FPM-Comment **Reducing the Noise**

Martin Wirth – 4/2017 dated October 9th 2017

Conditions for equities remain stable – but keep an eye on interest rates

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- Experience in German equities since 1990
- Funds: mutual funds FPM Funds Stockpicker Germany All Cap, institutional special mandate for NBIM

- Pleasing development in Q3 2017
- Bull market based on sound fundamentals
- Fixed income markets still distorted
- Higher interest rates expected
- Conditions are still good for our favourites

Q3: The economic direction is right; considerable gains on the equity market in some cases

Contrary to expectations of a summer weakness, the third quarter of this year turned out to be quite satisfactory. The global economy is moving in sync in the right direction, political uncertainty has taken a back seat, corporate profits are doing well, and the bond markets did not impair the good sentiment even though interest rates are trending upwards. However, the last statement only applies to the market as a whole: the safe havens on the equity market, which were extremely popular in recent years, have significantly underperformed this year. By contrast, cyclical stocks trading on low valuations benefited from the stabilisation of the economy and some posted substantial gains. Overall, we still consider the market to be fairly valued in absolute terms and undervalued compared with the bond market.
The valuation spread between market segments has narrowed but still exists.

Bull market based on sound fundamentals but fixed income markets are still distorted

In our view, the situation is currently quite stable. However, times like this lay the foundations for future problems.

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

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There is no denying that political risks, which are the focus of media attention, are a problem: improbable but of enormous significance if they materialise. That said, despite North Korea, the EU crisis, Brexit, Russia and Trump, the problems are unlikely to be much more relevant than they have generally been in the past: they are only minor with hindsight; at the time they were as big as the problems looming at present. Since this is a topic where we cannot make a real contribution, we will not be discussing it.

The big advantage at present is that, at first sight, the global economy seems to be in a solid upward trend. The USA has been developing steadily for years, China is continuing to boom, in Europe all countries are now improving, and even countries like Russia and Brazil, which had been in the grip of crisis, are now back on a growth track. Consequently, the bull market is no longer built simply on hopes; it is based on sound fundamentals.

We do not share the fears that the rally is coming to an end because it has already been going on for a long time. Rallies do not die of age but because their key drivers are no longer operative. These may comprise a range of parameters. By far the most important are excessive valuations, overheating of the economy leading to misallocation of capital, or a more restrictive central bank policy, generally due to one of the first factors. Nothing of that sort is evident at present, with the possible exception of the valuation of the US equity market. So it seems that investors can remain relaxed.

Nevertheless, there is one relevant problem in our view: the continued distortion of the fixed income markets, both in the euro zone and in the dollar area. Most regions of the world are now posting nominal growth rates which are accompanied by interest rates far below the level that used to be common. That is not just due to the (too) low central bank rates. It is also attributable to the fact that the central banks have bought up large bond holdings. That also has an impact on longer term rates in currency areas where the central banks have not used this tool. For example, Asian central banks have reduced their holdings of bunds and bought US and other sovereign bonds instead. In addition, after a certain time, this distortion of the bond markets is no longer perceived as such, so the interest rate level is considered sustainable. That encourages investors to shed their inhibitions about investing in debt in countries that were regarded until recently as being at risk of bankruptcy – with good reason.

Interest rate policy: desirable effects ...

Contrary to established doctrine, bond purchases by central banks may be acceptable in exceptional circumstances. However, in a relatively synchronous global upswing they do not simply seem superfluous; at some point they could even become a danger. Low interest rates do not simply make life easier for debtors at the expense of creditors, as can be seen from the miraculous improvement in European budget deficits. Low interest rates also encourage investments which would never be made if interest rates were higher. This incentive to increase investment is also exactly what the central banks want to see and have subsidised, along with the redistribution between creditors and debtors.

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… and unwanted side-effects

Unfortunately, this subsidisation has (at least) two unwanted side-effects. It results in redistribution between market participants, from fixed income savers to those who are prepared to take on new debt or are already in debt. That is not just the state. Basically, the beneficiaries are companies, to the detriment of savers. Over time, this is likely to make a big contribution to the much lamented redistribution from the bottom (or rather, from the middle, where people put their savings in fixed interest products and life insurance) to the top, especially if – as in Germany – a high proportion of the population sees entrepreneurial investments such as shares as casino chips. Secondly, it provides incentives to invest in non-sustainable projects. That is evident, for example, from the German market for luxury property, the global willingness to buy luxury cars because saving is no longer worthwhile, and possibly also from phenomena like bitcoins, because the opportunity costs are basically zero.

There has also been a shift in preferences on the equity market: the incentive to reduce debt is extremely low. Instead, companies are now praised for acquisitions, even if they are expensive, because refinancing is extremely low. Therefore, higher profits are virtually certain without making any major effort. All this is driving other industries, which benefit through second and third-round effects.

Still no major risks in sight, but: keep your eyes skinned

We do not want to seem too pessimistic. While these processes are no longer in their infancy in our view, we feel that possible problems would not be beyond control at present, even if interest rates were to rise substantially. So far, at any rate, financing is much more solid than it was before the financial crisis, and banks and debtors have far higher equity ratios than they did back then. Above all, though, the general risk awareness that has emerged in recent years should limit a major impact on the real economy.

For many years investment was too low rather than too high, and that is reflected to some extent in the shortages emerging today. So, there is no major threat at present, but the seeds have been sown and central banks would be well advised to respond in good time, in other words, soon.

That is principally due to the unwanted side-effects of monetary policy outlined above and not primarily to the fact that in the near future the German finance minister no longer has to pay any interest at all. The redistribution mentioned above would only become a problem if no-one was willing to save any more. But a loss of confidence that would trigger that is likely to become visible far later than the effects of misallocation of capital. Besides, rising interest rates will not give rise to immediate problems for European government budgets. After all, for a relevant portion of the debt, low interest rates are locked in for a long time. Consequently, rising interest rates would only affect new debt or the renewal of existing debt, not all debt. That would give countries time to adjust to the changing conditions (although looking at the USA, perhaps we should not be too optimistic here).

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Higher interest rates expected – bringing further tailwind for some of 2017's winners

One thing is clear in our view: interest rates will rise. The most probable scenario in our opinion is that they will not return to the common levels of the past, but will settle at a lower level. However, declining confidence in currencies and central banks that remain well behind the curve could mean we see interest rate rises on a quite different scale. If interest rates remain in line with our expectations, alongside the losers that are already known today, such as stable, high-value companies and some indebted companies, there would also be some winners. These are the companies that have been on a winning streak through a large part of 2017. Examples are banks, insurance companies, debt-free companies and companies with high pension obligations.

The favourites altered a year ago – valuations provide scope for further gains

Based on experience in recent years, we assume that once a trend starts it will continue until there is a fundamental change in the underlying conditions. The trend to cyclicals, average companies and the beneficiaries of rising interest rates is just over a year old. The valuations of companies in these categories range from below-average to fair. The last trend (high quality, strong visibility, strong free cash flow) started in 2009 from an extremely low valuation base. That was partly due to the general conditions created by the global financial crisis, and partly due to the fact that many stable companies had high levels of debt back then. In 2009, that was a no-go area, but today it is almost a virtue again.

The valuations and perception of our favourites are not distorted in this way. Therefore, we anticipate solid rather than exorbitant gains if the stable conditions continue – and we are keeping our eye on interest rates.

Sincerely yours,

M. Wirth

Martin Wirth

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