# FPM-Comment **Reducing the Noise**

**Martin Wirth – 1/2018** dated January 30th 2018

# 2018: Further confidence in Germany from our value perspective

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

- 2017 was a good year for the international equity markets – and an extremely successful year for FPM
- Central bank policy started to have a broadly based impact in the EU in 2017
- Declining uncertainty and a self-perpetuating upswing
- Continuation of the trends in 2018
- The old risks are the new risks – with valuations at a higher level
- 2018: active management offers further opportunities



## FPM in 2017: an exceptionally good year

2017 was a good year on the international equity markets – and an exceptionally pleasing year for our investors. Measured against the indices, clear double-digit gains were regularly achieved and the FPM Funds outperformed their benchmark indices, with the outperformance varying from well over 10% to 30%. That was not due to a particularly aggressive investment strategy, but to utilisation of the valuation spreads that have emerged between different segments of the equity market in recent years, and which we have regularly drawn attention to here: the high valuations of high-quality companies whose profits could be forecasted reliably, which were, in some cases, only justified by the extremely low interest rates, and the low valuations of companies of more average quality and above-average cyclicality. In addition, we were able to exploit a variety of special situations, which displayed a similar pattern.

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## Consequences of central bank policy: redistribution, buying time and finally higher investment

So why did sentiment change? 2017 was the year when the ultra-accommodating monetary policy started to have a broadly based impact in the EU. Moreover, it became clear that the banking regulators would not be tightening their stance further and there would be no further increase in capital requirements beyond the already massive rise.

Central bank policy has two implications: First, as a result of central bank bond purchases, interest rates and risk premiums are well below the level that would be set by the market. That takes pressure off debtors, so they find it easier to bear debts. As a result of the lower risk premiums, debtors with weak credit standing benefit most. Assuming that German interest rates are about 1% lower than they should be given general economic conditions, this reduces pressure on the German state to the tune of some €20 bn p.a. at the expense of its creditors. Measured by German financial assets, based on this assumption the redistribution from creditors to debtors is around €50 bn p.a., while Europe-wide the figure runs into triple-digit billions. That preserves structures that would not otherwise survive, which will hold back economic growth in the long run. Yet at the same time, it has also bought time to implement reforms. That has happened to some extent, although not always as extensively as would be desirable, so it is still debatable whether the structures in some states are sustainable. We doubt that, but it will not be an issue for a while.



In addition to this redistribution effect and to buying time, central bank policy has made investment easier to calculate: as a result of low interest rates, lower returns are sufficient to earn a positive return.
In recent years, that has been clearly understood by the equity market, especially in the case of companies with stable prospects, and above all by the real estate market. Nevertheless, it took time for that to be reflected in higher investment and a rise in consumption. As the old adage goes: the central bank can take a horse to water, but it cannot make it drink. The fact that more horses across Europe were ready to drink last year was probably due to the brighter prospects for banks: with adequate capital both from a regulatory viewpoint and in the banks' own perception, the reluctance to grant loans has largely been eliminated. The credit cycle has picked up almost everywhere. However, there is no reason for concern: credit growth is lagging economic growth by a wide margin in this cycle. At some time, it will overshoot the appropriate level, but that should still be a long way off.

## Declining uncertainty and a self-perpetuating upswing

Therefore, the brakes have been released, uncertainty has declined, leading to a self-perpetuating upswing that is still being driven by an extremely expansionary central bank policy. The problems experienced by governments in recent years are declining: on the one hand, lower unemployment is proving less of a drag, while on the other tax receipts are rising, so budget deficits are shrinking. That in turn means less uncertainty for companies and private individuals, because they are no longer plagued by the fear that they will bear the brunt of government deficits through higher taxes. And that brings us back to where we started: the reduction in uncertainty has reduced the extremely high risk premiums on shares in those



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companies where stability is not extremely high. Since some of these companies also benefited from an upturn in business, with profits rising along with their valuation, there has been a massive rise in the price of some shares.

By contrast, the scarcity premium priced into the valuation of some companies became unnecessary as risk appetite normalised. Despite a sound bull market, shares in quality companies that did not quite meet expectations therefore sustained considerable losses in some cases. As we have often explained here, the supposedly risk-averse strategy of investing in first-class companies was no longer low-risk: the risk of overstretched valuations was simply ignored.

## Looking ahead I: ongoing trends

In our view, two principal factors suggest that the trends seen in 2017 will continue in the new year. Firstly, valuation spreads have narrowed considerably, but not disappeared completely. Equities with above-average quality that did not prove disappointing last year still have a substantially higher premium versus the rest of the market, which looks unsustainable. The situation is quite different for quality stocks that failed to meet expectations: here we feel that valuation premiums have disappeared, in many cases for reasons that are relatively insignificant or at any rate temporary. From a valuation viewpoint, these stocks are once again attractive buys.



That said, the second factor needs to be considered: as we have seen in recent years, the markets are increasingly dependent on profit and price momentum. Stocks that run continue to run and even valuations that are stretched to the limits do not hold back this trend. That frequently continues until something happens, even something relatively transient. That brings the trend to an end and can have a perceptible impact on the share price, depending on where the valuation is.

As the global economy stabilises, even the earnings position of more cyclical stocks will become increasingly stable. At any rate, that is the general perception. Provided there are no major upsets, this suggests that last year's trend will continue. Alongside growing confidence among companies that they will be able to revise their targets upwards in a stable environment, this is being reinforced (from the viewpoint of trend-driven investment) by portfolio restructuring as investors abandon their cautious approach because it increasingly means lower returns. Another aspect is probably that in recent years many investors were of the opinion that money could be made with bonds despite low interest rates because they confused current yields with price gains on outstanding bonds. That is likely to become clear in the upcoming interest rate reversal. And then (theoretically) there should be further potential for equity purchases in the categories that have recently been successful.

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## Looking ahead II: the old risks are the new risks – with valuations at a higher level

As value investors, we naturally look first and foremost at equity market valuations. Here, we see a relatively neutral situation in Germany, albeit with segments with a far higher valuation than in the past. The very cheap investments of the past have now become far more expensive. Nevertheless, in most cases the level is still acceptable in absolute terms. We do, however, have two reservations: First, profits are being driven to a considerable extent by the good economic situation, and also, to some extent, by low interest rates and the low valuation of the euro. The favourable profit situation could therefore vanish into thin air in the event of an economic downturn, although at present there is no reason to anticipate one in the near future. The interest rate and currency situation could, however, have a different effect on some companies. The right stock selection should therefore pay off. To sum up: German equities may not be expensive, but the situation in the USA looks different. As the leading global market, the USA ultimately sets the tone - and here, the buffer has been reduced considerably.

Alongside valuation, the main macro risks are the same as in previous quarters: the anticipated turnaround in global interest rates and the question as to whether or not there is a bubble in China, which is – as usual – particularly difficult to assess.

The interest rate situation is basically clear: nominal global growth is well above the level that would justify present central bank policy. In the same conditions in the past, interest rates on 10-year German government bonds were closer to 3-4% than to 0.5%. The situation is similar for most other government bonds, albeit to a slightly lesser extent than in Germany. A normalisation of yields would presumably have a massive impact on equity valuations, although the effect would vary depending on the sector. At present it is not possible to predict when this will happen (if at all).



Quite possibly, the expectation that the ECB will end its bond purchase programme is a first sign of movement. That may be pure speculation, but it should be kept in mind.

In China, nothing is clear. There is enormous potential, the country is focusing on growth and rising prosperity rather than on managing what has been achieved, but that is being purchased with sky-rocketing lending (and environmental problems, although it may be possible to reduce these without cutting growth too much). Presumably no-one knows how it will all end, but it entails a considerable risk, which we need to keep an eye on. Here is an example to illustrate the dependency: the German automotive industry probably generates at least a quarter of its profits in China, and the proportion is possibly much higher at VW.

As usual, there are also short-term aspects such as the timing of central bank decisions on interest rates, unexpected hikes in inflation (the oil price has tripled since its low two years ago!!), which may not be viewed quite as positively as in recent years and, as always, the political risks (and as usual, we do not consider their implications to be particularly relevant). All that is not new, but against the background of a higher valuation, it may not be quite as easy to take in one's stride as in the recent past.

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## 2018: active management offers further opportunities

Overall, the situation is not a no-brainer: the conditions ought to prove profitable, but active portfolio management could play a bigger role than in recent years. We estimate that even rising interests rates will still be low by historical standards. Combined with the continued widespread scepticism (with regard to the EU, banks, the economy, etc.), our inclination is that on balance there are far more opportunities than risks.

Sincerely yours,

M. Wirth

Martin Wirth



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