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FPM-Comment **Reducing the Noise**

Martin Wirth – 1/2017 dated January 24th 2017

Shift in preferences on the equity markets

Martin Wirth – Fund Manager, founder and Member of the Board FPM AG

•Experience in German equities since 1990
•Funds: mutual funds FPM Funds Stockpicker Germany All Cap, institutional special mandate for Norges Bank Investment Management (Norwegian Government Fund)

- Value-driven investment approach proves its worth again
- Sticking to our investment style pays back
- The economic cycle is picking up
- Stock valuation not expensive
- Very likely that rates have bottomed
- Highly valued bond replacement stocks will suffer upon rising rates
- FPM Funds: keeping our above average weight in „deep-value stocks“

2016: a year of two halves – from old pals to new favorites

2016 can be divided into two parts. Initially, the previous years' trend continued. Interest rates dropped to ever new record lows, fueled by bond purchases by central banks, especially the ECB. Commodity prices also fell to their lowest point in the first quarter. In this environment, equities with stable and readily forecastable profits, above-average quality and good growth prospects were in demand. Valuations were not particularly important. With commodity prices at a low, the interest rate environment started to change in the summer: the bond markets no longer rose to new highs, despite the ECB's bond purchases. That led to a shift in preferences on the equity markets: investors started to buy the losers of the low interest rate scenario, some of which had previously changed hands at bargain basement prices. Viewed over the year as a whole, the big winners were shares in companies with an average to slightly above-average business model, without grandiose growth prospects but, above all, without any particularly problematic issues, which had been moderately valued compared with the favorites of the previous years. Given a stable business performance, they generated solid double-digit returns even though their valuations had not previously been particularly low. In the second half of the year, some of the former favorites among the quality stocks posted considerable losses, which negated their previous gains.

This comment is intended for fund analysts, consultants and asset managers only. No supply to retail clients.

FPM Frankfurt Performance Management AG • Freiherr-vom-Stein-Str. 11• D-60323 Frankfurt am Main
Telephone: +49 69.795886-0 • E-mail: kontakt@fpm-ag.de • Website: www.fpm-ag.de

FPM Funds performance reflects current trends

In view of FPM's focus on a valuation-driven investment approach, our funds performed in line with these trends. Initially performance was weak in both absolute and relative terms, but a very strong second half made it possible to recoup losses and turn them into gains, significantly outperforming the market in some cases. Sticking to the investment style that has been the most successful in the long term and has a sound economic basis proved right (and is ultimately the only possible course). We do not subscribe to "quality is the new value" and similar approaches that are touted in connection with extreme market trends.
Even though it can be painful at times, volatility is not the same as risk, except in mathematical models.
It only becomes a risk if investors cannot tolerate it and exit the market at the wrong time instead of utilizing the opportunities it offers. Risk means the risk of a lasting loss of capital, which cannot be recouped by waiting for the situation to improve. However, this type of risk often has nothing to do with the operational risk of a company; it simply relates to the fact that a share is overvalued.

Cycle is stable and German stocks over all fairly valued

On balance, it can be said that not much had happened since the end of the year. Naturally, we need to consider whether the trends of the past few months were one-offs or an indicator of changing times. Before we outline our view of the upcoming prospects, here is an overview of the present situation.

First of all: growth expectations. Despite the subdued sentiment that continues to prevail both on the financial markets and among the general public, the economic outlook has stabilized in recent months. For the first time since the start of the financial crisis, the global economy is rising at a moderate pace. Pleasingly, apart from exceptions such as real estate in some major German cities, this is taking place in a less euphoric environment. In some cases, it seems as if people do not really believe that this time the improvement could prove more sustainable. Ten years of ups and downs are a long period and every region of the world has come close to disaster on at least one occasion during this time. For the time being, it is clear that not one relevant parameter is pointing downwards - quite the contrary! (As always, China is too difficult to be regarded as anything but a black box, but it also seems to be developing positively.)

Overall, in absolute terms German equities do not seem to be either too expensive or too cheap. However, valuations are still very low compared to interest rates. That said, there are still big discrepancies between different sectors and market segments, although they have narrowed in recent months. Furthermore, when comparing the valuation of the equity market on the basis of index values with historical data, it should be remembered that the composition of the German equity indices has changed considerably in recent years and decades. The clearest sign of this is that the largest sector, alongside automotive stocks, is no longer mechanical engineering, banking or utilities but health care. The software industry (SAP) accounts for more than twice as high a share of the index as the two remaining banks.
20 years ago, there were still five banks in the DAX.

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Another important although perhaps trivial indicator in our view is that just because the DAX is trading close to its all-time high does not mean it is expensive. The price-based DAX, which does not include dividend payments and is therefore comparable to the calculation of the S&P or the Dow Jones, is well below the highs of 2000, even though the majority of corporate profits generated since then have been reinvested rather than distributed to investors.

Inflation and interest rates are supposed to have bottomed out

So the economic trend is relatively positive and equity valuations are not expensive. That leaves the question of how interest rates and inflation will develop. In recent years, they have been the decisive factor in the massive valuation spread on the equity market. While some parts of the equity market benefited from falling interest rates, others visibly suffered. The losers include companies with high pension obligations, banks, and firms with low debt and high liquidity. The winners were companies with stable to high growth rates (the present value of profits in the distant future rises as interest rates fall) and those whose business model was based on significant levels of debt. Finally, in some cases, the positive and negative effects cancelled each other out.

Since valuation spreads are still high, interest-rate trends in the coming years could remain one of the main drivers of equity prices, although this time in the opposite direction. Since we do not invest top-down, our portfolios are not based primarily on economic considerations. However, if individual economic parameters are at extreme levels and they therefore have a significant influence on the valuation parameters for a large number of equities, it is evidently necessary to supplement our corporate analysis by taking a closer look at these parameters. In this case, that means interest rates.

In our view, interest rates have not hit lows simply because of the prospect of lasting low inflation rates. Rather, this situation has clearly been exacerbated by intervention by central banks, regulatory conditions and, in some cases, the smugness of many bond investors. Presumably, price gains have often been confused with sustainable coupons and investors have failed to recognize that current yields are likely to work to the detriment of future income. If they had misgivings, they put their faith in the fact that the central banks would buy them - which might happen, but cannot be relied on. It could end like a chain letter or US real estate before the crisis that started in 2007: the devil takes the hindmost.

From an economic standpoint, given the steady economic improvement our view is that interest rates will most probably not drop to new lows, as long as the central banks do not wish to completely undo every price regime.

Assuming that interest rates do not drop to new lows, there are two possibilities: they will hardly change or they will rise.

If interest rates remains stable, the valuations of the various equity market sectors should not drift further apart. Since the winners are still trading at a considerable premium, the valuations of those that stand to lose out if interests rates fall are cushioned. The world would look different if interest rates were to rise. In this case, the trends seen in recent years could start to reverse. There are therefore two possibilities: in

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the event of stable, low interest rates, there is not much to lose by focusing on the losers of low interest rates that have low valuations, and in the other scenario there could be a good deal to gain.

Will interest rates be stable or rise?

The principal question is therefore: what are the arguments in favor of rising interest rates and those in favor of stagnating interest rates?

Based on current data, deflation no longer seems to us to be an issue. Following the global financial crisis, the euro crisis and the commodity price crisis, there is little sign of a new bubble that could burst in the foreseeable future. The impact of these three crises, all of which went well beyond what could be considered a normal downturn, included extremely low inflation rates. However, the impact of these crises is beginning to weaken, reducing pressure on inflation rates. Now the fundamental trend is rearing its head again: ultimately, the inflation rate depends principally on wage trends and secondly on productivity gains, especially in a world where services account for an increasingly high proportion of national income.
Since unemployment rates are declining almost everywhere - and there is already full employment in relevant markets such as the USA and Germany - the spectre of deflation will probably not return in the near future.

We are not suggesting that inflation will rise quickly or attain unpleasant levels, quite simply because we do not know whether this will be the case. However, since the central banks are or will be very cautious about raising interest rates, especially if inflation rises, this possibility cannot be ruled out completely, even in the medium term. They are more likely to accept higher inflation than to throttle an upswing.
Even further stabilization of interest rates would prove positive for a number of companies, as the past months have shown. We see further considerable valuation opportunities for shares that could benefit from stable or only slight rises in interest rates. Fortunately, a sharp improvement in earnings would not be necessary for this. In our view, a steady continuation of the present trend would be completely sufficient to boost share prices.

How will the equity market respond – our scenarios

Finally, the question is how the equity market as a whole might react to rising interest rates. Without doubt, there is a level at which higher interest rates would be negative. What is not clear is what level this would be.

Different scenarios are possible. Normally, the correlation between equity and bond yields is positive. However, for the past 16 years, that has not been the case for the market as a whole, although it has been true for some substantial sub-segments of the equity market. The fears that are now emerging (there are always fears, otherwise there would not be a risk premium for equities vs. bonds) relate to the interest rate level at which the equity market would come under pressure. Generally, expectations of this level are not

far from the present position. For example, it is put at just under 1 % for bunds and 3 % for US treasuries. Moreover, there is a risk that equities could come under pressure as a result of above-average volatility.

Our scenario is different. The negative correlation has been in place since interest rates were 5-6 % for bunds and US treasuries, so it is not immediately clear why a problem should arise if interest on bunds were 1 % (except insofar as it is a self-fulfilling prophecy). Besides, this view relates to the market as a whole. As regards the fears relating to those equities that are at particular risk: the above-average risks seem to us to have been priced in for some time now through high valuation discounts. We consider it more probable that, in the event of rising interest rates, the beneficiaries of low interest rates that have high valuations would suffer, while low-valued segments that benefit from rising interest rates could post a positive performance in this scenario. The "old economy equities" that were trading on low valuations after the turn of the millennium and posted positive price trends in the historical bear market can be taken as an example. Looking further back in capital market history, in the 1950s there was also a negative correlation between equities and bonds for several years, with both interest rates and equity prices rising. That is logical, because otherwise bonds would permanently outperform equities. In our view, it is relatively clear which market segment has a risk buffer and which does not. Therefore our portfolio remains overweight in the "deep value" segment.

Sincerely yours, Martin Wirth

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