



FPM-Comment Reducing the Noise

Martin Wirth – 4/2024 dated October 10th 2024

Economy close to its bottom - large caps indices at record high - the broad market is still miles away from that

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

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- After years of shrugging shoulders: headwinds for bureaucracy expansion have increased
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The third quarter of 2024 saw further price gains on the international stock markets, contrary to the expectation promoted every year ('Sell in May...'). To put it very cautiously, there was a hint of a possible change of favourites among large-cap stocks: the long-term winners of recent years were no longer the outperformers, held back by the high valuations and the general conditions, which are not getting any easier. On the other hand, large caps with reasonable to low valuations recorded decent gains in some cases. Smaller and medium-sized stocks, on the other hand, tended to be avoided overall, regardless of valuation. However, as in the previous quarters, shares that were previously bought for quality reasons suffered substantial losses in some cases if expectations were not met. In this respect, one should be aware that highly valued shares can harbour substantial risks, particularly due to the quality assessment: Love can cool very quickly when disappointments occur, and then share prices and the assessment of management qualities are quickly corrected downwards. Admitting to yourself that you are on thin ice with your

assessments, on the other hand, is a rather rare occurrence; at least that is the impression you get from reading the various commentaries.

Large caps are the winners on the German stock market

As a result, large caps on the German stock market recorded significant gains at index level, while the broad market as a whole was little changed. As a result, the already existing valuation discrepancies have increased. A top-down explanation is of course also quickly found, for example the above-average cyclical nature of smaller companies. There are plenty of examples of stable companies that have nevertheless recorded significant share price losses. In the end, it usually has more to do with valuation than with a general change in fundamentals. Five to ten years ago, German and European small and medium-sized shares reached their relative peak compared to large caps. At the time, one reason often given was that this could have something to do with the greater flexibility of these companies in the face of global opportunities,

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while large companies were permanently held back by bureaucracy and regulation. *Tempi passati*.

In the end, the following applies:

1. Share prices make news: For every development, there is a story to match.

2. There are only two types of companies: Companies that have problems and companies that will have problems.

As far as the second aspect is concerned: in view of the current difficult situation, the group of companies in our universe that are currently experiencing more or less major problems has fortunately expanded significantly from a valuation perspective, meaning that there are plenty of attractive investments should the situation normalise again, especially in Germany. Even if the loudest critics consider this unlikely: There is a lot to be said in favour of this over the next few quarters.

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The current situation is difficult, but the reasons for this are often only temporary

In detail: A large part of the current economic weakness is the flipside of the two crises, the pandemic and the war in Ukraine: stockpiles, which were built up for safety reasons, are being reduced. This has been going on for quarters, but has now been completed in a growing number of companies. This is also having an impact on prices, which have turned from rising sharply to falling significantly, especially in the industrial sector. This also has its positive sides: For BASF, for example, the fall in energy prices in Europe means that most plants are once again competitive at the current level. This does not mean that the situation is favourable, but the doom and gloom propagated a year ago has at least been postponed. After all, BASF has used the situation to improve its structures, something that is not possible in the good times for well-known reasons. Similarly, capital goods or cars were sold with very high margins in times of shortage, then production was expanded, demand was met, and now there is a weakness. In construction, projects financed with low

interest rates have been completed and little is being added. So far, it's all a normal cycle, just faster and more violent than usual, and it's currently bottoming out.

After years of shrugging shoulders: headwinds for bureaucracy expansion have increased

In addition, there are also the familiar structural problems that the governments created in good times with good intentions and sometimes malicious insinuations and which were still accepted at the time, but which are no longer accepted in the face of pressure from all sides: bureaucracy, documentation requirements for all sorts of trivialities, requirements that turn out to be illusory and for whose implementation the governments do not create the preconditions are just a few examples. The red-green part of the German government is leading the way in this respect and thus serves as an example of how things should not be done. Somewhat later than the cyclical aspects mentioned above, improvements could also be made here: There is a growing realisation that well-intentioned and well-done need not be congruent. In any case, the current mood has made it less likely that further burdens will be secretly and quietly built up. And if you want to take the trends in banking regulation as an example: here too, the fact that bureaucracy was no longer tightened was enough to enable a sector that had previously been 'bombed out' in terms of regulation to significantly outperform in connection with a cyclical improvement, namely the rise in interest rates.

Inflation and interest rates on the decline

At least as important is what happens on the inflation side and therefore the interest rate side: Inflation has long since peaked and is clearly on the retreat, especially in Europe. Wage pressure is easing and companies will probably not miss the opportunity to improve their structures, see various chemical companies such as BASF. Volkswagen is known to be the case that has caused the most fuss. The announced plant closures would implement something that could

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have been done a few years ago: Car sales in Europe have been more or less at the current level for years, but with a pre-tax profit of more than € 20 billion, it is not easy to present a reduction in the workforce as necessary for survival. Beyond individual companies, the question also arises as to whether, in view of the demographic trend in recent years, employees have not generally been retained in companies that were not crucial to the company's success. That remains to be seen. In any case, in view of the constantly lamented shortage of skilled labour, the opportunities for redundant employees should be dazzling - mathematically - while at the same time the efficiency of former employers has increased, which has now obviously become more important.

The first interest rate moves have been initiated, but in our view the central banks are once again behind the curve. The interest rate level remains restrictive and the falling yield curve indicates this, as does economic activity, particularly in interest-rate dependent sectors such as the construction industry. What rising interest rates can achieve: You can currently marvel at this. The effect of falling interest rates will then become apparent in two to three years' time, when the new cycle, starting from today's level, will presumably have long since been reflected in share prices - and not just those of large companies.

Germany looks worse than it is in the short term due to sound budgetary policy

And finally: Compared to other countries, Germany has a wild card that has not yet been played, namely its low national debt. If the country were to run an annual budget deficit of 6% like the USA or some European countries, the external and internal view of the German economy would probably be different. In contrast to other countries, Germany has fortunately included a debt freeze in its constitution, even if this is admittedly difficult under the current conditions. Withdrawing the financial freedoms that politicians had allowed themselves in the years following the outbreak of the pandemic is difficult, especially when you don't want to

water down the expansion of the welfare state under any circumstances and at the same time have to deal with a substantial refugee crisis. But the next few decades will not be any easier from a demographic point of view, so we can practise. The good news is that things are unlikely to get any worse.

And just to clarify the dimensions involved: if Germany had new debt like the USA or France, the country could run up an additional €200 billion in debt every year. In other words, a special fund for the Bundeswehr every six months, or a tripling of pension subsidies from the federal budget. Or more than doubling investments from the federal budget, or a six-fold increase in railway investments. Annually, mind you.

Budget policy depresses growth rates and sentiment, but is a future tailwind

There are various reasons for the low valuation of large areas of the German stock market. In our view, one of the most important is the modest sentiment, which has a major reason in the low growth rates, which in turn can be attributed to political mistakes as well as the budgetary discipline that is now required. This sentiment also affects companies whose business depends only to a very limited extent on the German economy. Germany has been deprived of the deficit benefits of recent years and the effects have been exacerbated by various political caprices. In this respect, the scope for a further relative deterioration has clearly diminished. If, on the other hand, growth rates move towards the average, this represents a considerable opportunity from a relative perspective. Many investors have reportedly given up on Germany. The value of sound public finances is not priced in here in any form. This will disappear sooner or later: Either other countries will have to cut back, or Germany will relax the debt brake. Further transfers in the EU on the scale of the alleged reconstruction aid after the pandemic are obviously out of the question today and will always be reminiscent of the feel-good years of the Merkel era in the decades to come.

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And just to make sure: we are certainly not in favour of abolishing the debt freeze. Nor do we believe that the state has superior wisdom when it comes to spending money compared to individual citizens - quite the opposite. It's just that the path chosen by Germany is initially the more difficult one, but will lead to better results in the end. And with a public spending ratio of more than 50 % - according to Helmut Kohl, this is where socialism begins - talking about 'saving to the bone' is quite absurd. It is only a question of assessing the relative current situation, and in our view this should be adjusted for the considerable differences in budgetary policy.

Some readers may now be asking themselves whether we want to be macro-analysts all of a sudden. No, we certainly don't. But in an environment that is a far cry from the usual 'not too hot and not too cold', you have to take the general conditions into account when assessing companies and consider who is affected by the current conditions and how, and what a change in these conditions could mean for the individual company. This applies to the actual business as well as the valuation of this business. First and foremost, it is necessary to understand the company and its markets as well as possible. Then you can also recognise what significance the extreme framework conditions can have on profitability, but above all on the valuation of companies.

Despite the difficult general conditions, companies are doing surprisingly well

The last five years have been characterised by chaotic conditions judging by the standards of the last 30 years. The pandemic, the invasion of Ukraine, shortages of raw materials, wildly fluctuating inflation figures, interest rates rising beyond most expectations, record-high government deficits to partially compensate for the problems, which are now being brought back to normal levels depending on the country, and, on a very

large political stage, the disintegration of the world into two large political blocs: It is amazing, at least from our point of view, how resilient many companies have proved to be. So if companies can generate solid profits under these conditions (and not just, for example, as a beneficiary of temporary shortages), then there seems to be more stable substance than is often perceived.

Good starting position: companies with low valuations despite increased quality

There was once a time when major German companies were already making losses with stagnating rather than slightly growing sales. We are a long way from that now. Obviously, flexibility, price discipline, industry and market structures, risk management and perhaps also management quality and consistency in implementing necessary measures have improved over the years. In any case, none of this fits in with the current record-low valuations based on the underlying substance of many companies. In this respect, this is a good starting point for the period ahead, in which the current headwinds are beginning to turn. And where, despite record highs in the index, the shares of many solid companies are still miles away from their peak levels.

In a nutshell: The economy is down, interest rates are falling, resistance to further bureaucracy, changes in the German government's priorities, Germany's comparative competitive advantage thanks to solid public finances combined with a broadly low valuation of German equities are usually the prerequisites for a more than solid share price performance in the coming years.

Sincerely yours,

Martin Wirth

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