PFI Monthly

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Prague Finance Institute

AUGUST

DELIVERING KNOWLEDGE THAT MATTERS

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Financial markets monthly dashboard

Author: Michal Stupavský, CFA, Source: Bloomberg, Conseq; All data in local currency	August	YTD change	12 months change	Last value
Dollar index DXY	1,7%	0,1%	-4,7%	103,62
Emerging markets FX index to USD	-1,5%	1,0%	2,1%	1677
EUR/USD	-1,4%	1,3%	7,8%	1,084
EUR/CZK	0,7%	-0,2%	-1,9%	24,08
USD/CZK	2,0%	-2,1%	-9,8%	22,13
Global stock markets (MSCI All Country World)	-3,0%	13,3%	11,9%	
Developed stock markets (MSCI World)	-2,6%	14,7%	13,7%	
Emerging stock markets (MSCI Emerging Markets)	-6,4%	2,5%	-1,4%	
Global stock markets - Value (MSCI All Country World Value)	-3,4%	3,1%	6,7%	
Global stock markets - Growth (MSCI All Country World Growth)	-2,6%	24,3%	16,8%	
Global stock markets - Large Cap (MSCI All Country World Large Cap)	-2,8%	14,5%	12,9%	
Global stock markets - Mid Cap (MSCI All Country World Mid Cap)	-3,9%	6,8%	6,3%	
Global stock markets - Small Cap (MSCI All Country World Small Cap)	-3,6%	8,2%	6,7%	
US (S&P 500)	-1,8%	17,4%	14,0%	4508
US (NASDAQ)	-2,2%	34,1%	18,8%	
US - Big Tech (NYSE FANG+)	-2,5%	76,2%	49,1%	
Non-US stocks (MSCI All Country World ex-US)	-4,8%	6,5%	8,8%	
Europe (STOXX Europe 600)	-2,8%	7,8%	10,4%	
Japan (MSCI Japan)	0,0%	23,8%	18,4%	
Emerging Asia (MSCI Asia ex-Japan)	-6,6%	0,5%	-2,9%	
China (MSCI China)	-8,5%	-6,0%	-9,7%	
Latin America (MSCI Latin America)	-7,9%	10,9%	11,0%	
Central Europe (CECEEUR)	-4,8%	20,1%	36,5%	
Czech Republic (PX)	-1,4%	11,6%	14,2%	1341
Global bond markets (Bloomberg Barclays Global Aggregate Bond)	-1,4%	0,7%	-0,1%	
Global government bonds	-1,5%	-0,8%	-2,0%	
Global investment grade corporate bonds	-1,0%	3,5%	3,1%	
Global speculative grade corporate bonds (high-yield)	-0,5%	6,7%	9,4%	
EUR investment grade corporate bonds	0,2%	3,2%	1,0%	
EUR speculative grade corporate bonds (high-yield)	0,3%	5,8%	6,3%	
Czech government bonds (Bloomberg Czech Govt All > 1 Yr Bond)	-0,9%	6,9%	7,9%	
Average global bond yield (Bloomberg Barclays Global-Aggregate Yield to Worst)	0,06%	0,18%	0,81%	3,91%
US 10 year government bond yield	0,15%	0,23%	0,92%	4,11%
US 2 year government bond yield	-0,01%	0,44%	1,37%	4,86%
Germany 10 year government bond yield	-0,03%	-0,11%	0,93%	2,47%
Germany 2 year government bond yield	-0,06%	0,21%	1,78%	2,98%
Czech Republic 10 year government bond yield	0,31%	-0,67%	-0,35%	4,44%
Czech Republic 2 year government bond yield	0,13%	0,07%	-0,44%	5,65%
Credit spread - EUR investment grade (Markit iTraxx Europe / CDS)	0,03%	-0,21%	-0,50%	0,70%
Credit spread - EUR high-yield (Markit iTraxx Europe Crossover / CDS)	0,16%	-0,79%	-1,94%	3,95%
Global commodity markets (Bloomberg Commodity)	-1,2%	-6,0%	-12,8%	
Crude oil Brent	1,5%	1,1%	-10,0%	87
Natural gas (Netherlands TTF Natural Gas Forward Month 1)	15,5%	-57,3%	-86,2%	32
Electricity (Germany Power Baseload Forward Year 1)	-6,9%	-43,7%	-76,7%	134
Copper	-4,5%	0,6%	7,3%	8420
Gold	-1,2%	6,6%	13,4%	1947
Silver	-2,0%	1,8%	37,8%	24

INTERVIEW

Ján Hájek, Portfolio Manager of Top Stocks Fund, Erste Asset Management

Ján Hájek is the Portfolio Manager of Top Stocks fund at Erste Asset Management. Top Stocks fund is the biggest mutual fund in the Czech Republic with approximately 1 billion euro of assets under management. Ján Hájek has been the fund's Portfolio Manager since its foundation in 2006. Michal Stupavský, PFI's Chief Analyst, posed him several questions on the recent developments and outlook on the global economy and global financial markets, and his fund's investment strategy and top picks.

Global disinflation process has been rather slow, especially as regards the very sticky core inflation in the US and the Eurozone. How would you explain this development taking into account the fact that Fed and ECB have been hiking interest rates quite rapidly in the past 18 months?

While major central banks have increased rates in the fastest pace in the post-war history, until recently this tightening monetary policy was barely restrictive (real rates were negative for the most of this tightening campaign). Together with the fact that major central banks removed only approx. 1/3 of the global liquidity they have created during 2020-2021 time and fiscal policies remain very loose it does not surprise me that inflation remains stubborn and declines only gradually.

What are your expectations regarding the Fed's and the ECB's monetary policy in the coming months?

I expect that the first cuts that the consensus currently expects early next year will come much later as the inflation will not reach the targeted level so quickly and the restrictive monetary policy will have to stay with us much longer to get inflation back in check.

What is your general outlook on the global economy for the next 12–24 months, especially regarding GDP and inflation dynamics?

Although we still see very resilient corporate and consumer sector in the US, at some point the restrictive monetary policy will start bringing results and we will see the required economical pain (decline in consumption, rise in unemployment, etc.) that is needed to get inflation back to the target. My expectation is that we are rather close to the end of this economic cycle than at the beginning of the next one.

What is your general outlook on the Czech economy for the next 12–24 months as regards GDP and inflation dynamics? When do you think inflation will sustainably reach the 2% target?

Policy errors have led to stagflation of the Czech economy, and it will take much more effort (more fiscal cuts, getting to positive real rates and keeping them at positive levels for much longer) to get inflation declining sustainably to the 2% target.

How would you evaluate the development on global financial markets since the beginning of the year, particularly in terms of equities and bonds? In your view what have been the key drivers behind the equities rally?

At the beginning of the year, it has been a consensus that the fast pace of the rate increases by the central banks will lead to a recession in the major economies. As the economies remained more resilient and surprised positively, market participants started discounting the so-called soft-landing scenario (getting inflation back to target without entering a recession), which led to the increase of equity valuations, mainly in the US. Even though current earnings have not bottomed yet, earnings estimates for the next 12 months stopped declining and started gradual recovery towards previous peak. For the equity rally to continue it will be very important to see current earnings to start recovering as well. The main risks are that the pace of the recovery will be slower than expected and equity valuations will get under pressure form the higher long-term government bond yields or that we will finally see a recession and estimates will turn down again.

Since the beginning of the year the best performing equity sector were the US mega cap technology stocks with their index NYSE FANG+ delivering outstanding gain of approximately 75 %! What is your take on the truly outstanding performance of these stocks? Isn't it already a bubble?

The performance of the so-called Magnificent Seven (AAPL, MSFT, AMZN, NVDA, GOOGL, TSLA and META) is symptomatic for this year's US equity performance. Although the earnings estimates for 2024 have declined for the most of these stocks (the exceptions were NVDA and META) this year, their share prices advanced between 39% and 232% year-to-date. If the estimates do not start catching-up it will be very hard for these

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stocks to keep their premium valuations (collectively trade at above 30x expected earnings).

Moving to the investment process of your Top Stocks fund, could you please elaborate on your investment strategy in detail?

In the Top Stocks fund I follow a focus investing strategy. The portfolio consists of up to 25 equally weighted investments into individual stocks (or with one exception into a group of similar stocks). Although higher portfolio concentration will lead to higher volatility, company specific fundamental stories of each investment should allow to sufficiently diversify the existing risk. Generally, I focus only on a few segments of the market (historically, most of the fund investments were done in the Health Care, Technology & Consumer sectors), which should increase the odds of better selection thanks to the deeper understanding of business models and competitive environment. I'm targeting investment ideas, where above-average return could be expected, which allows me to compensate for relative losses from missing other good investments from not-covered segments as well as from my own mistakes with some investments. The absence of the significant part of investment universe will lead to higher tracking error compared to the main developed market indices. The regional split has been oscillating around 80% US equities and 20% European equities.

I look for companies with the ability to grow their sales/earnings above average in the long-term. My expected return is primarily driven by the growth of the fundamentals, not by the positive valuation change. In case this growth in fundamentals is higher than the consensus initially expected, increase in relative valuation could bring additional return, but this is not part of my expected return calculation. When investing in stocks with premium valuations, the growth in fundamentals must be so strong that it will outweigh the potential valuation normalization in time.

BIO

I have started my career in equity investments in 1994. After working as a Sell-side Analyst covering Czech stocks for 5 years, I joined ING IM in July 1999 and managed their Czech Equity Fund for two years. Then I worked as a Proprietary Trader for CEE equities in Patria Finance for two years. After sabbatical period, when I have been living in Paris for 18 months, I joined Ceska sporitelna in December 2004 as an Equity Strategist and later moved to the daughter company ISCS (now Erste Asset Management CR) to start managing the Top Stocks fund since its inception in August 2006.

During a typical year I look at 200-250 different investments and in the past 17 years I did 4 new investments per year on average (so the average turnover of the fund is above 6 years). I still hold two companies that are in the portfolio since the beginning of the fund.

Positions are sold for three reasons: when the investment thesis did not play out as expected (most of the time), when the investment thesis is fulfilled and no further above-average upside exists in my opinion and finally when there is a better investment than the existing 25, and there is need to make room for it.

What have been the major investment mistakes you have made as the fund's Portfolio Manager and what lessons you have learnt from them?

Obviously, I made many mistakes in the past 17 years, mainly by not correctly understanding the investment story of a particular stock and thus not correctly anticipating the future development of its fundamentals. These mistakes were both ways – investing in worse than expected stories and avoiding better than expected ones. I learned an important lesson to pay even more attention to the opposite views than mine. Now, I try very hard to disprove any investment story I have built while analyzing a new company before investing in its stock.

Could you please as well elaborate on and explain the rationale behind your five top picks in your fund? Do you hold them in particular because you expect a significant increase of their valuations or because you expect much higher growth of corporate fundamentals such as earnings and free cash flow in the upcoming years compared with the current analysts' consensus or is it a combination of both these two key fundamental factors?

Typically, all investments start with 4% weight and differences in individual stocks weightings arise because of the different price movements (I try to not rebalance the portfolio too often – usually new inflows are invested in below 4% positions, while significant outflows are paid out from selling part of the above 4% positions). Current top 5 investments are Sarepta Therapeutics (company will successfully develop the first gene therapy treatment for the Duchenne Muscular Disease), Biogen (commercial success of the first approved drug for Alzheimer Disease will surprise to the upside), Bloomin' Brands (casual dining restaurant chain's operating improvement is underappreciated by the consensus), Marriott (best managed hotel chain, people will continue spending on experiences instead of goods) and Biomarin Pharmaceuticals (two recently approved drugs for Achondroplasia and Hemophilia will surprise to the upside with their sales trajectories).

And now the final two questions. What do you think about gold? Do you think it should be a part of every well-diversified investment portfolio? What are the key pros and cons of this investment asset in your opinion?

Gold serves one important role as a very good insurance against big catastrophic scenarios (wars, hyperinflation), but its role should not be overestimated as it does not generate any cash-flow.

What do you think about crypto and especially Bitcoin?

I do not have positive view about crypto yet. In my opinion it will take more time and institutional development before it gets to the same level as widely traded precious metals (ie. gold).

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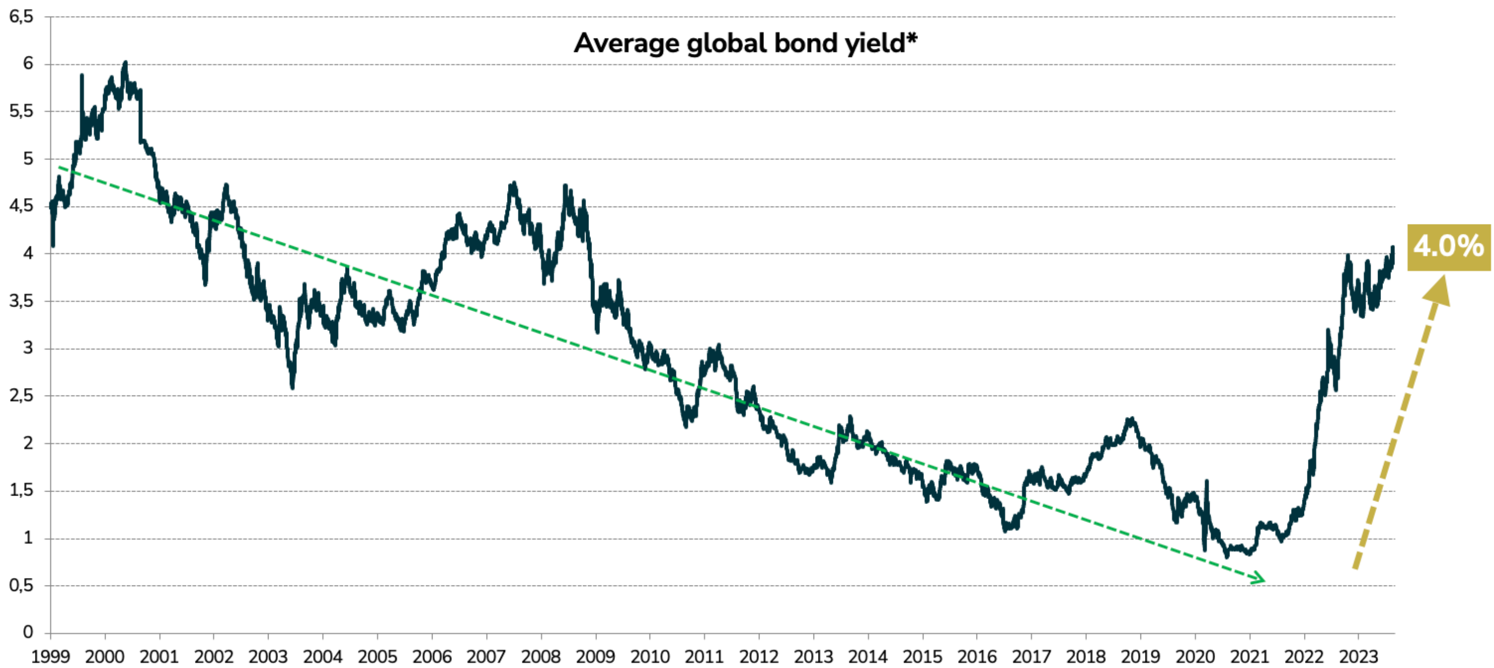
Cost of debt capital is currently at the highest level across the globe since 2008

Michal Stupavský, CFA
Chief Analyst

Cost of debt capital is currently at the highest level across the globe since 2008. Guess what it means for excessively indebted governments, companies and households. With the total volume of global debt at approximately USD 300 trillion, every 10 basis points increase in interest rates translates into a staggering USD 300 billion of additional annual interest costs globally. For heavily indebted companies this causes much weaker total cash flow generation and lower interest coverage ratios which potentially implies credit rating downgrades as well. For heavily indebted governments this questions the financial stability and sustainability of government debt, particularly taking into account the fact that major central banks such as Fed and ECB do not carry out the quantitative easing anymore. And for heavily indebted households this weakens their ability to take on a new mortgage or credit card loan. All in all the much higher current cost of debt capital compared with the ZIRP policies only two years ago seems to be a significant headwind for the global economy growth dynamics going forward.



*Bloomberg Barclays Global-Aggregate Yield to Worst

Source: Bloomberg

Is China ripe for a Lehman Moment?

Tomáš Pfeiler, CFA
Analyst

Since the Global Financial Crisis of 2008 investors have become obsessed with guessing when the next Lehman moment – an ostensibly idiosyncratic accident which will trigger a major financial implosion – occur. China seems to be the latest candidate for such an event. Are such analogies accurate or is the pessimism overdone?

Chinese economy is struggling with a trifecta of major problems: 1) structural imbalances in the financial system stemming from excessive leverage, 2) weaker than expected cyclical recovery and 3) a lingering decoupling between China and the West. Combined, these three factors can incur a massive slump in asset prices in the short-term, while over the longer horizon, they might result in a broader global economic rebalancing.

Country's pervasive debt overhang has been the principal issue. Entire financial system is extremely opaque and vast portion of intermediation is done through shadow banking. At the end of 2020, Chinese authorities embarked on their signature policy of Three Red Flags to combat excesses in the overleveraged construction sector. Those harsh measures exposed vulnerability of the country's economic model, where construction plays a prominent role.

Some big-ticket names such as Evergrande defaulted on its obligations. These days the contagion has been spreading among players earlier deemed safe and stable such as Country Garden. Local authorities are refusing to grant full-scale bailouts to ailing developers and instead they support the sector with rather cosmetic measures – such as easing of mortgage lending conditions for the first-time buyers. These steps have proven insufficient to stabilize the property market.

Evidences mount that the distress propagates beyond construction sector. Zhongzhi, a financial conglomerate missed payments on several wealth management products. Palpable slowdown in the property market therefore reverberates across the highly intertwined financial system. Traditional banking is also not insulated from negative spillovers.

At the start of the year asset managers tactically positioned for the economic rebound in the largest Asian country. There was a reason to believe that the post-covid recovery would turbocharge global growth. However, the economic momentum has finally proven surprisingly sluggish. The principal reason is the above-average precautionary savings among the Chinese households. There is no meaningful release of the pent-up demand which occurred in western countries as pandemic restrictions were lift. Inflation in China is virtually non-existent. On some basis, prices slipped into deflation territory.

Threats of geoeconomic fragmentation and unpredictable regulatory environment undermine investors' confidence. Funds are trimming their exposure to Chinese assets. Meanwhile, local decision-makers remain unwilling to flood the economy with fiscal or monetary stimuli. There were minor attempts to stabilize the financial system. However, a massive injection of liquidity seems to be anathema to Beijing. It would counteract government's longer-term effort: transformation of the economic model from the investment driven to the consumption driven one.

Under such circumstances renminbi plummeted and it is currently trading close to the multi-year lows. Weaker currency gives a boost to exports, but it is not a panacea. If the renminbi depreciates excessively, violent capital exodus may ensue. The PBoC must therefore perform a delicate balancing act. Higher interest rates would propel investors into Chinese assets and help the currency to regain strength. On the other hand, it would strike further blow to fading demand.

Chinese authorities need to deal with a non-trivial situation. Their response, however, will be calibrated. Those who bet on a large-scale QE-like stimulus will be probably disappointed. Defaults of property developers might proliferate and local equities could dive, which would drag down stock prices in western markets and derail the broader rally in risky assets. However, I dare say, fears of Lehman style implosion are overblown. Chinese economy is on precarious footing and it is heading to a new era of sub-par growth. But a serious financial accident is not inevitable. Nevertheless, we will probably witness global economic rebalancing. Recovery after the Crisis of 2008 was largely driven by insatiable Chinese demand. Recent events suggest that this will not be the case in the post-pandemic world.

M&A INSIGHT OF THE MONTH

BAE agrees to buy space technology firm Ball Aerospace for $5.6bn

Martin Bosák
Analyst

The acquisition would give BAE significantly more exposure to the growing government space market

BAE Systems, a defense and security conglomerate based in the United Kingdom, announced Aug. 17 it intends to acquire Ball Aerospace for gross proceeds of $5.6 billion in cash, which represents 19.6x Ball Aerospace's LTM comparable EBITDA (as of June 30, 2023). The purchase of the Colorado-based business would help BAE to expand in technologies that are US defence priorities.

The deal comes amid a surge in spending on global military and spying technology prompted by Russia's invasion of Ukraine. It also follows the US setting up a separate arm of the military, space command, to try to keep up with China. Both have prompted western allies to recommit to bigger military budgets, to the delight of weapons manufacturers that have received huge orders.

Defence industry boom has made mega-deals in that sector more attractive. In the US, L3Harris Technologies bought the rocket engine maker Aerojet Rocketdyne for $4.7bn in a deal that it completed in July.

Ball Aerospace's parent company, Ball Corporation, traces its roots back to making paint cans and glass jars in the 1880s in Buffalo, New York, and it now makes beer cans and aerosol bottles by the million. The Colorado-based aerospace business made $1.98 billion in revenue and accounted for 13% of Ball's consolidated net sales in 2022.

Ball Aerospace, up for sale since June, specialises in instruments, sensors and spacecraft, including some of the most sensitive satellite technologies, as well as civilian applications such as monitoring weather patterns. Ball's optics technologies were used on the Hubble space telescope and it built the Kepler telescope used to search for Earth-like planets.

However, its focus is selling high-margin military technology. Ball's defence technologies include laser communication systems to link infantry and drones via satellite, and satellite tracking systems that allow spacecraft to monitor potential threats from other vehicles in space, as military competition increasingly spreads into Earth's orbit.

More than 60% of Ball's 5,200 employees hold US security clearances, allowing them to work on sensitive military technologies. Its military space business includes a contract to build satellites for the U.S. Space Force and the Space Development Agency.

BAE is by far the UK's largest defence company, with a stock market valuation of more than £29bn. It makes and services a huge array of weapons ranging from tanks to fighter jets and the UK's Vanguard submarines that carry Trident nuclear missiles. Recently BAE also reported record orders since Russia's invasion, and its stock market value has risen by almost three-quarters since the start of 2022.

With $26 billion in annual revenues, BAE Systems has a significant U.S. presence. The U.S. government is now its largest customer. BAE's U.S. subsidiary, headquartered in Falls Church, Virginia, supports large Defense programs in air, land, sea and cyber warfare.

The Ball Aerospace purchase will give BAE a business with $2bn in revenues and $310m in profits in space, missiles and military computing technologies, and BAE wants to grow the business by 10% a year over the next five years.

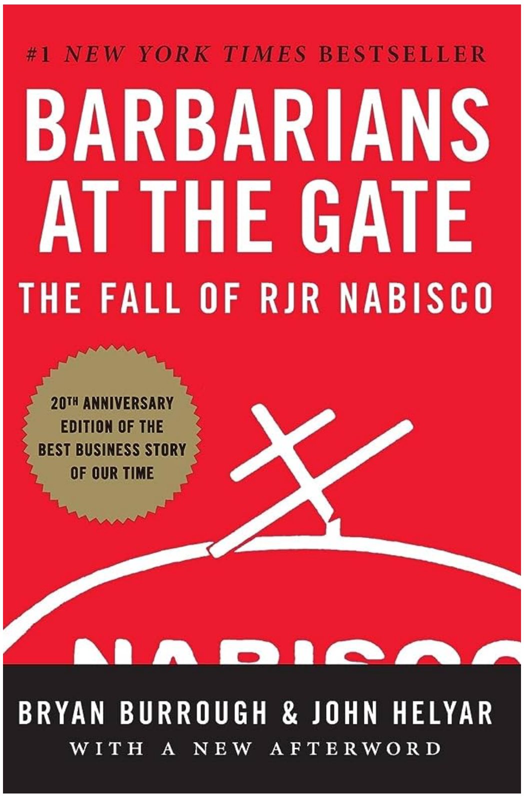
Ball began shopping around its aerospace division earlier this year, looking for a deal that would help trim its nearly $10 billion in debt. Ball said the transaction is expected to generate about $4.5 billion in after-tax proceeds.

BAE said there would be $30m of cost savings in areas such as joint procurement and better management of projects but did not make reference to job cuts. The deal is expected to be completed early next year, if regulators give it the green light.

Despite it is rare that business of this scale in defense sector is available and there are several potential cost and growth strategies, the valuation 19.6x of LTM comparable EBITDA seems to be slightly expensive (shares in BAE Systems fell by 4.5% on the announcement day, but almost recovered the following week).

BOOK TIP OF THE MONTH

Barbarians, at the Gate by Bryan Burrough and John Helyar



Jakub Mičian
Analyst

"Barbarians, at the Gate " authored by Bryan Burrough and John Helyar is a timeless masterpiece that explores the ruthless realm of takeovers and leveraged buyouts during the 1980s. The focal point of the book revolves around the leveraged buyout (LBO) of RJR Nabisco, a conglomerate orchestrated by a group of ambitious corporate raiders led by F. Ross Johnson.

Burrough and Helyar's narrative style is both engaging and informative, taking the reader on a rollercoaster ride through the intricate details of this high-stakes financial maneuver. They easily explain complex financial concepts in a way that is accessible to a wide range of readers, making it a must-read for both finance enthusiasts and those with a general interest in business.

In addition to shedding light on RJR Nabisco's LBO "Barbarians at the Gate" offers insights into Wall Street's culture during the 1980's – an era characterized by greed, ambition and risk taking. The narrative captures the extravagance of that time with its lifestyles and extravagant spending while also highlighting the consequences resulting from corporate behavior. Furthermore, it delves into boardroom politics and ethical dilemmas faced by key players involved in this deal – providing readers with a comprehensive understanding of its complexities.

Despite being over three decades old "Barbarians, at the Gate" remains highly relevant in today's business world. The insights it offers on governance, deal making and the psychology behind decision making still hold significance. The remarkable storytelling combined with in depth research and understanding of finance make this book a must read for anyone in the world of business, finance, or corporate drama.

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TECHNICAL ANALYSIS INSIGHT OF THE MONTH

EUR/USD

Miroslava Trantírková
Technical Analyst

EURUSD is moving in the long-term downtrend ever since reaching its all-time highs at 1,6038 in July 2008. Its most recent primary down move signalled by the completion of Head and Shoulders Top in August 2021 has bottomed out at 0,9536 in September 2022.

The following rebound has erased almost exactly 2/3rds of the losses when reaching 1,1275 recently. Using the Elliott Wave count we are now looking at a wave B from a corrective Zigzag pattern. Considering that there are the waves ABC in the corrective pattern we are now midway into the rebound. The wave B shall be now heading towards the 1,0600-1,0615 area with a further possible downside towards 0,9908-1,0405 before the last wave C with a upside potential of 1,1275 or even 1,1600-1,1700 area. That shall be a roof for the rebound and the primary downtrend is then expected to resume.

*The analysis concentrates on primary trends ranging from 9 months to 2 years and intermediate trends ranging from 6 weeks to 9 months.

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ABOUT

Prague Finance Institute (PFI)

Non-profit organization affiliated with CERGE-EI

PFI aims to connect experienced and young finance professionals, including students, especially through educational and networking events

Our key activities:

- **PFI Talks podcast** in cooperation with the daily E15 (e.g. Daniel Kahneman, Jeffrey Sachs, Aswath Damodaran, Marc Faber, Barry Eichengreen or Peter Oppenheimer)
- **Panel discussions** (roundtables)
- **Valuation Masterclass** (semester-long business valuation course)
- **Technical Analysis Masterclass** (unique six lectures on technical analysis)
- **Research** (PFI Monthly report)
- **PFI Scholarship** (forthcoming)
- **Platform for sharing interesting job opportunities** in the financial sector
- **Social media,** especially LinkedIn

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