FPM-Comment **Reducing the Noise**

Martin Wirth – 2/2017 dated April 7th 2017

We continue to be positive on German equities

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•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)

- Stable economic tailwind for the international equity markets
- German equity market still fairly valued
- Wide valuation spread between some market segments
- Tentative signs that central bank policy could be coming to an end
- Still enough potential for equities despite higher prices and risk avoidance tendencies

Upswing in Q1/2017 seems to be self-sustaining

Essentially, the international equity markets did well in the first quarter of 2017. The economy provided a stable tailwind and for the first time in many years there is a sense that the upswing is self-supporting. The trend is most advanced in the USA, where the Fed finally got round to making an incremental increase in interest rates. The situation does not look much worse in Europe either, although the economic development remains divergent. Here, it is important to distinguish between the present development, which is also proving positive in southern Europe, and potential, where there are still big differences between northern and southern Europe, as evidenced by unemployment rates and current budget deficits.

Equities: recent favourites are benefiting from ingrained investment patterns

The bond markets also performed well, presumably thanks to the ECB's bond purchases and the lower inflation rates as the commodity price effect declines. As a result, old investment patterns re-emerged: following a weak start, the favourites from recent years´ bull markets, i.e. companies with stable profits, solid growth rates and above-average quality, were able to recoup some of the relative losses sustained in recent months. By contrast, companies with low valuations, but which are perceived as rather average or cyclical, lost some of the outperformance of the second half of 2016.

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Overall, the German equity market remains fairly valued, and is undervalued relative to the bond market. That may seem somewhat surprising given that it is close to a record high, but the rise in recent years basically mirrored the development of profits and dividend payments. Most of the increase in market valuation came from the segment comprising stable companies, and was presumably driven primarily by interest rates. However, the increase in market valuation was far less than would theoretically have been appropriate given the trend on the bond market.

Tentative signs that the present central bank policy is coming to an end

The valuation spread between the various market segments therefore remains very wide. We still assume that interest rates will not drop to a new all-time low, unless the central bank decides to cross new frontiers. Given the economic trend, that would make absolutely no sense. Instead, there are initial signs that the policy pursued by the ECB in recent years could come to an end.

Why do we believe this to be highly probable? The side-effects of this policy are becoming increasingly clear. Initially, the ECB helped the countries with the most serious economic problems to overcome their liquidity shortages. That was the essentially positive aspect of its policy. Sadly, the expectation that once they had been freed from this burden the crisis-ridden states would have the courage to tackle the tasks facing them - i.e. to implement reforms - has only been partially fulfilled. The politicians hardly ever managed to market the opportunities associated with this policy to the electorate. Probably, the opportunities were not even understood because of the background of most politicians. (To put it clearly: it is not only in southern Europe that there is a dichotomy between social background and responsibility. For example, it is well-known that the German finance minister who helped Greece join the euro zone despite the resistance of the Bundesbank was a teacher by training. Besides, wishful thinking and economic laws of nature had nothing do to with each other - and that was not confined to southern Europe either.) As a result, in the most difficult years countries met the formal requirements by the skin of their teeth - if at all. However, action to abolish growth inhibiting and even corrupt structures were postponed and avoided. Consequently, it is hardly surprising that the momentum required to close the gap failed to materialise in the southern states.

And now let us turn to the other side of the coin: solvent countries and solvent investors embraced the low-interest policy along with the ailing states. Here is an indication of the scale we are talking about: With financial assets of €5 trillion (European, not US trillions), a one percent shift in interest rates means a redistribution of assets in Germany amounting to €50 billion a year. It is fairly certain that the ECB's policy has brought a shift of at least this magnitude in Germany. That means that borrowers have been relieved of about €50 billion in debts, while the same amount has been foregone by creditors. Naturally, in this situation the biggest borrower, the state, benefits most. The German finance minister can therefore proclaim himself to be a great saver without much effort (especially as he is benefiting from the fact that the taxes account for the largest share of national income seen in German history - partly due to fiscal drag, but that is another story). Other winners include property owners, property developers and companies with debt. The losers are nominal-value savers (evidently not those who invest in equities as we

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can see), life insurance policyholders, and tenants or potential property buyers, who are affected by rising prices. Basically, that boils down to a clear-cut redistribution from bottom to top, on a scale that makes the entire debate about social justice seem ridiculous. Finally, a word about the euro, which - by all common standards - is undervalued against the US dollar. This, too, tends to benefit companies more than consumers as they ultimately have to pay for the high cost of imports. However, since the state is the main beneficiary of this central bank policy, hardly any politician is likely to complain, especially as that would prevent him/her from parading his/her generosity.

Reminder: The reason for central bank independence

It was for precisely this situation that central bank independence was introduced: to take away the punch when the party starts to get out of hand. We find it virtually impossible to believe that the ECB has failed to recognise that its policy has had limited success in the crisis-ridden countries because it has reduced the incentive for politicians to take action, or that it is unaware of the unwanted side-effects in the more stable countries. This is not the first debacle caused by the ECB. An inappropriate policy geared to Germany, which was the problem country at the time, meant that interest rates were far too low for the southern European countries. Does this state of affairs really have to be repeated in the first twenty years since the introduction of the euro? That would be difficult to imagine.

Consequently, we believe it is compelling that the ECB alters its policy in the not-too-distant future. That may seem banal. But the equity market seems to see things differently. And that, in our view, is the opportunity - and one that would last several years.

The opportunities would be generated by eliminating the valuation spread between the various market segments and between the companies that are suffering from or benefiting from low interest rates. Moreover, in a world that functioned normally - a world where opportunities and risks could once again be weighed against one another instead of giving priority to avoiding risks regardless how high the opportunities are - it would be possible to take a more relaxed attitude to companies that are not always ultra-stable. It is clear that risk avoidance at any price does not pay off for ever. Examples are the German real estate market, the German equity market and companies that have utilised opportunities rather than giving in to the permanent talk of crisis. Unlike those who constantly prophesy doom and gloom and constantly find good reasons why now it´s not the time to grasp opportunities, in our view there is enough potential on the German equity market as a whole - despite higher prices. Above all, we see potential in specific sectors and companies.

We are more relaxed than the prophets of doom and gloom: there is still enough potential in our view

What could go wrong? Given the largely risk-averse or at least risk-aware focus of recent years, there seems little reason to fear a sudden economic downswing. Massive misallocation of capital is unlikely.

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On the contrary, there has been repeated criticism of the low level of investment, which has probably been partly responsible for the low productivity growth in recent years. Exceptions could be the bond markets (which are normally seen as a haven of risk avoidance) and possibly China. Although the German equity market has not exactly been overheating, normal volatility is likely. Possible causes will be elections somewhere, the US equity market, or concern about interest rates. And if that happens, such situations should be viewed as opportunities.

Still positive on equities

The biggest risk remains the fact that Europe's political leaders seem unaware of economic necessity. Instead of leading, they lurch from one panic attack to the next as elections approach, make promises they cannot keep, and bend one rule after the other. Fortunately, the state is not everything in our system. However, populist policies that build up debt without taking anyone else into account will extract their pound of flesh at some time. Thanks to the ECB, that is still some way off: countries have been able to run their debt on extremely low interest rates, and that looks set to continue for a while. The question is whether at this - hopefully distant - date equities will prove to be a worse place to be invested than bonds and liquidity. There is no historical or economic evidence for this. Therefore, at present valuations we remain positive about equities on a short and long-term view.

Sincerely yours,

M. Wirth

Martin Wirth

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