FPM-Comment Reducing the Noise

Martin Wirth – 2/2019 dated April 11th 2019

Economic weakness and rising share prices go hand in hand – as so often

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- Experience in German equities since 1990
- Funds: mutual funds FPM Funds Stockpicker Germany All Cap

- Clear rise in share prices despite economic weakness
- Prices once again driven by factors such as quality, visibility and stability – and the valuation of bombed out shares
- Market trend will depend on the reasons for the economic weakness
- Limited downside risk for many shares, considerable opportunities if the economy stabilises

Recession has been avoided for the time being

Prices on the international equity markets rose strongly in the first quarter of 2019. In Germany, some of last year's losses were offset at index level – although the extent of this varied considerably. The economy was weak, as the downturn on the equity markets indicated. However, the downward momentum has decreased rather than increased, so a recession has been avoided for the time being. Since this had been priced into the markets, there was a correction following the panic sell-off seen in the last quarter of 2018. We can therefore say that while the situation is bad, it is not as bad as some people had feared.

Strength of the recovery differed by market segment

Particularly strong rises were registered by shares in companies which investors had presumably sold principally on liquidity grounds in the fourth quarter of 2018, and that featured the attributes that were exceptionally sought-after in recent years: high earnings visibility, high quality and/or above-average growth rates. Some set new records in terms of valuation parameters as well as prices. Old favourites do not fall from grace that easily!

By contrast, most shares were able to stem their losses, but they remain way below the record highs seen in recent years. Valuations are still comparatively low, which is hardly surprising given the present uncertainty. Presumably, many companies will report significant earnings

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declines in the upcoming reporting period – and in many cases these will not be confined to the first quarter. Whether the second half of the year will bring a significant improvement, as many companies expect, is naturally questionable and in the light of recent experience, many investors tend to doubt it.

The final group comprises shares in those companies that have had to issue profit warnings in recent weeks – often not entirely unexpectedly – or whose general situation is unclear. Here, there have not been any gains to celebrate. On the contrary, their share prices have dropped considerably even though valuations were already low. Even shares in companies with a basically stable business model have not been immune to significant underperformance: mildly bad news was sufficient.

Price drivers unchanged

Consequently, the factors driving prices hardly changed in the first quarter. As was the case for a large part of last year, the dominant factors were quality, visibility and stability. Once again, that can best be seen from German government bonds. Here, investors are now once again prepared to pay to invest money in bunds for a decade.

As ever: the economy sets the trend

Looking forward, the question is evidently: will things go on like this? In our view, that depends principally on how the economy develops or, to be more precise, on the economic momentum.
As we have seen, even a slight reduction in downward momentum has alleviated the situation considerably, as is evident from the reduced pressure on valuation parameters. Important (in our view): this also applied to companies where the expectations for the first six months were anything but good. Consequently, valuation is relevant, in fact it is the most important factor in the long term. Clearly, the question is not whether valuation plays a part but rather, from what level it starts to overshadow other aspects such as quality, profit trends and stability.

The key question is: what is driving the economy?

So what can be expected from the economic side? We estimate that last year the economy was very heavily impacted by the mounting uncertainty - driven first and foremost by political factors, not, as is common in a sustained recession, by widespread misallocation of capital, combined with the belated general realisation that something has gone wrong. As we are aware, that was the situation with regard to real estate and state financing in the global financial crisis and in the technology bubble 20 years ago. Given the ongoing uncertainty caused by the financial crisis, broadly based misallocation of capital on a similar scale seems very unlikely to us at present. That said, exceptions prove the rule. And the big exception is China. It is clear that here overcapacities have been built up in industries the state considers to be strategic. However, the scale is unlikely to cause serious problems for western economies in the long term. Nevertheless, the situation is different in certain industries.

For those companies that either have above-average dependence on the Chinese market or compete with Chinese products, the situation has deteriorated. The key question now is whether, for example, the dip in demand is only temporary, driven by the uncertainty resulting from the trade dispute with the USA, or whether it is a longer lasting problem. In our view, the second of these scenarios is already priced into shares. While this is not dramatic, it takes the form of a discount to

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the fair value, which reflects sustained earnings power.

Political uncertainty is more important than undesirable economic developments

Aside from China, the development of companies is sluggish, but not dramatically negative. After all, the world is not in a recession. In our view, the economic slowdown is caused by the political disputes, which have led to a phase of uncertainty. No-one is prepared to stick their neck out too far unless they have to. Brexit and the customs dispute picked by the USA do not simply affect sentiment, they have concrete implications, for example for investment decisions. As long as the situation is unclear, decisions will simply be put off. That is completely rational and something that we should expect of companies.

Consequently, the development of the equity market is likely to depend on the direction of the next impulse. It therefore seems evident that finding a consensus is in the interests of everyone involved. If that happens, the uncertainty should decline, and that should have a corresponding impact on risk premiums and equity market valuations. At the same time, a slight easing of the bond market situation can also be assumed. That would have a varied impact on shares, depending on the market segment.

However, what actually happens is not always rational. Following the surprises of recent years, no-one should be too certain (and probably no-one is). On the other hand, a sustained deterioration in the political situation would be necessary to trigger further serious problems on the equity markets. Besides, given the experience of recent years, such problems would no longer be a bolt from the blue. Moreover, they are unlikely to be in the interests of the various parties involved in the disputes. While they cannot be ruled out entirely, they are therefore not the most probable outcome.

Valuation of German equities hardly euphoric

In all, the German equity market has moved broadly sideways for the past four years. The valuation of many shares has dropped considerably in anticipation of a recession. Sentiment has now moved from euphoric to at least sceptical and in some cases disinterested. Moreover, in some places perception of the German economy has shifted from outperformer to the sick man of Europe in record time. Since the sell-off at the end of 2018, the low valuation of value shares presumably means that the risks are limited. Unlike the opportunities, expectations should pick up slightly.

Sincerely yours,

M. Wirth

Martin Wirth

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