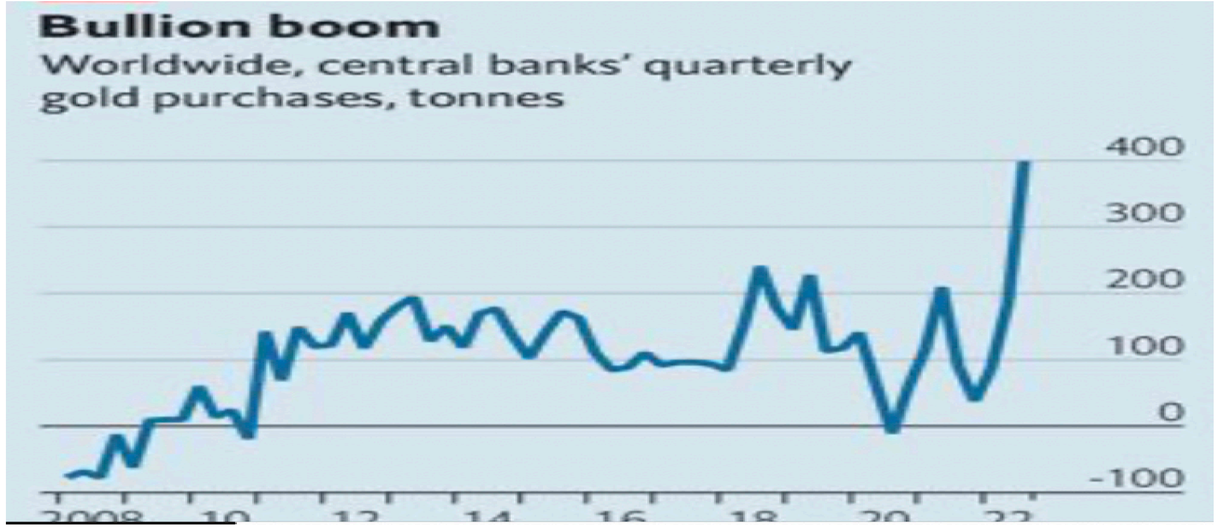
- We include a better chart than last week on the fact, that the **S&P 500 Index closed over the 200-day moving average, after a material 6-month period below.**
- Usually, it is a **bullish signal,** only in the early 2000's it was a single false positive signal.
- Mr. Callum also re-blogs the S&P 500 Index 4-year Presidential election cycle, which is bullish for the next 2 years (not included)



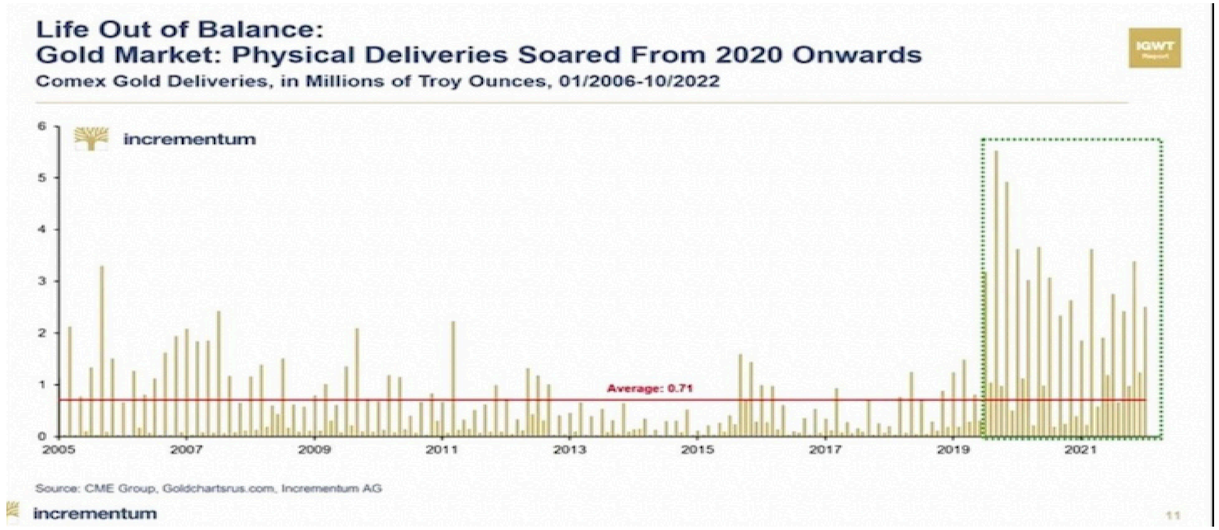
S&P 500 Index closing over the 200d - mostly a bullish signal (source Carson via Mr. Callum Thomas)

Gold - Central banks loading up physical gold

- Last week, we mentioned that gold spiked because of China/Russia planning to launch a gold backed new currency.
- Meanwhile, The Economist is showing a chart, left-hand side, whereby **global central banks are accumulating gold reserves** this year at a **pace never seen since 1967,** when the USD was still backed by the precious metal.
- Only in the quarter ending September, **demand for gold was up 28% YoY**, reaching 10’181 tons, according to the WGC (World Gold Council) report. Having the gold price still at 1’800 USD, the logical question is, who is selling?
- **Turkey was the biggest buyer of gold**, followed by Uzbekistan (26.13 tons) and India (17.46 tons). In addition, not all countries report their gold purchases regularly and therefore market participants **do not know, how much China and Russian bought.**
- Mr. Evangelista is wondering why the gold price is not higher. We have seen, investors are not buying, but is a matter of time!



Central banks buying massively gold (source The Economist)



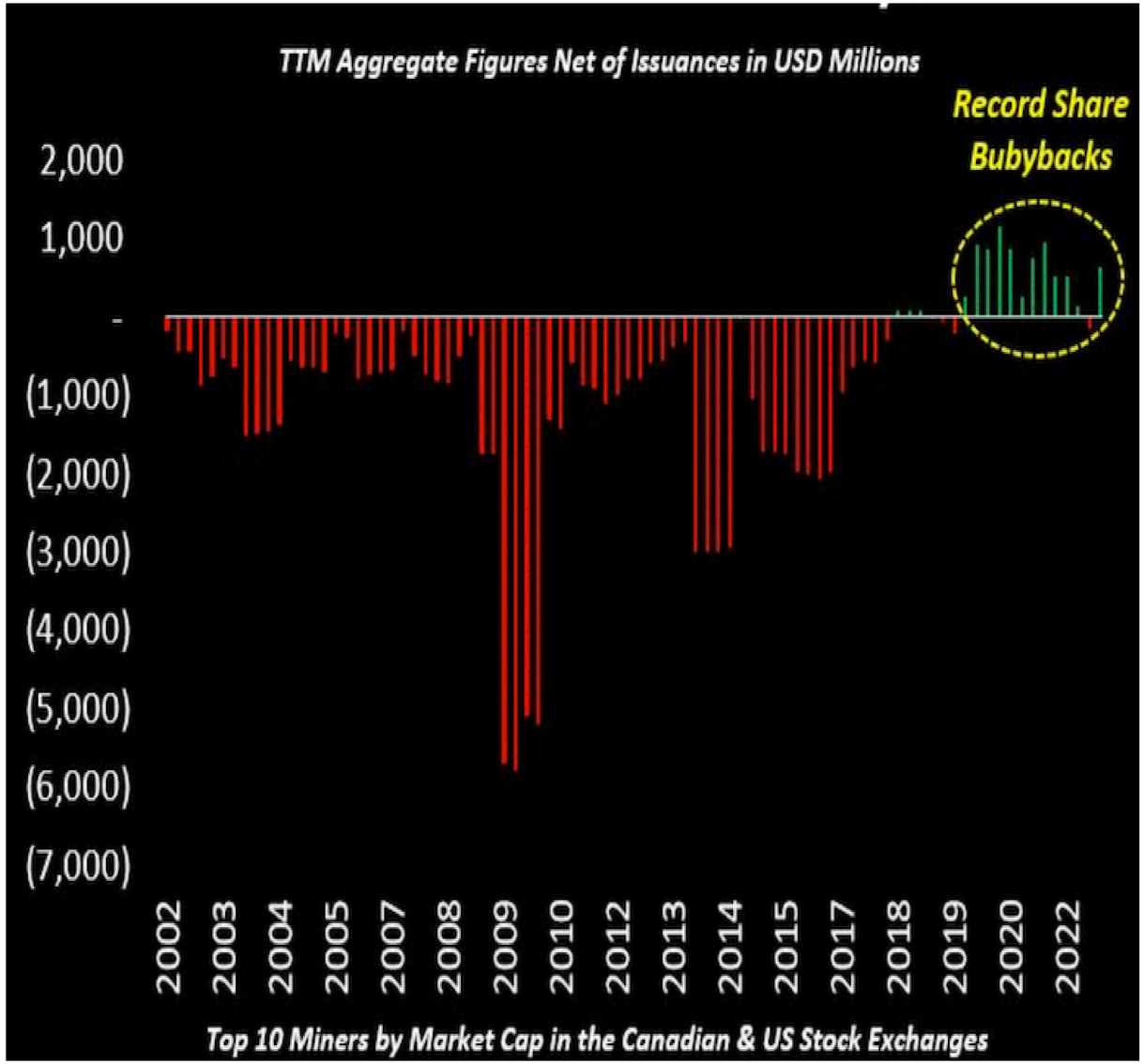
Comex physical gold deliveries soared on the last 2 years (Incrementum)

Gold - who is selling?

- As most of market participants are pointing out, why the gold price is still at 1’800 USD, when central banks are substantially accumulating physical gold?
- KTS was discussing the matter internally and we are speculating that **either Russia is selling gold physically to India, China or even Turkey** (being suddenly the biggest buyer of gold) in order to finance the conflict with Ukraine.
- Or it could be, that **pension funds were forced to sell gold positions**, in order to cover margin calls. This fact would confirm why gold etfs do not have buyers? In addition, we would argue, analyzing the year 2020, gold also collapsed, because investors very forced to sell investment vehicles which had better performances, in order to compensate major losses in other asset classes.
- During 2022 the gold price did not collapse, but could not also increase, even if as previously seen, theoretically the demand is strong.
- What it means going forward?
- KTS believes, that it does not matter, whoever was forced to sell gold. With the strong demand and stable price, combined to the fact, that **yields peaked and USD going to weakening**, the gold price should continue to remain at least stable and most probably finally break out the 1’818 USD, which would trigger positive and bullish technical signals and momentum investors or hedge funds could start to buy, finally followed by the investors community?
- We can not believe, Russia is selling gold, but in the meantime we are reading rumors about Russia and China planing a new currency backed by gold. On top, Russia also always announced the desire, to be paid in gold for oil.

Gold miners increasing share buyback and dividends

- KTS always argued, that **gold miners are accumulating strong cash flows** and therefore have solid balance sheets, which allow them to **increase share buyback programs and dividends,** further supporting our investment case, with the sector at **extreme attractive valuation.**
- The right-hand chart, courtesy of Mr. Costa Manager of Crescat Capital, shows how after 2 decades of continuous equity dilution, the top **10 gold and silver miners are now doing record amounts of share buybacks, in addition to increasing dividends.**
- Finally, if the gold price is not increasing, but just stay stable at USD 1'800, gold miners are going to continue to accumulate strong cash flow and therefore supporting our investment case in gold miners, rather than to be invested only in physical gold.



Source: Mr. Costa of Crescat capital

General news China / Asia

- According to Bloomberg, but also The Economist and Financial Times, **Chinese authorities have accelerated a shift toward reopening the economy,** with Shanghai and Hangzhou easing some Covid restrictions after protests against the nation's strict policies last week. The **new measures emphasized the importance of stabilizing the economy** rather than the battle against Covid-19, so Financial Times.
- Restrictions have also being reduced in Zhengzhou city, home to Apple's largest manufacturing site in China. But Apple announced that is **moving 40% of production out of China,** particularly to **India and Vietnam**, tracing to further diversify the supply chain. This is **good news for our investment in emerging markets**, less positive for the Chinese economy, which can count on domestic demand, but is going to have lower growth in the future, having many foreign companies moving out production. As we all know, such process is a long term process and is not going to be reversed between months.
- Nevertheless, the massive street protests in China is a demonstration, that Chinese citizens still have some power against the strong communistic system, giving some hope to Chinese citizens, there is still a kind of democracy?

General news on crypto

- We are reading, that **Goldman Sachs is going to spend big (tens of millions of dollars) on crypto firms,** whose valuations have been hit after the implosion of the crypto exchange FTX.
- In our opinion, it makes sense, because as explained, blockchains are the pillars for increasing efficiency in the Fintech, but was not regulated.
- Now with the FTX's debacle, the sector is going to be more institutionalized and, at the end of the day, controlled again from the major financial players. A fact which going to greatly disturb the true believers in crypto currencies, but on the other hands we have all seen, what sadly happens, when a segment is not regulated. In our weekly report nr. 35 of the 1st October 2021 we argued in our research on Decentralized finance (DeFi), that blockchains are the pillars for innovation, but not being regulated, it would be important to work together with major financial institutions in order to increase transparency and credibility. We believe, the FTX's debacle further accelerate this process.
- Once again, major institutions had the stance "wait and see" and at the end of the day, they take it all at deeply undervalue and de-stressed valuation.

Can you afford to retire?

- The magazine The Economist is pointing out in an article this week, the same long term subject, which was argued by KTS since 2 years now: **higher inflation, negative real wages (first negative real global wages decline in the 21st century) and negative real yields are going to hurt purchasing power of normal citizens** and therefore over a longer period of time, retirees will not be able to afford the same life standard as per today.
- The reduced purchasing power is hurting the middle class, but hits even harder low-income households.
- On this subject, we believe it is not unprofessional to include the links to a commercial of a Thai Bank, which perfectly gives the idea of the subject:

  https://youtube.com/watch?v=a2lv_Xl1e4U&feature=share

Twitter and free speech censorship

- In response to comments made by Yoel Roth, Twitter's former head of trust and safety, who indicated that social media platform was not safer under the Tesla CEO's leadership, **Mr. Musk announced that prior to his takeover, there is "obvious reality" that Twitter has interfered in elections back in 2020, through its content moderation policies.**
- Responsible for the key content moderation decision, including banning former President Donald Trump from the platform and suppressing the New York Post's coverage of the Hunter Biden laptop story, was Mr. Roth himself.
- We are not debating any politic and everyone can have his own opinion on the matter. **But for KTS is of vital importance to understand which source of information is credible and not influenced or censored.** Because investment decisions have to be made based on facts and not rumors or misinformation.
- Our focus on dictatorial and draconian measures were more direction China and other countries, but after such news, we have to start to realize, that there is no more free speech in many other countries, also in the West.
- Some market participants are pointing out that what the **Democrat Party did with the big tech companies back in 2020 (in fact it was not only with Twitter but apparently with Google, Apple & others)** is a massive fraud and this type and magnitude allows for the termination of all rules, regulations, and articles, even those found in the Constitution (Mr. Daniel Hood). Mr. Hood and Zerohedge are even entitling a blog with "Must is right: it's a battle for the future of civilization".
- Our conclusion is very simple: we are living in a world with the best global communication over and therefore, we should have the best and most transparent information in history. But unfortunately, the interconnection of the internet allow on the same time, to centrally control information and perversely nowadays communication is less transparent than the majority believe.

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