FPM-Comment Reducing the Noise

Martin Wirth – 2/2020 dated April 8th 2020

What do we think is the most plausible scenario in the current coronavirus maze?

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

- No relevant misallocations of capital can be seen in Europe and the USA
- The adjusted profit expectations are realistic from our point of view, in part cautious
- Companies with fundamentally stable business models, combined with a not insignificant level of indebtedness, are interesting

Coronavirus and the Lock-Down

After a solid start into the year with further price gains, the collapse on the international stock markets in March felt as if the world fell apart. With the outbreak of the coronavirus pandemic in Europe and North America, the financial markets were confronted with an unprecedented situation and reacted accordingly due to massive uncertainty and gloomy prospects, at least for the immediate future.

The outlook is bleak because of the lock-downs, as long as they last and obviously for some time thereafter. In this respect, no one needs to wonder about short-time work, unemployment, record losses at companies and the like. In extreme cases, it would only be a matter of survival. As long as everyone has a roof over their heads and enough to eat, they could get through this situation without paying rent or interest and without earning a salary. The state takes care of the basic needs, and that's it. We are miles away from this extreme scenario, despite the difficult situation. With the excitement over the reimbursement of prepaid holidays or the demand for a property levy from the "rich", the first usual reflexes reappear after one or two weeks in a state of shock.

What is our expectation?

First of all, the need for the measures taken by governments is imperative. They will obviously last for several weeks. If you look at it positively, this is (for the non-working part of the population) a very long weekend, during which most people will continue to receive their salaries.

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Until then, the state holiday fund is looted, which then has to be replenished accordingly over a long period, perhaps - also in extreme cases - pre-financed by the ECB. According to all we know, this long weekend will gradually come to an end from the end of April to mid-May, following the example of the Asian states (whose experiences might have been used as a guide as early as February, but afterwards one is always smarter).

The crucial question is at what level the companies and the economy will settle down again after the forced break. The current recession is being compared with its predecessors, and logically it is found that none came so quickly and none came so severely. However, this is not surprising and certainly not an indication for the time after: When the state bans a large part of economic activity, such an outcome is inevitable. By contrast, it is unclear how things will continue on the other side of the recession.

Below is our view of the "coronavirus recession" compared to a "normal" recession.

What is worse this time compared to a "normal" recession?

- The slump is faster and deeper.
- The situation has nothing that can be brought under control quickly and by government measures (except for the health sector). State action outside the health care system serves only to maintain economic structures that had proven themselves in the market without the pandemic.
- The running costs for these measures are massively higher. Economic activity is very limited, and the state must (partially) compensate for this in exchange for a higher-valued good, namely health. Germany generates a GDP of about €10 billion per day (arithmetically, including weekends), a large part of which is currently not taking place. The state has exploding expenditures and collapsing revenues, which means that in many economies it has to bear a large part of the loss of value creation itself.
- The fact that pandemic containment rules prevail over everything else could lead to changes in citizens' behaviour as well, even if government regulations no longer require it, such as for air travel or major events. Nobody knows how great this effect will be. It is possible that the behaviour patterns will adjust back to the time before the crisis fairly quickly, after all this is something that people have been comfortable with for decades. But perhaps the shock is so deep that this is not the case. In view of the current situation, a majority will probably tend towards the second option at the moment. But if the neighbours have again made the first long-distance journey, this could change quickly.
- And in this context it is only worth a side note: unlike in a normal recession, weak structures here will possibly be preserved thanks to government measures, which could now no longer be based on competition rules due to the sheer size of the need for action.

On the other hand, what is better?

- Unlike during a normal recession, (almost) everyone agrees on the causes of the problems, how to deal with them and how to solve them: There is no never-ending apportioning of blame, it is not a question of who has to give up something, who should morally bear the damage or what the right measures are to overcome the crisis. This is very different from the financial and public debt crisis, where the battles are still going on. In this respect, the solution is clear, which will save an

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extremely large amount of time and resources. It is the length of the measures, not their content, that is being disputed.

A normal recession has two problematic causes that cannot be solved quickly:

First of all, part of the upturn is regularly based on a misallocation of capital. Examples from the last recession are the properties that were built bypassing the market and sold to people who could not pay for them. Secondly, the public deficits, which enabled consumption that debtors could not afford. With the bursting of the bubble, the creditors then realize that the debtors cannot even service their loans.

So you have several problems:

(a) Write-offs of receivables and loans from creditors, which results in lower solvency/wealth than recently perceived, thus having a negative wealth effect that affects consumption;

(b) the inability of debtors to continue their debt-financed operations; and

(c) the loss of jobs that are no longer needed once the artificial demand has disappeared, e.g. construction Spain as one example among many.

This all settles down again, but takes time to digest the write-offs, adjust the economy to current income and create new jobs for the former "construction workers".

Despite the severity of the "coronavirus recession", we believe that this is quite different.

At least in Europe and the USA there is no relevant misallocation of capital (perhaps most likely in China, which has been a recurring issue for years).

- On the other hand, new borrowing to finance growth has been low in recent years, albeit not at a level that would reduce overall debt levels.

The exception here is the USA. Nevertheless, this means that, especially in Europe, at least the effects b and c are likely to be lower. How severe the credit defaults will be will become clear, but they are more easily manageable without major bad investments. At any rate, subprime loans have not been a problem so far.

Thanks to the trade disputes of recent years, the economy has weakened, but this has nothing to do with the current crisis. In this respect, we believe that the economies were largely in a stable state of equilibrium. The question therefore arises as to what should prevent the economies from continuing their development after this crisis. There is no need to "invent" new jobs on a large scale.

As far as the feared mass of insolvencies is concerned: If this affects previously well-functioning companies, the solution is obvious from our point of view: The state will provide bridge financing, that is its responsibility; after all, the problems of the companies are caused by the decisions of the state. If - as an example – a restaurant can no longer pay its rent, but has previously "worked well", it will not help to send the company into insolvency, if there is nothing to get anyway, the inventory is hardly usable and a new tenant is unlikely to be available at the moment. So everyone gives in a little, and then things can continue after the crisis.

This will not work if the business existence was already on the brink before the crisis. In this respect, this could lead to a market consolidation, as a counterbalance to the generous distribution of money by politicians.

One can also see things quite differently, or even forego having any idea how things will develop, after all, we are not virologists either. However, this will be extremely relevant for the development

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of the markets in the coming quarters. In this respect, despite all the peculiarities, it would be more than unwise to refrain from having an opinion on the facts.

The most plausible scenario in our view:

- A gradual easing of measures. Vulnerable groups will be kept safe. This can be seen as unfair, but anything else would simply be too expensive.
- For the time being, consumer behaviour will move towards areas that can be exercised individually, i.e. house, garden and car (if one can afford it) instead of holidays and concerts. Even if there might be problems there, too: Relatively speaking these areas will be the winners.
- On the other hand, topics such as events, travel or holidays will only return in a broader sense when there is a therapy or prophylaxis. After all: this will come.
- We have strong doubts as to whether it will take years for economies to normalise, as shown above.
- Public debt will rise massively for obvious reasons, but in most countries this will hardly affect current budgets due to low interest rates.
- At the moment, risk premiums are still high, if one calculates on the basis of normalized profits. However, the official earnings estimates, i.e. what is recorded in the databases, are probably still far too high compared with the current situation, which is due to the sluggish nature of the adjustments. In our view, the expectations that have currently been adjusted are realistic, in part cautious.

Valuation, based on the book values of companies, has reached lows of previous crises in Germany in recent weeks. This does not take into account the fact that the quality of the German stock market, measured by the distribution of market capitalisation across the various sectors, has improved significantly. Today, healthcare and technology companies dominate the market, not in terms of the number of names, but in terms of their size. In this respect, despite the recovery of the last days, valuation remains at an extremely low level when comparing apples with apples.

Regardless of what fluctuations will occur in the coming weeks, one thing is very likely: That there will be solutions to deal with the underlying cause of the problems in the foreseeable future, i.e. in 12 to 24 months. Until then, there will be an uncertain path, which is likely to be volatile, but which will lead to the desired outcome. It will be the tasks of companies to survive this period without depleting their substance, and in the best case even to make profits. Companies that are uncertain candidates - and there are some - should have a valuation that reflects this uncertainty. It can be stated that, due to the quality obsession of recent years, a considerable number of companies are considered highly likely to fail. This means that candidates for a massively positive performance can be found if there are signs of stabilization.

At the moment, however, we consider the most interesting group to be those companies that have a fundamentally stable business model, however combined with a not insignificant level of debt. Here we find astonishingly low valuations, which are inevitably affected by the current uncertainties. Due to the causes of the crises as well as government policies, we believe it is almost impossible that these companies will experience problems as a result.

The next group are the companies that have a rather cyclical business but a solid balance sheet,

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combined with usually above-average margins. Here, one can invest in strong companies at or below book value; brands, know-how or sales structures are granted for free. Actually a dream for every long-term investor. The riskier opportunities, on the other hand, are a little behind at the moment, the alternatives are simply too interesting in themselves at the moment.

In sum: Exceptional framework conditions, extreme uncertainties, extraordinary opportunities.

Stay healthy!

Sincerely yours,

M. Wirth

Martin Wirth

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